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**Franchise and Business Opportunity Project Group**
Dale Cantone, Chair
Office of the Attorney General Division of Securities
200 St. Paul Place, 20th Floor
Baltimore, Maryland 21202-2020

**NASAA, Legal Department**
Christopher Staley, Counsel
NASAA
750 First Street NE, Suite 1140
Washington, DC 20002

Re: Comments on the NASAA Franchise Project Group FPR Commentary

Dear Mr. Cantone and Mr. Staley:

This letter is being submitted on behalf of the law firm Gray Plant Mooty, Mooty & Bennett, P.A. ("GPM" or "Gray Plant Mooty") in response to the request of NASAA's Franchise and Business Opportunity Project Group (the "Franchise Project Group") for comments on its October 1, 2015 release of a "Proposed Franchise Commentary on Financial Performance Representations" (the "FPR Commentary"). Our comments below include (A) background and general comments, and (B) specific comments on individual questions and answers in the FPR Commentary.

## A. Background and General Comments

### 1. Thank you to the NASAA Franchise Project Group

GPM recognizes that NASAA and the Franchise Project Group have worked hard over the past several years to develop an FPR Commentary that seeks to serve the needs of prospective franchisees and their counsel, franchisors and their counsel (both in house and outside) and state regulators. We commend you and thank you for your time and effort. We understand that it is challenging to develop recommendations, suggestions, or answers to frequently asked questions that will be applicable to all or even many franchisors and franchisees. We thank you for your willingness to take on this task.

### 2. GPM Franchise Group

Gray Plant Mooty is a full-service law firm that will be celebrating its 150th anniversary in 2016. Gray Plant Mooty has been involved franchising matters for over 40 years. Currently, the GPM Franchise

Group includes 30+ lawyers who devote all or a majority of their practice to franchise, licensing and distribution matters. We currently represent more than 350 clients or brands in franchising, licensing and distribution, in more than 60 industries, from start-up franchisors, to some of the largest, most recognized brands in the world. More relevant to the Franchise Project Group, is that in the last two calendar years, the GPM Franchise Group has represented over 250 different franchisors or franchise brands in preparing or updating FDDs, and/or filing franchise registrations or renewals, and/or counseling on U.S. franchise regulatory and transactional matters. Many of our current clients, and many companies and brands that our lawyers have represented in the past, have prepared and included FPRs (and earnings claims) in their FDDs (and their UFOCs, prior to 2008). The issues raised in this letter – both the general comments and concerns, immediately below, and the specific comments addressed to individual FPR Commentary Items – are based upon and reflect this substantial experience. Further, while many of our comments are based on past practice and experience, our submission also reflects comments that we have received from some of our clients – large and small, long-term franchisors, and relative newcomers to franchising.

3. General Comments on the FPR Commentary

Because franchising covers 75 to 100 different industries, a "one-size-fits-all" approach to FPRs is not practical, useful or warranted. We are deeply concerned that the FPR Commentary will be viewed by regulators, lawyers, courts and arbitrators as the "final word" on FPRs, without room for reasonable variations based on the facts related to the franchise system. If so, valid, legitimate, reasonable, and helpful FPRs will not be permitted, and information which courts and the vast majority of people, including prospective franchises, would now consider to have a reasonable basis, will be the subject of litigation. Our reasons for these concerns follow.

a. NASAA is Substituting a Rigid Interpretation of "Reasonable Basis" for that of the Franchisor and its Counsel.

Under the FTC Franchise Rule and the NASAA Franchise Registration and Disclosure Guidelines a franchisor may make an FPR when the franchisor has a "reasonable basis" for making the claim and substantiating data for the claim. In the Introduction to the FPR Commentary, the Franchise Project Group writes:

> "What constitutes a reasonable basis, and what information is needed to substantiate an FPR, is fact-specific and varies from case to case, depending on the representation made."

We agree with this. In fact, it is the franchisor's obligation to evaluate and decide whether it has a reasonable basis for a claim, and it is the franchisor's burden to prove it has (or had) a reasonable basis for the FPR if challenged. However, the FPR Commentary seeks to define what is a "reasonable" basis for an FPR, in some cases by defining what is not a "reasonable" basis. The FPR Commentary paints with a broad brush, applying its definitions of "reasonable basis" to all FPRs, all industries and all franchisors, without an analysis or review of the specific facts or circumstances applicable to the FPR. The result is that franchisors and their counsel lose the ability to make judgments about how best to present financial information to prospective franchisees which may be relevant to the industry or the franchise system in which the franchise is being offered. We are unaware of any significant change in the interpretation of Item 19 by the courts that suggest a need for the limitations that the FPR Commentary would impose.

