

**ONTARIO
SUPERIOR COURT OF JUSTICE**

B E T W E E N:

GIOVANNI SPINA, JOHN SPINA DRUGS LTD.,
ROMEO VANDENBURG and ROMEO VANDENBURG DRUG COMPANY LTD.

Plaintiffs

- and -

SHOPPERS DRUG MART INC. and SHOPPERS DRUG MART (LONDON) LIMITED

Defendants

PROCEEDING UNDER THE *CLASS PROCEEDINGS ACT, 1992*

STATEMENT OF DEFENCE

1. The defendants admit the allegations contained in paragraphs 2 (provided that Shoppers Drug Mart Inc. is continued, not incorporated, under the laws of Canada), 3 (provided that the defendants do not admit the plaintiffs have no knowledge of the arrangement between SDMI and SDM London, there are 1309 Shoppers Drug Mart and Pharmaprix stores across Canada as of March 27, 2014, and approximately 56% of the stores are in Ontario as of the same date), 4, 5 (provided that certain of the agreements pleaded were new agreements, not renewals), 6, 7 (provided that certain agreements pleaded were new agreements, not renewals), 8 (provided that the defendants do not agree the renewal clause is "automatic"), 9 (provided that there are three parties to each Associate Agreement), 10, 12 (provided that the defendants do not admit that Associates are "entitled...to all of the profits earned by the business"), 13, 14, 16 (provided that the defendants' sales and other financial information are not material), 21, 27, 28 and 30 (provided that Associate Agreements speak for themselves) of the Second Fresh As Amended Statement of Claim, except to the extent such paragraphs are inconsistent with the pleadings herein.

2. The defendants deny the allegations contained in all other paragraphs of the Second Fresh as Amended Statement of Claim.

The Defendants

3. The defendant Shoppers Drug Mart Inc. (“SDMI”) is a corporation continued under the *Canada Business Corporations Act*.

4. SDMI is a wholly-owned subsidiary of Shoppers Drug Mart Corporation (“SDM”), which is a holding corporation. SDMI is the principal operating subsidiary of SDM.

5. SDMI grants licenses to operate full-service retail drug stores (each, a “Shoppers Store”) under certain trade-marks (the “Shoppers Trade-marks”), including SHOPPERS DRUG MART (PHARMAPRIX in Quebec).

6. The defendant Shoppers Drug Mart (London) Limited (“SDM London”), formerly known as Big V Pharmacies Co. Limited, is a corporation continued under the *Canada Business Corporations Act*. SDM London is a wholly-owned subsidiary of SDMI.

7. SDM London grants licenses to operate Shoppers Stores in Ontario under an arrangement with SDMI.

8. For simplicity, references to SDMI in this pleading should be read as references to both SDMI and SDM London, unless stated otherwise.

9. The terms “Class”, “2002 Agreement Class”, “2010 Agreement Class” and “Professional Allowance Class” have the meanings set out in paragraphs 5 and 6 of the certification order. References in this pleading to “Class Members” refer to the members of the Class.

10. Unless otherwise indicated, pleadings in the present tense should be read as applying since the commencement of the class period (January 1, 2002) until the date of this pleading.

11. Descriptions of the defendants' business and operations in this pleading apply only to their business and operations in provinces other than Québec.

The Representative Plaintiffs

12. The representative plaintiff Giovanni (John) Spina ("Spina") is an individual residing in Ajax, Ontario.

13. The representative plaintiff John Spina Drugs Ltd. ("Spina Drugs") is a corporation incorporated under the laws of Ontario.

14. Spina owns and/or controls Spina Drugs.

15. Since February 29, 1992, Spina has, through Spina Drugs, operated Shoppers Stores pursuant to a series of Associate Agreements (as defined below) made between Spina, Spina Drugs and SDMI or its predecessors.

16. As at the date of this pleading, the current agreement between Spina, Spina Drugs and SDMI is an Associate Agreement made March 1, 2009 in respect of the operation of the Shoppers Store located at 15 Westney Road North, Ajax, Ontario.

17. The representative plaintiff Romeo Vandenburg is an individual residing in Toronto, Ontario.

18. The representative plaintiff Romeo Vandenburg Drug Company Ltd. (“Vandenburg Drugs”) is a corporation incorporated under the laws of Ontario.

19. Vandenburg owns and/or controls Vandenburg Drugs.

20. Since August 19, 1994, Vandenburg has, through Vandenburg Drugs, operated Shoppers Stores pursuant to a series of Associate Agreements made between Vandenburg, Vandenburg Drugs and SDMI or its predecessors.

21. As at the date of this pleading, the current agreement between Vandenburg, Vandenburg Drugs and SDMI is an Associate Agreement made August 19, 2011 in respect of the operation of the Shoppers Store located at 3003 Danforth Avenue, Toronto, Ontario.

The Associate Concept

22. The business model that drives the Shoppers Drug Mart business and guides the relationship between SDMI and its franchisees is referred to as the “Associate Concept”.¹

23. The Associate Concept combines the principles of a franchise arrangement, through the licensing to individual franchisees of the right to operate retail drug stores in association with the Shoppers Trade-marks and SDMI’s business systems, with the benefits of a large chain operation.

24. Under the Associate Concept, pharmacists who are licensed to practise in the province in which their respective stores are located (each, an “Associate”) operate, through a

¹ The descriptions of the Associate Concept and the Associate Guarantee (defined below) in this pleading apply only to the Shoppers Drug Mart Business in provinces other than Quebec.

wholly or partially-owned corporation, the Shoppers Stores (excluding Shoppers Stores located in Quebec).²

25. Both the Associate and a corporation controlled and operated by the Associate enter into a standard form agreement with SDMI, referred to as an “Associate Agreement”.

26. The Associate Agreement describes the individual pharmacist as the “Pharmacist” and the pharmacist’s corporation as the “Associate”. In practice, SDMI and the Associates refer to the individual pharmacist as the Associate. The balance of this pleading uses the term Associate to refer to both the individual and his or her corporation, unless the context requires otherwise.

27. Under the Associate Agreement, SDMI grants the Associate the right to, among other things, operate a retail drug store business at a specific location using the Shoppers Trade-marks.

Unique Aspects of the Associate Concept

28. The Associate Concept is different than other franchise arrangements in a number of important respects, including:

- (a) Associates do not pay an initial “franchise fee” to SDMI.
- (b) Associates do not make any initial capital investment in the Shoppers Store.
- (c) Associates do not purchase or lease store premises.
- (d) SDMI identifies potential locations for Shoppers Stores.

² There are a very small number of Associates who are not licensed pharmacists.

- (e) SDMI acquires or leases the store premises and licenses the use of the premises to the Associate.
- (f) SDMI purchases and installs equipment, which it leases to the Associate.
- (g) SDMI guarantees every Associate minimum annual earnings (the "Associate Guarantee"), which have increased over time.
- (h) SDMI provides short-term and long-term financing to Associates for inventory and working capital through the provision of loans and loan guarantees.
- (i) SDMI providing guarantees to various Canadian chartered banks that support Associate loans to finance inventory purchases and working capital requirements.
- (j) An Associate may terminate his or her Associate Agreement on 60 days' written notice at any time (with SDMI having the right, after receiving such notice, to terminate the Associate Agreement before the end of the Associate's notice period).
- (k) Associates are eligible to participate in SDMI's Associate Registered Retirement Savings Plan (or ASSET).

The Associate Agreement

29. All Associates are required to enter into an Associate Agreement with SDMI.

30. As at March 27, 2014, there are 99 Associates, all in Ontario, that have Associate Agreements with SDM London rather than SDMI.

31. SDM London's form of Associate Agreement is materially identical to the form of Associate Agreement between SDMI and other Associates.

32. SDM London has appointed SDMI as its agent to carry out certain obligations and duties undertaken by SDM London pursuant to its form of Associate Agreement.

