ITEM 19: FINANCIAL PERFORMANCE REPRESENTATIONS

Like the original Rule and the UFOC Guidelines, the amended Rule permits, but does not require, franchisors to include representations about financial performance in their disclosure documents.[16] Unlike the original Rule, a franchisor that decides to make such representations must include them in Item 19, not in a separate document. A franchisor electing to make a financial performance representation must, among other things, have a reasonable basis[17] and written substantiation for the representation at the time it is made, and disclose the bases and assumptions underlying the representation in Item 19. The Item 19 disclosures also must include an admonition that a prospective franchisee's actual earnings may differ. Franchisors should keep in mind not only the affirmative disclosure requirements in Item 19, but the parallel prohibitions against making representations that are not true or are not substantiated at the time they are made. These prohibitions are discussed below, beginning on page 130.

<u>Required Item 19 Preambles</u>

All Item 19 disclosures must begin with a prescribed preamble that informs prospective franchisees about the law of financial performance representations:

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

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16 The amended Rule uses the broad term "financial performance representation," rather than the original Rule's more limited term "earnings claim," out of recognition that some industries, such as hotels, use variables other than earnings to measure performance, such as room occupancy rates.

17 For a discussion of what is "reasonable," see the discussion on page 135 below.

This preamble must be included word-for-word as set out above, with no modification in language or punctuation.

If a franchisor elects ***not*** to make any financial performance representations, then the franchisor's disclosure document must include in Item 19 not only the universal preamble set out immediately above, but also the following additional preamble:

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

Like the universal preamble, this preamble for those not making financial performance representations must be included word-for-word as set out above, with no modification in language or punctuation.

Note that franchisors that make no Item 19 financial performance representations are prohibited from making any such representations outside of the confines of the disclosure document. This prohibition encompasses any financial performance representations made in any advertisement or on a website directed at prospective franchisees. The making of any such contradictory representations is itself an independent violation of the amended Rule.

Financial Performance Representations: Historical or Projected?

The requirements of Item 19 vary depending upon whether a franchisor makes historical representations (how much existing franchisees have, in fact, earned in the past) or projections (how much an individual prospective franchisee is likely to earn in the future). In fact, Item 19 requires franchisors to state expressly whether any financial performance representation:

- pertains to historic performance of all or a subset of existing franchised outlets or

- is a forecast of future potential performance.

<u>Historic Performance</u>

A franchisor making an historic financial performance representation must state the material facts underlying the representation. Item 19 of the amended Rule specifies six separate elements comprising the material bases for such a representation, each of which must be expressly addressed:

- **The Group Measured –**

Did All Outlets in the System, or Only Some of Them, Achieve the Stated Level of Performance?

A franchisor that makes an historic financial performance representation, in Item 19 must state whether the representation relates to the performance of all its existing outlets or only a subset of them sharing some characteristic (*e.g.*, all in the same geographic region or locale, all occupying free-standing premises as opposed to premises in a shopping center, or all in operation for at least three years). Of course, nothing prevents a franchisor from basing a financial performance claim on system-wide data, such as a survey of all franchised outlets to gather data on average sales. The point is, a franchisor may base a financial performance claim on data from fewer outlets than are in the entire system if these outlets share one or more characteristics in common. The amended Rule permits this, provided the franchisor discloses the characteristics of the outlets from which data are gathered to form the basis of the financial performance representation, and the total number of franchises in the franchise system.

Are the Outlets in the Measured Group Franchised Outlets? Company-owned? Outlets of an Affiliated System with Similar Operations?

The group from which data is gathered need not be comprised of franchised outlets. It may be a group consisting of company-owned outlets, or, in certain limited circumstances, a group of reasonably similar outlets of an affiliate with operations reasonably similar to those of the franchisor making the offering in question – ***with two provisos.***[18] The first proviso is that any financial performance representation a franchisor makes must be reasonable and supported by the data collected from the group. That means the franchisor must have written substantiation of the representation in the franchisor's possession at the time the representation is made. The second proviso is that the franchisor's disclosure must make clear whether the claim is based on the experience of company-owned outlets, of outlets of an affiliate with reasonably similar operations, or of franchised outlets in the same system as those being offered for sale.

- **Time Period Measured –**

  When Was the Stated Level of Performance Achieved?

