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# ***Earnings Claims: Landmines or Golden Nuggets?***

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## **BACKGROUND**

As our clients and colleagues in franchising prepare for their 2005 franchise awards campaigns, we thought it would be wise to review some of the general rules regarding use of earnings claims in franchise marketing, covering both theoretical and practical aspects of earnings claims and the legal and illegal use of earnings claims in franchise marketing.

It's been our experience that while certain readers may have some familiarity with the earnings claims area, based on their experience in franchising, when we actually get down to the technical details surrounding earnings claims, there are a number of misconceptions and misunderstandings. Our objective here is to increase your level of knowledge and sensitivity in the earnings claims area and to educate you as to where the "legal landmines" are buried, along with a few opportunities for turning those landmines into nuggets of gold!

Since earnings claim litigation is one of the areas where Franchisors experience the greatest possible exposure, a review of a fairly detailed explanation of the rules in this area is probably a good investment of our reader's time, as well as that of anyone else involved in the franchise award process. Please pass this on to any of your associates involved in franchise marketing at your company.

By the way, our firm's clients should note that we offer a 1/2 day Franchise Law 101 seminar that covers this and many other subjects. Clients have been uniform in their praise of that class and report that it significantly assists them in reducing potential legal exposure. Please contact either our San Luis Obispo or Long Beach office, to schedule a class if you're interested.

## **SUMMARY**

A. Federal and State law severely limit the manner in which earnings claims and projections, which are far more dangerous, can be made as part of the sales process. In fact, this is perhaps the area in which problems most commonly arise that can result in litigation between an unsuccessful Franchisee and the Franchisor.

B. Typically, the Franchisee will claim that the Franchisor assured him or her that they would achieve certain results, which, in fact, were not reached. A sympathetic jury is likely to agree with the Franchisee, if he or she can make out a plausible case that they were given an earnings claim that wasn't part of the Uniform Franchise Offering Circular (U.F.O.C.).

C. Earnings claims and projections include any information given to a prospect from which a specific level or range of actual or potential sales, costs, income or profits of franchised or other units may be easily ascertained.

D. Prospective franchisees should contact existing Franchisees to learn from them, directly, what's needed to succeed in this business and what kind of experience they've had. For a start-up franchise organization, the inability to turn to existing franchisees for operating information is a challenge. The prospect in that instance typically will need to turn to industry sources to gather relevant data.

E. Don't use earnings claims unless they have been prepared by legal counsel and filed with and approved by the relevant states.

Never use projections! After all, Franchisors can rarely give reliable estimates of how well a company-owned unit will do. They certainly can't do so with any confidence for units run by someone else.

On the other hand, a formal Item 19 earnings claim, based on the Franchisor's and Franchisees historical results, can be an excellent marketing tool and serve legal defensive purposes. In addition, if a new Franchisor (or its affiliated companies) have had actual operating experience, that can also be the basis of a formal Item 19 earnings claim and a powerful marketing tool.

## DETAILED REVIEW

- Earnings Claims – The Definition and the Problem
- What is an Earnings Claim, Exactly?
- First of all, let's be clear what we're talking about.

Item 19 of the UFOC<sup>1</sup> defines an "earnings claim" as follows:

Earnings claims and projections include any information given to a prospect from which a specific level or range of actual or potential sales, costs, income or profits of franchised or other units may be easily ascertained.

Examples of earnings claims would include statements such as "Our typical unit, that's been open for at least a year, is doing \$34,000 in monthly gross volume". "Our stores in Pasadena, St. Louis and Milwaukee are each grossing over \$1,400,000 per year", "Typical labor costs at one of our units run about 28% of gross volume," as well a chart showing gross dollar volume at different levels of unit sales (300 hamburgers a day generates \$40,000 per month gross revenues, 600 hamburgers a day generates \$80,000 per month gross revenues, etc).

The UFOC instructions then go on to state that:

(a)n earnings claim made in connection with an offer of a franchise must be included in full in the [UFOC] and must have a reasonable basis at the time it is made.

This means that if an earnings claim is made, and is not included in the UFOC and/or fails to meet detailed UFOC and FTC requirements, it's illegal and the Franchisor can be sued for damages and/or cancellation of the franchise agreement, under a number of different legal theories.

## Why Illegal Earnings Claims Occur

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<sup>1</sup> The FTC definition is similar: "... (a)ny oral, written or visual representation to a prospective franchisee which states a specific level of potential sales, income, gross or net profit for that prospective Franchisee, or which states other facts which suggest such a specific level ..."

