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THE NEW ITEM 19 COMMENTARY AND OTHER ADVANCED PERFORMANCE FINANCIAL REPRESENTATION ISSUES: THE DEVIL IS IN THE DETAILS

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I. INTRODUCTION

The rules governing financial performance representations - - information conveyed to prospective franchisees disclosing historic or projected company-owned or franchised unit gross sales, net or gross profits or both - - are about to undergo their most sweeping transformation in nearly a quarter century.

It is anticipated that this month (May, 2017) the North American Securities Administrators Association ("NASAA")[1] will approve the "NASAA Franchise Commentary on Financial Performance Representations" (the "2017 NASAA FPR Commentary") proposed by NASAA's Franchise Project Group[2] following three years of study, proposals, receipt of public comments thereon and finalization.[3]

Following NASAA's anticipated adoption of the 2017 NASAA FPR Commentary, it is expected that each state having a franchise registration/disclosure statute will adopt the Commentary through new regulations, by policy or by acquiescence and that the Federal Trade Commission will likewise require adherence thereto (through a newly promulgated "FAQ" or other policy pronouncement). Because of the phase-in provisions of the Commentary, it is likely that most franchisors will have to adapt their financial performance representations ("FPRs") by the time they renew their disclosure documents in 2018.

In this program, we examine the centrality of financial performance representations to the very genesis of our nation's federal and state franchise laws; define what constitutes a "financial performance representation"; address how the regulation of financial performance representations has evolved over time; and detail the many significant new requirements, restrictions and prohibitions concerning financial performance representations ordained by the Commentary.

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[1] NASAA, founded in 1919, is a voluntary organization and the oldest international investor protector organization in the world. It consists of 67 state, provincial and territorial securities administrators in the 50 states, the District of Columbia, the U.S. Virgin Island, Puerto Rico, Canada and Mexico.

[2] NASAA conducts its affairs through standing committees, one of which is the Corporate Finance Section. Project Groups are formed in each section to work on topical issues. The Franchise Project Group is one of the project groups under the Corporate Finance Section. The authors serve on an Industry Advisory Committee appointed by the Franchise Project Group and served as advisors to the Franchise Project Group subcommittee that developed the Commentary.

[3] The latest public version of the Commentary can be found at http://www.nasaa.org/40282/notice-request-comments-regarding-proposed-franchise-commentary-financial-performance-representations/. The only change recommended by the Franchise Project Group in response to the comments received was to add the following footnote: "This FPR Commentary governs the preparation of FPRs following the effective date. NASAA does not intend that any FPR contained in a Franchise Disclosure Document issued before the effective date is necessarily deficient or unlawful."

II. THE CENTRALITY OF FINANCIAL PERFORMANCE REPRESENTATIONS TO THE GENESIS OF FEDERAL AND STATE FRANCHISE LAWS, RULES AND REGULATIONS

A bit of a history lesson for those new to the field.

When franchising burst on the American scene in full force during the second half of the 1950's and the decades of the 1960's and 1970's, there existed absolutely no franchise-specific law, rule or regulation governing franchise sales activity.

Abuse was rampant.

Reading stories of how both franchisors and franchisees were making millions of dollars in new franchise endeavors (including such then "new" franchisors as McDonald's, Burger King, Holiday Inn and KFC), criminals (and, in New York, organized crime) saw an opportunity. Their method was simple. Print up slick brochures promoting altogether non-existent franchise networks; travel from city to city handing out those brochures, which promised millions of dollars in profits if only folks attending would acquire their "franchises"; hold meetings making the same pitch; and then collect tens of thousands of dollars apiece from folks who thought they were buying legitimate franchises only to later find out they did not at all exist (with these criminals then racing from city to city to replicate the fraud - - remember, back then there were no instant communications, no 24/7 news outlets, no internet and folks had to wait either many minutes or many hours until they could place - - through a telephone "operator" - - a long distance telephone call).

The harm inflicted on these defrauded franchisee investors was massive, to the tune of many tens of millions of dollars (in today's money, many hundreds of millions of dollars). The harm wrought upon legitimate franchisors was similarly devastating - - the words "franchise" and "fraud" became virtually synonymous such that even the most upstanding and legitimate franchisor found it difficult to sell franchises.

It was in response to this plague of franchise fraud - - grounded in phony promises of massive franchisee gross sales and net profits - - that first the states, and the federal government, adopted the franchise sales regulatory scheme we are familiar with today - - the Federal Trade Commission Franchise Rule[4] and the 15 state franchise registration/disclosure laws (beginning with California's Franchise Investment Law, which was enacted in 1971). Those 15 states are: California[5], Hawaii[6], Illinois[7], Indiana[8], Maryland[9], Michigan[10], Minnesota[11], New York[12], North Dakota[13], Oregon[14],

4 16 CFR Part 436.

5 *California Franchise Investment Law*, California Corporations Code, Div. 5, Parts 1-6, Section 31000 *et. seq.*

6 *Hawaii Franchise Investment Law*, Hawaii Rev. Stat., Title 26, Ch. 482E, Section 482-E1 *et seq.*

7 *Illinois Franchise Disclosure Act*, Illinois Compiled Statutes, Ch. 815, Section 705/1 *et seq.*

8 Indiana Code, Title 23, Article 2, Ch. 2.5, Section 1 *et seq.*

9 *Maryland Franchise Registration and Disclosure Law*, Ann. Code of Maryland, Business Regulation, Rhode Island[15], South Dakota[16], Virginia[17], Washington[18] and Wisconsin[19].

Federal regulation of franchising commenced in 1979, when the Federal Trade Commission Franchise Rule (as promulgated in December 21, 1978) took effect.

All federal and state laws and regulations governing franchising focused particularly on the scourge of utterly false and baseless promises of future financial performance which, as noted above, criminal, fraudulent and bogus “franchisors” were using to destroy the lives of tens of thousands of hapless victims.

III. THE REGULATION OF FINANCIAL PERFORMANCE REPRESENTATIONS

The original FTC Franchise Rule, which took effect in 1979 (it was substantially revised in 2007 - - see below), and every state franchise registration/disclosure law did not and still does not require that any franchisor furnish “financial performance representations” (then known as “earnings claims”) to prospective franchisees.

However, then as now, if a franchisor did not set forth any financial performance representations in its disclosure document (then known as the “Uniform Franchise Offering Circular” and now simply the “Franchise Disclosure Document” or the “FDD”), then under both federal and state law that franchisor was prohibited from imparting any financial performance representation information whatsoever to prospective franchisees. And if the franchisor did include financial performance representations in its disclosure document, then with few exceptions (addressed below) it could not furnish any additional financial performance representations to the prospective franchisee and certainly could not furnish discrepant or contrary financial performance representations.

In the real world of franchise sales, the most critical information many prospective franchisees are interested in obtaining pertains to how much they can expect to make - - what company-owned or franchised units’ gross revenues and net

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Title 14, Section 14-201 *et seq.*

[10] *Michigan Franchise Investment Law*, Michigan Compiled Laws, Ch. 445, Section 445.1501 *et seq.*

[11] *Minnesota Statutes*, Ch. 80C, Section 80C.01 *et seq.*

[12] *New York General Business Law*, Art. 33, Section 680 *et seq.*

[13] North Dakota Franchise Investment Law, North Dakota Century Code Ann., Title 51, Ch. 51-19, Section 51-19-01 *et seq.*

[14] *Oregon Franchise Transactions Law*, Oregon Revised Statutes, Title 50, Ch. 650, Section 650.005 *et seq*.

[15] *Rhode Island Franchise and Distributorship Investment Regulations Act*, General Laws of Rhode Island, Title 19, Ch. 28.1, Section 19-28.1-1 *et seq.*

[16] *South Dakota Franchises for Brand-Name Goods and Services Law*, South Dakota Codified Laws, Title 37, Ch. 37-5A, Section 37-5A-1 *et seq.*

[17] *Virginia Retail Franchising Act, Virginia Code*, Title 13.1, Ch. 8, Section 13.1-557 *et seq.*

[18] *Washington Franchise Protection Act*, Revised Code of Washington, Title 19, Ch. 19.100, Section 19.100.010 *et seq.*

[19] *Wisconsin Franchise Investment Law*, Wisconsin Stats., Ch. 553, Section 553.01 *et seq.*

profits historically have been or what projections the franchisor is willing to make regarding future unit gross sales, revenues and net profits. And franchise sellers, eager to effect the sale, clearly have every motivation to disseminate such information.