History of the Associate Agreement

33. SDMI most recently updated the form of Associate Agreement in 2002 and 2010. The revised forms of agreement are referred to herein as the 2002 Associate Agreement and the 2010 Associate Agreement.

34. SDMI pleads and relies upon all of the terms of the 2002 Associate Agreement and the 2010 Associate Agreement.

35. All Associate Agreements that were based on a form in use prior to the 2002 Associate Agreement have expired.

36. The 2002 Associate Agreement has three versions with different terms: a one-year initial term, with a maximum of two consecutive renewals of one year each; a three-year initial term, with a maximum of two consecutive renewals of two years each; and a one-year term with no renewals.

37. The 2002 Associate Agreement remained in use until January 1, 2010.

38. On January 1, 2010, SDMI introduced the 2010 Associate Agreement for all new Associates and for all Associates whose term, inclusive of renewals, had expired on their existing Associate Agreement and to whom SDMI offered a new agreement.

39. The 2010 Associate Agreement is the current form of the Associate Agreement as of the date of this pleading.

40. The initial term of the 2010 Associate Agreement is one year, with a maximum of two consecutive renewal terms of approximately one year each.³ SDMI also has a version of the 2010 Associate Agreement that is for a one-year term, with no renewals.

41. Class Members may be parties to a 2002 Associate Agreement, a 2010 Associate Agreement, or both.

42. References to the "Associate Agreement" in the balance of this pleading should be read as applying to both the 2002 Associate Agreement and the 2010 Associate Agreement.

Roles and Responsibilities Under the Associate Agreement

43. In return for the licence to use the Shoppers Trade-marks and the other rights and privileges granted to the Associate under the Associate Agreement, an Associate must devote his or her full time and attention to the operation and management of all aspects of the Shoppers Store that is the subject of the Associate Agreement.

44. Among other things, Associates have the following responsibilities under the Associate Agreement:

- (a) maximizing profitability in their individual Shoppers Store(s);
- (b) supporting and/or protecting the Shoppers Drug Mart brand;

³ Technically, the term of the 2010 Associate Agreement is such number of "Accounting Periods" that are completed within 1 year of the date of the Agreement with two consecutive renewal terms of 13 Accounting Periods, but without further renewal after that date. There are approximately 13 Accounting Periods in one calendar year.

- (c) effectively implementing all store programs and standards;
- (d) observing and following all laws and regulations of federal, provincial and municipal governments and professional licensing authorities;
- (e) hiring and leading the store team;
- (f) providing overall leadership in their individual Shoppers Store(s); and
- (g) building and maintaining customer and patient relations.

45. By entering into an Associate Agreement, SDMI and the Associate agree that only such services and equipment as are specified by SDMI may be used by the Associate, and the Associate is not permitted to enter into any leases for equipment except with SDMI.

46. Associates, as pharmacists, are also subject to certain provincial statutory and regulatory obligations, in addition to their professional responsibilities.

47. Under the Associate Agreement, SDMI agrees to provide various services to the Associates. Section 5.01 of the 2002 Associate Agreement provides as follows:

Article 5.00 – Company’s Covenants

5.01 The Company in consideration of this agreement, agrees that it will render to the Associate the following services and assistance pertaining to the Franchised Business:

(a) assistance in store planning and store design;

(b) the acquisition and installation, on the Premises, of all furnishings, leasehold improvements, fixtures and equipment (hereinafter collectively referred to as the “Equipment”) as the Company deems appropriate for the conduct of a Franchised Business, it being understood and agreed that such Equipment shall at all times be and remain the property of the Company or its Affiliates, as the case may be. Only the Equipment as specified by the Company shall be used in the conduct of the Franchised Business and the Associate agrees that it will not

enter into any lease for Equipment with any person, firm or corporation other than the Company [...]

(c) the seeking out of sources of supply of merchandise and the provision of the advantages of bulk purchasing, where practical;

(d) the provision of efficient systems for bookkeeping and stock controls;

(e) the provision of advertising programs;

(f) the arrangement of certain insurance;

(g) the provision of training programs for staff;

(h) the provision of results of research on market trends of product lines;

(i) the provision of counselling with respect to merchandising and in respect of the operation and promotion of the Franchised Business;

(j) assistance regarding the Associate's dealings with the Provincial College of Pharmacy or other similar body having jurisdiction in the Province in which the Franchised Business is carried on;

(k) financial advice and consultation;

(l) consultations with the Associate regarding the establishment of an appropriate security program for the Franchised Business.¹

48. The Associate is not an agent of SDMI, but is an independent contractor. SDMI pleads and relies on Section 16.01 of the Associate Agreement.

49. By signing the Associate Agreement, Associates specifically acknowledge that they were given: (i) the opportunity to be advised by a professional advisor regarding all aspects of the agreement; and (ii) enough time to read and understand the provisions of the agreement. The defendants plead and rely on Section 17.12 of the Associate Agreement.

The Manual

50. SDMI denies that the documents pleaded at paragraph 85 of the Second Fresh as Amended Statement of Claim are specifications, standards, rules, policies and procedures relating to the operation of a Shoppers Store.

¹ Section 5.01 of the 2010 Associate Agreement is materially identical.

51. SDMI denies that these documents form, or ever formed, part of the “Manual” (as defined in the Associate Agreement) or otherwise form, or ever formed, part of the contract between SDMI and each Associate.

Law of the Contract

52. Each Associate Agreement is to be construed in accordance with the laws of the province in which the Shoppers Store that is the subject of the Associate Agreement is located. SDMI pleads and relies on Section 2.04 of the Associate Agreement.

Professional Allowances

The Generic Drug Supply Chain

53. SDMI acts as a pharmaceutical drug wholesaler. SDMI purchases drugs from manufacturers, maintains inventories of drugs, and resells the drugs to Associates, who dispense the drugs to patients.

54. Since 2003, Associates have been required to purchase generic drugs solely from SDMI.⁵ Associates submit purchase orders to SDMI for generic drugs listed by SDMI. SDMI satisfies these orders either from its inventory or by ordering drugs from the generic manufacturer.

55. Associates pay the same invoice price that is paid by SDMI to the generic manufacturers but before deduction of any rebates (whether described as “rebates” or “professional allowances”, depending on the applicable legislation at the time) received by SDMI.

⁵ There are some limited exceptions where Associates may order drugs directly from a wholesaler, such as if a Distribution Centre (as defined below) does not have inventory of a particular molecule.

56. SDMI has not charged, and does not charge, a distribution mark-up to Associates on generic drugs.

Evolution of the Regulation of Professional Allowances

57. Prior to 2006, the applicable legislation in Ontario – namely the *Ontario Drug Benefit Act* (the “ODBA”) and the *Drug Interchangeability and Dispensing Fee Act* (the “DIDFA”) – did not address the payment of rebates by generic drug manufacturers on purchases of generic drugs.

58. In 2006, the *Transparent Drug System for Patients Act, 2006* (the “TDSPA”) came into force. The TDSPA amended the ODBA and the DIDFA.

59. Since 2006, legislation in Ontario has prohibited drug manufacturers from paying, and wholesalers, franchisees, pharmacy operators and pharmacists from receiving, “rebates” on generic prescription drug products and prescription drug products listed on the public drug plan.

60. However, under the legislation that came into force in 2006, so-called “professional allowances” were created as a defined term and excluded from the definition of “rebates”.

61. The legislation defined “professional allowances” as “a benefit, in the form of currency, services or educational materials, that are provided by a drug manufacturer to [wholesalers, operators of pharmacies, or companies that own, operate or franchise pharmacies, or to their directors, officers, employees or agents] for the purposes of direct patient care...”

62. As of July 1, 2010, professional allowances are no longer permitted on sales of generic drugs within the public payor drug system (*i.e.*, the Ontario Drug Benefit (“ODB”) plan).

