

A New Item 19
and
the Changing Face of Earnings Claims

General

As many of our friends and clients already know, the Federal Trade Commission recently announced a proposed major revision (in what may be an almost perfect example of bureaucratese, the “proposed final revised Franchise Rule”; what we call the “2004 Proposed Rule”) to the FTC Franchise Rule.

Among many other revisions to the UFOC, those changes (when and if implemented) will affect how formal earnings claims are presented in UFOCs.

As has always been true, the federal rules in this area set a minimum standard for compliance by all franchisors offering and selling franchises within the United States. While state laws and regulations may set higher standards for the protection of Franchisees, all Franchisors in the U.S. must comply with the FTC standards.

The FTC has been studying possible changes to the Franchise Rule since 1995, and the process should now be close to conclusion. The changes proposed are properly characterized as evolutionary in nature, not revolutionary. While they do not represent any radically new approaches to franchise disclosure, they will require all Franchisors operating in the U.S. to revise their disclosure procedures and the contents of their disclosure documents, including changes to Item 19, whether or not a Franchisor makes a formal earnings claim.

From a policy standpoint, the proposals are, in our judgment, generally sound and constitute a worthwhile step forward in franchise disclosure regulation in the United States.

In essence, the 2004 Proposed Rule will accomplish three main objectives:

First, they will modernize the “mechanics” of disclosure, relating to when UFOCs are delivered, the use of alternative means of delivery, etc.



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Second, they will change the content of disclosure documents, in Item 19 and in essentially all other areas of the UFOC.

In a major departure, the FTC has adopted the Uniform Franchise Offering Circular (“UFOC”) format, eliminating the alternative FTC disclosure document (which almost no Franchisors use), but has made changes, many of them significant, to each of the items in the UFOC. Commentators have designated the proposed new disclosure document the “UFOC Plus” and, in many areas, it requires significantly greater disclosures than were previously the case.

Third, additional exemptions from the coverage of the FTC Franchise Rule have been proposed, removing certain transactions and/or prospective Franchisees from the coverage of the 2004 Proposed Rule.

Readers should also note the following:

A. This paper touches on only some of the more noteworthy changes which the FTC has proposed with respect to Item 19. Numerous other proposed changes exist throughout the UFOC, many of which substantially affect the content of the UFOC Plus.

B. As noted above, the 2004 Proposed Rule is exactly that: **proposed**. It is not yet finalized and the FTC will be receiving comments and suggestions through November 12, 2004, some of which will be forthcoming from Holmes & Lofstrom, LLP, and others. Therefore, while most commentators, including those of us at Holmes & Lofstrom, believe that relatively few changes of any great magnitude will be made in the proposal, and that it will be largely adopted in its current form, the possibility of further changes cannot be entirely ignored and it is certainly possible that changes in a number of the details may still be forthcoming.

C. Since the 2004 Proposed Rule is still, technically, merely a proposal, no specific date for implementation has been set. We expect that Franchisors will be able to prepare their UFOCs to be used beginning in the Spring of 2005 on the current form and that the UFOC Plus form will not be implemented until 2006 at the earliest, but we will have to wait to see if that judgment is correct.

Being mindful of the above cautions, set out below are some of the more significant changes proposed by the FTC with respect to Item 19. A copy of the full text of the proposed new Item 19 is attached for reference, but recall that the final form may be different.

Proposed New Item 19 – Executive Summary

This portion of the UFOC, relating to the question of potential financial results a prospective Franchisee might expect, has been changed in a number of significant areas.

- a. A non-significant change, but one which should be mentioned, involves terminology: The phrase “earnings claim” is replaced with the more general, and more accurate, term “financial

performance representations.” It’s likely, however, that the old phrase will continue in use informally, at least for some time.

- b. Also, the core philosophical approach of old Item 19 is retained. Financial performance representations are not mandatory, but, if they are made, they must be made in the UFOC and in compliance with its requirements.
- c. Mandatory language must be presented in Item 19 regarding financial performance representations, including specific language if financial performance representations are not made.
- d. In a significant departure from current Item 19, the definition of “financial performance representations” does not include costs. Therefore, at least in theory, a Franchisor might be able to present cost information without triggering the need for an Item 19 disclosure. However, one should note that, in some circumstances, cost information can imply information regarding gross revenues or earnings and that any such attempt could run afoul of the FTC’s general prohibitions regarding financial performance claims.
- e. The requirement that financial performance representations meet GAAP standards will be eliminated.
- f. Finally, changes are made allowing Franchisors to present financial performance representations regarding subgroups of Franchisees (for example, “express” units or kiosks, compared to traditional full-sized or “brick and mortar” units), but should prevent Franchisors from “cherry-picking” their best producing units and presenting non-representative information inapplicable to the proposed Franchisee.

Proposed New Item 19 – Detail

1. Definition.

A new definition, of what we have been calling “earnings claims” and are now called financial performance representations, will be put in place, as follows:

Financial performance representation means 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. A chart, table, or mathematical calculation that shows possible results based on a combination of variables is a financial performance representation. [Emphasis added.]

This definition may be somewhat more broad than previously used, since it includes the phrase “by implication” and the standard UFOC definition of earnings claims, as information “from which a specific level or range of actual or potential sales, costs, income or profit from franchised or non-franchised units may be easily ascertained,” is dispensed with.

On the other hand, note that representations regarding costs are not included in the new definition, at least as a formal matter.

