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VIA EMAIL

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Re: Comments on Proposed Commentary On Financial Performance Representations

Tanja E. Hens and Leslie J. Pujo of LaPlaca Pujo, P.C. submit the following comments on the proposed NASAA Franchise Commentary On Financial Performance Representations (the "FPR Commentary") released by NASAA's Franchise Project Group on October 1, 2015.

As an initial matter, we welcome the effort by the Franchise Project Group to provide clarification and harmonized guidance for franchisors who wish to make a financial performance representation ("FPR") in their franchise disclosure documents. We view this effort as supportive of the Federal Trade Commission's stated goal of encouraging franchisors to provide financial performance information.[1]

We represent franchisors in two principal situations affected by the proposed FPR Commentary's guidance on what constitutes a "reasonable basis" for an FPR:

(a) newer franchisors with a small number of established company-owned outlets and a small but growing number of new franchised outlets; and

(b) franchisors who receive only revenue information (not cost figures) from their franchisees, but who have one or more company-owned outlets for which the franchisor has complete revenue and cost data.

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[1] *See, e.g., Federal Trade Commission Amended Rule Statement of Basis and Purpose* ("SBP"), 72 Fed. Reg. 15444, 15499 (Mar. 30, 2007) (referring to the FTC's objective to "remove obstacles that discourage franchisors from making financial performance data available to prospective franchisees").

As noted in the proposed FPR Commentary:

> What constitutes a reasonable basis [for an FPR], and what information is needed to substantiate an FPR, is fact-specific and varies from case to case, depending on the representation made. In every case, however, written factual information in the seller's possession must reasonably support the representation, as the FPR is likely to be understood by a reasonable prospective franchisee. The FPR must be based on the sort of factual information upon which a prudent businessperson would rely in making an investment decision.[2]

Keeping in mind these principles, we have concerns about certain provisions of the proposed FPR Commentary, because they create real-life situations where the parameters permitted or required under the proposed FPR Commentary would result in an FPR that may be misleading to a prospective franchisee. The proposed FPR Commentary seeks to define what constitutes a reasonable basis in specific situations, so it is of great importance that the guidance take all reasonably likely scenarios into account, and not create situations where a well-meaning franchisor is precluded from making a compliant, non-misleading FPR. We encourage NASAA to address these issues before adopting the proposed FPR Commentary.

Comment 19.6 (Adjustments to Costs)

Comment 19.6 of the proposed FPR Commentary requires that, to base a gross profit or net profit FPR on company-owned outlets alone, a franchisor with operational franchises must adjust the cost figures for the company-owned outlets "to reflect potential material financial and operational differences between company-owned outlets and franchised outlets." We agree that it is reasonable to require franchisors to adjust cost figures in an FPR based solely on company-owned outlets to reflect known and quantifiable differences in costs, such as royalty and advertising fees, and to disclose the existence of other potential material differences of which the franchisor is aware.[3]

As drafted, however, Comment 19.6 imposes a much broader requirement: it requires the franchisor to adjust the FPR with actual numbers for all "<u>potential material financial and operational differences.</u>"[4] Indeed, Comment 19.6 specifically states that "[s]imply stating that there may be differences between the costs that a franchisee may incur and the costs disclosed for company-owned outlets, or indicating the types of costs unique to franchisees, is not sufficient."[5] We do not believe this to be a workable standard, for several reasons.

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[2] Proposed FPR Commentary, Introduction ¶2.

[3] We note that in many franchise systems, company-owned outlets pay royalty, advertising and other fees in the same manner as franchised outlets, so there would be no need for such adjustments in those systems.

[4] Proposed FPR Commentary, Comment 19.6 (emphasis added).