63. SDMI was permitted to continue receiving professional allowances on generic drugs dispensed in the private payor drug system, but these professional allowances were capped and eventually phased out entirely effective April 1, 2013.

SDMI's Receipt of Professional Allowances

64. Between 2006 and July 2010, SDMI received professional allowances from generic drug manufacturers on SDMI's purchases of generic drugs dispensed within the ODB plan.

65. During this same time frame, and continuing thereafter until April 1, 2013, SDMI also received professional allowances from manufacturers on SDMI's purchases of generic drugs dispensed in the private payor system.

66. These professional allowances were in the form of monies paid directly to SDMI by generic drug manufacturers.

67. In general, the professional allowances received by SDMI from each generic drug manufacturer were based on a percentage of the invoice price for generic drugs purchased by SDMI from the drug manufacturer.

68. The amount of professional allowances that could be received by SDMI was subject to limits imposed by applicable legislation.

69. SDMI did not pay or remit professional allowances to Associates, in the sense that SDMI did not make specific payments to an Associate that are identified as professional allowances to be used by the Associate for the purposes of performing direct patient care activities, and SDMI was not obligated to do so.

Direct Patient Care Reporting

70. During the relevant period, the applicable Ontario legislation required SDMI to report the amount of professional allowances received by SDMI from generic drug manufacturers and the amount expended for the purpose of providing direct patient care.

71. To comply with its reporting obligations with respect to expenditures for the purpose of providing direct patient care, SDMI required each Associate to complete, for each reporting period, an online form outlining the time and total amounts expended at the store for specified direct patient care activities.

72. SDMI used the information provided by Associates to report expenditures in Ontario for the purpose of providing direct patient care.

73. The direct patient care activities reported by Associates to SDMI were the same activities that Associates or their staff regularly performed prior to July 1, 2006, when the legislation regulating professional allowances was introduced. In other words, the direct patient care activities were not new activities or “extra work” being done by Associates.

74. Associates continue to perform these direct patient care activities as at the date of this pleading, even though professional allowances are no longer permitted.

75. SDMI never instructed Associates to perform particular direct patient care activities or to increase the amount of time or money spent on direct patient care activities for the purpose of increasing the amount of professional allowances that SDMI could receive from generic drug manufacturers.

76. At no time did the receipt of professional allowances influence how SDMI

encouraged or instructed Associates to operate the Shoppers Stores.

77. As of July 1, 2010, SDMI was no longer required by Ontario legislation to report its receipt of professional allowances or the total expenditures on direct patient care activities.

78. SDMI ceased requiring Associates to report to it on direct patient care activities after SDMI's legislative reporting obligation ended.

79. At all material times, SDMI's reporting of the amount of professional allowances received by SDMI from generic drug manufacturers and the amount expended for the purpose of providing direct patient care complied with applicable legislation, regulations and executive directions.

80. SDMI's reports regarding the amount of professional allowances received contain highly confidential commercially sensitive information, the public disclosure of which could seriously prejudice SDMI by giving its competitors a competitive advantage and/or adversely affecting SDMI's relationships with generic drug manufacturers. These reports were delivered to the Ontario government on a confidential basis in the expectation that they would at all times remain confidential.

81. SDMI had no obligation to disclose its reports to Associates.

SDMI Was Entitled to All Professional Allowances

82. Generic drug manufacturers paid professional allowances to SDMI pursuant to lawful agreements between SDMI and each manufacturer.

83. Under these agreements, SDMI calculated a professional allowance amount based upon a percentage of the price of generic drug molecules purchased from each manufacturer and

billed the amount back to the manufacturer. The manufacturer either paid the amount to SDMI or the amount was credited against SDMI's future purchases from the manufacturer.

84. This agreed percentage varied by manufacturer and by generic drug molecule and was subject to "caps" imposed by applicable legislation.

85. Each of the Class Members has expressly acknowledged and agreed that SDMI was entitled to the professional allowances. SDMI relies on Section 11.04 of the 2002 Associate Agreement and Section 11.10 of the 2010 Associate Agreement, which provide, in relevant part:

2002 Associate Agreement, Section 11.04

The Associate and Pharmacist acknowledge and agree that the Company shall be entitled to the benefit of any and all discounts, volume rebates, advertising allowances or other similar advantages that the Company or its Affiliates may obtain from any person, firm or corporation by reason of its supplying merchandise or services to the Associate or to associates of the Company or its Affiliates.

2010 Associate Agreement, Section 11.10

The Associate and Pharmacist acknowledge and agree that the Company shall be entitled to the benefit of any and all discounts, rebates, advertising or other allowances, concessions, or similar advantages obtainable from any person by reason of the supply of merchandise or services to the Company, the Associate or to Associates of the Company or its Affiliates.

86. Further, and in any event, there was no express or implied term of the Associate Agreement that entitled the Class Members to some or all of the professional allowance payments.

87. The defendants deny that the professional allowance payments received by SDMI are included in "Gross Sales", as defined in the 2002 Associate Agreement and 2010 Associate Agreement.

88. The defendants deny that the receipt and retention of professional allowances was

a breach of the Associate Agreement or breach of any duty of good faith or fair dealing in the performance of the Associate Agreement.

SDMI Was Not Unjustly Enriched by Professional Allowances

89. The agreements between SDMI and the generic drug manufacturers are a juristic reason for SDMI's receipt and retention of professional allowance payments from the manufacturers.

90. Further, and in any event, the Associate Agreements, and in particular Section 11.04 of the 2002 Associate Agreement and Section 11.10 of the 2010 Associate Agreement, are also juristic reasons for SDMI's receipt and retention of the professional allowance payments.

91. In addition, the Class Members have suffered no deprivation. As all Associates are, and were, required to purchase their generic drug requirements solely from SDMI, Associates were not permitted by contract to negotiate or enter into agreements with generic drug manufacturers under which professional allowances could be paid. Associates therefore did not have, and could not have had, any opportunity to receive professional allowance payments. SDMI pleads and relies on Section 6.01(j) of the 2002 Associate Agreement and the 2010 Associate Agreement.

92. Further, and in any event, at no material time did the applicable legislation in Ontario create any right of franchisee-pharmacists to professional allowance payments received by a franchisor.

93. SDMI has therefore not been unjustly enriched by its receipt and retention of professional allowances.

Fees Payable by Associates

94. Under the Associate Agreement, the Associate must pay certain fees to SDMI, as described below.

95. SDMI disclosed these fees to Associates.

(a) Advertising Contribution

96. Pursuant to Section 11.04 of the 2002 Associate Agreement and Section 11.05 of the 2010 Associate Agreement, Associates are required to pay a fee (the "Advertising Contribution") to SDMI as a contribution to the cost of advertising and marketing.

97. As the representative plaintiffs did not seek to certify any common issue relating to fees payable pursuant to Section 11.04 of the 2002 Associate Agreement and Section 11.05 of the 2010 Associate Agreement and the Court has not certified such a common issue, the defendants decline to plead to the plaintiffs' allegations regarding the Advertising Contribution at, *inter alia*, paragraphs 30 to 32 of the Second Fresh as Amended Statement of Claim at this time, beyond their denials as set out above.

98. The defendants reserve the right to plead to any claims in respect of the Advertising Contribution, in the event the plaintiffs choose to pursue any such claims following the common issues phase of this proceeding.

(b) Store Charges

99. Associates pay various charges to SDMI on account of the services and programs provided to Associates by SDMI. SDMI refers to these charges as "Store Charges". SDMI does not use, and has never used, the term "Cost Recovery Fees" to refer to these charges.

