

Healthcare Franchises: A Prescription for Profit?

Legal Considerations and Risks

by Steven T. Lawrence, Esq.



In today's struggling economic cycle, many new business models have been proposed in the healthcare industry. In the face of dramatic changes in the delivery of healthcare in the United States, many entrepreneurs have turned to a business structure that today may be thought of as an old standby: the franchise. In fact, all one has to do is take a quick look at the healthcare page at entrepreneur.com⁽¹⁾ to get a sense of the breadth of franchise opportunities that are available in healthcare related businesses.

If you are considering buying a healthcare related franchise, there are significant legal issues to consider. On the opposite side, if you are considering starting a healthcare related franchise, legal compliance is a critical component of the business. This article briefly examines what constitutes a franchise, considerations when purchasing a franchise and issues when starting a franchise system. Many people are confused as to what constitutes a franchise, so we start with the fundamental question: what is a franchise?

Franchise Defined

When asked “what is a franchise?” most people respond with a reference to McDonald’s or Subway, or one of the other 6,000 franchise systems in operation in the United States. At its core, franchising is a method of distributing goods or services. The typical franchise relationship includes the franchisee paying certain fees in exchange for the right to sell the goods or services of the franchisor, along with access to the franchisor’s business methods, trade secrets, goodwill, training, and operating assistance.

The law, however, defines a “franchise” using broad terms. The definition is so broad that parties may create a franchise without ever intending to create such a relationship. As discussed below, federal and state laws regulate franchises and define what constitutes a franchise. While federal and state laws differ in some instances, as a general matter, a franchise consists of any relationship in which the following three elements exist:

- (i) **Use of a Trademark.** The franchisor grants the franchisee the right to use the franchisor’s trademark or service mark in connection with goods or services associated with the franchisor’s marks.
- (ii) **Royalties.** The franchisee is required to pay the franchisor (or an affiliate of the franchisor) a royalty of greater than \$500 in the first six months as a condition of obtaining or beginning the franchise operation.

- (iii) **Control.** The franchisor imposes various requirements on the franchisee, such as the location of the franchised business, appearance, hours of operation, sales methods, management systems or non-competition obligations.

Federal law governing franchises is found at 16 Code of Federal Regulations Part 436, which is referred to as the “FTC Rule.” The FTC Rule does not require franchisors to file or register with any federal government agency. The FTC Rule requires franchisors provide certain disclosures to prospective franchisees called the Federal Disclosure Document or the FDD.⁽²⁾ An FDD must be given to a prospective franchisee at the earlier of: (i) at least

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fourteen (14) calendar days before the execution of any agreement, or (ii) at least fourteen (14) calendar days before money changes hands.

One difficult aspect of franchise law is that the FTC Rule has not been held to preempt state franchise law. Several states have franchise statutes that create differing requirements

on the offer and sale of franchises, including the imposition of mandatory terms in franchise agreements regarding termination and renewal rights. There currently are 14 states with statutes specifically requiring a franchise to register with the state or file a notice prior to the sale of a franchise. Arizona has no specific franchise law.

Now that we have the definition of a franchise and the legal and regulatory framework set out, we can approach the acquisition of a healthcare franchise.

What Should I Consider When Buying a healthcare Franchise?

If you are considering the acquisition of a healthcare franchise, you should begin with a careful examination of the franchisor and the franchise system. Due diligence regarding the franchisor should be thought out and carefully executed. When it comes to legal due diligence, there are a number of areas on which to focus. In the healthcare space, it will be important to analyze the franchisor’s healthcare law compliance efforts. A prospective franchise purchaser will want to obtain assurance from the franchisor that the franchisor, its franchisees and the system are in compliance with all applicable healthcare laws and regulations.

A further question to ask is what is the franchisor’s franchise law compliance program? Has the franchisor registered the sale of its franchises in the states where registration is required?

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Has the franchisor delivered a FDD in compliance with the FTC Rule?

If the franchisor is in compliance, prior to the signing of the franchise agreement and prior to any money changing hands, the franchisor will provide the prospective franchise

purchaser with its FDD. Read the FDD carefully and examine the disclosures that the franchisor describes in the FDD. There are 23 Items required in the FDD. Each Item provides important insight into the background of the franchisor.

In particular, Item three provides information about the franchisor's litigation history. Have any prior franchisees sued the franchisor for misstatements or breach of contract? Item five describes other fees beyond the initial franchise fees. Are there any fees here that you were not prepared for or were not disclosed elsewhere? You will also want to review the marketing and advertising programs offered by the franchisor, including whether there is a collective fund in which the franchisees have to participate.

Another important diligence step is to pick up the phone and call existing franchisees. There is a list of existing franchisees contained in item 20 in the FDD. Talk to other franchise owners and ask them how business is going? What was the best part about the training? What is the biggest weakness in the franchise system?

An important diligence matter that some franchisees gloss over is the operations manual. Typically, a franchise agreement will mandate that the franchisee adhere to the franchisor's operations manual. The operations manual becomes a back-door way for franchisors to impose strict operating terms without including such terms in the face of the franchise agreement. The FDD will include the table of contents of the operations manual, but it is important to dig deeper and study the franchisor's mandates contained in the operations manual.

After examining the acquisition of a franchise, many prospective purchasers begin to analyze whether it would be profitable to start a franchise from scratch. In any analysis of a starting franchise system, there are many legal considerations.

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Starting a Healthcare Franchise

Putting aside the possible healthcare regulatory issues, there are a host of legal matters to consider. The most successful franchises have a franchise law compliance strategy from the very beginning. Thinking that you can avoid registration or put that effort off until later is misguided. You should include the fees and costs of preparing the necessary FDD and registration in the applicable states into your business model. The franchise structure will also mandate accounting controls, including audited financial statements. Costs for accounting should also be built into your franchise start-up's budget.

While there are a host of issues to consider at start-up, one important area to focus on is the terms and conditions of the franchise agreement. A brief list of the issues to consider in structuring the franchise agreement includes:

- The duration of the agreement and the renewal terms.
- The breadth of the geographic territory and the ability to expand or contract that territory based on performance.
- Performance criteria before the agreement will be terminated.
- Initial franchise fee.
- Royalties.
- What products must be purchased within the system and what products may be purchased outside the system.
- What financing will be available for franchisees.

- What will be the duration and scope of non-competition and non-solicitation provisions.
- What will be the default provisions and will the franchisee be given an opportunity to cure.
- Will the franchisor create marketing cooperatives run by local franchisees.
- Venue and process for dispute resolution.

Conclusion

The proliferation of healthcare franchises is expected to continue for the foreseeable future. When analyzing the acquisition of a franchise or starting from scratch, legal due diligence and legal compliance are important considerations and should be the starting place for a successful acquisition or launch. 

References

(1) The list of healthcare-related franchise opportunities can be found at www.entrepreneur.com/franchises/categories/hlth.html.

(2) The disclosure document required by the FTC Rule is formerly referred to as the Uniform Offering Circular or "UFOC." Amendments to the FTC Rule on July 1, 2007 changed the title of the disclosure document to the Federal Disclosure Document of "FDD."



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