When the FTC Franchise Rule took effect in 1979, there were only two requirements concerning “earnings claims” which were fairly liberal and a third which was fairly restrictive. The first two requirements were simple: the “earnings claim” had to have a reasonable basis and the franchisor had to have in its possession at the time the claim was made material sufficient to substantiate the accuracy of the claim. It was the third requirement that proved troublesome: any “earnings claim” had to be geographically relevant to the prospective franchisee’s proposed location.

On the state level, the rules governing “earnings claims” between 1979-1993 were far more restrictive. The then-governing “Uniform Franchise Offering Circular Guidelines” (as promulgated by NASAA and accepted as a disclosure format by states having franchise registration/disclosure statutes) mandated a strict, formulaic and rigid approach which many franchisors found altogether too constrictive and difficult to satisfy. However, this very circumscribed approach was abandoned, first by certain amendments to this disclosure item in 1986, and again in 1993 when the NASAA Franchise Project Group (then known as the NASAA Franchise Committee) significantly updated its “Uniform Franchise Offering Circular Guidelines” to greatly liberalize the approach by imposing only two “earnings claim” prerequisites upon franchisors: that any “earnings claim” be included in full in a franchisor’s offering cicular and that any such “earnings claim” have a “reasonable basis” at the time it was made (an approach which mirrored that ensconced in the FTC Franchise Rule).

The Federal Trade Commission substantially revised its FTC Franchise Rule in 2007 and greatly modified its rules and requirements pertaining to what were now no longer referred to as “earnings claims” but, instead, “financial performance representations.” We will not herein review each and every change effected by the revised FTC Franchise Rule save to note that the restrictive “geographic relevance” requirement of the original FTC Franchise Rule was eliminated and a number of new requirements, restrictions and prohibitions imposed.

It should be noted that the FTC Franchise Rule and state franchise regulatory liberalization of financial performance representation requirements appear to have achieved their intended goal. 20 years ago it was estimated that fewer than 20% of franchisors included financial performance representations (then “earnings claims”) in their disclosure documents. It is estimated that today over 60% of franchisors do so. So it is that many more prospective franchisees of many more franchise systems are able to receive disclosure concerning one of their key areas of interest.

IV. THE GENESIS OF THE NASAA FRANCHISE PROJECT GROUP'S FINANCIAL PERFORMANCE REPRESENTATION COMMENTARY

The NASAA Franchise Project Group was receiving reports from individual state examiners (and some franchise law practitioners) about franchisors setting forth financial performance representations in their Franchise Disclosure Documents which, while technically permissible, were potentially deceptive and misleading.[20]

Some franchisors would furnish financial performance representations featuring only either their top ten, or top 10%, highest performing outlets. Others would disclose historic company-owned unit net profit data without disclosing that, as opposed to franchised units, these company-owned units paid no royalties and had many of their expenses (rent and employees) paid by their corporate parent. Yet other franchisors would feature average "gross sales only" financial performance representations of company-owned units without also disclosing their franchised units' much lower average gross sales.

Again, under both the FTC Franchise Rule and the NASAA's Franchise Registration and Disclosure Guidelines, such financial performance representations were technically legal - - but viewed by the regulatory community as deceptive.

Thus, the NASAA Franchise Project Group formed a subcommittee in 2014 to address the issue of financial performance representations and what new requirements, restrictions and prohibitions, if any, should be imposed upon franchisors.

NASAA released the proposed Commentary in October 2015 for public comment. After receiving extensive public comment, the Franchise Project Group subcommittee then analyzed the comments and modified the proposed Commentary which was released by NASAA for a second round of public comment in September, 2016. After making minor tweaks to the Commentary in response to the additional comments received, the revised final NASAA Commentary was submitted to NASAA itself for approval by its membership[21] at its Annual Spring Conference meeting in May 2017 in Washington, DC.

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[20] The Franchise Project Group sought input on the FRP Commentary from both FTC Franchise Rule Staff and the Illinois Franchise Bureau. Because the Illinois Franchise Bureau is not part of the Illinois Securities Division, its staff members are not eligible to participate on the NASAA Franchise Project Group.

[21] The NASAA membership consists of each state securities administrator from all U.S. states and territories, as well as the Canadian provinces, and Mexico.

V. HOW THE FTC FRANCHISE RULE AND THE 2008 NASAA FRANCHISE REGISTRATION AND DISCLOSURE GUIDELINES DEFINE "FINANCIAL PERFORMANCE REPRESENTATION"

The FTC Franchise Rule (at Section 436.1(e)) and the 2008 NASAA Franchise Registration and Disclosure Guidelines (at Section VII(e)) advance identical definitions of what constitutes a "financial performance representation," as follows:

> "(A)ny representation, including any oral, written or visual representation, to a prospective franchisee, including a representation in the general media, that states, expressly or by implication, a specific level or range of actual or potential sales, income, gross profits, or net profits. The term includes a chart, table, or mathematical calculation that shows possible results based on a combination of variables."

VI. THE CARDINAL RULE REGARDING FINANCIAL PERFORMANCE REPRESENTATIONS/EARNINGS CLAIMS

The cardinal rule governing the dissemination of financial performance representations/earnings claims remains entirely unchanged by the 2017 NASAA FPR Commentary and may be stated simply: under both federal and state law, absolutely no information may be given to prospective franchisees regarding financial performance representations - - that is, with two exceptions noted below, nothing said and nothing written concerning past or projected sales, income or profits of company-owned and/or franchised units - - unless that financial performance representation appears in Item 19 of the franchisor's disclosure document.

Franchisors and their personnel generally well understand the prohibition when it comes to direct representations - - that is, financial performance representations uttered or written by franchisor salespeople. But the trap for the unwary comes from the indirect financial performance representation/earnings claim - - instances where franchisees state what they believe their franchises will generate in terms of gross revenues, expenses or profits (or even full blown pro forma financial statements for their forthcoming units) and ask franchisor personnel to comment on same. Responding to those inquiries by commenting on the accuracy or inaccuracy of the franchisee's estimated numbers is as prohibited by federal and state law as the franchisor generating those numbers itself.

And recall that, for the time being, a franchisor merely disseminating "cost only" information to prospective franchisees is prohibited in certain of the franchise registration/disclosure states.

There are two key exceptions to the foregoing blanket prohibition. Under the revised FTC Franchise Rule and all state franchise registration/disclosure laws, a franchisor is permitted to disclose to prospective franchisees - - separate and apart from its disclosure document, and with no reference therein - - the actual operating results of a specific unit which the franchisor is offering for sale, provided that such information is given only to potential purchasers of that unit. If this path is chosen by a franchisor, the financial performance representations must be accompanied by the name and last known address of each owner of the subject unit during the prior three years. Also, a franchisor that imparts financial performance information in Item 19 of its disclosure document may separately furnish to prospective franchisees outside of that document a "supplemental earnings claim" directed to a particular location or circumstance.

VII. NEW (OR MODIFIED) REQUIREMENTS, RESTRICTIONS AND PROHIBITIONS IMPOSED BY THE 2017 NASAA FPR COMMENTARY GOVERNING FINANCIAL PERFORMANCE REPRESENTATIONS

In this section we address the more significant new requirements, restrictions and prohibitions imposed upon franchisors by the 2017 NASAA FPR Commentary. We emphasize that not every single new requirement or restriction is addressed herein (though the most important ones are) and refer you to the Commentary itself, annexed hereto as Exhibit A.

When will the requirements of the 2017 NASAA FPR Commentary become effective? For most franchisors with a calendar year end fiscal year, the likely effective date is April 30, 2018. The Commentary states that it will be effective on the later of 180 days after its adoption or 120 days after a franchisor's next fiscal year end. However, franchisors can expect franchise examiners in states that require the registration of franchise offerings to immediately start requiring any changes to Item 19 based on the Commentary.

A. Carryover of 2008 NASAA Commentary

Nearly a decade ago, the NASAA Franchise Project Group issued its "2008 NASAA Franchise Registration and Disclosure Guidelines" in an effort to harmonize state franchise disclosure requirements with those imposed by the extensive 2007 revisions to the Federal Trade Commission Franchise Rule (16 CFR Part 436), which revisions established a new - - and preemptive - - disclosure "floor" to which the states had to adhere. Following the issuance of the 2008 Guidelines, NASAA issued a Commentary on April 27, 2009 (which NASAA characterizes as the "2008 Commentary")[22] to provide assistance in interpreting those disclosure requirements.

Included in the 2008 Commentary were provisions specifically addressing financial performance representations. These provisions are specifically carried forward by the 2017 NASAA FPR Commentary, as follows.