100. The services and programs provided by SDMI to Associates benefit Associates.

101. The Store Charges consist of the following:

- (a) **Academy Fee** – Associates pay a charge calculated as a percentage of Gross Non-Employee Sales for training that covers the costs of courses for franchisees, prospective franchisees and for the franchisees' employees.
- (b) **Retail Accounting Fee** – Associates pay a fee for bookkeeping and accounting services supplied by SDMI to Associates through SDMI's Retail Accounting Department.
- (c) **Insurance Fee** – Associates pay a fee for a blanket insurance program obtained by SDMI.
- (d) **Loss Prevention Fee** – Associates pay a fee for an overall loss prevention process and strategy for all Associates.
- (e) **IT Support Fee** – Associates pay a fee for technical support of computer systems.
- (f) **Dataline Communications Fee** – Associates pay a pre-tax charge for use of SDMI's data network.
- (g) **PIN Pad Fee** – Associates pay a fee for PIN pads provided to Associates, which allow Associates to process debit and credit card transactions through banks.
- (h) **Optimum Fee** – Associates pay a fee (the "Optimum Fee") for the Optimum Program, which is described in more detail below.

102. SDMI is expressly permitted to charge the Store Charges to each Associate pursuant to Section 11.05 of the 2002 Associate Agreement and Section 11.07 of the 2010 Associate Agreement:

2002 Associate Agreement, Section 11.05

11.05 The Associate acknowledges and agrees that the payments from time to time required of the Associate on account of the rental of the Equipment or the lease of the Premises or on account of services rendered by the Company in respect of (i) the establishment of a security program for the Franchised Business; (ii) training programs from time to time provided by the Company; (iii) taking of inventory, and (iv) other services from time to time rendered by the Company to the Associate that are not included in the services furnished by the Company to associates generally at the present time, shall be in addition to the fees payable by the Associate from time to time under Section 11.01 hereof. The fee or fees to be charged to the Associate for any such additional services shall be such amount or amounts as the Company, in the good faith exercise of its judgment, determine.

2010 Associate Agreement, Section 11.07

11.07 The Associate acknowledges and agrees that the payments from time to time required of the Associate on account of the rental of the Equipment or the lease of the Premises or on account of services or programs rendered or made available by the Company or its Affiliates in respect of (i) the establishment of a security program for the Franchised Business, (ii) training programs from time to time provided by the Company or its Affiliates, (iii) taking of inventory, (iv) loyalty programs from time to time developed by the Company or its Affiliates, and (v) other services or programs from time to time rendered or made available by the Company or its Affiliates to the Associate that are not included in the services or programs furnished by the Company or its Affiliates to Associates generally at the present time, shall be in addition to the Fee and other amounts payable by the Associate from time to time under this Agreement. The fee or fees to be charged to the Associate for any such additional services or programs shall be such amount or amounts as the Company shall determine in the good faith exercise of its judgment.

103. SDMI is expressly permitted to charge the Retail Accounting Fee to Associates pursuant to Section 6.03 of the Associate Agreement, which provides:

2002 Associate Agreement, Section 6.03:

6.03 At such time as the Company provides a centralized bookkeeping and accounting service to the Associate and other associates of the Company, the Associate agrees to appoint the Company to act as its agent to provide such bookkeeping and accounting services and to cooperate with the Company in the implementation and use of such centralized bookkeeping and accounting services. The Associate will pay to the Company such fee as may be determined by the Company from time to time in respect of the centralized bookkeeping and

accounting services, and will be released from its obligation to itself prepare and furnish reports, books, records, accounts and statements as provided for in Sections 6.01(k) and (l). The Associate acknowledges that the centralized bookkeeping and accounting services will be comprehensive and may include supervision of banking, payment of accounts payable, the collection of accounts receivable and the preparation of statements, balance sheets and other reports of the financial status of the Associate. The Associate and the Pharmacist will cooperate fully with the Company and provide to it all information required by the Company in order to perform the centralized bookkeeping and accounting service.

The services provided as part of the centralized bookkeeping and accounting service to the Associate will be as outlined in the bookkeeping and accounting manual to be provided by the Company to the Associate and the Associate agrees to comply with all of the policies and operating procedures prescribed from time to time by the Company in the bookkeeping manual or otherwise communicated to the Associate in writing.

The fee or fees to be charged to the Associate for the provision of a centralized bookkeeping and accounting service shall be such amount or amounts as the Company shall, in the good faith exercise of its judgment, determine, and shall be charged on a basis consistent with the basis on which such fees are determined for other associates in the Shoppers Drug Mart system.

2010 Associate Agreement, Section 6.03:

6.03 So long as the Company provides or arranges to provide a centralized bookkeeping and accounting service to the Associate and other Associates of the Company, the Associate agrees to and does hereby retain the Company to provide or arrange to provide such bookkeeping and accounting services and to cooperate with the Company in the implementation and use of such centralized bookkeeping and accounting services. The Associate will pay to the Company or the service provider (the "Service Provider") such fee as may be determined by the Company from time to time in respect of the centralized bookkeeping and accounting services, and will be released from its obligation to itself prepare and furnish reports, books, records, accounts and statements as provided for in Sections 6.01(k) and (l). The Associate acknowledges that the centralized bookkeeping and accounting services will be comprehensive and may include supervision of banking, payment of accounts payable, the collection of accounts receivable and the preparation of statements, balance sheets and other reports of the financial status of the Associate. The Associate and the Pharmacist will cooperate fully with the Company or the Service Provider and provide to it all information required by the Company in order to perform the centralized bookkeeping and accounting service.

The services provided as part of the centralized bookkeeping and accounting service to the Associate will be as outlined in the Manual and the Associate agrees to comply with all of the policies and procedures prescribed from time to time by the Company in the Manual or otherwise communicated to the Associate in writing.

The fee or fees to be charged to the Associate for the provision of a centralized bookkeeping and accounting service shall be such amount or amounts as the Company shall, in the good faith exercise of its judgment, determine, and shall be charged on a basis consistent with the basis on which such fees are determined for other Associates of the Company.

104. SDMI determines the Retail Accounting Fee for each Associate on a basis consistent with the basis on which such fees are determined for other Associates.

105. Further, pursuant to Section 6.02 of the Associate Agreement, the Associate expressly agrees to introduce, utilize and pay for information systems and technology specified by SDMI:

2002 Associate Agreement, Section 6.02

6.02 Recognizing the continuing need to optimize procedures for recording and reporting financial information, for merchandise reordering, for labour scheduling, for inventory control, and for otherwise operating the Franchised Business, the Associate agrees that the Company may from time to time require the Associate to introduce and utilize in the operation of the Franchised Business information systems and technology specified by the Company, including without limitation computerized bookkeeping, accounting, point-of-sale and inventory control systems. The Associate agrees on request of the Company to promptly purchase or otherwise obtain, implement and use any such system specified by the Company. All components of any such system may be purchased, leased or licensed only from sources of supply authorized in writing by the Company. The Associate agrees that it will not utilize in connection with the Franchised Business any computer hardware, application software, operating software, supplies or services that have not previously been approved by the Company in writing. The Associate further agrees, that upon request by the Company, it will execute any license agreements, confidentiality agreements, user agreements, letters or other documents whatsoever which the Company deems necessary in order to protect the said information systems and technology.

The Associate may not enhance or modify any such system without the Company's prior written approval. The Associate is solely responsible for paying all amounts owing to suppliers for any such system and in respect of the maintenance, service and support of any such system. The Associate shall follow all procedures established from time to time by the Company with respect to the use of such system, including without limitation, procedures for off-site back-up and implementation and use of new releases and updates. The Associate shall at its own expense obtain and maintain maintenance and support for all such information systems and technology, for the minimum hours of coverage specified from time to time by the Company, and from suppliers approved by the Company. The Associate agrees that it will not relocate any computer hardware forming a part of such information systems and technology without the prior written consent of the Company.

