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## Side effects include ...

*Medicine Shoppe franchisees are finding out what happens to a franchise system when the franchisor cuts its services but doesn't let operators out of their agreements without a hefty buyout.*

By Jonathan Maze

Last year, Medicine Shoppe offered the owners of its franchised pharmacies a deal that, on the surface, should have been a no-brainer. Operators would get a more friendly franchise agreement and would pay a flat royalty of \$495 a month—a significant savings considering that many pharmacies make well over \$2 million a year in revenues.

In exchange, they'd receive fewer services, and have to buy medications from Medicine Shoppe's parent company, the drug wholesaler Cardinal Health. At the time, the deal was viewed as a cure for the system's ills. Operators had been leaving the system for several years and lawsuits between franchisees and Medicine Shoppe were frequent.

Instead, the cure only seemed to make matters worse, at least in terms of franchisee relations. Dozens of pharmacy owners left the system. Many of those left—at least 200—are now suing Medicine Shoppe over the switch in the franchise agreement. “A lot of us said no,” said Don Schreiber, a former Medicine Shoppe CFO who became a franchisee.

They said no, because the deal came with a caveat. Those who opted for the new franchise agreement had to buy out of their old one, by paying 55 percent of their estimated future royalties. For a \$2 million pharmacy, that's \$330,000. Others could pay the entire buyout and get out of the system entirely—and many did.

In their lawsuit, the franchisees claim that Medicine Shoppe initially said it would

only go through with the change if 95 percent of operators decided to buy out their deals and switch to the new contract. Yet, according to the lawsuit, just more than half agreed to the buyouts.

Rather than ditch the new deal, the franchisor proceeded anyway, creating what the operators say are two distinct systems, neither of which is functioning properly. The group that opted out of the buyout pays the old royalty fee, but get the services of the \$495-a-month franchise. Those who did buy out their deals get a disjointed system with no consistency from one store to another.

“They've got the pharmacy light program with limited services,” Schreiber said. “Then they've got legacy stores paying a ton of money with no annual services. It's kind of a sad state.”

Medicine Shoppe would not comment in detail on the lawsuit or the change in the franchise agreement. A spokesman with Cardinal told Franchise Times that, “We firmly believe franchisees were provided the option to determine the business model that would be best for their business.”

A company statement released after the lawsuit was filed in the spring stated the complaint has “no merit.” Since introduc-

### I can't afford plane fare, let alone future royalties

A federal judge in Missouri recently put a dent in a growing practice among franchisors: requests that terminated franchisees pay “lost future royalties” on franchise agreements. And the franchisee didn't even need to make an argument in court.

The case involves a New York Medicine Shoppe franchisee, TLC Pharmacy. Laura Soboleski opened the pharmacy in 2004 and signed a 20-year deal. She closed up shop in December 2008. Medicine Shoppe sued for unpaid royalty and marketing fund payments. But it also asked for future royalties on the remaining 16 years on the franchise contract. How much? Nearly \$900,000 total.

Soboleski said in letters to the court that she could not afford an attorney or the plane fare to Missouri where the case was heard. After months of delays designed to get the sides to negotiate a settlement, Medicine Shoppe moved for summary judgment in March. Soboleski didn't respond, and the judge ruled in the company's favor. But the judge refused to grant lost future royalties, awarding the franchisor \$128,000 in past due royalties and interest, plus additional legal fees.

Requests for lost future royalties were once rare, but that's no longer the case, even in cases when a franchisee shut down for financial distress, according to Ron Gardner, attorney with the Minneapolis law firm Dady Gardner. “When I started practicing franchise law, you heard this type of claim once every 100 cases,” Gardner said. “Now it's at least threatened in 40 to 50 percent of the cases I handle.”

“Franchisors have figured out that they have some potential leverage when a franchisee is required to close for whatever reason, even in financial distress,” Gardner added. “Franchisors can at least make a claim that will put significant financial pressure on a franchisee to then cause the franchisee to come up with money out of pocket or face bankruptcy.”

So far, judges have allowed awards to go through. But Gardner believes this ruling could “turn the tide” against the practice by providing case law in the franchisee's favor. Gardner said the trouble with lost future royalties in a situation when a financially distressed operator gets terminated is that there is no guarantee that operator will remain in business. Franchisors thus have the burden of proof to show that the franchisee would have remained in business.

“The franchisee did not even make this argument,” Gardner said. “That is just a basic concept of the law. She looked. She said, ‘OK, you'd be entitled to past royalties. But not future royalties. You just showing up and saying ‘We're entitled to it’ is not enough.”

“It's an important decision that not only recognizes such a fundamental side of the law, it underscores it in giant red marker.”

—Jonathan Maze

ing the new agreement, the company said it has seen renewed interest in opening new Medicine Shoppe and Medicap locations.

### Background

Medicine Shoppe was started in 1970 in St. Louis by a group of physicians. The company grew quickly, and by 1995 the system had about 1,000 stores in the U.S. The stores are typically small, especially by today's big-box pharmacy standards, and most of them focus almost entirely on medications and over-the-counter drugs. A typical store might be about 800 square

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feet. In 2003, Cardinal acquired a similar pharmacy franchise, Medicap.

The pharmacies aren't as profitable as they once were. In the 70s and 80s a pharmacy was largely a cash business that was simple. These days, insurance companies pay the bulk of the bills, requiring more paperwork. And reimbursements are often discounted. "In 1983, a high-volume store did \$1 million a year," Schreiber said. "Now a store needs to be doing \$3 million a year to be profitable." And intensifying competition from CVS, Walgreens and big-box retailers like Wal-Mart and Target aren't helping.

Twenty-year deals signed in the '80s and '90s have come up for renewal recently, and with the thinned profits many opted to leave the system. "We had a hard time

convincing people to renew," Schreiber said. He said operators tried convincing Cardinal to reduce the 5 percent royalty, to 2 percent, to no avail. "We're a stepchild of distribution now," Schreiber said.

The new agreement was supposed to fix the problem, "but the only way it works is if there is uniformity and standardization in terms of the franchise agreement," said David Harris, attorney with Greensfelder Hemker & Gale, who is representing the operators. "Those who signed on, signed on with the promise of a new system that would be unitary." Instead, he said, "They get a splintered franchise that fails to meet expectations."

The reason many didn't opt for the new deal was the buyout. While a buyout made sense financially for many operators, some

said they couldn't afford the buyout even if they wanted the smaller royalty. Pat Helm has owned her Medicine Shoppe in Chickasha, Oklahoma, since 1985. She bought it with her husband, who was a pharmacist, and ran it for years. They got divorced in 2002. He lost his pharmacy license, and she ended up with the store.

She estimates a smaller franchise fee would have saved her thousands of dollars per month. Yet she also estimates that a buyout of the six years she has remaining on her franchise agreement would cost her \$300,000.

"I just have to keep going long enough so when I do leave I have a little bit of an egg there," she said. **FT**