If a state examiner has a question regarding the reasonable basis of a specific FPR, she may request additional information from the franchisor. But to preclude legitimate, reasonable FPRs, applicable to a franchise system, is unfair to franchisors and harmful to franchisees.

b. The FPR Commentary Inhibits Providing Useful Data to Prospective Franchisees. The principal purpose of the FDD and pre-sale disclosure is to assist prospective franchisees in making a well-informed decision regarding investing in a franchise. The FDD and Item 19 are just the starting points for further investigation, review and diligence. Several of the FPR Commentary Items run counter to this fundamental principle (under federal and state laws), are likely to inhibit the inclusion of valuable financial performance information, and will stifle a prospective franchisee's opportunity to obtain answers to preliminary as well as follow-up questions.

c. The FPR Commentary Reflects a Bias Against Newer and Smaller Franchisors. Several of the FPR Commentary Items limit the type of data that a franchisor can include in its FPR if it does not have specific types of information, or a specific number of outlets. According to FRANdata, of the more than 3,000 franchise brands in the United States, 62% have fewer than 50 outlets, and another 13% have between 51 and 100 outlets. All chains, no matter their current size, started small, and had data from only a small number of outlets. Data from a small system is not inherently unreliable. By limiting the type of data permitted, the FPR Commentary is putting smaller chains at a disadvantage. As noted in our specific comments below, we suggest that the Franchise Project Group not only permit, but encourage, franchisors with a relatively small number of operating outlets to include a warning or admonition (but not a "disclaimer") that the FPR includes a relatively small number of outlets and that a prospective franchisee should evaluate the franchise opportunity carefully.

d. The FPR Commentary Treats All Franchisees as First-Time Single Unit Franchisees. Many of the FPR Commentary Items appear to assume that prospective franchisees are unsophisticated, naïve, and inexperienced single-unit franchise buyers. While some prospective franchisees may fit this profile, they are hardly the typical franchisee prospect. According to FRANdata, 55% of all franchised outlets are owned by multiple-unit operators and 20% of all franchisees are multiple unit-operators. Many new franchisees are not naïve, but have significant business and commercial experience and advanced educational backgrounds, and they expect sophisticated data. In many situations, the types of FPRs that are prepared and presented by franchisors include data that franchisees specifically request, and/or are for the benefit of multi-unit investors, private equity companies or other sophisticated investors who demand information from franchisors and who can evaluate its strengths and weaknesses. They demand the best, and most relevant, available information, because without it, they cannot make an informed investment decision.

e. Franchisors May Not Be Able to Obtain Optimal Data From Franchisees. Many franchise agreements do not require that franchisees provide cost and expense data to their franchisors. Even if a franchise agreement requires that sort of information, many franchisees do not provide it, or do not provide reliable data or data in a format that a franchisor can use.[1] Franchisors that have the contractual right to obtain the information often do not receive it, and are reluctant to send default notices, or to terminate franchisees, for these sorts of violations. Consequently, franchisors often do not have the

[1] We have litigated many cases and have read of many more examples of franchisees underreporting sales, underpaying royalties, and maintaining different sets of books and records. In addition, we have many examples of franchisors that have sought to obtain costs data from franchisees for internal analytics and benchmarking, yet franchisees fail to provide the data, or fail to follow the instructions to enable the franchisor to retrieve useful or correct information.

data to make comparisons between franchised and company-owned outlets. The FPR Commentary does not appear to take this into account. As a result, we suggest modifying the FPR Commentary to eliminate FPR disclosure obligations or limitations that may need to be based on information that franchisors do not have and cannot obtain.

f. Company-Owned Outlets Are Not Always More Profitable and Do Not Always Have a Higher Sales Volume Than Franchised Outlets. We know from our clients' experiences, that not all company or affiliate operations (individually, or in the aggregate, or on average) are more profitable or higher grossing than franchisees. Yet, an unarticulated premise of the FPR Commentary is that company-owned outlets always perform better than franchised outlets. Regulators have told us that they believe that franchisors benefit from efficiencies or economies of scale. Even if some systems have more profitable company-owned outlets, multiple-unit franchisees may enjoy the same benefits as company-owned outlets. Also, many FPRs do not report cost/expense data, or they explain how the company-owned outlets account for certain costs. Several of the FPR Commentary Items appear to be based on false assumptions regarding company-owned outlet sales volumes or profitability. We suggest that the FPR Commentary Items that are based on this unproven assumption be modified to permit company-owned and franchised data to be co-mingled, if there is a reasonable basis to do so.