1. Expense and Cost Information

Section 19.1 of the 2017 NASAA FPR Commentary carries forward from the 2008 Commentary the clarification that cost and expense information alone may be

[22] The 2008 Commentary can be found at http://www.nasaa.org/content/Files/FranchiseCommentary_final.pdf.

provided to prospective franchisees outside of a franchisor's FDD Item 19 - - but not if those anticipated operating expenses are set forth as a percentage of a stated level of revenue (which, under both the 2009 and 2017 Commentaries, would elevate that cost information to a financial performance representation).

This has always been a nettlesome subject for franchisors. Key metrics that prospective franchisees desire to ascertain are what percentages of revenues a company-owned or franchised unit expends on certain key items - - usually costs of occupancy, labor and goods. By way of illustration, it is fairly common knowledge in the quick service restaurant sector that an average cost of goods exceeding 30% of revenues will typically prove excessively burdensome on bottom line profits. However, this inability to convey such key percentage cost metrics standing alone and without incorporation in FDD Item 19 remains in place under the 2017 NASAA FPR Commentary.

2. Blank "Pro Formas"

Also carried forward in Section 19.2 of the 2017 NASAA FPR Commentary is the 2008 Commentary clarification that a franchisor may not attach a blank "pro forma" to its Franchise Disclosure Document and treat it as a financial performance representation. A franchisor may furnish a blank pro forma to prospective franchisees - - but may not include it in its Franchise Disclosure Document. Section 19.2 of the 2017 NASAA FPR Commentary also carries forward the warning that a blank pro forma, or a pro forma that contains cost information alone, may constitute franchise advertising under certain state franchise laws (seven of which require pre-filing before use).

3. Admonitions

Section 19.3 of the 2017 NASAA FPR Commentary similarly carries forward the 2009 Commentary's required admonitions (one for historical financial performance representations, the other for projections). Importantly, Section 19.3 of the 2017 NASAA FPR Commentary also carries forward the requirement that franchisors may not include additional language that serves to disclaim the financial performance representations they are making in Item 19 or state that a franchisee may not rely on the information presented.

B. <u>Definitions</u>

In its 2017 NASAA FPR Commentary, the NASAA Franchise Project Group sets forth a number of definitions critical to properly interpreting the requirements, restrictions and prohibitions of the balance of the Commentary. It is clear from the Commentary that, when preparing an FPR, franchisors need not use the terms defined in the Commentary. Franchisors can use other terms, so long as they properly define the terms they use.

"Company-owned outlet" is defined for the very first time in the 2017 NASAA FPR Commentary and clarifies that the term means not only an outlet of the type being franchised which is owned either directly or indirectly by a franchisor, an affiliate of the franchisor or any person required to be identified in FDD Item 2, but also includes any such outlet that: (i) is operated as a joint venture owned in part by a franchisor, any of its affiliates or any person required to be identified in that franchisor's FDD Item 2, and (ii) is managed by the franchisor, one of its affiliates or such person required to be identified in FDD Item 2. Thus, the distinction is established between franchised unit joint ventures in which the franchisor contributes only money (beyond granting a franchise to the subject enterprise), which are not to be considered "company-owned outlets," and those in which the franchisor, in addition to granting a franchise and contributing financially to the enterprise, also manages (itself, through an affiliate or one of its officers/directors/key management employees) the franchised outlet.

On the other hand, if a franchised outlet is managed by the franchisor (or one of its affiliates or any person required to be identified in FDD Item 2) but the unit is owned exclusively by the franchisee and operated under a franchise agreement, then that unit is deemed an **"operational franchise outlet"** under the 2017 NASAA FPR Commentary (provided that it has been fully operational for one full year or, in the case of seasonal franchise systems, for at least one full season).

Critically for guest lodging networks (many of whose larger properties are not franchised but rather managed by the franchisor) and for certain other franchisors, the 2017 NASAA FPR Commentary defines the term **"managed outlet"** as meaning any outlet that (i) is owned by a person that is not a franchisee, the franchisor, an affiliate of the franchisor or a person required to be identified in the guest lodging network's FDD Item 2, and (ii) is managed by the guest lodging network's (or other franchisor's) individuals or entities just recited. Those new to franchising should understand the distinction between a franchised unit and a franchisor-managed unit: with respect to the former, and as the definition of "franchise" under federal and state franchise laws anticipates, a trademark license is always granted to the franchisee. But for franchisor-managed units, there is no such trademark license granted; instead, the franchisor - - as manager - - is granted the right to itself affix its name to the subject unit, never licensing that name/mark to the owner of the hotel.

Quite significant as well are the 2017 NASAA FPR Commentary's definitions of **"gross profit," "gross sales"** and **"net profit."** The NASAA Franchise Project Group's FPR Subcommittee spent much time debating these definitions (including whether they should be set forth at all). It is important to note that the definitions to these terms afforded by the 2017 NASAA FPR Commentary may not dovetail with GAAP, FASB or AICPA definitions.

C. Disclosure of FPRs Generally

1. Disclosure of Gross Sales Generally

When a franchisor makes a "gross sales" FPR in Item 19 of its Franchise Disclosure Document what, exactly, is the franchisor referring to? In some instances, franchisors are using the term "gross sales" to mean something different in their Item 19 disclosures than they are presenting in Item 6 when they are describing the sales subject to royalty payments by the franchisee.

State franchise examiners were encountering conflicting definitions (or no definition at all). Sometimes, "gross sales" (or an analogous term such as "gross revenues") encompasses every dollar received by a company-owned or franchised outlet. Other times, "gross sales" means all such total revenues minus sales tax. Yet other times "gross sales" explicitly or implicitly means total revenues minus sales tax, allowances, returns or refunds given to customers.

To ensure that the reader of an FDD knows exactly what "gross sales" purports to embrace, Section 19.4 of the 2017 NASAA FPR Commentary mandates that franchisor making a "gross sales" (or, again, "gross revenues" or any analogous term) FPR disclose exactly what "gross sales" means - - that is, disclose which items, if any, the franchisor is deducting from total revenues, whether sales tax, discounts, allowances, returns, refunds or credits.

2. Disclosure of Net Profit Generally

In a similar vein, Section 19.5 of the 2017 NASAA FPR Commentary requires a franchisor making a net profit FPR (whether characterized as "net profit," "net income" or "EBITDA") to disclose which items it is deducting from gross profit to arrive at its figure, including ordinary and recurring operating expenses, interest, income taxes, depreciation and amortization. Taken literally, this requirement would appear to require a franchisor making a "net profit" FPR to always first perform a "gross profit" calculation. However, the authors do not believe that was the intent of the NASAA Franchise Project Group and that, if a franchisor's FPR, by way of example, features only "gross sales" (fully defined - - see above) and "net profit" (or any fungible substitute term), and fully details what is being deducted from "gross sales" to arrive at "net profit," Section 19.5 will be satisfied.

3. Identifying Sources of Data Underlying FPR

The 2017 NASAA FPR Commentary confirms yet again, and quite explicitly, that a franchisor making an FPR must clearly identify the sources of all data presented in that FPR.

If a franchisor is making an FPR based on both company-owned and franchised outlets, the two different types of data must be clearly identified. If a franchisor is adjusting or supplementing actual cost data in an FPR, the franchisor must clearly identify which data are actual costs, which are adjusted or supplemental costs and the method and rationale for determining the adjusted or supplemental costs. For example, if a material expense item (such as labor or fuel) has materially increased over the previous calendar year and the franchisor wants to reflect that increase in its FPR, it may do so but it must clearly disclose what adjustments it is making, its method and rationale for doing so, and how and why the adjustments were made.

4. Managed Outlets

As noted above (see Section VII(B)), for the very first time in franchise regulatory history the term “managed outlet” has been defined, an especially consequential development for guest lodging networks (many of whose larger properties are managed and not franchised) and for certain other categories of franchisors. Some franchisors with managed outlets have historically grouped these outlets with company-owned outlets and others have included them with franchise outlets.

In turn, the 2017 NASAA FPR Commentary addresses how such “managed outlets” must be disclosed. And the answer varies depending on whether the financial results of managed outlets are materially different from the results of other outlets (company-owned and/or franchised) included in an FPR.

If the financial results of managed outlets are not materially different from the results of other such outlets included in the FPR, then the franchisor is given great leeway as to how it may characterize them, so long as it fully discloses the existence of such managed outlets and how they are being characterized. It may have a distinct FPR subcategory for managed outlets and include therein all data related to such outlets; it may characterize managed outlet as a company-owned outlet (again, so long as it clearly disclose that it is doing so); or, it may characterize a managed outlet as a franchise outlet if it makes clear that it is doing so.

However, if the financial results of managed outlets are materially different than those of company-owned and/or franchised outlets featured in the FPR, then managed outlets may not be included in the FPR.

D. Use of Data from Company-Owned Outlets

This section of the Commentary expands upon previous FAQs issued by the FTC and other interpretations of when a franchisor can present information from company-owned outlets either in lieu of or along with franchise outlet data.

