Advanced Drafting of Financial Performance Representations

A Reasonable Basis

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ADVANCED DRAFTING OF
FINANCIAL PERFORMANCE REPRESENTATIONS:
A REASONABLE BASIS

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of the ABA Forum on Franchising’s *The Franchise Lawyer* from 2010 to 2013, and as an associate editor of the same publication from 2008 to 2010. He recently co-authored a chapter on structuring franchise relationships in the latest edition of the ABA Forum on Franchising’s *Fundamentals of Franchising*. Max frequently writes and speaks on franchise-related topics, both locally and nationally.

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ADVANCED DRAFTING OF
FINANCIAL PERFORMANCE REPRESENTATIONS:
A REASONABLE BASIS

I. INTRODUCTION

Although the Federal Trade Commission ("FTC") elected not to impose mandatory financial performance representations ("FPRs") (formerly known as "earnings claims") in its amended Franchise Rule\(^3\) (the "FTC Franchise Rule" or the "Rule"), which became effective in July 2007, the number of franchisors that include FPRs in Item 19 of their franchise disclosure documents ("FDDs") has risen. Recent statistics show that at least one-half of all franchisors now include FPRs in Item 19 of their FDDs.\(^4\) This number has increased significantly over the past five years and continues to grow. We believe that competitive forces and a concern about the disclosure of unauthorized FPRs has led to this rise.

Accordingly, franchise attorneys find themselves preparing and reviewing more and more FPRs. While Item 19 does not dictate a form FPR and allows the franchisor and its counsel a large amount of flexibility in crafting an FPR that fits the franchisor's business and story, a franchisor must have a "reasonable basis" and "written substantiation" for an FPR at the time it is made.\(^5\)\(^6\) The determination of whether a franchisor has a reasonable basis to make a particular FPR, therefore, is at the heart of the analysis involved in preparing an FPR.

Recognizing the need for additional guidance on this important issue, as further described in Section III.A below, the North American Securities Administrators Association, Inc. ("NASAA")\(^7\) has been hard at work over the past few years preparing an FPR Commentary, the

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1 The authors wish to thank Kathryn Hauff and Karli Hussey of Gray Plant Mooty, and Sara E. Kitaeff of Witmer, Karp, Warner & Ryan LLP for their valuable contributions to this paper.

2 The opinions expressed in this paper are those of the authors and do not represent the opinions or position of the Maryland Securities Division or the North American Securities Administrators Association, Inc.


4 Darrell Johnson, CEO of FRANdata, indicated that, based on the data they have collected, of the franchisors with recently filed FDDs that had at least one outlet, almost exactly one-half have FPRs. This is consistent with the following information we received from the State of Maryland: as of August 2016, 60.65% of franchisors registered in Maryland included some type of FPR.

5 16 C.F.R. § 436.5(s).

6 For example, an FPR can be as simple as listing gross sales of a franchisor’s one franchise outlet, to as complex as including a full profit and loss statement (P&L) for each of a franchisor’s franchise outlets that are all part of a large franchise system. With the permission of Goddard Systems, Inc., we have attached as Appendix D a copy of Item 19 from its 2016 FDD. This document is an example of a comprehensive FPR that includes EBITDA for almost all of its over 400 franchised Schools. A redlined copy of the full 2016 Goddard Systems, Inc. FDD is available by searching for "Goddard Systems, Inc." under "Franchise Registrations" on the Minnesota Department of Commerce website at: https://www.cards.commerce.state.mn.us/CARDS/security/search.do?method=showSearchParameters&searchType=new.

7 Organized in 1919, NASAA is the oldest international organization devoted to investor protection. NASAA is a voluntary association whose membership consists of 67 state, provincial, and territorial securities administrators in
most-current, proposed version of which was released on September 14, 2016 (“Current Proposed FPR Commentary”). Once finalized and adopted, the FPR Commentary will not only provide instruction to franchise practitioners who prepare and review FPRs, but also will help ensure that the FPRs prospective franchisees receive are more uniform and expansive, and less likely to mislead. NASAA’s FPR Commentary is poised to become the most impactful interpretation of pre-sale disclosure laws since the adoption of the FTC Franchise Rule.

This paper is intended to help franchisor attorneys draft and structure FPRs that comply with federal and state law, including the Current Proposed FPR Commentary, and to assist franchisee lawyers in evaluating FPRs and assessing whether they satisfy all legal requirements. Section II sets forth the federal and state laws that govern FPRs. Section III describes the purpose and procedural history of NASAA’s FPR Commentary, and then analyzes how the questions and answers included in the most current version of the FPR Commentary, if adopted, will impact the content and format of FPRs of all types, and dictate which FPRs will no longer be acceptable. Section IV summarizes the case law regarding FPRs, focusing on cases that involved issues relating to the content of FPRs, and not whether unlawful FPRs were made outside of the FDD. Section V describes what FPR questions and issues should be pursued and addressed by and on behalf of prospective franchisees. Finally, Section VI provides practical tips and best practices.

II. FEDERAL AND STATE LAWS GOVERNING FPRS

A number of different sources govern and guide the drafting of FPRs. The FTC Franchise Rule establishes the general disclosures franchisors are required to make in their FDDs in offering and selling franchises in the United States. The FTC Compliance Guide (the “Compliance Guide”), the FTC Frequently Asked Questions (FAQs), and the Statement of Basis and Purpose (“Statement”) all shed light on the FTC Franchise Rule, and provide drafters of FPRs with necessary instruction. Additionally, NASAA’s 2008 Franchise Registration

the 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, Canada, and Mexico. NASAA’s Franchise and Business Opportunity Project Group proposes model laws, commentaries, and other initiatives regarding franchise disclosure in an effort to further its investor protection role and to promote uniformity among state franchise regulators and the FTC.


9 A number of quality papers and books have been written on the drafting, using and litigating of FPRs. The following is a list of some of them: Brian B. Schnell, Andrew C. Selden, and Anne Connelly, Financial Performance Representations—Shield or Sword?, 31st Annual ABA Forum on Franchising (2008); Financial Performance Representations: The New and Updated Earnings Claims (Stuart Hershman & Joyce G. Mazero eds., ABA Book Publishing 2008); Gary R. Batenhorst and Charles S. Modell, Tips, Techniques and Traps for Drafting and Using Financial Performance Representations, 34th Annual ABA Forum on Franchising (2012); Leslie D. Curran and Benjamin L. Mitchell, The Art and Science of FDD Drafting, 37th Annual ABA Forum on Franchising (2014).


and Disclosure Guidelines (“2008 Guidelines”)\textsuperscript{13} and related Commentary (“2008 Commentary”),\textsuperscript{14} as well as various state laws, include important direction and requirements.

A. FTC Franchise Rule

1. Item 19 – A Reasonable Basis

The FTC Franchise Rule allows franchisors to elect whether to make an FPR in Item 19 of their FDD, and defines an FPR as:

Any 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.\textsuperscript{15}

Essentially, an FPR is any statement to a prospective franchisee regarding the return on investment they may achieve or that others have achieved. Regardless of whether a franchisor decides to make an FPR in Item 19, the FTC Franchise Rule requires the franchisor to begin its Item 19 disclosure with the following preamble:

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.\textsuperscript{16}

If a franchisor elects not to make an FPR in Item 19, then it may not, except in limited circumstances, provide a prospective franchisee with any financial performance information before a prospective franchisee signs a franchise agreement. A franchisor must also include the following prescribed statement if it does not make an FPR:

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


\textsuperscript{15} 16 C.F.R. § 436.1(e).

\textsuperscript{16} 16 C.F.R. § 436.5(s)(1).
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.\footnote{17 16 C.F.R. § 436.5(s)(2).}

If a franchisor chooses to include an FPR in Item 19 of its FDD, the FTC Franchise Rule states that the franchisor must have a “reasonable basis” for the representation at the time the representation is made. Item 19 of the FTC Franchise Rule, however, does not provide instructive guidance regarding what constitutes a “reasonable basis,” and yet, it is the franchisor that ultimately bears the burden of proving the sufficiency of its Item 19 disclosure if it is ever challenged.\footnote{18 16 C.F.R. § 436.5(s)(3).}

Item 19 also requires a franchisor to include a statement that “written substantiation” of its FPR is available. Essentially, this statement prohibits a franchisor from refusing to provide prospective franchisees with the data from which its FPR was constructed, although the Rule does not prescribe the format or particular information that must be used. Next, the Rule requires that a franchisor state whether the representation is either a historic performance FPR based on the franchise system’s outlets in existence or, alternatively, a forecast of a prospective franchisee’s future financial performance. The Rule also requires the franchisor to disclose the “material bases” for the representation, and lists specific information that must be included. Ultimately, these bases and assumptions demonstrate whether the franchisor had a “reasonable basis” for making the FPR. Finally, the FTC Franchise Rule requires that an FPR 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,” but does not provide prescribed language that must be used. As further described in Section III.C.8 below, however, the Current Proposed FPR Commentary provides clarification as to the language and format of the required admonition.

Although the FTC Franchise Rule is clear that any FPR must be included in a franchisor’s Item 19, there are two primary exceptions to this general rule, which can be found at the end of the Item. First, a franchisor is permitted to provide a prospective franchisee the actual operating results of a particular outlet the prospective franchisee is interested in purchasing, even though this information is not included in the franchisor’s FDD.\footnote{19 16 C.F.R. § 436.5(s)(4).} A franchisor should be sure, however, that the prospect is legitimately interested in purchasing the outlet that is for sale and the exception is not being abused.

Second, if a franchisor includes an FPR in Item 19 of its FDD, it may also provide to a prospective franchisee a supplemental FPR, outside of the FDD, about “a particular location or variation” relating to the franchise being offered to the prospective franchisee.\footnote{20 16 C.F.R. § 436.5(s)(5).} For example, if a franchisor’s FPR in Item 19 includes average gross revenues and gross profits of all franchise outlets across the country, the franchisor may want to provide a supplemental FPR containing

\footnote{See also, FTC, \textit{Franchise Rule Compliance Guide}, supra note 10 at 92-93, 137-138.}
average gross revenues and gross profits of only those franchised units in Miami, if the prospective franchisee desires to purchase a franchise to be located in Miami, or only those franchised units in strip malls, if the prospective franchisee desires to purchase a franchise to be located in a strip mall. A supplemental FPR must be in writing, explain how it is a departure from the FPR in the FDD and be prepared in accordance with the other requirements of Item 19. We advise against a franchisor introducing new categories of information in its supplemental FPR.

2. FTC Compliance Guide

The FTC Compliance Guide provides significant additional guidance regarding Item 19 disclosures. The Compliance Guide summarizes and provides additional details for each part of the Item 19 disclosures included in the FTC Franchise Rule. Regarding FPRs based on historic performance, the Compliance Guide lists the six bases identified in the Rule—1) the group of outlets measured, 2) the time period measured, 3) the number of outlets measured, 4) the number of outlets reporting, 5) the number and percentage of outlets that achieved the stated level of performance, and 6) any distinguishing characteristics of the outlets measured—and provides additional explanation, including illustrations and examples, of each. The Compliance Guide also addresses FPRs based on projections, and includes a list of factors which should be considered in order to make reasonable forecasts. Sample FPRs based on historic performance and projections are also included in the Compliance Guide. Finally, the Compliance Guide includes specific sections regarding whether cost and expense information alone constitutes an FPR, FPRs in the general media, and the required treatment of company-owned outlets in an FPR.

3. FTC FAQs

The FTC FAQs currently consist of 38 questions and answers, four of which—FAQs 8, 27, 33, and 38—relate to FPRs.

FTC FAQ 8 addresses the issue of whether a franchisor is permitted to base an FPR on affiliate information. It is common practice for an affiliate or affiliates of a franchisor to operate system outlets, rather than the franchisor itself. Consistent with the UFOC Guidelines, FTC FAQ 8 explains that “in limited circumstances, a franchisor may base a financial performance claim upon the results of operations of the substantially similar business of an

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22 Id. at 135-136.

23 Id. at 93-95.

24 Id. at 131.

25 Id. at 131-134.

26 Id. at 137.

27 FTC, Frequently Asked Questions, supra note 11. at No. 8.

28 An “affiliate” is defined under the FTC Franchise Rule as “an entity controlled by, controlling or under common control with, another entity.” 16 C.F.R. § 436.1(b).
affiliate,” but only if it lacks adequate performance data of its own and it discloses any characteristics of the subset of affiliate outlets that may differ materially from the characteristics of the franchised outlets being offered. It’s worth noting that if taken literally, FTC FAQ 8, which is meant to apply only in “certain narrow circumstances,” would prevent many franchisors from making the types of FPRs they currently make, because so many base their FPRs on company-owned outlets which are, in almost all cases, owned by affiliates.

FAQ 27 clarifies that if a franchisor elects to make an FPR in Item 19, it may also elect to include a statement that the franchisor does not make any other FPRs, however, it must do so using the following prescribed statement:

Other than the preceding financial performance representation, [name of franchisor] does not make any financial performance representations. 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.29

FTC FAQ 33 is similarly straightforward and states that the FTC Franchise Rule does not allow a franchisor to include an FPR in an attachment to its FDD, instead of placing it directly in Item 19, because it could confuse and mislead a potential franchisee.30

Finally, FTC FAQ 38, the newest FAQ issued on July 2, 2014, advises that when a franchisor revises its Item 19 at the request or direction of one registration state, it should ordinarily incorporate the same revisions in the FDD it uses in all other registration and non-registration states.31 While there may be a difference of opinion as to whether an FPR has a reasonable factual basis and can be substantiated, FTC FAQ 38 includes the following sobering reminder:

As always, the franchisor will bear the burden of proving that its written substantiation shows that factual information in its possession at the time it made the representation supports the FPR as it is likely to be understood by a reasonable prospective franchisee. Any failure to use the same FPR in all states will not change the franchisor’s burden, but may expose the franchisor to the risk of heightened scrutiny by federal or state franchise law enforcers.32

Given that there is likely to be some uncertainty as franchise practitioners and state franchise examiners come to terms with the final version the FPR Commentary, once NASAA adopts it, franchisors and their attorneys will be wise to keep in mind the implications of FTC FAQ 38 in dealing with any FPR-related comments they receive from state examiners.