g. The FPR Commentary May Be Treated as Law. Our overarching concern about the FPR Commentary is that when state regulators review an FPR they will be directed to treat the FPR Commentary Items as mandatory interpretations of the "law," and that they will have no discretion (or willingness) to evaluate each FPR individually, or to understand the franchisor's business or the business or economic facts underlying the FPR. These are critical factors in evaluating whether an FPR has a reasonable basis.

If the FPR Commentary is intended to be a set of "presumptions" as to what is or is not a reasonable basis, or presumptions as to what is or is not fair, the Franchise Project Group should state that clearly. If the FPR Commentary includes presumptions, we assume each presumption is rebuttable. We recommend, therefore, that the Franchise Project Group (a) include the basis for each presumption, and (b) state that franchisors may include FPRs that may not align with the presumption, but franchisors may include explanations as to how and why an FPR was developed and the reasonable basis for the FPR. We are also very concerned that, in the absence of a method for rebutting presumptions, franchisee plaintiff lawyers will seize upon the FPR Commentary to claim FPRs do not have a reasonable basis. This concern will undoubtedly cause many franchisors to avoid making FPRs if the method of rebutting presumptions is not addressed in the FPR Commentary.

* * *

Of all the Items in the FDD, Item 19 permits – and in fact encourages – flexibility, and discourages rigidity. Our general comments above, and our specific comments and suggestions below, are designed to limit the potential chilling effect of the FPR Commentary, and allow franchisors to provide the type of information – with a reasonable basis – that prospective franchisees are seeking.

## B. Comments on Specific Commentary Items

### 1. Definitions

Our interpretation of the FPR Commentary is that the terms and definitions are provided for purposes of interpreting the FPR Commentary and that a franchisor is not required to use the same terms and definitions in its Item 19. The Commentary seems to contemplate the use of different terms as it references "similar terms" within the definition of gross sales and net profits. However, it would be helpful to clarify that a franchisor may continue to use its own terms and definitions, provided that the franchisor explains or defines the terms used.

In the Definitions, we suggest using the term "franchised outlet" instead of "operational franchises" because the term "franchise" suggests (and is often defined by state law as) an agreement or relationship, and not the actual business. The use of the term "franchised outlet" also is consistent with the term "company-owned outlet" and the terms used in Item 20. In addition, we suggest using the term "commenced operation" instead of "fully operational" as there is some ambiguity about what it means to be fully operational.

2. <u>19.4 Item 19 – Gross Sales FPR Based on Company-Owned Outlets Alone When Franchisor Has Both Operational Franchises and Company-Owned Outlets</u>

The conclusion that a franchisor cannot make a gross sales FPR based solely upon company-owned outlets, unless the FPR also incorporates franchised outlet information is not reasonable, and can be detrimental to full and useful disclosure. FPR Commentary Item 19.4 is a perfect example where the notion "one size fits all" does not work. There are a myriad of situations in which data based on company-owned outlets is more useful and more reliable than data based on franchised outlets.

A new franchisor with one franchised outlet and 10 or 50 or 100 company-owned outlets clearly has valuable and reasonable information upon which a prospective franchisee can base its own projections, even if it does not include information about the first—or even subsequent franchisees. Each situation should be evaluated on a case-by-case basis.

As discussed below with respect to FPR Commentary Item 19.13, the FPR Commentary suggests that for systems with less than 10 outlets, an FPR cannot be constructed with a subset of those (fewer than) 10 outlets. In addition to our questions and concerns about FPR Commentary Item 19.13, if FPR Commentary 19.13 applies to all FPRs and applies across all issues discussed in the FPR Commentary, a franchisor with fewer than 10 outlets could not comply with both FPR Commentary Item 19.4 (which requires the separation of company-owned outlets from franchised outlets), and FPR Commentary Item 19.13 (which prohibits using subsets of a sample that has a maximum of 9 outlets). Therefore, FPR Commentary Item 19.13 should not prevent a franchisor with fewer than 10 substantially similar company-owned and franchised outlets that have been open for at least one full year from making a gross sales FPR based on company-owned outlet data alone, without franchised outlet data.

