FINANCIAL PERFORMANCE REPRESENTATIONS –

SHIELD OR SWORD?

Brian B. Schnell
Faegre & Benson LLP

Andrew C. Selden
Briggs and Morgan, Professional Association

Anne Connelly
Illinois Attorney General’s Office

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Financial Performance Representations Information – (including sample financial performance representations and general information about franchisees that use or include financial performance information in Item 19 of their financial disclosure documents).
I. INTRODUCTION

From the very beginning in 1970, both state and federal franchise pre-sale disclosure requirements have addressed franchisors' use of financial performance information to stimulate interest in their franchise offerings. Originally referred to collectively as "earnings claims," these disclosures had caused mounting problems throughout the 1960s. The record reflected in the Statement of Basis and Purpose (SBP) of the original FTC Rule shows that many franchisors used unsubstantiated, exaggerated, and misleading statements concerning actual past performance of earlier franchises or of projected future performance of the franchises being offered. Many investors lost large sums as a result of investments made in reliance upon these claims.

As a result, the initial wave of state franchise registration and disclosure laws between 1970 and 1975 directly regulated earnings claim disclosures. When states in the Upper Midwest first put together the precursor to the Uniform Franchise Offering Circular (UFOC) in 1974, earnings claim regulation was a significant separate category of disclosure, captured in the now-famous "Item XIX."

When the Federal Trade Commission (FTC) joined the party in 1979, on the basis of a rulemaking record completed five years earlier, it, too, directly regulated earnings claim disclosures, even more extensively than the states had through the UFOC. The FTC Rule required a "reasonable basis" and geographic relevance, for example, and (in the FTC format disclosure document) had to be in a separate "Earnings Claim Document." The Rule also extensively regulated "media earnings claims."

Now, more than a quarter of a century later, with the FTC completing its first review and revision of the franchising rule in 2007, which essentially modernized and federalized the UFOC Guidelines, what had been UFOC Item 19 now is part of the FTC's new "Franchise Disclosure Document" (FDD) regulation. Among other changes, the FTC also changed the name "earnings claims" to the new nomenclature of "financial performance representations."

Financial performance representations (FPRs) still can be a powerful selling tool for franchisors precisely because they respond to the prospective franchise investors' compelling need for investment information concerning the possible financial results of their investment, whether based on statements of historical performance of system locations or projections or forecasts of future performance. FPRs may consist of a wide variety of types of financial information, ranging from simple periodic gross sales data, through break-even points, stated rates of return on invested capital, partial or comprehensive statements of profit and loss, cost categories or structures, or industry-specific metrics of performance usually based on volume information rather than monetary data.

Despite more than three decades of franchise disclosure regulation, however, problems persist with FPRs. The record reveals a steady, if low, volume of civil litigation and public agency enforcement proceedings involving unsubstantiated, exaggerated, fraudulent, or

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1 The authors would like to acknowledge and thank Danell Olson, an associate at Faegre & Benson LLP, and John Nyanjom, a summer associate at Briggs and Morgan, for their valuable contributions to this paper.

2 See, Bus. Franchise Guide (CCH) ¶6302.

3 44 F.R. No. 166 at 49982 et seq. (August 24, 1979); See, Bus. Franchise Guide (CCH) ¶ 105.
technically illegal FPRs. Opinions vary among franchisors, prospective franchise investors, and professionals advising both groups. For prospective franchisees, financial performance information often is critical, with some variation of "how much money can I make" as one of the key questions in their decision-making process. Some franchisors believe that Item 19 FPRs are the key difference in distinguishing their franchise offerings from their competitors. Other franchisors choose not to offer any financial performance information, fearing litigation over such disclosures if franchisees' actual experiences do not meet the levels reflected in the disclosure.

The Forum last visited the subject of earnings claim disclosure in 1999, and before that in 1995. With the recent revisions to the Franchise Rule, it is time to update those papers with a new review of the revised law regulating pre-sale disclosure of financial performance information. This paper, therefore, develops the revised FTC Rule's treatment of financial performance disclosure in the new FDD Item 19. We provide an overview of the history and policy of regulation of FPRs, address franchisors' preparation and use of FPRs by franchisors under the new FDD requirements, discuss FPRs from the investor's point of view, and close with a review of recent experience by states and their staff in dealing with UFOC, and now FDD, filings that include positive disclosures in Item 19.

The goal of the paper is to review recent changes in the law, encourage broader use of FPR disclosure in Item 19, and assist practitioners in understanding the updated FDD disclosure requirements concerning FPRs.

II. FINANCIAL PERFORMANCE REPRESENTATIONS – THE LAW

The first step to drafting, understanding or interpreting FPRs is to determine what is a "financial performance representation." When enacting the revised FTC Rule, the FTC included a definition of financial performance representation.

A. Definition of Financial Performance Representation

The revised FTC Rule defines "financial performance representation" to mean:

[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.  


5 16 C.F.R. § 436.1(e). The Original FTC Rule defined "earnings claim" to mean:

An oral, written or visual representation to a prospective franchisee or for general dissemination in the media which states or suggests a specific level or range of potential or actual sales, income, gross or net profits.

16 C.F.R. 436.1(b) and (c).
The financial performance representation definition encompasses not only the information set forth in Item 19 of a franchisor's FDD, but also covers financial information set forth in any advertisement on the franchisor's website and verbal representations made by a Franchise Seller on behalf of a franchisor. With the notable exception of cost information (as explained in Section II.C below), the definition essentially covers every aspect of financial information that a prospective franchisee might request or a franchisor might provide during the franchise sales process.

Similar to the original FTC Rule and the UFOC Guidelines, there is no requirement that a franchisor include a financial performance representation in its FDD. If a financial performance representation is not included in Item 19, a franchisor, except in limited circumstances, may not provide a prospective franchisee with any financial information before the franchisee signs a franchise agreement.

Regardless of whether a franchisor includes a financial performance representation in its FDD, the revised FTC Rule requires all franchisors to begin their Item 19 disclosure with the following prescribed disclaimer:

The FTC's Franchise Rule permits a franchisor to provide information about the actual or potential financial performance of its franchised and/or franchisor-owned outlets, if there is a reasonable basis for the information, and if the information is included in the disclosure document. Financial performance information that differs from that included in Item 19 may be given only if: (1) a franchisor provides the actual records of an existing outlet you are considering buying; or (2) a franchisor supplements the information provided in this Item 19, for example, by providing information about possible performance at a particular location or under particular circumstances.

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The revised FTC Rule's definition of financial performance representation closely resembles the 1993 UFOC Item 19 Requirements and Guidelines definition of "earnings claim" which was as follows:

Information given to a prospective franchisee by, on behalf of or at the direction of the franchisor or its agent, from which a specific level or range of actual or potential sales, costs, income or profit from franchised or non-franchised units may be easily ascertained. A chart, table or mathematical calculation presented to demonstrate possible results based upon a combination of variables (such as multiples of price and quantity to reflect gross sales) is an earnings claim subject to this item.

Bus. Franchise Guide (CCH) ¶5771, UFOC Guidelines Item 19, Instructions, i.

6 Franchise Seller is defined in the revised FTC Rule to mean a person that offers for sale, sells or arranges for the sale of a franchise. 16 C.F.R. § 436.1(j). It includes not only the franchisor and its employees, representatives, agents and subfranchisors, but also any third party brokers involved in the franchise sales process. The revised FTC Rule expressly excluded existing franchisees who sell their own outlet and who are otherwise not engaged in franchise sales on behalf of the franchisor from the definition of Franchise Sellers.

7 There are two key exceptions to this rule. See, 16 C.F.R. §§ 436.5(s)(4)-(5). As described more fully in Section II.D below, a franchisor may provide a prospective franchisee with financial performance information for a specific outlet the prospect is interested in purchasing. Additionally, if a franchisor has made an Item 19 FPR, it may provide a prospect with supplemental financial information relating to a particular location or addressing a particular characteristic of an outlet.

8 16 C.F.R. § 436.5(e)(1). A franchisor may not vary the disclosures made in this prescribed statement. This exact paragraph must appear as the opening paragraph in Item 19 of every franchisor's FDD.
This prescribed disclaimer informs prospective franchisees that the revised FTC Rule does in fact allow franchisors to provide prospective franchisees with financial performance information. The FTC specifically addressed this issue because it observed that too many franchisor representatives were claiming that the FTC Rule prohibited the franchisor from providing financial information, a position that has never been true under any state or federal franchise law. Thus, franchisors who elect not to provide prospective franchisees with financial information cannot claim that it is illegal to provide such information to prospects prior to signing a franchise agreement. Franchisors not providing financial information in their disclosure documents will need to train their sales team to address this issue when prospective franchisees ask the questions, “how much will I make?” or “what are the average annual sales at your existing locations?”

In addition to including the prescribed disclaimer identified above, if a franchisor chooses not to include any financial performance information in its FDD, the franchisor must include a second prescribed disclaimer stating that they do not provide financial performance representations, and also warn a prospect if they receive any financial information that the prospect should report the representation to the franchisor, the FTC and any appropriate state agencies.

If a franchisor elects not to make a financial performance representation, then the second paragraph of Item 19 must state as follows:

We do not make any representations about a franchisee's future financial performance or the past financial performance of company-owned or franchised outlets. We also do not authorize our employees or representatives to make any such representations either orally or in writing. If you are purchasing an existing outlet, however, we may provide you with the actual records of that outlet. If you receive any other financial performance information or projections of your future income, you should report it to the franchisor's management by contacting [name, address, and telephone number], the Federal Trade Commission, and the appropriate state regulatory agencies.

As with the first prescribed disclosure, franchisors may not vary the language of this disclosure, but, instead, must adopt the entire disclosure word-for-word.

B. The Rules

If a franchisor chooses to include a financial performance representation in its FDD, the revised FTC Rule identifies specific rules and requirements a franchisor must follow when

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9 During the rulemaking process, evidence was presented to show that some franchisors falsely state that the Commission or the Franchise Rule prohibits them from making financial information available. To prevent this deception from continuing, Item 19 now requires franchisors to expressly state that the Franchise Rule allows franchisors to share financial information, so long as the information is set forth in the franchisor's FDD. See 72 Fed. Reg. 155444, 15500 (March 2007). The required preamble negates any representation or suggestion that the Franchise Rule prohibits franchisors from disclosing financial performance information. As a result, prospective franchisees can now question a franchisor as to why it does not provide financial information.

10 16 C.F.R. § 436.5(s)(2).
preparing and presenting its representation. First, a franchisor must have a reasonable basis for making the representation and written substantiation for the information contained in the representation at the time the representation is made.\footnote{16 C.F.R. § 436.5(s).} The revised FTC Rule further requires a franchisor to expressly state whether its financial performance representation reflects a historic performance of all or a subset of existing franchised outlets, or whether the information is a forecast of future potential performance.\footnote{16 C.F.R. § 436.5(s)(3)(i).} The financial performance representation also must include a clear and conspicuous admonition that a new franchisee's individual financial results may differ from the results stated in the financial performance representation.\footnote{16 C.F.R. § 436.5(s)(3)(iv).} Finally, a franchisor must have written factual information in its possession that reasonably supports the financial performance representation\footnote{16 C.F.R. § 436.5(s)(3)(v).}, and Item 19 must expressly state that written substantiation for the financial performance representation will be made available upon reasonable request.\footnote{The reasonableness of a request depends in large part on the time and location of the request. A request is reasonable when the prospect provides the franchisor with adequate time to gather the information and the location for providing the information is a convenient location such as the franchisor's corporate headquarters.\footnote{16 C.F.R. § 436.5(s)(3)(i).}} The supporting information must include the type of information upon which a prudent businessperson would rely in making an investment decision.

Regardless of whether a franchisor's financial performance representation is a historic report of all or a subset of existing franchised outlets, or whether the information is a forecast of future potential performance, a franchisor must identify the supporting facts and underlying basis for the representation.\footnote{16 C.F.R. § 436.5(s)(3)(i).} The type of information needed to support the underlying basis of the financial performance representation, however, varies depending on whether the FPR is a historical representation or a performance projection as to what a prospective franchisee can expect to make in the future.

1. **Historic Representation**

A historic representation includes information based upon the past performance of an outlet or group of outlets. As further noted in the following section, the past performance could relate to the performance of a franchised or company-owned outlet or a similar outlet operated by an affiliate of the franchisor. A properly prepared historic representation has some practical advantages over a forecast of future performance because it is based on actual operating results, while a forecast by its nature will include more assumptions which others later can challenge or second-guess.

If a franchisor makes a historic representation, the revised FTC Rule identifies six separate elements that a franchisor must include in its FPR to satisfy the requirement that the franchisor's financial performance representation have a reasonable basis. Specifically, a franchisor must disclose the: (i) group measured; (ii) time period measured; (iii) number of outlets measured; (iv) number of outlets reporting; (v) number and percentage of outlets that...
attained or surpassed the stated level of performance; and (vi) distinguishing characteristics of the outlets included in the representation from the outlets offered under the franchise disclosure document.\(^{17}\)

\[\text{a. The Group Measured}\]

A franchisor making a historic financial performance representation may include all of its franchised outlets in the representation or a subset of outlets that share a particular characteristic.\(^{18}\) For example, a franchisor could include all outlets operating under the system, or include only those outlets that have been operating for at least 12 months and exclude those outlets that are still in their initial operating stages. Regardless of which approach a franchisor takes, a franchisor must expressly state whether the representation includes information from all of the outlets in the system or only a subset of outlets sharing a particular characteristic.\(^{19}\) If only a subset of outlets is used, the franchisor also must clearly disclose the common characteristics of the outlets included in the subset.\(^{20}\) The key is to disclose the common factors that link the subset of outlets.

Subset examples might include a breakdown of outlets by geographic region or by number of years in operation. Another example might be full service restaurants versus limited menu locations, particularly if the franchisor’s current offering is only one of the subsets. They key is that the subset decisions must be reasonable and not mislead prospects. One common subset approach is a breakdown of outlet information by years of operation. An Item 19 FPR that shows an average unit volume breakdown of outlets in operation for: (i) one to two years, (ii) three to four years, and (iii) at least five years may be more meaningful than just one average of all outlets, particularly if the differences by years are significant.

A franchisor is not limited to providing information only from its franchised outlets in its financial performance representation. The representation may include information from both franchised and company-owned outlets, company-owned outlets only, or, if certain requirements are met, similar outlets operated by an affiliate.\(^{21}\) Specifically, a franchisor may use information from an affiliate if the franchisor has written substantiation of the representation in its possession at the time the financial performance representation is made, and the franchisor clearly discloses that the information is based on the performance of an affiliate-owned and operated outlet.\(^{22}\)

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\(^{17}\) See, 16. C.F.R. § 436.5(s)(3)(ii).

\(^{18}\) 16 C.F.R. § 436.5(s)(3)(ii)(A). The revised FTC Rule specifically identifies the following categories of outlet subsets: geographic location, type of location (such as free standing vs. shopping center), degree of competition, length of time the outlets have operated, type of services or goods sold, services supplied by the franchisor, and whether the outlets are franchised or franchisor-owned or operated.

\(^{19}\) 16 C.F.R. § 436.5(s)(3)(ii)(A).


\(^{21}\) See, Bus. Franchise Guide (CCH) ¶ 6090.

\(^{22}\) Id. For example, if a franchisor is utilizing actual results of an affiliate-owned outlet the FPR should include a statement noting that the FPR reflects the actual performance results of a similar business operated by the franchisor’s affiliate. The FPR should further state the FPR information franchisor franchisor’s affiliate should not be considered as the actual or probably results a franchisee can expect to realize. Finally, if there are any differences between the products or services offered or sold by the affiliate than will be offered and sold by the franchise outlet, these differences should be noted and explained.
A franchisor, however, must use caution when basing its financial performance representation on information obtained from an affiliate. Specifically, in FAQ 8, the FTC staff stated that "[w]hen a franchisor has adequate performance data of its own upon which to base a performance representation, basing a financial performance representation on affiliate information likely would not be reasonable." A new franchisor with limited operating experience may find it beneficial to include a financial performance representation utilizing its affiliate’s operating history. Again, the key is that the representation has a reasonable basis and is not misleading to prospective franchisees. A franchisor who uses the financial information of an affiliate must clearly disclose that the information is based upon the operations of its affiliate and does not include information relating to performance by the franchisor or any franchisee of the franchisor.

b. **The Time Measured**

A franchisor must disclose when the stated level of performance included in the financial performance representation was achieved. Generally, the information disclosed in a franchisor's financial performance representation may include information collected for any reasonable timeframe. For example, a franchisor may wish to disclose financial information for its outlets for the prior two or three years. Franchisors, however, should use caution when basing a financial performance representation on information that was collected a number of years ago. Using data gathered too far in the past may result in a representation that is no longer relevant or applicable to current market conditions, and may not provide a reasonable basis for the representation.

This is particularly true and evident when economic conditions are tight as is currently the case. Current economic and market conditions have resulted in consumers reducing the amount of money they spend on luxury and non-essential products and services. When market conditions change, franchisors need to be especially mindful of the information set forth in their FPR. For example, franchisors whose FPRs contain information from five years ago are not necessarily relevant to the current conditions franchisees are facing due to consumers keeping a close eye on their spending habits.

c. **Number of Outlets Measured and Number of Outlets Reporting**

A franchisor must disclose the number of franchisees that are included in the group or subgroup used in the Item 19 representation as compared to the total number of franchisees in the entire franchise system. For example, if a financial performance representation includes information from all Minnesota-based outlets, a franchisor must disclose the total number of outlets in the franchise system, along with the total number of Minnesota-based outlets. Franchisors also must disclose the number of outlets in the group from which the financial performance claim is made and from which information was gathered. Expanding on the example above, if a franchisor sends out questionnaires to all of its Minnesota-based outlets,

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23 Id. See also, Franchise Rule 16 C.F.R. Part 436 Compliance Guide, p. 88.

24 16 C.F.R. § 436.5(s)(ii)(B).

25 16 C.F.R. § 436.5(s)(ii)(D).
and only 80 of the 150 Minnesota-based franchised outlets respond to the survey, the franchisor must disclose that the financial performance representation includes information obtained from the 80 questionnaires returned by its 150 Minnesota based-franchised outlets. Finally, if a franchisor only sends the questionnaire to a randomly selected group of Minnesota outlets instead of all 150 outlets, the franchisor must disclose the number of franchisees who received the questionnaire, the number of franchisees who responded to the questionnaire, and the criteria used to select the franchisees who received the questionnaire.26

d. **Number and Percentage of Outlets that Attained or Surpassed Stated Amount**

A franchisor must disclose both the number and percentage of franchisees that actually attained or surpassed the stated results.27 Again, using the Minnesota example from above, this disclosure might state, "of the 150 Minnesota franchisees that received the questionnaire, 80 responded and 45 (56%) achieved or surpassed the stated level of performance." One of the most commonly litigated financial performance representation claims is when a franchisor fails to include the number and percentage of franchisees that attained or surpassed the stated representation.28 The reasoning behind this requirement is that it allows a prospective franchisee to understand if the representation is skewed due to the unusually high performing outlet, or if the numbers represent the average outlet performance.

e. **Distinguishing Characteristics**

A franchisor making a historic representation must identify the common characteristics of the outlets that achieved the stated level of performance.29 Even though there is no guarantee that a prospective franchisee will perform as well, the assumption underlying a historic representation is that a prospective franchisee may achieve similar results. Accordingly, all factors tending to call this assumption into question must be disclosed in Item 19. Thus, Item 19 must include an explanation of any circumstance or characteristic of the group or subgroup on which a financial performance representation is based that might distinguish that group from outlets currently being offered for sale.30

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26 *Franchise Rule* 16 C.F.R. Part 436 Compliance Guide, p. 89. For instance, a franchisor could send surveys out to those Minnesota-based franchisees who have been in operation for at least 12 months or those located in a certain geographic areas, or both.

27 16 C.F.R. § 436.5(s)(ii)(E).

28 See, e.g., *Randall v. Lady of America Franchise Corp.*, 532 F.Supp.2d 1071 (D. Minn. 2007); *U.S. v. Vend Direct, Inc.*, 2007 WL 2176205 (D. Col. May 11, 2007); and *F.T.C. v. USA Beverages, Inc.*, 2005 WL 5654219 (S.D. Fla. Dec. 6, 2005) (noting that a franchisor violates the FTC Rule when its fails to include the number and percentage of franchisees known by the franchisor to have achieved the same or better results).

29 16 C.F.R. § 436.5(s)(ii)(F).

