3D ADVISORS

This 3DAdvisors Report Covers:
✓ **Insider Trading**: Insider Trading Behavior
✓ **Accounting**: Quality of Earnings Issues
✓ **Governance:** Corporate Governance Issues

As Legal Issues Mount, Chief Counsel Dumps Shares Caremark Rx Inc. (NYSE:CMX)

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Caremark Rx Inc. is a pharmaceutical services company that conducts its operations primarily through its wholly owned, indirect subsidiary, Caremark Inc. Caremark Rx's pharmaceutical services are generally referred to as pharmacy benefit management services and involve the design and administration of programs aimed at reducing the costs and improving the safety, effectiveness and convenience of prescription drug use. The Company's customers are primarily sponsors of health benefit plans and individuals located throughout the United States. The Company dispenses pharmaceuticals to eligible participants in benefit plans maintained by its customers and utilizes its information systems to perform safety checks, drug interaction screening and generic substitution. During 2003, Caremark Rx managed over 114 million prescriptions for individuals from over 1,200 organizations. In March 2004, the Company merged with AdvancePCS, a health improvement company.

Summary of 3DAdvisors Findings for CMX

- **Governance:** Board and management connections with HealthSouth and IHS
- **Accounting:** Despite mounting legal challenges, company makes no allowances
- **Insider Trading:** Actions of Chief Counsel speak louder than words of company
- **Governance:** Issues abound and start with CEO Crawford's compensation
- **Accounting:** Miscellaneous noteworthy items

Discussion of 3DAdvisors Findings

On the surface, Caremark Rx's strong stock performance (800% appreciation in past five years) and small current short position (2.8% of outstanding shares) would indicate to some that this issue has not been a particularly good short candidate. We'd bet that this has not always been the case, however. Surely, this company, with a board and management that has ties with the HealthSouth and IHS meltdowns, plentiful governance issues and a swelling list of legal challenges has caught the attention of the short community from time to time. But anyone who has acted would have had to display uncanny nimbleness to avoid getting run over by the relentless advance of Caremark shares. The stock continues to move up, in spite of the fact that an alreadyhigh number of legal issues keep piling up at the same time, a situation the Company insists it has managed and does not represent a material risk.

Through the five years of upside insiders have remained patient, holding onto their shares and accumulating options, providing no clues of an impending inflection point for the price of Caremark common. Until recently, that is. In 2004, insider sales were brisk and many key officers have managed to shed, for the first time since CMX shares have been publicly traded, significant pieces of their holdings. Their selling picked up steam noticeably at the end of last year as the group took large profits, seemingly unwilling to wait until this year to defer gains for tax purposes. Not lost on us is the fact that, in the face of a relentless barrage of lawsuits, Caremark's chief counsel has emerged as the most aggressive seller of this group, a group whose convergence of action is unprecedented.

Making the analysis of Caremark more interesting is the Company's proclivity towards providing great detail in some areas of its financials while leaving other crucial disclosures practically non-existent. This kind of obfuscation under the cover of partial disclosure does not go unnoticed by us and only serves to cause us to drill deeper.

Governance: Board and management connections with HealthSouth and IHS

To understand some of the legacy issues involving Caremark's board and to put certain executive behaviors in historical context, one needs to go back to the Integrated Health Services (IHS) days. Before IHS crashed and burned, we had become aware, and will not forget, how its insiders managed to clear out of major pieces of their holdings well before things hit the fan. IHS served as a prime example for what not to ignore with regards to insider distribution as aggressive selling by both executives and directors went overlooked by most while the Company was in its final periods prior to collapse.

Caremark Chairman and CEO, **Edwin Crawford** was one of the IHS directors, as was former Caremark director **Charles Newhall**. **Richard Scrushy** (of HealthSouth fame) was also a director of both the old IHS and founder of Caremark's predecessor, Medpartners.

