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HEALTHCARE SERVICES:

An Accidental Franchise?

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Franchises and healthcare services may not appear to have much in common. Franchising conjures up the image of uniform products sold by minimally-skilled clerks from a chain outlet. However, franchising has expanded beyond fast food, hotels, and car rental businesses. Over 60 industries utilize franchising as a method of distributing goods and services, from financial services to high tech data and video distribution.

Likewise, the traditional image of healthcare -- licensed professionals, providing carefully considered and thorough advice and care on an individualized basis -- is also evolving, with new and innovative healthcare organizations and delivery systems. Furthermore, many industries that deliver healthcare services have already embraced franchising as a method of doing business. For example, there are franchised dental care clinics, optical stores, home infusion therapy businesses, pharmacies and drug stores, weight loss programs, vitamin and nutrition stores, and home healthcare agencies.

A recognition of the varied methods by which healthcare services are delivered, and the broad sweep of the laws that regulate franchising, reveals that there exists a business and legal nexus between healthcare and franchising. This article will discuss how a healthcare service provider may be subject to -- accidentally or intentionally -- the federal and state laws that regulate franchising.

The healthcare industry is changing. Managed care has spawned a variety of new healthcare entities and delivery systems, such as health maintenance organizations, preferred provider organizations, independent practice associations, management service organizations and physician practice management companies. In addition, technology and innovation have led to new techniques, programs, therapies, and treatments that can be offered to patients as part of an individual physician's practice or the services of a managed care organization. As healthcare service organizations seek efficiencies in providing services, and find the need to "compete" for patients and revenue, certain healthcare delivery models may exhibit traits of franchising. As that happens, healthcare pro-

viders need to be cognizant of the franchise laws.

To highlight the potential applicability of franchise laws to healthcare providers, this article will consider two examples of healthcare organizations or healthcare services: physician practice management companies or PPMCs, and a licensed medical diagnostic technique. A PPMC provides various administrative and marketing services to the physicians in exchange for a management fee. PPMCs may be established as a means by which physicians or groups of physicians operate under a similar name, trademark or service mark, and derive the benefits of increased name, or "brand," recognition. A second example, for illustrative purposes, is a new medical treatment that involves an optical diagnostic technique and a related therapy. The tests and treatment are marketed under a particular trade name or mark, and are sold or licensed to physicians or practice groups who offer the testing and therapy to their patients. As discussed below, these two models may bear traits typically associated with franchising, and may be subject to the franchise laws.

I. Franchise Laws: An Overview

There are generally two types of franchise laws in the United States: (1) franchise sales laws, and (2) franchise relationship laws.

A. Franchise Sales Laws: Disclosure and Registration

Franchise sales laws are designed to protect prospective franchisees, principally by providing franchisees with full disclosure of the relationship they are about to enter. Disclosures are made in the form of a prescribed offering circular. The Federal Trade Commission has adopted a trade regulation rule entitled "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures" (the "FTC Rule") (16 C.F.R. § 436), which requires that franchisors provide an offering circular for franchise sales in the 50 states and the District of Columbia. In addition to the FTC Rule, 15 states, including Maryland, have enacted franchise sales (or franchise investment) laws, that require pre-sale disclosure to prospective franchisees, and require that the franchise offering circular be filed with, and/or approved by, state authorities before it is used. The approval process is referred to as "registration." These states, referred to as "franchise registration states," are California, Hawaii, Illinois, Indiana, Maryland,

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Michigan (filing only, no substantive review), Minnesota, New York, North Dakota, Oregon (disclosure, but no filing or review), Rhode Island, South Dakota, Virginia, Washington, and Wisconsin (filing only, no substantive review).

The franchise registration states, through statute or regulation, have adopted the Uniform Franchise Offering Circular ("UFOC") Guidelines (promulgated by the North American Securities Administrators Association) as the rules for preparing offering circulars. Despite the word "uniform," the UFOCs are not uniform because, as part of the registration process, franchisors must make state-specific changes to the agreements and UFOCs. The FTC has ruled that offering circulars prepared in accordance with the UFOC Guidelines (which are generally referred to as "UFOCs") satisfy the FTC Rule. Therefore, most franchisors prepare and furnish a UFOC to prospective franchisees.

