



# Healthcare's Invisible Giants: Pharmacy Benefit Managers

**T**he pharmacy benefit manager (PBM) industry is little known and less understood. But PBMs have a significant impact on public health and patient care, both through their ability to determine drug prices for government payers, private third-party payers, and patients, and through their ability to determine which drugs are available and affordable via formularies. Health law practitioners should recognize that PBMs exist and need to understand what PBMs' role is in the industry.

PBMs developed in the 1970s as adjudicators of prescription drug claims made by health plan members at pharmacies.<sup>1</sup> PBMs initially processed drug claims on paper for a per-claim fee. They were needed when prescription drug benefits became available to employees, retirees, and their dependents because neither pharmacies nor health insurance plans had the capacity to process the high volume of claims that were being made.<sup>2</sup> PBMs have since developed into much more, and they now comprehensively manage pharmacy benefits for health plans, including negotiating drug discounts with pharmaceutical manufacturers, providing drug utilization reviews and disease management, and managing formularies.<sup>3</sup> Their role is complex, their pricing is opaque, and their operations are not widely understood. They have been aptly described at a general level as "the middlemen of the prescription drug industry."<sup>4</sup>

Their importance cannot be doubted. Prescription drug costs are one of the largest components of rising healthcare costs in recent years; spending on prescription drugs has more than quadrupled since 1990.<sup>5</sup> Prescription drug sales totaled \$320 billion in 2011.<sup>6</sup> Two-thirds of all prescriptions in the United States pass through the hands of PBMs,<sup>7</sup> and the largest PBMs have annual profits in the billions and revenues in the tens of billions.<sup>8</sup> As we explain below, PBMs are heavily involved at numerous steps in the process between a pharmaceutical manufacturer's production of a drug and a patient's acquisition of the drug, including pricing.

### What Are PBMs and What Do They Do?

PBMs manage prescription drug benefits for third-party payers, such as health insurance companies. In this role, PBMs manage health plans' formularies, claims from retail pharmacies, and mail

order and specialty pharmacy services.

A formulary is a list of pre-approved, commonly prescribed prescription medications.<sup>9</sup> The PBM works with the health plan sponsor to determine the level of coverage the health plan will provide for medications on the formulary, and the amount of the associated co-pay.<sup>10</sup> Many formularies use a tiered approach, which assigns the lowest co-pay to generic drugs, and much higher co-pays to preferred and non-preferred brand name drugs.<sup>11</sup> Under this approach, non-preferred brand name drugs are the most expensive.<sup>12</sup> Therefore, a PBM has significant power to determine consumer access to particular drugs.

When a plan member picks up a prescription at a retail pharmacy, the PBM adjudicates the claim to determine how much is paid by each party: the pharmacy, which buys the drug from the manufacturer; the health plan, which pays part of the drug's cost to the PBM; the PBM, who reimburses the pharmacy for a percentage of the drug's cost; and the customer, who pays a co-pay.

Additionally, most PBMs own both mail order and specialty pharmacies. Mail order pharmacies typically provide a larger supply of medication (i.e., a 90-day supply instead of the 30-day supply typically provided by a traditional brick-and-mortar pharmacy) for the same co-pay, but deliver the medication to a plan member's home.<sup>13</sup> Mail order pharmacy services have become increasingly important because they provide cost savings to sophisticated health plan sponsors.<sup>14</sup> Because these PBMs own mail order pharmacies, they have the opportunity and incentive to direct prescriptions away from traditional pharmacies and toward their own mail order facilities.<sup>15</sup> This is true even if the prescription would cost less to fill at a competitor's traditional pharmacy.<sup>16</sup>

Many PBMs also own specialty pharmacies. Specialty pharmacies typically handle treatments of dynamic, complex, and serious illnesses, and many of the associated medications require unique handling, storage, and dispensing instructions. Specialty medications are generally more costly, making them an important area of concern for plan sponsors and a significant source of revenue for PBMs. Critics have suggested that PBMs improperly prevent other pharmacies from dispensing specialty drugs and force patients to use the PBMs' own specialty pharmacy services.<sup>17</sup>

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## How Do PBMs Work?

As discussed above, PBMs integrate retail pharmacy claims processing, formulary management, and home delivery pharmacy services.<sup>18</sup> A crucial aspect of PBMs' operations is how PBMs influence the pricing of prescription medication. As the industry middlemen, PBMs enter into contracts with pharmacies, pharmaceutical manufacturers, and pharmaceutical wholesalers, as well as with health plans and plan sponsors.