Then there was HealthSouth which, we all know, was headed by Scrushy. On the HealthSouth board were none other than current Caremark Chairman and CEO Edwin Crawford and former Caremark directors Charles Newhall and **Larry Striplin**. No need to go on about what happened to HealthSouth under the tenure of this board. **Larry House**, former Caremark CEO (1993 to 1998) had worked as an executive reporting directly to Scrushy at HealthSouth. **Michael Martin**, former HealthSouth CFO, who has admitted guilt on conspiracy charges, was also an earlier director at Caremark.

So in spite of the fact that Caremark would insist that all the old ties have been broken, it would have a hard time convincing us that Crawford does not have threads that tie him to two of the more spectacular failures in the industry in recent years.

Accounting: Despite mounting legal challenges, company makes no allowances

With one of the longest, and growing, lists of legal contingencies we've seen, Caremark would like us to believe that risks of problems are simply covered by insurance and, accordingly, has said nothing about any allowances for potential losses relating to any of the matters. It is obvious that legal fees are significant; significant enough to elicit questions in the Q3 conference call. When asked about the rising level of legal expenses, CFO **Howard McLure** would only say that they are up and that he did not have the costs "at the tip of my fingers" at the time of the question. When asked what Caremark has budgeted for legal expenses for 2005, all McLure would say is "I've not even looked at that detailed line". Considering the sheer number and magnitude of the issues, it is quite clear that McLure was avoiding revealing those amounts.

Suffice it to say that it seems a key to job security at Caremark is to work in the legal department. Caremark's Q3 Form 10-Q itemizes seventeen of the most significant cases filed against it. Some of them seem quite ominous, yet Caremark appears to have an "ignore that man behind the curtain" attitude when it comes to disclosure of any potential risks. A partial list of the more interesting legal entanglements includes:

- Caremark is under investigation by 23 state prosecutors who are questioning the Company's business practices in a widening probe. Other companies, such as Medco (MHS) and Express Scripts (ESRX) are also under investigation. The investigations focus on pricing practices employed by Caremark and others. State prosecutors suspect Caremark failed to properly share drug rebates with state customers.

- In a separate federal probe, the Office of Inspector General inside the Office of Personnel Management became interested in a case involving two Caremark whistleblowers who have claimed that Caremark has defrauded federal customers by failing to properly fill their prescriptions and selling them potentially damaged goods. Caremark has been accused of improperly switching and canceling patient prescriptions in order to maximize profits. It also faces the charge of selling drugs that were returned through the mail but never tested for damage. The two employees also allege that the company stamps false dates on drug orders in order to meet performance targets in a contract to manage pharmacy benefits for the State of Florida.

- Multiple class action suits have been filed alleging that Caremark acts as a fiduciary under ERISA and seeks unspecified monetary damages. Most of these suits also name other Prescription Benefit Management (PBM) companies as well. These suits are in various stages of development. It is interesting to note the wide range of disclosures, from the PBM's involved, related to the potential damages under these various actions. Although Caremark chooses minimum disclosure about potential risks, some of its competitors present a much more accurate picture. For instance, Caremark competitor Medco goes much further in discussing potential ERISA-related risks, even mentioning that "to the extent that we are required to indemnify Merck for liabilities arising out of a lawsuit, an adverse outcome with respect to Merck could result in us making indemnification payments in amounts that could be material, in addition to any damages that we are required to pay." Medco goes on to say that such adverse consequences could have "a material adverse effect on our business, financial condition, liquidity and operating results." Nothing of the sort out of Caremark, who chooses only to say that, given a similar scenario, "certain of our operations could be materially adversely affected…" No mention of the possibility for potential Merck-style claims.

- October and November 2003 – Two separate class action suits were filed against Caremark and several insurance companies that had provided coverage to Caremark at the time of the settlement of a 1999 class action lawsuit against Caremark. The lawsuits seek to recover $3.2 billion in compensatory damages plus unspecified punitive damages, pre-judgment interest, costs and attorneys' fees.

