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TIPS, TECHNIQUES AND TRAPS FOR DRAFTING AND USING FINANCIAL PERFORMANCE REPRESENTATIONS

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I. WHAT IS A FINANCIAL PERFORMANCE REPRESENTATION?

This paper will explore use by franchisors of financial performance representations in the sale of franchises. The term "financial performance representation," or "FPR," formerly known as an "earnings claim," is defined by the Federal Trade Commission Rule on Franchising (the "FTC Rule") 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."[1]

In plain English, a financial performance representation is any statement to a prospective franchisee as to the revenues or profits they might achieve, or that others have achieved.

The FTC Compliance Guide takes this statement even further, and includes any representation either that suggests, or which allows a prospective franchisee to easily infer, a specific level or range of income, sales or profits.[2] Statements such as "make big money," or "opportunity of a lifetime," would not suggest a specific level that can be achieved, and therefore can be made to prospective franchisees without triggering any requirements related to FPRs. However, statements such as "earn enough money to buy a new Porsche," or "100% return on investment within the first year of operation," are cited as examples of financial performance representations that must, if made, be included in the disclosure document, and meet the requirements for financial performance representations.[3]

II. THE GENERAL RULE CONCERNING FINANCIAL PERFORMANCE REPRESENTATIONS

Neither the FTC Rule, nor the state franchise disclosure laws, either requires franchisors to make financial performance representations to prospective franchisees, or prohibits them from doing so. The franchise disclosure laws are loose enough when it comes to FPRs that they permit a wide variety of financial performance representations to be made, including FPRs tailored to a specific business or industry, or to a particular set of circumstances. There are only three specific rules for providing the information to prospective franchisees:

1. The franchisor must have a reasonable basis for the representation at the time the representation is made,

[1] 16 CFR § 436.1(e) (2012).

[2] FTC Amended Franchise Rule Compliance Guide at 131 (2008), http://business.ftc.gov/documents/franchise-rule-compliance-guide (then follow "Franchise Rule Compliance Guide" PDF hyperlink) ("FTC Compliance Guide").

[3] *Id.*

2. The franchisor must have written substantiation for the representation at the time the representation is made, and
3. The franchisor must state the representation in Item 19 of its franchise disclosure document.[4]

III. WHY DO THE MAJORITY OF FRANCHISORS NOT MAKE FINANCIAL PERFORMANCE REPRESENTATIONS?

Actually, the tide may be turning on this issue. Historically, reports of the number of franchisors that included financial performance representations in their franchise disclosure documents varied from a high of 35%[5] to as low as "18% to 24%."[6] However, at a meeting of the Advisory Committee to the North American Securities Administrators Association ("NASAA") Franchise and Business Opportunity Project Group (the "Project Group") held in July of this year, Dale Cantone, Assistant Attorney General of the Maryland Securities Division and Chair of the NASAA Project Group, reported that over 50% of franchisors registered in Maryland now include some type of financial performance representation in their FDD. He subsequently confirmed that number at 52%.[7]

There are, in fact, both good and bad reasons why more franchisors do not include an FPR in their disclosure documents.

1. "We do not have enough representative units open."

As indicated above, the franchisor must have a reasonable basis for the representation at the time the representation is made as a condition to making a financial performance representation. The Compliance Guide provides direction as to what constitutes a reasonable basis. It must be based on "information upon which a prudent businessperson would rely in making an investment decision."[8] However, the devil is in the details. Is one unit that has operated for a number of years a reasonable basis upon which to make an FPR? Are multiple units, each operating for less than a year, sufficient for preparing an FPR? As the Compliance Guide tells us, "the quality and quantity of information constituting a reasonable basis may vary from case to case."[9] The Compliance Guide does, however, warn that data can become out of date.[10] Thus, the shorter the period of time that is measured, the greater the risk that the measurement will not prove, with 20/20 hindsight, to be representative of the actual operating experience of the franchisor's franchisees.[11]

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[4] 16 CFR § 436.5(s)(3).

[5] FRANdata Findings, Financial Performance Representations 1 (2009), *available at* http://www.franchise.org /uploadedFiles/IFA_NEWS/FRANdata_Finding-FPR.pdf.

[6] *See* Mark C. Siebert, *Should Franchisors Use Financial Performance Representations in the Franchise Sales Process?* Franchise Times Magazine (2012), *available at* http://www.franchisechat.com/resources/should_franchisors_use_financial_performance_representations.htm.

[7] E-mail from Dale Cantone, Assistant Attorney General , Maryland Securities Division, and Chair, NASAA Franchise and Business Opportunity Project Group, to author (July 17, 2012) (on file with Charles Modell).

[8] FTC Compliance Guide at 135.

[9] *Id.*

[10] *Id.* at 88.

[11] *Id*. at 89.

When preparing projections, the Compliance Guide advises consulting with the current standards for projections issued by professional organizations such as the American Institute of Certified Public Accountants. The Guide continues, however, by telling us that as a practical matter, the following should be considered when making an FPR that is a projection of revenues or profits:

- Financial forecasts should be prepared in good faith;
- Financial forecasts should be prepared with appropriate care by qualified personnel;
- Financial forecasts should be prepared using appropriate accounting principles;
- The process used to develop financial forecasts should provide for seeking out the best information that is reasonably available at the time;
- The information used in preparing financial forecasts should be consistent with the plans of the entity;
- Key factors should be identified as a basis for the assumptions;
- Assumptions used in preparing financial forecasts should be appropriate;
- The process used to develop financial forecasts should provide the means to determine the relative effect of variations in the major underlying assumptions;
- The process used to develop financial forecasts should provide adequate documentation on both the financial forecasts and the process used to develop them;
- The process used to develop financial forecasts should include, where appropriate, the regular comparison of the financial forecasts with attained results; and
- The process used to prepare financial forecasts should include adequate review and approval by the responsible parties at the appropriate levels of authority.[12]

The Compliance Guide also advises that an FPR based on historical performance must be based on data that will "reasonably support the representation as it is likely to be understood by a reasonable prospective franchisee".[13] The Compliance Guide states that the representation would not have a reasonable basis if, in fact, only a small minority of the franchisees earned the amount shown in the FPR, or if profits were due to unusual or non-recurring conditions, or if the businesses shown used inconsistent methods for determining and reporting their profits.[14]

Unfortunately, these statements do little to answer the questions posed above as to whether there were sufficient representative units to allow one to make a financial performance representation in the first place. As the Compliance Guide states, the answers will vary from

[12] *Id.* at 135-136.

[13] *Id.* at 136.

[14] *Id.*

one circumstance to another. However, there are certainly systems that do not have enough representative units open on which to base an FPR. If, for example, there is only unit open, the franchisor is taking a risk that this single unit will, in fact, turn out to be representative of the results of others.[15] Likewise, if the only open units are in unique venues, such as non-traditional venues, they may, with 20/20 hindsight, turn out not to be representative of the results franchisees can achieve. The same is likely to be true when all the existing units are in high density locations. Similarly, if there are only a handful of units open, and their results vary dramatically, it is difficult to know whether any or all of them will be representative of what a franchisee can expect in his business. In these situations, the answer that "we do not have enough representative units open" is a valid one for not making an FPR.

2. "We have plenty of successful franchisees who can give this information to our prospects."

This too is a valid reason why some franchisors choose not to jump through the hoops necessary to provide a financial performance representation to prospective franchisees. Unfortunately, this does not typically work for relatively small systems. In addition, current franchisees may simply refuse to provide this information.[16] In addition, franchisors should be careful about steering prospects to particular franchisees. On the one hand, provided existing franchisees are not given consideration for talking to prospects, there is no legal prohibition on suggesting to prospects that they talk to specific franchisees. On the other hand, when the prospect tells her lawyer that she was told the franchisees to whom she was directed were representative of others in the system, what evidence will the franchisor have to refute the contention?

3. "We do not have reliable numbers."

As indicated above, an FPR cannot be made unless the franchisor has, in writing, "the supporting data underlying any financial performance representations at the time it makes the representation."[17] The Compliance Guide tells us that the supporting data is not necessarily limited to profit and loss statements for franchisees. It may also include market studies, statistical analyses and "other types of information that customarily are relied upon by prudent persons in making business decisions."[18] The Compliance Guide advises that this data can specifically include data from a company-owned unit, but that when this is the information used, the franchisor must "clearly disclose that the representation was based on the performance of company-owned outlets."[19] Further, the representation must take into account the differences between company-owned and franchise units, such as differences in costs of goods, differences in financial obligations (like royalty payments), and differences based on economies of scale.[20] However, if a franchisor does not have any company-owned units, and if it does not require its

[15] Section IX of this paper discusses some of the unique challenges facing start-up franchisors that make financial performance representations.

[16] In *Rocky Mountain Chocolate Factory v. SDMS, Inc.*, No. 06-cv-01212, 2009 WL 579516 (D. Colo. Mar. 4, 2009) the court rejected the franchisee's common law fraud claims and California statutory claims, both for lack of reasonable reliance. In this case the franchisee sought financial information from four or five current franchisees before signing the franchise agreement, but in each case the current franchisees failed to provide this information.

[17] FTC Compliance Guide at 137.

[18] *Id.*

[19] *Id.*

[20] *Id.*

franchisees to report sales information (and cost information as well if the FPR will be a statement of profit, as opposed to simply a statement of revenues), then the franchisor would not have reliable numbers on which to base a financial performance representation as to profitability of units in its system.[21]

4. “We have reliable numbers, but they are not very good.”

This is certainly a valid reason for not presenting a financial performance representation to prospective franchisees. However, the authors would suggest that this might be an even more compelling reason to consider whether it is time to suspend selling franchises entirely.

5. “Our franchises sell themselves.”

For the handful of franchisors that can make this statement, there may be no compelling reason to provide financial performance representations.

6. “My attorney told me not to do so.”

Unfortunately, this is the reason given by many franchisors. It seems that many attorneys fear that by making a financial performance representation, the franchisor will expose itself to liability. In fact, the opposite may be true. We are reminded of a statement made at an ABA Franchise Forum workshop a number of years ago by J. Michael Dady, a prominent franchisee attorney. Mr. Dady said:

> “The first thing I ask to see when a prospective franchisee client comes to my office is the offering circular they received. I immediately turn to Item 19. If they have no earnings claim, I take the case. Because I know they gave him something.”

Contrary to Mr. Dady’s final statement, we do not assume that franchisors routinely provide financial performance representations outside of a disclosure document. However, Mr. Dady’s admonition should be instructive to those who fear that including an FPR in Item 19 could lead to litigation. In fact, the converse could be true; we would suggest that even absent a requirement that the numbers be included in Item 19 if they are to be provided at all, a franchisor is more likely to be protected, even from claims of misrepresentation, if the numbers are included in the FDD. For one reason, inclusion of the numbers in the FDD more likely assures an attorney and/or accountant will vet them. Perhaps even more importantly, a disclosure made in Item 19 of an FDD is far more likely to be made in a context that includes all the assumptions and appropriate disclaimers that protect a franchisor from liability, than if it could legally be provided outside the disclosure document.

[21] While the FTC Compliance Guide mentions market studies, studies showing sales of competitive systems, operating in the same industry, may not be representative of the sales a franchisee can expect to achieve, especially if one is comparing a national chain, backed by hundreds of millions of dollars of marketing money, to a start-up system that has limited resources for marketing. In some industries, however, market studies showing, for example, information such as occupancy rates and occupancy levels in surrounding hotels, contain valuable information that is often provided to prospective franchisees as part of a financial performance representation.

IV. INCLUSION OF FINANCIAL PERFORMANCE INFORMATION IN ITEM 19; EXCEPTIONS

The FTC Rule clearly provides that any financial performance representation must be set forth in Item 19 of the franchise disclosure document.[22] It is a violation of the Rule for a franchisor, or any person involved in the sale of a franchise, to make a financial performance representation that is either not included in Item 19 or that is inconsistent with what appears in Item 19. There are, however, a number of exceptions to this general rule.

A. Disclosure of Actual Operating Results of a Specific Unit

The FTC Rule allows a franchisor to disclose the actual operating results for specific outlets being offered for sale, without complying with the requirement that the information be included in the FDD.[23] However, this information can only be given to potential purchasers of that particular outlet,[24] and cannot be distributed broadly to all prospective franchisees. Moreover, if this outlet was previously owned by franchisees, then pursuant to Item 20 of the FTC Rule, the franchisor must provide additional information to prospective purchasers of that unit. The additional information includes the identity of each previous owner, the time period when each previous owner controlled the outlet, the reason for each previous change in ownership, and the time period or periods during which the franchisor had control of the outlet.[25]

B. A "Supplemental FPR"

One of the little used exceptions to the rule that financial performance representations must be included in Item 19 of the FDD relates to "supplemental financial performance representations."[26] This is a representation about a particular location or variation. Thus, for example, if a prospective franchisee is looking at a particular proposed site, it is possible for the franchisor to provide a projection for that particular site. As another example, if the franchisor were offering a franchise to a prospective franchisee with a non-traditional location, or even a non-traditional franchise offering limited products or services, it would be permissible to prepare a supplemental financial performance representation for prospective franchisees considering this particular variation, without amending the FDD.

The first condition to the ability of a franchisor to present a prospective franchisee with a supplemental financial performance representation is that the franchisor must already include a general financial performance representation in Item 19 of the FDD. One might suggest as a practice tip to practitioners, that if there is any likelihood a franchisor's sales people may want to provide a supplemental financial performance representation to prospective franchisees, this is a strong reason to include an FPR in Item 19 of the FDD.

A supplemental financial performance representation must also always be in writing, explain how it differs from the FPR included in Item 19, and otherwise be prepared in accordance with the requirements of 16 CFR 436.5(s)(3)(i)-(iv), which will be discussed later in

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[22] 16 CFR § 436.5(s)(3).