B. Franchise Relationship Laws

While the franchise sales laws address the franchise sales process, and are designed to protect prospective franchises, the state franchise relationship laws are designed to protect existing franchisees during the operation of the franchise. (Currently, approximately 20 states have such laws, and there is no federal law.) These laws regulate almost 30 aspects of the franchise relationship (e.g., advertising fees, discrimination, interference with free association, and required releases). The most common and important aspects of these laws are provisions which require (a) advance notice and "good cause" for termination, (b) limitations on a franchisor's refusal to renew a franchise, and (c) limitations on refusals to consent to a franchise transfer.

C. Business Opportunity Laws

In addition to the franchise sales laws, twenty-five states, including Maryland, have business opportunity laws (called "seller assisted marketing plan" laws in some states) that generally regulate sales of opportunities to engage in new or additional business enterprises. See, e.g., *Eye Associates, P.C. v. IncomRX Systems Limited Partnership*, 912 F.2d 23 (2d Cir. 1990). Most of these laws have a pre-sale regulatory scheme similar to that of the franchise sales laws. If, however, a business arrangement is a franchise, it generally will qualify for an exemption from the business opportunity laws. But if the business arrangement is structured to avoid the franchise laws, it may fall within the scope of a state business opportunity law. (The FTC Rule also regulates the sale of "business

opportunity ventures," but because the definition of a business opportunity under the FTC Rule is generally limited to certain types of distribution businesses, its applicability to healthcare providers is limited).

II. Can a Healthcare Service Provider be a "Franchise"?

A business arrangement or enterprise, including one that delivers healthcare services, may be a franchise if the arrangement satisfies the definitional elements of a franchise. The definition of a "franchise" varies under the different federal and state franchise laws. For the purposes of this article, however, we will consider the Maryland law as a model.

A. A "Franchise": Three Definitional Elements

The Maryland Franchise Registration and Disclosure Law (Md. Code Ann., Bus. Reg. tit. 14 § 201-233 (1998)) is similar to many state franchise laws, in that a "franchise" is:

- "an expressed or implied, oral or written agreement in which:
- (i) A purchaser is granted the right to engage in the business of offering, selling, or distributing goods or services *under a marketing plan or system* prescribed in substantial part by the franchisor;
 - (ii) The operation of the business under the marketing plan or system is *associated substantially with the trademark*, service mark, trade name, logotype, advertising, or other commercial symbol that designates the franchisor or its affiliate; and
 - (iii) The purchaser must pay, directly or indirectly, *a franchise fee*."

To generalize, therefore, a "franchise" under the Maryland law, many state franchise laws, and the FTC Rule, has three elements: (1) a trademark element; (2) a required payment or fee element; and (3) a marketing plan or system, control or assistance, or community of interest, element. For a franchise to exist, all three elements must be satisfied (with some exceptions).

1. Trademark Element

In order for the trademark element to be satisfied, the franchisee's business must be "substantially associated" with the franchisor's trademark. To determine whether a franchisee, licensee or dealer has been given the right to distribute goods or services which are "substantially associated" with a licensor or manufacturer, it is necessary to consider whether the commercial symbol is brought to the attention of the

licensee's customers to such an extent that they would regard the licensee's business as one in a chain identified with the licensor or manufacturer. Some states hold the view that if the franchisor's commercial symbol enhances the franchisee's chances of success, the trademark element will be satisfied. The use of a trademark or tradename in the healthcare environment may not be as pervasive as in a more traditional retail/franchise context. Therefore, there may be a degree of uncertainty whether the trademark element is met in certain circumstances. However, state interpretive opinions and court decisions have generally found the trademark element is present if the franchisee uses the franchisor's mark in its dealings with the public. (*But see Bakke Chiropractic Clinic, S.C. v. Physicians Plus Insurance Corporation*, 573 N.W.2d 542 (Wis. Ct. App. 1997), which found that in the context of an HMO (health maintenance organization), certain chiropractors did not have the right to use the mark of the HMO, and therefore, there was no franchise.)