- August and October 2003 – Both Caremark and AdvancePCS (acquired by Caremark in early 2004) were served with a class action complaint alleging violations of the Sherman Act. The plaintiffs are seeking treble damages and injunctive relief enjoining the alleged antitrust violations. In a separate class action suit, AdvancePCS was sued by the Pharmacy Freedom Fund and the National Community Pharmacists Association who alleged certain antitrust violations, under Section 1 of the Sherman Act, arising from AdvancePCS's establishment of network rates for retail pharmacies. Treble damages are sought.

- Various suits filed challenging the business practices of PBM's. Caremark and other PBM's have been named in at least three separate actions and specifically address the practices of pricing, rebates, formulary management, data utilization and accounting and administrative processes, and mail order services.

In the face of these legal challenges, the Company has steadfastly avoided suggesting that it is able to quantify any specific losses related to any of these matters, most likely, in efforts to avoid recording related allowances by virtue of the fact that they cannot be estimated. The Company implies that its insurance coverage is adequate to cover for contingencies. We suspect that Caremark is grossly under provided and may even be going bare bones as to recognizing these potential liabilities.

<u>Insider Trading: Actions of Chief Counsel speak louder than words of company</u>

It has always been significant to us when the top legal dog, at a company embroiled in significant legal issues, moves to sell a large piece of his holdings. It is a rare occurrence. We'll not forget the prescience displayed by former Philip Morris General counsel, **Murray Bring**, who, realizing that the company and the industry were about to suffer major legal setbacks, sold his largest-ever amount of MO shares, dumping 140,000 shares in August of 1999 for about $37 each. By the following January, landmark decisions had gone against the tobacco companies and MO shares were trading below $20.

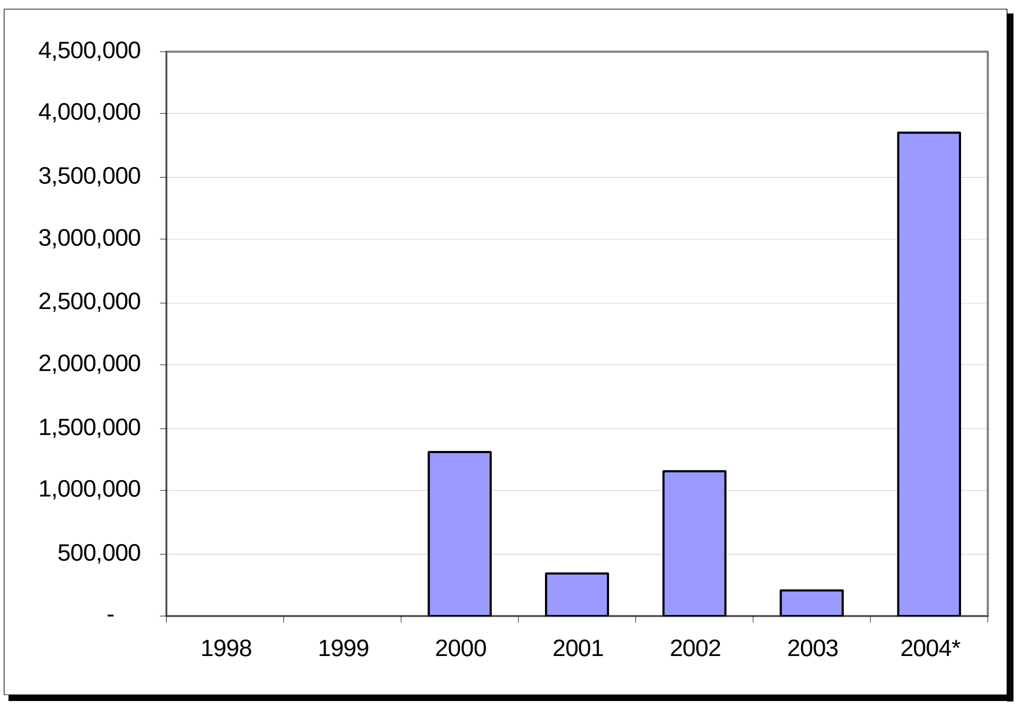
With the Company juggling multiple legal actions, and while insisting that it has successfully managed the attendant financial risks, Caremark's Chief Counsel has decided to unload the majority of his actionable position:

- **Edward Hardin (64)** – Executive V.P., General Counsel, Director. Selling by Hardin isn't anything new; in fact, he's probably been the most consistent distributor of

Caremark shares over the past five years. But Hardin's selling has now reached levels we haven't seen in the past. After holding a combination of common stock and vested options totaling 471,000 shares just twenty-two months ago, Hardin has since sold off the vast majority of his ownership position, leaving himself with very few vested options and a relatively insignificant amount of unvested options set to vest in 2005 (see Appendix). His behavior became more resolute on January 5th, when he cleared out five of the eight series of vested options he held and sold the underlying 160,000 shares at $40. The majority of the options he exercised were not expiring until between 2008 and 2011. The aggressive transaction wiped out 80% of his holdings, but what's even more telling, Hardin has now **sold 88% of his actionable position since the AdvancePCS merger**. Hardin's reluctance to hold shares leaves us to question if the Company's legal issues are more serious than the Company wants us to believe.

But Hardin is not alone. From November 4th through January 7th eleven insiders (which include Hardin's sales) sold 1,161,465 shares between the prices of $33.60 and $41.

Figure 1. Selling Volume by Key Caremark Rx Insiders (1998 through January 2005). Source: CMX SEC Filings.



* 2004 figure includes 250,000 shares sold in the first week of January, 2005

- **Edwin Crawford (55)** – Chairman, President, CEO. Shortly after closing the AdvancePCS deal, Crawford began dumping his Caremark shares. After selling a total of just 507,000 shares between 1998 and 2003, he sold 1.7 million shares between May 14th and June 4th at $33. Then, just after completing his last sale, he implemented a 10b5-1 trading plan, alerting us that the selling wasn't over yet. However, Crawford sat on his shares for six months while the issue dipped into the upper $20's by August, but as soon as the issue began to rebound, he resumed his activity. We question the validity of his pre-arranged trading plan, which is intended to allow for steady diversification without regard for material information an insider might possess or the issue's performance. On November 4th and December 6th, Crawford exercised options he was granted in March 1998 when he was given his current position which were generously re-priced from $10 down to $3.25 (see below). He then sold the underlying 592,600 shares at an average price of $35, marking his second largest transaction on record. Since the merger was completed, **Crawford has sold 25% of his holdings**, by far his most aggressive diversification to date.

Table 1. Holdings Reductions for Caremark Named Executives. Source: CMX SEC Fillings.

Insider	03/22/02	03/31/03	03/29/04	01/10/05	Chg. Since '03	Chg. Since '04
E. Crawford	8,326,000	8,751,000	9,576,000	7,306,000	-16.5%	-23.7%
E. Hardin	488,717	471,423	303,940	37,589	-92.0%	-87.6%
B. Karro	-	195,175	215,635	135,635	-30.5%	-37.1%
H. McLure	272,000	284,900	332,950	223,450	-21.6%	-32.9%
C.A. Piccolo	735,891	612,571	640,483	227,391	-62.9%	-64.5%
E. Banks	68,620	90,842	119,640	63,145	-30.5%	-47.2%

- **Howard McLure (47)** – Executive V.P., CFO. Though McLure's 35,000-share sale on December 3rd isn't as intimidating on the surface as some of the sales of his peers, it lends further credence to the fact that Caremark insiders have begun to more aggressively diversify their holdings since the AdvancePCS merger. Prior to the merger, McLure had only sold his shares once. Since the merger, he has exercised multiple options series and has now sold on four different dates, **reducing his holdings cumulatively by 33%**. Though he currently holds more vested options than most other executives, McLure doesn't hold any common shares (see Appendix).