[5] *Id.*

First, the franchisor may not have the factual information required to make a specific adjustment. Comment 19.6 fails to take into account that the primary reason many franchisors do not provide franchisee cost data is that they do not have access to reliable cost information from their franchisees.[6] As such, franchisee cost data is not "written factual information in the seller's possession" that could support a cost adjustment to an FPR. Although some franchisors have access to some franchisee cost data through their computer systems, many others do not, nor do they have a contractual right to collect that information from their franchisees. It is not reasonable to prevent franchisors from providing a gross profit or net profit FPR simply because they do not or cannot collect all cost data from their franchisees.[7]

Second, some potentially material financial and operational differences are simply not reliably quantifiable in advance. For example, the specific value of economies of scale or greater purchasing power attributed to multi-unit operations depends on many factors that are not within the knowledge of the franchisor preparing the FPR, and could not be reliably accounted for across all operators by a single projection. Similarly, some operational differences may tend to push sales and profits in different directions – some owner-managed franchised outlets outperform company-owned outlets, while others underperform. For these types of differences where the effect on costs is not specifically and objectively predictable, it should be sufficient for the franchisor to disclose the types of costs that may not be fully comparable, and allow the prospective franchisee to compile their own projections.[8]

Third, the nature and impact of cost adjustments may not be uniform even within a particular franchise system. For example, many systems offer both single-unit franchises and multi-unit development agreements, sometimes with large variance in the number of units.[9] Also, while company-owned outlets may in some cases have financial and operational advantages compared to franchised outlets, this is not always the case. Multi-unit franchise operators may operate more outlets than the franchisor. They benefit from the same (or better) economies of scale and purchasing arrangements as the franchisor does. It is simply not feasible to provide exact cost adjustments for each possible cost variation and for every type of potential franchisee in a single FPR.

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[6] Moreover, cost data provided by individual franchisees may not be as consistent or reliable as audited franchisor data due to variation in bookkeeping practices, operational procedures and sophistication. *See* SBP at 15498 (citing unavailability of franchisee data to some franchisors and the inability to ensure the receipt of accurate and complete information from franchisees as arguments against mandatory FPRs).

[7] *See* SBP at 15499 (noting the concern that "a franchisor may decline to disclose performance information if, in order to do so, it must first incur the expense of conducting a system-wide franchisee performance analysis").

[8] *See also id.* ("a disclosure document is not the only potential source of financial performance information. Prospective franchisees can obtain financial performance information from a variety of third-party sources. … Prospective franchisees may be able to discuss earnings and other financial performance issues directly with current and former franchisees[…].")

[9] NASAA's Multi-Unit Commentary explicitly permits franchisors to include both offerings in a single franchise disclosure document. NASAA Multi-Unit Commentary, AD0.1 (2014).

In our effort to ensure complete and meaningful disclosure by franchisors, we should not lose sight of the fact that prospective franchisees should be held responsible to do their own due diligence and assess the risks they are assuming by investing in a business. By creating an unlimited obligation to make cost adjustments, Comment 19.6 as drafted would impose an immense and undue burden on franchisors in preparing FPRs, and would virtually guarantee that disgruntled franchisees would assert claims that the FPR was false or misleading because it failed to adjust a particular category of costs, or because, with hindsight, the adjustments were not "properly" calculated. We would not be comfortable advising a client to include a gross profit or net profit FPR in its franchise disclosure document under those conditions.

Comment 19.7 (Gross profit/net profit FPRs in the absence of operational franchises)

Comment 19.7 would prohibit a franchisor with no operational franchises from providing a gross profit or net profit FPR under any circumstances. We do not believe this is a sensible result, or one suggested by the FTC's guidance.[10] A franchisor without operational franchises can adjust the FPR for the known and quantifiable cost differences between company-owned outlets and franchised outlets, such as royalties, advertising fees and other fees – all of which are listed in the franchise disclosure document. For the reasons stated above with respect to Comment 19.6, we believe that it is sufficient to advise prospective franchisees of the types of other potential financial and operational differences that may affect their franchise, which are known in the abstract but not quantifiable or predictable in a global manner. This type of information is no different than the disclosures required in other items of the franchise disclosure document, and is the sort of information prudent businesspeople review and act upon regularly in making business and investment decisions. For these reasons, we suggest eliminating the distinction between Comments 19.6 and 19.7 and creating a harmonized standard.

Definitions ("operational franchises")

Defining "operational franchises" to mean all franchises that have been "fully operational for one full year" (or, for seasonal franchises, "one full season") may lead to misleading FPRs in some franchise systems. For many franchise systems, a new outlet takes as much as three years to be fully stabilized. The stabilization period is an important factor; revenue and profit data from unstabilized and established outlets are not fully comparable.[11] This is true even though there may not be material differences in performance between company-owned and franchised outlets at the same stage of development.