1. Gross Sales FPRs Disclosing Company-Owned Outlet Data

If a franchisor has operational franchisees, it cannot disclose gross sales of company-owned outlets without data from franchised outlets. In most cases, franchisors have access to gross sales information from their franchisees. Even if they do not (because there are fixed fees rather than royalties based on a percentage of the franchisees' gross sales), franchisors generally have the right to obtain this information. If there are operational franchisees, their gross sales data is much more relevant to a prospective franchisee than gross sales data from company-owned outlets alone.

On the other hand, if there are no operational franchisees, disclosure of gross sales from company-owned outlets alone is permissible if the franchisor has a reasonable basis for making this disclosure. The franchisor must also include material financial and operational characteristics of the company-owned outlets that are reasonably anticipated to differ from franchise outlets. Neither the 2017 NASAA FPR Commentary nor the FTC Franchise Rule itself require any minimum number of units or operating history for a franchisor to make a financial performance representation. Nevertheless, the requirement that a franchisor have a reasonable basis for the information presented in a financial performance representation means that a franchisor will have to make a determination whether it has sufficient history to include an FPR in its disclosure document.

One interesting issue that came up during the public comment process was the observation by a number of commenters that a franchisor could disclose gross sales data alone in the Item 19 disclosure. Then, because costs are no longer part of the definition of a financial performance representation, the franchisor could separately provide information on costs to prospective franchisees. Citing the FTC Compliance Guide, the Commentary includes a footnote explicitly stating that if the franchisor discloses gross sales in Item 19, it cannot separately provide the prospective franchisee with data to permit the franchisee to readily calculate average net profits.

2. Gross/Net Profit FPRs Disclosing Company-Owned Outlet Cost information Alone

More comments were received on this section of the Commentary than on any other. As a result, the final FPR Commentary differs from the Franchise Project Group's original proposal, which would have prohibited a franchisor from making a gross or net profit FPR based on company-owned outlets alone, when the franchisor had no operational franchisees. Under the revised FPR Commentary, a franchisor can utilize company-owned outlet cost data alone in making a financial performance representation of net profit or gross profit, whether or not there are operational franchises. There are a number of reasons for this.

First, if there were a prohibition on doing so if the franchisor does not have operational franchises, the franchisor could still disclose gross sales alone, leaving out information that is arguably vitally important to the prospective franchisee. Franchisees often use this information to prepare business plans and obtain financing. Without this information, the projections that a prospect develops without it may be much less reliable than the data the franchisor can provide.

Even if a franchisor has operational franchises, the data that the franchisor receives from franchisees may not be accurate or may be less reliable. Absent a uniform point-of-sale system, franchisees may be reporting financial information using different methods or categories of costs.

When a franchisor is making a net profit or gross profit financial performance representation based on company-owned cost data alone, the franchisor must include all of the following:

♦ gross sales data from operational franchise outlets (when the franchisor has operational franchise outlets)

♦ actual costs incurred by company-owned outlets

♦ supplemental disclosure or adjustments to reflect all actual and reasonably expected material financial and operational differences between company-owned outlets and operational franchise outlets[23]

In providing the supplemental disclosure or adjustments, the franchisor must include royalties, marketing fund contributions and other fees the franchisee must pay. In addition, any other reasonably expected differences must also be disclosed. For example, will the franchisee incur increased management or labor costs than the franchisor? Will the cost of goods be higher?

This information must be presented clearly and in the same format as the information about company-owned outlet costs. If the latter information is presented in a table, the supplemental disclosure must be in table format, either as part of the table including company-owned outlet costs or immediately following it. They may <u>not</u> be simply described in a footnote.

3. Merging Data from Franchise Outlets and Company-Owned Outlets

If a financial performance representation includes data from both company-owned outlets and franchise outlets, the franchisor may not merge this data. This is not a new prohibition. The FTC Compliance Guide provides "If a financial performance

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[23] Query how this requirement is met in an FPR that is presenting a gross profit analysis rather than net profit. Following the definition for gross profit included in the Commentary, the only deduction from gross revenues would be the cost of goods sold or the cost of providing services. Presumably this requirement would be met by disclosing reasonably expected difference in this information alone rather than including <u>all</u> of the additional costs a franchisee would incur.

representation is based on both franchise and company-owned outlets the data for each type ordinarily should be separated to avoid potential misrepresentations."[24]

The Commentary contains one exception. If there are so few units in the system that a prospective franchisee would be able to determine the identity of franchisees if the data from franchise outlets is separated from that of company-owned outlets, the franchisor may merge the data. If a franchisor has ten or more franchisees, however, it will be presumed to have enough to disclose the data separately.

E. Use of Subsets

Another general area in which the Franchise Project Group members have noted confusion concerns the use of subsets in presenting financial performance information. The FTC Rule's changes to Item 19 in 2007 specifically permitted the use of subsets. Subsets are generally a group of outlets that share one or more common characteristics such as type of location or geographic distribution or length of operation. The franchisor must disclose those characteristics and how the outlets included in the subset might differ from the characteristics of the outlet that might be operated by a prospective franchisee.

Franchisors making subset disclosure must also include information on the nature of the universe of outlets measured, the total number of outlets in the universe measured and the number of outlets in that universe that were actually measured.[25]

The 2017 NASAA FPR Commentary provides importance guidance on some aspects of the use of subsets both generally and in specific circumstances.

1. Use of Subsets Generally

The Commentary re-confirms that the use of subsets is a permissible method of making a financial performance representation. It reiterates the necessity of having a reasonable basis, noting that the use of subsets is limited to those that are accurate and not misleading. This is an important clarification. Information can be accurate while also being misleading. For example, a subset of ice cream parlors based on the results of Florida and California locations alone may be accurately reported data, but it may be misleading to a prospective franchisee seeking to open a location in Alaska.

2. Best Performing Outlets

Another concern that the Franchise Project Group had was "cherry-picking" – choosing the best performing outlets in the franchise system as a subset. In the

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[24] FTC Compliance Guide, p. 137.

[25] Disclosure Requirements and Prohibitions Concerning Business Opportunities: Statement of Basis and Purpose, 72 Fed. Reg. 15444-01,15,499 (March 30, 2007) ("Statement of Basis and Purpose").

Statement of Basis and Purpose issued by the FTC when it amended the FTC Rule in 2007, the FTC noted its efforts to prevent cherry-picking the top performers.[26]

Despite receiving comments during the public comment period advocating for the ability to limit a financial performance representation to a system's best performing outlets, the Franchise Project Group declined to change the interpretation of the requirements of the FTC Rule. The concern was that prospective franchisees are likely to believe that they will operate at the level of the best performing outlets. Therefore, the Commentary provides that if a franchisor discloses data from its best performing outlets, it must provide a corresponding sample of the worst performing outlets. For example, if the subset includes the top 20% of the system, there must be disclosure of the bottom 20% of the system. Disclosure of the entire system's performance alone is not enough.

A challenging question is what happens if there is a different characteristic that defines a subset, but the resulting subset is comprised of the best performing outlets. A franchisor may have instituted a new optional training course. To encourage attendance, the franchisor may decide to disclose the improvement in performance of franchisees who attend the course. Coincidentally, those franchisees who did attend training were at the high end of the franchise performance spectrum. It would seem that this would not be "cherry picking" in the traditional sense because the subset was selected based on a definable criterion.

In contrast, a franchisor may analyze its top 10% franchisees and isolate a characteristic that defines them (other than being the best performing outlets) such as locations in areas where higher net worth individuals reside. From a policy perspective, allowing this type of reverse engineering would defeat the spirit of the Commentary's requirement, and a franchisor may be required to include the lowest 10% of its franchisees in the Item 19 disclosure.

3. Small Number of Outlets

When is a subset too small? Regulators were again concerned that if a franchisor is allowed to base a financial performance representation on too small of a sample size, the resulting information may be misleading even if it is accurate. The answer is 10. If a franchisor has fewer than 10 substantially similar company-owned and franchise outlets as of the conclusion of its last fiscal year, the franchisor may not make a financial performance representation using subset data.

It is important to clarify that a franchisor may still make a financial performance representation when it has fewer than 10 outlets; it just may not do

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[26] Id., "…Item 19 prevents franchisors from "cherry picking" their best locations as a basis for financial performance representations. Specifically, Item 19's substantiation requirements ensure that franchisors disclose how they derived the performance results of subgroups so that prospective franchisees can assess for themselves the sample size, the number of franchisees responding, and the weight of the results."

so by selecting a subset of them. There was some confusion during the comment period over this part of the Commentary. Some commenters understood this guidance to mean that a franchisor had to have at least 10 operational locations before it could make any financial performance representation. That is not correct. The limitation only applies to the ability to exclude any of the franchise outlets and company-owned outlets from the FPR.