30 *Franchise Rule* 16 C.F.R. Part 436 Compliance Guide, p. 90 (noting that Item 19 calls for disclosure of any characteristic of the group or subgroup on which a financial performance claim is based that might set that group apart from outlets currently being offered for sale). In the Compliance Guide, the FTC staff notes, for example, that financial performance data collected from ice cream store franchises in Florida might differ significantly from such data collected from ice cream store franchisees in Minnesota or Alaska. Accordingly, if a franchisor uses a subgroup as a basis for its FPR, the franchisor must clearly state that the performance results are based on franchisees located in Florida, and are likely to differ materially from those outlets being offered for sale in other regions.
A franchisor making a historic performance representation must make sure that the underlying data reasonably supports the representation. For example, a representation that franchisees earn a net profit of $60,000 per year implies that this figure is representative of the typical experience of the system’s franchisees. The representation would not have a reasonable basis if, in fact, only a small minority of the franchisees earn this amount, if the profits were due to an unusual or non-recurring condition, or if the franchisees used inconsistent methods for determining and reporting their profits. Use of information such as this can be unreliable and result in a misleading FPR.

The key to creating a fully substantiated FPR is to start with reliable information that reflects the typical operating results experienced by a majority of the outlets in existence. Utilizing the information from only the top performing franchisees will result in a FPR that is misleading and unreliable.

2. **Projected Performance Representation**

Unlike a historic representation, the revised FTC Rule does not enumerate specific factors that a franchisor must address when making a projected performance representation. Instead, if a representation is a forecast of future financial performance, a franchisor must state the material basis and assumptions upon which the projection is based. The material assumptions underlying a projected performance representation include any significant factors upon which a franchisee’s future results are expected to depend.

The revised FTC Rule identifies certain significant factors that a franchisor making a forecast projection should consider in preparing a projected performance representation. Specifically, a franchisor should disclose factors such as economic or market conditions, an increase in the cost of goods or services sold, and any changes with respect to operating expenses. A franchisor making a performance projection must include a description of the facts and materials it used and relied on when making the representation, including any market studies, statistical analyses and franchisee profit and loss statements. Identifying the underlying material used to create the FPR allows a prospective franchisee to make an independent judgment as to the validity and reliability of the performance projection.

Most franchisors who make a projected financial performance representation rely on the results of its franchisees’ prior performances in preparing the Item 19 representation. As is the case with historical projections, the franchisor must identify any characteristics of these outlets that differ materially from the outlets being offered under the franchise disclosure document. Examples of characteristics that typically make a material difference from one outlet to another

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31 16 C.F.R. § 436.5(e)(3)(iii).

32 *Id.* The Compliance Guide notes that significant factors include such things as economic or market conditions that are basic to a franchisee’s operation and include matters affecting a franchisee’s sales, the cost of goods or services sold and operating expenses. *Franchise Rule 16 C.F.R. Part 436 Compliance Guide*, p. 91.

33 16 C.F.R. § 436.5(e)(3)(iii); See also, *Franchise Rule 16 C.F.R. Part 436 Compliance Guide*, p. 91.


35 *Id.*

36 *Id.*
include: geographic location; type of business premises (free standing unit vs. unit located in a shopping center), the extent of competition in the market area, any differences in the services or goods sold, assistance or services supplied by the franchisor, and whether the outlets are franchised or company-owned.

As a general matter, the Franchise Rule Compliance Guide identifies the following list of factors a franchisor should consider when determining whether it has a reasonable basis for its projected forecast:

- Financial forecasts should be prepared in good faith.
- Financial forecasts should be prepared with appropriate care by a qualified person.
- Financial forecasts should be prepared using appropriate accounting principles – a franchisor making a financial forecast should consult the current standards for projections issued by a professional organization such as the American Institute of Certified Public Accountants.
- The process used to develop financial forecasts should provide for seeking out the best information that is reasonably available at the time.
- The information used in preparing financial forecasts should be consistent with the plans of the entity.
- Key factors should be identified as a basis for the assumptions.
- Assumptions used in preparing financial forecasts should be appropriate.
- The process used to develop financial forecasts should provide the means to determine the relative effect of variations in the major underlying assumptions.
- The process used to develop financial forecasts should provide adequate documentation of both the financial forecasts and the process used to develop them.
- The process used to develop financial forecasts should include, where appropriate, the regular comparison of the financial forecasts with attained results.
- The process used to prepare financial forecasts should include adequate review and approval by the responsible party at the appropriate levels of authority.\(^{37}\)

\(^{37}\) Id. at p. 135-36.
C. "Costs" No Longer Constitute Financial Performance Representations

One key change made under the revised FTC Rule is the exclusion of cost information — by itself — from the definition of financial performance representation.\textsuperscript{38} Under the revised FTC Rule, a franchisor can provide a prospective franchisee with cost or expense information without including this information in Item 19 of its disclosure document.\textsuperscript{39} In the Statement of Basis and Purpose (SBP) for the revised FTC Rule, the Commission stated that expense information alone is insufficient to enable a prospective franchisee to gauge their potential earnings with any degree of certainty that could rise to the level of a financial performance representation.\textsuperscript{40} For example, the disclosure of fees, required purchases, and expenses similar to the information reported in Items 5, 6 and 7 of the disclosure document ordinarily will not constitute a financial performance representation. Franchisors, however, may not present cost or expense data expressed as a percentage of sales. A presentation of cost data, coupled with additional sales or earnings figures from which prospective franchisees could calculate average net profits falls within the definition of "financial performance representation," and triggers Item 19 compliance requirements.\textsuperscript{41}

If a franchisor chooses to provide its prospective franchisees with cost and expense information that is outside the four corners of the disclosure document, the franchisor must make sure this information is consistent with the information contained in Items 5, 6 and 7 of the disclosure document.

In addition to discussing the information set forth in Items 5, 6 and 7 of the FDD, the franchisor also can provide operating costs and expense information such as food and labor costs. For example, a franchisor might provide prospective franchisee candidates with a cost information sheet that shows the Item 7 initial investment estimates in one column and ongoing monthly operating cost estimates in another column. As noted above, however, a franchisor may not provide food, labor or other costs as a percentage of gross revenues, unless that information is contained in Item 19 of the FDD. Another example of how a franchisor might effectively use cost data is a product-based franchisor providing a price list for its product line, subject to any confidentiality concerns.

D. Financial Results of Actual Outlet Offered for Sale; Supplemental Financial Performance Representations

A franchisor may not provide a prospective franchisee with financial performance information unless the information is set forth in Item 19 of the FDD. There are, however, two exceptions to this general rule.

\textsuperscript{38} Franchise NPR, 64 Fed. Reg. 57294, 57329 (Oct. 1999).

\textsuperscript{39} Franchise Rule 16 C.F.R. Part 436 Compliance Guide, p. 131.

\textsuperscript{40} Franchise NPR, 64 Fed. Reg. 57294, 57329.

\textsuperscript{41} Franchise Rule 16 C.F.R. Part 436 Compliance Guide, p. 131. Generally, if a prospective franchisee could utilize the cost information to back into a revenue or profit amount, the information will qualify as a FPR and, therefore, must be included in Item 19 of the FDD.
First, a franchisor may provide a particular prospective franchisee with financial performance information of a specific outlet the prospective franchisee is interested in buying. Specifically, the revised FTC Rule provides:

[If a franchisor wishes to disclose only the actual operating results for a specific outlet being offered for sale, it need not comply with this section, provided the information is given only to potential purchasers of that outlet.]

In this situation, a franchisor may provide a prospective franchisee for that outlet with the actual operating results for the specific outlet. This exception is limited to only those prospective franchisees actually interested in purchasing the outlet. A franchisor cannot publish the actual results of a specific outlet for sale and distribute this information to all prospective franchisees regardless of whether they are interested in purchasing the specific outlet. This exception also only applies to outlets currently open and operating. Any franchisor who relies on this exception should properly document the exception with the financial information provided and an acknowledgement from the prospective franchisee regarding the circumstances.

Second, if a franchisor has made an Item 19 FPR, it may provide a prospective franchisee with supplemental financial information relating to a particular location or addressing a particular characteristic of an outlet. In particular, the revised FTC Rule states:

[If a franchisor furnishes financial performance information according to this section, the franchisor may deliver to a prospective franchisee a supplemental financial performance representation about a particular location or variation, apart from the disclosure document.]

Accordingly, if a franchisor makes a financial performance representation regarding a standard free-standing restaurant location, a franchisor may modify the information contained in its financial performance representation to conform to a particular variation of an outlet, such as a kiosk location. Any such supplemental representation must be in writing, explain the departure from the financial performance representation set forth in the Item 19 disclosures, and be prepared in accordance with the requirements set forth for financial performance representations in the Revised FTC Rule. Section VI.B.4 discusses supplemental financial performance representations in greater detail.

On a related point, a unique FPR question arises when considering those franchisors that take advantage of the exemptions set forth in Section 436.8 of the revised Rule. Specifically, if a franchisor chooses to take advantage of one of these exemptions and does not

42 16 C.F.R. § 436.5(s)(4).
43 If a franchisor provides a prospective franchisee who is interested in purchasing an already existing location with the financial information relating to that particular location, the franchisor should obtain an acknowledgement from the prospective franchisee that the only financial performance information provided to the prospective franchisee, outside of the information set forth in Item 19, related to the actual operating history of a specific location the prospect was interested in purchasing. The acknowledgement should be signed by the prospective franchisee before the prospect signs any franchise agreement.
44 16 C.F.R. § 436.5(s)(5).
45 16 C.F.R. § 436.5(s)(5)(i-iv).
provide a FDD to the prospective franchisee, can the franchisor share any pre-sale financial information with the prospective franchisee? Section 436.8 states, in pertinent part, that "[t]he provisions of part 436 shall not apply if the franchisor can establish any of the [exemptions set forth in the Rule]."46 In addition, Section 436.9 of the revised Rule expressly states that the Rule's prohibitions only apply to those franchise sellers covered by part 436.47

Reading the provisions of the revised Rule together, if a franchisor or prospective franchisee qualifies for any of the exemptions identified in Section 436.8, then none of the requirements set forth in the revised Rule apply — including the requirements that a franchisor or franchise seller can make and discuss FPRs only if the information is set forth in Item 19 of the FDD. The authors, however, caution that franchisors under these circumstances must exercise care in deciding whether they can make FPRs outside of a FDD. In particular, not all states have adopted the exemptions identified in the revised Rule so the answer to the question raised in the preceding paragraph may be different under state law. Additionally, the exemptions identified in Section 436.8 will not insulate a franchisor from an antifraud claim brought under Section 5 of the FTC Act.

E. Examples of What Is / Is Not a Financial Performance Representation

When most people think of the term "financial performance representation" they think of a representation that explicitly states a specific level or range of actual or potential earnings — e.g., "earn a $50,000 profit," "sales volume of $350,000," or "earn up to $45,000 in your first year." While all of these examples meet the definition of a financial performance representation, the revised FTC Rule broadly defines financial performance representation to include any representation, including any oral, written or visual representation that states expressly or by implication a specific level or range of actual or potential sales, income, gross profits, or net profits. Accordingly, FPRs also include the identification of cost of goods sold if expressed as a percentage of sales, or assisting in the preparation of a financial performance statement, or providing a prospective franchisee with a pro forma or business plan, and any representation regarding occupancy rates or other expressions of transaction volume. Financial performance representations include not only what is contained in Item 19 of a franchisor's disclosure document, but also the information stated in a franchisor's brochures and advertising materials, on its website, and verbal representations made by franchise sellers.

In addition to the typical financial performance representation that comes to mind, other examples of financial performance representations include implied representations from which a prospective franchisee can infer a specific level or range of income, sales or profits. In fact, courts have held that statements such as "earn enough money to buy a new Porsche," and "100% return on your investment within your first year of operation" constitute financial performance representations.48 Additionally, assisting a prospective franchisee in preparing a pro forma, commenting on the pro forma, or reviewing a business plan also may qualify as a

46 16 C.F.R. § 436.8. Section 436.8 identifies 8 separate exemptions that a qualifying franchise company or prospective franchisee may take advantage of to avoid preparing a FDD. The exemptions include, inter alia, a minimum payment exemption, fractional franchise exemption, leased department exemption, oral agreement exemption, petroleum marketers and resellers exemption, large franchise investment exemption, large franchisee exemption, and the "insiders" exemption.

47 16 C.F.R. § 436.9.

financial performance representation. Mere puffery, however, has been excluded from the ambit of financial performance representations. Examples of mere puffery statements which do not qualify as a financial performance representation include, “make big money,” “this business is a real cash cow,” or “opportunity of a lifetime.” These types of statements may be ill-advised or troublesome for other reasons, but they are not by themselves a financial performance representation.

F. Requirements for Updating a FPR

Under the revised Rule, a franchisor is required to update its disclosure document annually within 120 days after the close of its fiscal year. The revised Rule also requires a franchisor, on a quarterly basis, to prepare and include in Item 22 an attachment to its FDD identifying any material changes to the information contained in the FDD.

In addition to the annual and quarterly updates that apply to all information contained in the FDD, the revised Rule also requires franchise sellers to update the information set forth in Item 19. In particular, a franchise seller must notify a prospective franchisee if the franchise seller is aware of any material change to the FPR. Specifically, the revised Rule states:

[w]hen furnishing a disclosure document, the franchise seller shall notify the prospective franchisee of any material changes that the seller knows or should have known occurred in the information contained in any financial performance representation made in Item 19 (section 436.5(s)).

This obligation arises at any time, even if the material change occurs between quarterly updates. A franchise seller is not required to furnish an updated FDD or prepare an attachment to the FDD to fulfill this requirement, but rather may inform the prospective franchisee of the material change to Item 19 in any reasonable manner, such as by letter, telephone call, or email.


50 Bus. Franchise Guide (CCH) ¶6254.

51 See 16 C.F.R. § 436.7(a).

52 See 16 C.F.R. § 436.7(b), noting that a franchisor must prepare this attachment “within a reasonable time after the close of each quarter of the fiscal year ....”

53 16 C.F.R. § 436.7(d).

III. HISTORY OF REGULATION OF FINANCIAL PERFORMANCE REPRESENTATIONS

A. Pre-1975 Sales Practices

Representations made by franchise sellers pertaining to the financial performance of the franchise being offered are an old, and serious, problem. Representations that are exaggerated, unsubstantiated, or simply fabricated are problematic both for investors and franchisors, and the broader public. They are even a problem for franchisors because they confer unfair and unwarranted competitive advantage to unscrupulous franchisors.

Investors have a lot to lose. As the FTC noted in the SBP for its original 1979 Trade Regulation Rule on Franchising (16 C.F.R. Part 436), investors rely on such representations, because they need the information but often have no other good source for such information; the cost of compiling it on their own, individually, is prohibitive. In the SBP, the FTC observed:

> The present record indicates that prospective purchasers of franchises and other business opportunities ... are at a distinct disadvantage compared to the seller in reaching conclusions concerning the performance of the [franchise] being offered. Here, the item being offered — the franchise opportunity — is complex, and the information necessary to test the accuracy of representations lies almost solely within the possession of the franchisor. Indeed, even if available, the search costs in obtaining such information would be prohibitive. Accordingly, prospective franchisees, of necessity, have to rely on the accuracy of the representation of the franchisor as to the profitability of the franchise.

From a public perspective, franchise sales practices that deflect available investment capital from prudent investments into unproductive ones drain resources from the economy and reward irresponsible behavior.

Exaggerated or unsubstantiated FPRs also are bad for franchisors and franchising. To the extent that irresponsible FPRs create a negative public impression of franchises as investment vehicles, they deter investors from considering franchises, lessening demand for franchises generally. Individual franchisors also suffer, as those that limit disclosures to information that is properly substantiated and trustworthy lose competitive advantage to other franchisors that do not incur the cost of compiling properly substantiated FPRs and lure unsuspecting investors based on unsubstantiated or exaggerated representations.

This has been a very long-standing issue in franchising. Nearly 50 years ago, in 1960, the original “Code of Ethics” of the International Franchise Association (IFA) called upon member franchisors to make a series of prescribed pre-commitment disclosures to prospective investors.

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franchisees. Among these disclosures, according to IFA, should be "... realistic or average yearly net profit projections" based upon "known figures." As well conceived as this normative prescription was, it had no muscle: enforcement was non-existent, and its influence, even upon IFA-member companies, was slight. Non-member companies were not affected.

Anecdotal reports from individuals involved in the development of the landmark California Franchise Investment Law in the late 1960s (enacted in 1970, effective January 1, 1971) suggest that widespread instances of investor losses associated with unsubstantiated, exaggerated and outright fraudulent financial performance representations were a major element in the efforts of the California Department of Corporations in the 1960s to apply the California Blue Sky law and other statutes (largely without success) to regulate franchise offering and sales practices in California.\(^{57}\) The California Franchise Investment Law when enacted prohibited unsubstantiated "earnings claims" disclosures.\(^{58}\)

Enactment of the California statute, followed closely by similar enactments in a handful of other states, and a rapidly growing number of complaints filed with the United States Federal Trade Commission led the FTC in 1971 to open its own formal rulemaking proceeding to investigate franchising practices in the United States. Over a three-year period, the FTC published proposed franchise sales practice regulations, conducted hearings, canvassed its own records of franchise complaints, and solicited public comment. The FTC closed its record on November 20, 1974, and promulgated its Franchise Rule (16 C.F.R. Part 436) in 1978, to be effective in early 1979.

In its final Statement of Basis and Purpose, the FTC noted it had "... received numerous complaints concerning deception and other abuses in franchising."\(^{59}\)

The SBP stated:

Complaints concerning misrepresentations made in advertisements, promotional materials and orally by sales persons regarding the potential profitability of a franchise constitute approximately one-quarter of the complaints contained in the record.\(^{60}\)

The problems associated with financial performance disclosures were noted by franchisees ("The record is filled with statements by franchisees who believe they were misled as to the potential profits of their enterprise."). and other government agencies ("The prevalence of misrepresentation of earnings is further documented on the record in comments submitted by Government officials and academics.").\(^{61}\) A representative of the New York Attorney General testified, "Franchise purchasers are not given sufficient information upon which they can make an intelligent evaluation of their purchase. In many cases, information provided is either half-truth or blatantly false."\(^{62}\) One academician testified, "It is no surprise, therefore, that there have


\(^{58}\) Ch. 1400, 1970 Cal. Stat. 2641.

\(^{59}\) 43 Fed. Reg. 59614, 59624.

\(^{60}\) Id. at 59629.

\(^{61}\) Id. at 59630 (footnotes omitted).

\(^{62}\) Id.
been many abuses in the area of earnings predictions. Indeed, misrepresentation in the disclosure of earnings is probably the most crucial disclosure problem in the franchising area.\footnote{Id.}

The FTC also focused on financial performance representations that were problematic because they were unsubstantiated, or because they reflected atypical results. In the words of the SBP:

The record indicates that franchisors have often made deceptively glowing earnings projections or forecasts to prospective franchisees without having information which constitutes a reasonable basis in fact for making such claims. In addition, the record contains brochures of some new franchise businesses with projected sales and profits of the franchise units being promoted but which did not disclose the material fact that they have few (or no) franchise units yet in operation.\footnote{Id. at 59631-32 (footnotes omitted).}

The SBP also comments on financial performance representations based on atypical franchisee results:

\[T\]he record also discloses that many franchisors have highlighted the atypical success of a few franchisees without disclosing the non-representative nature of these claims. Such representations are an unfair and deceptive trade practice.\footnote{Id. at 59632.}


The FTC was not alone in its critical view of earnings claims. The state legislatures that chose to regulate franchise sales also took a stern approach to financial performance representations. This experience, and the resulting regulatory philosophy, is well-represented in the original disclosure Requirements and Guidelines of the first Uniform Franchise Offering Circular, developed in 1974 and effective in 1975. The original UFOC resulted from a collaboration among member states of the Midwest Securities Commissioners Association, in an effort to craft a single, lowest common denominator, disclosure format that the participating states all could accept as compliant with their respective statutes. In preparing such a document, the participating state franchise administrators reflected their respective states’ statutes and policies. The resulting disclosure requirements relating to FPRs were catalogued at Item XIX (in the original UFOC numbering scheme) ever since referred to simply as “Item 19.”

Item 19 was a high hurdle for franchisors that wanted to use FPRs as part of their sales efforts. It was meant to be. The states, and the franchise law administrators, consciously sought to drive unsubstantiated, irresponsible earnings claims out of the marketplace for franchise offerings. They largely succeeded. Within a few years, it was widely reported that fewer than 10% of registered UFOCs contained voluntary disclosure of financial data in Item 19. Despite the beneficial effect on selling franchises from having financial performance data available, and despite the obvious need of prospective investors in franchises to understand
what financial results might be available from their investments, the compliance hurdles in Item 19 were sufficiently high that most franchisors chose not to attempt them.

