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LEADER (U.S.)

Suit Batters Penney Shares, But Serves Short-Sellers Well

Investors Helped to Pursue Claim That Eckerd Unit Overbilled for Drugs

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Shirley Minsky was observing the seven-day Jewish mourning period for her husband last January when a family friend called, not to offer his condolences, but to get information. He wanted to know if she used a prescription eyedrop called Xalatan.

Mrs. Minsky, a 77-year-old in Fort Lauderdale, Fla., says she was too upset to talk to the caller. She says the caller did speak to her daughter, though, and told her the pharmacy might have been overcharging for Xalatan. He asked for some information from her prescription label, Mrs. Minsky says.

A week later, a civil lawsuit accused Eckerd Drug Stores of widespread overcharging for prescription drugs. On behalf of Eckerd customers, the suit demanded \$100 million in damages. It had one named plaintiff: Mrs. Minsky.

She says she never talked to any of the lawyers who filed the litigation. In fact, she didn't even hear about the suit, Mrs. Minsky says, until a neighbor read about it in a newspaper and told her.

"They made up the whole damn story," Mrs. Minsky says of the plaintiffs' lawyers. "I am ashamed to go back to Eckerd's ... What kind of person would do this to me? It's awful."

Boon to 'Shorts'

Four law firms that filed the suit declined requests to discuss it, although one lawyer, Paul Paradis, contends he did have Mrs. Minsky's authorization to sue Eckerd on her behalf.

The suit -- with a new plaintiff inserted after Mrs. Minsky complained -- has made little progress since it was filed 11 months ago. The Florida attorney general closed an investigation sparked by the suit, after finding no evidence Eckerd had overcharged. The lawsuit, however, had one distinct effect: It knocked down the shares of J.C. Penney Co., owner of the Eckerd chain. Painful for shareholders, this drop rewarded another group of investors -- short-sellers, the people who bet on stock declines.

Short-sellers naturally take an interest in and investigate any reports that might cause a stock to fall. Sometimes they go further. The Eckerd case offers a window into a subculture of short-sellers and class-action law firms where negative reports about companies are often seized upon and circulated, to the

detriment of the companies or their stocks. Among the players in this case was Martin Lacoff, a consultant to class-action law firms and the family friend who called Mrs. Minsky.

The shorts' story begins in November 2001, when an investment analyst heard a tip that an Eckerd pharmacist in Deltona, Fla., was saying he had evidence of fraud by his employer. The analyst, Terrence Warzecha, works for Rocker Partners, a New York hedge fund, or private investment pool, that is known for often taking short positions. Mr. Warzecha says he began calling Eckerd drugstores in the Deltona area.

At one store, druggist Donald Reilly answered the phone. "Are you the whistleblower?" Mr. Warzecha asked.

For several years, in fact, Mr. Reilly had been voicing suspicion that Eckerd was overcharging customers who received certain quantities of liquid and cream prescriptions. He based this on his reading of drug labels and computer screens, which seemed to show Eckerd getting paid for more medicine than it dispensed. In 2000, Mr. Reilly wrote to the Food and Drug Administration, which referred the complaint to the Florida Board of Pharmacy. He also faxed documents to state and federal Medicaid investigators and to the state insurance-fraud bureau, all without apparent result. Mr. Reilly says he has never sold Penney's shares short.

When Mr. Warzecha of Rocker Partners called, Mr. Reilly says he eagerly shared documents copied from an Eckerd store. The analyst "seemed to be very excited," Mr. Reilly says. "He would say this is going to kill them. This will be very detrimental. This will cost them money."

Mr. Warzecha says he can't recall specifics of his talks with Mr. Reilly but says he believed the pharmacist had uncovered massive fraud. "Don was morally outraged as to what he saw or found and when he conveyed to me the information, I was likewise morally outraged," Mr. Warzecha says.

Rumors Spread

The Rocker Partners analyst, asked if he had a role in unearthing allegations later made in the lawsuit against Eckerd's corporate owner, says, "I did a lot of the initial work. We were interested in it as short-sellers and how big the fraud was and would it have a meaningful impact." (Short-sellers borrow shares and sell them, hoping to replace them later after their price has fallen.)

As early as November 2001, some investors who follow Penney began hearing rumors of a possible lawsuit or government action against its drugstore division. Penney's share price began to slide in the middle of that month.

