FRANCHISEUPDATE
THE MANAGEMENT RESOURCE FOR FRANCHISORS

The first question a franchise salesperson often gets from a prospective franchise is, “How much can I make?” Being able to answer the earnings question or to give prospects the means to answer it for themselves is one being reason for including an Item 19 in the UFOC.

Indeed, the competition for good, well-capitalized franchisees is fierce, with new and novel means of franchisee recruitment being developed every day. Providing meaningful information in Item 19 can be a tremendous competitive advantage as today’s franchise prospects evaluate and compare various opportunities. Moreover, if your competitors disclose earnings information to franchisee prospects, there is competitive pressure on you to provide such information.

Yet most franchisors still do not make an Item 19 earnings claim. Despite changes to the UFOC Guidelines in 1995 and now to the federal regulations (which make it easier to make a legally compliant earnings claim), the same old arguments, often centering around perceived liability risks, are bantered about for not making an earnings claim.

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The recent changes to the Federal Trade Commission’s Rule on Franchising (the “New FTC Rule”) – which was approved on January 22, 2007, goes into effect on a voluntary basis on July 1, 2007, and becomes mandatory on July 1, 2008 – will increase the competitive pressures on the franchisors to make what is now called a financial performance representation. However, the end result is that the regulators have again made it even easier to make a legally compliant earnings claim.

The New FTC Rule requires that a franchisor must state in Item 19 of the disclosure document the following:

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 the Item 19 may be given only if: 1) a franchisor provides the actual records of an existing outlets you are considering buying; or 2) a franchisor supplements the information in this Item 19, for example by providing information about possible performance at a particular location or under particular circumstances.

The New FTC Rule also mandates specific *additional* language if you do not make a financial performance representation warning prospects not to rely on unauthorized representations and to report any such representations to the company, the FTC, and the relevant state agency. The inclusion of the preamble will serve to undercut some franchisor's claims to prospects that the FTC prohibits them from making financial representations. Prospects could also shop for a system that does make financial performance representations. In addition, the preamble puts the prospect on notice to rely on claims made outside of the disclosure document.

Differences from the original FTC Rule While rendering the "The government won't let me tell you" excuse for not making an earning claim patently unusable, the New FTC Rule makes significant changes to the original FTC Rule. These changes are designed to make it easier and more attractive to make an earnings claim. For example, the New FTC Rule eliminates the previous requirement that franchisor making an earnings claim must provide prospective franchisee with a separate financial performance representation document. The New FTC rule also eliminates the express requirement that any earnings claim be geographically relevant.

Further, the New FTC Rule eliminates the requirement that any historical financial performance claims must be based upon generally accepted accounting principles (GAAP); permits franchisors, under specific circumstances, to disclose (apart from the disclosure document) the actual operating results of a specific unit being offered for sale; and expressly permits franchisors to furnish supplemental performance information directed at a particular location of circumstance.

Differences from the UFOC Guidelines As it pertains to financial performance representations, the New FTC Rule more closely resembles the format and requirement set forth in the UFOC Guidelines, including identifying an earnings claim as Item 19 in the disclosure document. But it does not contain some significant differences that make it even easier, and more attractive, for franchisors make an earnings claim.

The addition of the required preamble is perhaps the most striking difference with the UFOC guidelines. But more significantly, the New FTC Rule loosens the disclosure requirements relating to making earnings claims based on subsets of franchisor-owned or franchised outlets. For example, the New FTC Rule expressly permits an earnings claim based on all of the system's existing outlets or on a subset of outlets that share a particular set of characteristics, and limits disclosure of outlets that exceeded the stated result to only those outlets used in arriving at the representation. Thus, for a financial performance representation that set forth average gross sales for a specific subset of franchisees, the franchisor would only have set forth the number of franchisees in that subset that exceeded the average and not the percentage of the system as a whole.

