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IT IS TIME FOR THE FEDERAL TRADE COMMISSION TO REQUIRE FINANCIAL PERFORMANCE REPRESENTATIONS TO PROSPECTIVE FRANCHISEES

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I. INTRODUCTION

As our country moves beyond the recent years of financial and investment abuses fueled by greed and corruption—such as the Enron accounting scandal, Bernie Madoff and other Ponzi schemes, and the subprime mortgage housing crisis—the need for greater regulation and effective enforcement, as well as transparency in the financial community, have become vital issues. Burned by huge financial losses, the public clamors for reforms that will eliminate or at least mitigate similar calamities in the future. Although the country and Congress have their eyes glued on the banking industry and the investment sector,[2] another popular and very pervasive business system begs reexamination in terms of appropriate governmental regulation. This is the ever-growing arena of franchising.

The most comprehensive recent estimate of the total economic impact of franchised businesses on the United States economy comes from the 2005 PricewaterhouseCoopers prepared study, *The Economic Impact of Franchised Businesses*.[3] According to PricewaterhouseCoopers, in 2005 there were 909,253 establishments in franchise systems that provided 11 million jobs, which translates into 8.1% of all private-sector jobs.[4] Thus, franchised businesses accounted for more jobs than were found in durable goods, manufacturing, financial activities, or construction, and had an economic output worth $880.9 billion, equaling 4.4% of all private-sector output.[5] Combining this with the additional jobs and larger payrolls that result from franchise businesses and employees, which purchase products and services from other enterprises on both a professional and a personal level, the numbers swell to 21 million jobs (15.3% of all private-sector jobs) with an economic output worth $2.31 trillion (11.4% of all private-sector output).[6]

Notwithstanding the significance this business system has on the U.S. economy and on the lives of U.S. citizens, there continue to be serious gaps in the regulation of the sale of franchises to prospective franchisees by the Federal Trade Commission ("FTC"), the governing body at the Federal level. These gaps have created opportunities for

[2] Press Release, S. Comm. on Banking, Housing, and Urban Affairs, 111th Cong., Summary: Restoring American Financial Stability (2010), http://banking.senate.gov/public/_files/FinancialReformSummary231510FINAL.pdf.

[3] *See generally* PRICEWATERHOUSECOOPERS, THE ECONOMIC IMPACT OF FRANCHISED BUSINESSES VOLUME II: RESULTS FOR 2005 (2008).

[4] *Id.* at 6.

[5] *Id.*

[6] *Id.* at 7.

serious financial abuse, have helped perpetuate ongoing fraudulent schemes, bad investments and hidden agendas, and have fostered serious misrepresentations about the viability of new franchised businesses, thereby causing significant injury to investors purchasing start-up franchises.

Although the FTC's Franchise Rule requires pre-sale disclosure by franchisors to prospective franchisees of certain material information to assist the prospect in making an informed investment decision, surprisingly, the FTC fails to require the person selling the franchise ("franchisor") to answer the most pertinent question that any prospective buyer of the franchise ("franchisee") should ask, that is: "How much money can I reasonably expect to make operating the franchise, based on the experiences of the existing franchisees?" Although such a disclosure is of paramount interest to a prospective franchisee, the FTC, through Item 19 of the Franchise Disclosure Document ("FDD"), does not mandate such disclosure but rather merely makes disclosure of this information *optional.*[7]

For the improved health of the franchise industry—by rewarding profitable franchise concepts and weeding out the unprofitable ones—as well as the financial well-being of franchisees, it is imperative that the FTC correct this problem by making Financial Performance Representations ("FPRs") a mandatory pre-sale disclosure requirement.

II. A REAL-WORLD SCENARIO BETWEEN ATTORNEY AND CLIENT

To illustrate on a practical level how this lack of information could affect an attorney and his or her client, let's hypothetically step into the shoes of a successful commercial and business attorney. Because several of his commercial clients have been talking about expanding their business through franchising and a number of his individual clients are considering purchasing a franchise, he has become increasingly curious about the legal end of franchising, but has not yet delved into it.

[7] Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunities, 72 Fed. Reg. 15,444, 15,554-55 (Mar. 30, 2007) (to be codified at 16 C.F.R. pts. 436-37) [hereinafter Disclosure Requirements], *available at* http://www.ftc.gov/os/2007/01/R511003FranchiseRuleFRNotice.pdf .

The attorney receives a phone call early Monday morning from Fred, one of his clients who attended a franchise sales show over the weekend. Fred relates that he is interested in a hobby shop franchise and has been given a lengthy document called a Franchise Disclosure Document by the franchisor's salesperson. Fred said that he quickly perused the document and noticed, in Item 19 of the FDD, several paragraphs regarding financial performance representations. Fred asked the salesperson if this Item 19 tells him how the existing franchise outlets have performed financially over the past few years, thereby giving him an idea of what he may earn in the future. To Fred's utter dismay, the salesperson said: "No, the purpose of Item 19 is to inform you that the franchisor does not make any FPRs, and that the FTC does not require us to make such claims or representations." Fred asks his attorney the same question he posed to the salesperson: "How can I possibly consider buying a franchise when a franchisor does not, and cannot, provide me with the most important information I need to make a decision as to whether to purchase the franchise?" The attorney tells Fred that he cannot believe that this is the state of the law since it makes no sense, and intends to make some calls to determine how the sale of franchises is regulated.