A few of the laws, including the FTC Rule, require only that the franchisee be given the right to distribute goods or services which are "identified" by the franchisor's trademark. Also, the failure to grant a franchisee the right to use a franchisor's mark may not be sufficient to avoid satisfying the trademark element. The FTC has said that the trademark element will not be met only if a franchisor *expressly prohibits* the use of its mark.

2. Required Payment / Franchise Fee Element

The second element of the franchise definition is that the franchisee is required to make a payment to the franchisor. The element is satisfied by initial fees, periodic royalty fees, advertising fees, and/or other payments to the franchisor. A significant exception to this definition is the payment for goods at bona fide wholesale prices for resale. This exception removes many distributors from the scope of the franchise laws. In Maryland, certain other payments are also excluded from the definition of a required payment or fee, including, for example, supplies, fixtures, or real property that is/are needed to enter into the business or continue the business, and the amount paid for sales demonstration material and equipment sold at no profit by the seller, for use in making sales and not for resale (Md. Code Ann., Bus. Reg. tit. 14 § 201 (1998)). Also, under the FTC Rule, the required payment element is not met if the franchisee is not required to pay \$500 or more during the first six months of operation of the franchised business.

3. Control or Assistance/Marketing Plan or System/Community of Interest Element

The various franchise laws utilize three different tests for determining whether the third element of a franchise is satisfied. Each test, however, is designed to determine whether there is an adequate degree of reliance by the franchisee on the franchisor so as to trigger the need for the franchisee to be protected by the law. In general, this element is rather easily satisfied.

a. Control or Assistance (FTC Rule)

The "control/assistance" element is a characteristic only of the FTC Rule. While the FTC has indicated that the control/assistance must be "significant," the FTC also has provided examples of "significant controls" and "significant assistance" and, in doing so, indicated that "any one" of these examples will satisfy the element. Among the examples of "significant controls" are those over: (1) site approvals; (2) hours of operation; (3) production techniques; (4) accounting practices; (5) personnel policies and practices; (6) promotional campaigns requiring franchisee financial contributions; (7) site design and appearance requirements; (8) location or sales area restrictions; and (9) restrictions on customers. Examples of "significant assistance" are (10) formal sales, repair, or business training programs; (11) establishing accounting systems; (12) management, marketing, or personnel advice; (13) selecting site locations; and (14) furnishing of a detailed operations manual. Many of these examples of control or assistance are not generally part of a healthcare delivery system or program. However, the presence of one or two aspects of control or assistance may be sufficient to satisfy this third element of a franchise.

The FTC also has said that the control or assistance must relate to the franchisee's entire method of operation, rather than simply relating to the sale of a specific product, or products which are only a portion of the business. The franchisee's method of operation includes those business functions which are ordinarily within the discretion of an independent business person, such as organization, operational hours, management, promotional activities, marketing plans, and business affairs.

b. Marketing Plan or System (Maryland and Other States)

The marketing plan or system element is found in the Maryland law, and in many state franchise sales laws. There is little uniformity, however, in the state regulations that elaborate on this element. The

marketing plan or system element will be satisfied if a franchisor or manufacturer provides or prescribes, in substantial part, a sales program, a marketing program, uniform standards for goods or services, an exclusive territory, collateral services, a duty of observing directions with respect to the use of trade names and advertising, standards for training programs, standards for operation pursuant to an operating plan, and more. In essence, many of the factors that are evidence of significant control or assistance under the FTC Rule may be evidence of a marketing plan or system under the state laws.

c. Community of Interest (Several States)

Several state franchise laws provide that a key element of the definition of a franchise is the existence of a "community of interest" between the franchisor and franchisee in the marketing of goods or services. Some courts have stated that this element is satisfied if the franchisor and franchisee have a "common financial interest." Others refer to the franchisor and franchisee as being "interdependent," or evaluate whether the franchisee must make a significant investment which is "substantially franchise-specific" (i.e., of little use outside the context of the franchised business).