In December 2001, Mr. Reilly says, Mr. Warzecha asked him to talk to Eric Camil, a private investigator known by hedge-fund managers for his work with law firms that file class-action securities litigation. Mr. Warzecha says Rocker Partners didn't pay Mr. Camil.

Eckerd, the country's fourth-largest pharmacy chain, was an enticing potential target for short-sellers. It had just agreed in mid-2001 to pay \$1.2 million to resolve a 1996 federal criminal investigation for allegedly billing Medicaid full amounts on prescriptions only partly filled. Eckerd neither admitted nor denied those charges.

Penney Chairman Alan Questrom says he heard the overcharging rumors in December 2001 from a banker who cited Rocker Partners as his source.

By January 2002, says Mr. Reilly at Eckerd, his home phone number was widely known among short-sellers. The pharmacist says an especially frequent caller was Clifford Murray, a doctor-turned-analyst at the Boca Raton office of KSH Investment Group Inc., a broker-dealer based in Great Neck, N.Y.

The pharmacist says Dr. Murray called 30 to 40 times, sometimes updating Mr. Reilly on the progress toward filing the suit and what the timing might be. Mr. Reilly adds that Dr. Murray frequently admonished him never to reveal their conversations. After a reporter contacted Dr. Murray recently, the doctor left a message on Mr. Reilly's answering machine saying, "I don't know what you have done or said. ... I don't want this to turn ugly."

The head of KSH's Boca Raton office, Jeff Sultan, says Dr. Murray "does not recall" leaving such a message.

The pharmacist says Dr. Murray indicated he was communicating with the lead plaintiffs' lawyer in the Eckerd suit before it was filed. Mr. Sultan responds that the analyst didn't have advance knowledge of the suit and didn't talk to the lead lawyer until after the suit's filing.

That lead lawyer was Mr. Paradis, who is with a New York class-action law firm called Abbey Gardy LLP. Mr. Paradis didn't reply to questions about what prompted his interest in the Eckerd case or whether he discussed a possible lawsuit with short-sellers or other investment pros before filing it.

The suit was filed at 3:59 p.m. on Friday, Feb. 1, a clerk's stamp at the Fort Lauderdale courthouse shows. Mr. Sultan of KSH says he had sent an aide to the courthouse to pick up a copy on the day of the filing. The aide had to wait "a good part of the day" for it to be filed, he says, and "it was after 4 p.m. that he got his hands on a copy of the suit."

Mr. Sultan says KSH didn't have any advance knowledge of the suit. Asked why he sent an aide for a copy of it hours ahead of time, Mr. Sultan said he believed there had been a news report indicating it would be filed. If there was such a report, Eckerd says it didn't know about it. Later, Mr. Sultan said he had been mistaken and actually didn't send a messenger until the Monday after the filing. He produced a courthouse receipt for lawsuit photocopies obtained the following Monday.

Mr. Sultan said neither Dr. Murray nor KSH was ever short Penney's shares. Asked why, in that case, Dr. Murray spent so much time talking to the pharmacist, and whether the broker-dealer had been advising clients to short the stock, Mr. Sultan didn't respond.

A week before the suit's filing, on a day when Penney's stock was down, public television's "Nightly Business Report" said a Penney spokesman mentioned an "unconfirmed rumor" that Eckerd had overcharged Medicaid. Penney issued a formal denial of the rumor the next day. By that time, its stock was down about 15% from the price when the rumors began two months earlier. Short-sellers' activity in the stock rose 43% between Jan. 15 and Feb. 15, New York Stock Exchange data show.

Penney's shares fell further in the week following the filing of the suit on Feb. 1. They took another hit in April when plaintiffs' lawyers amended the suit, raising the damage estimate to "at least several hundred million dollars." The amended suit added three dozen more drugs for which it said Eckerd had overbilled.

Mr. Reilly says he provided documents for exhibits about those drugs in the amended complaint. The pharmacist says he did this at the request of KSH's Dr. Murray, who, the pharmacist says, called in March to say he needed the documents quickly.

By then, Penney shares had fallen 32% from the mid-November pre-rumor price. Stocks in general were rising at the time, and sales and profitability were improving at both Penney and its Eckerd unit, which is the source of 40% of Penney's revenue. "The rumors of litigation and the suit brought the stock down drastically," says Dan Barry, a Merrill Lynch retail analyst who follows Penney.