III. CURRENT REGULATION OF FRANCHISES

The attorney discovers, as do all other attorneys who enter the world of franchising, that the sale of a franchise is highly regulated by the FTC and by a number of states. These regulatory bodies in essence require the franchisor to give a franchisee an FDD before the franchisor can sell the franchise to the franchisee.[8] There are twenty-three categories of information about the franchisor and the franchise offering that must be included in the FDD.[9] The guidelines as to what each of these items in the FDD must contain and disclose are contained in the 2008 NASAA Franchise Registration and Disclosure Guidelines (also referred to as the 2008 UFOC Guidelines or Amended and Restated UFOC Guidelines).[10] Each item in the FDD contains representations by the franchisor that *must* be disclosed to a prospective franchisee, with the exception of what is, in the opinion of this author, the most important item—Item 19 pertaining to FPRs.[11]

[8] *See generally id.*
[9] *Id.* at 15,545-46.
[10] *2008 Franchise Registration and Disclosure Guidelines*, N. AM. SECS. ADM'RS ASS'N, (July 1, 2008), http://www.nasaa.org/content/Files/2008UFOC.pdf.
[11] *See* Disclosure Requirements, *supra* note 7, at 15,546.

As the attorney investigates further, he learns that the term FPR, which replaced the term "earnings claim" in 2007, means "any representation, including 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 factual or potential sales, income, gross profits, or net profits."[12] To his dismay, however, the attorney discovers that his client's concerns were correct. Under the present law, providing FPRs in Item 19 is merely an optional disclosure obligation. Franchisors are not required to provide potential franchisees with information pertaining to the financial performance of the franchise concept.[13] Because of the optional nature of Item 19, only twenty-five to thirty percent of franchisors make an FPR in their FDDs.[14] A recent publication of the American Bar Association Forum on Franchising stated that approximately seventy-five percent do not include FPRs.[15]

IV. THE NATURE OF A FRANCHISE – COMPARISON TO RENTING A BUSINESS

While this would be a concern in any form of investment, the very nature of a franchise exaggerates the magnitude of Item 19's permissiveness. If a person desires to start a business, such as a restaurant, he or she can go through the steps of starting a business from scratch or that person can "rent" an existing business or restaurant that has been developed by others. This idea of renting a business is the essence of a franchise. What does the franchisee actually rent or lease? He gets to use the name of the business. If it is a restaurant called McDonald's, the franchise essentially gives him a license to use that name while the franchise is in effect. He also rents an existing business system, which is usually set forth in a training manual that describes operating procedures. For example, in the case

[12] 16 C.F.R. § 436.1(e) (2010); Joyce Mazero, Rebekah Prince & Peggy Shanks, Advanced Financial Performance Representations: Preparing and Using Financial Performance Representations at the International Franchise Association Legal Symposium (May 17-19, 2009) [hereinafter Legal Symposium].

[13] *See* Legal Symposium, *supra* note 12.

[14] Andrew A. Caffey, *The Importance of Item 19 in the Franchise Disclosure Document*, ALL BUSINESS, http://www.allbusiness.com/franchises/buying-a-franchise/13425632-1.html (last visited Jan. 26, 2011).

[15] RUPERT BARKOFF ET AL., FINANCIAL PERFORMANCE REPRESENTATIONS: THE NEW AND UPDATED EARNINGS CLAIMS xxi (Stuart Hershman & Joyce Mazero eds., 2008).

of a restaurant, the manual would explain how to purchase food products and discuss the franchisor's basic experience in running the business. In addition to licensing the use of the trade name or trademark, part of the rental or franchise package includes the franchisor's agreement to provide training and assistance during the term of the franchise. In order to acquire this package, called a franchise, the franchisee pays an initial franchise fee to the franchisor and usually pays periodic royalties based upon a percentage of either gross or net income. It is not uncommon for the duration of a franchise to be twenty or thirty years.

The franchisee, upon entering into the franchise agreement, does not own the name of the business, nor does he generally own what is known as good will of the business. He is merely renting the business. At the termination of the franchise agreement, either through default or expiration of term, the franchisee must cease using the business name and essentially turn the business back over to the franchisor. In addition, the franchisee generally agrees not to compete with franchisor in the same type of business for a period of time.

Given the nature of a franchise, which includes elements of rental or lease arrangements, it is imperative that the prospective franchisee be provided with as many FPRs in Item 19 as possible; to make such FPRs optional, as does the present law, does not serve the best legal interest of either the franchisor or the franchisee.

V. PURCHASING A FRANCHISE WITHOUT AN FPR

Let's focus in on the problem even closer. Fred sits down with a salesperson while at the franchise show. The franchisor usually hires such salesperson on a commission basis. One of the first questions that enters Fred's mind is how well these hobby shops have done in the past, and what he can expect to make in the future if he works hard at the business. The salesperson has several options at this point. He can say: "Well, the sale of this hobby shop franchise is controlled by the rules of the FTC, and I would love to tell you about their financial performance, but the FTC just will not let me do it. Accordingly, we state in Item 19 of our FDD, which you have before you, that we do not make any FPRs." Note that the salesperson intentionally misleads Fred by not telling him that the franchisor had the *option* of making an FPR, but has chosen not to do so. The salesperson may also choose to pull out the proverbial cocktail napkin or other piece of paper and start writing figures with his ballpoint pen, all the while telling Fred: "Now

I am not supposed to be giving you these figures, but you look like a straight guy, and you need to know the facts, and here they are." Or an FPR may take a less explicit form, such as the salesperson pointing to an expensive car outside and saying to Fred that: "You'll be driving that in no time." Fred looks briefly at some numbers, which may or may not be accurate, whereupon the salesperson retrieves the paper from Fred's hands and tosses it in the trash. Fred believes that he has received certain FPRs, but there is no documentation or proof. Fred leaves without the essential and reliable information that he needs in order to make an intelligent investment decision as to whether to purchase the franchise.