Our firm's experience has been that inexperienced franchise salespeople, who may perceive themselves as selling from weakness, can easily fall prey to answering a simple question as posed by a prospective Franchisee: "Well, how much money do you think I can make with one of your stores" or "So ... what's the typical annual sales (or net) for one of your stores?"

This dynamic is particularly powerful where the Franchisor is new to franchising and is not selling from strength or doesn't have a significant number of operating franchised units to which the prospect can be referred.

On one level, this is an entirely natural set of questions for prospective Franchisees to ask. It's perfectly understandable that before someone makes a substantial business investment, he or she would want to understand some of the economics likely to result.

But let's think about it for a second. The problem with making "informal" earnings claims (*i.e.* earnings claims not included in the UFOC and not approved by regulators) is three-fold:

First, as much as we might prefer it otherwise, the business realities are such that no Franchisor can make a reliable prediction as to how well a new Franchisee (or even a new location for an experienced Franchisee) will do.

By definition, every franchise system will have a top performer who exceeds all expectations and will have a bottom performer who will always be struggling and who may even eventually have to sell out or close due to his or her lack of success. And this is true in spite of the fact that the top and bottom performer received exactly the same training, system, marks, access to suppliers, retail marketing tools, etc. and may even have equivalent locations and markets in which they're selling.

Since it's impossible at the front end of a business relationship to predict whether or not a particular Franchisee will be a top or bottom performer (stories of surprises both ways are legion in franchising), it's a fool's game for a Franchisor to give any information to any prospective Franchisee on which he or she might try to estimate what their results will be, since one can never know what level of performer a particular Franchisee will be.

The short (and honest) answer to the question, "How well will I do?" should be: "I don't know".

The long answer should go something like the following:

"We don't know. I wish we had that kind of crystal ball, but we don't and franchising experience teaches us that we just don't have the ability to reliably predict how well any particular unit will do, due to the multitude of competitive factors, differences in real estate and local markets, and the individual performance of each unit owner/operator (people do make a difference!)

So we don't know how well you'll do. But what I would do, if I were you, is to talk to our current Franchisees. They're out there on a daily basis and I think that a lot of them would be happy to share their experiences with you. There's a list of current and past Franchisees at the back of our UFOC, along with their phone numbers. I'll give you a code word so that they'll know that you're a legitimate franchise candidate calling and not a competitor. Please ask them whatever questions you'd like, including economic ones.

If they're reluctant to share exact figures with you (which is understandable), then ask our Franchisees questions like these:

Have you been satisfied with your economic results?

Have the bottom-line economics of the business generally met your expectations?

Would you recommend this business to a close relative or a good friend?

Would you like to have a second unit?

If you had it to do over again, would you buy the franchise?

Has the Franchisor delivered what they promised and been there for you when you needed them?

Is the Franchisor a straight shooter and do they keep their word?

Are you better off being part of this system than having tried to start in the business as an independent?

With the answers to those kinds of questions, from real-life Franchisees rather than a franchise marketing executive, you should be able to get comfortable with your possible investment and make an intelligent decision."

Second, people generally tend to hear what they want to hear. No matter how well you preface your statements, often what the prospective Franchisee hears, or believes he/she heard, is something entirely different. When the Franchisee asks how well he or she might do, or what typical unit numbers are:

You may believe you said:

"Gosh, I don't know and there certainly aren't any guarantees in this, or any other, business. Our average unit is doing \$80,000 in monthly sales by their first year in operation, but you might do better or worse than that."

The Franchisee may believe he heard, and may testify in open court, that you said:

"Don't worry. There should be no problem with you doing at least \$80,000 in monthly sales by your first year in operation. Just about all our people do that well."

Third, real-life psychological factors can lead a Franchisee to blame the Franchisor, and possibly the broker who sold him or her, for his or her lack of success if he/she fails.

Think about it: How often in business have you heard the following words come out of someone's mouth?

"I failed in this business. It was entirely my fault, I have no one to blame but myself and I have to admit I'm just not a very good businessperson."

Even though the failing Franchisee may have received exactly the same training, location identification and grand opening assistance, system, marks, access to suppliers, ongoing support, etc. as all of the other Franchisees who are quite successful, the Franchisee may look outward for sources of his/her failure. It doesn't make much sense then to give a Franchisee the weapon of an illegal earnings claim to turn against the Franchisor when the Franchisee wants to assign blame or get out of the deal and receive a refund of all monies paid.