[23] *Id.* § 436.5(s)(4).

[24] *Id.*

[25] *Id.* § 436.5(t)(6).

[26] *Id.* § 436.5(s)(5).

this paper. Perhaps this last requirement is the reason more franchisors do not use a supplemental financial performance representation; care must be taken to assure that the FPR otherwise complies with the requirements of Item 19, the same as if it were included in the disclosure document. Unfortunately, sales people who might want to use a supplemental FPR may not welcome the opportunity to interface with legal counsel in order to present such a document. Nevertheless, the exception for supplemental financial performance representations gives franchisors significant flexibility in being able to present information of interest to a single prospective franchisee, or small group of prospective franchisees, and is a technique that should be considered more often by franchisors.

C. Information Not Provided to Prospective Franchisees in Connection With the Offer or Sale of a Franchise

Not every statement a company may make concerning sales or profits of its business is a financial performance representation. Turning back to the definition of a financial performance representation, a key and often overlooked provision is that an FPR is a representation made "to a prospective franchisee." Indeed, there are other persons to whom franchisors may make statements regarding sales or profits of individual units.

1. Public Company Disclosures

Public companies are required to file financial information with the Securities and Exchange Commission, and much of that information either directly provides, or can be extrapolated to provide, information as to average revenues and profits of the individual units. However, so long as this information is not provided directly to prospective franchisees, it is not a financial performance representation.[27] While "best practices" might suggest that franchisors should also be counseled not to direct prospective franchisees to this information, the fact is that this is public information that is readily available to anyone having a computer and Internet access.

2. Statements Made to Lenders and Bankers

Prospective lenders will often ask franchisors, either directly or through their prospective borrower, for information concerning historical results of the franchise system, and possibly even a projection aimed at the particular location under consideration by the franchisee. If this information is given directly to a lender, and not "to a prospective franchisee," it is not covered by the prohibition on providing financial performance representations outside the FDD "to a prospective franchisee." However, information cannot be provided to the prospective franchisee to provide to its lender, nor can the information be provided to the lender as a subterfuge for providing information to prospective franchisees.[28]

As a practice tip, franchisors should make very clear, on the face of any financial information provided to lenders, that the information is provided only to the lender, at the lender's specific request, and should not be provided to prospective franchisees. "Best practices" would also suggest the financial information be accompanied by a cover letter

[27] FTC Compliance Guide at 133.

[28] *See* Informal FTC Staff Advisory Op. 97-3, Bus. Franch. Guide (CCH) ¶ 6,483 (February 4, 1997), advising that the delivery of earnings information to a prospective franchisee to deliver to a lender did constitute an improper earnings claim.

confirming that the information was prepared at the request of the lender. The letter should explain that it would be a violation of the law for the franchisor to provide the information to the prospective franchisee, and that the lender should maintain the information in confidence and not provide a copy to its prospective borrower.

3. Statements in and to the Press

Very few companies shun free publicity, and it is not unusual for companies to tout their numbers in speeches, press releases and interviews. So long as these materials are not specifically directed to members of the public interested in purchasing a franchise, these statements can be issued without concern that they might be read by a prospective franchisee.[29] The fact that people who might be interested in purchasing a franchise might find the information on their own does not make it a financial performance representation.

4. Information Provided to Existing Franchisees

Many franchisors also provide comparative financial information to existing franchisees as a service to them in connection with the operation of their business. Such information gives franchisees benchmarks against which they can compare their own performance, and can be very valuable, for example, in understanding when costs are out of line, or sales are below averages in their market. The routine provision of such information in the ordinary course of business does not make such information a financial performance representation, even though existing franchisees may also be candidates for future franchises.

5. A Word of Caution

There is, however, one very significant caution to all of the foregoing. The conclusion that none of the foregoing represents a financial performance representation changes as soon as that information is "republished" to prospective franchisees. Thus, if this information is included in a brochure that is given to prospective franchisees, the FTC Rule is triggered because this is now a representation made specifically "to a prospective franchisee." Likewise, if a franchisor reprints an article that contains financial information concerning sales or profits, and provides the reprint to prospective franchisees, it has now made a financial performance representation that is governed by the FTC Rule.

This caution can be particularly sensitive when dealing with existing franchisees. As suggested above, there would be nothing improper about a franchisor's president opening a company's national franchise convention with information as to the record sales levels achieved in the system in the prior year. However, if the president's next sentence is that existing franchisees should therefore seek out the franchisor's development team at the convention to explore opportunities for new stores, then that same statement could be deemed a statement made to a prospective franchisee, and therefore be subject to the rules concerning financial performance representation. The distinction may seem to be form over substance, but a tip for practitioners is to urge that when financial information of this nature is presented, it be presented in a context that is outside the sale of franchises.

[29] FTC Compliance Guide at 132.

D. Cost Information

In a change from the prior FTC Rule, under the amended FTC Rule the provision of cost information is not considered a financial performance representation. Thus, a disclosure of the costs associated with the franchise opportunity could be made separate from a disclosure document without violating the FTC Rule.[30] However, the Compliance Guide to the amended FTC Rule states that cost data coupled with sales or earnings figures from which a prospective franchisee can readily calculate net profits constitutes a financial performance representation.[31] For this reason providing information on operating costs as a percentage of sales will constitute an improper financial performance representation unless the information is disclosed in Item 19.[32] Franchisors should be aware, however, that the provision of any variable cost information, such as stating labor costs as a percentage of sales, implies a sales figure and therefore is considered a financial performance representation.

E. Other Information that Does Not Suggest Any Level of Sales or Profits

Apart from cost information, other numbers may be of interest to prospective franchisees that can be provided without concern as to the requirements for financial performance representations. Unless a number suggests a level of sales or profits, it is not a financial performance representation. However, this is another area in which franchisors and their sales team need to be careful. A couple of examples are illustrative.

In the restaurant business, customer counts are very important to seasoned operators. Providing information that a system's restaurants average 100 customers an hour does not suggest a level of sales or profits. Likewise, the concept of "average check" is an important concept to seasoned restaurant operators. Knowing that the average customer spends $10 for lunch and $15 for dinner would be important information to a seasoned restaurateur. That information also does not suggest any sales or profit levels. On the other hand, the provision of information as to both customer counts and average check certainly allows an average third grader, much less a seasoned restaurateur, to compute average revenues, and the provision of those sets of information outside Item 19 of the FDD would be improper.

Pricing information, in and of itself, also would not be considered a financial performance representation. After all, any consumer can look at a menu, or make a telephone call to the business, to learn not only suggested retail prices, but also discounts offered by a typical unit. The provision of such information therefore should not be considered a financial performance representation. On the other hand, if, for example, a membership-based business told prospective franchisees that their average unit charges $59 a month for memberships and that the average unit has 500 members, the two figures combined would constitute a financial performance representation because the two numbers together do suggest a level of sales.

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[30] The foregoing is not, however, the case in Maryland and California, which include cost information within the definition of a financial performance representation. *See* Md. Code Regs. § 02.02.08.13(C) (2012); Cal. Code Regs. tit. 10, § 310.114.1(6) (2010).

[31] FTC Compliance Guide at 131.

[32] *See* W. Michael Garner & Earsa R. Jackson, *Litigating Unlawful FPR's and Practical Tips for Doing So*, in ABA FORUM ON FRANCHISING W8, 12 (2010) at 5 [hereinafter Garner & Jackson], *available at* http://www2.americanbar.org/calendar/forum-on-franchising-annual-meeting-2010/Documents/W8.pdf; FRANCHISE AND BUSINESS OPPORTUNITIES PROJECT GROUP, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, COMMENTARY ON 2008 FRANCHISE REGISTRATION AND DISCLOSURE GUIDELINES 8 (2008), *available at* http://www.nasaa.org/industry-resources/corporation-finance/franchise-resources/.

Each industry will have its own specific benchmarks that are important to sophisticated franchise purchasers. Franchisors should consider the extent to which such information can be presented without inferring any particular level of sales or profits. At the same time, this is a situation where the franchisor needs to have control of the sales process because the provision of one figure in one conversation, and another figure in another conversation, could indeed be sufficient to allow prospective franchisees to infer sales or profit numbers. In that scenario, the provision of such information would be a financial performance representation that must be included in a disclosure document, if it is to be provided to prospective franchisees.

F. Information Provided in an Exempt Transaction

If a franchise transaction is exempt under the FTC Rule, that transaction would also be exempt from the requirements for financial performance representations under the FTC Rule. However, unless and until the states adopt the same exemptions as are found in the FTC Rule, the federal exemption does not exempt the franchisor from requirements under state law with respect to financial performance representations.

On the other hand, many of the transactions exempt under the FTC Rule, particularly those involving significant franchisee investments, involve franchisors that meet the large franchisor exemptions available under a number of state disclosure laws. These franchisors must still be careful, however, because the large franchisor exemption under state laws in Illinois,[33] Maryland,[34] Michigan,[35] Rhode Island,[36] South Dakota,[37] Virginia,[38] and Washington,[39] is only an exemption from registration, and a timely disclosure document, otherwise complying with the requirements of the FTC Rule, must still be provided.

In three states, franchisors meeting the large franchisor exemption are exempt from providing disclosure documents, but that still does not mean they are free to provide financial performance representations free of any government restriction. For example, a franchisor with an audited net worth of over $5 million that has at least 25 franchisees conducting the business that is the subject of the franchise and that makes certain limited disclosures to franchisees, and files an appropriate notice with the California Corporations Commissioner, is exempt from both the registration and general disclosure provisions of the California Franchise Investment Law.[40] However, if any "statement of estimated or projected franchisee earnings" is provided, then the written information provided must include "a statement of such estimation or projection and the data upon which it is based."[41] Indiana[42] and North Dakota[43] have similar provisions.[44]

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[33] 815 Ill. Comp. Stat. § 705/8 (2011).

[34] Md. Code Regs. § 2.2.8.10(D) and (H) (2012).

[35] Mich. Comp. Laws § 445.1508 (2012).

[36] R.I. Gen. Laws § 19-28.1-6(4) (2011).

[37] S.D. Codified Laws § 37-5B-13 (2011).

[38] 21 Va. Admin. Code § 5-110-75(3) (2011).

[39] Wash. Rev. Code § 19.100.030(4)(b)(i) (2011).

[40] Cal. Corp. Code § 31101 (West 2012).

[41] *Id*.

[42] Ind. Code Ann. § 23-2-2.5-3 (West 2012).

[43] N.D. Cent. Code § 51-19-4(1) (2011).

V. GENERAL MEDIA CLAIMS

Note that in the earlier definition of a financial performance representation, "a representation in the general media" was subsumed within the definition of a financial performance representation, and thus must meet the requirements for financial performance representations, including the requirement that the information be contained in Item 19 of the FDD. The Compliance Guide confirms the term "general media" is to be read broadly, and includes all forms of advertising, radio, television, magazines, newspapers, billboards, and electronic advertisements such as those placed on a franchisor's website or on a third party website.[45] Likewise, unsolicited mailings are included within the term "general media," and therefore any information as to revenues and profits that are included in such mailings is governed by all the requirements for financial performance representations contained in the FTC Rule. To leave no stone unturned, the Compliance Guide even includes in the definition of a general media representation email responses to franchise inquiries.[46]

An FPR made in the general media is subject to the same requirements that apply to all financial performance representations. In addition, an FPR in general media must state:

- The number and percentage of outlets from which supporting data for the representation were gathered that actually attained or surpassed the representative level of financial performance;
- The time period when the performance results were achieved; and
- A clear and conspicuous admonition that a new franchisee's results may differ from the represented performance.[47]

However, as noted above[48] a statement in the media is only subject to these rules if it is directed to prospective franchisees. These rules do not apply to a press release, interview or quote in a general publication that is not "republished" to prospective franchisees.

The foregoing suggests that merely copying a single statement from the disclosure document and placing it in an advertisement will not meet the requirements of the FTC Rule, as it would not have included the items set forth in the foregoing bullets. To date, there are no reported cases of any enforcement action being taken when an FPR made in Item 19 is repeated in a "general media claim," but is not accompanied by all the foregoing additional statements. Care should always be taken, however, to assure that statements from Item 19 are not taken out of context. Best practices would therefore suggest that including the information specified in the Compliance Guide is the best way to assure the information would be found to comply with the law, with appropriate context given to it.

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[44] The only state that exempts large franchisors from all disclosure requirements with respect to financial performance representations is New York. In that state, the disclosure requirements are limited to providing the franchisor's principal business address and the name and address of its agent in New York authorized to receive service of process. N.Y. Gen Bus. Law § 684(3)(a) (McKinney 2012).

[45] FTC Compliance Guide at 132.

[46] *Id.*

[47] *Id.* at 133.

[48] *See* Note 29 and accompanying text, *supra*.

The Compliance Guide provides that any franchisor making a general media claim that contains any financial performance information must "at the very least" furnish any prospective franchisees with the required Item 19 disclosures while the advertisement is running.[49] The Compliance Guide further provides that once the franchisor stops running the advertisement, "it nonetheless must continue to disclose information required by Item 19 for a reasonable period of time thereafter," suggesting that a reasonable period of time "is not less than six months."[50] The foregoing would not, however, seem to preclude a franchisor from updating an Item 19 disclosure within six months after it has ceased using the general media claim and, in fact, the law would require such an update in the event there were material changes, rendering the initial numbers out of date.[51] Further, an additional "best practice" would suggest that a general media claim containing a financial performance representation always caution readers that additional information concerning the statement can be found in Item 19 of the FDD.

