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Health Care

For PBMs, the Legal Moat Gets Narrower

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Pharmacy benefit managers have seen their once powerful immune systems weakened over the past year.

This month, they suffered an especially painful blow when a jury ruled that **Medco** (MHS:NYSE) -- the largest PBM -- has a fiduciary duty to a client for which it bought drugs. Medco must now pay \$7.8 million to a relatively small health plan in Ohio for allegedly breaching that duty and committing "constructive fraud" in the process. The company plans to appeal but still faces the possibility of punitive damages as well.

Moreover, it could find itself battling far bigger clients going forward.

Derek Brandt, a legal expert who assists PBM clients, says his phone started ringing as soon as the Ohio jury returned with its landmark decision against Medco. He counts a *Fortune 500* company, which he portrays as a "flagship" client, among those callers.

"I had clients on the phone who realized immediately, 'Hey, this is a big deal,'" says Brandt, a lawyer at SimmonsCooper in Chicago. "They're wondering, 'What do (the PBMs) owe us?'"

A.G. Edwards analyst Andrew Speller recently fretted over just this sort of risk.

"If this verdict is not overturned on appeal, it leaves the door wide open for additional civil legal action," wrote Speller, who has a hold recommendation on Medco's stock. "That prospect could have a negative effect not only on Medco's valuation but on valuation for the entire sector."

PBMs have always insisted that they should not be classified as fiduciaries. By definition, fiduciaries hold the power to make financial decisions for the clients that they serve. As such, they must abide by stringent rules that require them to place their clients' -- rather than their own -- interests first.

Some claim that PBMs, which negotiate drug discounts for big employers and health insurance plans, qualify as fiduciaries and should be held to strict standards as a result.

By now, PBMs have long been accused of relying on secret deals to boost their profits and save their clients less money than they should. The PBMs themselves have denied any wrongdoing.

Still, the industry has weathered some clear setbacks -- beyond the Medco ruling -- over the past year. Notably, a federal appeals court recently upheld a hotly contested law allowing Maine to regulate PBMs and force them to operate as fiduciaries in that state. The ruling could set a

precedent for other states seeking the same power.

Meanwhile, some big companies have grown so tired of waiting for industry reforms that they have stopped doing business with the "Big Three" -- Medco, **Caremark** (CMX:NYSE) and **Express Scripts** (ESRX:Nasdaq) . They have insisted on hiring more transparent PBMs instead.

Nevertheless, PBM stocks have enjoyed a banner 2005. Both Medco and Caremark have risen at least 30%, and Express Scripts has more than doubled over the past 12 months.

'Positive Spin'

For its part, Medco has downplayed the Ohio jury ruling.

Indeed, the company still maintains that it is not a fiduciary at all. And it points to past court decisions -- including one that the industry actually lost -- as evidence.

When upholding Maine's PBM law, Medco says, the federal court specifically stated that PBMs are not considered fiduciaries under the Employment Retirement Income Security Act. In contrast, it says, the Ohio court ruling has no impact on ERISA matters but instead represents nothing more than "one jury's decision in a unique contractual dispute."

Yet Brandt clearly feels otherwise.

"Medco keeps getting slammed on a number of different fronts, and they keep trying to put a positive spin on everything," he says. "But I'm not sure it all plays out the way they want in the end."

Rather, he suspects, PBMs will be forced to uphold fiduciary duties to their clients -- and lose one of their biggest battles overall.

"If you have a fiduciary duty, you need to disclose any potential conflicts that exist," he explains. "You can't profit on clients' backs, especially without telling them. ... That's exactly the reason why PBMs are fighting this so hard. Their very business model is at stake."

Target Practice

That model, while still embraced by Wall Street, has come under heavy fire by industry critics.

Federal prosecutor James Sheehan has taken perhaps the most powerful shot at the group. Sheehan has spent years investigating industry giant Medco, and even after a partial settlement that forced the PBM to change some of its business practices, continues to seek big monetary damages from the company. The case is set to go to trial next year.

Meanwhile, Maine has played a leading role in pushing for industry reforms at the state level. In a hard-fought legal battle, Maine recently managed to shoot down arguments by the Pharmaceutical Care Management Association -- a powerful PBM trade group -- and win a big courtroom victory that could help other states seeking to pass PBM regulation laws as well.

In the past, PCMA has successfully blocked similar measures by insisting that they violate PBM rights and actually push drug prices higher. But the group failed to win over any of the judges this

time around.

"In the conclusion of the [Maine] opinion," the National Conference of State Legislatures recently noted, "the court stated that if the PBMs truly assumed they would be free from disclosure requirements of the sort set forth in the Maine law, this would be more wishful thinking than reasonable expectation."

Washington, D.C., is hoping for a similar decision next year.

Fighting Force

In the meantime, dozens of giant employers -- frustrated by spiraling drug costs -- have taken matters into their own hands.

Last year, some 52 companies joined forces to create their own drug-buying coalition. The coalition, organized by the HR Policy Association, sought bids from PBMs willing to offer full transparency about the prices they pay for prescription drugs. Several large PBMs -- but none of the official Big Three -- responded to that call this year.

"These huge employers finally said, 'Enough is enough; here are the terms under which we will operate,'" Brandt says. "And Medco, Caremark and Express Scripts all dropped out" of the bidding process.

The PBMs turned their backs on the opportunity to serve 5 million employees, who spend nearly \$4 billion annually on prescription drugs, in the process. Moreover, they could keep losing business if the push for PBM transparency continues to build.

Certainly, coalition members like **IBM** (IBM:NYSE) hope it's a growing trend.

"Through the coalition, we are working toward lowering health care costs while improving the quality of care that patients receive," says J. Randall MacDonald, senior vice president of human resources for IBM and chairman of the HR Policy's health care policy roundtable. "If our efforts move the market toward our principles of transparency, we have helped employees and employers, as well as all health care consumers."

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