4. Geographic Subsets

During the process of amending its Franchise Rule, the FTC eliminated the requirement that the financial performance representation be geographically relevant to the franchise being offered for sale. The reason given was that it helped to remove an obstacle to franchisors' ability to make financial performance representations.

The 2017 NASAA FPR Commentary gives guidance on how to address differences based on geography. If a franchisor bases a subset on geographic location, it must disclose why and how the subset was selected. It may not include the data on this subset if that presentation would be misleading. Harkening back to the rules on making subsets generally that are discussed above, accurate information that is misleading is not a permitted financial performance representation.

F. Averages and Medians

As statisticians will confirm, the use of "average" and "median" numbers alone can be materially misleading.

Take, for example, the following range of numbers: 3-13-16-16-18-30. Both the "average" and the "median" of these numbers is 16. However, simply saying so conceals the extraordinarily wide differential between the lowest and highest "outlier" numbers in this range.

The NASAA Franchise Project Group was determined to eliminate this possible source of deception.

Accordingly, under Section 19.16 the 2017 NASAA FPR Commentary, if a franchisor is disclosing an "average" of numbers in its FPR, it must also disclose the median of those numbers since the existence of outliers (such as "3" and "30" in the example above) may skew an average thereby making it misleading (although the calculation itself is accurate). Further, it is now required that whenever a franchisor discloses the "average" of gross sales, it must also disclose the highest and lowest numbers in the range.

In a corollary vein, Section 19.17 of the 2017 NASAA FPR Commentary requires that whenever a franchisor discloses a "median" of a range of numbers in its FPR, it must also disclose the average of those numbers and if it is disclosing the median of gross sales, it must also disclose the highest and lowest numbers in the range.

But what if a franchisor is making an FPR that includes an average or median but desires to exclude data from any company-owned or franchised outlets that closed during the time period covered by the FPR - - may the franchisor do so? Section 19.18 of the 2017 NASAA FPR Commentary answers that question in the affirmative, provided that the franchisor discloses in its FPR precisely how many company-owned and franchised outlets closed during the time period embraced by the FPR and, of that number, how many excluded company-owned and franchised outlets closed after being open less than 12 months. The franchisor must include this information for every year covered by the financial performance representation.

G. <u>Use of Forecasts and Projections</u>

Most franchisors that include financial performance representations in their Franchise Disclosure Documents utilize some form of historic information. The FTC Rule does permit a franchisor to use projections or forecasts, however. Franchisors have been reticent in the past to include a financial performance representation that focuses on how much a prospective franchisee is likely to earn in the future instead of merely reporting on the historical results of how much, in fact, franchisees and company-owned outlets made in the past. As financial performance data analysis has become more specialized and sophisticated, there are an increasing amount of financial performance representations that blend historical data with projected information. Arguably, that is now a requirement if a franchisor presents information on net profit or gross profit that relies on company-owned outlet costs alone (see above).

Of course, the franchisor must have a reasonable basis for the information presented and the FTC has opined that a reasonable basis will be presumed if the financial performance representation is made in accordance with AICPA standards.[27]

Following are some of the factors that go into determining whether a franchisor has a reasonable basis to make a financial performance representation that is a forecast or projection:

- Preparation in good faith
- Preparation by qualified personnel with appropriate care
- Use of appropriate accounting principles
- Best information that is reasonably available
- Information used must be consistent with the franchisor's plans

[27] FTC Amended Franchise Rule Compliance Guide (2008), http://business.ftc.gov/documents/franchise-rule-compliance-guide (then follow "Franchise Rule Compliance Guide" PDF hyperlink) ("FTC Compliance Guide"), pp. 135-136.

- ♦ Identify key factors that form the basis for the assumptions
- ♦ Make appropriate assumptions
- ♦ Provide the means to determine the effect of variations in the assumptions
- ♦ Adequate documentation of the forecasts and the development process
- ♦ Regular comparison of forecasted results with those actually achieved
- ♦ Review by responsible party at appropriate levels of authority[28]

The franchisor must disclose all material bases and assumptions for the projection, and provide enough facts for the prospective franchisee to make an independent assessment of the projection's validity. In other words, how likely is it that the prospect will reach the projected results?

The 2017 NASAA FPR Commentary further narrows the information on which it is permissible for a franchisor to base an Item 19 projection or forecast.

1. Must be Based on Historical Data

The basis for a projection must still be limited to the historical data from outlets substantially similar to the type of outlet that is the subject of the franchise offering. A franchisor can adjust that information to reflect changes in the market, but may not make merely hypothetical claims. This appears to be a limitation that was not reflected in the FTC's original interpretation since the FTC Compliance Guide refers to market studies and statistical analyses as permissible supporting data for a financial performance representation.[29]

2. Must be Based on Brand Offered

The starting point for a forecast or projection must be the historical data of the brand being offered. Other brands operated by the franchisor or its affiliates or competitive brands operated by others are not permissible bases. The 2017 NASAA FPR Commentary also makes clear that industry reports are equally impermissible. Again, this seems to be narrowing the scope of acceptable forecasts and projections.

H. Disclaimers

As noted above in Section VII(A), the 2017 NASAA FPR Commentary carries forward from the 2008 NASAA Franchise Commentary the requirement that a franchisor

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[28] *Id.*
[29] FTC Compliance Guide, p. 137.

must include one of two required admonitions (one for historic FPRs and the other for FPR projections) if it is making financial performance representations.[30]

These NASAA-required admonitions are relatively brief. The first, with respect to historic FPRs, states: “Some [outlets] have [sold] [earned] this amount. Your individual results may differ. There is no insurance that you’ll [sell] [earn] as much”. The second, for FPRs featuring projections, states: “These figures are only estimates of what we think you may [sell] [earn]. Your individual results may differ. There is no assurance that you’ll [sell] [earn] as much.”

Section 19.3’s carryover of these 2008 NASAA Franchise Commentary FPR admonitions then states: “In either case (historic or projected FPRs), franchisors may not include additional language that serves to disclaim the financial performance representation they have just made or state that a franchisee may not rely on the information presented.”

May a franchisor vary the language of these NASAA-required admonitions? No, states Section 19.21 of the 2017 NASAA FPR Commentary, except in exceptional circumstances. Absent those circumstances, a franchisor must set forth word-for-word, without any variation - - and without adding any additional disclaimer language - - one of the two NASAA-required disclaimers quoted above.

The exception to the rule? If a franchisor is making an FPR based on something other than average unit sales or earnings, it may change the language of the required admonition, but only to the extent necessary to fit the precise FPR being made. For example, many guest lodging franchisors tie their FPRs not to “gross revenues,” “gross sales,” or “net profit,” but instead, “RevPAR” (revenue per available room), “occupancy rate” (as this term suggests, the percentage of a hotel’s rooms which, on average, is occupied by paying guests); and “ADR” (the “average daily rate” paid by customers in the subject hotel, motel or other guest lodging network). Such franchisors are permitted by Section 19.21 of the 2017 NASAA FPR Commentary to change the language of the above-quoted admonitions, but only to the extent necessary to fit the FPR made. Thus, a hotel franchisor disclosing average RevPAR during the preceding year may alter the standard admonition as follows: “Some hotels have achieved this RevPAR. Your individual results may differ. There is no assurance that your hotel will generate as much RevPAR.”

Moreover, the 2017 NASAA FPR Commentary also mandates that the above-quoted required admonition must be “clear and conspicuous,” defined as meaning that the admonition must be easily noticeable and easily understandable by a prospective franchisee. At the very least, the Commentary makes clear, the admonition must be presented in a separate paragraph from the rest of the FPR and in bold type (but not in capital letters, underlined or in larger type then the rest of the FPR).

[30] These admonitions are somewhat different from those set forth in the FTC Compliance Guide at p. 92. Franchisors should use the admonition language contained in the NASAA FPR Commentary.

A far thornier issue is raised both by Section 19.23 and the "admonition carryover" provisions of Section 19.3 of the 2017 NASAA FPR Commentary: a blanket prohibition on a franchisor from including additional language that serves to disclaim the financial performance representations they have just made or states that the franchisee may not rely on the information presented. Section 19.23 of the Commentary is blunt in this regard: "The admonition required in FPR Commentary Section 19.3… is not intended to allow a franchisor to disclaim responsibility for the FPR or advise a franchisee that it may not rely on the FPR. Under the FTC Franchise Rule, a franchisor is prohibited from disclaiming or requiring a prospective franchisee to waive reliance on any representation made in the Franchise Disclosure Document. A franchisor, therefore, may not include in Item 19 or elsewhere in a Franchise Disclosure Document any disclaimers that contradict, mitigate, or are inconsistent with the admonition prescribed in FPR Commentary Item 19.3."