VI. A BRIEF SUMMARY OF THE HISTORY OF FEDERAL AND STATE REGULATION AS THEY PERTAIN TO EARNINGS CLAIMS AND FPRs

It is beyond the scope of this article to chronicle the history of federal and state regulation of franchises. A recent publication of the ABA Forum on Franchising offers a detailed history of federal and state regulation of franchises, particularly as those regulations pertain to earnings claims (now FPRs).[16]

Until 1970, there were no specific laws regulating the sales of franchises. It was certain states and not the Federal Government that first began regulating the sale of franchises. The ABA publication describes the first franchise law adopted by the state of California in 1970, which is still in effect.[17] The California law mentions earnings claims and provides a procedure for their disclosure.[18]

In 1974, the Midwest Securities Commissioners Association ("MSCA") developed a set of guidelines entitled "The Requirements for Preparation of a Uniform Franchise Offering Circular and Related Documents" (the "UFOC Guidelines") that were adopted September 2, 1975.[19] This was in response to a number of states, primarily in the Midwest, enacting franchise registration and disclosure laws. Earnings claims were addressed in Item 19, which permitted

[16] *Id.* at 1.

[17] *Id.* at 2 & n.4 (citing CAL. CORP. CODE §§31000-31516 (1977 & Supp. 2002)).

[18] *Id*. at 2-3, n.7 ("The 1975 version of Item XIX stated in part: 'If franchises have not been in operation long enough to indicate what sales, profit or earnings may result, then use of actual, average, projected or forecasted sales, profits or earnings is prohibited.'").

[19] *Id.* at 3.

disclosure of actual or projected earnings claims based only on data from franchise units.[20] "[T]he underlying data must have been prepared in accordance with generally accepted accounting principles (GAAP)."[21]

In 1977, the MSCA changed Item 19 by adding Item 19a, which became known as Alternative Item 19.[22] Item 19a authorized franchisors to use company-owned or -operated outlets as the source of information upon which earnings claims could be based.[23] Item 19a still did not enable start-up franchisors without company-owned units to provide earnings claims because the earnings claim still had to be based on the specific system's experience.[24] At this point in time, very few franchisors were making earnings claims in their UFOCs, notwithstanding Alternative Item 19a.

The next significant regulatory action was the 1978 Franchise Rule promulgated by the FTC, which did not mandate, but merely permitted the disclosure of earnings claims.[25] The disclosure requirements proved onerous, and the data supporting those earnings claims had to have been prepared with generally accepted accounting principles (GAAP).[26] Franchisors found these requirements draconian and closed their eyes while cocktail napkins were being written upon with ballpoint pens.

There were other attempts to address earnings claims requirements, well-chronicled in the ABA publication, which led to the North American Securities Administrators Association (NASAA) adopting new Item 19 on November 21, 1986.[27] The effect of new Item 19 required that an earnings claim have a "reasonable basis" and eliminated the requirement "that earnings claims be based on actual operating results of franchise or company-owned units."[28]

[20] *Id.* at 3.
[21] *Id.*
[22] *Id.* at 4.
[23] *Id.*
[24] *Id.*
[25] *Id.* at 11.
[26] *Id.* at 3.
[27] *Id.* at 7.
[28] *Id.*

VII. FTC STAFF REPORT AND THE REVISED FTC FRANCHISE RULE

On August 25, 2004, the FTC released its "Staff Report to the Federal Trade Commission and Proposed Revised Trade Regulation Rule."[29] The Staff Report stated that FPRs should remain voluntary,[30] even though the report also stated that Item 19 was perhaps the most important anti-fraud disclosure.[31] The Staff Report pointed out three main arguments against mandating Item 19, which are as follows:

1. The cost involved in requiring franchise systems to employ new accounting data collection procedures and review costs;
2. The difficulty and cost of standardizing a format for Item 19 and the complexity of gathering and comparing data; and
3. Liability issues that could be incurred by existing franchisees subject to potential liability for indemnification where inaccurate financial performance data is furnished to the franchisor.[32]

The FTC stated that keeping Item 19 voluntary is a "free market" approach.[33] As such, prospective franchisees, in theory, can find franchise systems that voluntarily disclose such information. "If prospective franchisees were to seek out such franchise systems, or demand the disclosure of such information from franchisors, ordinary market forces may compel an increasing number of franchisors to disclose earnings information voluntarily, without Federal government intervention."[34] History has shown that this has not happened.

[29] *Id.* at 24; *see* FED. TRADE COMM'N, STAFF REPORT TO THE FED. TRADE COMM'N & PROPOSED REVISED TRADE REGULATION RULE (Sept. 2, 2004) [hereinafter STAFF REPORT], *available at* http://www.ftc.gov/os/2004/08/0408franchiserulerpt.pdf.

[30] STAFF REPORT, *supra* note 29, at 158.

[31] *Id.* at 162.

[32] *Id.*

[33] *Id.* at 159-60.

[34] *Id.* at 160.

VIII. THE 2007 FRANCHISE RULE

After considering the 2004 Staff Report and other input, on January 22, 2007, the FTC approved the 2007 Franchise Rule with an effective date of July 1, 2007, and a mandatory compliance deadline of July 1, 2008.[35] As will be noted below, the net effect of the 2007 Franchise Rule permits, but does not mandate, a franchisor to make FPRs. The FTC appeared to be moving in the direction of making it easier for a franchisor to make FPRs, but unfortunately, stopped short of mandating FPRs. Although the FTC did not diverge from its previous position on earnings claims, the ensuing 2007 Franchise Rule, which adopted the Staff Report, did make the following changes relating to earnings claims:

A. Changed the term “Earnings Claims” to “Financial Performance Representations;”[36]

B. Reversed the FTC staff’s position that financial performance data be prepared according to GAAP. The FTC staff concluded that GAAP was only one way of presenting accurate historical performance information, and historical performance representations should merely be “reasonable;”[37]

C. Recommended removal of cost and expense information from Item 19;[38] and

D. Recommended the adoption of two preambles to Item 19. One preamble would be for franchisors making earnings claims,[39] and the other would be required only if the franchisor did not make an FPR.[40]

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[35] *See* Disclosure Requirements, *supra* note 7, at 15,444.
[36] *Id.* at 15,473.
[37] *Id.* at 15,497.
[38] *Id.* at 15,456.
[39] *Id.* at 15,500 n.584 (“The first preamble reads: ‘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.’’’).
[40] *Id.* at 15,500 n.585 (“The second preamble reads: ‘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

The 2007 Franchise Rule defines an FPR as:

> [A]ny representation, including 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. The term includes a chart, table, or mathematical calculation that shows possible results based on a combination of variables.[41]

The net effect of the 2007 Franchise Rule, as it relates to FPRs, is the advancement of the same thirty-year-old regulation, although dressed in new language and set in a different context. As of the date of this article, FPRs are permitted, but not mandated.