2010 Associate Agreement, Section 6.02

6.02 Recognizing the continuing need to optimize procedures for recording and reporting financial information, for merchandise reordering, for labour scheduling, for inventory control, and for otherwise operating the Franchised Business, the Associate agrees that the Company may from time to time require

the Associate to introduce and utilize in the operation of the Franchised Business information systems and technology specified by the Company, including without limitation computerized or electronic bookkeeping, accounting, point-of-sale and inventory control systems. The Associate agrees on request of the Company to promptly purchase, lease, license or otherwise obtain, implement and use any such system specified by the Company. All components of any such system may be purchased, leased, licensed or otherwise obtained only from sources of supply authorized in writing by the Company. The Associate agrees that it will not utilize in connection with the Franchised Business any computer hardware, application software, operating software, supplies or services that have not previously been approved by the Company in writing. The Associate further agrees, that upon request by the Company, it will execute any license agreements, confidentiality agreements, user agreements, letters or other documents whatsoever which the Company deems necessary in order to protect the said information systems and technology.

The Associate may not enhance or modify any such system without the Company's prior written approval. The Associate is solely responsible for paying all amounts owing to suppliers for any such system and in respect of the use, maintenance, service and support of any such system. The Associate shall follow all procedures established from time to time by the Company with respect to the use of such system, including without limitation, procedures for off-site back-up and implementation and use of new releases and updates. The Associate shall at its own expense obtain and maintain maintenance and support for all such information systems and technology, for the minimum hours of coverage specified from time to time by the Company, and from suppliers approved by the Company. The Associate agrees that it will not relocate any computer hardware forming a part of such information systems and technology without the prior written consent of the Company.

106. SDMI determines each of the Store Charges in the good faith exercise of its judgment.

107. SDMI sets the Store Charges using a variety of approaches, depending on the nature of the charge, as follows:

(a) The Academy Fee, the Insurance Fee and the Loss Prevention Fee are set at a percentage of each store's Gross Non-Employee Sales on the assumption that each store's use of these services is proportionate to the size of the store, as follows:

(i) Academy Fee ~ 0.028% of Gross Non-Employee Sales

- (ii) Insurance Fee – 0.1% of Gross Non-Employee Sales (pre-tax)
 - (iii) Loss Prevention Fee – 0.07% of Gross Non-Employee Sales by the Associate
- (b) The Retail Accounting Fee is also set based on each store's Gross Sales on the assumption that larger, busier stores will need more accounting support. The Retail Accounting Fee levied for these services ranges from \$6,080 per annum for stores with Gross Sales of \$4,251,000 or less to \$18,905 per annum for stores with Gross Sales of \$11,662,000 or more.
- (c) The IT Support Fee, the Dataline Communications Fee and the PIN Pad Fee are set using "postage stamp pricing" (*i.e.*, one fixed amount charged to all stores). The underlying principle is that SDMI invests in technology across the country and all stores have access to essentially identical services, regardless of their sales or other factors. The IT Support Fee is a pre-tax charge of \$725 per period. The Dataline Communications Fee is a pre-tax charge is \$650 per period. SDMI currently charges each Associate for the PIN pads based on a per period flat charge of \$17, a charge which has been reduced.

108. SDMI denies the plaintiffs' allegation at paragraph 54 of the Second Fresh as Amended Statement of Claim that the Store Charges "are intended to allow the Defendant to recover only the costs of the specified services, and not to be a source of profit for the Defendant." The plaintiffs' allegation ignores the plain text of the Associate Agreement, particularly the provisions set out in paragraphs 102 to 105 above.

109. SDMI's overall approach to Store Charges is to set them at a level that the aggregate of charges paid by Associates is sufficient for SDMI to recover its capital investments, including a reasonable return on capital, and the operating costs associated with the programs and services provided to Associates.

110. However, the cost to SDMI of providing a service or program to an individual Associate may be greater than or less than the fee paid in respect of that service or program by that specific Associate.

(c) Occupancy Charge

111. SDMI (or one of its affiliates) leases almost all of the Shoppers Store premises from third party landlords. SDMI or an affiliate is the tenant under these leases.

112. Associates are not tenants or otherwise party to the leases with these third party landlords. Associates have no obligations to third party landlords and may terminate their Associate Agreements on notice at any time.

113. Pursuant to Section 6.01(c) of the Associate Agreement, each Associate agrees to pay all rent and other occupancy costs under the lease for the store premises:

2002 Associate Agreement, Section 6.01(c)

6.01 Throughout the term of this agreement and any renewal thereof, the Associate and the Pharmacist jointly and severally agree:

(c) to perform and observe all of the covenants on the part of the lessee contained in the lease of the Premises the particulars of which are set forth in Schedule "A" hereto, including the payment of all amounts reserved thereby and to indemnify and save the Company and its Affiliates harmless of and from any and all claims which may arise or be asserted against them or any of them by reason of the said lease during the term of this agreement;

2010 Associate Agreement, Section 6.01(c)

6.01 Throughout the Term of this Agreement, the Associate and the Pharmacist jointly and severally agree:

(c) to perform and observe all of the covenants on the part of the lessee contained in the lease of the Premises the particulars of which are set forth in Schedule "A" hereto, including the payment of all amounts reserved thereby and to indemnify and save the Company and its Affiliates harmless of and from any and all claims which may arise or be asserted against them or any of them by reason of the said lease during the Term of this Agreement;

114. Pursuant to these provisions of the Associate Agreement, SDMI charges a fee (the "Occupancy Charge") to each Associate based upon the amount of rent, Common Area Maintenance ("CAM") and realty tax payable under the applicable lease for the store for that year.

115. The Occupancy Charge reflects the actual amount of rent, CAM and realty tax payable under the applicable lease, without any mark-up by SDMI.

116. SDMI absorbs any unanticipated variances in rent, CAM or realty tax over the course of the year. In other words, if the amount of rent, CAM or realty tax payable under the lease for a store's premises unexpectedly increases during a year, SDMI will not hold the Associate accountable for the occupancy variance.

117. In the small number of cases in which SDMI owns the store premises, the Associate pays an Occupancy Charge for the premises, including an annual rental fee based on the fair market rent for the premises. SDMI denies that the Occupancy Charge in these cases is in excess of a commercially reasonable rate for the store premises.

118. Schedule "A" to each Associate Agreement sets forth the particulars of the lease of the premises for the Shoppers Store, including the term and minimum rent.

119. Further, SDMI prepares and provides to the Associate a summary of the material terms of the lease for the store.

120. SDMI also discloses the Occupancy Charge payable by the Associate on an annual basis.

121. SDMI does not provide Associates with copies of the leases that SDMI enters into with third party landlords, nor does it have any obligation under the Associate Agreement or at law to do so.

122. For some but not all Shoppers Stores, SDMI does receive inducements from third party landlords to enter into a lease, such as a rent free period, during which SDMI does not pay rent to the third party landlord, or a tenant allowance, which is paid by the landlord to SDMI towards the construction of tenant improvements.

123. When SDMI receives tenant allowances, SDMI does not disclose to the Associate operating the stores in question the fact of its receipt of the allowance or the amount of the specific allowance, nor does it have any obligation to do so under the Associate Agreement or at law.

124. SDMI receives the landlord inducements pursuant to lease agreements between it and third party landlords.

125. SDMI has no obligation to adjust the Occupancy Charge payable by a given Associate in light of landlord inducements in respect of a store operated by the Associate, and the Class Members have no right under the Associate Agreement or under any duty of good faith

or fair dealing to receive any benefit of landlord inducements that SDMI may have received during the class period.

126. SDMI relies on Section 11.04 of the 2002 Associate Agreement and Section 11.10 of the 2010 Associate Agreement in support of its receipt of landlord inducements.

127. Accordingly, SDMI's receipt of landlord inducements does not breach either the Associate Agreement or any duty of good faith or fair dealing.