29 Id.

30 Id. at No. 33.

31 Id. at No. 38.

32 Id.
4. **Statement of Basis and Purpose**

Although primarily intended to explain the justification of the FTC Franchise Rule, the Statement also provides advice on how the Rule will be applied in practice. The Statement addresses two main topics concerning Item 19—the Rule's treatment of cost and expense information, and its treatment of general media claims. Regarding the former, the FTC advises that the mere disclosure of costs and expense information does not rise to the level of an FPR because that information alone is not sufficient to enable a prospective franchisee to determine their return on investment. As further described below, this issue is also addressed in NASAA’s 2008 Commentary, as well as in the Current Proposed FPR Commentary.

The Statement goes on to address whether financial performance information found in general media, including a franchisor’s publication of financial information in press releases, speeches, articles, and publicly filed documents with the Securities and Exchange Commission, may be considered FPRs and thus trigger the disclosure and substantiation requirements. The FTC explains that it would be “unwarranted to sweep broadly” all of these forms of media into the definition of FPRs, and instead advises that franchisors delineate between information intended to educate the general public from information directed at potential franchisees, including financial information found in brochures, the franchise sales section of a website, and even promotional materials that merely reference general financial information.

**B. NASAA’s 2008 Franchise Registration and Disclosure Guidelines and Commentary – NASAA’s Initial FPR Comments**

In reaction to the FTC’s release of the FTC Franchise Rule, NASAA adopted its 2008 Guidelines as a model for states with specific franchise registration and disclosure laws, and published the accompanying 2008 Commentary. NASAA also consulted with the FTC Franchise Rule staff before finalizing the 2008 Commentary. The 2008 Commentary is intended to provide additional guidance regarding the 2008 Guidelines, and includes three questions and answers (Items 19.1 to 19.3) that relate to Item 19. These Items are further described in Section III.C.1 below, as NASAA has included them in the Current Proposed FPR Commentary.

**C. State Laws**

For the most part, the franchise registration states do not impose disclosure requirements that go beyond those described in the FTC Franchise Rule and NASAA’s 2008

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33 16 C.F.R. § 436(III)(A)(5)

34 16 C.F.R. § 436(III)(A)(5)(a)

35 16 C.F.R. § 436(III)(A)(5)(b)

36 **Id.**

37 NASAA, 2008 Franchise Registration and Disclosure Guidelines, supra note 13.

38 NASAA, Commentary on 2008 Franchise Registration and Disclosure Guidelines, supra note 14.

39 **Id.** at 19.1-19.3.
Guidelines and 2008 Commentary, which they have generally adopted and follow. There is, however, one notable exception relating to FPRs. While the FTC does not consider cost and expense information alone to be an FPR, the States of Illinois, Maryland and New York still arguably prohibit the disclosure of cost information outside of Item 19.\(^{40}\) In addition, Minnesota requires that "any estimated or projected franchisee earnings, proforma statements, or break even statements prepared for presentation to prospective franchisees" be included in the franchisor's FDD.\(^{41}\)

III. NASAA'S FPR COMMENTARY

A. Purpose

Even with the direction and clarification offered in the FTC Compliance Guide and FAQs and its own 2008 Commentary, NASAA recognized that there was "very little guidance" as to what constitutes a "reasonable basis" for making and substantiating an FPR in Item 19 of a franchisor's FDD under federal and state franchise laws.\(^{42}\) To fill this void, NASAA took on the task of creating an FPR Commentary consisting of answers to questions raised by state franchise examiners and franchisor representatives.\(^{43}\) Once adopted, the FPR Commentary will provide much needed additional guidance to franchise practitioners and examiners alike as to how to prepare and evaluate FPRs. The FPR Commentary also will ensure that FPRs provided to prospective franchisees present information in a manner that will better assist them in evaluating the potential investment. This additional guidance is critical because, as NASAA points out, "[w]hat constitutes a reasonable basis, and what information is needed to substantiate an FPR, is fact-specific and varies from case to case, depending on the representation made. In every case, however, written factual information in the seller's possession must reasonably support the representation, as the FPR is likely to be understood by a reasonable prospective franchisee."\(^{44}\)

B. Procedural History

1. Initial Proposed FPR Commentary (October 2015)

On October 1, 2015, the Franchise and Business Opportunity Project Group ("Franchise Project Group") released for internal and public comment a Proposed Franchise Commentary on Financial Performance Representations ("Initial Proposed FPR Commentary").\(^{45}\) The Initial Proposed FPR Commentary was the result of several years of meetings and negotiations among members of the Franchise Project Group, with help from its Franchise Industry Advisory

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\(^{41}\) See Minn. R. §2860.3500(14).


\(^{43}\) NASAA, Current Proposed FPR Commentary, supra note 8 at Introduction.

\(^{44}\) Id.

\(^{45}\) NASAA, Initial Proposed FPR Commentary at Background, supra note 36.
Committee and franchise law practitioners. The comment period remained open from October 1, 2015 to November 2, 2015.  

2. Comments to Initial Proposed FPR Commentary (November 2015)

During the comment period, NASAA received a total of 17 comments, which consisted of 14 public comments and three informal comments. Comments from the 14 public sources can be found on NASAA’s website. A task force made up of state and federal regulators, and franchisor and franchisee attorneys, began sifting through and analyzing the various comments. In some cases, that task force went back to specific commenters for specific, practical examples. While the Franchise Project Group did not adopt or incorporate into the subsequent version of the FPR Commentary all of the comments NASAA received, the task force reportedly considered (and often debated) each and every comment and did make revisions based on some comments.

C. Current Proposed FPR Commentary (September 2016)

On September 14, 2016, the Franchise Project Group published for public comment a revised version of the Proposed Franchise Commentary on Financial Performance Representations (“Current Proposed FPR Commentary” or “FPR Commentary”). A copy of the Current Proposed FPR Commentary is attached as Appendix A. The public was given until October 13, 2016 to submit comments. At the time of submitting this paper, the comment period had not yet run. As a result, this paper does not take into account any comments submitted to NASAA during the comment period. It is our understanding, however, that while the task force and the Franchise Project Group will again review and consider all of the comments NASAA receives, they do not anticipate making any significant changes to those items that were revised as a result of the public comments made during the Initial Proposed FPR Commentary comment period.

Accordingly, the discussion below focuses on the Current Proposed FPR Commentary and, assuming it is adopted as is, analyzes how its questions and answers relating to reasonable basis and substantiation will impact the content and format of FPRs of all types, and which FPRs will no longer be acceptable.

For purposes of reference, we also have attached as Appendix B a redlined document showing the changes between the Initial Proposed FPR Commentary and the Current Proposed FPR Commentary. As the reader can see, the Franchise Project Group made a fair amount of additions, deletions, modifications and reconfigurations to the Initial Proposed FPR Commentary

46 Id. at NASAA Comment Period.


48 Kudos to all the task force members for their work on this project. This acknowledgment and recognition comes from Eric Karp and Max Schott, who were not on the task force.

49 NASAA, Current Proposed FPR Commentary, supra note 8.

50 Id.
to create the Current Proposed FPR Commentary. Since the Current Proposed FPR Commentary is expected to be in close to (if not in) final form, we have chosen not to highlight the differences between the documents, unless they are instructive as to the ultimate disclosure requirement.

1. **Excerpt from 2008 Franchise Commentary – Simply Reprinted** (Items 19.1 to 19.3)

As stated in its introduction, the FPR Commentary supplements NASAA’s 2008 Franchise Commentary. Specifically, the FPR Commentary builds on the three Item 19 questions and answers adopted as part of the 2008 Franchise Commentary. For purposes of convenience and continuity, these Items are reprinted as Items 19.1 to 19.3 in the FPR Commentary. Although these Items received several comments during the public comment period, they were not up for comment and remain unchanged.

Item 19.1 clarifies that while costs and expenses are excluded from the definition of an FPR, a franchisor cannot provide those costs and expenses as a percentage of revenues outside of Item 19. Item 19.2 establishes that a blank “pro forma,” which only lists categories of revenue and costs without numbers, does not constitute an FPR and should not be included in a franchisor’s FDD. While these two Items represent concepts that are well-established and stand on their own, the third Item has led to additional questions and answers.

Item 19.3 contains two forms of admonitions – one for historical representations and one for projections – which a franchisor should include, as applicable, in a separate paragraph in its FPR. This Item also prohibits a franchisor from including in Item 19 “additional language that serves to disclaim the financial performance representation they have just made or state that a franchisee may not rely on the information presented.” Clearly, this Item alone has not offered enough guidance on the issue of admonitions and disclaimers, because the Franchise Project Group felt compelled to add Section F (Disclaimers) to the FPR Commentary. This Section includes three new questions and answers (Items 19.21 to 19.23) that reference and expand upon Item 19.3. These new Items are described below in Section III.C.8.

2. **Definitions – Additional Terms and Revisions**

The Current Proposed FPR Commentary includes definitions for the terms “average” and “managed outlet,” expanded definitions of the terms “company-owned outlet,” “operational

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51 Id. at Introduction.
52 Id. at Excerpt from 2008 NASAA Franchise Commentary.
53 Id. at 19.1.
54 Id. at 19.2.
55 Id. at 19.3. Item 19 specifically requires that a franchisor included a “clear and conspicuous admonition that a new franchisee’s individual results may differ from the result stated in the financial performance representation.” 16 C.F.R. § 436.5(s)(3)(iv).
56 Id.
57 Id. at Section F Disclaimers.
franchise outlet,” “gross sales,” “median” and “net profit,” and the same definition of “gross profit” as used in the Initial Proposed FPR Commentary. For ease of reference, we have included below all of the definitions from the Current Proposed FPR Commentary and, where relevant, our comments in italics.

The Current Proposed FPR Commentary does not mandate that franchisors adopt these definitions in their own FPRs. The defined terms have the meanings indicated in the FPR Commentary only. The FPR Commentary illustrates, however, that the franchisors may characterize important terms differently in different FPRs. Because different franchisors use different definitions for common terms in an FPR, such as gross sales, gross revenue, gross profit, net sales, and net profit, e.g., it is important for franchisors to clearly define how they use those terms.

The recent unpublished decision in Martinez v. Stratus Franchising, LLC illustrates the perils of failing to define terms used in financial performance representations. In the FDD in this case, the master franchisee, in a three-tiered janitorial franchise system, used the terms “gross revenue”, “gross annual billing” and “projected gross revenue per year.” On the other hand, a chart used during sales presentations to prospective franchisees used the term “total income.”

As a result of the claims asserted by the franchisees, the master franchisee filed for Chapter 7 bankruptcy and later reached a settlement. A trial was held on the claims asserted against the franchisor, with the plaintiffs asserting that the use of the words “total income” constituted a representation that the numbers presented as gross revenue would ultimately fall to the bottom line. While the franchisor prevailed after trial, and its judgment was upheld on appeal, one could argue that none of this litigation and its attendant expenses, would have been necessary had the relevant terms been carefully defined and used consistently in the manner contemplated by the FPR Commentary.

Average, also known as the “mean,” means the sum of all data points in a set, divided by the number of data points in that set.

Comment: Ties in with revised Section D (Averages and Medians) and Item 19.16.

58 Id. at Definitions (“When used in this FPR Commentary” the following have the meanings indicated.”) (italics added).

59 E.g., id. at 19.5 (explaining that the term “net profit” used in one FPR may be characterized by a similar term, such as “net sales,” in another).


61 Id. at 21.

62 Id. at 3.

63 Id. at 8.

64 Id. at 8.

65 For example, if the data points are 13, 13, 14, 19, and 26, the average is 17. This figure is arrived at as follows: Calculate the sum of all data points (that is, 3+13+14+19+26=85). Divide this number by the total number of data points in the set. Here, we get 85 divided by 5 (the number of data points) = 17. Thus the average is 17.
**Company-owned outlet** means an outlet owned either directly or indirectly by a franchisor, by an affiliate of the franchisor, or by any person required to be identified in Item 2 of the franchisor’s Franchise Disclosure Document, which operates a substantially similar business under the same brand as the business the franchisor offers to franchisees. It also includes any such outlet that: (i) is operated as a joint venture owned in part by a franchisor, by an affiliate of the franchisor, or by a person required to be identified in Item 2; and (ii) is managed by the franchisor, an affiliate of the franchisor, or by a person required to be identified in Item 2.

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

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

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


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

*Comment:* Ties in with new Item 19.7 question and answer regarding the characterization of “managed outlets” in an FPR. Interestingly, this term does not appear to include a franchisee-owned outlet that is managed by the franchisor, an affiliate of the franchisor, or a person required to be identified in Item 2, because this type of outlet is included in the definition of an “operational franchise outlet.” Managed outlets are quite common in the lodging industry.