  Franchisors have the flexibility to use any reasonable time period. For example, a franchisor may wish to disclose sales or profit figures for franchisees over the last two fiscal years. Be mindful, however, that using a time period that is not fairly recent may generate performance results that no longer are relevant to current market conditions. Using data gathered too long ago – even if true when collected – may not provide a reasonable basis for a financial performance representation if it is no longer relevant to current conditions. As one example, a franchisor may have conducted a survey of franchisees between 2000 and 2002. Use of statistics gathered so long ago may be no longer relevant – and is possibly misleading – in

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[18] As noted, all financial performance representations must have a reasonable basis. When a franchisor has adequate performance data of its own upon which to base a performance representation, basing a financial performance representation on affiliate information likely would ***not*** be reasonable. Nevertheless, if the franchisor lacks adequate operating experience of its own, it may base a financial performance claim upon the results of operations of a substantially similar business of an affiliate. As in any case when a financial performance representation is based on a subset of outlets that share a particular set of characteristics, the franchisor must also disclose any characteristics of these outlets that may differ materially from the outlets being offered for sale.

light of all the market changes that may have transpired since then. Likewise, representations based on the reasonably similar operations of an affiliate with reasonably similar operations may prove to be inaccurate or misleading, in a relatively short period of time, based on the actual operating experience of the franchisor's franchisees.

- **Number of Outlets Measured –**

How Many Outlets Are in the Group That Achieved the Stated Level of Performance, and How Many Are in the Entire System?

A franchisor must disclose the number of franchisees that were in the group or subgroup measured as compared to the number in the entire system, during the relevant time period. For example, if a franchisor wishes to base a financial performance representation on all franchisees in Florida during its last fiscal year, the franchisor must state how many franchisees were in the system (*e.g.*, "There were 1000 system franchises in fiscal 2006") and the number that existed in Florida during that period (*e.g.*,"There were 100 Florida franchisees in fiscal 2006").

- **Number of Outlets Reporting –**

How Many Outlets in the Relevant Group Supplied the Performance Data Underlying the Representation?

Franchisors must also disclose the number of franchisees in the group about which the financial performance claim is made and from which the financial performance data were gathered. Data could be gathered from all members of a group sharing the specified characteristics, or from fewer than all members of that group. For example, a franchisor may have sent out questionnaires to each of its 100 franchisees in Florida, or may have selected 50 randomly to receive the questionnaires. The franchisor's Item 19 disclosures would need to clearly disclose the number of franchisees who received questionnaires and how they were selected. The disclosure also could indicate how many responded to the questionnaire.

- **Number and Percentage of Outlets that Achieved the Stated Level of Performance –**

  What Proportion of the Group Measured Achieved the Results Claimed?

  With respect to the outlets that provided data used to arrive at the representation, franchisors must disclose both the number and percentage that actually attained or surpassed the stated results. For example, suppose that of 100 Florida franchisees who received survey questionnaires about their financial performance, 75 responded and 50 achieved or surpassed the represented level of performance. In that case, the franchisor's Item 19 disclosures would need to disclose clearly both the number (*i.e.*, 50 out of the 100 who received questionnaires) and the percentage of franchisees who achieved the represented results (*i.e*., 50%).

- **Distinguishing Characteristics –**

  What Are the Common Attributes of the Outlets That Achieved the Stated Level of Performance?

  The implicit assumption underlying any historic performance representation is that a prospective franchisee may achieve at least the same level of performance – although, of course, there is no guarantee that this will happen. Factors tending to call that implicit assumption into question must be disclosed. Thus, Item 19 calls for disclosure of any characteristic of the group or subgroup on which a financial performance claim is based that might set that group apart from outlets currently being offered for sale. For example, financial performance data collected from ice cream store franchises in Florida might differ significantly from such data collected from ice cream store franchisees in Minnesota or Alaska. Accordingly, if a franchisor uses a subgroup (*e.g.*, Florida franchisees) as a basis for a financial performance claim, the franchisor's disclosure documents used elsewhere (*e.g.,* in Minnesota and Alaska) must clearly state that the performance results represented in Item 19 are based upon Florida franchisees, and are likely to differ materially from those of the outlets being offered for sale.