VI. PREPARING CREATIVE FINANCIAL PERFORMANCE REPRESENTATIONS

A. <u>FTC Rule Requirements</u>

The FTC Rule does not describe a specific format for presentation of financial performance representations. This gives franchisors flexibility to provide a wide variety of information to prospective franchisees. The information can be historic information as to past results, or projections of future results. It can be limited to revenue information, or even ranges of revenue within the system. It can be limited to gross profit information.[52] It can be limited to key factors that will allow franchisees to prepare their own projections. And, of course, it can provide complete profit and loss information. Some franchisors may want to provide a number of financial performance representations, based on various assumptions. For example, information might be provided that is based on a unit offering all of the franchisor's approved products and services, and separate information aimed at a more limited offering (such as for a food service unit open only limited hours, or able to serve only a limited menu). Creative subsets can be disclosed, based on differing locations that might be available.

Franchisor counsel will need to caution franchisors that supply information based on creative subsets to avoid the trap of "cherry-picking" positive sales and profit results while minimizing negative results. The FTC states in the Statement of Basis and Purpose for the Amended Franchise Rule that the substantiation requirements of Item 19 are designed to ensure that franchisors disclose how they derived the performance results of subgroups to enable prospective franchisees to assess the sample size and the number of franchisees responding. The FTC further states that the franchisor must disclose material differences between the units reporting information and the unit offered for sale to help prospective

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[49] FTC Compliance Guide at 134.

[50] *Id.*

[51] 16 CFR § 436.9(c); *see also* FTC Compliance Guide at 134, stating that updated information "is clearly more material to a prospective franchisee than older, perhaps stale, and possibly misleading information."

[52] Franchisors registered in California are required to include the following additional statement in their disclosure document when their financial performance representation does not include either costs of sales or operating expenses: "The earnings claims figure(s) does (do) not reflect the costs of sales, operating expenses or other costs or expenses that must be deducted from the gross revenue or gross sales figures to obtain your net income or profit. You should conduct an independent investigation of the costs and expenses you will incur in operating your (franchised business). Franchisees or former franchisees, listed in the offering circular, may be one source of this information." Cal. Code Regs. tit. 10, § 310.114.1(c)(9) (2010).

franchisees avoid drawing unreasonable inferences from the data.[53] These requirements are intended to discourage franchisors from over emphasis on positive results that may not be representative of the system.

This section will address some of the more creative financial performance representations the authors have seen, short of complete profit and loss statements. However, regardless of the representation that is made, there is still some basic information that must be included in every financial performance representation. That information is set forth below, quoted from the FTC Rule.

> "The franchisor must . . . disclose the following:
>
> (i) Whether the representation is an historic financial performance representation about the franchise system's existing outlets, or a subset of those outlets, or is a forecast of the prospective franchisee's future financial performance.
>
> (ii) If the representation relates to past performance of the franchise system's existing outlets, the material bases for the representation, including:
>
> A. Whether the representation relates to the performance of all of the franchise system's existing outlets or only to a subset of outlets that share a particular set of characteristics (for example, geographic location, type of location (such as freestanding versus shopping center), degree of competition, length of time the outlets have operated, services or goods sold, services supplied by the franchisor, and whether the outlets are franchised or franchisor-owned or operated).
>
> B. The dates when the reported level of financial performance was achieved.
>
> C. The total number of outlets that existed in the relevant period and, if different, the number of outlets that had the described characteristics.
>
> D. The number of outlets with the described characteristics whose actual financial performance data were used in arriving at the representation.

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[53] Disclosure Requirements and Prohibitions Concerning Business Opportunities: Statement of Basis and Purpose, 72 Fed. Reg. 15444-01, 15,499 (March 30, 2007) [hereinafter Statement of Basis and Purpose] (to be codified at 16 C.F.R. Parts 436 and 437).

E. Of those outlets whose data were used in arriving at the representation, the number and percent that actually attained or surpassed the stated results.

F. Characteristics of the included outlets, such as those characteristics noted in paragraph [A. above], that may differ from those of the outlets that may be offered to a prospective franchisee.

(iii) If the representation is a forecast of future financial performance, state the material bases and assumptions on which the projection is based. The material assumptions underlying a forecast includes significant factors upon which a franchisee's future results are expected to depend. These factors include, for example, economic or market conditions that are basic to a franchisee's operation, and encompass matters affecting, among other things, a franchisee's sales, the cost of goods or services sold, and operating expenses.

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

(v) A statement that written substantiation for the financial performance representation will be made available to the prospective franchisee upon reasonable request.[54]

As a practice tip, we would add one other requirement. Include, as footnotes or otherwise, information as to any assumptions that were made in the numbers that were presented. For example, if the FPR is a profit and loss statement showing rent of $36,000 per year, state that the rent assumes X square feet of space leased, and a rental of $Y per square foot per month. That way, if a franchisee is looking at, for example, leasing 3,000 square feet, when the franchisor recommends 2,000, and paying $20 per square foot, when the franchisor's units average $15 per square foot, the franchisee will clearly have before him sufficient information to understand how his results are likely to vary from the results set forth in the FPR. Likewise, if the FPR is based on a subset of franchisees, the franchisor must adequately disclose the characteristics of the subset and explain the excluded units, so that prospective franchisees can clearly take their own factors, apply them to the numbers shown, and understand what changes the franchisees might have to make in order to have the information be relevant to their situation. The inclusion of this detailed information will also assist franchisees who use information from the FPR in building their business plan and in making applications to lenders.

The purpose of carefully setting forth the assumptions made by the franchisor is twofold. Franchisee advocates may suggest this information is given in order to avoid liability to franchisees who do not achieve the results shown in the financial performance representation.

[54] 16 CFR § 436.5(s)(3).

That is absolutely one purpose. The other purpose, however, is to prevent franchisees from being misled in the first place. The more information that can be provided to prospective franchisees, particularly when they are looking at numbers that presumably show a successful business, the more likely they are to understand and appreciate the many factors that go into a successful business, and thus evaluate whether this is an appropriate investment for them. Long-term, we would maintain that it is in everyone's best interest that franchisees are not misled, intentionally or unintentionally, by any information they receive, and the more explanation and yes, disclaimers (a subject that will be discussed later in this paper), the better for everyone.

B. Nontraditional Financial Performance Representations

While the most common form of financial performance representation is a profit and loss statement, and perhaps even a "low" and "high," or "low, middle and high" examples, there are many situations in which that information is either not helpful to prospective franchisees (if their cost structures will vary differently from one location to another), or simply not available to franchisors (in part, because franchisee financial records are not always uniform). In these situations, other information may be more helpful, and this section will provide examples of some creative financial performance representations.

1. Sales Information

A number of companies only provide sales information to prospective franchisees. Burger King Corporation ("BKC") has one of the more extensive disclosures of sales information that we have seen. In the Burger King system, there are traditional, freestanding locations, and there are nontraditional locations, such as those located within shopping malls and food courts. BKC provides information on both types of locations, giving franchisees information as to the percentage of the restaurants operated in each type of location that achieved the various results shown, as well as mean average sales, median average sales, high annual sales and low annual sales. A copy of this page of the BKC FDD from April 2012 is reproduced in Attachment 1 to this paper:[55]

2. Gross Profit Information

The next logical step beyond merely providing sales information would be to provide gross profit information. This disclosure will be particularly beneficial for franchisors that have a gross profit experience higher than is typical in their industry. Several good arguments favor limiting actual or projected numbers to gross profits. Franchisors must collect considerably more information to obtain net profit information, increasing the risks to the franchisor if it does not receive timely and accurate information from its franchisees. Actual or projected gross profit information may be very beneficial for prospective franchisees in their decision making process. In many systems gross profit is determined by subtracting inventory and direct labor costs from sales. For example, a restaurant franchise may calculate gross profits by subtracting food and direct labor costs from sales. It is not unusual for these two items to exceed fifty to sixty percent of sales. Not only are they the largest cost elements, they often are the elements most controllable by a good operator.

[55] BKC also includes sales distribution information for fuel co-branded restaurants in their franchise disclosure documents.

Attachment 2 to this paper is an example of an FPR that shows gross sales information, and selected additional data. It is taken from the April 1, 2012 FDD used by Bach to Rock, a music school franchise that utilizes a distinctive teaching method based on the principle that music instruction is most effective when conducted in a socially interactive environment. As the notes which follow the numbers explain, the representation is not intended as specifically a statement of gross profit or gross margin, but rather, it provides information on sales and direct costs that are of greatest concern to prospective franchisees. (As with most of these examples, many of the footnotes in the information in the attachment have been eliminated, as the issues shown in the footnotes are addressed elsewhere in this section.)

3. <u>Key Statistics</u>

There are some businesses in which there are key statistics that are more important to prospective franchisees than any other information, because those statistics will allow prospective franchisees to prepare their own projections, based on their own cost structure. An example is a business that principally relies on monthly membership dues for its revenues. This would include fitness centers, massage businesses, tanning salons, and no doubt others. In these systems, the best comparison of systems, and the best information that could be provided to independent operators considering converting to the franchise system, is not revenue numbers (membership fees often vary by market and can be researched by prospective franchisees independently of the franchisor), but membership numbers. While these numbers may not, by themselves, provide revenue or profit information to prospective franchisees, as discussed earlier, they may nevertheless constitute an FPR when they allow prospective franchisees to infer a top-line revenue number.

The hotel industry presents another example of a creative financial performance representation that relies on key performance numbers. If someone is looking at opening a hotel, information as to average hotel revenues in the system is of little or no benefit to a prospective franchisee because revenues from hotels will vary dramatically depending on the number of rooms, location, and other services offered at the hotel. The same is true for profit information. However, there are other numbers that are critically important, such as average room rates in the system, average occupancy percentage, "RevPAR" (revenues per available room), contribution to occupancy from the system's frequent stay program, and contribution to occupancy from the system's reservation system. Thus, most hotel systems provide this type of information to prospective franchisees in Item 19 of their franchise disclosure document. The Compliance Guide indicates that the FTC specifically chose the broader term "financial performance representation" over the prior term "earnings claim" in part to make clear that the term encompasses variables such as occupancy room rates.[56]

Attachments 3 and 4 show examples of franchisors that provide key statistical information to prospective franchisees from which a prospective franchisee can generate its own historic or projected numbers. Attachment 3 is taken from the April 2012 FDD issued by Anytime Fitness, a system with over 2,000 clubs throughout the world. That franchisor uses Item 19 to present membership statistics to prospective franchisees that allow prospective franchisees to prepare their own pro forma profit and loss calculations. Attachment 4 comes from the March 2012 FDD issued by the Snip-its system, a children's hair salon franchise. It gives prospective franchisees information as to haircuts performed per location in both

[56] FTC Compliance Guide at 85, n.16.

franchised and affiliate-owned salons, which again should allow prospective franchisees to prepare their own projections.

Each franchisor should ask itself whether there are key performance numbers in its business, or in its industry, that would be important to prospective franchisees. If there are, and they can lead prospective franchisees to revenue or profit information, it may be beneficial to include these statistics in Item 19, and presented in a manner that complies with the requirements for FPRs.

4. <u>FPR Combining Franchisee Sales with Franchisor Costs</u>

Franchisors that have systems in place to receive accurate sales information from franchisees, but do not receive cost information, or have concerns regarding the reliability of franchisee cost information, may want to consider combining the franchisees' sales numbers with the cost information from company operated units. Such an approach enables the franchisor to combine sales data from its franchisees, which will be of great interest to prospective franchisees, with the inherently more reliable cost data provided by company locations. Franchisors using this approach must ensure that their bases and assumptions fully disclose the sources of sales and cost information used in the projection and accurately reflect the basic differences between cost information derived from company rather than franchised locations.

In addition, practitioners should recognize that any actual or projected information involving net profits may vary significantly within a franchised system based on a variety of factors unrelated to operation of the franchised units, including the form of entity used by the franchisee, the franchisee's debt structure and its depreciation and amortization practices. Franchisors that provide net profit information will want their financial performance representations to present historical earnings or projections that focus primarily on operating or cash flow results. For this reason, franchisors who use net profit information should seriously consider using a net profit number that provides earnings before items such as interest, taxes, depreciation and amortization are included – commonly known as EBITDA. The example found in Attachment 5 to this paper, taken again from Item 19 of the April 2012 Anytime Fitness Disclosure Document, gives an example of how franchisee revenue information might be combined with franchisor cost information to produce net profits before interest, taxes, depreciation, amortization, and even owner salary. Note also that there are explanations both before the numbers themselves, and following the numbers, in the form of "Notes and Assumptions" that explain not only the source of the numbers, but the various assumptions that were made, including adjustments made to historical information. All of these should not only protect the franchisor against claims that a franchisee was misled, but more importantly, are designed to keep prospective franchisees from being misled in the first place.

5. <u>Conversion Franchises</u>

For franchise systems that focus on conversion of independent locations (or, setting aside non-competes and tortious interference issues, which are beyond the scope of this paper, conversion of franchisees from other systems), the most important information that can be provided to prospective franchisees is information as to sales increases, or "sales uplift" achieved immediately following conversion of the business. For example, a financial performance representation that tied specifically to the average percentage sales increases seen in the first year following conversion among new franchisees who converted their existing businesses in the last two or three years, would be of significant interest to prospective franchisees. This percentage would not, in and of itself, state the level of sales that a prospective franchisee could expect to generate. However, it would still be considered a financial performance representation because it would tell a particular prospect, who certainly knows his or her own historic sales levels, a level of sales that could be achieved if they were an average first year franchisee in the system.

