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Superior Court confirms the validity of royalties paid by a pharmacist to its franchisor

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Article 49 of the *Code of ethics of pharmacists* (the *Code*) precludes pharmacists from sharing profits from the sale of medications or from their fees with a non-pharmacist third party. Yet, in the pharmacy sector, franchise agreements usually stipulate that the pharmacist must pay royalties to its franchisor. Is such a royalty clause contrary to the ethics rules prescribed for pharmacists? According to a Superior Court judgment, *Quesnel c. Groupe Jean Coutu (PJC) inc.*, 2016 QCCS 6347, a royalty clause is legal, provided that the royalties paid correspond to the value of the services or goods provided by the franchisor.

Background

Michel Quesnel (Quesnel) was a pharmacist who owned and operated Jean Coutu pharmacies since 1988. His pharmacies were operated in accordance with franchise agreements between him and Groupe Jean Coutu (PJC).

The franchise agreements provided that the pharmacist had an obligation to pay the franchisor an annual royalty representing 4% of the gross revenues when the revenues reached more than $2 million, or 5% when revenues remained between $1 and $2 million. While the agreements contained an acknowledgment by the franchisee that "[TRANSLATION] the royalties in no way constitute a sharing of fees in favour of the franchisor," the revenues used for calculating the amount of royalties owed included revenues from the sale of medications.

In 2008, the syndic of the *Ordre des pharmaciens du Québec* filed with the disciplinary council several complaints against Quesnel. The syndic alleged that Quesnel illegally shared fees or profits from the sale of medications with a non-pharmacist, that is, PJC, contrary to article 49 of the *Code*. Quesnel pleaded guilty to the accusations and instituted an action against PJC, in the hope that the royalty clause would be declared null, such that the Court would preclude PJC from requesting royalties in the future and order PJC to repay the royalties collected illegally.

In June 2016, pursuant to an agreement between the parties, Quesnel discontinued his action. In exchange, PJC applied for a declaratory judgment with respect to the validity of the royalty clause.

Reasons for judgment and conclusions

The Court declared the royalty clause valid in the circumstances of this case. Article 49 of the *Code* did not provide for an absolute prohibition for a pharmacist to share revenues, including those from the sale of medications.

As was put forward by the *Ordre des pharmaciens du Québec*, the Court distinguished between the sharing of gross *revenues* and that of net *profits*. Article 49 intended to prohibit the sharing of net profits, rather than that of gross revenues. In addition, the prohibition should be read in light of its objective, which is to ensure that the pharmacist profession is only exercised by pharmacists and to prevent non-pharmacists from owning or operating a pharmacy, directly or indirectly through the sharing of the pharmacist's fees or profits from the sale of medications. Thus, the prohibition did not cover the use of operating revenues, including those from the sale of medications, to pay for expenses incurred by the pharmacist for the operation of the pharmacy, provided that these expenses represent the fair value of the goods and services received from the franchisor.

According to the Court, the disputed clause was not *a priori* illegal because the royalty was calculated on the basis of gross *revenues*. Moreover, non-contested expert evidence adduced by PJC showed that the royalties paid by Quesnel were reasonable given the fair value of the services and benefits provided by PJC.

For the purpose of its analysis, the Court considered the revenues from the sale of both prescription and over-the-counter medications. In the case of Quesnel's pharmacies, the royalties paid represented on average 4% of the revenues from the sale of medications. According to the expert evidence, the fair market value of the services provided by PJC ranged from 2% to 3% of annual revenues, depending on the business size. These services included advice with regards to the organization, planning and operation of the premises, national advertising efforts by PJC, the opportunity to buy products at advantageous prices as well as technical, administrative and financial assistance with regards to the operation of the business. It shall be added to these services the fair market value of the rights to use the PJC name and trademarks, which was evaluated as ranging from 1.75% to 2.25% of the revenues.

The Court found that a royalty rate between 3.75% and 5.25%, depending on the size of the pharmacy, would be reasonable and representative of the value of the services rendered by PJC. Since the average royalty rate of 4% paid by Quesnel fell within this range, the royalties paid by Quesnel represented the fair market value of the consideration received from PJC. The Court concluded that the disputed royalty clause complied with article 49 of the *Code* and was valid.

Commentaries

In addition to confirming that royalty clauses in banner or franchise agreements in the pharmacy sector are valid, this judgment gives interesting insights with respect to how a franchisor may prove, using expert evidence, that the royalties it collects correspond to the fair market value of the goods and services provided to the franchisee.

Furthermore, we cannot ignore the influence this judgment may have on the proceedings in another matter, filed by Sopropharm, an association of PJC franchisees. In this other matter, Sopropharm requests the authorization to institute a class action against PJC on the basis of a violation of article 49 of the *Code*. To be continued.