- **David Joyner (age not disclosed)** – Executive V.P., Sales and Account Management. Joyner is the only former AdvancePCS executive to join the recent round of selling by incumbent Caremark execs. But while we don't have either an AdvancePCS (for lack of selling) or Caremark trading history to base Joyner's recent sale on, it's a safe assumption Joyner isn't trying too hard to impress his new bosses, as he **sold 61% of his position** on January 5th with an 80,000-share sale at $39.95. The shares were acquired when he cleared out one option set to expire in July 2010, leaving himself with no common stock and just 60,602 vested options (see Appendix).

In addition to the selling executives, there were a few board members that executed their own notable sales. Vice Chairman **C.A. Piccolo (62)**, a long-time dependent board member, has sold 400,000 shares since the merger, including the 100,000 shares he sold on December 1st at $36.50. His selling during the second half of

2004 has **trimmed his holdings by 64%**, and his once prominent ownership position of 735,000 shares in 2002 is now just above 200,000 shares. Also selling was Director **Edwin Banks (41)**, a board member since 2000, who **pared back his holdings by 47%** when he dumped 50,000 shares on November 11th at $34. Prior to this sale, Banks had only sold a total of 15,495 shares over the past five years.

<u>Governance: Issues abound and start with CEO Crawford's compensation</u>

Perhaps we shouldn't be surprised, given Crawford's pedigree, to see the nature of certain of his dealings with the Company and the attendant cooperation he receives from the Caremark board:

- **The Crawford SERP.** Caremark has created a SERP for Crawford's benefit. Though the Company doesn't come right out and say it, it is implied that the SERP was created solely for him:

  > "Effective November 12, 2002, the Company adopted the Caremark Rx, Inc. Supplemental Executive Retirement Plan ("SERP"). **Mr. Crawford is currently the sole participant in the SERP**, which was adopted to recognize Mr. Crawford's success in leading the Company through a challenging turnaround situation, to create an incentive for him to remain employed with the Company and to provide him with a competitive retirement benefit."

  We have never seen a SERP created for just one person, except for self-employed individuals. Though it would seem that the Company is leaving its options open by saying that Crawford is "currently the sole participant" the fact that no one else has been included continues to make this look to be an exclusive club of one.

- **Crawford's son working for the Company.** Andrew Crawford is employed by Caremark as Senior V.P., Office of the President. He was provided $75,382 in relocation expenses upon coming aboard and was paid just shy of $300,000 in 2003.

- **Company no longer discloses it, but Crawford received preferential treatment when it re-priced options for him.** Upon joining the Company in March 1998 he was provided an option to purchase 3,250,000 shares with a strike price of $10. In August 1998, the Compensation Committee cancelled those options, which were under water, and reissued new options to purchase 3,250,000 shares of common stock at $3.25 per share. The Compensation Committee determined the cancellation and subsequent grant to Crawford was necessary to provide him with the performance incentives which the March 1998 grant was intended to provide him. **Though the Company re-priced options for all of its executives in August 1998, Crawford was the only exec that was provided new options on a one-for-one basis.**

- **Bonus criteria are cloudy.** Annual bonuses for senior executives are based solely on their performance as judged by the CEO. Equity awards are provided at the discretion of the Compensation Committee. "No fixed formula is used to determine particular grants."

➲ **Big consulting agreement for Director.** Further compromising the independence of board members are certain consulting agreements that are in place. Vice Chairman C.A. Piccolo was the former Chairman, CEO of Caremark International, which the Company acquired in 1996. When it was acquired, Piccolo was given a ten-year consulting agreement that would pay him $5.4 million over the term of the agreement, and is provided office space and secretarial support. And this for the person who, on his watch, Caremark pleaded guilty to two counts of mail fraud for paying doctors for patient referrals and defrauding government medical programs, with attendant fines totaling $161 million.