2. Mandatory Statements.

Whether or not the Franchisor provides financial performance representations, a mandatory statement must appear in the UFOC at Item 19 as follows:

The FTC’s Franchise Rule permits a franchisor to disclose 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 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 performance at a particular location or under particular circumstances.

In general, this language is designed to address situations in which Franchisors have (inaccurately) claimed that they are not permitted to provide unit-level financial information. Of course, Franchisors have always been able to do so, assuming that they complied with the relatively stringent requirements of Item 19.

If the Franchisor does not provide financial performance representations (which, as noted above, it is not required to do), then it must add the following language:

This franchisor does 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 and address], the Federal Trade Commission, and the appropriate state regulatory agencies.

This language seems generally appropriate, in order to provide some warning to prospective Franchisees that financial performance representations outside the UFOC are unauthorized, although warnings relating to such "cocktail napkin earnings claims" could be more clear, and we would generally recommend use of additional language which may have the effect of protecting a Franchisor.

3. Reasonable Basis, Substantiation, etc.

As before, a Franchisor must have a reasonable basis for the financial performance representations made, must have written substantiation for them and must present the representations within Item 19.

In addition, disclosure is required regarding 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. (Note that forecasts are generally considered, by franchising professionals, to be the most dangerous and litigation-prone form of financial performance representation and are disfavored for that reason.)

Where a historically-based financial performance representation is involved, additional disclosures must be given with respect to:

(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 free standing vs. shopping center vs. kiosk), degree of competition in the market area, 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 during which 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;

(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; and

(F) Characteristics of the included outlets that may differ materially from those of the outlet that may be offered to a prospective franchisee.

4. Future Financial Performance.

If the representation is a forecast of future financial performance (something we normally recommend against), the Franchisor must 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.

5. Admonitions and Substantiation.

Similar to the current rule, the Franchisor presenting a financial performance representation must

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

(b) state that written substantiation for the financial performance representation will be made available to the prospective franchisee upon reasonable request.

5. Sales of an Existing Unit.

As is currently true, if a franchisor wishes to disclose only the actual operating results for a specific outlet being offered for sale, it need not comply with the new rules regarding financial performance representations, provided the information is given only to potential purchasers of that outlet.

6. Supplemental Information.

If a franchisor furnishes financial performance information according to Item 19, the franchisor may deliver to a prospective franchisee a supplemental financial performance representation about a particular location or variation, apart from the disclosure document. The supplemental representation must:

(A) Be in writing;

(B) Explain the departure from the financial performance representation in the disclosure document;

(C) Be prepared in accordance with the requirements for reasonable basis and substantiation as discussed above and in the proposed Rule; and

(D) Be furnished to the prospective franchisee.

What Happens Next

As noted above, the 2004 Proposed Rule is open to comment through November 12, 2004, and there are a number of areas where comments can be expected. However, it seems unlikely that significant changes will be made, although some clarifications and “fine tuning” is both possible and appropriate in some instances.

There is no time limit on the FTC Staff for review of any comments, nor any deadline for adoption of the 2004 Proposed Rule by the full Commission.

Once the 2004 Proposed Rule is adopted, based on past experience, there will be a phase-in period allowing Franchisors to comply with the 2004 Proposed Rule and for states to accept the new format, including making any related changes to their laws and regulations.

Finally, the FTC Staff has signaled that it will issue interpretive guidelines providing practitioners with direction as to the implementation of the new rules.

This material is presented for training and discussion purposes only. It is not descriptive of all elements of the Proposed FTC Franchise Rule, is based only on a proposed form of that rule which has not been finalized, and should not be used or relied on without first consulting an attorney who is an experienced franchise law specialist, and discussing with him/her the facts and applicable law. Proceeding without the benefit of the advice of an experienced and knowledgeable franchise law specialist, specific to your fact situation, documents, business model, etc., is not recommended. © 2004 Holmes & Lofstrom, LLP

Text of Proposed Item 19

Item 19: Financial Performance Representations.

(1) Begin by stating the following:

The FTC's Franchise Rule permits a franchisor to disclose 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 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 performance at a particular location or under particular circumstances.

(2) If a franchisor does not provide any financial performance representation in Item 19, also state:

This franchisor does 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 and address], the Federal Trade Commission, and the appropriate state regulatory agencies.

(3) If the franchisor makes any financial performance representations to prospective franchisees, the franchisor must have a reasonable basis and written substantiation for the representations at the time the representations are made and must state the representations in the Item 19 disclosure. The franchisor must also 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, disclose 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 free standing vs. shopping center), degree of competition in the market area, 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;

(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; and

(F) Characteristics of the included outlets, such as those characteristics noted in § (s)(3)(ii)(A) of this section, that may differ materially from those of the outlet 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 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 encompass matters affecting, among other things, a franchisee's sales, the cost of goods or services sold, and operating expenses.

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

(v) State that written substantiation for the financial performance representation will be made available to the prospective franchisee upon reasonable request.

(4) If a franchisor wishes to disclose only the actual operating results for a specific outlet being offered for sale, it need not comply with this section, provided the information is given only to potential purchasers of that outlet.

(5) If a franchisor furnishes financial performance information according to this section, the franchisor may deliver to a prospective franchisee a supplemental financial performance representation about a particular location or variation, apart from the disclosure document. The supplemental representation must:

(i) Be in writing;

(ii) Explain the departure from the financial performance representation in the disclosure document;

(iii) Be prepared in accordance with the requirements of paragraph (s)(3)(i)-(iv) of this section; and

(iv) Be furnished to the prospective franchisee