**Median** means the data point that is in the center of all data points used. That number is found by examining the total number of data points and finding the middle number in that set. In the event the number of data points is an odd number, the median will be the center number. If the dataset contains an even number of data points, the median is reached by taking the two numbers in the middle, adding them together, and dividing by two.\(^{66}\)

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\(^{66}\) For example, if the data points are the odd numbered sequence of 13, 13, 14, 19, and 26, the median is 14, which is the third number in the five data point set. We have two numbers above this data point, and two below this data point. If our data set was modified by adding a 12 to our set, so that the even numbered sequence we are now using is 12, 13, 13, 14, 19, and 26, we discover that the two numbers in the middle of this dataset are the third and fourth numbers, which are 13 and 14. By adding these together (13+14=27), and dividing by two (27/2), we know the median is 13.5. In this example, we have three data points above this number, and three below this number.
Comment: Ties in with revised Section D (Averages and Medians) and Item 19.17.

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


To help practitioners understand the connection between some of these key terms, we have included the following chart:

<table>
<thead>
<tr>
<th>Defined Term</th>
<th>Minus</th>
<th>Equals: Defined Term</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Revenue</td>
<td>Sales tax, discounts, allowances and returns</td>
<td>Gross Sales</td>
</tr>
<tr>
<td>Gross Sales</td>
<td>Cost of goods sold, or minus the cost of providing services for a franchise system that offers services</td>
<td>Gross Profit</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>All ordinary and recurring operating expenses, interest, income taxes, depreciation and amortization</td>
<td>Net Profit</td>
</tr>
</tbody>
</table>

3. Disclosures of FPRs Generally (Section A, Items 19.4 to 19.7)

a. Disclosure of Gross Sales and Net Profit Generally – Define Your Terms

Despite the inclusion of definitions for gross sales and net profit in the Current Proposed FPR Commentary, Items 19.4 and 19.5 mandate that a franchisor making an FPR disclosing gross sales or gross profits must define how it calculated these items. Specifically, for an FPR that includes gross sales, a franchisor must disclose which items, if any, it deducted from total revenue, including sales tax, discounts, allowances, and returns, to reach the gross sales amount. Similarly, for an FPR that includes net profits, a franchisor must disclose which items it deducted from gross profit, including ordinary and recurring operating expenses, interest, income taxes, depreciation, and amortization, to reach the net profit amount. Again, the Martinez case, described in Section III.C.2 above, demonstrates the importance of defining terms in an FPR.

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67 NASAA, Current Proposed FPR Commentary, supra note 10 at 19.4 and 19.5.

68 Id. at 19.4.

69 Id. at 19.5.
b. Identifying the Source of Data Underlying FPR – Expanded Requirements

Item 19.6\textsuperscript{70} (which is different from Section 19.6 under the Initial Proposed FPR Commentary) clarifies that a franchisor has an obligation to clearly identify the sources and types of data it uses to make an FPR, especially if the FPR is based on both franchise and company-owned outlet data.\textsuperscript{71} More importantly, “[i]f a franchisor is adjusting or supplementing actual cost data in an FPR, the franchisor must clearly identify which data are actual costs, which data are adjusted or supplemental costs, and the method and rationale for determining the adjusted or supplemental costs.”\textsuperscript{72} This expanded obligation is linked to the question and answer included in Item 19.10 and the additional disclosure requirements involved in the preparation of gross profit or net profit FPRs based on company-owned outlets alone. This Item is described in Section III.C.4.c below.

c. Managed Outlets – A New Category

As further described in Section III.C.2 above, a new definition for “managed outlets” was added to the Current Proposed FPR Commentary and a fair amount of leeway has been granted as to their use in FPRs. Item 19.7 establishes that the results from managed outlets may be included in an FPR, provided they are not materially different from the results of other outlets included in the FPR and the franchisor discloses the existence of the managed outlets and identifies how they are characterized.\textsuperscript{73} Assuming these requirements are met, a franchisor may characterize a managed outlet as a “company-owned outlet,” a “franchise outlet” or a “managed outlet,” in a separate category.\textsuperscript{74}

4. Use of Data from Company-Owned Outlets – Clearly the Most Controversial Section
(Section B, Items 19.8 to 19.11)

Section B, which consisted of Items 19.4 to 19.8 in the Initial Proposed FPR Commentary,\textsuperscript{75} by far prompted the most public comments. All of the public commenters submitted at least one comment on this Section, and all but two of them submitted multiple comments. Specifically, NASAA received the most comments about Item 19.7 in the Initial Proposed FPR Commentary, perhaps the most controversial Item, which stated that a franchisor with no operational franchises may not make an FPR disclosing gross profit or net profit based on company-owned outlet data alone. All eleven comments NASAA received about this Item objected to this prohibition. As discussed below, those comments on this issue made a difference that is reflected in the revised Current Proposed FPR Commentary.

\textsuperscript{70} Note that Item 19.6 under the Current Proposed FPR Commentary is different from Section 19.6 under the Initial Proposed FPR Commentary, which is covered by Items 19.8-19.10 in the Current Proposed FPR Commentary. References to Item numbers in the body of this paper refer to Item numbers in the Current Proposed FPR Commentary, unless specifically described otherwise.

\textsuperscript{71} Id. at 19.6.

\textsuperscript{72} Id.

\textsuperscript{73} Id. at 19.7.

\textsuperscript{74} Id.

\textsuperscript{75} Id. at Section B.
The purpose of Section B is to establish when information from company-owned outlets can be included in an FPR and how that information must be presented. Essentially, it clarifies the connection that must be established between company-owned outlets and franchise outlets in order to give data from company-owned outlets a reasonable basis.

a. **Gross Sales FPRs Based on Company-Owned Outlets Alone – All Depends on Whether You Have Operational Franchised Outlets**

In keeping with the Initial Proposed FPR Commentary, Item 19.8 establishes that a franchisor cannot make a gross sales FPR based on company-owned outlet data alone, if it has both operational franchise outlets and company-owned outlets. In determining whether a franchisor has operational franchise outlets (as defined in the new Definitions section described above), a franchisor must look to its last fiscal year end. If a franchisor had no operational franchise outlets as of its last fiscal year end, it may make a gross sales FPR based on company-owned outlet data alone, provided it “has a reasonable basis for the FPR and discloses material financial and operational characteristics of the company-owned outlets that are reasonably anticipated to differ materially from future operational franchise outlets.”

b. **Limitation on the Disclosure of Cost and Expense Data Outside of an FPR that Includes Gross Sales**

The Current Proposed FPR Commentary adds new footnote 6 to Item 19.9, which describes two limitations on a franchisor’s ability to provide cost and expense information outside of its FDD if it makes an FPR based on gross sales. This addition may impact the current practices of a number of franchisors. Footnote 6 specifically states:

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

Included below is the pertinent language from p. 131 of the Compliance Guide.

76 Id. at 19.8.

77 Id. at 19.8 n.5.

78 Id. at 19.8. The language in this sentence was modified between versions of the FPR Commentary in response to comments suggesting that it is unreasonable to require franchisors to disclose all differences between company-owned outlets and franchised outlets, including those that franchisors may not be able to reasonably anticipate. Specifically, the phrase “and discloses material financial and operational characteristics of the company-owned outlets that may differ from franchised outlets,” in the Initial Proposed FPR Commentary, was changed to “and discloses material financial and operational characteristics of the company-owned outlets that are reasonably anticipated to differ from future operational franchise outlets,” in the Current Proposed FPR Commentary. (emphasis added).

79 Id. at 19.9.

80 Id.
Does Cost Information Constitute a Financial Performance Representation?

The presentation of cost or expense data alone is not a financial performance representation. Accordingly, the disclosure of fees, required purchases, and expenses reported in Items 5 through 7 ordinarily will not constitute a financial performance claim that would have to be disclosed in Item 19. Nevertheless, a presentation of cost data, coupled with additional sales or earnings figures, from which prospective franchisees could readily calculate average net profits, is a financial performance representation, and does trigger the Item 19 disclosure obligation.81

The Franchise Project Group’s position is that the language in the last sentence above has always prohibited a franchisor from providing cost and expense information outside its FDD if it makes an FPR based on gross sales alone. This interpretation is based on an assumption that the phrase “presentation of cost data” is not limited to the disclosure of this information in the FDD, which seems to be in keeping with the preceding sentence, but also applies to the disclosure of this information outside the FDD.

While somewhat difficult to quantify because it involves a disclosure outside of the FDD, our experience suggests that at least some franchisors have construed this language less broadly, and have assumed that it does not prohibit them from providing cost and expense data outside of the FDD even if their FPR only includes gross sales. Additionally, several of the commenters, and others who objected to the Initial Proposed FPR Commentary’s prohibition against making a gross profit FPR based on company-owned outlet data alone (formerly Item 19.7) when there are operational franchise outlets, suggested that if NASAA does not change that prohibition, franchisors could easily circumvent the prohibition, because franchisors with no franchise outlets can make a gross sales FPR in their FDDs based on company-owned outlet data alone (expressly allowed under the FTC Franchise Rule and the Initial Proposed FPR Commentary) and then, separately, provide cost data to prospects outside of their FDDs.82 Apparently, the possible occurrence of this practice was of great concern to the Franchise Project Group (which sought input from FTC Franchise Rule staff on this issue and the entire Initial Proposed FPR Commentary), who believed it was already prohibited, and led them to add footnote 6 Item 19.9 in the Current Proposed FPR Commentary to clarify this issue.83

Although footnote 6 is included in the section relating to the use of gross sales from company-owned outlets, NASAA intends it to apply equally to gross sales from franchise outlets. This footnote clearly establishes that a franchisor that includes gross sales alone in its FPR cannot provide to prospective franchisees outside of its FDD costs and expenses that would allow them to “readily calculate” net profits. An argument can be made that there may be some room for a franchisor to provide cost and expense information outside an FPR short of net profits (like average labor costs or average rent) even if it only discloses gross sales in its FPR. However, it appears to be NASAA’s position, as well as the position of the FTC, that a


82 NASAA, Current Proposed FPR Commentary, supra note 8 at 19.9.

83 Id. at 19.9 n.6.
franchisor that includes gross sales alone in its FPR is effectively prohibited from providing any
cost and expense information outside its FDD.

c. Gross Profit or Net Profit FPRs Based on Company-Owned
Outlets Alone – Allowed, But With New Disclosure
Obligations

One of the most significant changes between the versions of the document is that new
Item 19.10 in the Current Proposed FPR Commentary allows a franchisor to make an FPR
disclosing gross profit or net profit based on company-owned outlet data alone, regardless of
whether a franchisor has operational franchises.84

The Initial Proposed FPR Commentary would have allowed a franchisor to disclose
gross profit or net profits based on company-owned outlets alone when the franchisor had
operational franchises and adjusted the results to reflect financial and operational differences
between the two types of outlets (formerly Item 19.6), but not when the franchisor had no
operational franchises (formerly Item 19.7). Under the Current Proposed FPR Commentary
(Item 19.10), franchisors may disclose gross profit or net profit based on company-owned
outlets whether or not the franchisor also has operational franchise outlets. The disclosure
requirements of Item 19.10 of the Current Proposed FPR Commentary for company-owned
outlet data are similar to those disclosure requirements proposed in former Item 19.6, requiring
franchisors to adjust the company-owned outlet results, but it further clarifies how franchisors
should make the disclosures or adjustments to make them meaningful to prospective
franchisees, and it allows a franchisor to “supplement” rather than adjust results.85 This means
that a franchisor without operational franchisees may have to estimate or project certain
franchisee cost and expenses.

Under Item 19.10:

A franchisor can make an FPR disclosing gross profit or net profit based
on company-owned data alone if it has a reasonable basis to make the
FPR and includes the following information: (a) gross sales data from
operational franchise outlets, when the franchisor has operational
franchise outlets; (b) actual costs incurred by company-owned outlets;
and (c) supplemental disclosure or adjustments to reflect all actual and
reasonably expected material financial and operational differences
between company-owned outlets and operational franchise outlets.7
These differences consist of fees and other expenditures required by the
franchise agreement, disclosed in the Franchise Disclosure Document, or
that are otherwise known or reasonably should have been known by the
franchisor.

7 Representation based on data from company-owned outlets must take into account
"differences between company-owned and franchised outlets, imputing, where
appropriate, differences in costs (e.g., royalty payments) and economies of scale." See

84 Id. at 19.10.
85 Id.
86 Id. at 19.10 and n.7.
For example, a franchisor must adjust or supplement any FPR based on gross profit or net profit to reflect where a franchisee will pay more for goods or services. Similarly, a franchisor must adjust or supplement an FPR based on net profit to account for additional or higher fees that a franchisee will pay as compared to company-owned outlets, including “imputed royalties,” “advertising fund contributions” and a “full time third party manager.”87

While franchisors may have relied in the past on a general statement of the differences between company-owned outlets and franchised outlets to satisfy the requirements of Item 19 and the FTC Compliance Guide, statements of this sort will no longer suffice. Item 19.10 mandates that the disclosure of any differences or potential differences between company-owned outlets and franchised outlets “must be clearly presented and in the same format as the rest of the FPR. For example, if the FPR presents data in a table, the differences must be adjusted within or added to the end of the table.”88

To help franchise practitioners begin to grapple with what an FPR of this type should look like, we have attached as Appendix C a sample FPR of our old friend Belmont. Although we have adjusted and simplified some of the numbers and the formatting, this sample FPR is based on an actual FPR that was submitted for registration by a franchisor that was ahead of the curve on this issue.