Unlike every other element of required presale disclosures, some of which were, and are, amazingly trivial, franchisors were not required to offer financial performance information, even where a track record existed, or even where previous franchisees’ financial results had been negative. Item 19 disclosures were, and are, voluntary. But if a franchisor wanted to make an FPR, it had to be in the UFOC, and comply with all of the Item 19 restrictions. Among its restrictions, franchisors were not allowed to base financial performance representations on “company stores” but only on franchised units; no forecasts, projections or hypothetical data were allowed; only actual franchised units, which were identified in the UFOC, could form the basis for the disclosure; in theory, the disclosure had to be developed in accordance with U.S. Generally Accepted Accounting Principles; and, a breakeven point had to be stated.

If the franchisor elected not to offer an FPR, a bland “negative disclosure” was prescribed.

Although it did not happen overnight, the UFOC Guidelines had their intended effect. “Earnings claims” largely disappeared from the overt sales process. In what might be a testament to the law of unintended consequences, however, two unforeseen consequences followed: by all accounts, a vigorous “black market” developed in under-the-table disclosure of financial performance data, which was often undocumented and invariably unaccountable, and almost no one was happy with the result. Franchisors complained vigorously about the impairment of their ability to offer even reasonably-based financial data (which nevertheless did not meet the hyper-rigorous standards of the UFOC Guidelines), franchisees complained about the lack of access to and the lack of accountability for good if not perfect financial performance data, and even franchise regulators were frustrated by the widespread reports of illegal earnings claim disclosures. One FTC Franchise Rule administrator even reported at an early ABA Forum program that it was a wonder to him that franchisors “did not print their own ‘cocktail napkin’ earnings claim disclosures, if only to control the consistency of what their sales representatives were telling prospects.”

The states responded in 1977 by amending the UFOC disclosure Requirements and Guidelines to add “Alternative Item 19.” The alternative relaxed some of the more rigid requirements of the original Item 19. Disclosures still had to be presented in the UFOC alone, rather than in sales brochures and advertising, but now they could be based upon the results of similar businesses owned and operated by the franchisor, rather than only franchisees, a breakeven point was no longer required, the required identification of particular units upon which the information was based was dropped, and other technical requirements were relaxed. But not all of the franchise registration states agreed with this shift in regulatory philosophy. Notably, California and New York did not go along with the change and refused to accept “Alternative 19” disclosures.

Franchisors became adept at alternatives even to the Alternative 19. As the FTC had noted in the SBP, prospective franchisees want and need this information and had no other ready access to it, and franchisors wanted to be able to provide it. Everyone seemed to understand by this point that the UFOC requirements had it right insofar as they required substantiation for earnings claims disclosures: franchisors could no longer simply make up numbers in order to sell franchises. Some of the more common techniques for getting financial performance data to prospective investors outside the UFOC included: encouraging prospects to bring up earnings experience with existing franchisees listed in the UFOC; some franchisors
would often provide copies, citations or referrals to published trade magazine or popular media articles reporting on financial results for the chain or the industry; many franchisors would provide financial performance data under tightly controlled non-disclosure commitments to a prospective franchisee’s banker or accountant on the theory that they were not “prospective franchisees” covered by the UFOC prohibitions; and in cases where the franchisor operated company units, franchisees or their accountants would be invited to carefully interpret the franchisor’s financial statements to extrapolate its non-franchised units’ average commercial results. Some UFOCs provided sufficiently detailed and comprehensive operating cost information in Item 7 to encourage prospective franchisees and their accountants to construct budgets and breakeven point projections from it. And, by all accounts, some franchisors cheated (or turned a blind eye to cheating by sales representatives) and made non-UFOC FPRs to prospects, on cocktail napkins and otherwise.

Alternative Item 19 and the many indirect and surreptitious methods of getting financial performance data to prospective franchisees was a step in the right direction in getting this important information to investors, but not a complete solution, especially so long as registration states in major franchise development markets would not accept UFOCs with Alternative Item 19 disclosures and franchisees did not always have a documented trail of accountability for the under-the-table FPRs they were getting.

Between 1986 and 1993, the North American Securities Administrators Association (into which the old Midwest Securities Commissioners Association had been merged) engaged in an intense, ongoing examination of regulatory policy involving financial performance disclosure. By this time, of course, the FTC had supplemented the registration states with the FTC’s Rule mandate for presale franchise disclosure, including the FTC’s own distinctive regulation of financial performance disclosures which mirrored the UFOC in policy and effect, if not in exact language and structure. FTC staff was closely involved with NASAA’s reexamination of Item 19.

The outcome of this effort was a major rewrite of Item 19 in 1993, merging the state and FTC regulatory goals in an evolved new version of Item 19, which became part of NASAA’s last comprehensive update of the UFOC Guidelines. The revised version of the UFOC, including Item 19, was supported and eventually endorsed by the FTC. Alternative Item 19 was dropped. The final version of NASAA’s revised Item 19 solved fairly well the many issues surrounding the earlier attempts to regulate financial performance disclosure. The 1993 version of Item 19 in effect reversed the 1975 regulatory philosophy and set the disclosure hurdles very low. It allowed, indeed encouraged, franchisors to disclose financial performance information provided the disclosures (1) were in the offering circular, (2) had a “reasonable basis” (the FTC Rule’s standard), and (3) were formatted in accordance with the UFOC Item 19 requirements.

Although many franchisors were slow to respond to this change, the 1993 version of Item 19 changed everything. Now it was possible for any franchisor that had any financial performance information to impart, to do so, provided it was done in the offering circular and with a “reasonable basis.” Franchisors were not constrained in terms of the categories, scope, or quality of information they might choose to provide. One franchisor might provide a simple “gross sales” claim, while another might provide a comprehensive operating budget, and another might provide industry-specific performance information unique to that industry.

The proportion of registered offering circulars that included positive disclosures of financial information in Item 19 doubled over the next few years, but still represented a distinct minority of registered UFOCs.
Among the key innovations in the 1993 version were two very powerful exceptions to the normal requirements of Item 19. These exceptions are noted above in Section II.D of the paper. The first allowed a franchisor that was selling a "company store" to disclose that unit's actual books and records to a specific prospective buyer of that unit, without regard to the Item 19 disclosure requirements at all. The other was called a "supplemental earnings claim," which allowed a franchisor that had provided earnings claim information in its offering circular to supplement that information with respect to a specific prospective purchaser of a particular franchise, which would enable the franchisor to customize the generalized information in the offering circular to develop a specific projection or budget for a particular proposed franchise site or business. This was especially useful to franchisors in industries such as hotels and grocery stores, where capital inputs into the franchised business are significant, investors are sophisticated, and customized projections for individual sites are both common and expected.

C. The Revised FTC Rule Item 19

The detailed contents of Item 19 as it appears in the FTC's revised Rule, which essentially federalized the UFOC Item 19 Requirements and Guidelines, are described in Section II of this paper, and set out in Appendix A. The important point concerning the revised Rule is that it carries forward the 1993 UFOC version of Item 19, largely intact. The regulatory philosophy remains the same: franchisors, by virtue of the very low disclosure hurdles, are being invited to make financial performance data available to prospective franchisees provided the data has a "reasonable basis" and is presented in the format and with the disclaimers required by the new Rule.

One of the key issues raised during the Franchise NPR was whether financial performance representations should be mandatory. Ultimately, the Commission decided that financial performance representations would remain voluntary. In reaching its decision, the Commission stated that while false or misleading financial performance claims are one of the most commonly litigated claims, there is no assurance that requiring franchisors to include a financial representation in their FDD would reduce the level of false claims. Further, the Commission noted that it would not mandate a particular set of financial performance disclosures due to the different industries involved in franchising. Finally, the Commission

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66 See, 72 Fed. Reg. 15444, 15497. Both franchisor and franchisee advocates took a position with respect to making financial performance representations mandatory. Many franchisee advocates urged the Commission to mandate the disclosure of financial performance information noting that: (1) financial performance information is the most material information prospective franchisees need to make an informed investment decision; (2) franchisors already have performance information and it is a deceptive omission for them to fail to disclose this information; (3) franchisors are in the best position to collect and disseminate performance information; (4) a mandated financial performance disclosure would reduce the level of false and unsubstantiated oral and written financial performance claims; and (5) more disclosure regarding performance would benefit the marketplace and competition. Id. at 15497-498.

Not surprisingly, franchisors uniformly opposed a mandatory financial performance disclosure stating: (1) it is impossible for the Commission to create a single performance disclosure format that will be relevant for all industries; (2) not all franchisors have the contractual right to collect extensive financial information with which to prepare a reasonable performance disclosure; (3) financial performance data collected from existing franchisees is not necessarily complete and accurate; (4) a mandatory performance disclosure would be misinterpreted as a guarantee of future performance, thus increasing litigation; and (5) mandating financial performance disclosures would have a negative impact upon the franchisor-franchisee relationship, subjecting franchisees to more extensive accounting oversight and audits. Id. at 15498.

67 Id. at 15498.

68 Id. The Commission stated, "Given that many different industries are affected by part 436, what makes a financial performance disclosure reasonable, complete, and accurate is quite varied."
observed that if prospective franchisees were to seek out only those franchise systems that voluntarily provide financial performance information, "ordinary market forces might compel an increasing number of franchisors to disclose earnings information voluntarily, without a federal government mandate."\(^{69}\) Moreover, (contradicting the 1979 SBP) prospective franchisees can obtain financial information from a variety of third-party sources including existing franchisees and industry publications.\(^{70}\)

Because the SBP for the revised Rule expressly states that except to the extent of specific changes in the UFOC Guidelines made by the 2007 Rule revision, prior interpretations, analyses and cases are meant to carry forward under the revised Rule, the vitality of most of the old UFOC instructions, sample answers and folklore is assured.

One notable change made by the FTC in the revised Rule is the inclusion of an express prohibition relating to financial performance representations. Specifically, the revised Rule states:

> It is an unfair or deceptive act or practice in violation of Section 5 of the Federal Trade Commission Act for any franchise seller covered by part 436 to:

> * * * *

(c) Disseminate any financial performance representations to prospective franchisees unless the franchisor has a reasonable basis and written substantiation for the representation at the time the representation is made, and the representation is included in Item 19 (§ 436.5(s)) of the franchisor's disclosure document. In conjunction with any such financial performance representation, the franchise seller shall also:

(1) Disclose the information required by §§ 436.5(s)(3)(ii)(B) and (E) of this part if the representation relates to the past performance of the franchisor's outlets.

(2) Include a clear and conspicuous admonition that a new franchisee's individual financial results may differ from the result stated in the financial performance representation.

(d) Fail to make available to prospective franchisees, and to the Commission upon reasonable request, written substantiation for any financial performance representations made in Item 19 (§ 436.5(s)).\(^{71}\)

\(^{69}\) Id. The Commission noted that approximately 20% or more of franchisors voluntarily include financial performance information in their FDDs. Pressure from prospective franchisees that financial performance information be included may result in more franchisors voluntarily including financial information in their FDDs. The Commission further highlighted the fact that mandating financial performance disclosures would impose new accounting, data collection and review costs on all franchise systems, and could potentially expose existing franchisees to additional obligations and extensive audits and potential liability if the franchisee's performance data was found to be inaccurate.

\(^{70}\) Id.

\(^{71}\) 16 C.F.R. § 436.9(c)-(d).
Section 436.5(s) of the revised Rule, the Item 19 disclosure requirements, identifies the franchisor's obligations with respect to any financial performance representations included in the FDD. Accordingly, Section 436.5(s) only applies to the franchisor and does not extend liability to other franchise sellers, including, franchise brokers.\textsuperscript{72} The prohibition contained in Section 436.9, however, (contradicting the 1979 SBP) covers both franchisors and franchise sellers.\textsuperscript{73} As a result of the prohibitions applicable to franchise sellers included in the revised Rule, franchisors are not the only source of liability for claims relating to financial performance representations.

The revised Rule also limits a franchisor's use of disclaimers and waivers. In particular, the revised Rule states:

It is an unfair of deceptive act or practice in violation of Section 5 of the Federal Trade Commission Act for any franchise seller covered by part 436 to:

\textbf{****}

(h) Disclaim or require a prospective franchisee to waive reliance on any representation made in the disclosure document or in its exhibits or amendment. provided, however, that this provision is not intended to prevent a prospective franchisee from voluntarily waiving specific contract terms and conditions set forth in his or her disclosure document during the course of franchise sale negotiations.\textsuperscript{74}

Accordingly, the revised Rule prohibits a franchisor from disclaiming or requiring "a prospective franchisee to waive reliance on a representation made in the disclosure document or in its exhibits or amendments."\textsuperscript{75} This prohibition, however, is limited to the statements made in the franchisor's franchise agreement and FDD, and typically, will not extend to a franchisor's promotional materials and advertisements.\textsuperscript{76} Any advertisements or promotional materials that include information that contradicts the statements contained in the FDD, however, will constitute a violation of the revised FTC Rule.\textsuperscript{77} For example, a franchisor could not include a financial performance representation in an advertisement when they do not include a FPR in Item 19.

State regulators have taken an active approach in enforcing the prohibition against disclaimers and waivers made in connection with Item 19. In particular, if a statement in a FDD

\textsuperscript{72} Franchise Rule 16 C.F.R. Part 436 Compliance Guide, p. 130.

\textsuperscript{73} Id. The Compliance Guide specifically notes that while franchise brokers are not liable for failing to furnish disclosure or improperly preparing the contents of the FDD, franchise brokers may be held liable if they violate the revised Rule's prohibitions.

\textsuperscript{74} 16 C.F.R. § 436.9(h).

\textsuperscript{75} Franchise Rule 16 C.F.R. Part 436 Compliance Guide, p. 140.

\textsuperscript{76} Id. at 141.

\textsuperscript{77} Id. Section 436.9(a) of the revised Rule makes it an unfair or deceptive act or practice for any franchise seller to "[m]ake any claim or representation, orally, visually, or in writing, that contradicts the information required to be disclosed by this part." 16 C.F.R. § 436.9(a).
is prefaced as a warning or cautionary statement, some state examiners will request that the statement be removed as it is not required or authorized by the revised Rule. This is true even if the cautionary or warning statement includes material facts upon which the financial performance representation is based. Many franchisors, however, want to include warning and cautionary statements to ensure that the information presented is not misleading and to provide some protection against misleading or fraudulent claims.

What can a franchisor do to protect itself and make sure the statements made are not misleading? Franchisors should remove all “warning” or “caution” headings from their disclosure documents. Any statements made under these headings should be reworded from warning statements to statements which substantiate the content of the financial performance representation. Finally, to the extent the financial performance representation includes information from a certain geographically located subset of franchisees and the results in other geographic locations may be different, the Compliance Guide permits franchisors to require a prospective franchisee to sign a clear and conspicuous acknowledgement that the financial performance representation only applies to franchisees located in a certain geographic location.\footnote{Id. at 142.} For example, the Compliance Guide notes that if the financial performance representation is for an ice cream franchisor and is based on financial results obtained from the franchisor’s Florida-based franchisees, the franchisor could require an Alaskan prospect to sign an acknowledgement which states that the financial performance representation is based on results obtained from Florida franchisees and does not apply to states such as Alaska.\footnote{Id.}

D. Regulation of FPRs in Securities Offerings

As a side note, it is interesting to compare the regulatory philosophy in the securities trade relating to disclosure of financial performance information to the quixotic history of such regulation in franchise sales disclosure. It is not too much of an oversimplification to say that securities sales disclosure requirements concerning financial performance disclosure are the opposite of the old philosophy of the UFOC between 1974 and 1993. In securities offerings, under current SEC Regulations S-K and S-X, where financial performance track record information exists, it must be disclosed. Particularly in offerings for businesses such as real estate syndications where the past performance of projects developed by the sponsor of the current offering are of particular interest to prospective investors, such track records of previous projects must be disclosed. In many securities prospectuses, forward-looking forecasts and projections are common, if not mandatory.

Nevertheless, despite the obvious importance of financial track record information to prospective investors in franchises (as documented in the FTC’s own 1979 SBP), in the revised Rule the FTC categorically refused to entertain the idea of mandating disclosure of financial track record information in franchise offerings. The FTC’s regulatory skittishness in this area is difficult to reconcile with its own SBP and its mandate for disclosure of other (sometimes trivial) information in the FDD requirements.
IV. TRENDS IN FINANCIAL PERFORMANCE REPRESENTATION REGULATION

A. State Initiatives

As has been the case since the FTC first promulgated its Franchise Rule in 1979, the Rule preempts franchise disclosure regulation by states only to the extent that state regulation is "inconsistent." The FTC always has taken the position that states are free to go beyond the FTC Rule. The Rule is a floor, not a ceiling or a bar, to states' additional presale disclosure requirements. Individual states, or the registration states as a group, where the registration states as a group act through NASAA, are free to require disclosures that are more extensive than those required under the Rule or additional disclosures that are not required by the Rule at all. Thus, if the states were inclined to do so, individually or collectively, they could add to the financial performance disclosure requirements of the FDD as conditions for registration in the registration states. In the late 1990s and the early years of the current decade, NASAA actively explored both the philosophy and the possible design of a mandatory disclosure of financial performance track record information. An example of such a proposal is attached in Appendix A to this paper. The key concept of this proposal was to require disclosure of some measure (chosen by the franchisor) of financial performance information as reported by franchisees, but only once a franchisor's franchise system had crossed prescribed size and age thresholds where such financial performance track record information was reasonably available.

One of the strongest regulatory arguments for mandating such disclosure is the understanding that franchisors in effect can conceal adverse financial results of established franchise businesses, by the simple expedient of choosing not to disclose financial information in Item 19.

Large franchisors and representatives of the International Franchise Association (in contrast to the 1960 IFA Code of Ethics) vigorously resisted the idea of NASAA mandating financial performance disclosure. As noted in Section III.C, the reasons for the opposition to mandated financial performance disclosures included a strong belief that the marketplace, rather than the government, should be the primary influence on whether franchisors should make these disclosures and that any attempt at a mandate likely could result in some form of "one size fits all" requirement, which could not apply in any way to the thousands of franchisors in the marketplace. In addition, mandatory financial performance representations might be costly to compile and would be unreliable if based on self-reported franchisee data.

B. Case Law Trends

Notwithstanding 38 years of registration and disclosure law regulation of FPRs in franchise sales, the FTC still prosecutes an occasional FPR case against a franchise (or business opportunity) seller under the Franchise Rule or, more often, Section 5 of the FTC Act, alleging deceptive or unsubstantiated earnings or sales claims.80

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Reported private party cases alleging illegal (FPR information presented outside the UFOC/FDD), false or unsubstantiated FPRs are less common, but do appear periodically.\textsuperscript{81}

One of the most common issues that arises out of financial performance representation claims is a franchisor’s failure to identify the number and percentage of franchisees that attained or surpassed the stated representation. For example, in \textit{Federal Trade Commission v. USA Beverages, Inc.}, the court held that a coffee display rack franchisor violated the FTC Rule by failing to include the number and percentage of franchisees that attained or surpassed a stated gross revenue figure in their franchise advertisements.\textsuperscript{82} In its advertisements, USA Beverages represented to prospective franchisees that they could make $2,000 per week if they purchased a coffee display rack business.\textsuperscript{83} USA Beverages also engaged in scripted telephone communications with prospective franchisees and represented that other franchisees had already secured locations for their coffee display rack businesses and were profitable.\textsuperscript{84} The court held that USA Beverages violated the FTC Rule by making misrepresentations about earnings a franchisee could expect to make.\textsuperscript{85} The court also noted that in its advertising materials, USA Beverages failed to disclose the number and percentage of prior purchasers known by the franchisor to have achieved the same or better results, and failed to include a statement that the materials supporting the earnings claim were available upon request.\textsuperscript{86}

Similarly, in \textit{U.S. v. Vend Direct, Inc.}, the court held that Vend Direct violated the FTC Rule by failing to adequately substantiate its earning claims representations.\textsuperscript{87} Specifically, Vend Direct advertised its franchise opportunity by providing a toll-free telephone number for prospects to call to learn how much money they could expect to make if they purchase a vending machine franchise.\textsuperscript{88} Vend Direct also advertised its franchise opportunity on its website which included a profit calculator and testimonials of alleged current franchisees in which the franchisees stated the amount of money they earned through operating their franchise business.\textsuperscript{89} Additionally, Vend Direct made verbal statements to prospective franchisees which included a representation regarding the amount of money a prospect could expect to make. In particular, Vend Direct made statements such as, “we’d love to see you make probably about $1,500 to $2,000 per month profit and that 30 machines can generate $3,000 profit when they empty out.” The court in this case found that Vend Direct violated the FTC Rule because Vend Direct failed to provide its prospective franchisees with any information to substantiate its earnings claims.\textsuperscript{90} In particular, the court noted that in connection with the profit calculator and


\textsuperscript{82} 2005 WL 5654219 *3 (S.D. Fla. Dec. 5, 2005).