VII. RECENT ISSUES WITH THE STATES; COMPLAINTS FROM FRANCHISORS AND COMPLAINTS FROM REGULATORS

In preparing this paper, the authors asked state regulators for some of their experiences or "horror stories" in reviewing financial performance representations. Many of those stories involve FPRs that simply would not have met the requirements discussed earlier in this paper. For example, we cautioned earlier that franchisors must "avoid the trap of 'cherry-picking' positive sales and profit results while minimizing negative results." Alicia Brown, Senior Accountant with the Franchise Section of the New York Attorney General's Office, mentioned a system having 16 stores at the end of 2010 and 40 stores at the end of 2011, that generated an FPR using the results of a single store. In another example, Theresa Leets, Senior Corporations Counsel for the California Department of Corporations, reported on a franchisor that prepared an FPR based on a single company-owned location, which included the following line: "No franchises were operating in 2011 for very long, and none of their results were similar to those of the [affiliate-owned] location." Moreover, the FPR, which was rejected, attempted to provide a range of sales information, without indicating the actual sales information of the affiliate location.

Reports from practitioners as to recent issues raised by the States follow.

1. Use of Company-Owned and Affiliate Information.

At one point, there were some states questioning whether a franchisor could use financial information prepared exclusively from company-owned (or affiliate-owned) locations in preparing an FPR. The FTC initially attempted to address this issue in question 8 of its Frequently Asked Questions to the FTC Rule.[57] The question notes that the Amended FTC Rule deleted the express permission under the previous guidelines to use performance results of substantially similar businesses of affiliates. It then asks whether the FTC Rule now prohibits the use of performance claims based on affiliates. The FTC responded by first addressing the use of affiliate information versus company-owned information, stating that when a franchisor has adequate performance data of its own upon which to base a performance representation, basing the FPR on affiliate information likely would not be considered reasonable.[58] However, the FTC continued by stating that the Amended FTC Rule did allow franchisors to use affiliate information as a basis for performance claims when the franchisor lacked an adequate operating experience of its own. Thus, for franchisors that operate company-owned units, it is clear that (i) these results may form the basis of an FPR, and (ii) the results of these units are preferable to using results of units operated by affiliates. Moreover, for franchise systems that operate all company-owned units through affiliates, FAQ No. 8, which was actually intended to refer to affiliates operating similar concepts under other trademarks, would seem to make clear that the affiliate information may be used in preparing an FPR.

[57] Amended Franchise Rule FAQs, No. 8, http://www.ftc.gov/bcp/franchise/amended-rule-faqs.shtml (last visited July 6, 2012).

[58] *Id.*

This does not mean that a franchisor is free to use all historical company-owned or affiliate information. The units from which the information is taken, and the results, must still be representative of the results the franchisor would expect could be achieved by franchisees. Moreover, the franchisor is not necessarily free to use that information without explanation. Indeed, Theresa Leets reported that her chief concern in this area was the use of historical financial information from affiliates or company-owned units that did not have the same expenses as a franchised unit, citing specifically the ongoing royalties that must be paid by a franchisee. In those cases, franchisors often use the historical information as a basis for preparing a projection, explaining the additional expenses that were added to reflect the likely additional expense a franchisee will incur. This is consistent with FAQ No. 8, which states that when affiliate locations are owned, then "as in the case of using any financial performance representation based on a subset of outlets that share a particular set of characteristics, the franchisor must also disclose any characteristics of such outlets that may differ materially from the outlets being offered for sale."[59]

2. The Use of Disclaimers.

As long as franchisors have been presenting any type of earnings or potential earnings information to prospective franchisees, their attorneys have been writing language disclaiming those representations. Dale Cantone[60] reports as a pet peeve the efforts by franchisors (or their attorneys) to write disclaimers that tell franchisees they can place no reliance on these numbers.

The FTC addressed disclaimers in the FAQs. FAQ No. 27 asks whether a franchisor that makes a financial performance representation in Item 19 may include a statement that the franchisor does not make any other financial performance representations and has not authorized its employees or representatives to do so. The FTC responded that they could do so, provided they use the following statement, with no modification, at the end of the Item 19 financial performance representation:

> "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."[61]

The authors of this paper would suggest two concerns with respect to FAQ No. 27. First, the statement is not necessarily correct. It states that except for the FPR set forth in Item 19, and results of operation given to purchasers of an existing outlet, the franchisor does not, and cannot, make any financial performance representations. However, that statement

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[59] *Id.*

[60] *See* Footnote 7, *supra*, and accompanying text.

[61] Amended Franchise Rule FAQs, No. 27, http://www.ftc.gov/bcp/franchise/amended-rule-faqs.shtml (last visited July 6, 2012).

ignores the provision of the FTC Rule that permits those franchisors who do furnish financial performance information under Item 19 to also deliver to prospective franchisees a supplemental financial performance representation about a particular location or variation, apart from the disclosure document.[62]

We believe the other problem with this statement, is not the statement itself, but how state examiners have interpreted the statement. The states of Virginia, Maryland and Illinois require that all disclaimers other than that set forth above be removed from disclosure documents registered in their states.[63] State examiners in these states, and no doubt practitioners who represent franchisees in litigation, would also point to a provision in the Commentary on the Franchise Registration and Disclosure Documents issued by NASAA in 2008, stating that when a franchisor makes a performance representation, "franchisors may not include additional language that serves to disclaim the financial representation they have just made or state that a franchisee may not rely on the information presented."[64]

However, a close examination of the FTC Rule, the FAQs, and the foregoing language from the NASAA Commentary, confirms that <u>all</u> disclaimers and explanations are not prohibited, but only those that, in the words of NASAA "[serve] to disclaim the financial performance representation" that was just made, or that suggest "a franchisee may not rely on the information presented." This prohibition would certainly address Mr. Cantone's concern with efforts by franchisors to include disclaimers suggesting franchisees can place no reliance on these numbers. However, statements, for example, that the numbers included in Item 19 should not be construed as the actual or probable revenues, sales, profits or net income that will be realized by any franchisee, are not disclaimers of the financial performance representation included in Item 19, nor are they a statement that a franchisee may not rely on the information presented. As such, they are not prohibited either by the FTC Rule or by the NASAA Commentary. Likewise, a statement that sales may differ with each location, and that the franchisor does not represent that any franchisee can expect to attain any specific level of revenues, sales, profit or net income, would not be prohibited by the FTC Rule, the FAQs or the NASAA Commentary. In fact, such statements serve to warn franchisees that their results may not be the same as shown in Item 19.

While it may be true that such statements can also be cited against disgruntled franchisees seeking to sue franchisors based on information contained in the FDD, the purpose of the franchise disclosure laws is to be certain prospective franchisees are well informed.[65] We would therefore submit that the inclusion of statements clarifying what is intended to be shown in the FPR, and what is not represented, whether or not termed as disclaimers, actually further the purpose of the disclosure laws. Practitioners who have represented franchisors being sued by franchisees that failed, and those who have represented a franchisee that failed, would probably agree that it would have been better for everyone (except the lawyers) if the franchisee

[62] 16 CFR § 436.5(s)(v). *See* also footnote 26 and accompanying text.

[63] Letter from Sharon Smith, Exam'r, Commonwealth of Va. State Corp. Comm'n Div. of Sec. and Retail Franchising, to author (April 13, 2012) (on file with Charles Modell); Letter from Debra Luiza-Lee, Exam'r, State of Md. Office of the Attorney Gen. Sec. Div., to author (April 6, 2012) (on file with Charles Modell); Letter from Lisa Madigan, Exam'r, Office of the Attorney Gen. for the State of Ill., to author (April 23, 2012) (on file with Charles Modell).

[64] North American Securities Administrators Association Commentary on 2008 Franchise Registration and Disclosure Guidelines, Item 19.3, http://www.nasaa.org/industry-resources/corporation-finance/franchise-resources/ (follow NASAA Commentary on 2008 Franchise Registration & Disclosure Guidelines hyperlink).

[65] Statement of Basis and Purpose, 43 Fed. Reg. 59,621, 59,622 (Dec. 21, 1978).

had fully understood everything she was being told at the outset, rather than buying a franchise without a full understanding, and then having that business fail. Thus, we would advocate that state examiners not only allow such statements, but allow them to be included in capital letters to avoid having prospective franchisees misled by glowing numbers that may appear in Item 19. Such disclaimers, or explanations, were freely permitted under the former Uniform Franchise Offering Circular regulations and there does not appear any comment in the Statement of Basis and Purpose, or Commentary to the Amended FTC Rule, suggesting a change in this position was intended by the FTC.

VIII. LITIGATION ISSUES

It is also important to consider certain litigation issues when preparing financial performance representations and designing compliance programs aimed at minimizing the likelihood of disputes involving a franchisor's financial performance representations. Legal actions involving earnings claims or financial performance representations primarily arise out of two situations. First, the franchisor makes a misstatement in its Item 19 financial performance representations. Second, the franchisor's sales personnel made representations that contradict the financial performance representation in the FDD, including when the franchisor states in Item 19 that it does not make financial performance representations, but its sales personnel makes such representations to prospective franchisees.

In *Carousel's Creamery LLC v. Marble Slab Creamery, Inc.* the franchisee alleged that the franchisor made negligent misrepresentations in Item 19 when the franchisor did not disclose that food sales of company owned locations disclosed in Item 19 included catering revenues, and understated labor costs by not including the labor of corporate employees and franchise trainees.[66] The court determined that these allegations stated a claim for negligent misrepresentation, although the franchisee ultimately failed when the franchisee could not prove reasonable reliance. In *Team Tires Plus Ltd. v. Heartlein* the franchisor provided a prospective franchisee with a three-year pro forma projection that included demographic information purportedly provided by a nationally recognized third party.[67] The franchisor enhanced the earnings potential contained in the pro forma by using a multiplier factor, without disclosing that the multiplier came from the franchisor and not from the third party. In denying the franchisor's motion for summary judgment on a fraud claim, the court stated that the franchisor's representation that the information came from a third party constituted an existing actionable fact that could serve as the basis for a fraud claim.[68]

In other cases, Item 19 of the FDD specifically states that the franchisor does not make any financial performance representations, but the franchisee alleges that the franchisor's sales persons made extensive representations concerning potential sales and profits. This was the situation in *FTC v. Minutemen Press*.[69] The court found that the franchisor falsely claimed that franchisees would achieve a specific level of gross sales and that one-third of gross sales would be profits. The court also found that the franchisor made these claims without providing an earnings claims document, without having substantiating information for these claims, and made earnings claims while saying it did not do so in its offering circular.[70]

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[66] 134 S.W.3d 385 (Tex. Ct. App. 2004).

[67] No. Civ. 01-1197JGL, 2004 WL 3406090 (D. Minn. April 19, 2004).

[68] *Id.* at *10.

[69] 53 F. Supp. 2d 248 (E.D.N.Y. 1998).

[70] 53 F. Supp. 2d at 250-51.

In *Randall v. Lady of America Franchise Corp.*, a group of women's fitness center franchisees asserted that the franchisor's sales force made a number of representations, including representations that the franchisees could expect to have a specified number of members within a certain time period, the amount the franchisee could expect to make per month and that a prospective franchisee would be "driving a Mercedes within 6 months after opening."[71] The court rejected the franchisor's motion for summary judgment and allowed the cases to continue under claims based on state franchise statutes. Importantly, the court agreed with the plaintiff's contention that the disclaimers in the franchise agreement and the UFOC were void under the anti-waiver provisions of the Minnesota statute.[72]

The court in *Randall* also discussed the circumstances under which earnings projections can be actionable. The franchisor in *Randall,* just as many defendants in common law fraud cases argue, asserted that the inherently forward looking nature of projections makes them incapable of being material misstatements of actual facts for purposes of proving a fraud claim because it could not have known its projections would be false. The court rejected the franchisor's argument noting that the Minnesota Supreme Court has held that projections are actionable if they do not "accurately reflect surrounding past and present circumstances."[73]

Sections II and VI of this paper describe the actions franchisors must take in providing financial performance representations that comply with the FTC Rule and state franchise disclosure statutes. Franchisors that violate the FTC Rule and state franchise law financial performance representation rules risk potential claims from governmental agencies. In pursuing claims under the FTC Act, the FTC is not required to prove subjective reliance by each franchisee who receives an unlawful financial performance representation or to prove individual economic damage for each franchisee.[74] State agencies pursuing these claims have obtained civil fines when courts have held franchisors responsible for violations of financial performance representation guidelines.[75]

Unlike the FTC Rule, many state franchise statutes provide for a private right of action by the party to whom an improper financial performance representation is made.[76] Private parties who pursue claims for improper financial performance representations often utilize three theories for recovery - common law fraud, state franchise law provisions, and state unfair and deceptive trade practices acts. These theories afford franchisees with a variety of forms of relief, including damages, restitution and rescission. The FTC Act provides for personal liability for certain franchisor personnel.[77] A number of state franchise disclosure laws also provide for

[71] 532 F. Supp. 2d 1071, 1079 (D. Minn. 2007).

[72] *Id*. at 1089. The anti-waiver statute is MINN. STAT. § 80C.21 (2011).

[73] 532 F. Supp. 2d at 1089 (quoting *Berg v. Xerses-Southdale Office Bldg. Co.*, 290 N.W. 2d 612, 615 (Minn. 1980)).

[74] *See FTC v. Transnet Wireless Corp*., 506 F. Supp. 2d 1247, 1266-67 (S.D. Fla. 2007); Garner & Jackson, *supra* note 32 at 12.

[75] *People ex rel. Dep't of Corps. v. Speedee Oil Change Sys., Inc*., Bus. Franchise Guide (CCH) ¶ 12,245 (Cal. Dist. Ct. App. 2002).

[76] *See, e.g.*, ILL. COMP. STAT. § 705/26.