In short, if you don't want somebody shooting at you, it's probably not a good idea to give them ammunition!

*A True Story and a Caution:*

A few years ago the following (true) story came to our attention:

A Franchisor awarded three franchises to an attorney (Mistake No. 1) who was going to run them through absentee management over 600 miles away from his office (Mistake No. 2) with no prior experience in the industry or, for that matter, in any direct hands-on level experience with any retail business (Mistake No. 3).

In the course of the Franchise sales process, the prospect and the salesperson sat down to discuss the possible award of the franchise. In that discussion, the prospect asked the salesperson to "help me run some numbers," in this case consisting of a spreadsheet analysis of fixed and variable costs, to determine at what gross volume the business might reach breakeven.

According to later testimony by the franchise salesperson, he made it clear that he was not projecting what volume the business might actually do: in fact, he ran a number of scenarios at different gross volume level and gave no assurance as to which volume levels would be most likely to be achieved.

In essence, he was merely applying his knowledge of some of the cost factors in the business and using that knowledge in running the same type of Excel® spreadsheet that any second-year accounting student could do with ease, to determine where the gross revenue and fixed/variable cost curves crossed. (If you sell A basketballs at \$15.00 each, have B rent and C labor costs, your net should be D; while if you sell E basketballs at \$18.00 each, have F rent and G labor costs, your net should be H, etc., etc.)

The salesperson ran these numbers for the prospect (Mistake No. 4), printed out a copy of the results (Mistake No. 5), left out any written disclaimers or cautions (Mistake No. 6) and gave the prospect a copy of the results (Mistake No. 7).

In finalizing the deal, the attorney/prospect made a number of changes to the Franchise Agreement, many of which were agreed to by the Franchisor (probably Mistake No. 8, for other reasons such as general system consistency, but not directly relevant to this discussion.)

One of the areas not changed was that part of the Franchise Agreement where the Franchisee acknowledges that no other representations or promises have been made to him, except for what's actually written out in the Franchise Agreement.

Predictably, the Franchisee opened the business, failed (due in large part to the absentee management, as well as ignoring the Franchisor's recommendations regarding not signing an expensive lease, hiring a manager not recommended by the Franchisor, spending money on marketing efforts not recommended by the Franchisor, etc.)

The case went to arbitration (not a jury trial) and the Franchisor defended based on the Franchisee's obvious sophistication (he was a business attorney working for one of the largest businesses in California), the fact that the business failure was primarily related to the

Franchisee's self-inflicted business mistakes and the presence of the clause in the contract regarding no representations, etc. *Result:* Judgment for the Franchisee for over \$750,000.

Now, let's ask a few questions:

1. Did the franchise salesperson make any misrepresentations, provide bogus numbers or do anything unethical? No.
2. Was the franchise sales person trying to be helpful and share what knowledge he had with the prospect? Yes.
3. Were the Franchisee's business problems largely of his own making? Yes.
4. Did the Franchise Agreement contain a clause drafted by a lawyer, intended to deal with earnings claim suits and designed to avoid or defeat them? Yes.
5. Was the case being tried by inexperienced counsel defending the Franchisor or decided by a jury of persons inexperienced in business realities? No (The arbitrator was a retired and highly experienced Federal judge).

In spite of all this, did the Franchisor get hammered, at least partially unjustly? Yes.

Lesson: Goodwill and business common sense will not protect you from liability.

If you don't want to get sued and lose, don't make illegal earnings claims, which include any kind of pre-sale financial analysis of the business, including preparing business plans or commenting on a prospect's business plans, loan application documents, trial figures or otherwise!

Special Cases:

Letters to Banks

A special situation arises when a bank or other financial institution, perhaps in connection with providing financing to a prospective Franchisee, asks the Franchisor for financial information relating to operating units. From a strict definitional standpoint, providing such information to a bank or other lender may not be an earnings claim, if the information is not provided to a "prospect" or "prospective franchisee." (Recall the UFOC and FTC definitions of "earnings claim" discussed at the beginning of this paper). However, this is an area where special steps must be taken to avoid liability and, at a minimum, the Franchisor should obtain from the bank a written commitment to keep the information supplied by the Franchisor confidential and to not disclose it to the prospective Franchisee. This is another area where assistance by experienced franchise counsel will be helpful.