\textsuperscript{83} \textit{Id.}

\textsuperscript{84} \textit{Id.}

\textsuperscript{85} \textit{Id.}

\textsuperscript{86} \textit{Id.}

\textsuperscript{87} 2007 WL 2176205 *2 (D. Col. May 11, 2007).

\textsuperscript{88} \textit{Id. at *1.}

\textsuperscript{89} \textit{Id.}

\textsuperscript{90} \textit{Id. at *2.}
on-line testimonials, Vend Direct failed to disclose the number and percentage of prior purchasers known to have achieved the stated results.\textsuperscript{91} The court also noted that:

Misrepresentations concerning anticipated income from a business opportunity generally are material and likely to mislead consumers because such misrepresentations strike at the heart of a consumer’s purchasing decision. Neither proof of consumer reliance nor consumer injury is necessary to establish a § 5 violation. Otherwise, the law would preclude the FTC from taking preemptive action against those responsible for the deceptive acts or practices, contrary to § 5’s prophylactic purposes.\textsuperscript{92}

The failure of Vend Direct to provide any substantiation for the information set forth in their advertising materials constituted a violation of the FTC Rule because Vend Direct continued to mislead consumers by providing financial information without any substantiation.\textsuperscript{93}

In \textit{Randall v. Lady of America}, the court held that plaintiffs provided sufficient information needed to withstand defendant’s motion for summary judgment with respect to plaintiffs’ claims that defendant made illegal earnings claims.\textsuperscript{94} In particular, the plaintiffs alleged that they received illegal earnings claims as a result of the following representations made by defendant’s representatives: (i) plaintiffs could expect to have at least 100 members signed up before opening the store, (ii) plaintiffs could expect to add 15 to 20 members per week, (iii) defendants provided certain plaintiffs with financial information for franchisor’s top performing locations, (iv) plaintiffs would be profitable within 6 months of operation, (v) plaintiffs could expect $100,000 in pre-opening sales, and (vi) plaintiffs were told they would be driving a Mercedes within 6 months after opening their franchised business.\textsuperscript{95} Defendants attempted to disclaim the making of any earnings claims by relying on a disclaimer included in defendant’s UFOC.\textsuperscript{96} The court, however, held that the earnings claim did not directly contradict the language of the franchise agreement such that the parol evidence rule would bar the introduction of this evidence.\textsuperscript{97} The court further noted that even if the disclaimer language and earnings claims contradict, under Minnesota law, “the law should not and does not permit a covenant of immunity to be drawn that will protect a person against his own fraud.”\textsuperscript{98} The court held that “…if Lady of America made assurances to its franchisees about their expected membership numbers, revenues and profitability, and if those assurances did not accurately reflect surrounding past and present circumstances then

\textsuperscript{91} Id.

\textsuperscript{92} Id.

\textsuperscript{93} Id.

\textsuperscript{94} 532 F.Supp.2d 1071, 1090 (D. Minn. 2007).

\textsuperscript{95} Id. at 1076-79.

\textsuperscript{96} Id. at 1080.

\textsuperscript{97} Id. at 1085.

\textsuperscript{98} Id. at 1083.
those assurances could subject Lady of America to liability under the Minnesota Franchise Act.\textsuperscript{99}

Other common financial performance representation actions involve a franchisor preparing, or assisting in the preparation of, a business pro forma for a prospective franchisee. In \textit{KC Leisure v. Haber}, the court held that plaintiffs had set forth sufficient facts that defendant had participated in the development of plaintiff's pro forma spreadsheets to move forward with a claim for violation of the FTC Rule.\textsuperscript{100} In particular, the plaintiffs alleged that Mr. Haber assisted them in the preparation of their business pro forma financial documents and spreadsheets with full knowledge that the information was inaccurate.\textsuperscript{101} The pro forma showed the anticipated costs and revenues during the start up phase of the franchise business.\textsuperscript{102} As a result, the court reversed the lower court’s dismissal of plaintiff's claims.\textsuperscript{103}

In \textit{Federal Trade Commission v. Holiday Enterprises, Inc.}, the court held that defendants violated the FTC Rule by failing to provide its prospects with substantiation for the earnings claims they made and by failing to provide their prospects with the number and percentage of purchasers known to have achieved the same or better sales results as those claimed in the advertisements.\textsuperscript{104} Defendants promoted the sale of an ink cartridge display rack business through certain newspaper advertisements and telephonic and in-person sales pitches.\textsuperscript{105} For example, defendants represented to prospective purchasers that they could expect annual income ranging from $50,000-$250,000, and that they could expect to recoup their investment in 6-12 months.\textsuperscript{106} Defendants also mailed promotional materials to prospects which contained additional false claims that existing locations currently earned income between $20,000 to $200,000 per year.\textsuperscript{107} The defendants also sent prospects a pro forma which stated that the purchase of a five-display rack package would result in net profits in excess of $20,000 per year, and that a twenty-display rack package would earn net profits in excess of $82,000 per year.\textsuperscript{108} Defendants sent other pro formas to prospective purchasers which illustrated ranges of $34,000-$173,000 and $46,000-$184,000 in yearly profits.\textsuperscript{109} The court found that defendants misrepresented to the public that the earnings information was based on actual sales figures and that defendants' advertisements and distribution of pro formas violated the FTC Rule.\textsuperscript{110}

\textsuperscript{99} Id. at 1090.

\textsuperscript{100} 972 So.2d 1069, 1075 (Fla. Ct. App. 2008).

\textsuperscript{101} Id. at 1074.

\textsuperscript{102} Id. at 1074-75.

\textsuperscript{103} Id. at 1075.


\textsuperscript{105} Id. at *2.

\textsuperscript{106} Id.

\textsuperscript{107} Id.

\textsuperscript{108} Id. at *3.

\textsuperscript{109} Id.

\textsuperscript{110} Id. at *3 and *8.
In *Team Tires Plus v. Heartlien*, the court held that the pro formas distributed by the franchisor qualified as earnings statements and, therefore, the pro formas should have included the factual basis and material assumptions upon which the information underlying the pro forma's preparation and presentation was based.\textsuperscript{111} Heartlien provided plaintiffs a detailed three-year pro forma identifying costs, sales and earnings information for the market plaintiffs were interested in purchasing.\textsuperscript{112} The pro formas the plaintiffs received did not contain any disclaimers or further information regarding how the information was prepared.\textsuperscript{113} Further, the pro formas did not include a conspicuous admonition that a new franchisee's individual results are likely to differ from the results stated in the earnings claim.\textsuperscript{114} Based on this evidence, the court found that plaintiffs had presented sufficient evidence to make out a claim for violation of the FTC Rule.

Courts have dismissed claims of illegal or unlawful earnings claims based upon a franchisor's use of disclaimers and a finding that any damage suffered by plaintiff was not a direct result of any statement made by franchisor. In *Carousel's Creamery, LLC v. Marble Slab Creamery, Inc.*, evidence was presented that plaintiffs received financial information regarding the operation of a franchised business.\textsuperscript{115} The court, however, in upholding the jury's findings ruled that the financial information was not the cause-in-fact of plaintiff's injuries while noting that other evidence presented established that plaintiff's own actions and inactions caused the failure of their business, not the financial information provided by defendants.\textsuperscript{116}

Finally, in *Kieland v. Rock Mountain Chocolate Factory, Inc.*, the court dismissed plaintiff's illegal earnings claim cause of action because the language set forth in defendant's UFOC stated that the franchisor did not provide any earnings claims and plaintiff testified that he understood that franchisor would not provide any financial information.\textsuperscript{117} In *Kieland*, Item 19 of defendant's UFOC provided "except for the information in this item, no representations or statements of actual, average, projected, forecasted or potential sales, costs, income or profits are made to franchisees by us."\textsuperscript{118} The franchise agreement signed by plaintiffs provided that defendants would not be liable for any oral representations made prior to the execution of the franchise agreement or for any claims of negligent or fraudulent misrepresentations based on any such prior oral representations.\textsuperscript{119} Despite the acknowledgements and representations set forth in the UFOC and franchise agreement, plaintiff alleged that prior to the signing of the franchise agreement, he provided one of defendant's representatives with a pro forma budget for his franchise and stated "I don't believe you can state if these appear reasonable, but maybe

\textsuperscript{111} 2004 WL 3406090 at *10 (D. Minn. Apr. 19, 2004).
\textsuperscript{112} Id. at *3.
\textsuperscript{113} Id.
\textsuperscript{114} Id. at *10.
\textsuperscript{115} Id. at 389.
\textsuperscript{116} Id. at 400-01.
\textsuperscript{117} 2006 WL 2990336 at *8 (D. Minn. Oct. 18, 2006).
\textsuperscript{118} Id. at *4.
\textsuperscript{119} Id.
you can tell me if it is a rainy day or sunny day."\textsuperscript{120} According to plaintiff, defendant's representative responded by stating that "the numbers did not raise any issues with him."\textsuperscript{121} In dismissing plaintiff's claim that defendant gave him earnings claim information, the court relied on the disclaimer in defendant's UFOC stating that defendant does not authorize its salespersons to make any oral projections regarding a franchisee's potential success.\textsuperscript{122} The court further noted that plaintiff could not have reasonably relied on the information as plaintiff admitted that he understood that defendant's representatives could not provide him with any financial information.\textsuperscript{123}

Franchisors are always well advised to adopt or revise best practices based on lessons that we can learn from cases. The lessons learned from the cases summarized in this section include: (i) a franchisor must do its homework in determining whether to make a FPR, and, if so, determine how to make a lawful FPR, (ii) a franchisor must understand how its salespeople are responding to financial performance questions and how they are using any FPR information, specifically in any advertisements and verbal communications, and instruct these individuals on permissible responses to financial performance questions as well as appropriate uses of such information, and (iii) a franchisor should know how to use legally permissible disclaimers and at the same time understand that disclaimers will not be its salvation if the franchisor is indeed making unlawful FPRs.

C. FTC Compliance Guide

Curiously, neither of the two NASAA "Commentaries" on the UFOC Guidelines ever addressed Item 19 issues.\textsuperscript{124}

The FTC has provided slight elaboration on Item 19 of its FDD requirements with a single question and answer in its "Frequently Asked Questions" (no. 8, dealing with FPRs based on businesses owned by the franchisor's affiliates; reproduced in Appendix A), and with limited narrative in its new Compliance Guidelines (see Part II; also reproduced in Appendix A).\textsuperscript{125}

D. Intersection of FTC Item 19 with States' "10b-5" Rules

One interesting trend that may be latent in UFOC/FDD Item 19 jurisprudence is the largely unexplored intersection of the permissive nature of Item 19 disclosure (franchisors don't have to provide such information if they choose not to, unlike every other category in the FDD) with the still applicable requirements of the registration laws of the remaining registration states which require, in various formulations, that franchisors not fail to disclose information necessary to make the disclosures they do offer be not misleading.\textsuperscript{126}

\textsuperscript{120} Id.

\textsuperscript{121} Id.

\textsuperscript{122} Id. at *8.

\textsuperscript{123} Id.

\textsuperscript{124} See Bus. Franchise Guide (CCH) ¶¶ 5790 & 5800.

\textsuperscript{125} See Bus. Franchise Guide (CCH) ¶ 6086.

\textsuperscript{126} See, e.g., Arkansas (making it a felony to knowingly omit material facts in connection with the offer, sale, purchase, transfer or assignment of a franchise) Ark. Code Ann. § 4-72-207; California (making it unlawful to willfully
The "catchall" statutory disclosure requirement could be used to address a franchisor's failure to disclose financial performance track record information especially in cases where that information is negative. If a franchisor has an unusually large failure rate, or knows of patterns of franchisee financial failure or bankruptcy, or even simply knows that past franchisees have struggled for unusually long periods of time to reach break even in their day-to-day operations, its failure to disclose such information could be viewed as a material omission of information necessary to make the rest of the FDD, viewed in its entirety, not misleading. FDDs rarely if ever contain statements suggesting that the franchised business described in the document is likely to be (or has been) financially unsuccessful. Indeed, the entire implication of an FDD is that the franchise that it describes is, or is capable of being, commercially successful. Boilerplate disclaimers to the effect that the success of a franchised business depends on external market factors, the franchisee's skills and experience, adequate capitalization, etc. are fine as far as they go, but if the franchised businesses in fact have high failure rates, or even just very low success rates, prospective franchisees arguably should be warned. The authors are not aware of any cases to date that specifically address this issue.

A small number of cases suggest that a common law duty of due care concerning disclosure exists in some states, which compels a party negotiating a business arrangement to volunteer relevant, material information that the other party is not likely to discover on his own.127

V. FINANCIAL PERFORMANCE REPRESENTATIONS FROM THE FRANCHISOR'S PERSPECTIVE

A. Decision Whether a Franchisor Should or Should Not Make an Item 19 Representation

In determining whether a franchisor should make an Item 19 financial performance representation, the franchisor must identify the information that actually is available and determine whether this information is reliable, not misleading, and sufficient to provide a prospective franchisee with meaningful information. In particular, if a franchisor is going to use information collected from its franchisees to form the basis of its financial performance representation, the franchisor must evaluate whether its franchise reporting system produces accurate, reliable information. Further, the franchisor should analyze the information to determine if the compilation methods account for norms, means, averages or deviations, and whether the information presents a true reflection of the average or typical franchisee or whether the reported information is so diverse that using average information would be

misleading. If a franchisor decides to gather additional data from its franchisees, other than what its franchisees report, the franchisor needs to determine exactly what information it will obtain, how it will obtain this information, and if it will obtain this information from all franchisees or a subgroup based on a particular common characteristic.

After the franchisor gathers the information, the key to the decision of whether to make an Item 19 representation is focusing not only on the information a franchisor would like to include in its financial performance representation, but also on the information a franchisor will not present. What are the reasons behind a franchisor’s desire to present certain information and omit other information? For example, if a franchisor decides that it will only use information from franchisees located in a certain geographic region, the franchisor needs to evaluate whether including information from this subset of franchisees is representative of the entire system, or whether the information will result in an inflated or skewed representation. If a franchisor’s response to the question of why they do not want to include certain information is that it would not help them sell franchises, then that information likely will be material to prospective franchisees and should be included.

When preparing a financial performance representation, the preparer’s analysis must include at least the following key factors. First, a preparer must consider the nature of the franchise system, including its distribution method and the nature and characteristics of the goods or services being distributed. In particular, is the franchise subject to seasonal sales or is revenue flow generally consistent throughout the year? A preparer also will want to consider whether the franchise is unusually sensitive to fluctuations in the overall economy. If a franchise system is unusually sensitive to changes in the economy, a franchisor may want to spread its financial performance representation over a period of years. If fluctuations in the economy will have little to no impact on the franchise, accurate annualized information may be adequate.

Second, a preparer must analyze the industry in which the franchise operates. Industry indicators of success often will form the basis for financial performance representations in the disclosure document. For example, average room rates, average occupancy rates, and average revenue per available room will be of interest to prospective hotel franchisees. On the other hand, certain expense information (cost of goods sold and operating expenses) in addition to revenue information will be important to a prospective quick service restaurant franchisee. A franchisor also will want to review its competitor’s disclosure document to determine whether its competitors are making financial performance representations. If the franchisor makes no financial performance representation or a representation that is more limited than those of its competitors, and the competitors’ claims present positive financial performance indicators, the franchisor could encounter difficulties in selling franchises vis-à-vis their competitors.

B. How to Make an Accurate and Effective Financial Performance Representation

A few general rules apply to any financial performance representation. First, as discussed in Section II above, a franchisor must have a reasonable basis for any financial performance representation it makes at the time the representation is made. There is no clear test or guidance as to what constitutes a “reasonable basis,” thus each franchisor must engage in a process that probes and analyzes what is reasonable in the context of its business, its industry and its Item 19 FPR.

Second, any financial performance representation must include a description of its underlying factual basis, that is, identify all significant matters upon which a franchisee’s future
results are expected to depend. For example, any economic or market conditions that are inherent in the operation of a particular franchise system that could affect a franchisee’s sales, costs of goods and services sold, or operating expenses are the types of factual information that a franchisor should disclose in its financial performance representation. The representation must set forth a concise summary of the representation’s basis, including any relevant geographic factors or variances and state whether the representation is based on the actual experience of franchised outlets and the number and percentage of outlets that met or surpassed the stated results. The representation also must include the material assumptions underlying the representation. The claim should include several warning or cautionary statements and disclaimers prescribed by the revised FTC Rule, and a “conspicuous admonition that a new franchisee’s individual financial results are likely to differ from the representations set forth” in the financial performance representation.

In addition to complying with the revised FTC rule and accompanying guidelines for making a financial performance representation, a franchisor also must be cognizant of any applicable state-specific requirements or prohibitions. For example, California statutory law requires franchisors to include the following warning language when a representation does not include cost or expense information:

The financial performance representation does not reflect the costs of sales, operating expenses or other costs or expenses that must be deducted from the gross revenue or gross sales figures to obtain your net income or profit. You should conduct an independent investigation of the costs and expenses you will incur in operating your Franchised Business.128

C. Alternatives to Financial Performance Representations

If a franchisor elects to not include a financial performance representation in Item 19 of its disclosure document, a franchisor may not discuss any financial information with prospective franchisees. This includes not only direct references to income, revenue, and potential sales, but also any indirect information that a prospect could use to calculate financial information on its own. For example, quick service restaurant franchisors may not provide prospective franchisees with average ticket amounts because a prospect could then use this information, in connection with its own due diligence – i.e., sitting in the restaurant and counting customers, to calculate average sales information. Likewise, a franchisor of a health and fitness franchise cannot provide a prospective franchisee with information regarding the average number of club members as the prospect could then easily calculate average revenue by multiplying the average number of club members by the membership fee charged by franchised outlets.

If a franchisor chooses to not make a FPR, then the only way a prospective franchisee can obtain actual system financial information is to contact current franchisees. Franchisors, however, must be careful to not direct a prospective franchisee to their “top performing” franchisees. While no cases have directly addressed this issue, it is potentially misleading for a franchisor to steer a prospect to only its top performing franchisees. Instead, a franchisor should encourage a prospect to contact as many existing franchisees as it can.

Especially for new franchisors, because franchisees likely will obtain financial information and other information from existing franchisees, it is important for franchisors to

evaluate prospects and make sure the prospect is the right fit for the franchise system. Existing franchisees provide validation to prospective franchisees as to their experience with the franchise system. Having franchisees that are unhappy with the franchise system and the support they receive from the franchisor will negatively impact a prospect’s view of the franchise system. If the only financial information a prospect has is negative information, a franchisor may find it difficult to sell through the negative perception left with prospective franchisee.

D. Preparation and Presentation of Different Financial Performance Representations

There are a variety of different ways in which a franchisor can present its financial performance representation information. One of the most common financial performance presentations is for a franchisor to present actual or average sales attained by all or a subset of the franchised outlets. When making a presentation of average sales, franchisors often will include not only average sales, but also the high and low numbers making up the average sales representation. In addition to presenting average sales, some restaurant franchisors will provide average food, paper, and labor costs as a percentage of sales.

One modification made by some franchisors to the traditional average sales presentation is to identify average sales by quartile. Typically, the term quartile refers to the relative performance of the franchised outlets. Accordingly, the “1st Quartile” refers to the top 25% performing franchised outlets, based upon sales, gross profits, or whatever factor one is measuring. The “2nd Quartile” refers to the next highest 25% performing franchised outlets, and so on.

A second modification that franchisors can make to the traditional average sales presentation is to identify a range of average sales and then identify the number of restaurants that fit within that range. For example, assume a franchisor identifies a range of over $2,000,000 in gross revenues. The franchisor would identify the number and percent of franchised outlets that had over $2,000,000 in gross revenues during the stated period.

Some franchisors present their financial performance representation as a full pro forma or income statement. When presenting a pro forma financial performance representation, most franchisors identify actual sales, expenses and net income for a certain franchised or company-operated outlet. Franchisors, however, must be careful when selecting an outlet for their pro forma representation to make sure the pro forma is representative of the entire franchise system.

The type of financial information contained in a financial performance representation varies by industry. For example, franchisors in the lodging industry prepare financial performance representations based around industry indicators of success, such as average room rates, average occupancy rates and average revenue per available room. When identifying average room rates, occupancy rates or revenue per available room, franchisors must first disclose the total number of rooms included in the financial performance representation and then identify the average revenues and occupancy rates.