However, a franchisor still must have a reasonable basis and must disclose;

1. the nature of the universe of outlets;

2. the total number of outlets in the universe measured;

3. the number of outlets from the universe that was actually measured; and

4. any characteristics of the measured outlets that may differ materially from the outlet offered to the prospective franchisee (e.g. location, years in operation, franchisor-owned or franchisee-owned, and likely competition). Prospects can then assess for themselves what weight to give the financial performance representation.

Requirements of the New FTC Rule The New FTC Rule does not require a franchisor to make a financial performance representation, but if a franchisor does make on to prospective franchisee, it must have a reasonable basis and written substantiation for the representation at the time it is made and must state the representation in the Item 19 disclosure.

The franchisor must also disclose the following:

1) Whether the representation is an historic financial performance representation about the franchise system's existing outlets or a subset of those outlets, the material basis and written substantiation for the representation at the time it is made and must state the representation in the Item 19 disclosure.

The franchisor must also disclose the following:

1) Whether the representation is an historic financial performance representation about the franchise system's existing outlets or a subset for those outlets; or is a forecast of the prospective franchisee's future financial performance.

2) If the representation relates to the past performance of the franchise system's existing outlets, the material bases for the representation, including:

- Whether the representation relates to the performance of all of the franchise system's existing outlets or only a subset of outlets that share a particular set of characteristics; for example; geographic location, type of location (such as free-standing vs. 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;
- The dates that the reported level of financial performance was achieved;
- The total number of outlets that existed in the relevant period and, if different; the number of outlets that had the described characteristics;
- The number of the outlets with the described characteristics whose actual financial performance data were used in arriving at the representation;
- Of those outlets whose data were used in arriving at the representation, the number and percentage that actually attained or surpassed the stated results; and
- Characteristics of the included outlets that may differ materially from those of the outlet that may be offered to a prospective franchisee.

3) 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 include 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 that encompass matters affecting, among other things, a franchisee's sales, the cost of goods or services sold, and operating expenses.

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

5) A statement that written substantiation for the financial performance representation will be made available to the prospective franchisee upon reasonable request.

Using Item 19 Once a franchisor makes an Item 19 financial performance representation, it may also want to use it more ways that just in the disclosure document. After all, if a franchisor can answer the one question that prospects most want to know ("How must can I make?"), it gives them a competitive edge and they can use it to their advantage.

If a franchisor furnishes financial performance information in compliance with the New FTC Rule, the franchisor may also deliver to a prospective franchisee a supplemental financial performance representation about a particular location or variation, apart from the disclosure document. This supplemental representation must:

1) be in writing;

2) explain the departure from the financial performance representation in the disclosure document;

3) be prepared in accordance with the requirements of the New FTC Rule above; and

4) be furnished to the prospective franchisee.

Item 19 and the general media The New FTC Rule also retains the original FTC Rule's provision governing the making of financial performance representations in the general media, including advertising. If a franchisor makes an Item 19 financial performance representation, it may include such in its advertising. Financial performance representations in the general media include: 1) claims in advertising (i.e., radio, television, newspapers, etc.); 2) claims in speeches; and 3) claims in press releases.

Under the old FTC Rule, a franchisor who wishes to disseminate earnings information in the general media must have reasonable basis for the representation; must possess, and make available to the FTC upon reasonable request, material that constitutes a reasonable basis for the representation; must ensure that the data underlying the representation has been prepared in accordance with GAAP; and must provide certain disclosures in immediate conjunction with such representation detailing the number and percentage of franchisees who have earned the claimed amount and the time period in which the claim is based. The FTC staff intends to further address the specific scope of general media financial performance representations under the New FTC Rule in subsequent compliance guides.

Conclusion These days, the competition for good, well-capitalized franchisee is fierce, with new and novel means of franchisee recruitment being developed every day. If your competitors disclose earnings information to franchisee prospects, there is competitive pressure on you to provide such information. The New FTC Rule makes it even easier and more attractive to make an Item 19 financial performance representation. Finally, assuming the earnings information is good, you can reproduce it in your printed and television media advertising, use it in recruitment, and throughout the sales process to maximize franchise sales.