Accounting: Miscellaneous noteworthy items

➲ **Revenue Recognition.** Caremark goes through considerable detail explaining methods of recognizing revenues and cost of revenues, as well as its belief that it is in compliance with GAAP requirements. However, as it is so often the case, mere compliance with GAAP doesn't ensure that the reader of Company financials has the benefit of full disclosure.

Caremark recognizes revenues from prescription drugs dispensed through its third party retail network on a gross basis. That means that the Company's revenue includes the portion of the prescription drug prices paid directly by customers (retail Copayments) to third party retail pharmacies. For the nine months ended September 30, 2004, the Company's revenue included $3.2 billion in Retail Copayments. To offset the inclusion of these payments in revenue, an equivalent amount is included in cost of revenue. Granted, this treatment of gross vs. net basis has no effect on earnings. It does, however, inflate Caremark's revenue picture by a significant amount. To this, we would add that Caremark discloses that when one large contract was renewed, the Company had to change the revenue recognition on that contract from a gross to a net basis. Unfortunately they do not say why the change had to be made. If this disclosure had been made, we could better evaluate if this is a harbinger of things to come. The handling of these Copayments, the large numbers involved and the risk of timing differences in matching revenues and costs all beg caution on the part of the reader in evaluating real growth and making quarter to quarter comparisons.

➲ **Purchase Discounts.** Caremark receives various forms of purchase discounts on its products. Discounts in such forms as rebates and purchase volume allowances are typically received well after the time of the purchase. This necessitates making estimates on a periodic basis, thereby serving to reduce cost of revenue in a period subsequent to that when the original purchase is recorded. The Company indicates that reconciliation of rebates recognized and recorded to amounts billed and collected has not been material. With that said, it should be noted that, although Caremark does not quantify the amount of its rebates, AdvancePCS did. In 2003, rebates and administrative fees received by AdvancePCS from manufacturers totaled $1.4 billion, hardly an immaterial sum. With the significantly increased overall size of the Company and its operations since the AdvancePCS acquisition, it would seem that things previously deemed immaterial will become material.

- **Goodwill.** The AdvancePCS deal added $7 billion in Goodwill to Caremark's books. We will be interested to see if this total holds up when the auditors come in at year-end. Our guess is that they will be taking a very hard look at the first impairment test on this item.

- **Accounts Receivable.** Caremark's net A/R's have almost tripled since the AdvancePCS deal (from $670 million to $2.01 billion). At the same time its recorded Allowance for Doubtful accounts has only gone up about twofold (from $24.7 million to $48 million). Where the Allowance was just under 4% of the value of A/R's prior to the merger, it was moved down to just over 2% afterwards. We doubt that the quality of the acquired AdvancePCS receivables is any better than those of Caremark's and wouldn't be surprised to see an increase in that allowance when the 2004 Form 10-K is released.