It is thus clear that under both Section 19.3 and Section 19.23 of the 2017 NASAA FPR Commentary a franchisor may not include language in its Item 19 that states (by way of example): "You may not rely on the above financial performance representations." Similarly, a franchisor should not state: "Because the above-disclosed financial performance representations are not derived from audited financial statements, you may not rely on them."

Such "black and white" examples are easy to adduce and identify. But practitioners will be required to carefully distinguish between a prohibited "disclaimer" and a required "explanation." FPRs frequently require extensive explanations, clarifications, variations and limitations. These may be required to fully explain the data being conveyed in the Item 19 FPR and to avoid omitting to state a material fact (which itself triggers liability under applicable franchise laws).

To take an easy example, if a relatively new ice cream franchisor has 25 units - - 24 of which are situated in Florida and one of which is situated in Maine - - then merely setting forth average unit sales in Item 19 of that franchisor's FDD would be grossly misleading unless it goes on to disclose the disparity of revenue/profits and seasonality between the vast majority of its units and its one unit in Maine (or any other geographic area in which ice cream sales are largely seasonal and impacted by cold winters). Similarly, a guest lodging franchisor's FPR must almost universally feature a series of detailed disclosures, explanations and narratives to avoid the "core" FPR numbers being misleading - - disclosing variations between large center city hotels and suburban units, or between resort destination "mega" hotels and those adjacent to suburban airports.

Distinguishing between disclaimers and explanations is not always easy. After reviewing a number of FPRs, we noted some patterns, however. While not always determinative, consider the following tip-off language:

- ♦ Tip-off language for explanations:
  - We cannot attest to the accuracy of franchisee figures.
  - This data is based on …
  - Annual gross sales means …
  - These figures exclude …
- ♦ Tip-off language for disclaimers:
  - There is no assurance …
  - A number of factors will affect your results, including …
  - You should use our figures only as a reference …
  - You should not consider these sales to be the sales you will realize….

VIII. <u>CONCLUSION</u>

The requirements, restrictions, prohibitions and clarifications introduced by the 2017 NASAA FPR Commentary are truly significant, the most extensive overhaul of the rules governing "financial performance representations" (formerly known as "earnings claims") since 1993.

Franchise counsel have an urgent job to perform. They must swiftly digest the many changes wrought by the 2017 NASAA FPR Commentary and then advise their franchisor clients regarding the "ins and outs" of these new rules. Especially is this so with respect to larger franchisors, whose algorhythms and protocols for capturing financial performance information must soon be recalibrated - - well in advance of fiscal year end - - so that next January (or whenever the first month of the franchisor's next fiscal year falls) the franchisor is not caught short having captured data insufficient to meet the edicts of the 2017 NASAA FPR Commentary.

We hope this paper and its presentation at the 2017 IFA Legal Symposium proves helpful to you in this endeavor.

NOTICE OF REQUEST FOR COMMENTS REGARDING A PROPOSED FRANCHISE COMMENTARY ON FINANCIAL PERFORMANCE REPRESENTATIONS

September 14, 2016

The North American Securities Administrators Association, Inc. ("NASAA") is requesting public comments on a proposed Financial Performance Representations Commentary ("FPR Commentary"). This proposal is a second request for public comment following the feedback received from the FPR Commentary proposal released for public comment in October of 2015.

Comments are due on or before October 13, 2016. To facilitate consideration of comments, please send comments to William Beatty (bbeatty@dfi.wa.gov), Chair of the Corporation Finance Section; Dale Cantone (dcantone@oag.state.md.us); Chair of the Franchise and Business Opportunity Project Group; Anya Coverman (nasaacomments@nasaa.org), NASAA Deputy Director of Policy and Associate General Counsel; and Mark Stewart (nasaacomments@nasaa.org), NASAA Counsel, at the NASAA Corporate Office. We encourage, but do not require, comments to be submitted by e-mail. Hard copy comments may be submitted at the address below.

NASAA Legal Department
Mark Stewart, Counsel
NASAA
750 First Street, NE, Suite 1140
Washington, DC 20002

Note: After the comment period has closed, NASAA will post to its website the comments it receives as submitted by the authors. Parties should therefore only submit information that they wish to make publicly available. Further, the following notice will appear on NASAA's website where comments are posted: NASAA, its agents, and employees accept no responsibility for the content of the comments posted on this Web page. The views, expressions, and opinions expressed in the comments are solely those of the author(s).

Background

The FPR Commentary answers frequently asked questions about how franchisors can make a financial performance representation (also known as an earnings claim) under federal and state franchise disclosure guidelines. Those guidelines provide that a franchisor can make an FPR when it has a "reasonable basis" for making the claim and substantiation for the representation. There is very little guidance, however, regarding what constitutes a reasonable basis for making an FPR. Examiners agree that it would be helpful to have additional clarification about how franchisors should make an FPR in their disclosure documents. With help from our Industry Advisory Committee and franchise law practitioners, the Franchise Project Group reached a consensus on questions about FPRs that are worthy of clarification.

The revised FPR Commentary proposal is attached as Exhibit A.

EXHIBIT A

NASAA FRANCHISE COMMENTARY
FINANCIAL PERFORMANCE REPRESENTATIONS

INTRODUCTION

The following questions and answers supplement NASAA's Commentary on the 2008 Franchise Registration and Disclosure Guidelines adopted on April 27, 2009 ("2008 Franchise Commentary"). This NASAA Commentary ("FPR Commentary") addresses a number of questions raised by franchisor representatives and state franchise examiners about financial performance representations ("FPRs").

Under the FTC Franchise Rule and applicable state franchise laws, a franchise seller is prohibited from making an FPR unless it has a "reasonable basis" for the representation at the time it is made. What constitutes a reasonable basis, and what information is needed to substantiate an FPR, is fact-specific and varies from case to case, depending on the representation made. In every case, however, written factual information in the seller's possession must reasonably support the representation, as the FPR is likely to be understood by a reasonable prospective franchisee. The FPR must be based on the sort of factual information upon which a prudent businessperson would rely in making an investment decision.[1] This FPR Commentary provides additional guidance for making and substantiating an FPR. It does not address every question that may arise regarding FPRs. Nor does it address issues that may arise when a franchisor makes an FPR outside of a Franchise Disclosure Document.

The effective date of this FPR Commentary is the later of 180 days after the date of adoption by NASAA or 120 days after a franchisor's next fiscal year end, if the franchisor has an effective Franchise Disclosure Document as of the date of adoption by NASAA. This FPR Commentary guidance applies to Franchise Disclosure Documents updated after the effective date.

Date of Adoption by NASAA: ______________________

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[1] *See* FTC Franchise Rule Compliance Guide, p. 135 (May 2008).

Excerpt from 2008 NASAA Franchise Commentary[2]

These questions and answers, adopted by NASAA in 2008 as part of a general commentary, are reprinted here for convenience.

19.1 *Item 19 - Exclusion of Costs*

QUESTION: Item 19 no longer includes costs in the definition of a financial performance representation. Can cost information be provided outside of Item 19 in a form that sets forth those expenses as a percentage of revenues?

ANSWER: No. If a franchisor provides information about a prospective franchisee's anticipated operating expenses as a percentage of a stated level of revenue, that information constitutes a financial performance representation, and a franchisor may provide that information only if it complies with the requirements of Item 19.

19.2 *Item 19 – Pro Formas*

QUESTION: Can the franchisor attach a blank "pro forma" to the franchise disclosure document and treat it as a financial performance representation?

ANSWER: No. A blank pro forma that identifies categories of revenue and costs but without corresponding figures is not a financial performance representation and should not be attached or otherwise included in a Franchise Disclosure Document. A blank pro forma, or a pro forma that contains cost information alone, may constitute franchise advertising under state franchise statues, depending on how the franchisor uses that document.

19.3 *Item 19 – Disclaimers*

QUESTION: Under Item 19, when a franchisor makes a financial performance representation, what is an appropriate "clear and conspicuous admonition that a new franchisee's individual financial results may differ from the result stated in the financial performance representation?"

ANSWER: While Item 19 does not require any specific language, franchisors should use one of the following admonitions in a separate paragraph:

> **For historical representations—**
> "Some [outlets] have [sold] [earned] this amount. Your individual results may differ. There is no assurance that you'll [sell] [earn] as much."
>
> **For projections—**
> "These figures are only estimates of what we think you may [sell] [earn]. Your individual results may differ. There is no assurance that you'll [sell] [earn] as much."