128. In any event, during a rent free period, SDMI does not charge the Associate the rent component of the Occupancy Charge.

129. Further, SDMI uses tenant allowances to reduce the book value of the Equipment (as defined below) installed at the store, which in turn reduces the Equipment Rental Fee (as defined below) payable by the Associate.

(d) Equipment Rental Fee

130. SDMI purchases fixtures, leasehold improvements and equipment (collectively, "Equipment") for each Shoppers Store and leases the Equipment to the Associate, pursuant to Subsection 5.01(b) of the Associate Agreement:

2002 Associate Agreement, Section 5.01(b)

5.01 The Company, in consideration of this agreement, agrees that it will render to the Associate the following services and assistance pertaining to the Franchised Business:

...

(b) the acquisition and installation, on the Premises, of all furnishings, leasehold improvements, fixtures and equipment (hereinafter collectively referred to as the "Equipment") as the Company deems appropriate for the conduct of a Franchised Business, it being understood and agreed that such Equipment shall at all times be and remain the property of the Company or its Affiliates, as the case may be. Only the Equipment as specified by the Company

shall be used in the conduct of the Franchised Business and the Associate agrees that it will not enter into any lease for Equipment with any person, firm or corporation other than the Company. All Equipment shall be leased to the Associate upon terms and conditions to be mutually agreed upon between the parties from time to time. For greater certainty, it is acknowledged and agreed that all Equipment presently located on the Premises is the exclusive property of the Company or its Affiliates, as the case may be. The Associate further agrees that any asset (including but not limited to computer software) purchased for the Franchised Business and which has previously been classified as an expense of the Franchised Business in accordance with generally accepted accounting principles shall automatically be acquired by the Company under the terms of Section 13.06 hereof upon any termination of this agreement without any additional compensation being due to the Associate pursuant to Section 13.07.

2010 Associate Agreement, Section 5.01(b)

5.01 The Company agrees that it will render or cause to be rendered to the Associate the following services and assistance pertaining to the Franchised Business:

...

(b) the acquisition and installation, on the Premises, of all furnishings, leasehold improvements, fixtures and equipment (hereinafter collectively referred to as the "Equipment") as the Company deems appropriate for the conduct of the Franchised Business, it being understood and agreed that such Equipment shall at all times be and remain the property of the Company or its Affiliates, as the case may be. Only the Equipment as specified by the Company shall be used in the conduct of the Franchised Business and the Associate agrees that it will not enter into any lease for Equipment with any person, firm or corporation other than the Company or its Affiliates. All Equipment shall be leased to the Associate upon terms and conditions to be mutually agreed upon between the Associate and the Company or its Affiliates. For greater certainty, it is acknowledged and agreed that all Equipment presently located on the Premises is the exclusive property of the Company or its Affiliates, as the case may be. The Associate further agrees that any asset (including but not limited to computer software) purchased for the Franchised Business and which has previously been classified as an expense of the Franchised Business in accordance with generally accepted accounting principles shall automatically be acquired by the Company under the terms of Section 13.06 hereof upon any termination of this Agreement without any additional compensation being due to the Associate pursuant to Section 13.07;

131. SDMI charges each Associate a fee (the "Equipment Rental Fee") for the use of Equipment in the Associate's store pursuant to Section 11.05 of the 2002 Associate Agreement and Section 11.07 of the 2010 Associate Agreement.

132. The Equipment Rental Fee is generally based upon the useful life of the Equipment in the store. It is calculated as follows:

- (a) a 2 year asset has a lease rate of 55.91 % of the cost of the asset per annum;
- (b) a 3 year asset has a lease rate of 39.27% of the cost of the asset per annum;
- (c) a 5 year asset has a lease rate of 26.08% of the cost of the asset per annum;
- (d) a 10 year asset has a lease rate of 16.53% of the cost of the asset per annum; and
- (e) a 15 year asset has a lease rate of 13.64% of the cost of the asset per annum.⁶

133. SDMI set these lease rates to recover its original capital investment as well as a reasonable return on the invested capital.

134. SDMI denies that it had any obligation to set Equipment Rental Fees at a “commercially reasonable rate”.

135. In any event, the Equipment Rental Fees charged to each Associate were less than the cost of leasing the Equipment in the open market, taking into account that the SDMI did not require additional security from the Associate.

136. The leasing of Equipment to Associates benefits Associates.

137. SDMI discloses the planned Equipment Rental Fee to Associates for each year.

138. By their conduct, including by using the Equipment, the Class Members accept and agree to the terms and conditions on which SDMI leases the Equipment, including agreeing

⁶ Previously, SDMI also had a 7 year asset class, which had a lease rate of 20.54% of the cost of the asset per annum.

to pay the applicable Equipment Rental Fee in accordance with the lease rates specified by SDMI.

139. Accordingly, by charging Associates the Equipment Rental Fee, SDMI does not breach the Associate Agreement or breach any duty of good faith or fair dealing.

(e) Optimum Fee

140. The Optimum Program is a loyalty points program.

141. The Optimum Program operates at all Shoppers Stores.

142. Under the Optimum Program, customers accumulate points when they purchase goods, and these points can be redeemed for discounts on product purchases.

143. The Optimum Program is a benefit to Associates.

144. Three types of points are issued under the Optimum Program: (1) Base Points; (2) Bonus Points; and (3) Partner Points.

145. To fund the Base Points, SDMI charges a fee (the "Optimum Fee") to each Associate pursuant to Section 11.05(iv) of the 2002 Associate Agreement and Section 11.07(iv) of the 2010 Associate Agreement.

146. The Optimum Fee charged to each Associate depends on the volume of Base Points issued at each Associate-operated store. The calculation of the Optimum Fee does not depend on redemptions of points or promotions.

147. Associates are not charged for Bonus Points or Partners Points when these points are issued to customers.

148. When points are redeemed for a discount at a store, they are treated as a form of tender, like cash or credit cards.

149. As SDMI is permitted to charge the Optimum Fee pursuant to the Associate Agreement, SDMI did not breach the Associate Agreement or breach any duty of good faith or fair dealing by charging the Optimum Fee to the Class Members.

150. In the alternative, if the 2002 Associate Agreement does not permit SDMI to charge of the Optimum Fee and SDMI is liable to repay the Optimum Fee charged to members of the 2002 Agreement Class (which is not admitted but denied):

- (a) The members of the 2002 Agreement Class knowingly and willingly accepted the benefit of the Optimum Program and did not refuse to pay or object to paying the Optimum Fee prior to this proceeding.
- (b) SDMI provided the Optimum Program to the 2002 Agreement Class in reliance on the payment of the Optimum Fee.
- (c) The 2002 Agreement Class members were enriched by the benefits conferred by the Optimum Program.
- (d) There was a corresponding deprivation of SDMI, in that it incurred costs to operate the Optimum Program, which benefitted the members of the 2002 Agreement Class.
- (e) SDMI did not intend to provide the Optimum Program to members of the 2002 Agreement Class without receiving compensation from those Associates.

- (f) There was no juristic reason for the enrichment of the members of the 2002 Agreement Class, and therefore the members of the 2002 Agreement Class would unjustly enriched.
- (g) The benefits received by each member of the 2002 Agreement Class from the Optimum Program are clearly connected with the claim for repayment of the Optimum Fees charged to members of the 2002 Agreement Class, and so it would be inequitable and manifestly unjust to allow the 2002 Agreement Class to receive repayment without consideration of the benefits received.
- (h) The value of the benefit received by each Associate from the Optimum Program must therefore be set off against any amount of the Optimum Fee that the defendants may be liable to return to the members of the 2002 Agreement Class, such liability being denied.
- (i) The defendants rely on unjust enrichment and the doctrine of equitable set-off.
- (j) By their conduct, including accepting the benefit of the Optimum Program, all members of the 2002 Agreement Class have waived any breach of the 2002 Associate Agreement.