Projected Performance

As is the case with historical financial performance representations, financial performance projections must have a reasonable basis, and must disclose the material bases and assumptions upon which the projection is based. The amended Rule does not enumerate specific factors that must be addressed in describing the bases for a projected financial performance representation. Nevertheless, if a franchisor makes a performance projection, its Item 19 disclosures must include sufficient facts to enable a prospective franchisee to make an independent judgment as to the validity of the projection. The Item 19 disclosures should include a description of the material information on which the franchisor relied in making the representation. This may include market studies, statistical analyses, franchisee profit-and-loss statements, as well as other types of information that prudent persons customarily rely on in making business decisions.

Assumptions underlying a financial performance representation must be disclosed because they go to the heart of the issue – the probability that a prospective franchisee will achieve performance similar to that projected. Thus, the assumptions underlying a forecast include significant factors upon which a franchisee's future results may 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.

In this regard, if a projection is based upon the results of franchisees' prior performance, the assumptions disclosed must explicitly encompass any characteristics of the outlets upon which the claim is based that differ materially from the outlets currently being offered for sale. Examples of characteristics that typically make a material difference from one outlet to another include: geographic location; type of business premises (*e.g.*, free-standing units as opposed to units in a shopping center); the extent of competition in the market area; the services or goods sold; assistance or services supplied by the franchisor; and whether the outlets are franchised or company-owned or operated. More specific guidance in preparing assumptions for performance projections can be gained from the American Institute of Certified Public Accountants ("AICPA").

Admonition

The amended Rule's Item 19 requires a clear and conspicuous admonition that a new franchisee's individual financial results may differ from the results stated in the Item 19 disclosure. While no specific language is required, franchisors can look to the admonitions set forth in the original Rule as a model. These include:

For historical representations –

Some outlets have [sold] [earned] this amount. There is no assurance you'll do as well. If you rely upon our figures, you must accept the risk of not doing as well.

For projections –

These figures are only estimates of what we think you may earn. There is no assurance you'll do as well. If you rely upon our figures, you must accept the risk of not doing as well.

Availability of Substantiation

If a franchisor elects to make a financial performance representation in Item 19, then it must also include a statement that written substantiation for the representation will be made available to the prospective franchisee upon reasonable request. In this context, the term "reasonable" pertains to time and location. A request is reasonable when the prospective franchisee gives the franchisor sufficient time to produce the substantiation at a convenient location, possibly at company headquarters or where the substantiation is stored if it contains confidential information or is voluminous. For example, franchisors are not expected to bring substantiation with them to a trade show. Accordingly, a request by a trade show attendee for substantiation that afternoon at the trade show would probably be deemed unreasonable.

Financial Performance Representations on a Specific Outlet Offered for Sale

The amended Rule's Item 19 makes clear that a franchisor not wishing to make financial performance representations may nonetheless offer to show a prospective franchisee the actual operating results of a specific outlet being offered for sale. Such information, however, may only be furnished to potential purchasers of that outlet and no others.

Supplemental Representations

If a franchisor has furnished an Item 19 disclosure, it may furnish a prospective franchisee with a supplemental financial performance representation pertaining to a particular location or pertaining to a particular variation (*e.g.*, a kiosk, as opposed to a standard free-standing restaurant). Any such supplemental representation must be in writing, explain the departure from the financial performance representation set forth in the Item 19 disclosures, and be prepared according to the standards for financial performance claims noted above.

Sample Item 19-1: Financial Performance Representation (Based on Actual Historical Performance Results)

ITEM 19: FINANCIAL PERFORMANCE REPRESENTATION

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

Half of existing Belmont Mufflers franchisees in large metropolitan areas have had at least $200,000 in annual sales.

Some outlets have sold this amount. There is no assurance you'll do as well. If you rely upon our figures, you must accept the risk of not doing as well.

Bases

These sales figures are derived from the actual historical performance of Belmont franchisees in four large metropolitan areas: New York City, Boston, Chicago, and Los Angeles. These sales figures were achieved over calendar years 2005 and 2006.

There are 258 Belmont franchisees in the entire Belmont system, of which 100 are in New York City, Boston, Chicago, and Los Angeles. Of the 100 Belmont Muffler franchisees in these cities, we studied the sales figures from 90 standard 6-bay franchised outlets. Of the 90 franchisees, 50 attained at least $200,000 in annual sales, which is 50% of the franchisees in these cities.

Assumptions

Our study measured Belmont franchisees' performance in large metropolitan areas. The market where your Belmont Muffler shops is located, however, may be in a smaller urban or suburban area. Accordingly, the results achieved by these franchisees may not be typical for those in your area.