Although PBMs do not buy drugs directly in their claims processing role, they often receive retroactive rebates from pharmaceutical

agreements with some regional health plans—such as Blue Cross Blue Shield Kansas City—to continue filling prescriptions for plan members while it attempted to work out its issues with Express Scripts.<sup>22</sup> Walgreens ultimately did not renew its contract with Express Scripts by the time the new contract became effective in January 2012, and it was expected to lose \$4 billion in revenue in 2012 as a result of its exclusion from the Express Scripts network.<sup>23</sup> In July 2012, Express Scripts and Walgreens reached an agreement allowing Express Scripts customers to use Walgreens to fill their prescriptions.<sup>24</sup>



manufacturers or wholesalers based on the amount they increase a drug's market share.<sup>19</sup> PBMs also contract with pharmacies for drug reimbursement and dispensing. PBMs have networks of pharmacies where health plan members can fill their prescriptions, and pharmacies seek inclusion in the network because it can increase their market share and their customer base. After a pharmacy buys a drug from the manufacturer or wholesaler and dispenses it to the patient, the PBM reimburses the pharmacy a percentage of the drug's published average wholesale price plus a dispensing fee.<sup>20</sup> This series of interrelated transactions is illustrated in Chart 1 on the following page.

PBMs' pharmacy networks are important because inclusion in these networks allows the pharmacies to capture market share. The pharmacies' goal, of course, is to increase their market share and customer base relative to other pharmacies. A recent example is illustrative. Walgreens, one of the nation's largest chain retail pharmacies, had a heavily publicized dispute with Express Scripts beginning in June 2011 that resulted from Walgreens' efforts to help patients manage their prescriptions.<sup>21</sup> Walgreens entered into

## PBM Involvement in Legal Matters

Numerous third parties have expressed competitive concerns about this industry. Two areas of concern stand out.

The first area of concern can be characterized as unfair and unlawful practices in the PBM industry that is enabled by the complex and opaque nature of PBM business practices. In the past several years, a coalition of 28 states and the District of Columbia prosecuted cases against PBMs. The complaints allege fraud; misrepresentation to health plans, patients, and providers; absorbing plans' funds through spread pricing; improper substitution of drugs; unjust enrichment; kickbacks; and failing to comply with ethical and safety standards.<sup>25</sup> In particular, Caremark and Express Scripts were accused of encouraging physicians to switch patients' medication to drugs on the PBMs' preferred medications lists.<sup>26</sup> These switches ostensibly were made to save health plans and plan members money.<sup>27</sup> In reality, the cost of the preferred drug was the same or more expensive, and it often required additional health-care services that would not have been required if the prescribed drug had been used.<sup>28</sup> Doctors were not informed of the potential

for increased costs, and health plans were not always aware of the financial benefits the PBMs received as a result of these switches.<sup>29</sup>