As an additional aid to practitioners, we have included below a chart that summarizes the impact of Items 19.8 to 19.10, and when FPRs based on company-owned alone are permitted.

87 Id.

88 Id.
Are FPRs Based on Company-Owned Outlets Alone Permitted?

<table>
<thead>
<tr>
<th>If the Franchisor Has…</th>
<th>Only Company-Owned Outlets</th>
<th>Operational Franchised and Company-Owned Outlets</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Gross Sales</strong></td>
<td>Yes, if the franchisor has a reasonable basis for the FPR and discloses material financial and operational characteristics of the company-owned outlets that are reasonably anticipated to differ materially from future operational franchise outlets</td>
<td>No</td>
</tr>
<tr>
<td></td>
<td>Item 19.9</td>
<td>Item 19.8</td>
</tr>
<tr>
<td><strong>Gross Profit or Net Profit</strong></td>
<td>Yes, if the franchisor has a reasonable basis for the FPR and includes the following information: (a) actual costs incurred by company-owned outlets; and (b) supplemental disclosure or adjustments to reflect all actual and reasonably expected material financial and operational differences between company-owned outlets and operational franchise outlets. These differences consist of fees and other expenditures required by the franchise agreement, disclosed in the Franchise Disclosure Document, or that are otherwise known or reasonably should have been known by the franchisor.</td>
<td>Yes, if the franchisor has a reasonable basis for the FPR and includes the following information: (a) gross sales data from operational franchise outlets; (b) actual costs incurred by company-owned outlets; and (c) supplemental disclosure or adjustments to reflect all actual and reasonably expected material financial and operational differences between company-owned outlets and operational franchise outlets. These differences consist of fees and other expenditures required by the franchise agreement, disclosed in the Franchise Disclosure Document, or that are otherwise known or reasonably should have been known by the franchisor.</td>
</tr>
<tr>
<td></td>
<td>Item 19.10</td>
<td>Item 19.10</td>
</tr>
</tbody>
</table>

**d. Merging Data from Both Franchise Outlets and Company-Owned Outlets – Only in Limited Circumstances**

Item 19.11 sets forth the general rule that a franchisor making an FPR that includes data from both franchise outlets and company-owned outlets must disclose the data from each category of outlets separately. There are, however, a few exceptions to this rule. First, a franchisor that separately discloses franchise outlets and company-owned outlets in an FPR

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89 *Id.* at 19.11.
may then elect to present the same data in a combined format. Second, “if a franchisor has such a small number of total franchisees that the identity of franchisee(s) whose data is being reported in Item 19 is discernible, and the franchise and company-owned outlets have gross sales that are not materially different, the franchisor may merge the data in the FPR. In that case, the franchisor must include a representation in Item 19 that there are no material differences in the gross sales of franchise and company-owned outlets.” Footnote 9 to Item 19.11 explains that while the appropriate number of total franchisees necessary to allow a franchisor to combine data varies from franchise to franchise, a franchisor with 10 or more franchisees will be presumed to have a sufficient number to require the separate disclosure of data from franchise outlets and company-owned outlets. It’s interesting to note that this second exception focuses on the number of total franchisees and not on the number of total outlets. This approach makes sense because one franchisee can own multiple outlets, so one franchisee could have 10 or more outlets, and the exception focuses on whether the identity of a franchisee can be easily ascertained.

5. **Use of Subsets**
   (Section C, Items 19.12 to 19.15)
   
   a. **Subsets – May Be Used in Certain Circumstances**

   Generally, a franchisor can make an FPR based on a subset of outlets that share a particular set of characteristics, provided the FPR “(a) has a reasonable basis, (b) is accurate, and (c) is not misleading.” Item 19.14 establishes a presumption that a franchisor with less than 10 substantially similar company-owned outlets and franchise outlets as of the end of its last fiscal year has too few outlets to make an FPR based on a subset of those outlets. Footnote 10, however, clarifies that this does not prevent a franchisor from making “an FPR based on 10 outlets or less, when the franchisor has a reasonable basis for doing so.”

   b. **Limitation on Disclosure of Best Performing Outlets – the Yin and the Yang Rule**

   Item 19.14 establishes what we are calling the yin and the yang rule. Simply stated, a franchisor may not include a subset of its best performing outlets in an FPR without including the corresponding lowest performing outlets. This is true even if the FPR also discloses system-wide performance information for all outlets. In sum, “[a]n FPR that is based solely on

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90 *Id.*
91 *Id.*
92 *Id.* at 19.11 n.9.
93 *Id.* at 19.12.
94 *Id.* at 19.14
95 *Id.* at 19.14 n.10.
96 *Id.* at 19.14.
the performance of a subset of the franchisor’s best performing outlets is likely to be misleading and have no reasonable basis.”

**c. Geographic Subsets – Okay, But Explain Why**

Item 19.15 clarifies that a franchisor may use a subset based on a geographic area in its FPR, provided the franchisor describes “why and how that geographic subset was selected” and the presentation of the geographic subset is not misleading.

**d. How Many Reporting Franchisees is Enough?**

While not specifically addressed in Section C, another issue franchisors face is determining what percentage of system franchisees must report information to the franchisor to give an FPR based on that information a reasonable basis. In a perfect world, a franchisor would include in its FPR relevant information from all of its franchisees – or at least all of the franchisees open and continuously operating during a particular period. Some franchisors may enjoy this luxury, especially those that have the ability to directly access the data of their franchisees.

Many other franchisors, however, may only receive information from a portion of their franchisees, either because the franchisor does not have the right or the means to collect this information or the franchisees fail to provide the information to the franchisor. While an FPR based on data from 80% of the franchisor’s franchisees would likely have a reasonable basis, it is less clear whether this would hold true when the percentage of reporting franchisees falls to a lower percentage. For example, is 50% of franchisees reporting enough to create a reasonable basis? Is 30% of reporting franchisees too low? Also, are higher performing franchisees more likely to report thus skewing the data? This topic is further discussed in Section IV.E below where at least one Illinois court in the Avon case found that an FPR based on a subset of 37% of franchisees did not constitute fraud or a violation of the FTC Franchise Rule. These are practical questions, however, a franchisor and its counsel must address in preparing an FPR.

**6. Averages and Medians**  
*(Section D, Items 19.16 to 19.18)*

**a. Going Forward, You Cannot Include One Without the Other**

Items 19.16 and 19.17 respectively set forth the statistical requirements a franchisor must include when disclosing an “average” and a “median” in an FPR. Essentially, these Items establish that you cannot include an average in an FPR without including the corresponding median, and vice versa. The rationale is that including one without the other may be misleading (even if the calculation is accurate). For example, “the existence of outliers may skew an average.” These Items also respectively require that whenever a franchisor

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97 Id.
98 Id. at 19.15.
99 Id. at 19.16 and 19.17.
100 Id.
101 Id. at 19.16.
discloses the average of gross sales or the median of gross sales, “the franchisor also must disclose the highest and lowest numbers in the range.”

The following chart helps demonstrate the purpose of these requirements.

<table>
<thead>
<tr>
<th>Franchisee</th>
<th>Franchisor A</th>
<th>Franchisor B</th>
<th>Franchisor C</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Annual Gross Sales of Each Franchisee</td>
<td>Annual Gross Sales of Each Franchisee</td>
<td>Annual Gross Sales of Each Franchisee</td>
</tr>
<tr>
<td>1</td>
<td>$500k</td>
<td>$50k</td>
<td>$400k</td>
</tr>
<tr>
<td>2</td>
<td>$500k</td>
<td>$100k</td>
<td>$450k</td>
</tr>
<tr>
<td>3</td>
<td>$500k</td>
<td>$200k</td>
<td>$500k</td>
</tr>
<tr>
<td>4</td>
<td>$500k</td>
<td>$250k</td>
<td>$500k</td>
</tr>
<tr>
<td>5</td>
<td>$500k</td>
<td>$500k</td>
<td>$500k</td>
</tr>
<tr>
<td>6</td>
<td>$500k</td>
<td>$750k</td>
<td>$500k</td>
</tr>
<tr>
<td>7</td>
<td>$500k</td>
<td>$800k</td>
<td>$500k</td>
</tr>
<tr>
<td>8</td>
<td>$500k</td>
<td>$900k</td>
<td>$550k</td>
</tr>
<tr>
<td>9</td>
<td>$3,000k</td>
<td>$950k</td>
<td>$600k</td>
</tr>
<tr>
<td>Total</td>
<td>$7,000k</td>
<td>$4,500k</td>
<td>$4,500k</td>
</tr>
<tr>
<td>Average</td>
<td>$778k</td>
<td>$500k</td>
<td>$500k</td>
</tr>
<tr>
<td>Median</td>
<td>$500k</td>
<td>$500k</td>
<td>$500k</td>
</tr>
<tr>
<td>High</td>
<td>$3,000k</td>
<td>$950k</td>
<td>$600k</td>
</tr>
<tr>
<td>Low</td>
<td>$500k</td>
<td>$50k</td>
<td>$400k</td>
</tr>
</tbody>
</table>

The average annual gross sales of the nine franchisees of Franchisor A are $778k. Clearly, the outlier of $3,000k drives up the annual average and would be misleading by itself. The required inclusion of the $500k median and the $500k low and $3,000k high in an FPR containing this annual average gross sales information, however, provides context to this average and makes apparent the outlier to prospective franchisees.

Despite the different variations between franchisees, the average and median of annual gross sales of the nine franchisees of both Franchisors B and C are $500k. However, the low and high for Franchisor B are $50k and $950k, while the same numbers for Franchisor C are $400k and $600k. As the reader can see, the inclusion of the highest and lowest numbers in the respective ranges in an FPR containing the average annual gross sales information for Franchisors B and C tells a more complete story.

b. Omission of Outlets that Have Closed – Makes Sense, But Tell Me About Them

Item 19.18 clarifies that a franchisor can omit information from outlets that have closed during a period covered by an FPR as long as it discloses the number of outlets that have been omitted. Specifically:

\[^{102}\text{Id. at 19.16 and 19.17.}\]

\[^{103}\text{Id. at 19.18.}\]
A franchisor making an FPR that includes an average or median may exclude data from company-owned outlets and franchise outlets that closed during the time period covered in the FPR, provided the franchisor discloses in the FPR: (i) the number of company-owned outlets that closed during the time period, if the FPR includes company-owned outlets; (ii) the number of franchise outlets that closed during the time period, if the FPR includes franchised outlets; and (iii) the number of excluded outlets that closed during the same time period after being open less than 12 months. This disclosure should cover each year or other period of time covered in the FPR.\(^{104}\)

Many franchisors likely already disclose in their FPRs that a certain number of closed outlets are excluded from the data presented. What is new under this Item is the additional requirement that a franchisor identify how many of the excluded outlets closed within their first 12 months of operation.

7. **Use of Forecasts and Projections – What’s Left?**  
(Section E, Items 19.19 and 19.20)

Section E does not prohibit the use of forecasts and projections, but significantly restricts their content.\(^{105}\) Item 19.19 establishes that projections must be based on historical data and not on “mere hypothetical situations or expectations.”\(^{106}\) While a franchisor can adjust or supplement historical results based on changes in the market (like to reflect higher or lower than historic rents), “the projections still must be based on historical data from outlets substantially similar to the type of outlet offered in the Franchise Disclosure Document.”\(^{107}\) The language in the preceding sentence starting with “from outlets substantially similar” was added to the Current Proposed FPR Commentary thus further limiting the substance of projections.

More importantly, Item 19.20, which remains unchanged from the Initial Proposed FPR Commentary, takes this concept one step further and clarifies that “[a] projection must be based on a reasonable sample of the historic results of the brand offered to the prospective franchisee.”\(^{108}\) Specifically, “[a] projection may not be based on the results of other brands operated or licensed by the franchisor or its affiliates, or on the results of similar or competitive brands operated by others, or on industry reports.”\(^{109}\) While the number of franchisors currently using forecasts and projections is small, it likely will become even smaller as the result of Section E.

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\(^{104}\) *Id.*  
\(^{105}\) Id. at 19.19.  
\(^{106}\) Id.  
\(^{107}\) Id.  
\(^{108}\) Id. at 19.20.  
\(^{109}\) Id.
8. **Disclaimers**  
(Section F, Items 19.21 to 19.23)

a. **Standard Admonition – Nothing More, Nothing Less**

Section F provides clarifications regarding the use of the admonition included in Item 19.3, and whether franchisors can vary and add to it.\(^{110}\) Item 19.21 states:

A franchisor may not vary the language of the admonition provided in FPR Commentary Item 19.3, unless the franchisor makes a type of FPR that does not fit the situation for the language provided. FPR Commentary Item 19.3 states that a franchisor should use one of two forms of conspicuous admonition, one for an historical representation and one for a projection. The language of both types of admonition stated in Commentary Item 19.3 applies to an FPR based on sales or earnings. A franchisor that makes an FPR based on outlet sales or earnings must use the applicable language stated in Commentary Item 19.3, without any variation, and without adding any additional disclaimer language. When a franchisor makes an FPR based on something other than outlet sales or earnings (for example, hotel occupancy rates), it may change the language of the sample admonition, but only to the extent necessary to fit the FPR made.\(^{111}\)

Item 19.22 establishes once and for all the specific requirements for ensuring the mandated admonition is “clear and conspicuous.” The admonition must be presented in a separate paragraph and in bold type, and may not be “in capital letters or underlined or in larger type than the rest of the FPR.” The following is included in Item 19.22 as an example:

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

b. **No Disclaimer or Waivers, But Explanations Okay**

As further mentioned above in Section III.C.1, despite the language in Item 19.3 prohibiting the inclusion of additional disclaimers in FPRs and language stating that a prospective franchisee may not rely on the information presented (which was in NASAA’s 2008 Commentary), the Franchise Project Group determined it important to further emphasize and clarify this point in Item 19.23.\(^{112}\) Simply stated, beyond the mandated admonition, which serves to inform prospective franchisees, a franchisor may not include in its FPR language that disclaims responsibility for the FPR or advises a prospect that it may not rely on the content of the FPR. Specifically, this Item provides:

\(^{110}\) *Id.* at 19.21 and 19.22.