Further, each of the franchises studied has been in business at least three years. A separate market study we commissioned that was prepared by HFG Associates, an independent consulting firm, indicates that Belmont franchisees in their first year of operations are likely to achieve half the sales of those operating in business for three years or more.

Our study, the HFG Associates study, and other financial information that forms the bases for our financial performance representation are available to you upon reasonable request.

Sample Item 19-2: Financial Performance Projection (Based on Projected Results)

ITEM 19: FINANCIAL PERFORMANCE PROJECTION

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

We estimate that the most probable net income for your first twelve months of operation is $50,000.

This income figure is only an estimate of what we think you can earn. There is no assurance that you'll do as well. If you rely upon these figures, you must accept the risk of not doing as well.

Bases

This projected income figure is derived from the actual historical performance of first-year Belmont franchisees.

There are 258 Belmont franchisees in the entire Belmont system, of which 70 began their first year in operation in calendar years 2005 or 2006. Of these, 54 franchisees responded to our survey and submitted data, and 35 (or 50% of first-year franchisees) reported attaining at least $50,000 in annual income from their franchises.

Assumptions

Forty-five of the franchisees included in our survey are located in large metropolitan areas. The market where your Belmont Muffler shop will be located, however, may be in a smaller urban or suburban area. Accordingly, the results achieved by the these franchisees may not be typical for those in your area.

The above projection also assumes a stable supply of pipe, no additional competition for muffler parts and services, and retail price increases of no more than 3% in the next year.

Our survey and other financial information that forms the bases for our financial performance representation are available to you upon reasonable request.

ITEM 20: OUTLETS AND FRANCHISEE INFORMATION

Like the UFOC Guidelines, Item 20 of the amended Rule requires the disclosure of statistical information on the number of franchised outlets and company-owned outlets for the preceding three-year period. Note, however, that the tables in the amended Rule differ substantially from the version of these tables that may be familiar from the UFOC Guidelines. Item 20 of the amended Rule also differs from the UFOC Guidelines in the requirements for disclosure of contact information for former franchisees. In addition, Item 20 contains several new provisions pertaining to: (1) specific outlets offered for resale; (2) confidentiality agreements; and (3) trademark-specific franchisee associations.

Statistical Information

Item 20 of the amended Rule requires five tables. The first table provides a systemwide summary of outlets, detailing the net changes in the number of outlets – both franchised and company-owned – over the last three fiscal years. The second tracks transfers of outlets, state by state, over the last three fiscal years. The third shows, state by state, changes in the status of franchised outlets over the last three fiscal years. Similarly, the fourth table displays, state by state, changes in the status of company-owned outlets over the last three fiscal years. Finally, the fifth table projects new outlet openings in each state. It also shows the number of franchise agreements that have been signed but have not yet resulted in the opening of an outlet.

Definitions Used in Item 20

When preparing the Item 20 tables, be aware that the various terms used have specific meanings, as outlined below.

- ***"Transfer"*** means the acquisition of a controlling interest in a franchised outlet, during its term, by a person other than the franchisor or an affiliate. It covers private sales of an outlet by the existing franchisee-owner to a new franchisee-owner and the sale of a controlling interest in the ownership of a franchise.

- ***"Termination"*** means the franchisor's termination of a franchise agreement prior to the end of its term without providing any money or other consideration to the franchisee (*e.g.*, forgiveness or assumption of debt). For example, a franchisor may decide to terminate a franchisee for failing to abide by system health and safety standards. As a result, the franchisee leaves the system without receiving any payment or other consideration, such as cancellation of a debt owed to the franchisor.

- ***"Non-renewal"*** means failure to renew a franchise agreement for a franchised outlet upon the expiration of the franchise term. For example, a franchisee may operate a franchise for period of 10 years. At the conclusion of the 10-year term, the franchisor (or franchisee) may decide not to renew the franchise agreement.

- ***"Reacquisition"*** means the return of a franchise outlet during its term to the franchisor in exchange for cash or some other consideration, including the forgiveness of a debt. For example, during the course of a franchise agreement, a franchisee may wish to terminate its relationship with the franchisor, and the franchisor may agree to buy back the outlet for cash or to forgive overdue royalty payments.

- ***"Ceased operation"*** means the cessation of business operations for any reason other than transfer, termination, non-renewal, or reacquisition. It includes abandonment of the outlet by a franchisee. It also includes franchisees in an "inactive" status.