The Annual Budget Planning Process

151. As this Court has not certified common issues relating to the plaintiffs' claims in respect of the budgeting process, the defendants decline to plead to the plaintiffs' allegations regarding the budgeting process at, *inter alia*, paragraphs 121 to 128 of the Second Fresh as Amended Statement of Claim at this time, beyond their denials as set out above.

152. The defendants reserve the right to plead to the plaintiffs' claims in respect of the budgeting process, in the event the plaintiffs choose to pursue those claims following the common issues phase of this proceeding.

The Distribution Centres

153. SDMI operates a number of distribution centres (the "Distribution Centres") to supply products to Shoppers Stores.

154. The Distribution Centres distribute prescription drugs (generic and non-generic) and most front-store merchandise.

155. Associates are required (with limited exceptions) to obtain all products from the Distribution Centres. Subsection 6.01(j) of the 2010 Associate Agreement provides, in relevant part:

Throughout the Term of this Agreement, the Associate and the Pharmacist jointly and severally agree:

...
(j) to advertise and sell in connection with the Franchised Business only such goods and to provide only such services as are approved by the Company in writing from time to time and are not thereafter disapproved.

The Associate agrees that the maintenance of the standards of quality and uniformity of goods sold or merchandised and services provided, at or from Shoppers Drug Mart stores is essential to the goodwill, success and continued public acceptance of the Shoppers Drug Mart system, for the benefit of the Company, the Associate and all other Associates licensed by the Company to operate a retail store using the Shoppers Drug Mart system and the Shoppers Marks. Accordingly, the Associate agrees to (A) sell, merchandise, promote or otherwise deal in products specified from time to time by the Company to be offered in the operation of the Franchised Business and provide only such services specified from time to time by the Company to be offered in the operation of the Franchised Business; (B) purchase all materials and supplies needed for the operation of the Franchised Business, and all products specified from time to time by the Company to be offered in the operation of the Franchised Business, either directly from the Company or from such other suppliers specified from time to time by the Company, which may include an Affiliate.

So long as the Company has established a Distribution Centre or Centres (which may be owned and managed by the Company, an Affiliate or a third party designated by the Company) for certain of the products specified from time to time by the Company to be offered in the operation of the Franchised Business, the Associate shall purchase all of its requirements of these items solely from the Distribution Centre(s). The prices charged by the Distribution Centre(s) will, when assessed as a whole over a reasonable period of time, be competitive. Despite anything contained in this Agreement, the Company will not be liable for any delay or failure to supply these items due to any circumstances beyond its control.

If:

(A) the Distribution Centre(s) choose not to carry certain of the products specified from time to time by the Company to be offered in the operation of the Franchised Business, the Associate shall purchase such products directly from suppliers which are designated by the Company to be part of a specialized supplier distribution network ("Direct Suppliers");

(B) the Distribution Centre(s) established by the Company (i) are incapable of supplying to the Associate its total requirements of any products specified from time to time by the Company to be offered in the operation of the Franchised Business, or (ii) do not supply or carry certain products which are approved by the Company for sale in the Franchised Business, or (iii) if certain products are not available from either the Distribution Centre(s) or a Direct Supplier, then the Associate shall purchase such products from a secondary supplier designated in writing by the Company for the Franchised Business ("Secondary Supplier"); and

(C) the Associate wishes to sell certain products to meet the particular customer needs of the Franchised Business, which products are not otherwise specified by the Company to be offered in the operation of the Franchised Business, the Associate may purchase these items from other suppliers so long as the products:

(i) are of a similar or superior quality to the type of products specified from time to time by the Company to be offered in the operation of the Franchised Business;

(ii) will not result in a violation of any agreement which the Company may have with its suppliers (including Direct and Secondary Suppliers);

(iii) comply with all current packaging, labelling and language legislation;

(iv) are legitimate products not in violation of the trade-marks, trade dress, copyright, industrial design, patent, or other proprietary rights of any third party; and

(v) do not conflict with any products carried or offered for sale by the Distribution Centre(s) in the case of products which are "discontinued" or "close-out product lines".

The Associate acknowledges that the Company may add to or remove from the products or services specified from time to time by the Company that will be

provided or sold in connection with the Franchised Business, in which event the Associate will promptly conform to any such changes.

156. SDMI discloses these inventory purchasing requirements to Associates.

157. Further, all Associates expressly agree to operate the stores in conformity with the standards prescribed by SDMI. Section 6.01(b) of the 2010 Associate Agreement provides:

Throughout the Term of this Agreement, the Associate and the Pharmacist jointly and severally agree:

(b) to conduct the Franchised Business in an orderly and business-like manner, in compliance with all laws, rules, regulations and orders as are applicable to the Associate, to the Pharmacist and to the Franchised Business, and strictly in conformity with all specifications, standards, rules, policies and procedures from time to time prescribed by the Company relating to the operation of the Franchised Business (including without limitation the nature, type and quality of goods and services offered for sale by the Franchised Business and the maximum sale prices established for such goods and services, the safety, maintenance, cleanliness, function and appearance of the Premises and its contents, the general appearance, dress and use of prescribed uniforms and name badges by all employees, the use of the Shoppers Marks, hours during which the Franchised Business is open for business, and the use and retention of standard forms. Specifications, standards, rules, policies and procedures prescribed from time to time by the Company in the Manual, or otherwise communicated to the Associate in writing, shall constitute provisions of this Agreement as if fully set forth herein, and all references herein to this Agreement shall include all such specifications, standards, rules, policies and procedures. The Associate acknowledges that changes in such specifications, standards, rules, policies and procedures will be necessary from time to time and agrees that the Company may at its option from time to time add to, subtract from, or otherwise modify the Manual and any specifications, standards, rules, policies and procedures. The master copy of the Manual maintained by the Company shall govern if there is a dispute relating to the contents of the Manual. The Associate acknowledges and agrees that the uniform application of such specifications, standards, rules, policies and procedures is vitally important to the preservation of the goodwill and prestige which the Company enjoys with the public and to the collective success of all Associates. The Associate hereby acknowledges receipt and loan of a copy of the Manual in written or electronic format and it undertakes not to disclose the same or its contents to any person, except insofar as it may be necessary in the conduct of the Franchised Business or make any reproductions or copies thereof, in whole or in part, without the prior written approval of the Company. The Manual, together with any copies or reproductions thereof, including any copies stored in electronic format, shall at all times remain the

⁷ Section 6.01(j) of the 2002 Associate Agreement is materially identical.

sole property of the Company and shall promptly be returned to it upon the termination of this Agreement.⁸

Mass Order Generations (MOGs)

158. The term “MOGs” is a term used within SDMI to describe a mass delivery of product from its Distribution Centres to individual Associate stores.

159. SDMI uses MOGs, and Associates are obligated to accept MOG orders, pursuant to the Associate Agreement and standards prescribed by SDMI.

160. MOGs generally fall within one of the following categories:

- (a) **Flyer MOGs** – Products that are delivered to the stores to support the sale of products that are included in the weekly store advertising flyer.
- (b) **Seasonal Program MOGs** – Products that are consumed during various seasons or holidays in the year.
- (c) **Cosmetic Launch MOGs** – New cosmetic products that are launched in pre-packaged form.
- (d) **Prepack MOGs** – Products that have been prepackaged prior to delivery to the stores.
- (e) **New planogram item MOGs** – Products that are sent to a store to support a new planogram (display).
- (f) **Auto-Replenishment MOGs** – Product that is automatically sent to stores based on an automatic replenishment model to maintain quantities.

⁸ Section 6.01(b) of the 2002 Associate Agreement is materially identical.

161. For a period of time, SDMI had a category of MOGs referred to as “Service Level MOGs”, which were MOGs intended to buffer store inventory of core products through key selling periods. SDMI discontinued the use of Service Level MOGs a number of years ago.