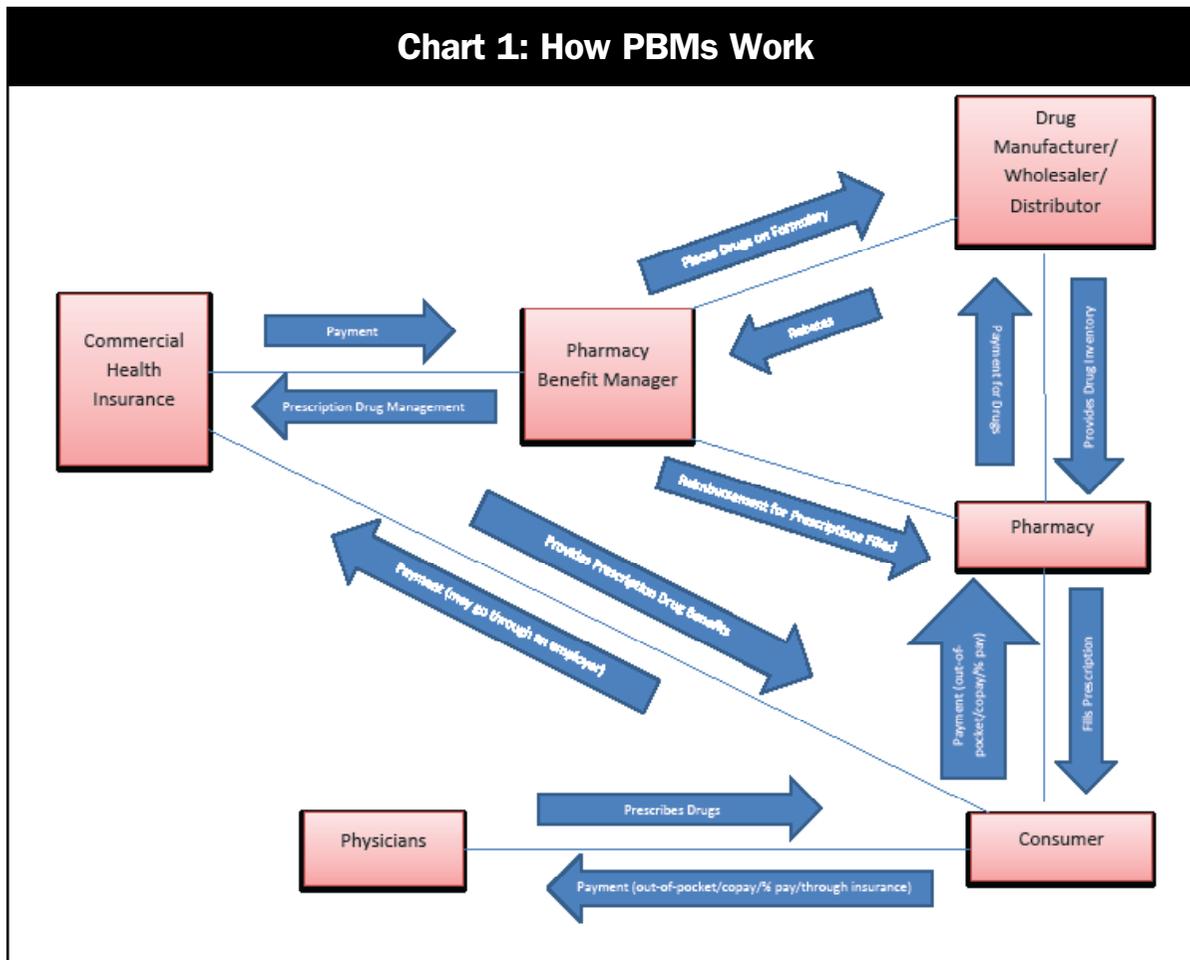
In 2008, the states and the District of Columbia settled with Express Scripts for \$9.5 million, as well as with Caremark for \$41 million.<sup>30</sup> Under these settlements, Caremark and Express Scripts are both required to end drug switching practices, and they must make disclosures related to financial incentives and reimbursements.<sup>31</sup> These requirements, however, are only in place for five years, meaning they are scheduled to expire in 2013.<sup>32</sup>

The second area of concern is continued PBM consolidation and market power. Recently, numerous industry participants and observers expressed concern about the \$29 billion merger of Express Scripts and Medco, two of the so-called Big Three PBMs that dominate the market.<sup>33</sup> (The third is CVS Caremark.) The Federal Trade Commission (FTC) cleared the merger in April 2012, following its review of antitrust concerns.<sup>34</sup> A number of pharmacies and pharmacy associations, however, filed a private antitrust suit seeking to enjoin the merger, which has become a suit seeking to unwind the merger.<sup>35</sup> Although the private plaintiffs face an uphill battle now that the FTC has cleared the merger, it is difficult to predict the result of their lawsuit because most of the data necessary to evaluate the merger's likely competitive effects has not been made public.

The various industry observers' and participants' concerns about the merger are as follows. First, the large PBMs control over 80 percent of the market for PBM services when measured in terms of contracts with large plan sponsors (these PBM services contracts

typically span three to five years), the merged firm will control about half of the market by that measure, and the large PBMs control more than half of the market when measured by prescriptions filled. Because of the market's structural aspects—especially as it relates to large plan sponsors—there are substantial barriers to entry and expansion, and the so-called small or second-tier PBMs struggle to compete for business or to provide PBM services to large plan sponsors, such as unions and large employers.<sup>36</sup> Some observers also view this merger as creating a duopoly in that market segment.<sup>37</sup> Additionally, observers are concerned that the merger may lead to the exercise of enhanced buyer power in the market for specialty and mail order pharmacy distribution and that the merged firm may exclude rivals in these areas.