[77] In *FTC v. Minuteman Press*, the court discussed the circumstances in which the president of the franchisor could be held liable for violations of Section 5(a) of the FTC Act. The court stated that he may be liable where the FTC proves "the corporate practices were misrepresentations or omissions of a kind usually relied on by reasonably prudent persons and that consumer injury resulted. Once corporate liability is established [as has occurred here], the FTC must show that the individual defendants participated directly in the practices or acts or had authority to control

personal liability and in the case of willful violations of these laws even provide for criminal liability.[78]

Despite an array of theories franchisees can use in pursuing claims based on financial performance representations, franchisees have had difficulty succeeding on their claims. The primary hurdle facing franchisees is whether they could have reasonably relied on financial performance representations that clearly contradict provisions in the franchisor's FDD or franchise agreement. Disclaimers in the FDD and franchise agreement, often combined with merger or integration clauses and non-reliance clauses in the franchise agreement, have often enabled franchisors to prevail in financial performance representation litigation.

Common law fraud cases in which the franchisor asserts a defense based on a disclaimer put the courts in a difficult position, as they must determine whether to promote contractual certainty by upholding disclaimers contained in the FDD or franchise agreement when doing so may allow the franchisor to avoid liability for making a representation that otherwise satisfies the elements of a fraud claim.[79] At least one court addressed this issue by stating that a disclaimer in a franchise agreement will only be enforced when it is specific enough to address the actual representations that formed the basis of the claim.[80] Such an approach requires the franchisor's counsel to draft disclaimers in the FDD and franchise agreement that address a broad range of potential representations, while expressing these disclaimers in very specific terms.

In an effort to avoid summary judgment, franchisees will seek to have the court treat reliance on the disclaimer as an issue of fact. In *Siemer v. Quizno's Franchise Co. Ltd.*, the court noted that while the issue of reasonable reliance is normally a question of fact, the court could decide it as a matter of law where no trier of fact could find it was reasonable to rely on the alleged statements.[81] In this case the franchisees filed class RICO and fraudulent inducement claims based on the franchisor's alleged misstatements regarding the cost to maintain the franchises, projected profits and Quizno's policies and procedures. The UFOCs and franchise agreements contained fairly standard disclaimer language and an acknowledgement in the franchise agreement that the franchisees had not relied on any statements by the franchisor outside of the UFOC. The court granted the franchisor's motion to dismiss the franchisee's civil RICO and common law fraud claims based on the disclaiming language. [82]

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them. Authority to control the company can be evidenced by active involvement in business affairs and the making of corporate policy, including assuming the duties of a corporate officer. The FTC must then demonstrate that the individual had some knowledge of the practices." 53 F. Supp. 2d 248, 259-60 quoting from *F.T.C. v. Amy Travel Serv., Inc.*, 875 F.2d 564, 573 (7th Cir. 1989).

[78] For examples of state franchise statutes providing for personal liability of certain franchisor personnel, see CAL. CORP. CODE § 31302 and WIS. STAT. § 553.51(3). For an example of a criminal statute that could be applicable to financial performance representations, see CAL. CORP. CODE § 31123.

[79] *See Sherman v. Ben & Jerry's Franchising, Inc.*, No. 1:08-CV-207, 2009 WL 2462539, at *3 (D. Vt. Aug. 10, 2009).

[80] *Commercial Prop. Investors v. Quality Inns Int'l, Inc*., 938 F.2d 870, 875-77, (8th Cir. 1991) (reversing summary judgment for franchisor on issue of whether contractual disclaimer was sufficiently specific to negate reliance defense to a common law fraud claim).

[81] No. 07 C 2170, 2008 WL 904874, at *7 (N.D. Ill. March 31, 2008).

[82] *Id.* at *9. The court in Siemer found persuasive a Wisconsin federal district court case that reached a similar conclusion in another Quizno's case. However, upon reconsideration the judge in the Wisconsin case found that he had "erred in concluding that Quizno's disclaimer and non-reliance clauses fatally undermined" plaintiff's fraud claims as a matter of law. *Westerfield v. Quizno's Franchise Co*., LLC, No. 06-C-1210, 2008 WL 2512467 at *9 (E.D.Wis.

In another case, the presence of an integration clause and a disclaimer in the franchise agreement led the court to find that certain fraud based claims under the Washington Franchise Investment Protection Act ("WFIPA") failed as a matter of law where the franchisor of an upscale clothing retailer allegedly made misrepresentations regarding the sales per square foot the franchisee could expect to achieve.[83] The court then applied New York law and determined that a similar common law fraud claim also failed for lack of reasonable reliance.[84]

A recent paper on litigating financial performance representation claims notes that the franchisor's chances of getting a franchisee's negligence and misrepresentation claims dismissed improve when a merger or integration clause is combined with specific non-reliance language in the FDD.[85] Such clauses may state that the franchisor is not providing certain projections and that its agents and representatives are not authorized to make these projections.

Disclaimers may shield franchisors from certain common law fraud claims, but often are less effective in defeating state statutory claims. For example, in *Emfore Corp. v. Blimpie Associates, Ltd.*, the court held that the franchisor's disclaimer defeated the franchisee's common law fraud claims, but not its statutory claim under New York law.[86] In addition, some state franchise statutes contain non-waiver language that makes it difficult for franchisors to use disclaimers to defeat misrepresentation claims.[87]

Misrepresentation claims based on the FDD do not arise solely from Item 19. In Item 7 of the FDD a franchisor provides detailed information regarding the range of expenditures a franchisee will incur in establishing a franchised business. Misstatements of this information have led franchisees to file misrepresentation actions against the franchisors. In *A Love of Food I, LLC v. Maoz Vegetarian USA, Inc.*, the court determined that a franchisee's allegations related to start-up costs were not mere statements of opinion but were sufficiently specific and material to state a fraud claim where there was an eighty-five percent difference between the franchisor's estimate and the franchisee's actual costs.[88] In that case the court found *Motor City Bagels, LLC v. American Bagel Company*, a case involving an understatement of start-up costs, persuasive[89]. In order to avoid a similar fate, franchisors should exercise caution in describing their start-up costs in Item 7 of the FDD, which often are expressed as a range of estimated

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April 16, 2008), as discussed in Alejandro Brito, William Killion and Joel D. Siegel, *I Said What? The Enforceability of Disclaimers, Waivers and Acknowledgements in Franchise Agreements Since the 2007 FTC Franchise Disclosure Rule, in* INTERNATIONAL FRANCHISE ASSOCIATION 45th ANNUAL LEGAL SYMPOSIUM (2012) at 15 (hereinafter "Brito, Killion and Siegel).

[83] *JM Vidal, Inc. v. Texdis USA, Inc.*, 764 F. Supp. 2d 599, 615 (S.D.N.Y. 2011). A claim against the franchisor survived summary judgment alleging that the Franchisor may have violated the WFIPA by failing to deal with the franchisee in good faith with respect to advertising and merchandising issues and certain other matters. *Id*. at 615. *See* Brito, Killion and Siegel at 31.

[84] *Id.* at 625.

[85] Garner & Jackson, *supra* note 32, at 45.

[86] 51 A.D.3d 434, 860 N.Y.S.2d 12 (App. Div. 2008).

[87] For examples of anti-waiver statutes in state franchise disclosure laws, see ILL. COMP. STAT. § 705/41 and MINN. STAT. § 80C.21. *See* Randall, *supra* note 71 for a case finding that a state anti-waiver statute precluded the franchisor's use of a disclaimer to avoid certain statutory claims brought by its franchisees. 532 F. Supp 2d at 1089.

[88] 795 F. Supp. 2d 365, 376-77 (D. Md. 2011).

[89] 50 F. Supp. 2d 460 (D. Md. 1999).

costs. Franchisors must also review and update these amounts periodically to ensure that they are consistent with recent experience within the franchise system.

In summary, it is clear that failure to follow the Item 19 requirements in preparing and disseminating financial performance representations may subject franchisors to a variety of claims that may be brought by the FTC, state agencies, or private parties. These claims include actions brought under the FTC Act, state franchise laws, state unfair and deceptive trade practices acts, common law fraud, and negligent or intentional misrepresentation. Franchisors often prevail in such cases when well drafted disclaimers, integration clauses, and non-reliance clauses allow the franchisor to successfully argue that prospective franchisees could not reasonably have relied on representations that clearly contradict the language of the franchise agreement or FDD. However, franchisees have found success as well, particularly where statutory claims are litigated. Even when the franchisor succeeds, the cost to the franchisor in terms of business distraction and legal fees can be significant.[90] As a result, franchisors should exercise great care to avoid certain traps in preparing financial performance representations and should adopt a set of best practices in implementing a compliance program to minimize the risks involved in disseminating these representations to prospective franchisees.

IX. ADDITIONAL TRAPS FOR FRANCHISORS IN PREPARING AND USING FINANCIAL PERFORMANCE REPRESENTATIONS

The franchisor's goal in making a financial performance representation is to provide a representation that will materially impact the prospective franchisee's investment decision without facing a substantial legal risk resulting from a material misstatement. In attempting to achieve this goal, franchisors face a number of traps when preparing financial performance representations. In earlier sections of this paper we have discussed some of these traps, including those related to the use of gross profit information, providing information regarding costs to prospective franchisees, and the dangers involved in "cherry picking" financial information given to prospects. This section discusses some additional traps of which franchisors should be aware when providing financial performance representations.

Franchisors face traps in deciding whether to base their financial performance representations on information from company locations only or to include franchisee information as well. In addition, franchisors face difficult decisions when deciding to provide projections of future sales and profits franchisees may expect to achieve, rather than limiting this information to historical information.

Making decisions regarding the use of company or franchisee information and the use of historical information or projections requires the franchisor to confront one of the central dilemmas in preparing financial performance representations. A financial performance representation that projects a strong level of net profits may significantly impact a potential franchisee's investment decision, and the franchisor is likely to receive pressure from its franchise sales staff to provide this information. However, as described earlier, a materially misleading financial performance representation can expose a franchisor to liability under

[90] *See Tankersley v. Lynch*, No. 11-12847, 2012 WL 683384 (E.D. Mich. Mar. 2, 2012) (involving attempted enforcement of an arbitrator's award against certain officers of a bankrupt franchisor, which included an award of attorney fees of over $378,000 for alleged violations of the Michigan Franchise Investment Law, common law fraud and misrepresentation).

common law fraud and misrepresentation theories as well as potential liability under a variety of state statutes and FTC enforcement actions. The franchisor must manage these liability risks by limiting its financial performance representations to those representations that have a reasonable factual basis and adequate supporting information.

A franchisor may significantly mitigate the legal risk in preparing financial performance representations by limiting its representations to information based on company locations only. Information collected from the operation of company locations will be inherently more reliable, as the franchisor will know that this data was prepared utilizing the company's established accounting systems. In addition, the franchisor has more thorough knowledge of the operations, marketing and purchasing personnel who played major roles in producing these results. As a result, the franchisor will have a much higher comfort level that the bases and assumptions prepared to support the financial performance representation are accurate.

While using information from company locations is less risky for the franchisor, limiting financial performance representations to information based on company outlets also has disadvantages for the franchisor. These disadvantages, discussed in Section III of this paper, include the differing cost structures of company outlets and franchised outlets. Company operations will often benefit from more experienced operators and economies of scale for franchisors with a substantial number of units. The franchisor must be aware of these differences in preparing the bases and assumptions that accompany its financial performance representations and provide full disclosure of these differences.[91]

Franchisors that provide financial performance representations based on historic information from its franchisees must avoid several traps. The franchisor must ensure that it has a standardized process for collecting sales, costs and profits information from its franchisees. The collection of sales information is a fairly straight forward process when franchisees report sales weekly or monthly in connection with the payment of franchise fees. However the collection of information on costs and profits from franchisees requires both a standardized reporting format, often in the form of a standardized profit and loss statement, and a reporting system that requires prompt and accurate reporting of sales, costs and profits information by franchisees with strong follow-up by the franchisor when the information is not provided on a timely and accurate basis. A good reporting system requires clear language in the franchise agreement obligating franchisees to submit financial information by the methods and in the format required by the franchisor, with flexibility to change these methods and formats during the term of the franchise agreement.[92] The franchisor's audit rights in the franchise agreement should enable the franchisor to obtain the information necessary to confirm the accuracy of sales and cost information provided by franchisees and make the franchisee responsible for the cost of the audit when there is a material misstatement of the required information.

Franchisors that provide performance projections in their financial performance representations must have sufficient facts to enable prospective franchisees to make an independent judgment regarding the validity of these projections. Franchisors must have this supporting data available when they make these projections. The FTC Compliance Guide

[91] Statement of Basis and Purpose at 15,499.

[92] The language regarding the methods and formats for providing this information should emphasize the likelihood that the computer systems or other means that franchisees use to provide this information will change during the term of the franchise agreement.

provides guidance to franchisors in preparing these projections. This guidance is discussed in more detail in Section III of this paper. The FTC Compliance Guide states that the assumptions underlying the projections must be disclosed. According to the FTC the assumptions go to the heart of the major issue related to projections—the probability the franchisee will achieve the projected performance. These assumptions may include economic and market conditions, geographic location, type of premises, competition, services provided by the franchisor and whether the information comes from company or franchised locations.[93]

Start-up franchisors face some unique traps in preparing financial performance representations. Given their lack of substantial operating history and small number of units, these franchisors should carefully explain their bases and assumptions and make it clear that franchisees' operating results may vary widely, given the limited information available to the franchisor in preparing its financial performance representations. However, courts may give new franchisors more leeway in the use of financial performance representations. At least one court has ruled that due to the preliminary stage of the franchise system when the franchisee entered into his franchise agreement, it was unreasonable for the franchisee to rely on any representations of prospective earnings by the franchisor.[94]

Franchisors also need to ensure that the financial performance representation information in Item 19 is not out of date. Compliance programs should include a process for reviewing all Item 19 data on a regular basis and updating this information when necessary. The FTC Rule provides for the updating of the FDD on an annual basis within 120 days after the end of the franchisor's fiscal year, with quarterly updates required when material changes occur.[95] However, with respect to financial performance representations, the FTC Rule provides that it is an unfair or deceptive practice to disseminate any financial representation to prospective franchisees "unless the franchisor has a reasonable basis and written substantiation for the representation **at the time the representation is** made. . . (emphasis added)."[96] Thus, at any time the FPR contained in Item 19 becomes out of date based on then-current results within the system, it is incumbent upon the franchisor to update the FDD. The requirement that the information be current as of the time the representation is made becomes particularly important during times of economic downturns or when a franchised company, or its industry, has experienced economic problems and results can deteriorate significantly from one month to another.