In many instances, franchisors are unable to collect gross sales data for franchised outlets (e.g., where the franchisor does not charge a royalty based upon the franchisee's gross sales). Such systems should not be prohibited from making gross sales FPRs based on company-owned outlet data alone.

3. <u>19.5 Item 19 – Gross Sales FPR Based on Company-Owned Outlets Alone When Franchisor Has No Operational Franchises</u>

FPR Commentary Item 19.5 imposes a standard on franchisors that very few will be able to meet — disclosing "material financial and operational characteristics of the company-owned outlets that <u>may differ</u> from franchised outlets." What that could mean is virtually impossible for a new franchisor to know and can only really be known in 20-20 hindsight when evaluated in a courtroom. We address this concept further below. However, FPR Commentary Item 19.5 requires a statement of characteristics that may differ, and is therefore even more difficult for a franchisor to address than the standard in FPR Commentary Item 19.6. We suggest that the FPR Commentary modify the standard to require disclosure of "financial and operational characteristics of the company-owned outlets that are reasonably expected to differ materially from franchised outlets."

4. 19.6 Item 19 – FPR Disclosing Gross Profit or Net Profit Based on Company-Owned Outlets When Franchisor Has Operational Franchises

For the reasons described below, we recommend that FPR Commentary Item 19.6 be revised to remove the requirement set forth in (b) of the FPR Commentary Item (that franchisors adjust their results) and require instead that franchisors state whether franchisees may incur other categories of expenses and may not achieve economies of scale available to the franchisor.

FPR Commentary Item 19.6 requires the franchisor to compare historical costs with projected costs ("actual costs incurred by company-owned outlets that are adjusted to reflect potential material financial and operational differences…" [emphasis added]). In every case where a franchisor makes such an FPR, the morass created by attempting to project "imputed royalties," and all other costs that a franchisee might incur, regardless of obligations of the franchise agreement, turns any gross profit or net profit FPR into a projection. We suggest that the FPR Commentary modify the standard to eliminate projections of costs, and to require franchisors to identify those financial and operational differences between company-owned outlets and franchised outlets that are reasonably expected to differ materially based on previous experience. Because this statement requires franchisors to make guesses, they should be able to use an admonition to explain that the factors identified, as well as other factors or circumstances over which the franchisor has no control, and to caution prospective franchisees to consider these issues when preparing their own business plans.

FPR Commentary Item 19.6 is based upon the false assumption that a franchisor will know whether its franchisees are likely to pay more for goods and services and will be able to quantify and document the difference. Further, staffing, labor, and employee compensation issues are exceedingly location-, outlet-, geographic-, or situation-specific. More often than not trying to develop these adjustments is impractical. If the Franchise Project Group insists upon retaining this requirement, it should exclude the disclosure obligation where price differences have nothing to do with the distinction between a franchised and a company-owned outlet (e.g., franchisees are in a different market and use different suppliers, differences based on creditworthiness and different shipping costs). Similarly, the Franchise Project Group should clarify whether there is a threshold minimum percentage or number or number of franchisees who pay more for goods and services before this requirement applies, and, if so, state the threshold or percentage.

The adjustments to the results that FPR Commentary Item 19.6 would require are impractical, imprecise and cannot be accomplished with certainty. As a result, franchisors will be exposed to an unreasonable risk of litigation. For example, how is a franchisor to impute a royalty and ad fund fee for company-owned units? Should it apply the royalty and ad fund amounts under the current form of franchise agreement, or those that were in effect when the company-owned unit first opened or was acquired by the franchisor? How does a franchisor impute the cost of a full time third party manager? What is the imputed salary, benefits, other costs? Does a franchisor impute the starting salary of a new manager, a mid-level manager, or a highly experienced manager? If managers of franchised outlets often receive stock options in the privately-held franchisee, how is a franchisor to value the stock options? What if the options vest over a period of years? And if a franchisee's spouse or relative operates as a manager for no or reduced compensation, how is that supposed to be accounted for?