On the other hand, the Express Scripts-Medco merger followed years in which several other PBMs merged and there was significant consolidation in this industry. CVS Caremark resulted from a \$21 billion merger of CVS and Caremark in 2007, and several other PBMs have merged and acquired new businesses. For example, Express Scripts acquired NextRx, the PBM business of the large insurer WellPoint, in a \$4.7 billion merger in 2009.<sup>38</sup> Express Scripts previously acquired National Prescription Administrators in 2001 and Value Rx in 1998; Caremark acquired AdvancePCS in 2004; and Medco acquired Provantage in 2000.<sup>39</sup> Subsequent to the Express Scripts-Medco merger, two more PBMs merged in a \$4.14 billion cash-and-stock deal in which SXC Health Solutions acquired Catalyst Health Solutions in 2012 (the merged firm is known as Catamaran).<sup>40</sup> SXC's recent acquisition of Catalyst highlights that



the PBM industry continues to consolidate and become increasingly concentrated.

### Importance for Health Law Practitioners

As discussed above, health law practitioners need to understand the role of PBMs. PBMs impact public health and patient care through their influence over prices, availability, and affordability of drugs. This impact may manifest in various ways.

For example, health law practitioners who work on contracts on behalf of commercial health insurance companies need to be aware that PBMs' influence could have a real impact on costs paid by the insurer for drug benefits. PBMs can also impact the amount consumers pay for their prescription drugs. For commercial health insurers, this can greatly impact consumers' satisfaction with their prescription drug benefits, and could therefore influence whether a commercial health insurance company continues to be the best provider for an employee benefit plan. Additionally, PBMs claim to obtain cost savings for insurers through their relationships with drug manufacturers, wholesalers, and distributors. Insurers should push the PBMs for explanations of how the cost savings directly benefit the commercial insurer. These cost issues also impact government agencies (such as the Centers for Medicare and Medicaid Services) and self-insured employers, such as unions, in a similar way.

Health law practitioners working with healthcare providers must also be aware of the PBMs' influence over formularies. As discussed above, PBMs' placement of a certain drug on a formulary may in some instances be less a function of clinical efficacy and more a function of rebates the PBM receives for such a placement.

Efforts to increase transparency are underway. Under the Patient Protection and Affordable Care Act, PBMs that contract with Medicare or health plans under newly created healthcare exchanges must report generic dispensing rates and rebates, discounts, and price concessions.<sup>41</sup> This is an important legislative step, but the extent of the Act's practical effects in this area remains to be seen. ☉

### Endnotes

<sup>1</sup>Allison Dabs Garrett & Robert Garis, *Leveling the Playing Field in the Pharmacy Benefit Management Industry*, 42 VAL. U. L. REV. 33, 34 (2007).

<sup>2</sup>See MIKE WINKELMAN, WHAT ARE PBMS? (Winkelman Management Consulting 2006), available at [www.mwinkrx.com/publications/What%20Are%20PBMS%20March%202006.pdf](http://www.mwinkrx.com/publications/What%20Are%20PBMS%20March%202006.pdf).

<sup>3</sup>Garrett & Garis, *supra* note 1, at 34.

<sup>4</sup>Mark Meador, *Squeezing the Middleman: Ending Underhanded Dealing in the Pharmacy Benefit Management Industry Through Regulation*, 20 ANNALS HEALTH L. 77, 78 (2011).

<sup>5</sup>Garrett & Garis, *supra* note 1, at 33.

<sup>6</sup>Linda A. Johnson, *Prescription Drug Spending Was Flat in 2011*, USA TODAY, Apr. 4, 2012, available at [usatoday30.usatoday.com/money/industries/health/drugs/story/2012-04-04/prescription-drug-spending-2011/54000818/1](http://usatoday30.usatoday.com/money/industries/health/drugs/story/2012-04-04/prescription-drug-spending-2011/54000818/1).

<sup>7</sup>Garrett & Garis, *supra* note 1, at 34.

<sup>8</sup>See *id.* at 36-37.

<sup>9</sup>Formulary, Blue Cross Blue Shield of Massachusetts, [www.bluecrossma.com/bluelinks-for-employers/glossary.html](http://www.bluecrossma.com/bluelinks-for-employers/glossary.html) (last visited Feb. 20, 2013) [hereinafter Blue Cross Blue Shield of Massachusetts].

<sup>10</sup>Meador, *supra* note 4, at 83.

<sup>11</sup>*Id.*

<sup>12</sup>*Id.*

<sup>13</sup>Mail Order/Mail Service Pharmacy, Blue Cross Blue Shield of Massachusetts, *supra* note 9.

<sup>14</sup>FEDERAL TRADE COMM'N, PHARMACY BENEFIT MANAGERS: OWNERSHIP OF MAIL-ORDER PHARMACIES (2005).

<sup>15</sup>Meador, *supra* note 4, at 84.