\(^{111}\) *Id* at 19.21. The following is a sample of an admonition used by a franchisor in the hotel industry: “Some hotels have achieved these Average Occupancy Rates and Revenue per Available Room figures. Your individual results may differ. There is no assurance you’ll obtain the average occupancy rates or revenue per available room disclosed in this financial performance representation.”

\(^{112}\) *Id.* at 19.23.
Under the FTC Franchise Rule, a franchisor is prohibited from disclaiming or requiring a prospective franchisee to waive reliance on any representation made in the Franchise Disclosure Document. A franchisor, therefore, may not include in Item 19 or elsewhere in a Franchise Disclosure Document any disclaimers that contradict, mitigate, or are inconsistent with the admonition prescribed in FPR Commentary Item 19.3.\footnote{Id.}

The following is a recent example of the type of disclaimer franchise examiners have not allowed and which will not be allowed under the Current Proposed FPR Commentary:

> We specifically instruct our sales personnel, agents, employees, and officer that they're not permitted to make such claims or statements as to the earnings, sales or profits, or prospects or chances of success, nor are they authorized to represent or estimate dollar figures as to a franchisee’s operation. We will not be bound by allegations of any unauthorized representations as to earnings, sales, profits, or prospects or chances for success.

Franchise examiners also routinely require franchisors to remove disclaimers that include phrases like “and you cannot rely on. . .” or “this is for informational purposes only.”\footnote{For example, a recently submitted FDD included the following phrase at the beginning of Item 19: “This is for informational purposes only and cannot be relied upon as what you will receive or should expect to receive when selling your business.”}

While Item 19.23 explicitly prohibits a franchisor from including in its FPR additional disclaimers and non-reliance language, a franchisor is free to add detailed information regarding the FPR’s background, assumptions and basis. Arguably, the more detailed an FPR, the less likely it is to mislead. In addition, as further described in Section IV.A below, the cases suggest that the mandated admonition described above adequately protects franchisors, despite the desire of many franchisor lawyers to include redundancy.

IV. Case Law regarding Financial Performance Representations

A. Negative Disclaimers in Item 19

The preponderance of the case law regarding financial performance representations involves claims of oral or written representations of actual or projected financial results, which are made outside of the FDD and in many cases contradict it. These cases are outside the scope of this paper, which is devoted to the drafting of financial performance representations. However, one prominent case, \textit{Randall v. Lady of America Franchise Corporation}, a 2007 decision of the District of Minnesota, straddles both worlds.\footnote{532 F. Supp.2d. 1072 (D. Minn. 2007).} This case was decided based upon the UFOC Guidelines of franchise disclosure.\footnote{See NASAA, Uniform Franchise Offering Circular Guidelines- 1993 and Commentary, Item 19 – Earnings Claims, Bus. Franchise Guide (CCH) ¶ 5771 (adopted April 25, 1993).}
The UFOC in *Lady of America* contained a negative earnings claim disclosure in the form permitted under those guidelines, indicating that the franchisor does not furnish or authorize its salespersons to furnish any oral or written information concerning actual potential sales, costs, income or profits of the franchise. However, one franchisee plaintiff alleged that at Discovery Day events, they were informed that their women’s fitness franchise could expect to have between 125 and 150 members, and that the franchise business would eventually generate $22,000 per month in profits. Another franchisee was given a figure of $23,000 per month in profits. The plaintiffs, in alleging violations of the Minnesota Franchise Act, took the position that the negative disclosure in Item 19 of the UFOC, although apparently in a format consistent with the UFOC Guidelines, was nevertheless a false statement, because the franchisor was actually engaged in making earnings claims, albeit outside the disclosure document. The franchisees also alleged that these oral financial performance representations were false statements.

The following chart demonstrates the consistency between the negative disclosure under the UFOC Guidelines and the negative disclosure contained in the Lady of America Item 19:

<table>
<thead>
<tr>
<th>UFOC Guidelines-Sample Answer&lt;sup&gt;117&lt;/sup&gt;</th>
<th>Lady of America Item 19&lt;sup&gt;118&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belmont does not furnish or authorize its salespersons to furnish any oral or written information concerning the actual or potential sales, costs, income or profits of [a Belmont muffler shop]. Actual results vary from unit to unit and Belmont cannot estimate the results of any particular franchise.</td>
<td>We did not furnish or authorize (our) salespersons to furnish any oral or written information concerning the actual or potential sales, costs, income or profits of your Franchise. Actual results vary from Franchise to Franchise, and we cannot estimate the results of any particular franchise.</td>
</tr>
</tbody>
</table>

The plaintiffs’ claims largely survived summary judgment, the court holding that these allegations were viable and not barred by the integration clause in the franchise agreement, that the plaintiffs were not required to demonstrate justifiable reliance on the representations in order to pursue common law claims, that the issue of justifiable reliance under the Florida Franchise Act was a question for the jury and that the anti-waiver provisions of the Minnesota Franchise Act precluded reliance upon the disclaimers in the UFOC to defeat the claims.<sup>119</sup> The court opined that “…contractual disclaimers do not, as a matter of law, relieve those accused of fraud of liability.”<sup>120</sup> More to the point for the purposes of this paper, the court declined to dismiss any of the plaintiffs’ claims, both statutory and common law, that the negative disclosure in the Item 19, was false and fraudulent in light of the pattern of oral representations of future membership levels and profitability.

<sup>117</sup> *Id.*

<sup>118</sup> 16 C.F.R. §436.5(s)(2).

<sup>119</sup> The same view concerning the anti-waiver provisions of the Minnesota Franchise Act were adopted by the District of Maryland in *Hanley v. Doctors Express Franchising, LLC*, No. ELH-12-795, 2013 WL 690521 (D. Md. Feb. 25, 2013).

<sup>120</sup> 532 F. Supp.2d. at 1100.
An earlier case against Minuteman Press, and one of the largest cases ever brought by the FTC, came to essentially the same conclusion. The FTC brought this enforcement case against Minuteman Press, Inc., its affiliate, Speedy Sign-A-Rama USA, Inc. and its Chief Executive Officer. The testimony included recordings of investigators operating undercover posing as prospective franchisees, with franchisor representatives stating, among other things, that some stores in the system were grossing as much as $200,000 per month. Investigators were variously told during secretly recorded conversations that typical franchisees had gross sales of $20,000, $25,000 and $30,000 per month. There was testimony from an expert testifying on behalf of the FTC that the average or median monthly sales in the system was nowhere near $20,000, with only two of 11 franchisees ever having achieved that level of sales.

Among the claims made by the FTC was that the corporate defendants had failed to comply with the Federal Trade Commission Act, as well as the Franchise Rule, based on the UFOCs which uniformly stated that no earnings claims were being made, and that the officers, directors and employees of the franchisor, were not authorized to make such statements. That stark contradiction between the negative disclosure in Item 19, and the pervasive sales representations made outside the disclosure document, the court held, violated the Franchise Rule. In addition, the court held that written substantiation of the oral sales presentations could not have been made because the written substantiation would necessarily also be false.

These cases appear to stand for the proposition that the negative disclosure under the old UFOC Guidelines was an affirmative statement of fact – that the franchisor does not make earnings claims – that if proved to be false, could be the basis for liability. In this case, the FTC proved not only that the franchisees did not achieve financial results consistent with the presale representations made, but also that those presale representations were false. As we can see from other decided cases, proving only a variance between the representation and actual results, is frequently not enough to create liability on the part of the franchisor.

Other courts, however, have considered whether that negative disclosure is a disclaimer, a warning to franchisees not to rely on oral representations outside the disclosure document, which might actually defeat such a claim.

For example, in *EV Scarsdale Corp. v. Engel & Voelkers North East, LLC*, one of the plaintiffs considering the purchase of a real estate brokerage franchise opportunity, was provided with a PowerPoint presentation that included an extensive earnings claim, detailing such metrics as net operating profits, sales transactions per real estate agent and sales commissions per real estate agent. That plaintiff was also provided with a spreadsheet summarizing the information provided in the presentation and was orally told that he could expect a 10% market share in Scarsdale, the community in which he intended to open the


122 Id. at 255.

123 Id. at 259.

124 See Section E, infra.

franchised business. Another plaintiff in the case, whose franchise was to be located in Rhode Island, was provided a spreadsheet showing the average financial performance of franchisees in the system, and was told that based on the expected financial performance of the business, that their initial investment would be recouped within two years. Each plaintiff received an FDD, which contained the negative disclosure explicitly permitted by the FTC Franchise Rule.

The following chart illustrates how the negative disclosure changed in the transition from the UFOC Guidelines to the FTC Franchise Rule. The changes involved breaking the first sentence of the UFOC Guidelines Negative Disclosure into two sentences, the first dealing with whether the franchisor makes representations and the second with whether or not it authorizes others to make representations on its behalf. The FTC Franchise Rule Negative Disclosure also authorizes disclosures regarding the financial performance of an actual outlet that the prospective franchisee may be purchasing and includes instructions on reporting unauthorized financial performance representations.

<table>
<thead>
<tr>
<th>Negative Disclosure-UFOC Guidelines</th>
<th>Negative Disclosure-FTC Franchise Rule</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belmont does not furnish or authorize its salespersons to furnish any oral or written information concerning the actual or potential sales, costs, income or profits of [a Belmont muffler shop]. Actual results vary from unit to unit and Belmont cannot estimate the results of any particular franchise.</td>
<td>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.</td>
</tr>
</tbody>
</table>

Plaintiffs argued that Section 687(5) of the New York Franchise Sales Act made the disclaimer invalid and unenforceable. Although other appellate case law in New York might have dictated a different result, the court chose to follow the reasoning in *Emfore Corp. v. Blimpie Assocs. Ltd.*, which held that non-reliance could not be the basis for dismissing a fraud claim. In so holding, the court said, in relevant part that,

… In the franchise context, written contractual provisions, are not as likely to be scrutinized by less sophisticated people, whose judgment may be

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126 Id. at 809.
127 Id. at 810.
128 Id. at 818. See also 16 C.F.R. §436.5(s)(2).
130 16 C.F.R. §436.5(s)(2).
compromised in the face of aggressive salesmanship. That oral representations will be realistically considered, regardless of written disclaimers, is perhaps, a reason §683(8) requires the FDD to be disclosed prior to first personal meeting.131

In this case, the negative disclosure in Item 19 of the FDD did not shield the franchisor from liability.

B. First Year Revenues

Another issue with respect to Item 19 disclosures, which does not involve disclaimers or warnings and does not involve any allegations of false representations, relates to the prevalent absence of information regarding financial results during the first 12, 18 or even 24 months of operation.

In 2013, the United States Government Accounting Office issued a report regarding Small Business Administration guaranteed loans to franchisees from a particular franchisor.132 Over an 11-year period, this selected franchise system was involved in 170 loans guaranteed by the SBA, 74 of which defaulted. The GAO observed that those franchisors that do provide an FPR in Item 19 of their disclosure document typically do not include data for units that are open less than one full year as of the end of their most recent fiscal year.133

The GAO concluded that this is problematical for two reasons.

First, prospective franchisees seeking SBA guaranteed loans are required to submit a loan application that includes their projection of first-year revenue. That information is not generally available to them, even for franchise opportunities that have an FDD containing an FPR.134 This requires prospective franchisees to seek information regarding first year revenues from other sources, not all of which might be reliable. In addition, some seem to have used the average system-wide revenues in the FPR in order to project their first year revenues.135

Second, the GAO calculated that, for the specific franchisor that was the focus of the report, a high percentage of failures occurred in the first year of operation,136 and the

131 13 N.Y.S.3d 805 at 1037. Notwithstanding the elimination of the first personal meaning requirement that existed under the UFOC guidelines, but which was eliminated from the Franchise Rule in 2007, the first personal meeting delivery requirement remains the law in New York. N.Y. GEN. BUS. LAW, §683(8)(a).


133 Id. at 29.

134 Id. at 21. Note also that the Definitions included in the Current Proposed FPR Commentary exclude from the definition of ‘Operational Franchise Outlet’ any outlet that has not been fully operational for one full year, or, in the case of franchise systems that operate seasonally, for at least one full season.

135 Id. at 15.

136 Item 19.18 of the Current Proposed FPR Commentary requires the disclosure of the number of outlets excluded from the FPR during the time period covered by that FPR, that closed after being open less than 12 months.
systemwide average sales projections by franchisees were materially higher than the first year sales experienced by franchisees in that system.\textsuperscript{137}

The GAO’s conclusion was that the franchise disclosure regime is flawed because it deprives prospective franchisees of material information that they need, not only to obtain loans, but to assess the true risks of the franchise opportunity.