IX. FPRs AS ADDRESSED BY THE FTC AND THE SEC

The need for mandatory FPRs continues to grow and some experts have begun to speak out. In the fall of 2007, to celebrate the thirtieth anniversary of the ABA Forum on Franchising, the *Franchise Law Journal* invited all former chairs of the ABA Forum on Franchising to express their views on franchising.[42] One of the questions asked of the panel was, "What is the biggest surprise in franchising in the past twenty years, was it positive or negative, and why?"[43]

Shelley Spandorf, chairman of the ABA Forum on Franchising, from 1995-1997, answered the question as follows:

> I was surprised when the FTC took up the idea of mandating that franchisors disclose earnings information and dismayed when it ultimately decided against it. In representing franchisors for almost thirty years, I have found UFOC Item 19 disclosure rules sufficiently flexible to allow franchisors to fashion a

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.'").

[41] 16 C.F.R. § 436.1(e) (2007).

[42] Shelley Spandorf et al., *Thirty Years of Franchising*, 27 FRANCHISE L.J. 85 (Fall 2007).

[43] *Id.* at 99.

> basic earnings claim so that they can capitalize on the disclosures marketing advantages. For some time even before the FTC began rule making on the amended Rule, I thought franchisee advocates made a sound case that earnings information is not only critical to an informed investment decision but also the single most important piece of information that prospective franchisees need to make a truly informed purchasing decision . . . . It has never seemed a good enough reason to deny prospective franchisees the critical information they seek because franchisors fear that revealing earnings information may subject franchisors to liabilities if franchisees fail to achieve the level of disclosed earnings or profits. Federal securities laws require issuers to make forward-looking statements in their prospectuses, which has not brought about a torrent of litigation from every disappointed stockholder. . . . When the benefits of mandatory earnings disclosures to franchisees are weighed against the cost of franchisors, I expected the FTC's scale to tip in favor of changing the current voluntary system.[44]

Ms. Spandorf suggested a compelling case for mandatory FPRs by comparing FTC regulation of franchises to the SEC's regulation of the sale of securities.[45] When corporate stock is sold to an investor, prodigious requirements regarding financial representations are placed upon the company selling its stock. The SEC's initial public offering ("IPO") process for even a small company (less than $20 million in revenue) takes six to nine months and costs at least $100,000 in fees for legal, accounting, audit, printing, filing fees, and underwriter commissions.[46] The SEC requires a company selling shares of its stock to virtually jump through hoops regarding disclosing financial representations relative to the company's history.

This is a far cry from the permissive FTC disclosure requirements of FPRs by a franchisor to a prospective franchisee, despite the fact that franchisees may take significantly more risk in purchasing franchises than investors do in purchasing stock. A franchisee, upon the purchase of a franchise, generally pays an up-front fee, in many cases nonrefundable, which can be anywhere from $5,000 to $75,000,

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[44] *Id.* at 100.

[45] *Id.*

[46] *Going Public*, VENTURE ASSOCIATES, http://www.venturea.com/public.htm (last visited Jan. 18, 2011); *Initial Public Offerings*, SMALL BUSINESS NOTES, http://www.smallbusinessnotes.com/financing/ipo.html (last visited Jan. 18, 2011).

or more. The franchisee will also be required to expend many thousands of dollars to acquire leases on property to conduct the business, make capital improvements, and hire employees, all of which must be disclosed in Item 7 of the FDD. If a franchisee signs a lease for the business premises and/or borrows money from a bank to finance the purchase of the assets to be used in the franchised business, in all likelihood, the franchisee must personally guarantee these obligations, thereby creating hundreds of thousands of dollars of personal liability. On top of the initial outlay of capital by the franchisee, he or she is also entering into a contract to establish the franchise with the franchisor, which can last twenty or thirty years.

X. THE MARYLAND EXPERIENCE REGARDING FPRS AS VIEWED BY A REGULATOR

From May 17-19, 2009, the International Franchise Association (IFA) held a legal symposium that included a session and written materials on "Advanced Financial Performance Representations: Preparing and Using Financial Performance Representations."[47] One of the authors of the paper was Peggy Shanks, a Senior Franchise Examiner with the Office of Attorney General - Division of Securities, Baltimore, Maryland. Ms. Shanks offered valuable insight in the paper included as "Regulator's Notes." Ms. Shanks included a disclaimer that the opinions and observations "are her own and do not necessarily represent the views of the Attorney General of Maryland or the Securities Division of the Maryland Attorney General's office."[48] Ms. Shanks stated that:

> [T]here is a trend toward including financial performance representations in FDDs . . . . [t]he amended rule is less restrictive. It is estimated that only 10% of franchisors included a financial performance representation (then known as earnings claims) in 1975. By 2002, the percentage had only risen to 20%. In 2007 and 2008, over 40% of franchisors that sought registration in Maryland provided a financial performance representation.[49]

[47] Legal Symposium, *supra* note 12.
[48] *Id*. at 1.
[49] *Id.* at 2.

It is thus apparent from the Maryland experience that there has been an increase in the number of franchisors making FPRs. One can only conclude from this trend that those franchisors believe they are deriving benefits from making Item 19 disclosures.