Due to the fluctuation in financial information for lodging franchises due to their different geographic location – e.g., close to major metropolitan airports, situated near main highways, located in a suburban or metropolitan area – many lodging franchisors will break out their financial performance information to reflect the different financial performance attained by its franchised outlets due to their geographic location. For example, a franchisor may first provide
average room rates, occupancy rates and revenue per available room for its hotel franchises located within a determined number of miles from a major metropolitan airport. Lodging franchisors then may provide financial information for another subset of outlets located in a different, but common geographic area – e.g., franchised outlets located near highway locations, in suburban markets and in other rural locations. Because the financial performance of lodging franchisers can vary significantly as a result of the outlets’ locations, linking the financial performance information with the differing locations may provide prospective franchisees with a clearer picture of the financial performance of the franchised outlets.

Franchisors can be creative in the presentation of the financial performance representation. So long as the financial performance representation is accurate, not misleading and has adequate support, franchisors can and should present the information in a manner that best reflects the financial performance of its franchised outlets. Appendix B includes sample formats for presenting a financial performance representation.\textsuperscript{129}

E. Methods to Compile Information

A franchisor has many potential sources from which to assemble data for its FPR. If a franchisor operates company-owned outlets, it will have vast performance information at its disposal including, gross sales and detailed expense information, profit and loss numbers and, if applicable, industry indicators of success, such as average room rates, average occupancy rates and average revenue per available room in the hotel industry. Even though company-owned outlet information is available, franchisors need to evaluate and determine whether information generated by its company-owned outlets is reliable, similar to what a franchised outlet can expect, and useful to prospective franchisees.

Data from existing franchised outlets is another source of information a franchisor can use in preparing a FPR. Using franchisee general information, however, can present a more significant challenge for a franchisor. Many franchisees simply do not maintain the detailed information that a franchisor needs to prepare an effective and accurate FPR. Further, the information available from existing franchised outlets may be suspect if a franchisee is running personal expenses through the business therefore inflating the true costs of operating the franchise. A franchisee’s information may not be completely accurate or present a full picture of the financial condition of the franchised outlet.

Several options exist for a franchisor to assemble data from existing franchised outlets. A franchisor may require franchisees to submit periodic financial reports for their franchised outlets. The information may vary from a simple statement of gross sales report to a more detailed monthly profit plan, balance sheet, and statement of profit and loss, together with check registers, purchase records, sales summaries, and inventories. A franchisor also may require its franchisees to submit an unaudited or audited annual statement of profit and loss, a balance sheet as of the end of the franchisee’s fiscal year, and a cash flow statement, together with tax returns for the business.\textsuperscript{130}

\textsuperscript{129} The Appendix includes financial performance representations information, including sample financial performance representations and general information about franchisors that use or include financial performance information in Item 19 of their financial disclosure documents.

\textsuperscript{130} Including a provision in a franchise agreement requiring a franchisee to submit detailed financial information to the franchisor on a regular basis ensures that franchisors will have access to information relating to the financial operations of its existing franchised outlets. Franchisors, however, should expressly notify franchisees in the franchise agreement that while the franchisor will not disclose the franchisees financial information unless required to
One challenge franchisors face with using information prepared by its franchisees is that franchisees might not have a uniform method of accounting and reporting financial information to the franchisor. Most franchisors do not require their franchisees to submit audited financial information. Without appropriate verification of franchisee information, a franchisor should closely evaluate whether the information prepared by the franchisee is reliable for use in a FPR. In addition, some franchisees might include other costs and expenses in their reports that other franchisees do not. For example, some franchisees may include managers' salaries or ownership compensation in their financial information while others do not. One way to reduce variations in the information received from franchisees is to require franchisees to use a standardized form or report prepared by the franchisor.

In recent years, many franchisors have required franchisees to use computerized recordkeeping or cash register systems in their franchised outlets. These systems have functions that collect and manage information about the nature of the sales transactions and provide permanent financial records of the transactions. The types of information collected may include sales levels, pricing, product movement statistics, detailed financial expense information, and time and attendance information for employee payroll. Many franchisors have electronic access to this information and can poll this information from franchised units on a regular basis.

Another way a franchisor can gather sales and expense information is by auditing its franchised outlets. A franchisor who reserves the right to audit its franchisees may conduct the audit itself or hire an independent consultant to conduct the audit. The primary problem with this approach is that most franchisors only audit those franchised outlets that they suspect are underreporting financial information or are experiencing financial difficulties. Utilizing information from franchisees suspected of underreporting or that are experiencing financial difficulties may not generate the best information for creating a FPR.

Franchisors also may obtain information on sales at franchised outlets through reports from suppliers of products to the system. For example, some franchisors that have an approved supplier system might require its suppliers to provide reports on supplies delivered to franchisees. The franchisor can then use this information to obtain or verify financial information. This type of information, however, is not necessarily reliable and should be used as a cross-check with information obtained through other means rather than as the sole basis for the FPR.

Some franchisors also utilize questionnaires and surveys as a means of gathering financial information for a FPR. The benefit to using a questionnaire is that the franchisor can tailor the questions asked and information obtained to produce streamlined information for the FPR the franchisor would like to make. Of course, franchisors who use questionnaires must do so by law, the franchisor may use the franchisee's financial information to compile financial information to share with prospective franchisees. For example, the franchise agreement could provide:

We will keep your financial books, records and reports confidential, unless the information is required by tax authorities or used as part of a legal proceeding or whether your information is grouped with similar information from other franchisees to produce shared results like high-low ranges or average gross sales or expenses on a system-wide or regional basis.

The key, of course, is to require franchisees to comply with these reporting obligations.
rely on their franchisees to complete the questionnaires in a timely manner and provide truthful and accurate information.

Regardless of the method used by the franchisor to compile franchisee generated information, franchisors that use information prepared by franchisees as the basis for their FPR should include a statement in their FPR noting that the FPR is prepared based on information prepared and submitted by franchisees and the information is unaudited.

A franchisor can use industry standard information if the information has a reasonable basis and the material assumptions upon which the representation is made are disclosed. For example, a franchisor could compare its franchise system’s averages with industry averages to show variations. This type of comparison, however, must be reviewed carefully to ensure that similar factors and assumptions were used in preparing and presenting the financial information for each set of averages. Another use for industry information might be to present expenses for which industry averages are available and which fit within the parameters of the franchisor’s claim if the franchisor does not believe that it has reliable company-owned or franchised unit information.

One of the significant challenges facing a franchisor in assembling data for its FPR is the cost and time that must be invested in collecting the data. Huge investments by the franchisor and franchisees might be necessary to procure and implement computerized recordkeeping or cash register systems. In addition, it takes time to collect and review the data to make sure the information is reliable and accurate.

F. Unique Challenges for New Franchisors

New franchisors face unique issues when deciding whether to include a FPR in their FDD. New franchisors will not have any franchisee information to include in a FPR and, therefore will need to use information from their company or affiliate-owned outlets. As noted in Section II.B.1.a above, a franchisor may use information from an affiliate if the franchisor has written substantiation for the representation in its possession at the time the FPR is made and the franchisor clearly discloses that the information is based on the performance of an affiliate-owned and operated outlet, not a franchise or company-owned outlet.\(^{131}\)

A new franchisor with limited operating experience may find it beneficial to include a FPR based on an affiliate’s operating history. A new franchisor using an affiliate’s information, however, must make sure that the affiliate’s business and method of operation are substantially similar to the franchise business being offered by the franchisor. The franchisor also must be mindful of any differences in the affiliate’s economic or market conditions. If any key differences exist, the franchisor is well advised to highlight and disclose these differences in its FPR. The FTC staff has limited a franchisor’s ability to utilize an affiliate’s results in lieu of the franchisor’s operating experience by expressly stating in FAQ 8 that if a franchisor has adequate performance data of its own, it is not reasonable for a franchisor to use data from its affiliate company.\(^{132}\)

\(^{131}\) See, Bus. Franchise Guide (CCH) ¶ 6090.

\(^{132}\)Id. The FTC staff stated that "[w]hen a franchisor has adequate performance data of its own upon which to base a performance representation, basing a financial performance representation on affiliate information likely would not be reasonable." See also, Franchise Rule 16 C.F.R. Part 436 Compliance Guide, p. 88.
In addition, if a new franchisor does not include a FPR in its FDD because data is unavailable or unreliable, the new franchisor faces another challenge in that its prospective franchisees do not have any existing franchisees from whom they can obtain financial information. Many franchisors that elect to not make a FPR instead rely on their existing franchisees to provide prospects with financial information. In the case of a new franchisor, however, the new franchisor will not have any existing franchisees to share this information with prospective franchisees. Accordingly, a new franchisor who does not make a FPR and who does not have existing franchisees for a prospect to communicate with will need to train its salespeople on the appropriate response when a prospects asks, “how much can I expect to make?”.

In these situations, franchisors should advise their salespeople to focus on the franchise system and the reasons why the prospect was drawn to the franchise concept originally. For example, if the franchise is a children’s activity center, the prospect likely was drawn to the franchise as a result of his or her interest in helping and working with children. Therefore, the salesperson should highlight the key aspects of the franchise system that originally appealed to the prospective franchisee. As noted in Section II.A, a franchisor may not represent a prospective franchisee that the FTC Rule prohibits it from providing prospective franchisees with financial information prior to the signing of the franchise agreement.

G. Use of Financial Performance Representation Information in Franchise Sales Advertisements

One key advantage to making a financial performance representation is in using the information as part of the franchise sales process. Franchisors that include financial performance representations in Item 19 of their disclosure document may then use this information in their marketing materials where they likely will attract members of the public interested in purchasing a franchise system.133

Franchisors, however, must keep in mind that providing a prospective franchisee with any information relating to potential sales, income, gross profits or net profits, even if provided through marketing material or other written or verbal advertisement, qualifies as a financial performance representation. As noted in Section II.A, a financial performance representation is any representation, including any oral, written, or visual representation to a prospective franchisee, including a representation in the general media, that state a specific level or range of actual or potential sales, income, gross profits, or net profits.134 Accordingly, if a franchisor makes any statement, whether verbal or written, regarding the information contained in Item 19 of the franchisor’s FDD, that statement is a financial performance representation and the franchisor must make sure their communication complies with both federal and state requirements.

It is important to remember that franchisors can be held liable under the revised FTC Rule if the franchisor violates the Rule’s provisions that prohibit: (1) making any financial performance representation unless the franchise seller has a reasonable basis and written substantiation for the representation at the time the representation is made, (2) failing to include in any financial performance representation a clear and conspicuous admonition that a new


134 See, 16 C.F.R. § 436.1(e).
franchisee's individual financial results may differ from the results stated in the financial performance representation, or (3) making any financial performance representation that is not included in Item 19 of a franchisor's disclosure document.\footnote{See, 16 C.F.R. § 436.9(c).}

When making a verbal financial performance representation, the issue then becomes does a franchisor need to comply with each of these requirements at the same time they make a verbal financial representation or can the franchisor wait and comply with these requirements at a later time. Unfortunately, there is nothing directly on point that provides a decisive answer to this question. The authors review of the revised FTC Rule and Compliance Guide suggests that a franchisor likely would not be required to immediately provide a prospect with the written substantiation for any verbal financial representation made. A franchisor, however, would be required to simultaneously notify the prospect that their financial results may differ from the financial results stated.

As expressly stated in the definition of financial performance representation, claims made in the general media constitute a financial performance representation. The term "general media" is construed broadly to include all forms of advertising, including radio, television, magazines, newspapers, billboards, and advertisements placed on a franchisor’s website.\footnote{Franchise Rule 16 C.F.R. Part 436 Compliance Guide, p. 132.} The Compliance Guide notes that, ordinarily, statements made in speeches, press releases and the like will not be considered "general media representations," unless the representations are specifically directed at members of the public interested in purchasing a franchise.\footnote{Id. For example, the Compliance Guide states that where a franchisor utilizes financial performance information disseminated, or intended to be disseminated, to the public generally in its franchise promotional material (e.g., in a brochure or franchisee section of a website), and includes in its franchise promotional materials a reference to general financial information on its website, or otherwise repeats the general financial information to lure potential franchisees (such as in a face-to-face meeting with an audience of prospective purchasers), such information will be deemed general media financial performance representations.\footnote{Franchise Rule 16 C.F.R. Part 436 Compliance Guide, p. 133.}}

Financial performance representations made in the general media are not only subject to the requirements that apply to all financial performance representations, i.e., that they be truthful and reasonably backed by substantiating written information, but general media financial performance representations also must state: (i) the number and percentage of outlets that attained or surpassed the represented level of financial performance, (ii) the time period when the performance results were achieved, and (iii) a clear and conspicuous admonition that a new franchisee’s results may differ from the represented performance.\footnote{Ill. Admin. Code tit. 14, § 200.304.}

In addition to the revised FTC Rule, franchisors must be cognizant of any state laws or regulations relating to the use of financial representations in their verbal and written advertisements. Many states have statutory provisions which provide that any advertising that does not correspond with the information contained in the FDD is deemed a “false, fraudulent, misleading or deceptive practice.” For example, Illinois statutory law provides that any advertisement which suggests a range or specific level of sales, income, gross or net profits, or other types of earnings claims must be consistent with the guidelines contained in Item 19 of the FDD.\footnote{See, 16 C.F.R. § 436.9(c).} Illinois law does not distinguish between written advertising and verbal advertising.
Accordingly, a court may apply Illinois statutory law to both written and verbal advertising provided to an Illinois prospect.

There are few pressure points a franchisor should consider before using the information set forth in its Item 19 FDD to make verbal or written financial performance representations. First, the franchisor must ensure that the verbal or written representation made is identical to the written disclosures in the franchisor’s Item 19 representation – this includes making sure the representation is not misleading by excluding from the representation key underlying facts upon which the representation is based. In any franchise sales advertisement that includes financial performance information, the franchisor should include a note stating that additional information relating to the financial information is contained in Item 19 of the franchisor’s FDD. If, however, the advertisement refers to only a portion of the franchisor’s Item 19 FPR, the franchisor should clearly state the underlying facts upon which the representation is based. For example, if a franchisor’s Item 19 categorizes its franchisees’ average operating income by years of operation – outlets operating for a period of 1 year but less than 2 years, and 2 years or more, and the advertisement only includes information for those outlets operating 2 years or more, the franchisor should clarify that the representation relates to franchised outlets in operation for at least 2 years or more. Failing to include this qualifying statement in a franchisor’s advertisement is untrue and misleading.

In connection with the verbal or written financial performance representation, the franchisor must remember to notify the prospective franchisee that their financial results may differ from the results stated. A franchisor, however, should consider whether including the required warning statement as part of its financial performance representation advertisement contradicts the message the franchisor is trying to portray – we are a great franchise system, just look at how our franchisees are doing financially.

Finally, while a verbal communication between a franchisor and a prospect does not fit squarely within the definition of a general media representation, the example provided in the Compliance Guide relating to a franchisor referencing its financial performance representation during a face-to-face meeting in an effort to “lure potential franchisee” raises the question of whether a franchisor, when verbally discussing a financial performance representation with a prospective franchisee, is required to disclose the number and percentage of outlets that attained or surpassed the represented level of financial performance and identify the time period when the performance results were achieved. The key to the analysis is the purpose behind the communication. If the purpose of the communication is to “lure potential franchisees” then the communication is more in line with a general media representation and franchisors would be well-advised to err on the side of disclosing this additional information and identify the number and percentage of outlets that attained or surpassed the represented level of financial performance, state the time period when the performance results were achieved, and notify the prospective franchisee that the prospect’s performance results may differ from the financial performance representation.

A franchisor running an advertisement containing financial performance information at the very least must furnish any prospective franchisee with the required Item 19 disclosures while the advertisement is running. If a franchisor stops running the advertisement, the franchisor must continue to disclose the information required by Item 19 for a reasonable period thereafter, which is not less than six months.

If a franchisor replaces one advertisement containing a financial performance representation with a new one containing updated financial information, the Revised FTC Rule
requires that the updated financial information be included in the franchisor’s Item 19 disclosure, rather than the information included in the initial version of the advertisement. Finally, if a franchisor runs multiple advertisements with different types of financial performance information, the franchisor must disclose and provide information for each type of claim in Item 19 of its disclosure document.

H. Franchise Sales Compliance

All financial performance representations must appear in Item 19 of the disclosure document, except for supplemental claims and disclosure of actual records of a particular outlet being sold. It is a violation of the revised FTC Rule for a franchise seller to make a financial performance representation not included in Item 19 or that is inconsistent with what appears in Item 19. A franchisor cannot provide or authorize others to provide prospective franchisees with financial performance information while at the same time stating in Item 19 that the franchisor does not authorize the making of any financial performance representations.

Most prospective franchisees want financial performance information as part of their due diligence in deciding whether to purchase a particular franchise. They are understandably hesitant to invest thousands of dollars if they have no idea what kind of financial results they can expect. If a franchisor does not include a FPR in its FDD, it needs to make sure everyone in its organization is aware that they cannot talk with prospects about possible financial performance and they are precluded from reviewing or commenting on the prospect’s financial plan or pro forma.

Reputable franchisors establish franchise sales compliance programs to assist the company in training its employees on the franchise sales legal issues and how those employees can comply with the legal requirements and still effectively perform their jobs. The objectives of a franchise sales compliance program should be (i) outline the legal “do’s and don’ts” of franchise sales in a way that business people (particularly salespeople) will understand, (ii) specifically identify what actions or statements are prohibited with real life examples and not just legal principles (this step is critical even if a franchisor makes an Item 19 FPR), (iii) engage in interactive dialogue in group settings, as well as individual sessions, to make sure all issues and questions are explored and answered, (iv) create a culture where compliance is paramount and dialogue on issues is encouraged, (v) design a sales process that properly addresses FPR issues and also achieves the company’s development goals, and (vi) state unequivocally that compliance is mandatory.

I. The Role of the Lawyer and Other Professionals in Preparing a Financial Performance Representation

Lawyers participating in preparing a FPR must understand and appreciate that the client’s motivation for including a FPR is to sell franchises. As a result of the client’s motivation, the lawyer must challenge and question the client’s decision to include and exclude certain information, and help the client minimize the risk of liability exposure from a lawsuit or government investigation related to the FPR.

A lawyer must counter its client’s motivation for including a FPR with the requirement that the information provided be reliable and not misleading. Franchisors will want their FPRs to include information that will help them sell franchises by presenting the most positive FPR. As a

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140 See, 16 C.F.R. § 436.9(c).
result, the franchisor client will want to focus on the financial information that puts the FPR in a favorable light and discount or ignore information that negatively impacts the FPR. The franchisor also will want its lawyer to bless the FPR and provide some comfort that the FPR will not result in a huge verdict in favor of the franchisee. The lawyer’s role therefore is to caution the client in preparing and using a FPR and question why certain information was used and other information was left out. After all, the first attack made by a disgruntled franchisee likely will be a claim that if the information left out of the FPR was included in the FPR, the franchisee never would have entered into the franchise relationship.

The franchise lawyer also must make sure that the support and analysis for the information contained in the FPR is accurate, substantiates the information presented in the FPR, and is kept readily available. Any data used in preparing the FPR must be available for the prospective franchisee and FTC to review if requested, and should be maintained even after the FPR is no longer used. When the final FPR is prepared, a franchisor should prepare a record noting the reasons why certain information was included in the FPR and identifying the reasons why other information was excluded.

A franchisor also should consider having an outside accounting professional review its proposed FPR. A certified public account would make an excellent witness in court if he or she is able to testify that he or she independently reviewed the FPR and agreed with the franchisor’s decisions to include and exclude certain information.

Finally, franchise lawyers should consider including explanatory and clarification statements in the FPR. If a decision has been made to exclude certain information from the FPR, a franchisor may want to consider including a disclosure explaining why the information was excluded. The more specific the disclosure the more likely a court or jury will accept the argument that the franchisee was not misled by the FPR.

VI. FINANCIAL PERFORMANCE DISCLOSURE FROM THE INVESTOR’S PERSPECTIVE

A. Role of FPRs in Investment Decisions

1. Uses of Financial Performance Information

It is odd, in one sense, even to have to discuss the role of financial performance information in prospective franchisee investor decision-making, as the importance of such information is self-evident. The absence of financial performance information from a strong majority of registered disclosure documents even in the permissive regulatory regime that exists under the revised FTC Rule may suggest more about the role of franchise lawyers and their endemic risk aversion than it does about the rationality of franchise presale disclosure as practiced currently.