It is also unreasonable to require a franchisor to collect franchisee expense information regarding goods, services, labor and operating expenses, and to distill this information within 120 days after its fiscal year end. Few franchise agreements require a franchisee to provide expense information to the franchisor, to break this information down into line items that would enable a franchisor to determine whether differences exist, and to do so within a time frame that would enable the franchisor to prepare its FDD in a timely manner. Moreover, a franchisor may have little or no basis to confirm the accuracy of the expense figures collected from franchisees. The Franchise Project Group should remove this requirement. If the Franchise Project Group does not remove the requirement, it should, at a minimum, include a safe harbor provision which would permit the franchisor to rely upon cost figures received from franchisees.

Finally, as expanded upon below in our comments to FPR Commentary Item 19.13, there is a potential conflict between FPR Commentary Item 19.6 and the "subset" proposal in FPR Commentary Item 19.13. We believe that the Franchise Project Group should address this issue.

5. <u>19.7 Item 19 – FPR Disclosing Gross Profit or Net Profit of Company-Owned Outlets When Franchisor Has No operational franchises</u>

FPR Commentary Item 19.7 creates an apparent prohibition on all forms of gross profit and net profit statements based on company-owned outlets when no franchised outlets are operational. FPR Commentary Item 19.7 provides no background or evidence to suggest that gross profit or net profit information from company-owned units is necessarily either unhelpful to prospective franchisees or inherently misleading.

In many cases, if a franchisor has accurate historical information about gross profits, that information is likely to be more helpful to a prospective franchisee than just information about gross sales. It enables a prospect to understand margins and work with advisors to construct financial plans and to identify the likely band within which all other operating expenses must be covered. For example, in the restaurant industry the two most important expenses prospective franchisees are seeking are food costs and labor costs. A franchisor with company-owned operations will have this information and prospects will want to review it.

Similarly, in the absence of evidence showing that net profit information is universally misleading when no franchises are operational, franchisors should have the option of presenting that information to prospective franchisees to develop benchmarks for their own business plans.

We recommend that the prohibition on profit-based FPRs for franchisors that have no franchised outlets be abandoned, allowing franchisors and their counsel to use their best judgment about how to comply with the requirements of Item 19. Moreover, we request clarification about whether a franchisor is precluded by other FPR Commentary Items from including profit information when the number of franchisees it has are less than a specified number.

Another problem with FPR Commentary Item 19.7 arises because the terms "gross profit" and "net profit" used in the FPR Commentary are not the only definitions of those terms. A franchisor may identify the cost of particular goods that it sells and have reliable information about gross sales prices. If a franchisor pays $1 for a widget and sells it to customers for $3, it has a $2 gross profit. That information is historical and valuable to a prospective franchisee, and should not be barred by this FPR Commentary Item. At a minimum, the FPR Commentary Item should require the franchisor to state what is meant by gross profit and net profit in the FPR, and expressly allow other forms of profit FPRs that fall outside of the FPR Commentary's definition.

6. <u>19.8 Item 19 - FPR Merging Data from Both Franchised Outlets and Company-Owned Outlets</u>

FPR Commentary Item 19.8 relates to every kind of FPR. FPR Commentary Item 19.8 restricts the merger of company-owned and franchised outlet data to situations in which "the franchisor can demonstrate that the franchised and company-owned outlets have gross sales that are not materially different," and where the franchisor has such a small number of total franchisees that their identity is discernible from the FPR.

The FTC Franchise Rule Compliance Guide ("Compliance Guide") permits merged information and does not limit the use of merged data to situations in which company-owned and franchised outlets have similar gross sales, or to situations in which franchisees' identity will be discernable if the data is not merged. [2] Thus, FPR Commentary Item 19.8 changes the standards established by the FTC without any discussion of public policy reasons, and without any evidence that such a limitation is needed to avoid misleading prospective franchisees. Merger of information should be permitted, so long as the presentation is not misleading.

Although, as noted in the FPR Commentary, the Compliance Guide under "*Substantiation of Financial Performance Representations*," states "If a financial performance representation is based upon both types of outlets—franchise and company-owned—the data for each type ordinarily should be separated to avoid potential misrepresentations…," the language applies to substantiation of the data itself and not the actual FPR, and it assumes the use of a merged FPR.[3]

In addition, many other types of FPRs can be made that do not depend upon an analysis of gross sales for their validity, including gross profit margin, repeat customers, number of customers, average traffic count, average sale, and more.

Even if the standard outlined in FPR Commentary Item 19.8 were to be adopted, it is ambiguous. How does a franchisor demonstrate that "franchised and company-owned outlets have gross sales that are not materially different?" What does that mean? If a franchisor has company-owned outlets with gross sales ranging from $100,000 to $1,000,000 per year, and two franchised outlets with gross sales of $125,000 and $150,000 during their last year of operation, are their gross sales "materially different" from the franchisor's sales at company-owned outlets?