162. Contrary to the allegations in paragraphs 111 to 113 of the Second Fresh as Amended Statement of Claim, SDMI does not use MOGs to send “excess inventory” to Associates to “move this inventory from the SDM Distribution Centre” and “shift[] a part of the cost of stale merchandise from the Defendants to the individual Class Members”. The plaintiffs’ allegations regarding why and how SDMI uses MOGs are simply false.

163. On the contrary, when perishable inventory at the Distribution Centre reaches its expiry date, SDMI writes off such inventory, absorbing the entire cost at a head office level.

164. In the past, in cases where MOG products were approaching their expiry date, SDMI shipped the product at 50% off reduced store cost. In the event that any product remained at the store level at the time of expiry, the store was credited with the balance. In other words, the stores were fully compensated for any margin investment or remaining product that they could not sell so that the store was kept 100% whole on profitability. SDMI no longer engages in this practice; when product is approaching its expiry date and SDMI does not expect the product can be sold through a store prior to the expiry date, it will write off the product.

Process for MOGs

165. Generally speaking, the criteria for MOG selection are items for which the stores have limited history or experience in determining an appropriate order quantity or items that stores frequently run out of early in a promotional week.

166. SDMI uses sophisticated analytics to estimate the appropriate product quantities for MOGs. Generally speaking, to determine MOG quantities, SDMI's analytical tools will consider the following variables:

- (a) for a Flyer MOG, the current inventory for the MOG product at each individual store;
- (b) whether the MOG product is carried at the store;
- (c) anticipated sales for the MOG product for each store;
- (d) the prior season's sell through;
- (e) whether the product has experienced an increase in sales at each store through seasonality or on major event promotions;
- (f) promotional activity at each store between the time the MOG product is determined and the actual flyer date;
- (g) product that is out-of-stock;
- (h) lost sales; and
- (i) the category of store.

167. As part of the MOG process, district managers also review the allocations of product.

168. As a result of this process, MOGs may vary from store to store. Not all stores receive all MOGs.

169. MOG ordering is not a perfect science, and there may be cases where a MOG results in the delivery of unsuitable quantities or types of products to a particular store.

170. Where this happens, Associates have a number of options available to them for dealing with this inventory, including selling the product to another Associate or raising the matter with the Associate's district manager, who may facilitate a transfer to another store.

171. Further, some categories of products are returnable by the Associate to the vendor in some circumstances, resulting in no loss to the Associate.

MOGs Benefit Associates

172. SDMI uses MOGs for legitimate business purposes and denies that SDMI's use of MOGs is prejudicial to Associates.

173. On the contrary, the use of MOGs increases overall sales at the individual stores by reducing the frequency of out of stock items and increasing (or at least maintaining) customer loyalty.

174. In particular, with respect to the plaintiffs' allegation at paragraph 113 of the Second Fresh as Amended Statement of Claim that "Class Members may be forced to discount the price of these unwanted goods to sell them to customers", the plaintiffs ignore the lost sales and lost profits that would result in the event a store is unable to make sales because the Associate is out of stock.

175. Associates have the ability to escalate a complaint regarding a MOG to their district manager, who will investigate and determine whether any action should be taken.

176. Further, and in any event, the use of mass product delivery is common and widely accepted in the retail industry.

Inventory Adjustment Claims

177. SDMI has prescribed standards relating to inventory adjustment claims as part of its Distribution Centre Claims and Receiving Policies and Procedures (the “DC Claims and Receiving Policies”).

178. Section 6.01(b) of the Associate Agreement expressly requires Associates to comply with standards prescribed by SDMI, including without limitation the DC Claims and Receiving Policies.

179. SDMI consults with Associates regarding the DC Claims and Receiving Policies through working groups established from time to time.

180. As set out below, the provisions of the DC Claims and Receiving Policies impugned by the plaintiffs were established in good faith, are not unfair and are in accordance with reasonable commercial standards.

181. Accordingly, the impugned provisions of the DC Claims and Receiving Policies do not breach any duty of good faith or fair dealing.

Claim Submission Time Limits

182. Under the DC Claims and Receiving Policies, if there are any discrepancies in an order, the store must submit a claim within a certain period of time.

183. The purpose of the time limit is to protect the integrity of the claims process and to allow SDMI to properly investigate the claim to ensure the accuracy of the on-hand inventory.

184. The time limit is based on a reasonable assumption about how long it should take an Associate to merchandise a delivery and identify shipping errors or damaged products.

185. Claims for seasonal inventory are an exception and are subject to a longer time limit. The rationale for this exception is that seasonal products may not be merchandised immediately upon delivery, and so it may take longer for an Associate to detect missing or damaged seasonal products. SDMI introduced this exception in 2008 or 2009 following consultation with Associates.

186. The time limit reflects a fair and reasonable balancing of the costs and benefits of investigating claims to the entire system.

187. The time limit is in accordance with reasonable commercial standards.

Minimum Claim Values

188. Under the DC Claims and Receiving Policies, SDMI will not process certain claims with claim values of less than specified minimums.

189. Investigating claims requires an expenditure of time by both the Associate's staff and staff at SDMI's Distribution Centres.

190. The minimum claim values protect against Associates and SDMI incurring greater costs to identify, submit, investigate and resolve a claim than the value of the product that is the subject of the claim.

191. The minimum claim values reflect a fair and reasonable balancing of the costs and benefits of investigating claims to the entire system.

192. Further, SDMI has reduced the upcharge to Associates on products shipped from the Distribution Centre as a result of costs savings realized from the minimum claim values.

193. The minimum claim values are in accordance with reasonable commercial standards.

Receiving Policy

194. The DC Claims and Receiving Policies provide Associates should do a complete pallet and tote count at the time a delivery is received from a Distribution Centre.

195. SDMI does not advise Associates to do a detailed item-by-item inventory count because, among other things, it is not efficient for either SDMI or Associates.

196. SDMI's direction regarding the receiving process reflect a fair and reasonable balancing of the costs and benefits of the time spent receiving products.

197. This aspect of the DC Claims and Receiving Policies is in accordance with reasonable commercial standards.

Claims Escalation Process

198. Associates have the ability to escalate a claim under the DC Claims and Receiving Policies to their district manager, who will investigate and determine whether an exception should be made.

Limitations Defence

199. The representative plaintiffs and some or all of the Class Members discovered, or ought to have discovered, some or all of the claims asserted in this proceeding more than two years prior to the commencement of this proceeding.

200. Further, with respect to claims based conduct, events or other facts that allegedly occurred prior to January 1, 2004, the representative plaintiffs and some or all of the Class Members discovered, or ought to have discovered, such claims prior to January 1, 2004 or, in the alternative, at least two years prior to the commencement of this proceeding.

201. The defendants plead and rely on, *inter alia*, sections 4, 5 and 24 of the *Limitations Act, 2002*, S.O. 2002, c. 24, Sched. B, as amended and, *inter alia*, section 45 of the *Limitations Act*, R.S.O. 1990, c. L.15, as amended.

Damages

202. The defendants deny that the representative plaintiffs or any of the Class Members have each in fact suffered any injury, loss or harm caused by the defendants' conduct.

203. In the alternative, the alleged injuries, losses and harms are excessive, not reasonably foreseeable, speculative and too remote to be recoverable at law.

204. Some or all of the Class Members have fully mitigated any damages, such damages being denied.

205. In the further alternative, some or all of the Class Members have failed to take reasonable steps to fully mitigate their alleged damages.

206. The defendants ask that this action be dismissed with costs on a full indemnity basis.

April 30, 2014

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Court File No. CV-10-414774-00CP

**ONTARIO
SUPERIOR COURT OF JUSTICE**

PROCEEDING COMMENCED AT
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STATEMENT OF DEFENCE

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