Appendix

Option Vesting Schedules for Selected Caremark Rx Inc. Insiders

Grant Date	Options	Price	Date Exercisable	Expiration Date	Remaining Options in Series	Unvested Options in Series	Vesting Dates of Remaining Options
Edwin Banks, Director. Common stock holdings: 7,000 shares							
01/02/02	25,000	$15.80	01/02/02	01/02/12	25,000	25,000	Fully vested
02/25/03	25,000	$17.20	02/25/03	02/25/13	25,000	8,250	02/25/05
01/02/04	25,000	$25.14	01/02/04	01/02/14	25,000	16,500	01/02/05, 01/02/06
Edwin Crawford, Chairman, CEO, President. Common stock holdings: 80,000 shares							
03/18/98	3,250,000	$3.25	03/18/98	03/18/08	350,000	0	Fully vested
09/21/98	1,000	$3.00	09/21/98	09/21/08	1,000	0	Fully vested
01/27/99	500,000	$5.43	01/27/99	01/27/09	500,000	0	Fully vested
03/08/00	3,875,000	$4.46	03/08/00	03/08/10	3,875,000	0	Fully vested
08/28/01	2,500,000	$16.86	08/28/01	08/28/11	2,500,000	0	Fully vested
05/10/04	600,000	$32.03	05/10/05	05/10/14	600,000	600,000	05/10/05, 05/10/06, 05/10/07, 05/10/08, 05/10/09
Edwin Hardin, EVP, General Counsel, Director. Common stock holdings: 4,189 shares							
09/05/96	10,000	$19.87	09/05/96	09/05/06	10,000	0	Fully vested
01/31/97	10,000	$18.62	01/31/97	01/31/07	10,000	0	Fully vested
03/31/03	20,000	$18.35	03/31/03	03/31/13	20,000	6,600	03/31/05
05/10/04	100,000	$32.03	05/10/05	05/10/14	100,000	100,000	05/10/05, 05/10/06, 05/10/07, 05/10/08, 05/10/09
David Joyner, EVP Sales and Account Management. Common stock: 0 shares							
07/25/00	102,152	$7.81	07/25/00	07/25/10	2,152	0	Fully vested
01/02/02	35,000	$15.80	01/02/02	01/02/12	35,000	0	Fully vested
04/02/03	35,000	$18.35	04/02/03	04/02/13	35,000	11,550	04/02/05
04/10/04	160,000	$32.03	05/10/05	05/10/14	160,000	160,000	05/10/05, 05/10/06, 05/10/07, 05/10/08, 05/10/09
Bradley Karro, EVP, Corporate Development. Common stock holdings: 6,595 shares							

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Option Vesting Schedules for Selected Caremark Rx Inc. Insiders

Grant Date	Options	Price	Date Exercisable	Expiration Date	Remaining Options in Series	Unvested Options in Series	Vesting Dates of Remaining Options
10/13/99	50,000	$5.06	10/13/99	10/13/09	21,000	0	Fully vested
01/12/01	50,000	$12.12	01/12/01	01/12/11	50,000	0	Fully vested
11/07/01	50,000	$13.21	11/07/01	11/07/11	50,000	0	Fully vested
04/02/03	12,000	$18.35	04/02/03	04/02/13	12,000	4,000	04/02/05
04/10/04	180,000	$32.03	05/10/05	05/10/14	180,000	180,000	05/10/05, 05/10/06, 05/10/07, 05/10/08, 05/10/09
Howard McLure, EVP, CFO. Commons stock holdings: 0 shares							
10/13/99	50,000	$5.06	10/13/99	10/13/09	50,000	0	Fully vested
11/15/00	50,000	$12.12	11/15/00	11/15/10	50,000	0	Fully vested
11/07/01	100,000	$13.21	11/07/01	11/07/11	100,000	0	Fully vested
04/02/03	35,000	$18.35	04/02/03	04/02/13	35,000	11,550	04/02/05
04/10/04	200,000	$32.03	05/10/05	05/10/14	200,000	200,000	05/10/05, 05/10/06, 05/10/07, 05/10/08, 05/10/09
C.A. Piccolo, Vice Chairman. Common stock holdings: 85,641 shares							
01/27/99	50,000	$5.43	01/27/99	01/27/09	50,000	0	Fully vested
03/08/00	25,000	$3.87	03/08/00	03/08/10	25,000	0	Fully vested
01/12/01	25,000	$12.25	01/12/01	01/12/11	25,000	0	Fully vested
01/02/02	25,000	$15.80	01/02/02	01/02/12	25,000	0	Fully vested
02/25/03	25,000	$17.20	02/25/03	02/25/13	25,000	8,250	02/25/05
01/02/04	25,000	$25.14	01/02/04	01/02/14	25,000	16,500	01/02/05, 01/02/06