[2] See FTC Franchise Compliance Guide, p. 87 (May 2008).
[3] *Id.* at 137.

7. 19.12 Item 19 – Best Performing Outlets

Contrary to the FPR Commentary, we believe that an FPR based solely on the performance of a subset of a franchisor's "best performing outlets" is accurate and not misleading, provided that such an FPR includes clear statements describing the subset included. Moreover, if the franchisor has the data to support the claim, the franchisor clearly has a "reasonable basis" for the claim it has made, which is only about the best performing outlets. We recommend that franchisors be allowed to provide an FPR based solely on the "best performing outlets" if franchisors include clear statements describing which outlets were included.

8. 19.13 Item 19 – Small Number of Company-Owned Outlets and Franchised Outlets

We believe that the meaning and intent of FPR Commentary Item 19.13 needs clarification. Our interpretation of FPR Commentary Item 19.13 is that a franchisor with fewer than 10 substantially similar company-owned outlets and franchised outlets that have been operational for at least one year full year may make an FPR based on all of its outlets (both company-owned and franchised), but may not make an FPR solely based on a subset of these outlets because it is presumed that the subset will consist of too few outlets to have a reasonable basis. We recommend that the Franchise Project Group clarify that this is the correct interpretation, and that FPR Commentary Item 19.13 is not intended to require that a franchisor have at least 10 substantially similar company-owned outlets and franchised outlets that have been operational for at least one full year before it can make an FPR. This is in keeping with the FTC Franchise Rule, which specifically allows for FPRs based on subgroups.[4]

Even with this clarification, we are troubled with the presumption at the heart of FPR Commentary Item 19.13 that less than 10 outlets of a subset do not form a reasonable basis for an FPR. To be clear, we believe that it is often appropriate to make an FPR based upon the results of a set or subset of 10 or fewer outlets and the FPR Commentary Item 19.13 presumption should be eliminated.

However, if Franchise Project Group chooses to retain this presumption in this FPR Commentary Item, the Franchise Project Group should explain the interplay between the presumption in FPR Commentary Item 19.13 and all of the other FPR Commentary Items (i.e., whether it applies to the other FPR Commentary Items). Otherwise, franchisors may find themselves in a "Catch-22" situation where complying with another FPR Commentary Item will result in a violation of this FPR Commentary Item 19.13, and vice-versa. For example, the "subset" limitation described in this FPR Commentary Item 19.13, should not prohibit a franchisor with fewer than 10 substantially similar company-owned and franchised outlets that have been open for at least one full year from making a gross sales FPR or a gross profit or net profit FPR based on data from only company-owned outlets pursuant to FPR Commentary Items 19.4 and 19.6. These FPR Commentary Items do not require a minimum number of operational outlets and the same statistical principles apply in all cases.

As another example, FPR Commentary Item 19.13 appears to mean that a franchisor with fewer than 10 substantially similar company-owned outlets and franchised outlets that have been operational for at least one full year may not make separate FPRs for company-owned outlets and franchised outlets. If true, what is a franchisor to do if its franchised and company-owned outlets have gross sales that are materially different? FPR Commentary Item 19.8 suggests that the franchisor would not be allowed to combine the data from both franchised and company-owned outlets in such case. Instead of preventing a franchisor

[4] *See* Federal Register / Vol. 72, No. 61 / Friday, March 30, 2007 / Rules and Regulations 15499.

from making an FPR, the Franchise Project Group should clarify that the FPR Commentary Item 19.13 "subset" limitations do not apply in this type of situation.

As currently drafted, franchisors run the risk that a court will provide a formal interpretation that fewer than 10 outlets of a subset (or a set) do not form a reasonable basis for an FPR. Hence, the Franchise Project Group's failure to expressly state how the presumption in this FPR Commentary Item is imposed throughout all of the FPR Commentary Items would expose franchisors to claims that they have made unlawful FPRs. Accordingly, we urge the Franchise Project Group to provide further instruction on this important issue.