The proposed strict one-year definition has two principal damaging effects, particularly in newer franchise systems with established company-owned outlets. First, it would require a franchisor wishing to provide a gross sales FPR to include data for franchised outlets that are not yet stabilized and therefore

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[10] *See Federal Trade Commission Franchise Rule Compliance Guide* (2008), at 87 ("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 questions….").

[11] In fact, the FTC Franchise Rule Compliance Guide identifies "all [outlets] in operation for at least three years" as a possible subset for a historical performance FPR. *Id.*

not fully comparable.[12] Second, read in conjunction with proposed Comments 19.8 and 19.13, it would permit the merging of data of fully established company-owned outlets and newer unstabilized franchised outlets – but prevent the use of a subset of data to exclude unstabilized franchised outlets (even with full disclosure of the reasons for the exclusion).[13] If the FPR Commentary were adopted as written, franchisors with a small number of established company-owned outlets and a small number of new franchised outlets would be forced to choose between (1) making no FPR at all; (2) providing an FPR that essentially identifies the franchised outlets; or (3) providing an FPR that is potentially misleading in that it may overstate the revenues and profits of a new outlet.

These problems could be addressed by using a three-year period rather than one year to define "operational franchise." This timeframe is commonly used among the franchisors we have observed in a number of industries, and we believe it is a more appropriate benchmark. If NASAA nevertheless determines that the one-year timeframe is appropriate for most franchisors, we suggest that the definition be modified to explicitly provide additional flexibility for franchisors to use the subset of data that will be most appropriate in its particular system, to provide greater clarity and avoid potentially misleading FPRs. For example:

> Operational franchises means franchises that have been fully operational for one full year (or, in the case of franchise systems that operate seasonally, for at least one full season); provided that if revenues or costs of outlets in a particular system are not generally stabilized within the first year, the franchisor may base its FPR on outlets that have been operational for a sufficient period to be stabilized, but must disclose the reason for the departure from the standard one-year period and identify the period used.

Alternatively, Comment 19.13 should be modified to permit the use of a comparable subset to exclude unstabilized units in situations where the franchisor would otherwise be precluded from making a compliant FPR.

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[12] Under the proposed FPR Commentary, if the franchisor has any "operational franchises," it must include franchised outlet data in a gross sales FPR. *See* Comment 19.4. This is apparently true even if the system includes only unstabilized franchised outlets and established company-owned outlets.

[13] Comment 19.8 permits merging the company-owned and franchised outlet data in systems with a very small number of franchised outlets, but requires the franchisor to represent that "there are no material differences in the gross sales of franchised and company-owned outlets." As a practical matter, it is not clear how any franchisor of a very small system could assure the truth of that representation, since there are material differences in gross sales between different geographic markets (consider, for example, a franchisor with company-owned outlets in a major metropolitan area and franchised outlets in smaller cities) and based on many other factors. The franchisor's difficulty is further exacerbated by the franchisor's inability to exclude outlets that are not comparable. *See* Comment 19.13.

Conclusion

Franchising provides an opportunity for franchisees to operate a business using an established system. Franchisors do not and cannot guarantee that all franchisees will achieve equal results, or that the investment will be free of risk. Nor is a franchisor that provides the required disclosures responsible if a prospective franchisee fails to perform his or her own due diligence concerning the opportunity.

We have serious concerns about the ability of at least some franchisors to prepare a non-misleading FPR in compliance with the proposed FPR Commentary with the factual information they have available to them. If the proposed FPR Commentary is adopted without revisions, we expect to see a number of franchisors that will cease providing an FPR at all or will limit the information provided to revenue data. In that case, prospective franchisees will have less information to review in considering the franchise opportunity. We believe this is inconsistent with the stated goal of the FTC to encourage FPRs in franchise disclosure documents. We therefore encourage NASAA to modify the proposed FPR Commentary to address these concerns before adopting it.

Thank you for your consideration of these comments.

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