<sup>16</sup>*Id.*

<sup>17</sup>See, e.g., *Hearing Before the Subcomm. on Intellectual Property, Competition, and the Internet of the House Comm. on the Judiciary*, 112th Cong. (2011) (statement of David Balto).

<sup>18</sup>Meador, *supra* note 4, at 78-79.

<sup>19</sup>Garrett & Garis, *supra* note 1, at 44-46; Kaiser Family Foundation, *Follow the Pill: Understanding the U.S. Commercial Pharmaceutical Supply Chain* 14, 17, 21 (Mar. 2005), [www.kff.org/rxdrugs/upload/Follow-The-Pill-Understanding-the-U-S-Commercial-Pharmaceutical-Supply-Chain-Report.pdf](http://www.kff.org/rxdrugs/upload/Follow-The-Pill-Understanding-the-U-S-Commercial-Pharmaceutical-Supply-Chain-Report.pdf).

<sup>20</sup>Garrett & Garis, *supra* note 1, at 46; Kaiser Family Foundation, *Follow the Pill*, *supra* note 19, at 19.

<sup>21</sup>Walgreens Tries to Stay in Express Scripts' Tricare, REUTERS, Oct. 17, 2011, available at [www.reuters.com/assets/print?aid=USTRE79G55X20111017](http://www.reuters.com/assets/print?aid=USTRE79G55X20111017).

<sup>22</sup>*Id.*

<sup>23</sup>Jim Doyle, *Express Scripts-Walgreens Battle Speaks to Merger Fears*, ST. LOUIS TODAY, Apr. 7, 2012, available at [www.stltoday.com/business/local/express-scripts-walgreen-battle-speaks-to-merger-fears/article\\_222f0000-8019-11e1-a97e-0019bb30f31a.html](http://www.stltoday.com/business/local/express-scripts-walgreen-battle-speaks-to-merger-fears/article_222f0000-8019-11e1-a97e-0019bb30f31a.html).

<sup>24</sup>Peter Frost, *Walgreens, Express Scripts Back Together*, CHI. TRIB., July 19, 2012, available at [articles.chicagotribune.com/2012-07-19/business/chi-walgreen-express-scripts-back-together-20120719\\_1\\_express-scripts-greg-wasson-walgreen-business](http://articles.chicagotribune.com/2012-07-19/business/chi-walgreen-express-scripts-back-together-20120719_1_express-scripts-greg-wasson-walgreen-business).

<sup>25</sup>See David Balto, AAI White Paper, *The FTC Should Issue a Second Request on Express Scripts' Proposed Acquisition of Wellpoint's PBM Business*, May 11, 2009, at 4.

<sup>26</sup>Compl. for Inj. and Other Relief Under the Consumer Protection Act, RCW 19.86, *State v. Caremark Rx, LLC*, No. 08-2-06098-5 (Wash. Super. Ct. Feb. 14, 2008), available at [www.atg.wa.gov/uploadedFiles/Home/News/Press\\_Releases/2008/CaremarkComplaint.pdf](http://www.atg.wa.gov/uploadedFiles/Home/News/Press_Releases/2008/CaremarkComplaint.pdf); Order Approving Entry of Assurance of Discontinuance, *In re Express Scripts, Inc.*, No. 08-02-0155-4 (Wash. Super. Ct. May 28, 2008), available at [www.atg.wa.gov/uploadedFiles/Home/News/Press\\_Releases/2008/ProposedExpressscriptsAOD.pdf](http://www.atg.wa.gov/uploadedFiles/Home/News/Press_Releases/2008/ProposedExpressscriptsAOD.pdf).

<sup>27</sup>Compl. for Inj. and Other Relief Under the Consumer Protection Act, RCW 19.86, *State v. Caremark Rx, LLC*, *supra* note 26.

<sup>28</sup>*Id.*

<sup>29</sup>Press Release, Washington State Office of the Attorney General, Attorney General McKenna Announces Caremark to Pay \$41 Million to Resolve Multistate Consumer Protection Claims (Feb. 14, 2008), available at [www.atg.wa.gov/pressrelease.aspx?&id=19122](http://www.atg.wa.gov/pressrelease.aspx?&id=19122).

<sup>30</sup>*Id.*; Press Release, Washington State Office of the Attorney General, Attorney General McKenna Announces Express Scripts to Pay \$9.5 Million to Resolve Consumer Protection Claims (May 27, 2008), available at [www.atg.wa.gov/pressrelease.aspx?&id=19850](http://www.atg.wa.gov/pressrelease.aspx?&id=19850).

<sup>31</sup>Press Release, Ill. Attorney General Lisa Madigan, Madigan,