Apart from the circumstances described above, we can envision many other situations, especially with smaller or newer systems, where it would be reasonable, and not misleading, for a franchisor with fewer than 10 franchised outlets and company-owned outlets to use only a subset of its outlets in an FPR. For example, assume a franchisor has four company-owned outlets and four franchised outlets that have been operational for at least one full year. What if the first two company-owned outlets were built with a square footage that is 25% to 50% larger than the next two or the four franchised outlets? What if two of the eight outlets did not have drive-thru windows, and the franchise is based on a drive-thru model? In these situations, and many others, a subset of less than the entire system is reasonable.

In addition, assume that an established franchisor with well over 10 existing franchised outlets and company-owned outlets offers and sells four franchises that operate under the same brand, but are not substantially similar to the existing outlets (for example, they are kiosks, rather than free-standing locations). May the franchisor prepare an FPR based on these four outlets? Are they considered a subset of all system outlets or a separate set of outlets for FPR Commentary Item 19.13? We believe that franchisors in this type of situation should be able to make an FPR based on the outlets that are substantially similar to the franchise being offered but not substantially similar to the other existing outlets (even if fewer than 10 outlets) and encourage the Franchise Project Group to clarify this issue.

Franchisors should be allowed to prepare subsets of their system, regardless of size, provided the FPR explains what is included or excluded from the sample. Instead of limiting data, we recommend that the Franchise Project Group permit franchisors to include FPRs, even with a relatively small number of outlets, if the franchisor has a reasonable basis to include the FPR and it is not misleading.

If there is a concern over using data from a small number of units, the Franchise Project Group may wish to require that the franchisor include a "warning" or "notice" in Item 19 that advises prospective franchises that the franchisor's FPR is based on a relatively small number of outlets, and the franchisee should investigate carefully the facts and data supporting the FPR, and determine its relevance to the prospective franchisee's proposed franchise investment. An alternative approach, would be to allow franchisors with fewer than 10 substantially similar company-owned outlets and franchised outlets that have been operational for at least one year to make FPRs based on a subset of the outlets, but only if they also include in their FDDs an FPR based on all of the outlets, or explain the deviations or excluded outlets in a note.

9. 19.15 Item 19 – Averages

FPR Commentary Item 19.15 provides that whenever an average of numbers is disclosed in an FPR, the median of those numbers—and not just the mean (which is the average)—also must be disclosed. While we understand the purpose of this requirement, we believe that, in some cases, it will prove to be cumbersome and make FPRs more difficult to read. For example, one of our clients has an FPR that includes average volume for all outlets for each of the first 60 months of operation. This FPR currently has 60 separate average numbers, and 60 separate data points with the number of outlets that have met or exceeded the average. This new FPR Commentary Item 19.15 "requirement" means that in addition to the outlet average, and the number and percentage of outlets that attained or surpassed the average, the franchisor will now also have to include the 60 "median" data points. The Franchise Project Group should limit this requirement to situations where the average without the median is misleading or the median value is materially different than the average value.

10. 19.16 Item 19 – Disclosures of Outlets that Opened and Closed during the First Year of Operation

FPR Commentary Item 19.16 is somewhat perplexing to us. Most FPRs are based on data from outlets (company-owned or franchised) that have been operating for at least one full year, and that have been in operation during the full fiscal year that is covered in the FPR. This is done, among other reasons, to avoid potentially skewing data, whether higher or lower, due to annualizing partial year numbers. Therefore, if an outlet closes during a year (regardless of when opened) the data for that outlet would not be included in an FPR, and there would be no effect in the averages. FPR Commentary Item 19.16 states that the franchisor must disclose the number of outlets that "both opened and closed during their first year of operation." This is information that is or should be disclosed in Item 20. It has no impact on Item 19 FPRs.

We do not understand the genesis of FPR Commentary Item 19.16. We request that the Franchise Project Group explain the rationale and the connection to FPRs. Following that, we recommend that the Franchise Project Group allow another comment period for franchisors, franchisees and counsel to react. In the alternative, we recommend deleting FPR Commentary Item 19.16 from the FPR Commentary, and re-considering the issue the next time the Industry Advisory Committee and franchise examiners consider Item 20.

We assume that FPR Commentary Item 19.16 will not apply to a franchisor that has both company-owned and franchised outlets, but less than a total of 10 substantially similar outlets (company-owned and franchised outlets) that have been operational for at least one full year, because FPR Commentary Item 19.13 (as currently written) will require the franchisor to include information for all of the outlets in any FPR it prepares (and not use any subsets). We ask the Franchise Project Group, however, to confirm our assumption and, as described above, to provide additional guidance as to how FPR Commentary Item 19.13 intersects with FPR Commentary Item 19.16.