XI. FITTING FINANCIAL INSTITUTIONS INTO THE FPR DILEMMA

One of the ironies regarding FPRs is that even those franchisors that do not make FPR claims in their FDD must often create and distribute those exact same numbers to the financial institutions of prospective franchisees seeking financing to purchase the franchise. Unless a franchisee has sufficient personal capital for the franchise fee and the total initial investment to purchase, construct, and open the franchise, he may seek a loan from a bank (usually to be guaranteed by the Small Business Administration) to fully fund the franchisee's investment. In the process of a bank performing its due diligence, it will not make a loan to the prospective franchisee without first getting an FPR of the franchisor. If the franchisor wants to sell a franchise, it will furnish the FPR directly to the lending institution. Neither the franchisor nor the lender, however, is required to forward such numbers to the prospective franchisee without exposing the franchisor to a claim of making an illegal FPR to the prospective franchisee. Ultimately, the franchisee may find out how solid these numbers are based on the bank's reaction to granting the loan, but chances are good that the franchisee will never directly see the numbers. Given the number of SBA loans involving franchises, it is clear that many franchisors have FPR data, but are unwilling to share it with prospective franchisees through an Item 19 FPR.

While industry-wide failure rates on franchisees are not available, this author was able to get a clear snapshot of such failure rates from those franchisees who obtained SBA guaranteed loans. The SBA released failure rate information of franchises in which at least ten franchisees have outstanding SBA loans. The failure rate reported was based on defaulted loan failure rates by franchise brand from October 1, 2000 until September 31, 2008, which totaled 399 franchisors. Additionally, FRANdata, a franchise information and document retrieval firm in Arlington, Virginia,[50] was gracious enough to provide

[50] FRANDATA, http://www.frandata.com (last visited Sept. 9, 2010) (data and letter of authorization on file with author).

Statistical raw data was calculated by Keith Kanouse, Jr., by utilizing a three-step further information on those 399 franchisors concerning whether they had made an Item 19 FPR.

The data showed that those franchisees that were not provided an Item 19 FPR were more likely to default on their SBA loan.[51] A "risky franchise opportunity" is defined as a franchise program with over a 35% default rate of its franchisees.[52] Only 23% of these "risky" franchisors had made an Item 19 FPR.[53] In contrast, of the "safest" franchise programs, defined as a franchise program with a 10% or less default rate, 67% of these franchisors had made an Item 19 FPR.[54] Thus, there is an interesting and direct correlation between those franchisors that made an Item 19 FPR, and the safety of the franchise opportunities they represent. It can be fairly surmised that those SBA loan recipients who purchased a franchise benefitted from an Item 19 FPR.

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process in order to derive the increased franchisee SBA loan failure rate of those whose franchisor did not make an Item 19 claim versus those whose franchisor did make such a claim (all computation data sheets are on file with author). The three-step process is as follows:

1. The SBA released the failure rate of all the loans given to franchisees of individual franchises (minimum ten distinct loans). The franchise industry website BlueMaumau is a source for such a list.
(http://www.bluemaumau.org/6812/2008s_sba_loan_failure_rates_franchise_brand)

2. The franchise analytic company, FRANdata (www.frandata.com), then was able to provide the information of whether or not each of the distinct franchisors listed in the SBA default list did or did not provide an Item 19 claim in their FDD. This was done pro-bono as the information is to be used for educational/research purposes only.

FRANdata's business is turning vast amounts of data into information that helps businesses make better decisions. FRANdata is the franchise industry's source for objective information and analysis. With the world's largest repository of franchise information, an experienced staff of franchise specialists, and a genuine commitment to objective research and analysis, FRANdata stands alone as the franchise world's information source.

3. By cross-referencing the SBA default data with franchisor's Item 19 claims, I was able to statistically compute how the Item 19 claims factored into the failure rate of franchisees. In short, the overall SBA failure rate of those franchisees of franchisors which did make an Item 19 claim was 11.07%, versus a failure rate of 17.28% for those franchisees of franchisors who did NOT make an Item 19 claim. Therefore, a franchisee is 56.11% more likely to default on a SBA loan when the franchisee is working with a franchisor who did not make an Item 19 claim versus a franchisor that did make such a claim.

[51] *Id.*
[52] *See id.*
[53] *See id.*
[54] *See id.*

Another metric to show how much riskier an investment is for a franchise opportunity where no Item 19 FPR is made is based on the overall default rate of such opportunities. The SBA default rate for those franchise opportunities that did not make an Item 19 FPR is 17.28%, while the default rate for franchise opportunities that did make an Item 19 FPR was 11.07%.[55] Therefore, based on SBA guaranteed loans, a franchisee was *56.11% more likely to default* in his or her loan when purchasing a franchise from a franchisor that did not make an Item 19 FPR, compared to franchisee purchasing a franchise from a franchisor that did make an Item 19 FPR. This higher default rate is significant, and supports the theory that franchise opportunities that do not make an Item 19 FPR are riskier, while strengthening the argument in favor of an Item 19 FPR becoming mandatory for transparency.

XII. COMMON OBJECTIONS BY FRANCHISORS TO MANDATORY FPRS

It is necessary to examine the objections asserted by franchisors to mandatory disclosure of FPRs, which are well-chronicled in many franchise publications, such as the *Franchise Law Journal*.[56] The remainder of this article will be devoted to addressing and refuting these "red herring" objections.

A. *Increased Costs*

One of the principal objections against mandatory FPRs cited by the FTC and others is the increased cost[57] to the franchisor to assemble the data. Ignored by the argument are the costs prospective franchisees incur in developing their own data without the benefit of the actual information in the possession of the franchisor. However, in 2007 and 2008, over forty percent of franchisors that sought registration in Maryland provided an FPR, according to Ms. Shanks.[58] While it is true that there would be additional costs to a franchisor in making an Item 19 FPR, cost is only relevant when compared to the benefits. Even though making an FPR may be more costly and time-consuming to the franchisor, the extra time and expense are worth the

[55] *See id.*
[56] *E.g.*, David J. Kaufmann, *Mandatory Earnings Claims Disclosure: The Case Against*, 15 FRANCHISE L.J. 3 (1995).
[57] Legal Symposium, *supra* note 12, at 12.
[58] *Id.* at 15.

effort, with benefits to both the franchisor and the prospective franchisee. There are some obvious benefits to a franchisor for making a financial representation.