X. TIPS FOR USING FINANCIAL PERFORMANCE REPRESENTATIONS IN COUNSELING PROSPECTIVE FRANCHISEES

Lawyers who represent prospective franchisees understand the value of having the opportunity to counsel prospective franchisees before they sign a franchise agreement. These lawyers welcome the opportunity to review the FDD and franchise agreement to advise their clients of the potential strengths and weaknesses of the franchised system. A review of the financial performance representations is an important part of this process.

[93] FTC Compliance Guide, *supra* note 2, at 90-91.

[94] *Peterson v. Sprock*, No. 1:06-CV-3087, 2009 WL 631219 (N.D. Ga. Mar. 10, 2009).

[95] The FTC Rule's general updating requirement is found in 16 C.F.R. § 436.7.

[96] 16 C.F.R. § 436.9(c).

The lawyer for a prospective franchisee will want to ensure that the prospective franchisee has carefully reviewed the financial performance representations, and is comfortable they are consistent with the client's overall understanding of the system and with what the franchisor's sales persons have told the client. However, if the franchisee is not sophisticated in accounting matters, the franchisee's attorney either needs to be proficient in these matters, or recommend the franchisee obtain assistance in reviewing the FPR from an accountant or other person well versed in reviewing financial statements. A person with such proficiency should become comfortable that the information presented is based on a reasonable set of assumptions, that it accounts for all factors that can materially change the sales or costs, and hence, the profitability of the business, and that it is based on sufficient data to be representative of what a franchisee can expect to achieve in the operation of its business. At the end of the day, the prospective franchisee needs to be comfortable that the historical or projected sales and income information appears reasonable and attainable based on the client's prior discussions with the franchisor and other due diligence. Results that appear unrealistic, or are based on a very small sampling of units, raise a large red flag issue that the franchisee and his or her counsel need to resolve before the prospective franchisee places any reliance upon these numbers.

The prospective franchisee and counsel should also confirm that information in Item 19 appears to be consistent with the cost projections in Item 7 and the information contained in the franchisor's audited financial statements. A rosy projection of sales and income in Item 19 coupled with audited financial statements showing that the franchisor has lost money the past three years at an increasing rate should cause the prospective franchisee to be very cautious in proceeding.

Experienced franchisee lawyers understand the important of resolving issues and concerns about the franchisor before the franchisee signs the franchise agreement, and not after the franchisee has operated at a loss and wants to sue the franchisor—only to find they may have limited remedies that can only be pursued through expensive litigation in a distant forum. A careful review and analysis of the financial performance representation is an important part of this process.

XI. COUNSELING FRANCHISORS ON BEST PRACTICES IN USING FINANCIAL PERFORMANCE REPRESENTATIONS

In other sections of this paper, we have offered some practice tips and suggestions for best practices for franchise lawyers to consider when counseling franchisors on the use of financial performance representations and the legal risk management issues related to the use of these representations. We conclude with some additional best practices for franchisors and their counsel when making financial performance representations.

1. Ensure that franchisors and their franchise sales staffs understand the problems that arise when financial performance representations are made outside of the FDD, and understand that all of their financial performance representations must comply with the FTC Rule and state laws. Franchisors that provide financial performance representations in Item 19 of the FDD typically work with franchise counsel in preparing and vetting these claims. The franchisor's accounting and finance personnel need to be actively involved in the preparation and review of the information that goes into Item 19. This process when executed properly will result in representations, and the bases and assumptions that support projections, being accurately set forth in the FDD, along with the required cautionary language mandated by the

FTC Rule and state franchise laws. While these actions are necessary, they are only one aspect of complying with the legal requirements for financial performance representations.

Misrepresentation claims may arise when franchise sales personnel make claims to prospective franchisees that are inconsistent with the Item 19 information.[97] In some cases franchise sales personnel used spreadsheets or worksheets to provide unsubstantiated earnings information or assisted prospects in preparing pro formas.[98] Claims may also be asserted when information inconsistent with the Item 19 information is presented in advertisements, on franchisor websites or in discovery day presentations by franchisors.[99] The proliferation of a variety of forms of social media makes it only a matter of time before claims will arise for information inconsistent with Item 19 provided on a franchisor's or franchise seller's Facebook page or such information is disseminated by a franchise sales person with an itchy Twitter finger. Often overlooked are disclosures that a franchisor's operations and training personnel may make to new franchisees during the franchise training process.

For these reasons, it is very important that the franchisor have a comprehensive and integrated approach to its franchise sales compliance process. A good on-going training program to educate franchise sales personnel, as well as other employees of the franchisor who come into contact with new and prospective franchisees, on the requirements of Item 19 and the consequences of violating these requirements is a key component to manage the legal risks related to financial performance representations. Strong procedures for assessing compliance by franchise sales and other franchisor personnel with these rules, and the use of questionnaires or similar documents completed by prospective franchisees confirming they did not receive improper financial performance representations, also are important elements in managing the risks involved in this area.

2. Encourage franchisors to limit financial performance representations to those for which the franchisor has reliable information. The FTC Rule limits financial performance representations to those for which the franchisor has a reasonable basis. The use of financial performance representations that project future performance is inherently riskier than a financial performance representation limited to historical information. Franchisors and their sales personnel may want to make an aggressive representation regarding projected future performance. The franchisor's counsel can help strike a balance between mitigating the legal risk and providing financial performance representations that have an impact on prospective franchisees by stressing the need for the franchisor to have reliable information to substantiate these representations. By asking to see the supporting information and counseling against projections that are more aggressive than is justified by the supporting information, the franchisor's counsel can help the franchisor manage the risks that accompany making projections in their FDDs.

3. Draft the franchise agreement to provide the franchisor the ability to obtain from franchisees all of the information required to support a variety of financial performance

[97] *See FTC v. Minuteman Press*, 53 F. Supp. 2d 248 (E.D.N.Y. 1998); Randall v. Lady of Am. Franchise Corp., 532 F. Supp. 2d 1071 (D. Minn. 2007).

[98] *See, e.g.*, *Comm. Prop. Investments, Inc. v. Quality Inns Intern., Inc.*, 938 F.2d 870 (8th Cir. 1991) (noting misrepresentations in form of embellishment of pro forma information).

[99] *See Lady of Am. Franchise Corp. v. Arcese*, Bus. Franchise Guide (CCH) ¶ 13,561 (S.D. Fla. 2006) (holding that there were material issues of fact regarding whether the slides used by a franchisor at its discovery day constituted an earnings claim and whether prospective franchisees were likely to be misled by this information).

representations. Counsel for franchisors understand the importance of drafting franchise agreement language that has the flexibility to adapt to the changing needs of a franchise system over a long period of time. This need for flexible language in the franchise agreement extends to the information necessary for preparing financial performance representations. The franchise agreement should: (a) require that franchisees report in a timely manner all sales, costs and profitability information that the franchisor requires; (b) make clear that the required information and the means for reporting this information may change during the term of the agreement; (c) make failure to provide timely and accurate financial information an event of default under the franchise agreement; (d) make it clear that this information may be used in preparing financial performance representations to abrogate any claim by the franchisee that the information provided is confidential; and (e) permit the franchisor to have broad rights to audit the franchisee's financial information, including online access to the franchisee's point of sale or similar system. These audit rights should include the right to charge the cost of an audit to the franchisee when the audit shows material inaccuracies.

4. Encourage franchisors to have systems to appropriately track and use franchisee data. It is also important that the franchisor has good data collection, analysis and retention procedures for processing the data received from franchisees. These procedures can facilitate preparation of timely and accurate financial performance representations, facilitate the process of updating these representations and make this data readily accessible in the event franchisees bring claims against the franchisor based on this information contained in the financial performance representation or a prospective franchisee simply requests to see the supporting information as permitted by Item 19.

5. Work with franchisors to determine the best way to use meaningful financial performance representations while also encouraging prospective franchisees to contact existing franchisees. Many franchisors realize that their existing franchisees can be an important part of their franchise sales process. The FTC Rule requires the FDD to include identifying information regarding current franchisees.[100] For franchisors that do not use financial performance representations, encouraging prospective franchisees to contact current franchisees is one of the few lawful means of providing financial information. Current franchisees, particularly those in the same geographic area as a prospective franchisee or with a similar business background, can provide powerful support and encouragement to prospective franchisees in their investment decision. The willingness of successful franchisees to share operating results with prospective franchisees may provide powerful validation to the franchisor's financial performance representation. Franchisor's counsel should encourage franchisors to develop a good balance between the use of financial performance representations and the information provided by existing franchisees.[101]

6. Encourage franchisors to be cautious in preparing their bases and assumptions and expansive in explaining them. A franchisor's counsel may play an important role in the franchisor's risk management process related to financial performance representations. An important aspect of this risk management process is the preparation of bases and assumptions for projections that are accurate and easy to comprehend. It is important that these bases and

[100] 16 C.F.R. § 436.5(t)(4).

[101] In some instances existing franchisees refuse to provide information to prospective franchisees. In *Rocky Mountain Chocolate Factory v. SDMS, Inc.*, No. 06-cv-01212, 2009 WL 579516 (D. Colo. Mar. 4, 2009) the court rejected the franchisee's common law fraud claims and California statutory claims, both for lack of reasonable reliance. In this case the franchisee sought financial information from four or five current franchisees before signing the franchise agreement, but in each case the current franchisees failed to provide this information.

assumptions address a variety of issues. Results within a franchise system may vary widely based on factors such as type of location (freestanding building versus in-line shopping center locations), company or franchise units, geographic area, demographics of the surrounding area and length of time a unit has been in operation. These factors will differ from system to system but should be fully disclosed in the bases and assumptions. For example, some systems will provide financial performance representation information only for locations that have operated for more than one year.

The presence of a realistic set of projections or historic data, backed by thorough explanations in the bases and assumptions, plays an important role in defending misrepresentation claims pursued by unsuccessful franchisees. Franchisors and their sales personnel may resist expansive bases and assumptions as unnecessary legalese that dilutes the effectiveness of the financial performance representations. This resistance is often misplaced, as a good set of bases and assumptions will often help the sales staff when dealing with sophisticated potential franchisees by answering many of their questions before they are asked—making the sales staff look good in the process. As with other portions of the FDD, the franchisor's attorney must counsel the franchisor on striking a balance between a financial performance representation that aids the franchise sales process with the need for language that reasonably limits the franchisor's legal exposure.

7. Counsel franchisors to refrain from minimizing or eliminating negative information. Few issues related to financial performance representations present more challenges than constructing a financial performance representation that minimizes the impact of negative information without exposing the franchisor to significant legal risk. Inevitably, franchisors will want to use financial performance representations that highlight the results of successful locations while minimizing or ignoring any negative information involving under-performing locations. This "cherry picking" of positive information poses a significant threat to effective risk management of financial performance representations. This is a subject where the franchisor and its lawyer may receive strong pushback from franchisor sales personnel. Franchisor counsel should acknowledge the concern of sales personnel, explain the legal risk in minimizing negative information and help formulate the financial performance representation and its bases and assumptions in a way that presents positive information without ignoring negative results. Franchisor counsel may not always prevail to the extent he or she may prefer in such discussions. In that case it is important to ensure that the franchisor understands the risk involved in minimizing negative information.

8. Help educate franchise sellers in the role of the financial performance representation. A well written financial performance representation will play a central role in the franchise sales process. It gives franchise sellers a legally permissible means to answer prospective franchisees' questions regarding how much they may expect to make as a franchisee. It is important that franchise sellers fully understand the information contained in the financial performance representations along with their bases and assumptions. Counsel can assist franchise sellers in determining how to combine the financial performance representation with encouraging prospects to contact existing franchisees.

Critically, franchise sellers must be educated to understand that the financial performance representation defines the outer limits of the sales and profitability information they can provide, and the consequences to the franchisor if the franchise seller does not observe these limits. The compensation and advancement of franchise sales personnel is often closely tied to their ability to close sales, so they are likely to view the financial performance representation as at best a necessary evil and at worst an obstacle to be avoided. For this reason it is important for the franchisor's counsel to skillfully and forcefully explain the financial performance representations, their benefits and limitations, to franchise sellers.

9. <u>Work with franchisors who do not make financial performance representations to ensure they have strong compliance programs.</u> Most of this paper has discussed the rules for making financial performance representations, but as described in the introduction sixty percent or more of franchisors do not make financial performance representations. These franchisors present a challenge to their counsel, who need to ensure that the franchisor's compliance program focuses on preventing the making of unsubstantiated representations. These compliance programs should emphasize the importance of informing prospects that the franchisor does not make financial performance representations and directing them to existing franchisees to obtain information about sales and profits.[102] These systems are likely to make use of cost information that is not subject to Item 19 requirements, so sales personnel need to be cautioned to avoid the use of cost information expressed as percentages of sales. The risk of improper financial performance representations by sales personnel in systems that make no Item 19 claims heightens the need for strong disclaimers, integration and non-reliance clauses in the FDD and franchise agreement.