B. Alternative Definitions

Although the three elements discussed above are typically required to find the existence of a franchise, that is not always the case. New York, for example, requires that only two elements be present to have a franchise; the trademark and the fee elements, or, the marketing plan or system and the fee elements. Consequently, a healthcare program may be a franchise in New York, even if it is not a franchise in another state.

Some states, such as New Jersey or Wisconsin, define a franchise as a "written arrangement . . . in which a person grants to another person a license to use a trade name, trademark, service mark, or related characteristics, and in which there is a community of interest in the marketing of goods or services." These states do not include the payment of a franchise fee as an element of the franchise definition. It is notable, however, that the only state laws of this sort are those which regulate the franchise relationship.

III. Applicability of Franchise Laws to Healthcare Providers

Returning to the hypothetical healthcare providers described briefly at the beginning of this article, we can begin to see how certain healthcare organizations or service

providers, or arrangements for the provision and/or distribution of healthcare services, could fall within the definition of a franchise.

A. Trademark

In many cases, a determination of whether the trademark element is satisfied is quite simple. In the PPMC and licensed technology models discussed above, the trademark element is arguably satisfied by the use of the mark in the name of the business, or in connection with promoting the licensed diagnostic and therapy services.

B. Franchise Fee/Required Payment

Licensing fees and other payments made to the PPMC or to the licensor of the diagnostic services will likely satisfy the required payment element. Appropriate structuring of the business, financial, and legal relationships of the parties may, however, alter the analysis and conclusions. (Several other issues to consider when analyzing the legality of a healthcare arrangement, particularly when evaluating the revenue structure, include the prohibition against the corporate practice of medicine, anti-kickback provisions of the Medicare and Medicaid statutes (which may be implicated due to franchise fee payments), prohibitions against physician self-referral, and prohibitions against fee splitting. These subjects, however, are beyond the scope of this article.)

C. Control or Assistance/Marketing Plan

Satisfaction of the third element -- the control or assistance/marketing plan -- is often a close call. The healthcare model, unlike a restaurant or retail franchise, does not generally include comprehensive rules and requirements concerning the entire method of operation of a healthcare provider. In almost all cases, the healthcare organization that would be the putative franchisor will explicitly disclaim any control over the physician's professional practice, and agreements will state that the physician may exercise his/her/its professional judgment in treating patients without interference. Also, many aspects of the control or assistance or marketing plan element, enumerated by the FTC or the states, are usually not present.

Nonetheless, in our examples, the healthcare provider or licensee must operate in accordance with a detailed operating manual prescribed by the PPMC or the licensor. Also, the physician's employees may be required to attend training. Further, at least a modicum of marketing materials may be provided. Therefore, conducting a business

in accordance with an operating manual and pursuant to a training program, coupled with the provision of marketing materials, may, according to the FTC and several state laws, be sufficient to satisfy the control or assistance, marketing plan or system, or community of interest element. Furthermore, certain practice management and practice development services that may be provided to a physician or licensee may satisfy this third definitional element.

Healthcare providers may consider the franchise laws inapplicable to their business relationships, particularly where the control or assistance provided is not related to the "entire method of operation." For example, even though a PPMC may provide administrative services to a practice group, the services may not relate to the principal focus of the practice group -- healthcare delivery and patient service. However, an FTC Staff Advisory Opinion (FTC Staff Opinion 97-7 (August 18, 1997), Bus. Fran. Guide (CCH) ¶ 6487) that analyzed a license for health travel services granted to hospital systems and ambulatory care clinics found that the term "entire method of operation" is narrowly construed by the FTC staff. The FTC staff found that the entire method of operation must be viewed in the context of the business relationship entered into between the parties. Therefore, even if a new product or service is one of many products or services offered by a putative franchisee, if the putative franchisor's control relates to the new service or product, the control or assistance may be deemed sufficiently "significant" to satisfy the FTC Rule definition of a franchise.

While the discussion above only scratches the surface of the potential for a healthcare delivery arrangement to fall within the franchise laws, it is important to recognize that the possibility exists, in Maryland and elsewhere. (The health travel services franchise discussed above is a Maryland-based franchise.) Assuming a healthcare delivery system is a franchise under one or more laws, what are the applicable obligations?