As noted above (Section III), the FTC’s original SBP found financial performance information to be vital to investors’ ability to evaluate franchise offerings, but not efficiently available from other sources than the franchisor. In the period between the 1975 promulgation of the original UFOC Guidelines, and their eventual revision in 1993, during which “earnings claims” disclosures were, if not prohibited, at least very difficult to make legally, the marketplace-driven need to provide investors with intra-system-sourced financial performance information drove a large part of this disclosure process underground. A relative handful of registered offering circulars offered actual or projected earnings information in Item 19, but most
did not. A great deal of financial disclosure went on outside of the formalities of the offering circular. Some plaintiffs’ lawyers observed that it was a rare franchise sale in which illegal earnings claims disclosures could not be found somewhere in the history of the transaction, and the only challenge was to find and prove them.

Prospective franchisees need financial performance information for a number of obvious reasons. At the most elemental level, if a franchise system does not have a track record of financial success by earlier franchisees, because there are none, or it has an unfavorable track record because earlier franchisees’ financial results have been negative, that by itself is material information likely to influence the judgment of a rational investor whether to purchase or to forgo purchasing a given franchise.

If a franchise system has sufficient scale and operating history to have a non-trivial track record of financial results by franchisees, and that track record is positive, a statistical display of some measure of financial performance would be extremely useful to later investors. It might consist of simple periodic gross sales, some measure of profitability, time to break-even, a return on investment value, or some idiosyncratic industry-specific measure. The variation in experience among system franchisees would be equally important: What proportion of franchisees managed to achieve the stated level of financial performance? What are the top quartile and the third quartile? Such information is critical in guiding the judgment of an investor. Because of the huge variation in the sophistication and array of investment goals of franchise investors across thousands of possible franchise investments, it would be easy to over-generalize and over-simplify exactly how investors use this information. But it cannot be gainsaid that having access to a reliable record of some financial performance metric is indispensable to making such an investment judgment on an informed basis.

No thinking person would buy an existing business with a track record of financial performance without closely examining its books and records, and perhaps even demanding third-party verification through an audit or similar process. It is baffling why anyone would think an investor in a start-up franchise should not do likewise, but instead make such a leap, blindfolded, when counterpart information exists but its disclosure is left to the subjective judgment of the seller of the franchise opportunity.

For many franchise investors, having financial performance information available in the disclosure document better facilitates comparison between or among competing investment candidates. A franchise with a weak financial record would not fare well in such a comparison, and it is understandable why the franchisor of such an offering might prefer not to disclose it. But the usefulness of the information to the investor seeking to make the comparison is plain.

Another high-value use of financial performance information in an FDD is to compare the advantages and disadvantages to an investor of buying a new franchise to start up a business as compared to buying an existing outlet in the same chain. An existing unit will always have financial records showing its actual financial performance, which can be compared to the Item 7 cost information and (where it is offered) the Item 19 financial performance information relating to a new franchise.

One unavoidable downside to putting financial performance information into an FDD is that in states where the FDD is registered it is public record information, and thus accessible to competitors of the franchisor. This will enable competitors who wish to do so to draw comparisons between their own offering and that of the other franchisor.
Most franchisees need to raise capital to invest in a franchise, whether to buy an existing business or start up a fresh one. Prospective franchisees need to have something to show their lender to make a case for the lender to advance financing to start the franchise. Whether that lender is a bank, a private equity fund, or a relative, a lender will want to see where the money is going, and determine its prospect of repayment. Reliable financial performance information of other, similar franchisees is a material part of that lender’s underwriting decision process. This is another reason that offering FPRs in Item 19 is in the franchisor’s interests just as much as it is in the franchisee’s.

2. Implications of a Negative Disclosure

The new FDD Guidelines to Item 19 require a fairly bluntly-worded “negative disclosure” in disclosure documents where the franchisor has chosen not to offer financial performance information. The required disclosure states: “We do not make any representations about a franchisee’s future financial performance or the past financial performance of company-owned or franchised outlets. We also do not authorize our employees or representatives to make any such representations either orally or in writing.”

To negate the past practice of some franchisors hiding behind a misrepresentation of the effect of the original FTC Rule and UFOC Guidelines (by telling prospective investors that the franchisor was prohibited by law from offering financial data in Item 19), the revised Rule now also includes a required preamble for all Item 19 disclosures, whether negative or positive, which includes this statement: “The FTC’s Franchise Rule permits a franchisor to provide information about the actual or potential financial performance of its franchised and/or franchisor-owned outlets, if there is a reasonable basis for the information, and if the information is included in the disclosure document.”

The combination of these two required statements should alert investors, and their advisors, to be wary of franchise offerings that do not contain any financial performance information in Item 19. Professional advisors especially who are (or should be) aware of the very low hurdles in the revised Rule's substantiation requirements to making financial performance disclosures should ask, and encourage their clients to ask, why a given FDD does not provide financial performance data, except in the case of first-year start-up franchise programs. A negative disclosure in an FDD should be a major red flag in a prospective franchisee’s due diligence process. It should give rise to questions such as, “What is this franchisor hiding?”, and “If previous franchisees have had good financial results, why isn’t this franchisor broadcasting them?”

If nothing else, a negative disclosure in an FDD should stimulate substantial additional due diligence, even though it is illegal for a franchisor who has made a “negative disclosure” in Item 19 of its FDD to provide financial performance information to a prospective franchisee outside of the offering circular.

142 id. at 9129-247.
143 For a more complete description of due diligence procedures in purchasing a franchise opportunity, see ch. 7 of Fundamentals of Franchising, 3rd ed., R. Barkoff and A. Selden, Eds., ABA Forum on Franchising 2008.
3. Relationship of FPRs to Regulatory Purposes

One very basic aspect of franchise disclosure practice that is often overlooked in various contexts is that the core purpose of state franchise registration and disclosure laws, as with the FTC Rule, is to provide pre-commitment investment information to prospective franchisees to enable them to make relatively better-informed investment judgments than would be possible in the absence of the prescribed disclosure. Contrary to much of what one sometimes hears from some corners of the franchise bar, the cost and convenience of the franchisor is not one of the central concerns of the franchise disclosure laws.

Against this background, financial performance disclosure, where offered, is squarely within the core purpose of franchise presale disclosure requirements at both the state and federal level. This is a fact that in turn is sometimes forgotten by state franchise registration review staff, which put franchisors that volunteer financial performance information in Item 19 through the wringer of aggressive review that seems to be motivated by the regulatory animus toward earnings claim disclosure that existed pre-1993. This kind of aggressive regulatory scrutiny is counterproductive to the core purpose of the statutes, and of the revised FTC Rule.

4. Role of Professional Advisors

When financial performance information is provided in Item 19, it is almost always prudent for the investor to get professional advice in interpreting and understanding the information provided. Lawyers may or may not be the best source of such advice, as lawyers do not always have sufficient professional competence in financial and business matters necessary to interpret such information correctly, especially in conjunction with fee and cost information presented in Items 5 and 7 of the FDD. A qualified CPA or experienced business consultant may be in a better position to interpret such information and guide the investor in using it appropriately.

B. Other Sources of Financial Information

As noted in Section III.B above, during the 1971 – 93 era, when legal earnings claim disclosures were very difficult to make, franchisors became adept in guiding prospective franchisees to other sources of financial performance information to facilitate their investment decision-making. Even in the current regulatory environment that is extremely permissive towards financial performance disclosures, those other sources of information remain relevant, and investors can profitably amplify the financial performance data displayed in Item 19 of an FDD by referring to such other external sources of information.

1. Data Sources

Many other sources of such information exist. Some are in the FDD itself. Items 5 and 6 contain information about one-time and recurring fees and other payments to the franchisor and its affiliates; Item 7 reports initial investment obligations primarily focused on the cost of setting up the franchise before it opens for business; some other cost information can sometimes be gleaned from Items 8 and 11 concerning supply chain issues; and the franchisor’s financial statements (including the notes) can be a rich source of information about the performance of individual non-franchised business units on an aggregate, average basis. Publicly-traded franchisors also make regular filings with the U.S. Securities and Exchange Commission, and their quarterly and annual report filings can be a rich vein of information concerning the characteristics and financial results of operations of their retail businesses.
Item 20 of the FDD includes charts that offer a wealth of statistical information about the franchise system. High rates of turnover, termination, voluntary surrender of franchises, etc., by earlier franchisees can lend valuable context to whatever other financial information is available.

Item 20 also contains two lists that can be of great use in gleaning useful financial performance information: the list of current franchisees, and the list of departed franchisees over the 12 months before the cover date of the FDD. Among other reasons for these lists, prospective franchisees should use them to contact both existing franchisees and the departees as part of their due diligence process, to inquire about financial factors of interest to the prospective buyer. Neither current franchisees nor departees are required to disclose anything to anyone, of course, but in practice, most are quite willing (within reason) to meet with a prospective franchisee in the same franchise and discuss (sometimes in remarkable levels of detail) their own experiences, good or bad, including financial issues and experiences both in setting up the franchise and operating it.

Financial performance information sometimes can also be gleaned and validated by consulting competing franchisors. Sometimes, one franchisor might be willing to discuss (perhaps “off the record”) its perception of the financial results achieved by franchisees in a competing chain. While such information probably should be taken with a grain of salt, it can provide a useful frame of reference or gloss on the financial performance information provided by the other franchisor.

Published neutral sources of information are often available on financial results within a given industry, or even a given chain. These sources are readily accessible through online databases, and old-fashioned libraries. Some franchisors might steer prospective franchisees towards particular published sources of information. These, too, should be taken with a grain of salt given the probability that journalists do not always get their facts 100% right.

2. **Reliability and Accountability**

The regulatory hurdles to putting financial performance information into Item 19, and the liability risk if such data is incomplete or misleading, motivates most franchisors and their professional advisors to be cautious and thorough in compiling the Item 19 disclosure. This, in turn, suggests that with a reputable franchisor, Item 19 FPR information is probably both accurate and reliable.

Other sources of information may be less accurate and less reliable. Certainly, a franchisor with a negative disclosure in Item 19 who still offers surreptitious financial performance information should not be trusted. Financial performance disclosures by or on behalf of a franchisor that occur outside the disclosure document (with the exceptions for supplemental financial performance disclosures, and disclosure of actual records of a particular unit being offered for sale by a franchisor) also should be regarded as a major red flag in the due diligence process. A franchisor that makes financial performance disclosures outside the disclosure document is either in reckless (or intentional) disregard of the law, or so naïve and unsophisticated, that the prospective investor should run for the door if such disclosures are encountered.

One of the underlying purposes of the basic requirement that financial performance disclosures be made in the disclosure document if they are to be made (lawfully) at all, is to provide a trail of accountability to enable franchisees to rely on that information in making their
investment decision. The provision of the revised FTC Rule outlawing the use of disclaimers and integration clauses to negate the effect of the required disclosures underscores the FTC’s purpose to enable prospective franchisees to rely on FDD disclosures in general, and Item 19 disclosures in particular.144 Other sources of financial performance data do not carry this level of assurance.

3. **Self-Generated Information**

Even though prospective franchisees can, and should, be able to rely in large measure on FPRs in an Item 19, it is usually wise to go beyond the FDD to develop one’s own financial expectations for a new franchise. In this endeavor, use of an independent professional advisor, such as a CPA or an experienced business consultant, is highly advisable.

Franchisees considering starting up a new franchise business need to do a great deal of financial planning. At the outset, the franchisee often needs to put together a comprehensive business plan both for his or her own use, and to provide to a lender. New franchisees will also want to use financial performance information from the FDD and other sources to develop at least three additional budgets: an initial investment budget (fleshing out the information provided in Item 7 of the FDD); an operating budget for day-to-day operation of the franchised business; and a capital budget to anticipate and guide downstream capital replenishment requirements for the business for such items such as periodic facility renovation and replacement of worn-out equipment.

4. **Particularization to a Site; Supplemental FPRs**

Once a franchisee has gathered whatever financial performance information is available, from the FDD and whatever other sources have been consulted, the investor must apply that information to evaluate and then to develop budgets for a particular location. Once again, independent professional support is extremely valuable. Certainly a CPA should be consulted, but it may also be useful to consult a professional commercial realtor well-acquainted with the trade area. How a given site or trade area differs from the characteristics or assumptions that determined the information in the Item 19 FPR, and how they differ from the traffic patterns, age, patterns of evolution, competitive circumstances and competitive density of the target trade area, must be fully evaluated.

In this regard, an innovation introduced into FPR regulation in 1993 (in the old UFOC Guidelines), and preserved in the revised FTC Rule, can be extremely valuable. The Item 19 disclosure requirements include a planning tool called the supplemental financial performance disclosure.145 This provides that if a franchisor has included financial performance information in its FDD Item 19, it may then develop with a particular prospective franchisee, in reference to a particular proposed location, a "supplemental" financial performance disclosure. This usually takes the form of specific budgeting or projections that extend the generalized information of the Item 19 FPR to develop a particularized set of financial assumptions and plans for the given location or trade area. The value to the new franchisee of such particularized information in business plans both for internal use and for use with lenders cannot be overstated. The FTC's new Compliance Guide is especially informative in explaining the supplemental FPR:

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144 16 C.F.R. ¶ 436.9(h).
145 See, 16 C.F.R. § 436.5.
If a franchisor has furnished an Item 19 disclosure, it may furnish a prospective franchisee with a supplemental financial performance representation pertaining to a particular location or pertaining to a particular variation (e.g., a kiosk, as opposed to a standard free-standing restaurant). Any such supplemental representation must be writing, explain the departure from the financial performance representations set forth in the Item 19 disclosures, and be prepared according to the standards for financial performance claims [for FDD Item 19 FPRs].

Supplemental financial performance disclosures do not necessarily have to mimic the exact scope or content of the information in Item 19 of the FDD, so long as they satisfy the three requirements noted in the Compliance Guide: be in writing, explain how they differ from the FDD Item 19 disclosure, and be prepared in accordance with the other general substantiation requirements for Item 19 disclosures.

5. Particular Industries

Item 19 allows FPRs to be customized to the idiosyncratic needs of particular industries. In many industries, a top-line annual dollar sales number, by itself, is sufficiently useful to satisfy the most basic needs of investors. In other industries, a breakeven point (expressed in terms of a periodic rate of dollar sales volume) or a stated return on investment or return on equity may be more useful, and in still other industries, other more indirect measures of financial results may be more useful than simple dollar volume data. For example, in affiliation franchises, where the franchisee is already operating a business in the industry segment, a net contribution value may be the most useful information, by disclosing what affiliating the existing business with the franchisor’s system may add to the existing base of business, either in dollar terms, or in some measure of transaction volume. In the hotel industry, the net addition of monthly or annual room-nights is often used to indicate the value to the owner of the hotel property of affiliating with a given chain, driven primarily by access to the advertising-supported central reservation service of the franchisor. Hotels often use “revenue per available room-night” (or “REV-PAR”) as an index both of financial performance and of the contribution to results from affiliating with a given franchise system. In a quick service restaurant, by contrast, a simple monthly or annual dollar sales volume disclosure may be most useful.

C. Limitations to the Usefulness of FPRs

As critical as FPRs are to the investment analysis of a prospective franchisee, there are several limitations of which investors should be mindful.

1. Statistics

First, the quality and comprehensiveness of FPR information must always be scrutinized even with a reputable franchisor. Item 19 FPR disclosures rarely consist of a comprehensive profit and loss statement. More likely they will include one or more selected metrics measuring some aspect of financial results of operations of franchised or non-franchised units in the system.

The FTC’s Compliance Guide, while written to guide franchisors in preparing FPRs for Item 19, also doubles as a useful series of due diligence questions for franchisees and their

146 Bus. Franchise Guide (CCH) ¶ 6086 at 9129-246.
professional advisors to follow in evaluating financial performance disclosure. The Compliance Guidelines ask the following questions:

- Did All Outlets in the System, or Only Some of Them, Achieve the Stated Level of Performance?
- Are the Outlets in the Measured Group Franchised Outlets? Company-Owned? Outlets of an Affiliated System with Similar Operations?
- When was the Stated Level of Performance Achieved?
- How Many Outlets are in the Group that Achieved the Stated Level of Performance, and How Many are in the Entire System?
- How Many Outlets in the Relevant Groups Supplied the Performance Data Underlying the Representation?
- What Proportion of the Group Measured Achieved the Results Claimed?
- What are the Common Attributes of the Outlets that Achieved the Stated Level of Performance?\(^\text{147}\)

Franchisees need to understand the answers to all of those questions in order to evaluate the quality and comprehensiveness, hence reliability, of the information provided. Another trap for unwary readers of many FPR disclosures is the use of averages, especially in the absence of quartile or quintile (or similar) bracketing information to understand what proportion of franchisees achieved the reported level of results. Averages can be quite misleading. They can blur the extremes, be skewed by the extremes, and may not be representative at all of "typical" unit performance. A \textit{median} level of performance is far more useful than an \textit{average}, (the arithmetic mean) because the median, arithmetically, is the point in a curve where half of the reported results occurred above, and half below, the stated result.

2. \textbf{Unit Characteristics}

Aging is also a factor that the investor needs to understand. In any given franchise system, a new start-up unit might perform significantly worse than a well-established unit, or conversely, might open with a spike of high performance, only to settle down later at a lower level of performance. Or, in a system expanding into new geographic areas, depressed openings, or spike-openings, might be the opposite of the initial results of units developed in that system's well-developed traditional geographic territories. Aging also can affect results based on myriad local cultural, demographic and economic factors. Older units may perform better simply by virtue of having amortized a large part of the initial investment costs incurred to open the business. Investors need to understand all of these, and other, drivers of variability in reported financial results.

Another significant driver of variability is seasonality. Some systems will naturally perform better financially based on season, and those differences may be exaggerated in geographic areas where seasonality is exaggerated. For example, a recreational equipment

\(^{147}\) Bus. Franchise Guide (CCH) ¶ 6086 at 9129-244.
rental business will probably be heavily influenced by both seasonality, and the degree of seasonality in the particular market in which it is operated. The same could be expected of an ice cream franchise.

FPRs also must be understood in reference to the simple geography in which different units are located. Are the units used to form the basis of the FPR all in “A” locations? Or do they include units in less expensive, but lower-performing, “B” or “C” locations? Are they urban, suburban or rural? What is the mix, and how does that mix influence the reported results?

Another, less well-understood driver of variability is the simple size or scale of the reported facility. Some operators may find that a given trade area will support a much higher volume of operation than can be achieved physically with a smaller, but less expensive to build and operate, physical facility. To illustrate, if a given trade area might support a $2 million a year KFC restaurant, but the franchisee chooses to build a less-costly 60 seat facility rather than a more costly, but higher capacity, 140 seat restaurant with a drive-thru, the $2 million potential of the trade area cannot and will not be realized. What is the pattern of the scale of the units the results of which form the basis for the FPR?

3. **Self-Inoculation**

Another major limitation to the value and effectiveness of Item 19 disclosures, at least before the FTC updated the Franchise Rule, was the practice of many franchisors to attempt to inoculate themselves against responsibility for the consequences of franchisees’ use of their own disclosure information. In addition to the prescribed notices and disclaimers for Item 19 (described in Part II of this paper), franchisors would often add additional disclaimers and limitations both to their offering circulars and to their franchise agreements in an effort to preclude franchisees from later asserting that they had received or relied upon information from the franchisor or its representatives, sometimes even the UFOC itself, in making their investment decision concerning the franchise. This practice amounted to franchisors in effect wanting to have their cake and eat it too, by providing Item 19 information, but then disclaiming any responsibility for it.

The revised Rule prohibits franchise sellers from disclaiming or requiring “...a prospective franchisee to waive reliance upon any representation made in the disclosure document ...”.\(^{148}\)

In the SBP for the revised Rule, the FTC discussed how some franchisors used the integration clause in the franchise agreement to negate pre-contractual representations and disclosures, including in the UFOC. The SBP notes:

> The use of such clauses, therefore, may lead to deception by enabling franchisors to make incomplete, inaccurate, or even false statements in their disclosure documents, while prospects effectively waive reliance on any such statements by signing the franchise agreement.\(^{149}\)

\(^{148}\) 16 C.F.R. § 436.9(h).

\(^{149}\) 72 Fed. Reg. 15444, 15533.
Based on this concern, the FTC concluded "... that a limited disclaimer prohibition, rather than a total ban, is warranted."\textsuperscript{150} The SBP went on to explain:

At the same time, we are persuaded that franchise sellers should not be able to use integration clauses or waivers to insulate themselves from false or deceptive statements made in a franchisor's disclosure document. This is particularly true of those sections of the disclosure document pertaining to matters other than the terms of the franchise agreement that cannot be negotiated, such as the franchisor's ... financial performance representations ...."