10. <u>Encourage franchisors to make cautious use of supplemental financial performance representations.</u> As discussed in Section IV. B of this paper, the FTC Rule permits franchisors to make supplemental financial performance representations to complement a general financial performance representations.[103] These supplemental financial performance representations allow franchisors to address more specific situations targeted to a particular prospective franchisee. While the use of supplemental claims may sound attractive, in practice they can create risk management issues. Franchisors typically put significant effort into preparing their financial performance representations, and their counsel and financial personnel review these financial performance representations and prepare appropriate bases and assumptions. Supplemental claims on the other hand may be prepared more quickly to address a specific situation, perhaps one raised by a prospective franchisee. This may result in preparation of a supplemental claim that lacks proper financial or legal vetting—despite the requirement that supplemental claims must satisfy all Item 19 requirements and describe how they vary from the franchisor's general Item 19 financial performance representation. For these reasons a franchisor should exercise caution to ensure that the use of supplemental financial performance representations does not undermine an otherwise effective risk management program for the use of financial performance representations.

XII. CONCLUSION

Franchising may seem to be unique when compared with other forms of investment or business opportunities in the barriers it erects to answering a prospective franchisee's most basic question—how much can I reasonably expect to earn if I invest in your system? For that

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[102] Franchisors need to use care to avoid steering prospects toward only those franchisees that have strong sales and profits but may be unrepresentative of the system. The court in *FTC v. Minuteman Press*, 53 F. Supp. 2d 248 (E.D.N.Y. 1998), gave no weight to the testimony of existing franchisees regarding sales levels where there was no indication that this testimony was representative of franchisees in general.

[103] The FTC Rule permits the making of supplemental financial performance representations "about a particular location or variation". 16 C.F.R. § 436.5(s)(5). Such claims may be made only where a franchisor furnishes financial performance information according to Item 19, makes the supplemental claim in writing, explains "the departure from the financial performance representation in the disclosure document" and the supplemental claim is prepared in accordance with the requirements of Item 19. *Id.*

reason, some commentators have suggested that the regulations should *require* franchisors to provide financial performance representations to prospective franchisees.[104] To date, lawmakers have not accepted that proposition and, in some instances, have established requirements governing the making of financial performance representations that appear to impose a substantial obstacle to some franchisors in considering whether to provide these representations. We have attempted to show how the Item 19 guidelines provide a variety of means by which legally permissible financial performance representations may be made, and how a franchisor also can provide a wide range of valuable information to prospective franchisees without being required to comply with Item 19. We also have provided our recommendations for some best practices for franchisors and their counsel to consider in developing a program for providing prospective franchisees with meaningful financial performance representations while managing the legal risks that go along with making such representations.

It is our belief that a carefully developed and maintained program for disseminating financial performance representations can benefit most franchise systems and help reduce their liability exposure in the franchise sales process. However, unless and until state regulators permit franchisors wide latitude in warning prospective franchisees that they may not achieve the same results, and should not rely on their ability to do so, it is likely that a significant number of franchisors will continue to refrain from including this information in their disclosure documents.[105]

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[104] *E.g.*, Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunities; Final Rule, 72 Fed. Reg. 15,444, 15,446 (Mar. 30, 2007) (to be codified at 16 C.F.R. pt. 436, 437); Marvin E. Rooks, *It Is Time for the Federal Trade Commission to Require Financial Performance Representations to Prospective Franchisees*, 11 Wake Forest J. Bus. & Intell. Prop. L. 55, 57 (2010).

[105] Mr. Batenhorst wishes to thank Adam W. Barney, an associate at Cline Williams Wright Johnson & Oldfather, L.L.P., for his assistance in the preparation of this paper.

ATTACHMENT 1
BURGER KING CORPORATION

Exhibit 19-1
SALES DISTRIBUTION
"TRADITIONAL" AND "NON-TRADITIONAL" RESTAURANTS
JANUARY 1, 2011 – DECEMBER 31, 2011
Percentage of Restaurants at Sales Level (3)

	Traditional (1)			Non-Traditional (2)		
Annual Sales Level - Range	**Consolidated**	**Company**	**Franchise**	**Consolidated**	**Company**	**Franchise**
Above $1.5M	15%	16%	15%	16%	28%	16%
$1.3M - $1.5M	15%	15%	15%	9%	4%	9%
$1.1M - $1.3M	22%	25%	21%	11%	16%	10%
$0.9M - $1.1M	25%	24%	25%	15%	16%	15%
$0.7M - $0.9M	17%	17%	17%	21%	16%	21%
$0.5M - $0.7M	5%	2%	5%	20%	20%	20%
Below $0.5M	0%	0%	0%	9%	0%	9%
Total Restaurant Sample	**6,462**	**784**	**5,678**	**492**	**25**	**467**
Mean Average Sales	1,164,561	1,195,313	1,160,315	1,085,752	1,198,894	1,079,696
Median Average Sales	1,115,751	1,162,727	1,109,655	910,638	1,052,914	900,765
High Annual Sales		2,593,268	5,463,645		2,797,079	5,465,398
Low Annual Sales		327,961	263,611		534,255	50,221

The sales levels, sales ranges and median sales shown above reflect the experience of certain franchised and BKC-operated Restaurants and should not be considered as the actual or potential sales that you will realize. BKC does not represent that you can expect to attain any particular sales level.

Notes:

(1) The information provided in this Sales Distribution is sales information for a total of 6,462 Restaurants treated as "Traditional" Restaurants for purposes of this Item. Of those Restaurants, 5,678 were Franchisee-owned and 784 were BKC-owned as of December 31, 2011. Only those Restaurants with 12 months of actual sales as of December 31, 2011 are reported in this chart.

(2) The information provided in this Sales Distribution is sales information for a total of 492 Restaurants treated as "Non-Traditional" Restaurants for purposes of this Item. Of those Restaurants, 467 were operated by Franchisees and 25 were operated by BKC as of December 31, 2011. Only those Restaurants with 12 months of actual sales as of December 31, 2011 are reported in this chart.

(3) Due to rounding percentages may not equal 100%.

(4) Figures do not include “Temporarily Closed” restaurants.

ATTACHMENT 2
BACH TO ROCK
SALES AND DIRECT COST INFORMATION

Presented below are gross sales data, and certain cost and expense data for 2011 for five affiliate-owned Bach to Rock Schools that have been open and operating for a full 12 months, as of December 31, 2011. Please carefully read all of the information in this Item 19, and all of the notes following the chart, in conjunction with your review of the historical data.

Gross Sales and Certain Instructional Costs - 2011					
	School 1	**School 2**	**School 3**	**School 4**	**School 5**
Year Opened	2007	2007	2008	2008	2009
Gross Sales	$962,241	$678,993	$852,274	$582,465	$474,902
Direct Instructional Costs	$287,740	$172,978	$260,863	$169,452	$119,377
Direct Margin	70.1%	74.5%	69.4%	70.9%	74.9%

* * *

Notes

1. "**Gross Sales**" – This represents the actual gross sales for each School in the sample for the period January 1, 2011 to December 31, 2011. "Gross Sales" includes all revenue from the sale of all Courses, services and products offered to customers and clients at or from the School. However, "Gross Sales" does not include any coupon sales (for which customers do not pay for the services or products), customer refunds, sales taxes or other taxes collected from customers and actually transmitted to the appropriate taxing authorities, or sales of equipment not in the ordinary course of business (such as sales of obsolete instruments or audio equipment). The gross sales data figures are compiled by our affiliates that operate the Schools and are reported to us. We have not audited or verified the reports, nor have our affiliates confirmed that their reports are prepared in accordance with generally accepted accounting principles.

2. "**Direct Instructional Costs**" includes costs and expenses related to the provision of classes, Courses and programs, including salaries, wages and benefits for teachers and other instructional staff who teach or otherwise provide instructional programming. Instructional Costs do not include the salaries of the site director, assistant director, or any manager, except to the extent a portion of their time is used in teaching or delivering instructional programs or services. Also included in Instructional Costs are the costs for instructional materials used in the Courses, or provided to students.

3. "**Direct Margin**" is the percentage of revenues that a School retains after paying for Direct Instructional Costs. Direct Margin is not gross profit or net profit. As discussed in Note 4 below, there are many other costs and expenses that must be deducted from gross sales to determine gross profit or net profit.

4. The cost and expense data does not reflect all of the costs of sales, costs of goods, operating expenses or other costs or expenses that must be deducted from gross revenue or gross sales to obtain a net income or net profit figure. Examples of costs that are not included are: salary, wages, taxes and benefits for managers, site directors, assistant directors and non-instructional staff; rent, utilities and other occupancy costs; equipment lease costs; music, audio, video and instrumental equipment; repairs and maintenance of the premises; telephone and

internet service; debt service and financing costs; advertising and marketing costs; voluntary employee benefits, such as health, vacation or pension plan contributions; insurance; copyright license fees; business and regulatory fees and licenses; ongoing and supplemental training expenses; recruitment expenses; and bookkeeping, accounting, legal and other professional services. In addition, a franchisee will have royalty payments and advertising and marketing expenses and/or contributions to the National Advertising Fund and/or Regional Fund or Cooperative, if established. Also, any franchisee compensation above, or in addition to, any salary or wages paid to the operator/owner franchisee is not included.

ATTACHMENT 3
ANYTIME FITNESS

KEY INFORMATION

AVERAGE MEMBER NUMBERS

We had 1,361 Anytime Fitness clubs open for at least 12 months as of February 29, 2012. The average number of members at these clubs as of that date was 769. 571 of the 1,361 clubs that were open for at least 12 months as of February 29, 2012 (42%) had 769 or more members, and 790 (58%) had less than 769 members. This is an increase from an average of 737 members as of February 28, 2011.

We also had 46 Anytime Fitness Express clubs open for at least 12 months as of February 29, 2012. The average number of members at these clubs was 523. 19 of the 46 clubs that were open for at least 12 months as of February 29, 2012 (41.3%) had 523 or more members, and 27 (58.7%) had less than 523 members.

ATTACHMENT 4
SNIP-ITS

KEY INFORMATION

Haircuts Provided at Franchised and Affiliate-Owned Salons

Presented below in Table 1 is data relating to the number of Haircuts (defined below) provided at all franchised and affiliate-owned Snip-its Salons in 2011, that have been operating for at least 12 months, as of December 31, 2011. Please read carefully all of the information in this Item 19, and all of the notes following the Table, in conjunction with your review of the historical data.

Table 1
Snip-its 2011 Haircut Customers in Salons (57 Salons)

Range of the Number of Haircuts Provided to Customers During 2011	Number of Salons Within The Range of Haircuts Provided	Average Number of Haircuts Provided by Salons Within This Range	Number of Salons Above Average	Number of Salons Below Average
20,001 or more	4	26,072	1	3
10,000 to 20,000	39	13,405	18	21
Less than 10,000	14	7314	7	7

Notes to Table 1:

Table 1 presents the number of Haircuts provided by 57 Snip-its Salons operated by our franchisees and our affiliate during the entire 2011 calendar year, from January 1, 2011 through December 31, 2011(three affiliate-owned Salons and 54 franchised Salons met this criteria). Snip-its Salons that did not operate for the entire 2011 calendar year have not been included in the results for the Table (four franchised Salons met this criteria).

A “Haircut” at a Salon means an individual customer entering a Salon and purchasing a haircut, regardless of the type of Haircut provided or the length of time given to the customer in connection with the Haircut. Prices for a regular Haircut range from $15.95 to $24.99. Bang cuts, trims and buzz cuts may have been offered from some Salons at a reduced price. Snip-its Salons also offer certain services that are ancillary to a Haircut (such as a shampoo and blow-dry). In addition, Snip-its Salons sell retail products, offer birthday parties, and some Salons offer spa services, and these items are not reflected in Table 1 above.

Several factors may affect the number of Haircuts provided at a Salon, including, among other things, the number of days each week and the number of hours each day that the Salon is open, as well as the number of hair-cutting stations at the Salon. Some Salons have achieved these results. Your individual results may differ. There is no assurance you will sell as much.

The Haircut information was compiled by using data reported to us by franchisees and affiliate. We have not audited or verified the reports, nor have franchisees or operators confirmed that their reports are prepared in accordance with generally accepted accounting principles.

Table 1 does not include any revenue data, nor any summary or average for Gross Sales or net sales. Revenue for each Salon will depend upon the prices charged for each Haircut, as well as the sale of ancillary services and products. In addition, Table 1 does not include any costs or expenses that franchisees or affiliate-owned Salons incurred or may incur. You should conduct an independent investigation of the costs and expenses you will or may incur in operating your franchised Snip-its Salon. Franchisees or former franchisees listed in this disclosure document may be one source of this information.

ATTACHMENT 5
ANYTIME FITNESS

STATEMENT OF ANNUAL PROJECTED REVENUES AND EARNINGS FOR AN ANYTIME FITNESS CENTER

The following are statements of projected annual revenues and earnings for a franchised Anytime Fitness center. These projections are for a second year of operation. They assume that at the end of the first year you have a fixed number of memberships, and, even though most of our clubs continue to increase their memberships after the first year, that you remain at that level for the entire year, adding as many new members as the number of members that leave. (During the first year, it will take you time to build your member base.) We have listed below three projections, one based on a center having 500 members, one based on 769 members, and one based on 950 members. They are based on revenue information provided to us by our designated billing processor for our franchisees in 2011, and on the 6 Anytime Fitness centers that we or our affiliates operated during all of 2011.