IV. Consequences of Being a "Franchisor" or Offering a "Franchise"

A. Disclosure and Registration; Exemptions

As discussed in Part I above, if an entity offers a "franchise," a UFOC must be prepared (with 23 prescribed disclosure items) and provided to prospective franchisees in all states (under the FTC Rule). Also, pre-sale registration and/or disclosure is

required in 15 states, including Maryland.

Even though healthcare organizations or arrangements may fall within the coverage of one or more of the franchise laws, there may be exemptions from the pre-sale registration and/or disclosure requirements. The exemption most likely to be applicable to healthcare providers is the "fractional franchise" exemption. This exemption, or similar ones, is available under the FTC Rule and several state franchise sales laws (e.g., Illinois, Indiana, Michigan, Minnesota, and Virginia), but not in Maryland.

The fractional franchise exemption applies if two conditions are met: (a) the franchisee must have at least two years of prior experience in a business similar to (or the same as) the franchised business; and (b) the parties anticipate that the sales arising from the proposed relationship would represent no more than twenty percent of the dollar volume of the franchisee's projected gross sales within the reasonable foreseeable future. Certain healthcare arrangements, such as the license of a new diagnostic test or therapy, may satisfy the exemption. The applicability of the fractional franchise exemption depends upon individual circumstances. The FTC's interpretive opinions concerning the fractional franchise exemption do not always provide comfort to putative franchisors that their business arrangements will be exempt from compliance with the FTC Rule. In 1997, the FTC staff reviewed an arrangement in which a system for providing rehabilitative services for back problems was licensed to a sophisticated group of healthcare providers (FTC Staff Opinion 97-1, Bus. Fran. Guide (CCH) ¶ 6481). The potential licensees fell into two classes: (a) hospitals, medical centers, and physical therapy clinics that previously offered physical therapy or rehabilitation services (for more than two years); and (b) healthcare entities that had been providing comprehensive health services (for more than two years), but did not offer physical therapy or rehabilitation services. After analyzing the basis for the fractional franchise exemption, the FTC staff held that while the exemption would be available as applied to the first class of prospective licensees, it would not be available for the second class. The FTC staff noted that the exemption is not equivalent to a "sophisticated investor" exemption.

B. Restrictions on Termination

If the arrangement is a franchise, a franchisor's ability to terminate, not renew, or refuse to permit a transfer of, a franchise, is severely limited in about 20 states. If the PPMC or licensor of diagnostic services in the examples above offers franchises, the

PPMC or licensor may have difficulty terminating its relationship with its participating physicians or licensees.

C. Violation of the Laws

Failure to comply with the FTC Rule can subject a franchisor to civil fines (up to \$11,000 per violation per day), consumer redress, and injunctive relief. As there is no private right of action for FTC Rule violations, the principal threat is from the FTC itself. (Some private plaintiffs have sought relief by suing under "state" or "little" FTC Acts, claiming that the "unfair or deceptive act or practice" was the failure to comply with the FTC Rule.)

Failure to comply with state franchise laws could subject a franchisor to a variety of penalties which vary from state to state. Actions brought by the state may include civil fines, cease and desist orders, injunctive and declaratory relief, as well as criminal fines and penalties. Also, a franchisee may bring an action against a franchisor based upon an alleged violation of the state franchise laws. In such actions, the plaintiff may seek damages, rescission, and restitution.

V. Summary

It is generally recognized that franchise laws were designed primarily to regulate businesses different from healthcare providers. The franchise (and business opportunity) laws are quite broad, however, and, as a consequence, have far-reaching effects on many organizations and business arrangements. Also, as healthcare providers experiment with new models for marketing and distributing healthcare services, these organizations, and the arrangements created within the healthcare industry, are more likely to become ensnared in the broad sweep of the franchise laws. A healthcare organization may, without proper advice and structure, be held responsible for violations of the franchise laws simply because it fits within the statutory definition of a "franchise." It is imperative, therefore, that healthcare organizations recognize and understand the franchise laws. Once understood, healthcare providers can make the informed decision to comply with the laws (which many healthcare businesses do today), or try to restructure the arrangement to avoid coverage of the laws.

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