The same issue was presented in a 2011 case involving the 7-Eleven franchise system.\textsuperscript{138} The franchisor filed this action and obtained an order requiring the franchisee to surrender possession and control of the store. The franchisor later sought and received a finding that the franchisee was in contempt of that order and then brought a motion to dismiss the outstanding counterclaims filed by the franchisee. The franchisee, acting \textit{pro se}, alleged that the franchisor had failed to provide material information regarding the financial performance of the specific store that she purchased. The franchise agreement had been signed in March 2008. The UFOC furnished to the prospective franchisee contained an earnings claim regarding franchised stores in the market area of the store that she wished purchase, but the earnings claim explicitly excluded stores that had not operated for a full calendar year.

The UFOC also indicated that a franchisee would receive the actual operating results of any store that they wished to franchise, but only if that store had been operated for at least a full calendar year. The franchisee alleged that the reason that the franchisor did not provide the operating results for the store that she franchised was because the franchisor knew that store was (a) not operating profitably, (b) operating below expectations, or (c) yielding financial results inconsistent with the average market results presented in the Item 19.

The court, noting that the franchisor was not required to make any Item 19 disclosure, dismissed the franchisee’s counterclaims pointing out that the franchisor had specifically told the franchisee that information regarding the store in question would not be provided, precisely because it had not been open and operating for at least 12 months. The court also found that the information that the franchisee claimed had been withheld, even if alleged to be material to her decision to invest, was of no moment:

\begin{quote}
But 7-Eleven was not under an obligation to disclose every piece of information that may have been material to Defendants’ investment decision. It was obligated to provide disclosure in accordance with the Guidelines. See \textit{America’s Favorite Chicken Co. v. Cajun Enters., Inc.} 1996 WL 306350, at *3 (E.D.La. June 5, 1996)(holding that a franchisor has no duty to go beyond the disclosure requirements required by the UFOC Guidelines).\textsuperscript{139}
\end{quote}

\textsuperscript{137} \textit{id.}


\textsuperscript{139} \textit{id} at 12.
It was not deceptive or fraudulent for 7-Eleven not to give Defendants exactly what 7-Eleven’s told Defendants that they would not receive (and what 7-Eleven had no duty to provide in any event).  

This case appears to have been decided under the now superseded UFOC Guidelines. The FTC Franchise Rule provides, in relevant part that “... franchisors may have additional obligations to impart material information to prospective franchisees outside of the disclosure document under Section 5 of the Federal Trade Commission Act.” It is not clear whether the result would have been different if the case had been decided under the new FTC Franchise Rule, or if the franchisee had not been acting pro se and was able to demonstrate the truth of the allegation that the franchised store she purchased had been underperforming.

Hanley v. Doctors Express Franchising, LLC involved the relatively rare examination of the interplay between an Item 19 FPR and the “additional funds” disclosure required in Item 7. The franchisee alleged that the franchisor was well aware that the additional funds estimate in the FDD was materially lower than the actual operating capital required of a prospective franchisee. More specifically, because of changes in Medicare enrollment processes, the franchisor was aware that a delay in the insurance contracting process would impede cash flow at the outset of the franchise relationship, and those challenges had not affected its Maryland affiliate, whose financial performance was the sole basis for the representations in both Items 7 and 19.

With respect to the Item 19 disclosure, the court recited that the representation was based solely on a single affiliate owned location in Maryland. The court concluded that this Maryland location was not representative of the experience of a new franchisee. This was in part because of the Medicare issues noted above, as well as the fact that the affiliate owned location was not required to make use of the same expensive vendors as were the franchisees.

In denying the franchisor’s motion to dismiss, the court stated,

...Doctors Express was under no obligation to make a representation as to projected financial performance of the franchisee in its FDD in the first place. (Internal citations omitted) But, having decided to make such a representation, Doctors Express was required to make a representation that was supportable based on what it knew at the time it made the representation. See 16 C.F.R. § 436.5(s)...  

Finally, we note that the practice of not disclosing first year revenues is not universal among franchisors. The April 2016 FDD of Goddard Systems, Inc. discloses in its FPR, in addition to other extensive disclosures, data for what that franchisor designates as “New
Franchise Schools (open 18 months or less)." The Item 19 disclosure, perhaps one of the most extensive, useful and informative that the authors have ever seen, includes a condensed statement of EBITDA (earnings before interest, taxes, depreciation and amortization) for each franchised school in the system that was open 18 months or less as of the end of its most recent fiscal year, which in this case included 18 schools. The disclosure also indicates the calendar quarter in 2014 or 2015 in which the school opened. The Item 19 contains a separate disclosure of average EBITDA for the first 12 months of operation of all schools opened in 2014, by month of operation, including the number of schools and percentage of schools that attained or surpassed the average figure for each month.

The materiality of this information is illustrated by the data. Of the seven locations that opened in the 3rd or 4th quarter of 2014, six had negative EBITDA in 2015, ranging from a low of $13,162 to a high of $220,321. Of the eleven locations that opened in 2015, six had negative EBITDA in 2015, ranging from a low of $19,121 to a high of $345,737. Overall, two thirds of the franchise locations opened during the 18 months prior to the end of the franchisor's fiscal year had negative EBITDA during that period of operation.

A copy of Item 19 from the 2016 Goddard Systems, Inc. FDD is attached to this paper as Appendix D.146

C. Representations That Information is Not Available to the Franchisor

In Rocky Mountain Chocolate Factory, Inc. v. SDMS, Inc., the District of Colorado examined an Item 19 disclosure in the UFOC issued by a franchisor that stated: “We do not have access to nor knowledge of the expenses or costs incurred by each of the 169 franchised Stores.” The franchisee alleged in its fraud counterclaim that this was a false statement, because the franchisor maintained profit and loss statement for each of its corporate owned retail stores and also required franchisees, pursuant to the terms of their franchise agreements, to provide quarterly profit and loss statements to the franchisor. The franchisor’s motion for summary judgment on this claim was denied, the court holding that there were genuine issues of material fact as to whether or not the statement was false, whether the statement was material and whether the franchisees reasonably relied on the statement.

The message of this case is clear and simple. The FTC Franchise Rule does not require a franchisor making an FPR to provide expense or cost information. Indeed, the Statement of Basis and Purpose of the 2007 Franchise Rule states that “mere disclosure of cost information does not.... constitute a financial performance representation, triggering Item 19 disclosure obligations.” Moreover, if a franchisor decides not to provide expense or cost information within the Item 19, it need not provide a reason or excuse for not doing so. However, making an affirmative representation of the reason for not doing so which is false, may well yield liability.

145 See Appendix D for FPR and see supra note 6 for instructions to view full FDD.

146 In Avon Hardware Company v. Ace Hardware Corporation, 998 N.E.2d 1281 (Ill. App. Ct. 2013) the court describes the UFOC provided to the plaintiffs as including estimated annual sales for the first year of business, and several years thereafter.


The ruling in *Rocky Mountain Chocolate Factory* can be readily analogized to the result in *Lady of America*. In both cases, the franchisor undoubtedly believed that it was inserting a disclaimer. In *Lady of America*, the representation was that the franchisor does not make financial performance representations and in *Rocky Mountain Chocolate Factory*, the representation was that the franchisor had no information regarding the costs incurred by its franchisees. Each of these statements was not treated by the respective courts as a disclaimer, but rather as an affirmative representation of fact, which in each case turned out not to be true.

**D. False or Misleading Financial Performance Presentations**

One of the earliest reported cases in this area was a Consent Decree issued in favor of the FTC on May 7, 1993, against Gingiss International, Inc.149 The FTC alleged in a Complaint for Civil Penalties, Injunctive and Other Relief filed contemporaneously with the Consent Decree, that the defendant franchisor had distributed UFOCs which included an earnings claim. The statement of cash flow was designed to allow a prospective franchisee to determine the amount of cash flow that would be available to the owner before debt service.

The FTC alleged that there were two ways in which the earnings claim was misleading. First, the franchisor used salary expenses of non-management personnel from their company-owned stores in Chicago, and not the salary expenses reported by franchisees. The FTC further alleged that the salary expenses from company-owned stores were not comparable to the type of franchises that were being sold. In addition, prospective franchisees were not informed that adjustments to the company-owned store data would need to be made in order to accurately forecast the prospective franchisee’s cash flow. The end result was that salary expenses were understated in the earnings claim.

Second, in connection with UFOCs issued in later years, the franchisor included a statement of expenses which was also designed to allow prospective franchisee to estimate cash flow available to the owner. The FTC alleged that the statement of expenses did not include a statement of the cost of goods sold for the average retail sales number. The result was an overstatement of cash flow available to owner because that category of expense was not included in the presentation.

The franchisor entered into a Consent Decree, the terms of which included a fine in the amount of $25,000, injunctive relief for a five-year period, and continuing jurisdiction of the court for enforcement purposes.

In *Federal Trade Commission v. Tashman*, the Eleventh Circuit150 reversed a judgment in favor of the business opportunity seller defendant, which followed a six-day bench trial in the Southern District of Florida. The defendants sold telephone calling card machines. They were accused of engaging in high-pressure sales tactics, which included representations that the machines would be put in places that would experience at least 500 passersby per day, that 2% of those passersby were likely to purchase phone cards from the machines, and that they could expect to pay off their investment in the machines within six months. Prospective purchasers were given a disclosure document which the court characterized as reinforcing the rosy picture presented by the defendants. Prospective buyers were encouraged to speak to references, all

150 318 F.Supp.3d 1273 (11th Cir. 2003).
of whom were paid by the seller and some of whom had never actually purchased machines. The disclosure documents stated that the business opportunity seller had received 287 positive letters, and only 20 negative ones.\textsuperscript{151} Among those who purchased this business opportunity, 95\% lost money on the investment.\textsuperscript{152} The case was remanded to the District Court to fashion appropriate monetary and injunctive relief.

A later FTC action against internet kiosk companies and their principals involved a franchise seller that largely ignored the disclosure obligations under the FTC Franchise Rule.\textsuperscript{153} The disclosure documents furnished to some of the prospective purchasers contained earnings claims that the court found did not have a reasonable basis, and did not disclose the number and the percentage of prior purchases known by the seller to have achieved the same or better results. The FTC further alleged that the seller had failed to provide purchasers with written substantiation of its earnings claims, as required by the FTC Franchise Rule. The Southern District of Florida ruled in 2007 in favor of the FTC, finding that it had proved its allegations, and that the franchise seller had violated numerous provisions of the Rule.\textsuperscript{154}

\textbf{E. Subsets}

A 2013 case involving hardware store franchisees, decided by the Appellate Court of Illinois, examined the issue of whether or not disclosing the financial performance of a subset of franchise locations constituted fraud or a violation of the FTC Franchise Rule. In \textit{Avon Hardware Company v. Ace Hardware Corporation},\textsuperscript{155} the franchisees had received UFOCs which contained average store performance numbers for the two most recent complete calendar years, but the numbers presented represented data from only about 37\% of all franchised stores. The franchisor stated that the numbers presented were only from reporting stores, representing that “… because we do not receive detailed financial data in a consistent format from all Members, the Statements reflect average store performance only for reporting stores.”\textsuperscript{156}

The UFOC further went on to warn the prospective franchisee that the data in the earnings claim “should not be relied upon or solely considered as the probable results that will be realized by any Member.”\textsuperscript{157}

\begin{itemize}
  \item \textsuperscript{151} Id. at 1276.
  \item \textsuperscript{152} Id. at 1275.
  \item \textsuperscript{153} \textit{Federal Trade Commission v. Transnet Wireless Corporation}, 506 F. Supp.2d 1247 (S.D. Fla. 2007).
  \item \textsuperscript{154} Id. at 1270.
  \item \textsuperscript{155} 998 N.E.2d 1281 (Ill. App. Ct. 2013).
  \item \textsuperscript{156} Id. at 1285.
  \item \textsuperscript{157} Id. at 1286.
\end{itemize}
On appeal, the Appellate Court turned aside the contention of the plaintiffs that the Franchisor had cherry picked the data and had failed to include data regarding failed stores, indicating that the UFOC made plain that the data was based on a subset of 37% of stores. The court concluded,

… the UFOC sufficiently apprised the plaintiffs that the data did not represent the past performance of all Ace stores, but only a small fraction thereof. The UFOC, along with the other documents provided to the plaintiffs, was replete with warnings to not rely upon any of the projections of past performance data to predict the future performance by any store.\(^{158}\)

The FDD delivered to prospective franchisees of Steak n Shake led to litigation in the District of Colorado, which was resolved by summary judgment in favor of the franchisor in 2015.\(^{159}\) The Item 19 presentation included both historical and projected financial performance. The historical performance reflected average performance of company-owned full-service restaurants and the projected performance resulted from certain franchised restaurants. A separate table reflected a 21% profit margin before rent, depreciation, administrative expenses, interest and taxes.\(^{160}\)

The record reflects the fact that the prospective franchisees consulted with a CPA who examined the Item 19 representations. They were also reported to have consulted with an attorney, done their own calculations and generally did a lot of research.

The Item 19 contained cautionary language stating that the numbers were estimates and that there was no assurance that the prospective franchisees would do as well. The FDD also pointed out that performance could be affected by “diminishing sales following initial exuberance, seasonality, or general economic market conditions.”\(^{161}\)

In granting the franchisor’s motion, the court, citing an earlier case in the same district, and the same issue,\(^{162}\) stated that the plaintiffs’ allegations that their restaurants did not do as well as the projections contained in the FDD, did not necessarily mean that the projections were false.

Finally, the court stated that reliance upon the projections by the franchisees would not be justified, given the warnings and disclaimers in the FDD and their own due diligence.\(^{163}\)

\(^{158}\) *Id.* at 1289. Note that, under Item 19.3 of the Current Proposed FPR Commentary, a franchisor may not advise a prospective franchisee not to rely on the content of the FPR.