In either case, franchisors may not include additional language that serves to disclaim the financial performance representation they have just made or state that a franchisee may not rely on the information presented.

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[2] http://www.nasaa.org/wp-content/uploads/2011/08/FranchiseCommentary_final.pdf.

NASAA FPR COMMENTARY

Definitions

When used in this FPR Commentary, the following terms have the meanings indicated:

Average, also known as the "mean," means the sum of all data points in a set, divided by the number of data points in that set.[3]

Company-owned outlet means an outlet owned either directly or indirectly by a franchisor, by an affiliate of the franchisor, or by any person required to be identified in Item 2 of the franchisor's Franchise Disclosure Document, which operates a substantially similar business under the same brand as the business the franchisor offers to franchisees. It also includes any such outlet that: (i) is operated as a joint venture owned in part by a franchisor, by an affiliate of the franchisor, or by a person required to be identified in Item 2; and (ii) is managed by the franchisor, an affiliate of the franchisor, or by a person required to be identified in Item 2.

Operational franchise outlet means an outlet operated under a franchise agreement that: (i) is not a company-owned outlet; and (ii) has been fully operational for one full year or, in the case of franchise systems that operate seasonally, for at least one full season. It also includes any such outlet that: (i) is owned by a franchisee; and (ii) is managed by the franchisor, an affiliate of the franchisor, or a person required to be identified in Item 2.

Gross profit means gross sales minus cost of goods sold, or minus the cost of providing services for a franchise system that offers services.

Gross sales means the total revenue derived from the sale of goods or services less sales tax, discounts, allowances, and returns.

Managed outlet means any outlet that: (i) is owned by a person that is not a franchisee, the franchisor, an affiliate of the franchisor, or a person required to be identified in Item 2; and (ii) is managed by the franchisor, an affiliate of the franchisor, or by a person required to be identified in Item 2.

Median means the data point that is in the center of all data points used. That number is found by examining the total number of data points and finding the middle number in that set. In the event the number of data points is an odd number, the median will be the center number. If the dataset contains an even number of data points, the median is reached by taking the two numbers in the middle, adding them together, and dividing by two.[4]

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[3] For example, if the data points are 13, 13, 14, 19, and 26, the average is 17. This figure is arrived at as follows: Calculate the sum of all data points (that is, 3+13+14+19+26=85). Divide this number by the total number of data points in the set. Here, we get 85 divided by 5 (the number of data points) = 17. Thus the average is 17.

[4] For example, if the data points are the odd numbered sequence of 13, 13, 14, 19, and 26, the median is 14, which is the third number in the five data point set. We have two numbers above this data point, and two below this data point. If our data set was modified by adding a 12 to our set, so that the even numbered sequence we are now using is 12, 13, 13, 14, 19, and 26, we discover that the two numbers in the middle of this dataset are the third and fourth

Net profit means gross profit minus all ordinary and recurring operating expenses, interest, income taxes, depreciation and amortization.

A. Disclosure of FPRs Generally

19.4. *Item 19 – Disclosure of Gross Sales Generally*

QUESTION: Must a franchisor making an FPR disclosing gross sales define how it calculates gross sales?

ANSWER: Yes. A franchisor making an FPR disclosing gross sales (whether characterized as gross sales or a similar term, e.g., "gross revenue") must disclose which items, if any, it is deducting from total revenue, including sales tax, discounts, allowances, and returns.

19.5. *Item 19 – Disclosure of Net Profit Generally*

QUESTION: Must a franchisor making an FPR disclosing net profit define how it calculates net profit?

ANSWER: Yes. A franchisor making an FPR disclosing net profit (whether characterized as net profit or a similar term, e.g., "net income") must disclose which items it is deducting from gross profit, including ordinary and recurring operating expenses, interest, income taxes, depreciation, and amortization.

19.6 *Item 19 – Identifying Source of Data Underlying FPR*

QUESTION: Does a franchisor have an obligation to identify the sources of data it uses to make an FPR?

ANSWER: Yes. A franchisor must clearly identify the sources of all data presented in an FPR. If a franchisor makes an FPR based on both franchise and company-owned outlet data, the two different types of data must be clearly identified. If a franchisor is adjusting or supplementing actual cost data in an FPR, the franchisor must clearly identify which data are actual costs, which data are adjusted or supplemental costs, and the method and rationale for determining the adjusted or supplemental costs.

19.7 *Item 19 – Managed Outlets*

QUESTION: Must a franchisor disclose managed outlets separately from company-owned outlets?

ANSWER: Not in all cases. If managed outlets are included in an FPR, the franchisor must disclose the existence of managed outlets in the FPR and identify how they are characterized. As long as the results of managed outlets are not materially different from the results of other outlets

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numbers, which are 13 and 14. By adding these together (13+14=27), and dividing by two (27/2), we know the median is 13.5. In this example, we have three data points above this number, and three below this number.

included in the FPR, a franchisor may characterize a managed outlet as any of the following in an FPR: (i) as a company-owned outlet; (ii) as a franchise outlet; or (iii) in a separate "managed outlet" category. If the results of managed outlets are materially different from the results of other outlets included in the FPR, the franchisor may not include results from managed outlets in the FPR.

B. Use of Data from Company-Owned Outlets

19.8 *Item 19 – Gross Sales FPR Based on Company-Owned Outlets Alone When Franchisor Has Both Operational Franchise Outlets and Company-Owned Outlets*

QUESTION: If a franchisor has operational franchise outlets,[5] can the franchisor make a gross sales FPR based on company-owned outlet data alone?

ANSWER: No. A franchisor with operational franchise outlets has no reasonable basis for making a gross sales FPR based on company-owned outlet data alone.

19.9 *Item 19 – Gross Sales FPR Based on Company-Owned Outlets Alone When Franchisor Has No Operational Franchise Outlets*

QUESTION: If a franchisor has no operational franchise outlets, can the franchisor make a gross sales FPR based on company-owned outlet data alone?

ANSWER: Yes. If a franchisor has no operational franchise outlets, the franchisor can make a gross sales FPR based on company-owned outlet data alone, if the franchisor has a reasonable basis for the FPR and discloses material financial and operational characteristics of the company-owned outlets that are reasonably anticipated to differ materially from future operational franchise outlets.[6]

19.10 *Item 19 – Gross Profit or Net Profit FPR Based on Company-Owned Outlets Alone*

QUESTION: Can a franchisor make an FPR disclosing gross profit or net profit based on company-owned outlet data alone?

ANSWER: Yes. A franchisor can make an FPR disclosing gross profit or net profit based on company-owned data alone if it has a reasonable basis to make the FPR and includes the following information: (a) gross sales data from operational franchise outlets, when the franchisor has operational franchise outlets; (b) actual costs incurred by company-owned outlets; and (c) supplemental disclosure or adjustments to reflect all actual and reasonably expected material financial and operational differences between company-owned outlets and operational

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[5] For purposes of this Commentary, the determination about whether a franchisor has operational franchise outlets is made as of the end of the franchisor's last fiscal year.

[6] Although a presentation of cost or expense data alone is not an FPR, a franchisor that makes an FPR disclosing gross sales alone may not separately provide cost or expense data outside of the FPR from which a prospective franchisee could readily calculate average net profits. *See* FTC Franchise Rule Compliance Guide p. 131 (May 2008).

franchise outlets.[7] These differences consist of fees and other expenditures required by the franchise agreement, disclosed in the Franchise Disclosure Document, or that are otherwise known or reasonably should have been known by the franchisor.

In an FPR disclosing gross or net profit, if franchisees pay more for goods or services than the franchisor, the franchisor must adjust or supplement the FPR to include the costs the franchisee would incur. In an FPR disclosing net profit, the franchisor must adjust or supplement the FPR to include imputed royalties, advertising fund contributions, and other fees not paid by company-owned outlets, such as the costs of a full time third party manager if, for example, multiple company-owned outlets are managed by a single employee.

The disclosure of these differences must be clearly presented and in the same format as the rest of the FPR. For example, if the FPR presents data in a table, the differences must be adjusted within or added to the end of the table.

19.11 *Item 19 – FPR Merging Data from Both Franchise Outlets and Company-Owned Outlets*

QUESTION: If a franchisor makes an FPR that includes data from both franchise outlets and company-owned outlets, can the franchisor merge the data from both types of outlets in the FPR?

ANSWER: No, except as set forth in this answer. Generally, if a franchisor makes an FPR that includes data from both franchise outlets and company-owned outlets, the franchisor must disclose the data from the company-owned outlets and the franchise outlets separately.[8] Once a franchisor separately discloses data from both franchise outlets and company-owned outlets in an FPR, the franchisor may then choose to also present the same data in a combined format.