First, the prospective franchisee is going to gather information pertinent to whether he or she can make money with the franchise. In a 2007 decision, the FTC voiced that it is aware of investors' natural inclinations to educate themselves before any investment and points to a myriad of resources an investor can utilize to gather an investment projection on earnings. Without an Item 19 FPR, however, an investor is forced to become a detective in order to gather relevant investment data and inspect not only the 100-plus pages of information the FTC does mandate in the FDD, but also the other outside sources, including the initial investment costs and certain other ongoing costs. For each prospective individual franchise investment, an investor will need to look at information such as: the number of years the franchisor has been in business, any pending litigation (of franchise company or its owners), and/or direct interviews with existing and former franchisees. Additionally, the investor can hire outside agencies that specialize in FDD analysis[59] or pay an accountant to prepare a business plan including a financial forecast. The most reliable information, however, should come from an Item 19 FPR that serves as a foundation upon which all further analysis is based.

An analogy can be made to new automobiles. Imagine if automobile manufacturers no longer listed mileage per gallon on the windows due to their complaints about the costs and liability associated with formulating that number. Without such transparency, it would put the responsibility on the prospective buyer to guess the MPG based on size, engine, etc., or would force a buyer to interview other car owners to get their estimates. Such a system would create extra, inadvertent upfront costs and time that each buyer would have to invest in order to educate themselves before such a large purchase.

Second, he franchisor would benefit in making an Item 19 FPR by marshalling the information in one place: Item 19. This would give the franchisor more control over financial information disseminated about its business, as opposed to forcing a prospective franchisee to gather the information piecemeal from other sources.

A third benefit to the franchisor that would justify the cost of an Item 19 FPR is its use as a sales tool. From the seller's perspective, it is easier for a salesperson to close the deal if allowed to answer that

[59] *See, e.g.*, FRANCHISE FOUNDATIONS, http://www.franchisefoundations.com/fddevaluator.html (last visited Dec. 6, 2010).

initial question as to potential earnings, particularly if there is good news to tell.[60] "We don't have anything to hide, and here it is in black and white."

B. Potential Liability of Franchisors for Incorrect Information

Another common objection to mandatory FPRs is the potential liability that could be incurred by franchisors if the information provided does not meet the standard of reasonableness required by the 2007 Franchise Rule, or is simply incorrect. This fear, however, has proven to be unfounded. While there are reported cases involving earnings claims and FPRs, primarily in the sale of business opportunities, these cases relate to instances where (1) the disclosure document stated that no earnings claim was being made, but a claim was made orally or in another writing, and (2) in cases where an unsubstantiated and grossly exaggerated earnings claim was made. At the time of publication, no case could be found where liability was imposed on a franchisor that followed the rules in making an earnings claim or FPR, even if the franchisee's experience was different than what was disclosed by the franchisor.

An example of where a franchisor was protected from a class action suit brought by franchisees involved a claim that defendant/franchisor Quiznos fraudulently induced the franchisees to enter into the franchise agreement by making various misrepresentations concerning the profitability of the franchises.[61] Defendant Quiznos made an Item 19 earnings claim, giving sales figures for various individual franchisees; however, the following disclaimers were contained in the Quiznos UFOC:

> YOUR ACTUAL FINANCIAL RESULTS ARE LIKELY TO DIFFER FROM THE FIGURES PRESENTED. THE AVERAGE GROSS SALES FIGURES PRESENTED ABOVE REPRESENT SALES BEFORE DEDUCTIONS FOR CONTINUING ADVERTISING AND ROYALTY FEES PAYABLE TO THE FRANCHISER [sic] AND ALL OTHER OPERATING EXPENSES. SEE ITEMS 6 AND 7 OF THIS OFFERING CIRCULAR FOR A PARTIAL LIST OF EXPENSES YOU WILL INCUR.

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[60] Legal Symposium, *supra* note 12, at 12.

[61] Siemer v. Quizno's [sic] Franchise Co., No. 07 C 2170, 2008 U.S. Dist. Lexis 25907 at *3-4 (N.D. Ill. March 31, 2008).

> THE SALES FIGURES ABOVE ARE AVERAGES OF HISTORICAL DATA OF SPECIFIC FRANCHISES. THEY SHOULD NOT BE CONSIDERED AS POTENTIAL SALES THAT MAY BE REALIZED BY YOU. WE DO NOT REPRESENT THAT YOU CAN EXPECT TO ACHIEVE THESE SALES LEVELS. ACTUAL RESULTS VARY FROM RESTAURANT TO RESTAURANT, AND WE CANNOT ESTIMATE THE RESULTS OF ANY PARTICULAR FRANCHISE.
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> . . . .
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> OTHER THAN THE ABOVE INFORMATION, WE DO NOT FURNISH OR AUTHORIZE OUR SALESPERSONS TO FURNISH ANY ORAL OR WRITTEN INFORMATION CONCERNING THE ACTUAL OR POTENTIAL SALES, INCOME OR PROFITS OF A QUIZNO'S [sic] RESTAURANT.[62]

The Court held that the franchisees could not reasonably rely on any claims of profitability allegedly made outside of the UFOC and the franchise agreement, in view of the explicit disclaimers stated above. In rendering its opinion, the Illinois court relied on what it described as "an almost identical case."[63] The court in that case pointed out that Quiznos moved to dismiss a similar complaint filed by franchisees on the grounds that the explicit disclosures given to franchisees "gutted" plaintiff's claims.[64] Judge Griesbach, in the Wisconsin case, found Quiznos' argument persuasive:

> In the face of these clear and unambiguous disclaimers and non-reliance clauses, plaintiffs cannot plausibly claim that they relied on oral statements concerning likely profits and expenses in deciding whether to invest in a Quiznos franchise. [I]t is simply unreasonable to continue to rely on representations after stating in writing that you are not so relying.[65]

The Illinois court adopted the same reasoning and Quiznos was "let off the hook" for any alleged earnings claims made outside of the

62 *Id.* at *5-6.
63 *Id.* at *11, citing Westerfield v. Quizno's [sic] Franchise, LLC, 527 F. Supp. 2d 840 (E.D. Wis. 2007).
64 *Westerfield*, 527 F. Supp. 2d at 844.
65 *Id.* at 849.