\(^{160}\) *Id.* at 1066.

\(^{161}\) *Id.* at 1067.

\(^{162}\) *Qdoba Restaurant Corp. v. Taylors, Inc.*, No. 08-cv-01179-MSK-KMT, 2010 WL 1240410 (D. Colo. March 23, 2010)(evidence that franchisee’s restaurants did not perform in accordance with projections insufficient, by itself, to create an inference that the projections were false when made, and that Franchisor knew they were false)

\(^{163}\) 110 F. Supp.3d at 1084.
V. FPR DUE DILIGENCE BY AND ON BEHALF OF PROSPECTIVE FRANCHISEES

In reviewing an FPR on behalf of a prospective franchisee, the following questions and issues should be pursued and addressed:

1. If the franchisor chooses not to make an FPR, try to discern from other disclosures within the FDD why this might be the case. Have the number of franchise outlets declined? Has there been a significant turnover of franchise outlets which have been the subject of terminations, non-renewals or cessation of operations? Is there a substantial pipeline of franchises that have been sold, but the outlets have not yet opened? Is there a significant amount of deferred revenue from unearned initial fees on the balance sheet of the franchisor? Has the royalty revenue on the franchisor’s profit and loss statement declined over the last three years? If the franchisor has company-owned outlets, is there sufficient detail in the franchisor’s P&L to compute the average gross sales or average gross profit of those outlets, which might provide a clue as to the performance of franchised outlets? Is there a significant amount of litigation by or against franchisees? Does the franchisor not include an FPR because the numbers would not help franchise sales? Do the FDDs of the franchisor’s principal competitors have FPRs? Visit the franchisor’s website, as well as other websites such as www.bluemaumau.org to see if there are complaints about the financial results of the franchise outlets in the system.

2. If the franchisor discloses revenue from royalties in its financial statements, divide the royalty income for each year by the number of outlets at the beginning of the year, plus the number of outlets at the end of the year, divided by two. This average (but not median) will provide a sanity check, admittedly imprecise in nature, on the reasonableness of the gross sales numbers for franchise outlets in the FPR.

3. Does the FPR contain more than gross sales? The more detailed the financial presentation, the more meaningful the review and the more valuable the information for the prospective franchisee investor. An FPR which contains a complete or even a condensed profit and loss statement is much more valuable for the creation of a business plan and a loan application by the prospective franchisee, as well as to his or her financial and business advisors. Watch for profit and loss statements based on EBITDA (earnings before interest, taxes, depreciation and amortization) or EBITDAR (earnings before interest, taxes, depreciation, amortization and rent), which some franchisees do not understand do not include financing costs or financing costs and rent, respectively.

4. Is the FPR based upon a significant and meaningful portion of the existing franchised outlets in the system? Is the sample or subset large enough to be representative? If the subset is a low percentage of the system, skeptically examine the stated rationale for the small sample. If the business is seasonal, such as ice cream or yogurt, are there any geographic differentiations within the sample represented by the FPR? Does the franchise agreement require franchisees to submit information on a periodic basis to the franchisor regarding gross sales, gross profit or net profit?

5. Does the FPR provide financial information for multiple years? In complying with the required disclosures for financial statements in Item 21, franchisors are required to provide statements of operations and cash flow for the most recent three fiscal years.164 FPRs are most

164 16 C.F.R. §436.5(u)(1)(iii).
useful when they contain multiple years of financial information so that trends, whether positive, negative or inconclusive, can be discerned. If the franchisor is registered in California, Minnesota, or Wisconsin, you may be able to get access to earlier FDDs in order discern trends.

6. Does the FPR provide information on the performance of franchise outlets during the first 12 or 18 months of operation? Consider this information, or the absence of it, in light of the additional funds disclosures in Item 7 of the FDD, which is in essence a representation of how much money the franchisee will need in order to breakeven during the initial period of time for which disclosure is made, typically 3 to 6 months.165

7. Analyze whether the FPR provides separate representations of financial performance for different formats of franchised outlets. Some systems have multiple formats of operation, such as enclosed shopping centers, strip malls, freestanding locations, kiosks, and special purpose location, such as stadiums, military bases and transportation centers, including airports, train stations and the like. It is very useful for prospective franchisees to have historical financial information regarding the specific format of franchised outlet that they intend to open.

8. Does the FPR use averages, means or quartiles in its presentations? Many prospective franchisees and their advocates find quartile presentations less than useful and in some ways misleading. As the Current Proposed FPR Commentary indicates, a mean is a much more meaningful presentation, than an average, because an average can be skewed by a few outliers.

9. If the FPR contains projections, check to make sure that all of the assumptions upon which the projections are based are included within the FPR. Projections are rarely used, and require heightened scrutiny.

10. Be on guard for cherry picking in any form. If the FPR includes the top-performing locations, does it also include the bottom-performing locations as well as an overall mean?

11. Does the FPR provide information that differentiates existing locations as to how long they have been operating? Prospective franchisees find it very useful to see whether or not revenue or profit tends to increase over time, meaning, do outlets open, say five years or more, tend to outperform outlets open for two years?

12. Does the FPR comply with the requirements of the FTC Franchise Rule, the FTC Compliance Guide, the FTC FAQs and the NASAA Commentary? This is not an idle concern. Not only does a non-compliant FPR deprive the prospective franchisee of information need to make a knowing and intelligent investment decision, but may also signal a franchisor with insufficient resources or willingness to comply with the requirements of the law. This could have an impact on the ongoing relationship between the franchisor and the franchisee, not to mention the diversion of time, energy and legal fees in dealing with allegation of franchise disclosure violation asserted by franchisees or by federal or state franchise regulators.

165 16 C.F.R. §436.5(g)(1)(iii).
VI. PRACTICAL TIPS; BEST PRACTICES

The following are some common deficiencies state examiners have noted regarding FPRs. FPR drafters are encouraged to review this list before submitting FDDs with Item 19 disclosures.

• Delete disclaimers not expressly permitted under the FTC Franchise Rule.

• Separate the franchisee data from the company-owned outlet data, except as expressly permitted by the FTC Franchise Rule and guidance regarding FPRs.

• Disclose the number and percentage of outlets whose data was used in the FPR that actually attained or surpassed the stated results.

• Revise language of the admonition that varies from the specific legend language allowed under the 2008 NASAA Franchise Commentary. ["Some outlets have earned this much. Your individual results may differ. There is no assurance that you'll earn as much."]

• Include the following statement: “Written substantiation for the financial performance representation will be made available to the prospective franchisee upon reasonable request.” [In some cases, the statement omits the word “written,” or the franchisor may omit the statement entirely.]

• Explain the reasonable basis for including the subset of outlets in the FPR. [a.k.a. Are you “Cherry Picking”?]

• Explain the reasonable basis for disclosing a subset apparently consisting of the franchisor’s best performing outlets.

• Explain the reasonable basis for making an FPR based solely on the results of a small number of company-owned outlets, when the franchisor has a large number of franchised outlets.

• The FPR does not contain sufficient data to substantiate the projection or forecast. Disclose the material bases and assumptions on which the projection is based, or delete the projection.

• Explain the reasonable basis for making an FPR based entirely on survey results received from a relatively small number of franchisees.

VII. CONCLUSION

As the subtitle of this paper implies, the evolving regulatory guidance and case law surrounding FPRs can be boiled down to a continuing search for the still somewhat elusive definition of what constitutes a “reasonable basis.” It is our hope and expectation that when issued, the final version of the FPR Commentary, will provide needed clarity and guidance for the benefit of those practitioners who draft FDDs, some safe harbors for the franchisors that they represent, additional valuable information to prospective franchisees to help them make a more knowing and intelligent decision about whether to invest, and a roadmap to those that represent prospective franchisees, and to those that evaluate potential claims on behalf of franchisees, to what is or is not proper in the preparation and presentation of an FPR.
Appendix C

Sample BELMONT FPR

Item 19
FINANCIAL PERFORMANCE REPRESENTATIONS

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: (l) 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.

This financial performance representation discloses historical information regarding the average and median end-of-year membership numbers, annual Gross Sales, annual expenses, annual EBITDAR, annual rent and occupancy costs, and annual EBITDA (all terms defined below) for 35 BELMONT Yoga Studios owned and operated by our parent and affiliated company, BELMONT Holdings, in the States of Connecticut (28) and New Jersey (7) that were open and operating for at least one full year as of December 31, 2015.

Of these 35 BELMONT Yoga Studios that were open and operating for at least one full year as of December 31, 2015, 23 of them (66%) also had been open and operating for at least 2 full years (but less than 3 full years) as of December 31, 2015, 9 of them (26%) also had been open and operating for at least 3 full years (but less than 4 full years) as of December 31, 2015, and 3 of them (9%) also had been open and operating for at least 4 full years as of December 31, 2015. As of December 31, 2015, BELMONT Holdings also operated an additional 6 BELMONT Yoga Studios in the State of Connecticut (a total of 41 BELMONT Yoga Studios were open and operating as of that date), However, the performance of those 6 additional BELMONT Yoga Studios is not included below because they had not been open and operating for at least 1 full year as of December 31, 2015. No franchised BELMONT Yoga Studios were in operation as of this disclosure document's issuance date.

The 35 affiliate-owned and operated BELMONT Yoga Studios included in this financial performance representation are substantially similar to the BELMONT Yoga Studios for which we are offering franchises in this disclosure document, and their services and products are the same as those to be offered and sold by franchised BELMONT Yoga Studios. These affiliate-owned and operated BELMONT Yoga Studios reflect the standard BELMONT Yoga Studio prototypes and a wide range of demographics and business conditions found in urban and suburban markets.

The information in the tables below shows both the historical average and the historical median end-of-year membership numbers, annual Gross Sales, annual expenses, annual EBITDAR, annual rent and occupancy costs, and annual EBITDA of all 35 affiliate owned and operated BELMONT Yoga Studios during their first full 12 months of operation, of 24 of those affiliated BELMONT Yoga Studios during their 2nd full 12 months of operation, of 9 of those affiliate owned and operated BELMONT Yoga Studios during their 3rd full 12 months of operation, and of 3 of those BELMONT Yoga Studios during their 4th full 12 months of operation.
### Average Year-End Results for BELMONT Yoga Studios Open at Least 12 Months

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total # of BELMONT Yoga Studios</strong></td>
<td>35</td>
<td>24</td>
<td>9</td>
<td>3</td>
</tr>
<tr>
<td><strong>Year-End Membership</strong></td>
<td>4,965</td>
<td>5,361</td>
<td>5,573</td>
<td>7,012</td>
</tr>
<tr>
<td>Number (%) of Studios exceeding average</td>
<td>16 (46%)</td>
<td>9 (38%)</td>
<td>4 (44%)</td>
<td>1 (33%)</td>
</tr>
<tr>
<td><strong>Gross Sales</strong></td>
<td>$1,186,184</td>
<td>$1,492,344</td>
<td>$1,584,989</td>
<td>$2,155,793</td>
</tr>
<tr>
<td>Number (%) of Studios exceeding average</td>
<td>18 (51%)</td>
<td>9 (38%)</td>
<td>3 (33%)</td>
<td>1 (33%)</td>
</tr>
<tr>
<td><strong>Personnel Costs</strong></td>
<td>$276,461</td>
<td>$281,543</td>
<td>$284,434</td>
<td>$305,455</td>
</tr>
<tr>
<td>Number (%) of Studios exceeding average</td>
<td>14 (40%)</td>
<td>8 (33%)</td>
<td>5 (56%)</td>
<td>1 (33%)</td>
</tr>
<tr>
<td><strong>Supplies &amp; Maintenance</strong></td>
<td>$35,025</td>
<td>$32,378</td>
<td>$32,961</td>
<td>$31,191</td>
</tr>
<tr>
<td>Number (%) of Studios exceeding average</td>
<td>16 (46%)</td>
<td>11 (46%)</td>
<td>4 (44%)</td>
<td>1 (33%)</td>
</tr>
<tr>
<td><strong>Utilities</strong></td>
<td>$88,104</td>
<td>$89,390</td>
<td>$78,372</td>
<td>$78,475</td>
</tr>
<tr>
<td>Number (%) of Studios exceeding average</td>
<td>18 (51%)</td>
<td>9 (38%)</td>
<td>5 (56%)</td>
<td>1 (33%)</td>
</tr>
<tr>
<td><strong>Other Studio Expenses</strong></td>
<td>$151,459</td>
<td>$190,596</td>
<td>$204,172</td>
<td>$253,477</td>
</tr>
<tr>
<td>Number (%) of Studios exceeding average</td>
<td>19 (54%)</td>
<td>10 (42%)</td>
<td>5 (56%)</td>
<td>1 (33%)</td>
</tr>
<tr>
<td><strong>EBITDAR</strong></td>
<td>$635,134</td>
<td>$898,436</td>
<td>$985,049</td>
<td>$1,487,195</td>
</tr>
<tr>
<td>Number (%) of Studios exceeding average</td>
<td>16 (46%)</td>
<td>9 (38%)</td>
<td>4 (44%)</td>
<td>1 (33%)</td>
</tr>
<tr>
<td><strong>Rent &amp; Occupancy</strong></td>
<td>$394,068</td>
<td>$576,300</td>
<td>$525,587</td>
<td>$536,270</td>
</tr>
<tr>
<td>Number (%) of Studios exceeding average</td>
<td>17 (49%)</td>
<td>9 (38%)</td>
<td>3 (33%)</td>
<td>1 (33%)</td>
</tr>
<tr>
<td><strong>EBITDA</strong></td>
<td>$241,066</td>
<td>$322,135</td>
<td>$459,463</td>
<td>$950,925</td>
</tr>
<tr>
<td>Number (%) of Studios exceeding average</td>
<td>18 (51%)</td>
<td>11 (46%)</td>
<td>4 (44%)</td>
<td>1 (33%)</td>
</tr>
</tbody>
</table>