The SBP concludes:

[The original and final amended Rules also prohibit franchisors from making statements that contradict those in their disclosure documents. The use of integration clauses or waivers to disclaim statements in the disclosure document that the franchisor authorizes would undermine the Rule's very purpose by signaling to prospective franchisees that they cannot trust or rely upon the disclosure document.\textsuperscript{151}]

This new provision of the revised Rule should go a long way towards eliminating the confusion that has resulted under the previous version of the Rule, and the various state registration and disclosure statutes. Courts have divided on whether franchisors can invoke questionnaires, integration clauses and other contractual disclaimers to exclude consideration of UBOC/FDD disclosure in subsequent disputes about the content or meaning of the franchise agreement, based on such common law doctrines as the parol evidence rule, "reasonable reliance," or contract ambiguity. To that end, some courts have held that an investor could not have "reasonably relied" upon a disclosed representation.\textsuperscript{152}

4. Failure Modes of FPRs

As useful as FPRs are, based on all of the factors discussed in the previous sections, it is evident that they can fail of their essential purpose in any of a number of ways, some of which may or may not be foreseeable. Franchisors who are too carefully selective in the categories of data, or the stores or units represented in the data sets employed, in an Item 19 FPR may be successful in painting a more rosy picture of the system's history than the full set of facts

\textsuperscript{150} Id. at 15534.

\textsuperscript{151} Id. (footnotes omitted).

warrant, but they will also be planting seeds of later trouble, both for their new franchisees and possibly for themselves.

Statistical shortcomings in the selection, preparation and presentation of financial data can be equally unhelpful and misleading, unless great care is taken in the compilation, presentation, characterization, and in the interpretation and analysis of FPR information.

Finally, all of the FDD regulations in the world will not prevent a minority of franchisors or their representatives from making unauthorized FPRs outside the FDD, or in what will hopefully be a very small number of cases, committing outright fraud in the use of financial information just as the original FTC's SBP documented was the case in the 1960s.

VII. FINANCIAL PERFORMANCE REPRESENTATIONS REGULATION / THE STATES' VIEW

To date, the franchise examiners in the State of Illinois report no significant differences in the deficiencies they find in FPRs under the revised FTC Rule as opposed to the earnings claims they reviewed under UFOC Guidelines. The issue which generates the most comments on FPRS, as it did with earnings claims, is the lack of a "reasonable basis."

"Reasonable Basis" deficiencies include the following:

- The failure of the franchisor to disclose the number of units that achieved or surpassed the disclosed results. Under the UFOC Guidelines a franchisor was required to compare this number against all franchisees and/or franchisor-owned units in its system. The revised FTC Rule allows the franchisor to base the FPR on subgroups and to compare the number achieving or surpassing the given results against only the units in that subgroup. So, even though the requirements have been reduced, franchisors still fail to disclose this information. However, this deficiency is easily rectified once brought to the attention of the franchisor's disclosure document preparer.

- Another common deficiency occurs when the FPR is based on the results of franchisor-owned outlets rather than franchisee-owned units. If a franchisor has had a number of operational franchises for at least two years, Illinois requires that the FPR include the results of the franchisee-owned units.

- Recently, one Illinois examiner reviewed a FPR which was based on 11 of 21 franchisor-owned stores when the franchisor had approximately 600 franchises for the past three fiscal years. In another instance, a franchisor's FPR was based on one (1) franchisor-owned unit when the franchisor had at least eight (8) franchises and seven (7) franchisor-owned units for the past three fiscal years.

- Relativity comes into play when such a miniscule number of franchisor-owned units are utilized as an FPR basis and when the financial performance of franchisor-owned units is used, rather than those of franchisees. Illinois' position was that neither of these FPRs met the test for "reasonable basis" and both were denied.

One last observance regarding "reasonable basis" is that both the UFOC Guidelines and the revised FTC Rule provide that the operations of an affiliate can only be used as an earnings
claim/FPR when the franchisor lacks adequate operating experience of its own. In fact, the FTC’s Compliance Guide specifically states that “[w]hen a franchisor has adequate performance data of its own upon which to base a performance representation, basing a financial performance representation on affiliate information would not be reasonable.” Therefore, FPRs based on the operating experience of an affiliate will not be accepted unless the franchisor has no such experience of its own.

Other deficiencies unrelated to the “reasonable basis” issue include:

1. The failure of franchisors to use the exact language required by the revised Rule’s Item 19 for the two required disclosures in the Item 19 of their disclosure documents. These disclaimers are discussed in Section II.A of this paper. The Rule requires that the exact language prescribed by it for these disclaimers be used right down to the punctuation. Often, the examiners have found that the disclosure is paraphrased or mimics the legends required under the Item 19 requirements. In addition, disclaimers which attempt to absolve the franchisor from claims against it are often included and the preparer is instructed to remove them.

2. The failure to disclose the required language that a new franchisee’s individual financial results may differ from the result state in the FPR and that written substantiation for the FPR will be made available upon reasonable request.

3. Inconsistencies between the franchise agreement and the Item 19. Franchise agreements will often include “disclosure acknowledgments” which require the franchisee to state that it received no statements of actual, average, projected or forecasted sales, profits or earnings (or similar language) when the Item 19 does contain an FPR. These acknowledgments should be modified or eliminated completely.

Franchisors that do not provide an FPR must be careful that their financial statements included in the FDD do not do so. In many cases, when unaudited statements are included in the disclosure document, they will break out the amount of royalty and advertising fees the franchisor received as revenue from each of its franchisees. In cases where these fees are based on the franchisee’s gross revenues, it would be simple for a prospective franchisee to “do the math” to determine what each franchisee’s revenues are based on the figures provided in the financial statements.

Most complaints the Illinois Attorney General’s Office receives from franchisees include allegations of unregistered FPRs. Rarely, however, are these unregistered FPRs given in writing which makes it difficult to substantiate the allegation. Allegations which can be substantiated are met with active enforcement actions. The examiners routinely check franchisor internet websites to determine whether they contain FPRs which have not been registered. In such cases, an investigation will ensue and enforcement action taken.

In summary, the Illinois State Examiners are seeing the same types of problems with FPRs as they did with earnings claims. Franchisors can expect to see strict enforcement of the Rule’s Item 19 requirements and the denial of FPRs not meeting the “reasonable basis” criteria.
VIII. CONCLUSION

Financial performance issues (whether referred to as earnings claims or FPRs) have been critical to franchising for many years and continue today. Prospective franchisees seek financial performance information as part of their due diligence. Some franchisors have successfully used Item 19 disclosures as key parts of their sales process. Potential abuses, however, remain. Federal and state regulators, therefore, continue to address financial performance issues in their oversight of franchising.

This paper has examined financial performance representations from those different perspectives – franchisor, franchisee, and regulator. The paper's objective has been to identify the legal and practical aspects of financial performance representations and then suggest best practices for franchisors to consider in preparing a lawful and meaningful Item 19 FPR.
Current Statistics regarding the use of FPRs

Darrell Johnson from FRANdata provides the following information regarding franchisor’s use of FPRs:

(i) approximately 20% of the franchisors in the United States use FPRs with that percentage increasing to 25% for those franchisors with more than 50 units;

(ii) 80% of the franchisors who make FPRs have systems more than three years old;

(iii) almost half of the franchisors that make FPRs include expense and revenue information, and

(iv) 44% give data about franchised units, 59% give data about company-owned units, and 16% give data on both franchised and company-owned units.

The balance of this Appendix B includes sample FPRs formats. Certain state examiners may consider some of the statements contained in the sample FPRs as unnecessary disclaimers or information. Be sure to review applicable state law when preparing your own FPR.
SAMPLE A – CLAIM BASED ON FRANCHISED UNITS IN A MALL-BASED BUSINESS

UNAUDITED STATEMENT OF SALES, MANAGEABLE PROFIT, AND SELECTED EXPENSES.

The FTC's Franchise Rule permits a franchisor to provide information about the actual or potential financial performance of its franchised and/or franchisor-owned outlets, if there is a reasonable basis for the information, and if the information is included in the disclosure document. Financial performance information that differs from that included in Item 19 may be given only if: (1) a franchisor provides the actual records of an existing outlet you are considering buying; or (2) a franchisor supplements the information provided in this Item 19, for example, by providing information about possible performance at a particular location or under particular circumstances.

The following statement of certain sales, manageable profit, and selected expense ranges, averages, and medians are based upon profit and loss statements submitted to us by franchisees of the stores included in the statement for store operations during their fiscal year 2007. We have not audited the franchisee profit and loss statements for purposes of this statement. We have no assurances that the franchisees used generally accepted accounting principles in preparing their statements.

The information included in this statement is for the stores that were developed and first opened for business in enclosed malls between January 1, 1998 and December 31, 2006, and that were open and operating for a full 12 months in the year 2007.

The statement presented in this Exhibit provides the following information:

1. Average and median sales, Manageable Profit, and selected expenses for our stores located in malls with Gross Leasable Area (GLA) of at least 1,000,000 square feet and the high and low range for each item disclosed;

2. Of the stores located in malls with at least 1,000,000 GLA, the number of stores that attained or exceeded the items disclosed in this Exhibit is as follows:
   
   ____ (___%) attained or surpassed the average sales amount;
   
   ____ (___%) attained or surpassed the average manageable profit; and
   
   ____ (___%) attained or surpassed the average selected expenses.

3. Average and median sales, Manageable Profit, and selected expenses for our stores located in malls with less than 1,000,000 GLA and the high and low range for each item disclosed;

4. Of the stores located in malls with less than 1,000,000 GLA, the number of stores that attained or exceeded the items disclosed is as follows:
   
   ____ (___%) attained or surpassed the average sales amount;
___ (___%) attained or surpassed the average manageable profit; and
___ (___%) attained or surpassed the average selected expenses.

5. Average and median sales, Manageable Profit, and selected expenses for all
___ stores included in the Statement without regard for the GLA of the mall in
which each store is located, and the high and low range for each item disclosed;

6. Of our ___ stores include in the Statement, the number of stores that attained or
exceeded the items disclosed is as follows:

___ (___%) attained or surpassed the average sales amount;
___ (___%) attained or surpassed the average manageable profit; and
___ (___%) attained or surpassed the average selected expenses.

7. A breakdown of the ____ stores included in the Statement among 4 categories
defined solely by mall GLA.

8. A blank form of a profit and loss statement that identifies the various expense
items generally included in a profit and loss statement for a store is included as
an exhibit to this disclosure document.

For purposes of this statement, the following definitions apply:

1. **Net Sales.** Gross sales less sales taxes and discounts.

2. **Cost of Goods Sold.** The cost of the food products that are sold to consumers
   and the associated packaging. The food products include ingredients,
   beverages, and condiments. The associated packaging includes bags, product
   wraps and containers, and other paper products. Because this statement is
   based on unaudited profit and loss statements received from franchisees that do
   not identify each item included in the store's cost of goods sold, we cannot
   identify the specific items that each store actually included in its cost of goods
   sold calculation.

3. **Labor.** The sum of crew labor wages, manager's salary and other
   compensation, and related taxes and benefits. Labor does include payments
   that may be made to a franchisee or its owners in the form of a manager's salary
   or wages. Labor does not include payments that may be made to a franchisee or
   its owners in the form of an owner's draw, a dividend, or similar distributions.
   Because of the many forms through which franchisees may be compensated for
   their work in a store, not all stores paid a manager's salary and benefits.

4. **Controllable Operating Expenses.** The sum of utilities, repairs and
   maintenance, laundry and cleaning, office supplies, store supplies (other than
   inventory), trash and recycling, and bank charges (other than debt service).

5. **Occupancy Costs.** The sum of base rent, applicable percentage rent, common
   area maintenance charges, food court common area maintenance charges
(when applicable), mall property taxes, city and business taxes, business licenses, and promotional fund charges.


Other than as set forth above, we do not furnish, or authorize our salespersons (or anyone else) to furnish, and you should not rely on, any oral or written information concerning the actual or potential sales, income or profits of a store. We have not suggested, and certainly cannot guarantee, that you will succeed in the operation of your store, because the most important factors in the success of any store, including the one to be operated by you, are your personal business, marketing, management, judgment and other skills and your willingness to work hard and follow the System. Actual results vary from store to store, area to area, and market to market. We cannot estimate or project the results for any particular store.

Written substantiation of the data presented in this financial performance representation will be made available to you upon reasonable request.

You are likely to achieve results that are different, possibly significantly and adversely, from the results shown below. Many factors, including location, management capabilities, local market conditions, and other factors, are unique to each store and may significantly impact the financial performance of your store.

Neither we nor any of our affiliates make any promises or representations of any kind that you will achieve any particular results or level of sales or profitability or even achieve break-even results in any particular year of operation.

You are responsible for developing your own business plan for your store, including capital budgets, financial statements, projections and other elements appropriate to your particular circumstances. The expenses identified in this statement are not the only expenses that you will incur in connection with the operation of your store. Additional expenses that you may incur include royalty and marketing fees (see item 6 of this disclosure document), interest on debt service, insurance, legal and accounting charges, and depreciation/amortization. We encourage you to consult with your own accounting, business, and legal advisors to assist you to identify the expenses you likely will incur in connection with your store, to prepare your budgets, and to assess the likely or potential financial performance of your store. We also encourage you to contact existing store operators to discuss the business.

In developing the business plan for your store, you are cautioned to make necessary allowance for changes in financial results to income, expenses, or both, that may result from operation of your store during periods of, or in geographic areas suffering from, economic downturns, inflation, unemployment, or other negative economic influences.

Historical costs do not necessarily correspond to future costs because of factors such as inflation, changes in minimum wage laws, location, financing, construction costs, lease-related costs, and other variables. For example, costs such as rent, CAM charges, taxes, interest, insurance and utilities vary from store to store. All information should be evaluated in light of current market conditions including such cost and price information as may then be available.

The store performance results included in this statement relate to 2007 performance results for the specific stores included in this statement and should not be considered as the
actual or probable performance results that you should expect to achieve through the operation of your store. You must bear in mind that a newly opened business should not be expected to achieve sales volumes or maintain expenses similar to those of an established business.
SAMPLE B – HOTEL FRANCHISOR

The FTC’s Franchise Rule permits a franchisor to provide information about the actual or potential financial performance of its franchised and/or franchisor-owned outlets, if there is a reasonable basis for the information, and if the information is included in the disclosure document. Financial performance information that differs from that included in Item 19 may be given only if: (1) a franchisor provides the actual records of an existing outlet you are considering buying; or (2) a franchisor supplements the information provided in this Item 19, for example, by providing information about possible performance at a particular location or under particular circumstances.

The following financial performance representation consists of two sections. Section A provides historical data for the ______________ Reservation System, as further explained below. Section B lists historical performance figures for certain franchised hotels, as further explained below. We will provide you written substantiation of the data used in preparing the financial performance representations set forth in this Item 19 upon reasonable request.

Section A

The ______________ Reservation System accepts and transmits reservations to System Hotels through various media including ______________ and other means that we may use from time to time. During 2007, the ______________ Reservation System delivered ____% of the room revenue for all franchised hotels located in the United States that had been open as a hotel for twelve full months. We have not audited or otherwise verified the information reported to us by our franchisees.

During 2007, the ______________ Reservation System delivered from ____% to ____% of total room revenue to individual Hotels. The mean contribution was ____%. There are _____ Hotels used in calculating the figures above.

During 2007, the average room rate booked through the ______________ Reservation System for Hotels ranged from $____ to $____. The mean rate was $____. Factors such as location and season may significantly influence these rates.

We calculated the percentages of our contributions to total hotel room revenue and differentials in room rates booked shown above based on reservations made through the ______________ Reservation System for rooms at the ______________ hotels in the domestic U.S., reduced by cancellations and adjustments made directly through our Reservation System. Cancellations or no-shows that are not processed through our Reservation System are included in the percentages and would have the effect of or overstating the percentage contributions to room revenue and average room rate, in relation to the actual revenue and rate obtained by participating hotels.

Section B

This Section contains information regarding average room performance figures for all franchised hotels that were open for the full year of 2007. This statement sets forth the Average Room Rate, the Average Occupancy Rate and the Average Revenue Per Available Room for the year 2007. Each of these terms is defined below. All information presented in these System averages is based principally on information received from independent franchisees and has not been audited or otherwise verified by us. Immediately following the statement is additional
information that you should carefully consider in order to understand this performance information in the appropriate context.

**Average Room Rate:** $____
A total of ____ hotels or ____% of all hotels in 2007 achieved or surpassed this Average Room Rate.

**Average Occupancy Rate:** $____
A total of ____ hotels or ____% of all hotels in 2007 achieved or surpassed this Average Occupancy Rate.

**Average Revenue Per Available Room ("REVPAR"):** $____
A total of ____ hotels or ____% of all hotels in 2007 achieved or surpassed this Average REVPAR.

These averages are based on performance information for ____ franchised hotels in operation in the US for revenues reported and estimated during the fiscal year 2007. In compiling the data, we used the following calculations:

"Average Room Rate" was calculated by dividing the total amount of room revenues reported by franchisees by the total number of guest rooms rented at the franchised hotels during the study period.

"Average Occupancy Rate" was calculated by dividing the number of guest room nights reported by franchisees by the total of rooms available for rent.

"REVPAR" was calculated by multiplying the Average Room Rate for each hotel by its Average Occupancy Rate.

Your _________ hotel likely may achieve different, possibly significantly and adversely different, results from operations than the results shown above.

Many unique factors to each hotel, including location, physical layout, hotel design and structure, management capabilities, local market conditions and other factors may significantly impact the financial performance of the hotel and the contribution from our Reservation System and marketing programs.

We cannot and do not guarantee or promise that you or any _________ franchisee will achieve results within the range of percentages set forth above, or any particular level of sales or profitability, or achieve break-even, in any particular year of operation.

You have the responsibility of developing your own business plan for your hotel, including capital budgets, financial statements, projections and other elements appropriate to your particular circumstances. We encourage you to consult with your own accounting, business and legal advisors in doing so. In developing the business plan, we caution you to make necessary allowance for changes in financial results to income, expenses, or both, that may result from operation of your hotel in an unusual location, in different geographic areas or new market areas, of an unusual size, decor or arrangement, or during periods of or in areas suffering from economic downturns, inflation, unemployment, or other negative economic influences.
SAMPLE C – CLAIM BASED ON FRANCHISEE RESULTS FOR A HOME-BASED BUSINESS

The FTC’s Franchise Rule permits a franchisor to provide information about the actual or potential financial performance of its franchised and/or franchisor-owned outlets, if there is a reasonable basis for the information, and if the information is included in the disclosure document. Financial performance information that differs from that included in Item 19 may be given only if: (1) a franchisor provides the actual records of an existing outlet you are considering buying; or (2) a franchisor supplements the information provided in this Item 19, for example, by providing information about possible performance at a particular location or under particular circumstances.

Except as set forth in this Table, we do not furnish or authorize our salespersons to furnish any oral or written information concerning the actual or potential sales, costs, income or profits of a __________ franchise. Actual results will vary from franchise to franchise and we cannot estimate the results of any particular franchise.

The Table includes, as qualified, (i) an unaudited Statement of Average Gross Sales for all franchisees in our system who submitted specific gross sales information during 2007; and (ii) an unaudited Statement of Average Sales, Expenses and Gross Profit for jobs performed by franchisees who submitted specific information on those jobs during 2007. Your financial results may differ from the information set forth in this Exhibit.

Statement of Average Gross Sales
For Franchisees During the Year 2007

The information provided in this table represents average gross sales for franchisees as further noted below. This gross sales information is not a forecast, projection or prediction of how your franchise will perform. These gross sales figures should not be relied upon as the actual or potential gross sales that you will realize. It is likely that your gross sales will differ from the information in this financial performance representation. We have not audited or reviewed the franchisees’ financial records in compiling this information, and there are no assurances that generally accepted accounting principles were used by the franchisees. We do not represent that any franchisee can expect to attain such sales.

As of December 31, 2007, we had ____ individual franchisees who had been in business for all or most of the 12-month period ending December 31, 2007. Each month franchisees provide us with information regarding the amount of business conducted during the prior month. The royalties which franchisees pay us are based upon that information.

The top 5 franchisees (____ % of all franchisees) averaged $____ in annual gross sales per franchisee. Of these 5 franchisees, ____ (%) attained or surpassed this average gross sales amount. The top franchisee’s sales volume for 2007 was $____.

The top 10 franchisees (____ % of all franchisees) averaged $____ in annual gross sales per franchisee. Of these 10 franchisees, ____ (%) attained or surpassed this average gross sales amount.

The top 20 franchisees (____ % of all franchisees) averaged $____ in annual gross sales per franchisee. Of these 20 franchisees, ____ (%) attained or surpassed this average gross sales amount.
The top 50 franchisees (___% of all franchisees) averaged $___ in annual gross sales per franchisee. Of these 50 franchisees, ___ (___%) attained or surpassed this average gross sales amount.