Item 19 disclosure for the reasons stated above. Implicit in the court's analysis is the idea that if the franchisees believed they had been given improper earnings claims regarding the profitability of the Quiznos franchise, they should have raised those objections or concerns before they signed the franchise agreement, which specifically disclaimed that any claims regarding earnings claims or FPRs had been made to them.

It is submitted that one of the reasons why there is not a great body of litigation striking down an Item 19 FPR is due to the reasoning used by the court in the above-cited cases relative to disclaimer language. How could a prospective franchisee claim that he had been given false earnings claims and then subsequently sign a franchise agreement specifically disclaiming that any such earnings claims outside of the franchise agreement had been made?

From the point of view of Ms. Shanks, a regulator in Maryland,

> It's harder to prove an unlawful earnings claim if the franchisor's Item 19 contains a financial performance representation. For example, it would not be unreasonable for the franchisor to raise the issue that if a prospective franchisee received a financial performance representation that substantially deviated from the Item 19 disclosure, they would have questioned it at the time the representation was made, and not after the purchase of the franchise.[66]

Over the years, franchise lawyers with whom I have spoken have shied away from making Item 19 earnings claims or FPRs because of a supposed exposure to liability on the part of their clients. These fears, which were in fact shared by this author for many years, have simply not been well-founded. There is not any significant amount of litigation in which Item 19 earnings claims have been successfully challenged.

In the interest of fairness, a provocative case against mandatory earnings claims relating to the issue of potential liability to the franchisors was presented by David J. Kaufmann in an article entitled "The Case Against Mandatory Earnings Claims Disclosure."[67] When Mr. Kaufmann wrote the article, both FTC and NASAA were considering mandatory disclosure of earnings claims, which would

[66] Legal Symposium, *supra* note 12, at 23.
[67] Kaufmann, *supra* note 56.

require franchisors to disclose average gross sales, average net profits, and average annual "break-even" levels of gross sales of all units in their chain.[68] Mr. Kaufmann states that those three types of mandatory earnings claims being considered by the FTC and NASAA would give rise to massive liabilities for franchisors compelled to make them,[69] and concluded that such mandatory claims would be relatively meaningless to franchisees.[70] Rather than being a mandatory earnings claims-bashing, as the title would initially suggest, Mr. Kaufmann's article actually offered an interesting compromise, which he states "more closely adheres to the norms customarily observed when businesses are sold in the United States, and one that would impart far more useful information to prospective franchisees."[71]

Mr. Kaufmann went on to state:

> If one is offering to sell an existing unit to a "new" franchisee (one who has not previously been a franchisee in the chain), then disclosure of that unit's actual operating results for the immediately preceding three years should be required. Nothing could better assist a prospective franchisee considering the purchase of an operating unit than the actual numbers achieved by that unit. Under this scenario, the problems associated with any average unit numbers are done away with.[72]

While Mr. Kaufmann does not go as far as this author would go regarding mandatory claims, he certainly proposed a reasonable compromise back in 1995,[73] which has not yet been accepted by either NASAA or the FTC.

C. The "One Size Does Not Fit All" Argument

The next major objection to mandatory earnings claims is what is described as the proverbial "one size does not fit all" argument. An

[68] *Id.* at 3.
[69] *Id.*
[70] *Id.* at 7.
[71] *Id.* at 8.
[72] *Id.*
[73] *See* Kaufmann, *supra* note 56, at 8.

excellent discourse of this argument is set forth in an article by Andrew C. Selden.[74] Mr. Selden states:

> This argument asserts that no single financial datum or set of financial information is both available and relevant across the broad spectrum of franchising. This is a concern because with two to three thousand companies offering franchises in several dozen different lines of business, it is difficult to imagine a single set of financial information that could be compiled by and be relevant to all of them.[75]

Mr. Selden goes on to say that in 1995, NASAA was grappling with three different draft proposals of a mandate: "disclosure of 'top-line' gross sales information; disclosure of an abbreviated statement of profit and loss showing only certain major categories of expense;" and disclosure of "a generalized mandate directing each franchisor to choose something that is relevant to its business and disclose that."[76] And Mr. Selden pointed out that each of these approaches, although not without challenges, did not appear to be insurmountable.[77] The one-size-fits-all argument, as aptly noted by Mr. Selden, was not persuasive in 1995, and certainly is not persuasive under the 2007 Franchise Rule where the new guidelines state that any franchisor making an FPR must have a "reasonable basis and written substantiation for the representation at the time the representation is made, and the representation is included in Item 19 (§ 436.5(s)) of the franchisor's disclosure document."[78]

The one-size-fits-all disclosure format has been identified as the principal argument against FPRs.[79] As was pointed out in the IFA Legal Symposium, neither the amended rule nor the UFOC Guidelines clearly state what constitutes a reasonable basis, yet the franchisor bears the burden of showing it had a reasonable basis for the FPR when such representation was made.[80] The symposium authors went on to say that the concept of reasonable basis "is subjective, and as a result every franchisor must analyze the information offered in the context of what is reasonable for its business and its industry."[81]

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[74] Andrew C. Selden, *Mandatory Earnings Claims Disclosure: The Case For*, 15 FRANCHISE L.J. 3 (1995).
[75] *Id.* at 4.
[76] *Id.*
[77] *Id.*
[78] 16 C.F.R. § 436.9 (2007).
[79] BARKOFF, *supra* note 15, at 13.
[80] Legal Symposium, *supra* note 12, at 6.
[81] *Id.*

Thus, it would appear that the one-size-fits-all standard has been answered by the reasonable basis standard. The article does point out, by quoting from the compliance guide, that there are several factors that a franchisor should consider in determining whether it has a reasonable basis, but those guidelines do not box in the franchisor in the manner that was being considered in 1995 by the IFA and NASAA.