Sales of Existing Units

Another technical exception from the general rules against informal earnings claims is in the area of sales of existing units. UFOC Item 19 provides that:

(a)n earnings claim limited solely to the actual operating results of a specific unit being offered for sale need not comply with this item if it is given only to potential purchasers of that unit and is accompanied by the name and last know address of each owner of the unit during the prior three years.

To qualify for this exemption, each of the above requirements must be met. The information supplied to the prospective Franchisee must be limited to historical results for the unit being sold, not projections and not information regarding other units or system-wide averages It must only be given to potential purchasers of that unit and must be accompanied with information regarding the unit's owners over the last three years.

As a practical matter, any use of this exemption should be only attempted with assistance of experienced franchise counsel and should be accompanied by a disclaimer letter to be signed by the prospective Franchisee.

#### What to Do When an Illegal Earnings Claim Is Made

Suppose an illegal earnings claim has been made and it comes to light before the sale is closed. For example, the Franchisee fills out a Statement of Prospective Franchisee or completes a Pre-Acceptance Interview and indicates that a salesperson made an oral representation regarding financial performance.

Well, the safest course is to "burn the sale" and not complete the franchise award. As unpleasant as this may be, it can have the effect of reducing any exposure to the minimum possible level available in the situation.

If the Franchisor elects to not do that, then (at a minimum) the Franchisor should (a) supply the prospect with a disclaimer letter after appropriate review by experienced franchise counsel and have the letter signed by the prospective Franchisee, all prior to completion of the sale, and (b), in California, consider use of the Notice of Violation procedure established by the Department of Corporations to limit the Franchisee's rights to bring a claim to a 90 day period. Some other states have similar provisions. While these procedures cannot guarantee that the Franchisor will not have any exposure, when implemented with guidance by experienced franchise counsel, they may substantially reduce that exposure.

#### **CONCLUSIONS AND RECOMMENDATIONS**

Both Federal and State law severely limit the manner in which historical earnings claims can be made as part of the sales process. In fact, this is perhaps the area in which problems most commonly arise that can result in litigation between an unsuccessful Franchisee and the Franchisor. Use of informal "back-of-the-napkin" or oral earnings claims of any type pose significant risks for Franchisors, almost guaranteeing lawsuits when the Franchisee fails to meet expectations, as at least some of them inevitably will. Therefore, don't use earnings claims unless they have been prepared by legal counsel and filed with and approved by the relevant states.

Never use projections! After all, Franchisors can rarely give reliable estimates of how well a company-owned unit will do and they certainly can't do so with any confidence for units run by someone else.



On the other hand, a formal Item 19 earnings claim, based on the Franchisor's and Franchisees' historical results, can be an excellent marketing tool and serve legal defensive purposes. After all, the best answer to the claim that the Franchisor gave unit-level operating numbers to a prospective Franchisee is probably "You bet we did. And the document we used to do it was filed with, and officially permitted for use by, the States of California, New York, Illinois, etc.!"

This can be particularly useful in the franchise award process when dealing with a new franchise system without any Franchisees with significant operating histories. In these situations, third-party validation may be difficult to obtain but company-owned units' numbers can be presented (with appropriate disclaimers) in a formal Item 19 earnings claim.

We've had essentially no resistance from state authorities in filing formal Item 19 earnings claims and we believe that they serve as one of the best answers to a Franchisee's understandable desire to know how units in the system have been doing, before he or she makes an investment.

While it's illegitimate and extremely dangerous for all of the practical reasons discussed above to attempt to make a projection of the results any individual Franchisee might achieve or to give an informal answer to questions regarding even historical unit financial performance, it's entirely legitimate to prepare a formal, written historical review of how company-owned and franchised units have actually done, have that document contain appropriate legal disclaimers, file it with relevant state authorities, obtain approval and then use it as part of the formal UFOC to address prospective Franchisee's concerns.

Where a Franchise system has had sufficient real-life experience with operating units, preparation and use of a formal Item 19 addition to the UFOC is certainly worthy of consideration. Also, be sure that you're using an up-to-date form of Statement of Prospective Franchisee, which offers significant protections in this area.

One final note: If you're in the process of a franchise award and discover that an earnings claim may have been made, there are ways to address the problem, both before and after an award has been completed. Let your legal counsel know, and appropriate steps can be designed and implemented that may substantially reduce or even eliminate your exposure.

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*This material is presented for training and discussion purposes only. It 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 experienced legal advice specific to your fact situation, documents, business model, etc. Is not recommended! © 2004 Holmes & Lofstrom, LLP*

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