Rocker's Role

At Rocker Partners, founder David Rocker says the fund opened its sole short position in Penney shares on the day the suit was filed, adding to it in the following weeks. Asked if he knew the suit was going to be filed on that day or if he opened the short position prior to the 3:59 p.m. filing of the suit, Mr. Rocker says, "I honestly don't know."

Mr. Rocker says he gradually closed out the short position, eliminating it in May. He won't say how big the position was or how the hedge fund did on it.

He says there was no organized effort to drive down Penney shares. "You may have thought this was done with shorts talking to each other and creating a story, and I want to disabuse you of this notion," Mr. Rocker says. "People talk, but it is no different than what happens on the long side" -- that is, among those who bet on shares to rise.

Mrs. Minsky, the woman the suit listed as plaintiff, says she had never spoken to Mr. Paradis or any of the other plaintiffs' lawyers involved. Mr. Paradis, while declining to answer several questions about the case, said, "We clearly had Mrs. Minsky's consent and authorization to represent her and file a lawsuit against Eckerd."

Mr. Lacoff, the family friend who called to learn whether Mrs. Minsky used eyedrops sold by Eckerd, lives in Boca Raton. A mansion he owns in Greenwich, Conn., was rented to Martin Frankel, the reclusive financier who looted small Southern insurance companies, fled and was nabbed in Germany. Mr. Lacoff's Capital Markets Legal Consulting Inc. helps identify targets for firms that file class-action lawsuits.

His wife, Cheryl Rona Lacoff, has been a plaintiff in two such suits, including one against the publishers of "The Beardstown Ladies' Common-Sense Investment Guide," a suit that said the book misstated the ladies' investment return. The suit was her husband's idea, according to plaintiffs' lawyer Oliver Koppell.

Ideas for Lawsuits

Mr. Koppell, a former New York state attorney general, says he pays Mr. Lacoff a monthly consulting fee to come up with case ideas. "He is very inventive and creative," Mr. Koppell says. "He has brought me many ideas. Sometimes friends are involved. Sometimes he comes up with an idea with a plaintiff." Mr. Koppell and Ms. Lacoff lost their Beardstown Ladies suit in New York but joined up with lawyers who were pursuing a similar action in California. In that state, the lawyers eventually agreed to a settlement. Buyers of the book got another book free from the publisher, while several law firms shared a \$1.4 million fee.

The Eckerd lawsuit, filed in Broward County, Fla., Circuit Court, alleged that Mrs. Minsky's Xalatan package contained 2.5 milliliters of the eyedrops, but that the label said 3 milliliters. Eckerd had "rounded up" the amount and charged her and others for too much medicine, the suit asserted.

The practice of rounding up label amounts dates from the 1970s, when it was instituted to save computer memory by eliminating decimal points. Most major drugstore chains did it, but all say they charged the correct price, and some later stopped the rounding-up. Eckerd began phasing out the practice in 2001,

before the suit was filed.

Eckerd says that while the amount on the label for liquids and ointments was often inaccurate, owing to rounding-up, its computers were programmed to charge the correct price.

Florida's attorney general, after investigating, concluded in July that it would have been difficult for Eckerd to overcharge private health insurers or Medicaid. That's because liquids and ointments are packaged in certain sizes, and the bill payers will pay only a predetermined, fixed price for these sizes. If an incorrect price is put into their payments systems, computers reject the claim. "The billing process for third parties makes it very difficult to overcharge on fractional quantities," says John Newton, Florida's senior assistant attorney general. His office also concluded it was highly unlikely Eckerd had overcharged uninsured customers who pay their own bills.

AdvancePCS, the largest pharmacy-benefits manager, said after the suit was filed that if a drugstore chain tried to submit an inflated claim, AdvancePCS's computers would catch the incorrect price and reject it.

The lawsuit against Eckerd still is pending. The case frustrates Penney's Mr. Questrom, who says that because of it, "We lost credibility with our customers, our shareholders lost a lot of money, and our pharmacists were shamed."

Mr. Reilly, the pharmacist, says he remains convinced his employer overcharged customers, but he acknowledges that the evidence he gathered isn't definitive. Mr. Reilly says Eckerd suspended him in March, with pay, accusing him of removing company documents. He says the short-sellers no longer call.

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Short Seller Pleads Guilty to Racketeering
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