Advanced Drafting of Financial Performance Representations:

* A Reasonable Basis *

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Disclaimer

The views expressed by Dale Cantone are his own and are not necessarily those of the Maryland Attorney General or the North American Securities Administrators Association.
What Do These Words Have in Common?

• Probable Cause
• Due Process
• Equal Protection
• Beyond a Reasonable Doubt
• Preponderance of the Evidence
• Abuse of Discretion
• Good Faith
• Fair Dealing
• A Reasonable Basis
Who Wrote These Words?

• I shall not today attempt to further define the kinds of materials I understand to be embraced within that shorthand description, and perhaps I could never succeed in doing so?

• But I know it when I see it.....

• ... and the motion picture involved in this case is not that.

• Justice Potter Stewart, concurring, Jacobellis v. Ohio, 378 U.S. 184 (1964)
FPR Commentary

- First issued October 1, 2015
- 17 comments submitted
- Current draft issued September 14, 2016
- Comment period ended October 13, 2016
- Effective date will be the later of 180 days after date of NASAA’s adoption or 120 days after franchisor’s next fiscal year end, if it has an effective FDD as of the adoption date
### Key Financial Terms - Definitions

<table>
<thead>
<tr>
<th>Defined Term</th>
<th>Minus</th>
<th>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>
Define Your Terms and Show Your Work

- Disclosure of Gross Sales Generally-Item 19.4
- Disclosure of Net Profits Generally-Item 19.5
- Identifying Source of Data Underlying FPR-Item 19.6
- Managed Outlets-Item 19.7
### Franchisee Annual Gross Sales in Thousands of Dollars

<table>
<thead>
<tr>
<th>Franchisee</th>
<th>Franchisor A</th>
<th>Franchisor B</th>
<th>Franchisor C</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>500</td>
<td>50</td>
<td>400</td>
</tr>
<tr>
<td>2</td>
<td>500</td>
<td>100</td>
<td>450</td>
</tr>
<tr>
<td>3</td>
<td>500</td>
<td>200</td>
<td>500</td>
</tr>
<tr>
<td>4</td>
<td>500</td>
<td>250</td>
<td>500</td>
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<tr>
<td>5</td>
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<td>500</td>
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<tr>
<td>6</td>
<td>500</td>
<td>750</td>
<td>500</td>
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<tr>
<td>7</td>
<td>500</td>
<td>800</td>
<td>500</td>
</tr>
<tr>
<td>8</td>
<td>500</td>
<td>900</td>
<td>550</td>
</tr>
<tr>
<td>9</td>
<td>3,000</td>
<td>950</td>
<td>600</td>
</tr>
<tr>
<td>Total</td>
<td>7,000</td>
<td>4,500</td>
<td>4,500</td>
</tr>
</tbody>
</table>

#### Averages and Medians

You can’t include one without the other.

Items 19.16 and 19.17

<table>
<thead>
<tr>
<th></th>
<th>Franchisor A</th>
<th>Franchisor B</th>
<th>Franchisor C</th>
</tr>
</thead>
<tbody>
<tr>
<td>High</td>
<td>3,000</td>
<td>950</td>
<td>600</td>
</tr>
<tr>
<td>Low</td>
<td>500</td>
<td>50</td>
<td>400</td>
</tr>
<tr>
<td>Average</td>
<td>778</td>
<td>500</td>
<td>500</td>
</tr>
<tr>
<td>Median</td>
<td>500</td>
<td>500</td>
<td>500</td>
</tr>
</tbody>
</table>
FPRs Based on Company-Owned Outlets Alone
Items 19.8, 19.9 & 19.10

<table>
<thead>
<tr>
<th></th>
<th>Only Company-Owned Outlets</th>
<th>Operational Franchise and Company-Owned Outlets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Sales</td>
<td>Yes, if...</td>
<td>No</td>
</tr>
<tr>
<td>Gross Profit or Net Profit</td>
<td>Yes, if...</td>
<td>Yes, if...</td>
</tr>
</tbody>
</table>
Gross Sales FPR
Franchisor Has Company-Owned Outlets Only
Item 19.9

• Must Have a Reasonable Basis and

• Disclose material financial and operational characteristics of company-owned outlets reasonably anticipated to differ materially from future operational franchise outlets
Gross Profit or Net Profit FPR
Franchisor Has Company-Owned Outlets Only
Item 19.10

• Must have a reasonable basis and
• Disclose actual costs incurred by company-owned outlets
• Supplemental disclosure or adjustments to reflect actual and reasonably expected material financial and operational differences between company-owned outlets and operational outlets
• Include fees and other expenditures required to be disclosed in the FDD or that are otherwise known or reasonably should have been known by the franchisor
Gross Profit or Net Profit FPR
Franchisor Has Operational Franchise and Company-Owned Outlets
Item 19.10

• Must have a reasonable basis and
• Disclose actual costs incurred by company-owned outlets
• Supplemental disclosure or adjustments to reflect actual and reasonably expected material financial and operational differences between company-owned outlets and operational outlets
• Include fees and other expenditures required to be disclosed in the FDD or that are otherwise known or reasonably should have been known by the franchisor
Limitation on Disclosure of Cost and Expense Data Outside of an FPR that Includes Gross Sales

Item 19.9

• Footnote 6 to Item 19.9 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).”

• Applies to gross sales of both franchise and company-owned outlets
Merging Data From Franchise and Company-Owned Outlets
Item 19.12

• Data must be disclosed separately
  • Taking into account differences between company-owned and franchise outlets
  • Imputing differences in costs and economies of scale
• Following separate disclosure, combined format permitted
• Merger also permitted if a small number of franchise outlets
  • Such that the identity that of the franchisees is discernible
  • Franchise and company-owned outlets have gross sales that are not materially different
  • Must represent that there are no material differences in the gross sales of franchise and company-owned outlets
Subsets Generally
Item 19.12

• Reasonable Basis

• Accurate

• Not Misleading
Best Performing Outlets
Item 19.13

• Not permitted standing alone
• Likely to be misleading
• Permitted if accompanied by corresponding subset of lowest performing outlets
Geographic Subsets

Item 19.15

• Describe how and why geographic subset selected

• May not be presented if misleading
Omission of Outlets That Have Closed When Using an Average or Median

Item 19.18

- Must disclose the following
  - If FPR includes company-owned outlets, number that closed during the time period
  - If the FPR includes franchise outlets, number that closed during the time period
  - The number of excluded outlets that closed after being open less than 12 months

- Disclosure must be for each year or other time period covered by the FPR
Clear and Specific Admonition-Substance
Item 19.23

• Franchisor may not vary the admonition in Item 19.3, advising that a new franchisee’s individual financial results may differ from the results stated in the FPR

• If the FPR is not based on sales or earnings, the language of the sample admonition may be changed, but only to the extent necessary to fit the FPR actually made
Clear and Specific Admonition-Form

Item 19.22

- Must be clear and conspicuous
- Presented in a separate paragraph
- And in bold type, for example:

“Some outlets have earned this amount. Your individual results may differ. There is no assurance that you’ll earn as much”
Clear and Specific Admonition-Additional Disclaimers

Item 19.23

• Not permitted

• Franchisor may not
  • Disclaim responsibility for the FPR
  • Advise a franchisee that it may not rely on the FPR
  • Use disclaimers that contradict/mitigate/are inconsistent with required admonition
Questions?