If, however, a franchisor has such a small number of total franchisees[9] that the identity of franchisee(s) whose data is being reported in Item 19 is discernable, and the franchise and company-owned outlets have gross sales that are not materially different, the franchisor may merge the data in the FPR. In that case, the franchisor must include a representation in Item 19 that there are no material differences in the gross sales of franchise and company-owned outlets.

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[7] Representation based on data from company-owned outlets must take into account "differences between company-owned and franchised outlets, imputing, where appropriate, differences in costs (*e.g.*, royalty payments) and economies of scale." *See* FTC Franchise Rule Compliance Guide, p. 137 (May 2008).

[8] *See Id.* ("If a financial performance is based on both franchise and company-owned outlets "the data for each type ordinarily should be separated to avoid potential misrepresentation".) A franchisor that discloses gross sales data from franchise outlets and actual cost data based on company-owned outlets as described in Commentary Item 19.10 is not "merging data" for purposes of this Item.

[9] What constitutes a small enough number of franchisees to allow the franchisor to combine this data varies depending on the franchise. A franchisor with 10 or more franchisees, however, will be presumed to have a sufficient number of franchisees to require data from franchise outlets and company-owned outlets to be disclosed separately.

C. Use of Subsets

19.12 *Item 19 – Subsets Generally*

QUESTION: Item 19 allows a franchisor to make an FPR based on a subset of outlets that share a particular set of characteristics. Are there any general limitations on a franchisor's ability to make an FPR based on a subset of outlets?

ANSWER: Yes. In general, a franchisor may make an FPR based on a subset of outlets but only if the FPR based on the subset (a) has a reasonable basis, (b) is accurate, and (c) is not misleading.

19.13 *Item 19 – Best Performing Outlets*

QUESTION: May a franchisor make an FPR based solely on the performance of a subset of its best performing outlets?

ANSWER: No. An FPR that is based solely on the performance of a subset of the franchisor's best performing outlets is likely to be misleading and have no reasonable basis. For that reason, an FPR based solely on the performance of a subset of a franchisor's best performing outlets must also include the results of one or more corresponding subsets of its lowest performing outlets. For example, if a franchisor prepares an FPR subset showing the average and median sales of the highest grossing 10% of outlets in its franchise system, the franchisor also must show the average and median sales of the lowest grossing 10% of outlets in its franchise system. Even if a franchisor presents system-wide performance information, it may not include a subset of its best performing outlets without including the corresponding results of its lowest performing outlets.

19.14 *Item 19 – Small Number of Company Owned Outlets and Franchise Outlets*

QUESTION: May a franchisor with a relatively small number of substantially similar company-owned outlets and franchise outlets as of the end of the franchisor's last fiscal year base an FPR on a subset of those outlets?

ANSWER: No. A franchisor with fewer than 10 substantially similar company-owned outlets and franchise outlets as of the end of the franchisor's last fiscal year will be presumed to have too few outlets to base an FPR on a subset of those outlets.[10]

19.15 *Item 19 – Geographic Subsets*

QUESTION: If a franchisor uses a subset based on a geographic area in its FPR, must the franchisor describe why that geographic subset was selected?

ANSWER: Yes. The franchisor must describe why and how that geographic subset was selected. The franchisor may not present information for a geographic subset if that information is misleading.

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[10] This answer does not mean that a franchisor cannot make an FPR based on data from 10 outlets or less, when the franchisor has a reasonable basis for doing so.

<u>D. Averages and Medians</u>

19.16 *Item 19 – Average*

QUESTION: Are there any statistical requirements that a franchisor must include when disclosing an "average" in an FPR?

ANSWER: Yes. Whenever a franchisor discloses an average of numbers in an FPR, it also must disclose the median of those numbers because the existence of outliers may skew an average, thereby making it misleading (even if the calculation is accurate). Whenever the franchisor discloses the average of gross sales, the franchisor also must disclose the highest and lowest numbers in the range.

19.17 *Item 19 – Median*

QUESTION: Are there any statistical requirements that a franchisor must include when disclosing a "median" in an FPR?

ANSWER: Yes. Whenever a franchisor discloses a median of a range of numbers in an FPR, it also must disclose the average of those numbers because disclosure of the median alone may be misleading (even if the calculation is accurate). Whenever the franchisor discloses the median of gross sales, the franchisor also must disclose the highest and lowest numbers in the range.

19.18 *Item 19 – Omission of Outlets that Have Closed*

QUESTION: If a franchisor makes an FPR that includes an average or median, may the franchisor, in calculating that average or median, exclude data from any company-owned outlets or franchise outlets that closed during the time period covered in the FPR?

ANSWER: Yes. A franchisor making an FPR that includes an average or median may exclude data from company-owned outlets and franchise outlets that closed during the time period covered in the FPR, provided the franchisor discloses in the FPR: (i) the number of company-owned outlets that closed during the time period, if the FPR includes company-owned outlets; (ii) the number of franchise outlets that closed during the time period, if the FPR includes franchised outlets; and (iii) the number of excluded outlets that closed during the same time period after being open less than 12 months. This disclosure should cover each year or other period of time covered in the FPR.

<u>E. Use of Forecasts and Projections</u>

19.19 *Item 19 – FPR Presenting Forecasts (Projections)*

QUESTION: Must forecasts (projections) be based on historical data?

ANSWER: Yes. Projections cannot be based on mere hypothetical situations or expectations. Historical results may be adjusted or supplemented based on changes in the market (for example, when current rents are higher or lower than historic rents), but the projections still must be based on historical data from outlets substantially similar to the type of outlet offered in the Franchise Disclosure Document.

19.20 ***Item 19 – FPR Presenting Projections Not Based on Franchisor's Brand Data***

QUESTION: Must the historical data on which projections are based be data from the brand being offered?

ANSWER: Yes. A projection must be based on a reasonable sample of the historic results of the brand offered to the prospective franchisee. The historic results must be from outlets substantially similar to the type of outlet offered in the Franchise Disclosure Document. A projection may not be based on the results of other brands operated or licensed by the franchisor or its affiliates, or on the results of similar or competitive brands operated by others, or on industry reports.

F. Disclaimers

19.21 ***Item 19 – Clear and Conspicuous Admonition (Substance)***

QUESTION: May a franchisor vary the language of the admonition provided in FPR Commentary Item 19.3, advising that a new franchisee's individual financial results may differ from the results stated in an FPR?

ANSWER: No. A franchisor may not vary the language of the admonition provided in FPR Commentary Item 19.3, unless the franchisor makes a type of FPR that does not fit the situation for the language provided. FPR Commentary Item 19.3 states that a franchisor should use one of two forms of conspicuous admonition, one for an historical representation and one for a projection. The language of both types of admonition stated in Commentary Item 19.3 applies to an FPR based on sales or earnings. A franchisor that makes an FPR based on outlet sales or earnings must use the applicable language stated in Commentary Item 19.3, without any variation, and without adding any additional disclaimer language. When a franchisor makes an FPR based on something other than outlet sales or earnings (for example, hotel occupancy rates), it may change the language of the sample admonition, but only to the extent necessary to fit the FPR made.

19.22 ***Item 19 – Clear and Conspicuous Admonition (Form)***

QUESTION: Are there any limitations on the form of the admonition a franchisor must include in Item 19 when the franchisor makes an FPR?

ANSWER: Yes. Item 19 requires that the admonition a franchisor must include when it makes an FPR must be "clear and conspicuous." Clear and conspicuous means that the admonition must be easily noticeable and easily understandable by a prospective franchisee. The admonition required in FPR Commentary Item 19.3, therefore, must be presented in a separate paragraph from the rest of the FPR and in bold type, for example:

"Some outlets have earned this amount. Your individual results may differ. There is no assurance that you'll earn as much."

The language may not be in capital letters or underlined or in larger type than the rest of the FPR.

19.23 ***Item 19 – Disclaimers In Addition to Clear and Conspicuous Admonition***

QUESTION: May a franchisor include in Item 19 disclaimers in addition to the admonition required in FPR Commentary Item 19.3?

ANSWER: No. The admonition required in FPR Commentary Item 19.3 is intended to inform a prospective franchisee. It is not intended to allow a franchisor to disclaim responsibility for the FPR or advise a franchisee that it may not rely on the FPR. Under the FTC Franchise Rule, a franchisor is prohibited from disclaiming or requiring a prospective franchisee to waive reliance on any representation made in the Franchise Disclosure Document. A franchisor, therefore, may not include in Item 19 or elsewhere in a Franchise Disclosure Document any disclaimers that contradict, mitigate, or are inconsistent with the admonition prescribed in FPR Commentary Item 19.3.