The first example, for a 500-member club, is intended to give you an idea of the revenues, expenses and projected income of a club that performs well below our average, but is still profitable. Of the 1,361 Anytime Fitness clubs open for at least 12 months as of February 29, 2012, 1,083 (79.6%) had over 500 members as of February 29, 2012. The 769-member example will give you an idea of the revenues, expenses and income of a club that is able to maintain throughout the year the same number of members as the average number of members we had in our clubs that were open for at least 12 months as of February 29, 2012 (a relatively strong time of year for club memberships). Of the 1,361 Anytime Fitness clubs open for at least 12 months as of February 29, 2012, 571 (42%) had over 769 members as of February 29, 2012. The 950-member example gives you an idea of the revenues, expenses and profitability of a high achieving club. Of the 1,361 Anytime Fitness clubs open for at least 12 months as of February 29, 2012, 331 (24.3%) had over 950 members as of February 29, 2012.

The assumptions we made in compiling these projections are detailed following the projections. Any change in these assumptions would require material alterations to the projections.

	500 Members	769 Members	950 Members
Revenues[1]			
Enrollment Fee[2]	$11,000	$17,000	$20,900
Membership Fees[3, 4]	186,500	286,900	354,400
Vending Revenues[5]	1,500	2,300	2,900
Personal Training[6]	40,000	61,500	76,000
Total Revenues[7]	$239,000	$367,700	$454,200
Operating Expenses[1]			
Rent[8]	83,600	83,600	83,600
Equipment Lease[9]	45,600	45,600	45,600
Royalties	6,000	6,000	6,000
Processing/Credit Card Fees[10]	9,300	14,300	17,700
Bad Debt[11]	6,700	10,300	12,800
Utilities[12]	15,750	15,750	15,750
Insurance	2,500	2,500	2,500
Proximity Cards[2, 3]	1,100	1,600	2,000
Advertising Funds[13]	3,600	3,600	3,600
Local Advertising[14]	6,000	8,200	9,200
Anytime Health Fees[15]	2,700	2,700	2,700
Vending Products[5]	500	700	900
Maintenance	6,500	10,000	12,400
Software/Web Hosting[16]	2,400	2,400	2,400
Bodyworkz Fees[17]	1,900	1,900	1,900
Annual Training Fee	350	350	350
Miscellaneous[18]	12,000	15,000	17,500
Total Operating Expenses	$206,500	$224,500	$236,900
Income Before Salaries, Depreciation, Interest, Taxes and Debt Expense[19]	$32,500	$143,200	$216,900
Manager Salary and Payroll Costs[19]		$30,000	$40,000
Personal Training Commissions[6]	$20,000	$30,750	$38,000
Income Before Depreciation, Interest, Taxes and Debt Expense[19]	$12,500	$82,450	$138,900

THESE PROJECTIONS OF SALES, INCOME, GROSS OR NET PROFITS ARE MERELY ESTIMATES AND SHOULD NOT BE CONSTRUED AS THE ACTUAL OR PROBABLE SALES, INCOME, GROSS OR NET PROFITS THAT WILL BE REALIZED BY ANY FRANCHISEE. WE DO NOT REPRESENT THAT ANY FRANCHISEE CAN EXPECT TO ATTAIN SUCH SALES, INCOME, GROSS OR NET PROFITS. THE FINANCIAL RESULTS FOR A NEW FRANCHISEE ARE LIKELY TO DIFFER FROM THE RESULTS STATED IN THESE PROJECTIONS.

THESE FIGURES WERE 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 THE CONTENT OR FORM.

NOTES AND ASSUMPTIONS

1. We rounded most revenues and expenses to the nearest $100.

2. In projecting enrollment fee revenues and the cost of proximity cards, we assumed that 45% of your members would be replaced through attrition, and that the average enrollment fee you charge is $49. The 45% attrition rate is an average in the industry.

3. In projecting membership revenues, we had to make certain assumptions regarding the types of memberships you will sell in your center and the prices you will charge for each type of membership. Based on reports we received from our designated billing processor, the average Anytime Fitness franchisee for whom they processed memberships fees in 2011 had 75% as many membership agreements in effect as members. In other words, if you have 500 members, on average, you could expect to have 375 memberships, with approximately 75% of those memberships being individual memberships, and 25% of those memberships being couples (or family or multiple) memberships. Some of these memberships will be for fitness only, while others will include tanning memberships. It is up to you to set your own prices for each type of membership you sell (subject to minimum and maximum amounts we may specify). Based on the report from our designated processor, the average monthly membership fees paid under each membership agreement to our Anytime Fitness franchisees for whom they processed billings in 2011 was $41.45. (Individual memberships would typically pay lower fees, couples memberships would pay fees higher than the average, and those with tanning would pay higher fees than those without tanning.) We used this average in compiling the membership fee projection. However, membership rates will vary significantly between clubs, depending upon what you elect to charge, how your rates are affected by competition, the number of members you have who add tanning memberships, the number of couples memberships you sell, and the number of memberships you sell that receive corporate discounts.

4. Under the 2010 Affordable (Health) Care Act, you are required to collect sales taxes on tanning services, and remit those taxes to the Internal Revenue Service. We assumed that you will collect the tax and pay it to the taxing authorities, which has no effect on your bottom line, and that tanning sales will not be impacted by this new tax.)

5. It is up to you to determine whether you offer vending machines in your center, the products you place in those machines and the vending prices. The amounts we have projected for vending revenue reflect the per membership revenues we receive from vending. We also do not tell you the sources from which you can purchase vending products. We assumed you would purchase your vending products from a warehouse seller such as Sam's Club, and that you pick up these items. If you go to other sources, or have these products delivered, your expenses will likely be higher.

6. Most of our clubs hire personal trainers to provide personal training services to their members. Members pay the trainers, and our franchisees typically collect a percentage of what the trainers receive. (In some cases, franchisees charge trainers a monthly rental, and allow them to keep all or a greater share of the training revenues they receive.) We have projected training revenues equal to $80 per member per year. The training fees will vary by trainer, but the average training fee is $40 an hour. Thus, the training revenues assume you have between 2 and 4 members per day, 5 days per week, taking training. We believe that this is consistent with the average for all our franchisees, but many franchisees do not report their training revenues to us. Near the bottom of each column, we projected that you pay one-half of

these revenues to your trainer. If you perform all or a portion of the training services yourself, this would increase your income from operating your center.

7. There are other revenue sources we have not included. For example, we have recommended that our clubs charge members $1 a month for membership in Anytime Health ($2 for a couples or family membership). While we included in expenses the fees you pay us for each member (which we cap at $225 a month), since the majority of our clubs have elected not to separately charge their members for these memberships, we did not include them in revenues. Likewise, we recommend that our franchisees charge members a club enhancement fee of $20-$25 per year that can be used to purchase new equipment and upgrade their club. While more than a third of our clubs are charging these fees, and most of our newer clubs are charging them, we have not included these fees in revenues because we also did not include in your expenses the cost of purchasing new equipment or upgrading your facilities. Thus, if you are charging these fees, your cash flow would increase.

8. Your rent can vary significantly depending on the size and location of your center. However, in our experience, the number of members you have does not necessarily correlate to the size of your center. Our projections therefore assumed that the center had 4,500 square feet, and that the gross rent paid was $18.57 per square foot per year. If you have a larger center, or you pay more for rent, your rent expense could increase significantly.

9. This amount assumes you enter into a 3 year lease purchase agreement for your equipment, paying approximately 15% down, and financing the balance. For a center with 4,500 square feet, we estimated that the balance was $110,500. (Larger centers will typically have more equipment. See Item 7 for additional information about the range of initial investment for equipment and improvements.) Our projection assumes an interest rate of 10% per annum. We also assumed you are required to pay sales tax of 6 5/8% on these lease payments. These numbers will likely be different for each franchisee, as you may decide to make more of a down payment (which would lower your payments), you may decide to finance your equipment over a longer period of time (which will also lower your payments), you may have to pay a higher interest rate (which would increase your payments), and your sales tax may be higher or lower than 6 5/8%. In our company-owned centers, we typically purchase these assets without leasing.

10. Processing and credit card fees will vary depending on how many members prepay their membership fees, how many pay by credit card, and the credit card they use. In our experience, costs for these services generally average about 5% of your membership fees.

11. We assumed you would have 3.6% bad debt on your membership fees. This is consistent with the bad debt experience for our franchisees in 2011 as reported to us by our designated billing processor.

12. This amount includes gas, electric, water, cable, Internet and telephone. It assumes utilities average $3.50 per square foot.

13. This amount is based on our current requirement that you contribute $150 per month to our General Advertising Fund and $150 per month to our Local Marketing Fund.

14. We expect you to spend at least $6,000 per year for advertising. Our projection assumes your spending or local advertising increases more as you have more members.

15. As noted in footnote 7, you will be selling Anytime Health memberships for us, and you keep everything you charge for those memberships above $0.50 for individual members, and $1.00 for couples or family memberships. However, the maximum amount you must pay us each month for these memberships is $225 (and $675 if you own 3 or more centers).

16. In some states, you will also be required to pay sales tax on these fees. We have not included those sales taxes because they are payable in only a handful of states.

17. You are not required to use the Bodyworkz Training Program, but our revenue projection assumes that you do so. Thus, we have also assumed expenses of $160 per month for using this program. (If you have more than 2 centers, the fee is actually reduced to $135 per month for the second and any subsequent center.)

18. Miscellaneous includes janitorial services, legal and accounting fees, cell phone, supplies, licenses, and other similar items. Many of these costs can vary significantly depending on the location of your center and the time you spend looking for the best possible cost on these items. The projections are consistent with the experience of our company owned centers.

19. The low projection assumes you act as manager of your center and do not receive a separate salary. As your business grows, you may wish to hire a manager to oversee the club operations. We are assuming you would pay that manager $1,800 per month, plus commissions and limited benefits, so that with payroll costs, the total cost for a manager will be $30,000 a year. This is consistent with what we understand to be the average compensation our franchisees pay their managers. In the 950 member projection, we assumed the manager would receive a salary closer to $2,500 per month, plus additional commissions as the club continues to grow. Except as noted in footnote 6, the projections assume you do not hire any other employees to help you. (Because our centers are designed to operate 24 hours a day, without the necessity of having staff on premises, you should not need any other employees. However, some states or municipalities may require you have an employee on premises whenever your center is open. If you are an absentee-owner, or you operate in a location that requires the center to be staffed at all times, your expenses will increase significantly because you will have to pay salaries and benefits to employees. In our company-owned centers, we do pay a manager, or a management fee, to somebody to oversee the centers for us. Thus, we had additional expenses for wages or management fees.)

We gave you information above about the number of all our centers that were open for at least 12 months as of February 29, 2012. We or our affiliates operated 6 of those centers. All 6 (100%) had 500 or more members, all 6 (100%) had 769 or more members, and 3 (50%) had over 950 members, as of February 29, 2012. 5 of those 6 centers (83.3%) exceeded the revenue and income projections in the first (500 members) column, 3 (50%) exceeded the revenue and income projections in the second (769 members) column, and 1 (16.7%) exceeded the revenues and income projections in the third (950 members) column. Because our franchisees are not required to give us this level of detail as to their revenues and expenses, we cannot tell you how many of our franchisees exceeded the projected revenues or projected profits.

CHARLES S. ("CHUCK") MODELL

Chuck is an attorney and chairman of the franchise practice group at Larkin Hoffman Daly & Lindgren Ltd., Minneapolis, Minnesota. He has been an active member of the franchise community for four decades. His practice consists primarily of representing franchisors concerning the business aspects of franchising, including the structuring of the franchise relationship; drafting franchise agreements and disclosure documents; compliance with state and federal franchise laws and regulations; negotiations with franchisees; terminations and non-renewals; and the purchase and sale of franchise companies. However, he also currently represents private equity companies that own a large number of franchised units in the QSR and family dining segments.

Chuck is a certified commercial arbitrator with the American Arbitration Association and has also served as a mediator in a number of franchise disputes. He is a former member of the Governing Committee of the Franchise Forum, and served as the Forum's Finance Officer for over six years. He has also been active in the IFA for over three decades, having served on the Legal/Legislative Committee, the Franchise Relations Committee, and the Board of the Council of Franchise Suppliers. He is a member of the Advisory Committee to the North American Securities Administrators Association Franchise Project Group which meets regularly with state franchise regulators from across the country.

As a leader in the franchise field, Chuck is recognized by Chambers USA, Best Lawyers in America,® Who's Who of International Franchise Lawyers and Super Lawyers.® He served on the Larkin Hoffman Board of Directors for more than ten years, and as the firm's Chief Financial Officer. He received a Bachelor of Science degree from the University of Florida in 1974 and graduated with high honors from the University of Florida College of Law in 1977.

GARY R. BATENHORST

Gary R. Batenhorst is a partner in the Omaha, Nebraska office of Cline Williams Wright Johnson & Oldfather, L.L.P. As a member of the firm's Franchising and Distribution Practice Group, he concentrates his practice on transactional and compliance matters, representing primarily franchisors, product manufacturers and multi-unit franchisees. He also represents start-up franchisors in the establishment of franchise systems.

Gary was Vice President, Secretary and General Counsel for Godfather's Pizza, Inc. from 1988-2001. He taught Franchising as an Adjunct Professor at Creighton University School of Law for 14 years, where he currently teaches Business Planning. Gary received his B.S.B.A. from Creighton University (*magna cum laude* 1973) and his J.D. from New York University School of Law (1976).

Gary has been recognized by Best Lawyers in America®, Who's Who of International Franchise Lawyers and Super Lawyers®. He has written on franchise topics in state and national publications and has presented programs on franchise topics for national and state continuing education programs and seminars for individuals interested in establishing franchised businesses.