The 40 franchisees (___% of all franchisees) with the lowest gross sales averaged $___ in annual gross sales. Of these 40 franchisees, ___ (___%) attained or surpassed this average gross sales amount. ____ of the bottom 40 franchisees started their business in the year 2007 and did not record a full 12 months in sales.

All figures used in determining the average gross sales in this report are on file and a matter of record in our records. Written substantiation of the data presented in this representation will be made available to you upon reasonable request.
Statement of Average Sales, Certain Expenses and Gross Profit  
For The Period of Time From  
January 1, 2007, to December 31, 2007  

The figures below are taken from reports from the franchisees who submitted specific information on jobs they performed during the period from January 1, 2007, to December 31, 2007.

**Jobs not including installation: (__) jobs**

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
<th>Number of Franchisees that Attained or Exceeded Amount</th>
<th>Percentage of Franchisees that Attained or Exceeded Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average Total Sales Price</td>
<td>$_______</td>
<td>____________</td>
<td>____%</td>
</tr>
<tr>
<td>Average Material Expenses (including,</td>
<td>$_______</td>
<td>____________</td>
<td>____%</td>
</tr>
<tr>
<td>_________________________________________</td>
<td></td>
<td></td>
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<tr>
<td>_________________________________________</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>shipping &amp; Misc. Materials)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average Gross Profit</td>
<td>$_______</td>
<td>____________</td>
<td>____%</td>
</tr>
</tbody>
</table>

**Jobs including installation: (__) jobs**

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
<th>Number of Franchisees that Attained or Exceeded Amount</th>
<th>Percentage of Franchisees that Attained or Exceeded Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average Total Sales Price</td>
<td>$_______</td>
<td>____________</td>
<td>____%</td>
</tr>
<tr>
<td>Average Material Expenses (including,</td>
<td>$_______</td>
<td>____________</td>
<td>____%</td>
</tr>
<tr>
<td>_________________________________________</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>_________________________________________</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>shipping &amp; Misc. Materials)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average Gross Profit</td>
<td>$_______</td>
<td>____________</td>
<td>____%</td>
</tr>
</tbody>
</table>

These sales, expenses, and gross profits are averages for franchisees and should not be considered as the actual or probable sales, income, gross or net profits or earnings that will be realized by any franchisee. We have not audited or reviewed the franchisees' financial records in compiling this information, and there are no assurances that generally accepted accounting principles were used by the franchisees. We do not represent that any franchisee can expect to attain such sales, income, gross or net profits, or earnings.
All figures used in determining the average gross profit in this report are on file and a matter of record in our records. Written substantiation of the data presented in this financial performance representation will be made available to you upon reasonable request.

The average gross profit as listed here does not include overhead expenses such as advertising, telephone, insurance, office rental, secretarial help (if needed), etc., or the payment of continuing license fees. These expenses will vary a great deal depending on each franchisee's location and particular situation. Therefore, each prospective franchisee will have to estimate these figures for themselves. Each prospective franchisee can make their own projections as to the number of jobs they plan to make per week or month.
SAMPLE D – CLAIM BASED ON FRANCHISED UNITS – LARGE AND SMALL UNITS

The FTC’s Franchise Rule permits a franchisor to provide information about the actual or potential financial performance of its franchised and/or franchisor-owned outlets, if there is a reasonable basis for the information, and if the information is included in the disclosure document. Financial performance information that differs from that included in Item 19 may be given only if: (1) a franchisor provides the actual records of an existing outlet you are considering buying; or (2) a franchisor supplements the information provided in this Item 19, for example, by providing information about possible performance at a particular location or under particular circumstances.

The following statement of Unaudited Average Annual Sales and Profit displays the average of _____ Units which had been in operation at least 2 years as of December 31, 2007. The figures shown are the actual unaudited results that these stores achieved in the 12 month period ended December 31, 2007.

The gross sales and profits stated below are averages we compiled from information and reports submitted by franchisees. You should not consider this information as the actual or potential gross sales or profits that you or any other franchisee will realize. We do not represent that any franchisee can expect to attain these gross sales or profits. Your individual financial results are likely to differ from the information included in this statement.

We will, upon reasonable request, provide to prospective franchisees the written substantiation of the data presented in the financial performance representation illustrated below. We do not otherwise furnish to prospective franchisees any oral or written information concerning the actual or potential sales, costs, income or profits of a Unit. Actual results vary from unit to unit and we cannot estimate the results of any particular franchise.

UNAUDITED STATEMENT OF AVERAGE ANNUAL SALES AND PROFIT

The statements of average annual sales and profit includes average sales, cost of sales, operating expenses, and income before income taxes during fiscal year 2007. The statements are from franchised Units that commenced operations during the years 2001 through 2005. These statements include information from only those Units that have been in operation at least two years as of December 31, 2007. No other Units are included in these statements due to insufficient history of operations (less than two years of operation as of December 31, 2007). There were _____ franchised Units which had been in operation at least two years as of December 31, 2005. The size of the Unit premises ranged from _____ to _____ square feet. The first column represents the results of the _____ “large” Units (Units with more than _____ square feet and annual revenues above $______). The second column represents the results of the _____ “small” Units (Units with less than _____ square feet and annual revenues below $______).

These results relate to specific Units and should not be considered as the actual or probable results that any franchisee will realize. Your individual financial results will likely differ from these results.
# Average Annual Sales and Profit

<table>
<thead>
<tr>
<th></th>
<th><strong>Large Units</strong></th>
<th></th>
<th><strong>Small Units</strong></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td><strong>Year Ended</strong></td>
<td><strong>% of Sales</strong></td>
<td><strong>Year Ended</strong></td>
<td><strong>% of Sales</strong></td>
</tr>
<tr>
<td><strong>Total Sales</strong></td>
<td>$___ ___%</td>
<td>___ ___%</td>
<td>___ ___%</td>
<td>___ ___%</td>
</tr>
<tr>
<td><strong>Cost of Sales</strong></td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
</tr>
<tr>
<td><strong>Gross Profit</strong></td>
<td>___ ___%</td>
<td>___ ___%</td>
<td>___ ___%</td>
<td>___ ___%</td>
</tr>
<tr>
<td><strong>Operating Expenses:</strong></td>
<td>___ ___%</td>
<td>___ ___%</td>
<td>___ ___%</td>
<td>___ ___%</td>
</tr>
<tr>
<td>Salaries – Management &amp; Administration</td>
<td>___ ___%</td>
<td>___ ___%</td>
<td>___ ___%</td>
<td>___ ___%</td>
</tr>
<tr>
<td>Payroll Taxes &amp; Employee Benefits</td>
<td>___ ___%</td>
<td>___ ___%</td>
<td>___ ___%</td>
<td>___ ___%</td>
</tr>
<tr>
<td>Advertising</td>
<td>___ ___%</td>
<td>___ ___%</td>
<td>___ ___%</td>
<td>___ ___%</td>
</tr>
<tr>
<td>Insurance</td>
<td>___ ___%</td>
<td>___ ___%</td>
<td>___ ___%</td>
<td>___ ___%</td>
</tr>
<tr>
<td>Office Expenses</td>
<td>___ ___%</td>
<td>___ ___%</td>
<td>___ ___%</td>
<td>___ ___%</td>
</tr>
<tr>
<td>Other Expenses</td>
<td>___ ___%</td>
<td>___ ___%</td>
<td>___ ___%</td>
<td>___ ___%</td>
</tr>
<tr>
<td>Outside Services</td>
<td>___ ___%</td>
<td>___ ___%</td>
<td>___ ___%</td>
<td>___ ___%</td>
</tr>
<tr>
<td>Repairs/Maintenance – Building &amp; Equip. Utilities</td>
<td>___ ___%</td>
<td>___ ___%</td>
<td>___ ___%</td>
<td>___ ___%</td>
</tr>
<tr>
<td>Property/Sales Taxes</td>
<td>___ ___%</td>
<td>___ ___%</td>
<td>___ ___%</td>
<td>___ ___%</td>
</tr>
<tr>
<td>Rent</td>
<td>___ ___%</td>
<td>___ ___%</td>
<td>___ ___%</td>
<td>___ ___%</td>
</tr>
<tr>
<td><strong>Total Operating Costs</strong></td>
<td>___ ___%</td>
<td>___ ___%</td>
<td>___ ___%</td>
<td>___ ___%</td>
</tr>
<tr>
<td></td>
<td>$ ___ ___%</td>
<td>___ ___%</td>
<td>___ ___%</td>
<td>___ ___%</td>
</tr>
<tr>
<td><strong>Franchise Royalties</strong></td>
<td>___ ___%</td>
<td>___ ___%</td>
<td>___ ___%</td>
<td>___ ___%</td>
</tr>
<tr>
<td><strong>Depreciation &amp; Amortization</strong></td>
<td>___ ___%</td>
<td>___ ___%</td>
<td>___ ___%</td>
<td>___ ___%</td>
</tr>
</tbody>
</table>
DEBT SERVICE

TOTAL SUPPLEMENTAL EXPENSES

INCOME BEFORE INCOME TAXES

NO. OF UNITS THAT ATTAINED OR EXCEEDED THE AVERAGES:

TOTAL SALES

GROSS PROFIT

INCOME BEFORE INCOME TAXES

[NOTE: Definitions Section Omitted]

We have not suggested, and certainly can not guarantee, that you will succeed in the operation of your Unit since, in our experience, the most important factors in the success of any Unit, including the one to be operated by you, are your personal business, marketing, management, judgment and other skills and your willingness to work hard and follow the Business System. Actual results vary from area to area and market to market, and we cannot estimate or project the results for any particular Unit. Substantiation of this data will be made available to you upon reasonable request.

You are likely to achieve results that are different, possibly significantly and adversely, from the results shown below.

Many factors, including location, management capabilities, local market conditions, and other factors, are unique to each unit and may significantly impact the financial performance of the unit.

Neither we nor any of our affiliates make any promises or representations of any kind that you will achieve any particular results or level of sales or profitability or even achieve break-even results in any particular year of operation.

You are responsible for developing your own business plan for your unit, including capital budgets, financial statements, projections and other elements appropriate to your particular circumstances. We encourage you to consult with your own accounting, business, and legal advisors in doing so. In developing the business plan, you are cautioned to make necessary allowance for changes in financial results to income, expenses, or both, that may result from operation of your unit in different geographic areas or new market areas, or during periods of or in areas suffering from economic downturns, inflation, unemployment, or other negative economic influences.
SAMPLE E – CLAIM BASED ON GROSS REVENUE ONLY FOR FRANCHISED LOCATIONS

The FTC's Franchise Rule permits a franchisor to provide information about the actual or potential financial performance of its franchised and/or franchisor-owned outlets, if there is a reasonable basis for the information, and if the information is included in the disclosure document. Financial performance information that differs from that included in Item 19 may be given only if: (1) a franchisor provides the actual records of an existing outlet you are considering buying; or (2) a franchisor supplements the information provided in this Item 19, for example, by providing information about possible performance at a particular location or under particular circumstances.

The following Table presents unaudited information about the actual revenues of franchised Stores for the period from January 1, 2007 to December 31, 2007 (the "2007 Fiscal Year"). Written substantiation of the data presented in this financial performance representation will be made available to you upon reasonable request.

The franchised Store information included in the Table below is based on reports from _____ franchised Stores located in the United States that were owned and operated by franchisees for the entire 2007 Fiscal Year (the "Franchised Stores"), and exclude the locations described below. We prepared this Table based on sales reports submitted by the _____ franchisees. The Franchised Store information contained herein does not include data for (i) Franchised or corporate Stores opened or closed in the United States during the 2007 Fiscal Year; (ii) corporate Stores located in the United States; or (iii) Franchised and corporate Stores operated in conjunction with one or more additional concepts. The Franchised Stores are primarily located within regional malls, but may also be located in strip shopping centers.

**TABLE**

**GROSS REVENUES\(^1\) OF FRANCHISED STORES**  
**BY QUARTILE\(^2\) FOR 2007 FISCAL YEAR**

<table>
<thead>
<tr>
<th>QUARTILE</th>
<th>NUMBER OF STORES IN QUARTILE</th>
<th>GROSS REVENUE RANGE(^3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1(^{st})</td>
<td></td>
<td>$_________ to $_________</td>
</tr>
<tr>
<td>2(^{nd})</td>
<td></td>
<td>$_________ to $_________</td>
</tr>
<tr>
<td>3(^{rd})</td>
<td></td>
<td>$_________ to $_________</td>
</tr>
<tr>
<td>4(^{th})</td>
<td></td>
<td>$_________ to $_________</td>
</tr>
</tbody>
</table>

**TABLE NOTES:**

(1) As used herein, "Gross Revenues" means the aggregate amount of all revenue and receipts derived from operations of a Franchised Store, including, all amounts received from sales made at or away from the premises of such Franchised Store, whether from cash, check, or credit, but excluding all federal, state or municipal sales, use or service taxes collected from customers and paid to the appropriate taxing authority.

(2) Quartile. As used herein, "Quartile" refers to the relative performance of the Franchised Stores. Therefore, the "1\(^{st}\) Quartile" refers to the top 25% performing stores, based on Gross Revenues, the "2\(^{nd}\) Quartile" refers to the next highest 25% performing stores, and so on.
(3) **Gross Revenues Range.** This Table combines the Gross Revenues of all of the Franchised Stores for the 2007 Fiscal Year, and lists the actual high and low end of the Gross Revenues Range for each Quartile. The information relating to the Franchised Stores is based on unaudited reports prepared by franchisees.

(4) **Highly-Performing Stores.** Only ____ of the Franchised Stores reported total Gross Revenues in excess of $____. Excluding these highly-performing stores, which are all located in A-class malls in busy metropolitan areas, the next highest performing Franchised Store reported Gross Revenues of approximately $____. By contrast, the Franchised Store reporting the lowest Gross Revenues in Quartile 1 is located in a mall in a blue-collar suburban area. A comparison of these stores illustrates the effect that location can have on Gross Revenues and store performance.
SAMPLE F – CLAIM BASED ON RANGE OF SALES AND AVERAGE SALES PER SQUARE FOOT FOR CORPORATE UNITS

The FTC’s Franchise Rule permits a franchisor to provide information about the actual or potential financial performance of its franchised and/or franchisor-owned outlets, if there is a reasonable basis for the information, and if the information is included in the disclosure document. Financial performance information that differs from that included in Item 19 may be given only if: (1) a franchisor provides the actual records of an existing outlet you are considering buying; or (2) a franchisor supplements the information provided in this Item 19, for example, by providing information about possible performance at a particular location or under particular circumstances.

The Table below displays ranges of actual gross sales and sales per square foot of ____ Units, which have been in operation at least ____ months as of _________________. We own and operate these Units. The Units are substantially similar in design and operation to the Unit described in the disclosure document.

The ranges of actual gross sales and sales per square foot stated below are based on specific company-owned units. You should not consider this information as the actual or potential gross sales or sales per square foot that you or any franchisee will realize. We do not represent that any franchisee can expect to attain these gross sales or sales per square foot. Your individual financial results are likely to differ from the information stated in the table.

We will, on reasonable request, provide to prospective franchisees the written substantiation of the data presented in the financial performance representation illustrated below. We do not otherwise furnish to prospective franchisees any oral or written information concerning the actual or potential sales, costs, income or profits of a Unit. Actual results vary from unit to unit and we cannot estimate the results of any particular franchise.

EXHIBIT A

STATEMENT OF ACTUAL GROSS SALES AND SALES PER SQUARE FOOT

The following statement contains information on ranges of actual gross sales and sales per square foot for the ____ company-owned Units that were open more than ____ months, as of _________________. The Units are located in ________________________.

The ____ locations include ____ standard units and ____ super units (as described in Item 1). Although all units offer substantially the same types of products to the public, the super units will have more extensive product lines. The gross sales are the actual annual sales for the company-owned Units for the year ended _________________, and this information is included in the financial statements of _________________, which are prepared in accordance with generally accepted accounting principles. The sales per square foot amounts were calculated by taking the annual sales for each unit divided by the “sales area” square footage (which does not include storage area) of the unit to determine the sales per square foot for each unit. Sales per square foot is used by retailers as a measure of sales production for a retail location.

You should note that the units used in this Table have been open more than ____ months, and that newly opened units cannot be expected to immediately achieve sales volumes similar
to those of an established unit. You also may experience different results, depending on your franchise location and other similar factors.

The range of gross sales and sales per square foot are of “company-owned” units and should not be considered as the actual or probable sales and sales per square foot that you will realize. We do not represent that you can expect to attain these gross sales and sales per square foot. You must accept the risk of not doing as well as the units illustrated in this statement.

Substantiation of all data illustrated in this statement will be made available to you on reasonable demand.

<table>
<thead>
<tr>
<th>Range of Sales</th>
<th># of Stores</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>$____ - $____</td>
<td></td>
<td>___%</td>
</tr>
<tr>
<td>$____ - $____</td>
<td></td>
<td>___%</td>
</tr>
<tr>
<td>$____ - $____</td>
<td></td>
<td>___%</td>
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<tr>
<td>$____ - $____</td>
<td></td>
<td>___%</td>
</tr>
<tr>
<td>$____ - $____</td>
<td></td>
<td>___%</td>
</tr>
<tr>
<td>TOTAL</td>
<td></td>
<td>___%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Range of Average Sales per Square Foot</th>
<th># of Stores</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>$___ - $___</td>
<td></td>
<td>___%</td>
</tr>
<tr>
<td>$___ - $___</td>
<td></td>
<td>___%</td>
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<td>$___ - $___</td>
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<td>___%</td>
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<tr>
<td>$___ - $___</td>
<td></td>
<td>___%</td>
</tr>
<tr>
<td>TOTAL</td>
<td></td>
<td>___%</td>
</tr>
</tbody>
</table>
Brian B. Schnell

Brian is a partner in Faegre & Benson LLP’s Minneapolis office and is a leader of the Faegre Franchise Team. Brian counsels both emerging and mature franchisors in a variety of industries with regard to all aspects of their franchise programs. He is the lead corporate franchise lawyer for more than 80 franchisors, ranging from companies with thousands of locations worldwide to companies who are in the initial stages of building their franchise systems. Brian is a past chair of the International Franchise Association’s (IFA) Supplier Forum, a past ex officio member of IFA’s Board of Directors and Executive Committee, and a member of its Legal Symposium Task Force and its Legal/Legislative, Awards and Membership Committees. He also sits on the Board of Trustees for IFA’s Educational Foundation and the Franchise Advisory Board for WomenVenture. He is a frequent speaker and author on franchising, and for many years has been consistently recognized as one of franchising’s leading lawyers.
Andrew C. Selden

Mr. Selden is a shareholder of Briggs and Morgan, P.A., Minneapolis, Minnesota, where he heads the Franchise Practice Group. He was Chairman of the Forum on Franchising from 1985 to 1989; Editor of the Franchise Law Journal 1983-84; and a member of the Forum’s Governing Committee from 1983 to 1989. Mr. Selden was the Reporter of the Uniform Franchise and Business Opportunities Act promulgated by the National Conference of Commissioners on Uniform State Laws, and is a member, and former Chairman (1983-87), of the Industry Advisory Committee to the Franchise Regulation Committee of the North American Securities Administrators Association. Mr. Selden was an accredited delegate of the International Bar Association to the UNIDROIT conference on a model international franchise law. He has published articles on franchising and other topics in the FRANCHISE LAW JOURNAL, THE WALL STREET JOURNAL, THE BUSINESS LAWYER, the IFA FRANCHISE LEGAL DIGEST, and other publications, and has spoken at numerous programs on franchising and antitrust issues sponsored by the Forum on Franchising, International Franchise Association, Practicing Law Institute, Minnesota (and other states') continuing legal education, and the ABA Sections on Antitrust Law, and Patent, Trademark and Copyright Law. Mr. Selden was Chairman (1994-96) and is a member of the Board of Directors of the Better Business Bureau of Minnesota, Inc. He is listed in The Best Lawyers in America, and has been selected as a "Leading Minnesota Attorney." Mr. Selden's law practice involves representation of regional, national and international franchisors, national and global franchisee associations, and franchise system purchasing cooperatives.
Anne Connelly Spooner

Anne Connelly has been with the Illinois Attorney General's Office for 25 years, the past 24 of which as a franchise examiner with the Franchise Bureau. In addition to the review of franchise application documents, Ms. Connelly reviews complaints, conducts investigations and assists with enforcement actions. For the past several years, she has also assisted in the training of new employees to the Bureau. Prior to joining the Franchise Bureau, Ms. Connelly served as a consumer advocate in the Consumer Protection Bureau of the Attorney General’s Office and prior to joining the AG’s Office she was a high school teacher in a Northwest suburb of Chicago. Ms. Connelly received both her Bachelor and Master of Arts degrees in Political Science and Public Administration from Eastern Illinois University.