11. 19.17 Item 19 – Outliers

FPR Commentary Item 19.17 instructs franchisors to exclude a "material number of atypical results from company-owned outlets or franchised outlets." We respectfully request that the Franchise Project Group explain this answer. What is meant by "material"? Is it determined by the number of unusually successful outlets included or by the impact of including the unusually successful outlets in the data presented, or both? For example, could one outlet be deemed material if it has a significant impact on the average? Also, if a franchisor has a material number of high performing franchised outlets then it would seem that the results are not atypical and can be included.

The concept of "outliers" is already addressed by averages, means, medians, and number of outlets that have achieved an average result. Further, if outliers are problematic, and not adequately addressed in Item 19, there should be no difference in the treatment of high performing and low performing outliers.

In addition, franchisors regularly test programs, but usually conduct the tests with a relatively small group of outlets before rolling out changes system-wide. If a franchisor includes in its FPR a statement that all new franchisees will be required to offer the new program, and that when it was tested in 10 units, gross sales increased by 10% over what they had been before the new program was introduced, that is valid and helpful information to new and existing franchisees. Those outlets should not be considered outliers; nor should they be considered to be a prohibited subset.

Moreover, if an FPR discusses averages of or ranges of gross margin, repeat customers, ratio of warranty coverage, etc., the fact that some information comes from "unusually successful" outlets does not necessarily make all data collected from them "outliers." The "unusually successful" outlets may have higher sales volumes, but have other characteristics that fit within the norms of what is disclosed.

As a result, we suggest that FPR Commentary Item 19.17 be removed. If the Franchise Project Group is unwilling to remove this information, we instead suggest that the term "outlier" be defined and allow franchisors to exclude both high-performing and low-performing outliers.

12. <u>19.21 Item 19 – Disclosures In Addition to Clear and Conspicuous Admonition</u>

Both here and in FPR Commentary Item 19.3, this prohibition against "disclaimers" changes and contradicts the Rule. By not defining the word "disclaimers," FPR Commentary Item 19.21 suggests that any admonition or clarification a franchisor includes in an FPR is unacceptable. An <u>admonition is not a disclaimer</u>, and the Compliance Guide recognizes that admonitions and clarifications are permissible, stating "[f]inally, nothing in the amended Rule would prevent a franchise seller from seeking alternative ways to narrow its disclosures to avoid making misleading statements."[5]

The problem arises when state regulators ask franchisors to strike material basis and assumption disclosures from their FDDs because examiners misinterpret them as "disclaimers." Ultimately, franchisees are harmed because much of the context surrounding the FPRs is removed. The following are some examples of disclosures that state examiners have struck from FPRs as "disclaimers," none of which repudiate or disclaim the performance data presented in the FPRs:

a. A recitation of factors affecting the performance of a particular outlet (such as seasonality, local demographics, whether the outlet will be owner-managed or managed by a third party, the manager's level of experience).

b. If the FPR presents data for established outlets, a statement that a new outlet's results may differ substantially from those of an established outlet.

c. A statement that the term "gross sales" does not include "profits," and that cost information is excluded from the FPR.

d. A statement that the cost data may not include owners' draws.

e. If the FPR presents historical data, a statement that the results presented in the FPR are historical, and not forecasts, or projections of future performance.

[5] FTC Franchise Rule Compliance Guide at 120.

f. A statement urging franchisees to engage independent financial advisors to review the FPR.

We recognize the states' need to streamline the franchise registration application review process, and the importance of uniformity in the presentation of FDDs. Therefore, rather than remove the proscription against disclaimers altogether, we strongly urge the Franchise Project Group to define a "disclaimer" *as a disclosure that repudiates the results provided in the FPR*. We believe that this definition will further the Franchise Project Group's aim while providing concrete guidance to franchise examiners and franchisors alike. And franchisees will benefit from the additional information and clarifications.

* * * * *

Once again, thank you for the opportunity to submit these comments. Based on our experience we have many examples that can illustrate the points discussed in the general and specific comments above. Several of our clients have provided specific examples too. In the interest of keeping these comments to a manageable length, we have not included the examples. However, if the Franchise Project Group would like us to submit examples and illustrations, or discuss them with the members of the working group, we would be pleased to do so. We sincerely hope that this information will be useful in your consideration of the final adoption of the FPR Commentary.

Respectfully submitted,

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