### Annual Franchise Expenses Not Included in Table Above (assuming average annual Gross Sales) (See Note A below)

- **Royalties (5%)** | $59,309 | $74,617 | $79,249 | $107,790
- **Technology Fees ($600 monthly)** | $7,200 | $7,200 | $7,200 | $7,200
- **Brand Fund (2%)** | $23,724 | $29,847 | $31,700 | $43,116
- **Local Marketing (5%)** | $59,309 | $74,617 | $79,249 | $107,790
### Median Year-End Results for BELMONT Yoga Studios Open at Least 12 Months

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
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<tbody>
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<td>35</td>
<td>24</td>
<td>9</td>
<td>3</td>
</tr>
<tr>
<td>Year-End Membership</td>
<td>4,593</td>
<td>5,016</td>
<td>5,208</td>
<td>6,628</td>
</tr>
<tr>
<td>Gross Sales</td>
<td>$1,189,440</td>
<td>$1,369,948</td>
<td>$1,444,956</td>
<td>$1,784,977</td>
</tr>
<tr>
<td>Personnel Costs</td>
<td>$257,960</td>
<td>$263,067</td>
<td>$293,862</td>
<td>$279,570</td>
</tr>
<tr>
<td>Supplies &amp; Maintenance</td>
<td>$32,585</td>
<td>$31,610</td>
<td>$31,165</td>
<td>$28,751</td>
</tr>
<tr>
<td>Utilities</td>
<td>$88,204</td>
<td>$82,447</td>
<td>$79,581</td>
<td>$75,913</td>
</tr>
<tr>
<td>Other Studio Expenses</td>
<td>$159,085</td>
<td>$187,511</td>
<td>$220,977</td>
<td>$221,404</td>
</tr>
<tr>
<td>EBITDAR</td>
<td>$651,606</td>
<td>$805,314</td>
<td>$819,370</td>
<td>$1,179,339</td>
</tr>
<tr>
<td>Rent &amp; Occupancy</td>
<td>$385,197</td>
<td>$548,967</td>
<td>$507,263</td>
<td>$488,234</td>
</tr>
<tr>
<td>EBITDA</td>
<td>$266,409</td>
<td>$256,347</td>
<td>$312,107</td>
<td>$691,105</td>
</tr>
</tbody>
</table>

### Annual Franchise Expenses Not Included in Table Above (assuming median annual Gross Sales) (See Note A below)

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Royalties (5%)</td>
<td>$59,472</td>
<td>$68,497</td>
<td>$72,248</td>
<td>$89,249</td>
</tr>
<tr>
<td>Technology Fees ($600 monthly)</td>
<td>$7,200</td>
<td>$7,200</td>
<td>$7,200</td>
<td>$7,200</td>
</tr>
<tr>
<td>Brand Fund (2%)</td>
<td>$23,789</td>
<td>$27,399</td>
<td>$28,899</td>
<td>$35,700</td>
</tr>
<tr>
<td>Local Marketing (5%)</td>
<td>$59,472</td>
<td>$68,497</td>
<td>$72,248</td>
<td>$89,249</td>
</tr>
</tbody>
</table>

For purposes of the charts above, "Year-End Membership" means the total number of members under contract as of the end of the particular 12 months of operation (as described above), regardless of the number of members during the course of those 12 months. "Gross Sales" is comprised of monthly member dues billings, annual dues billings, start-up fees, personal training and small group training fees, day passes, contract fees, and retail, food, and beverage collections. "Personnel Costs" is comprised of all salaries, wages, benefits, workers compensation and unemployment insurance and payroll taxes. "Other Studio Expenses" includes expenses for cost of goods sold, computer, telephone, data and software costs, insurance, credit card charges, and allowance for uncollectible balances. "EBITDAR," which is an acronym for "earnings before interest, taxes, depreciation, amortization, and rent," is defined as Gross Sales minus (i) all studio cash expenses before debt repayment, (ii) leasehold improvement costs, and (iii) any financing costs and ongoing expenditures for yoga equipment or other depreciable assets. "EBITDA," which is an acronym for "earnings before interest, taxes, depreciation, and amortization," is defined as Gross Sales minus (i) all studio cash expenses before debt repayment, (ii) leasehold improvement costs, (iii) Rent & Occupancy expenses, and (iv) any financing costs and ongoing expenditures for yoga equipment or other depreciable assets. "Rent & Occupancy" expenses include all base rent and any extra charges, such as property taxes and Common Area Maintenance (CAM) paid for affiliate-owned and operated BELMONT Yoga Studios. Rent & Occupancy costs can vary widely by market. No part of EBITDAR or EBITDA reflects any Royalty, Brand Fund and local marketing contributions, or similar payment you must make under your Franchise Agreement.
A BELMONT Yoga Studio's actual Gross Sales volume may vary widely. Numerous factors will affect a particular BELMONT Yoga Studio's sales, including goodwill and name recognition in the market; length of time in business; nearby businesses; nearby working and living population; traffic count; site accessibility and visibility; the local market and competition from other health and yoga clubs; general economic conditions; the franchisee's management skill, experience, business acumen, and ability to promote and market its BELMONT Yoga Studio effectively in the local market; service levels and customer satisfaction; and the degree of adherence to our methods and procedures in operating the BELMONT Yoga Studio.

A BELMONT Yoga Studio's actual operating costs (impacting EBITDAR and EBITDA) may vary widely based on many of the same factors impacting Gross Sales. Even the chief operating costs, for example, Personnel Costs and Rent & Occupancy expenses can vary significantly depending upon the specific market and location. All 35 affiliate-owned BELMONT Yoga Studios included in this financial performance representation are located in metropolitan areas (including 7 BELMONT Yoga Studios in New Jersey), which may have higher population densities, labor costs, and rent expense than other markets across the United States in which you are interested in developing a BELMONT Yoga Studio.

We expect to provide to franchisees some of the services that our affiliates' management provides to the BELMONT Yoga Studios whose results appear above. However, we do not provide services that a BELMONT Yoga Studio's owner normally would provide, such as financing, accounting, legal, personnel/labor, construction, and management services. The availability of these services to a franchisee, as well as their cost and quality, will affect operations.

Explanatory Notes

(A) Because the BELMONT Yoga Studios whose results appear above are affiliate-owned and operated, they paid no Royalties. You must consider your Studio's required Royalty payment (currently 5% of monthly Gross Sales) as part of its expected operating expenses. The annual Royalty your Studio would have been required to pay had it achieved the average and median Gross Sales levels reflected in the tables above is identified in the tables.

These affiliate-owned and operated BELMONT Yoga Studios spent various amounts during the applicable 12-month period on advertising and marketing. Under the Franchise Agreement, we may establish a Brand Fund into which you must contribute up to 3% of your Studio's monthly Gross Sales (we do not currently collect this 3%), and you must spend at least 5% of your Studio's annual Gross Sales on local advertising and marketing. (We may require you to contribute an additional 1% of your Gross Sales to an advertising Cooperative established in your market (described in Item I); that contribution will count toward your Local Marketing Spending Requirement.) The annual Local Marketing Spending Requirement and Brand Fund contributions (had the Brand Fund been operational) your Studio would have been required to pay had it achieved the average and median annual Gross Sales levels reflected in the tables above is identified in the tables. We calculated the annual Brand Fund contributions in the tables above at a 2% contribution rate because we expect to charge 2% when the Brand Fund first becomes operational. Although we have assumed in the tables above that you will spend 5% of your Studio's annual Gross Sales on local advertising and marketing, which is the minimum requirement, we anticipate that some franchisees may elect to spend more than this amount.

These affiliate-owned and operated BELMONT Yoga Studios also spent various amounts on technology services during each 12-month period of operation. The Franchise Agreement obligates you to pay us monthly technology fees for certain technology services, including point-of-sale, data
warehousing, and Intranet support. You also will incur costs for necessary technology services obtained from other service providers. The annual technology and support services fee currently payable to us is identified in the tables above.

(B) Depreciation of leasehold improvements and equipment is not included in EBITDAR or EBITDA. To the extent leasehold improvements and equipment purchases (estimated in Item 7 of the disclosure document) are paid for and capitalized by a franchisee, these amounts are normally depreciated over the life of the lease. Our affiliate-owned and operated BELMONT Yoga Studios have depreciated Equipment over 3 to 5 years, and depreciated Leasehold improvements over 10 to 15 years depending on the lease's term.

(C) The financing, amortization, and interest costs for leasehold improvements and equipment are not included in EBITDAR and EBITDA. Similarly, amortization of the initial franchise fee and organization costs are not included.

Other Possible Differentiating Factors in Operations

Operating results of BELMONT Yoga Studios are likely to be affected by the following:

1. Differing rent and related expenses for which a franchisee is obligated;
2. Economic conditions in a franchisee's market;
3. Competition from other businesses offering the same, similar, or competitive services and products;
4. Different leasehold improvement or financing costs;
5. Different levels of employee wages, fringe benefits, and other costs; and
6. Different costs on a local basis of obtaining products and supplies.

Our management prepared this financial performance representation based on information provided by our affiliates that we believe to be reliable. This financial performance representation was prepared without an audit. Prospective franchisees or sellers of franchises should be advised that no certified public accountant has audited these figures or expressed his/her opinion with regard to their contents or form. Written substantiation of all financial information presented in this financial performance representation will be made available to you upon reasonable request.

Some BELMONT Yoga Studios have earned this amount. Your individual results may differ. There is no assurance that you will earn as much.

Other than the preceding financial performance representation, we do not make any financial performance representations. 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 our management by contacting Maharishi John Smith BELMONT Yoga Studios, 111 South Street, Hartford, CN 07177, (800) 555-1111, the Federal Trade Commission, and the appropriate state regulatory agencies.
Dale E. Cantone

Dale Cantone is an Assistant Attorney General for the State of Maryland and the Deputy Securities Commissioner for the Maryland Securities Division. Dale is the chief of the franchise and business opportunity unit of the Maryland Securities Division. In addition, Dale serves as Chair of the Franchise and Business Opportunity Committee/Project Group of the North American Securities Administrators Association, Inc. ("NASAA").

Dale has spoken at programs sponsored by the American Bar Association Forum on Franchising, the International Franchise Association, the International Society of Franchising, the American Franchisee Association, the Direct Sellers Association, the United States Department of Commerce, the Maryland State Bar Association, the Maryland Institute for the Continuing Professional Education of Lawyers, the New York Attorney General’s Office, the University of Maryland Law School, the U.S. Hispanic Chamber of Commerce, the Better Business Bureau, the International Franchise Expo, and the Coalition of Franchisee Associations. Dale also has spoken about franchise related issues to foreign delegations from Russia, Japan, China, and Romania.

In 2001, NASAA presented Dale with its Outstanding Service Award for his work in franchising at the state level. In 2002, Dale testified about state franchise issues before the Commerce, Trade and Consumer Protection Subcommittee of the Energy and Commerce Committee of the U. S. House of Representatives. In 2005, the American Association of Franchisees and Dealer awarded Dale its Total Quality Franchising Chairman’s Award for Distinguished Contributions and Service to the Franchising Community.

Eric H. Karp

Eric H. Karp serves as counsel to numerous franchisee associations and has represented franchisees throughout the country in a myriad of franchise issues.

He has been selected for inclusion in The International Who’s Who of Franchise Lawyers, as a Legal Eagle by Franchise Times, one of America’s Leading Franchise Lawyers by Chambers
USA, and a New England Super Lawyer by *Boston Magazine*.

Since 1996, Mr. Karp has served on the Franchise Project Group of the Franchise and Business Opportunities Committee of the North American Securities Administrators Association. He has been a presenter at the ABA Forum on Franchising and the IFA Legal Symposium, served as the Editor-In-Chief of *The Franchise Lawyer* from 2008 to 2010, is a member of the Forum’s Governing Committee and most recently served as its Finance Officer.

Mr. Karp served on the Board of Directors of the American Franchisee Association for ten years. He also served as Chair of the AFA Model Responsible Franchise Practices Act Committee, was the principal author of the Model Act and served as the Program Chair of the 1999 AFA Franchisee Legal Symposium. He was Co-Chair of the 2009 Annual Meeting of the American Association of Franchisees & Dealers and served on the AAFD’s Fair Franchising Standards Committee.

In June, 1994 Mr. Karp testified before the U.S. House Small Business Committee on "Self Regulation of Franchising: The IFA Code of Ethics" and was an elected delegate to the 1995 White House Conference on Small Business.

Mr. Karp is a graduate of Boston University and Boston University School of Law.

**MAX J. SCHOTT, II**

Max J. Schott, II is a principal in the Minneapolis office of Gray Plant Mooty. For more than 20 years, he has focused his practice on representing franchisors and distributors—from start-up companies to nationally-recognized franchisors with multiple brands. Max assists and counsels clients in structuring their domestic and international programs, and addressing issues of disclosure and registration, relationship matters, supply chain maintenance, advertising, licensing, and acquisitions.

Max received a B.A. in political science from Grinnell College in 1990, and a J.D., *with distinction*, from the University of Iowa College of Law in 1993. Max served as the editor-in-chief