D. New Franchisors Will Be Handicapped

Another interesting objection cited by Mr. Selden in his article pertains to a supposed handicap for new franchisors in having a mandatory disclosure requirement. Mr. Selden argues that new franchisors and new programs are always at a competitive disadvantage relative to established programs in some respects, but they have competitive advantages in others. He states "[l]ack of a track record, or lack of a track record with any particular magnitude, is intrinsic to the circumstances; it is not a function of a disclosure mandate."[82] There, of course, could be time periods available to a new franchisor to enable it to obtain the required data.

E. FPRs and the Unsuccessful Franchisee

If the logic of this paper is persuasive, it should probably be asked: "What successful franchisor would not want to make an Item 19 FPR?" Ms. Shanks, in her regulator's note quoted above, opines: "A system that is not doing well, whether based on revenue loss due to competition, decline in system size, or even marketing of a product/service that is no longer in demand, probably would not elect to include a financial performance representation."[83] The fact that this category of franchisors described by Ms. Shanks is able to sell franchises at all to an unsuspecting pool of prospective franchisees is perhaps the most cogent argument in favor of mandatory Item 19 FPRs.

This author, along with most other franchise attorneys, has refused to accept as clients potential franchisors that are not doing well as a business. Such franchisors may see the initiation of a franchise program as a last ditch effort to generate revenue, either by obtaining franchise fees or other means. Most of the professional services—

[82] Selden, *supra* note 69, at 5.
[83] Legal Symposium, *supra* note 12, at 13.

such as attorneys, consultants, and brokers—needed to sell a franchise are compensated on a purely transactional basis, which is usually commission-driven. This instant gratification allows these service providers to profit on a franchise sale for a business that has not developed the necessary qualifications to become franchised. The franchise industry should learn from the lessons of the current "Great Recession" sparked by the bursting of the housing bubble in which realtors, brokers, and banks all were compensated on a transactional basis, without having "skin in the game" in the long-term solvency of their deals. While they profited, countless others were seriously hurt.

A mandatory Item 19 FPR would weed out these weaker players and prevent them from showing up at franchise shows and eluding the appropriate question of a prospective franchisee by saying, "Well, we would love to tell you what our financial history is, but we are prevented from doing so because we don't make Item 19 representations in our FDD." Weeding out these piranhas from franchise sales is an appropriate measure of federal regulation in the franchise sales process but can only be accomplished by requiring Item 19 FPRs.

F. Maintaining the Free Market Approach

One final objection advanced by the FTC, noted earlier, is that keeping Item 19 optional promotes a free market approach by encouraging prospective franchisees to search out franchise systems that disclose financial information voluntarily. According to this theory, if enough potential franchisees were vigilant in pursuing franchise opportunities that included Item 19 disclosures, ordinary market forces would force franchisors to voluntarily make FPRs, and government intervention would be unnecessary.

However, the opinion of this author is that a true "free market" can only be achieved when pertinent financial information is transparent to the investment community. Many prospective franchisee investors will typically go through the entire franchise procurement process without engaging with a third party, such as an attorney, CPA, or industry association. These franchisees are often unaware of the flexibility of the Item 19 rule and the more transparent disclosures that other franchisors might make. Mandating Item 19 disclosures would provide the financial transparency needed to better educate the investor in their decision making.

XIII. CONCLUSION

Not only is a franchisee investor damaged by a bad franchise investment, but also, in the long term, investors purchasing flawed franchises hurt every person involved in the franchise industry. By not mandating an Item 19 FPR, the FTC is undermining the main source of capital—the new franchisee investor—used to grow the franchise industry. The franchise industry, just like our nation's GDP, is not a finite pie; instead, it is constantly seeking to expand. However, some prospective franchisees that comprise these pieces of the pie are crushed by an unsound business concept. Without a mandatory Item 19 FPR, the FTC is not allowing these poisoned pieces of the pie to become visible to investors before they take a bite. Once these investors are poisoned and lose their investment, they rarely try to bite off another piece. They also communicate their bad franchise experience to their network of friends, family, and business relations. These negative experiences may serve to be the worst type of public relations for the franchise industry, and the entire franchise industry may be damaged. In contrast, the primary parties that may be damaged by requiring an Item 19 FPR are those underperforming franchisors that will be exposed to the investment community. Any increased costs to legitimate franchise concepts will be balanced by better investor confidence in franchise investment that will increase the size of the franchise pie.

In examining the various arguments against mandatory FPRs, none of them outweigh the advantages, nor are any of them convincing enough to justify the grave injustice being done to potential franchisees. Denying potential franchisees the advantage of examining the FPRs of the franchisor in order to weigh the financial pros and cons subjects them to unnecessary hardship. It is evident that FPRs provide valuable information needed by the prospective franchisee to make a decision as to whether to invest in the franchise.

Requiring an Item 19 FPR is not only a good idea, it is also a necessary addition to the franchise process and imperative to growing a healthy franchise system. With franchising now making such a significant contribution to the U.S. business community, a strong system of viable franchise concepts will benefit all Americans and the U.S. economy as a whole. It is time for the FTC to regulate, rather than placate, the franchise industry. The SEC is doing its job in regulating the sales of securities, and the FTC needs to follow suit in mandating an Item 19 FPR. The time has come for Item 19 Financial Performance Representations to be mandatory.