



The Franchise Valuations Reporter

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Welcome to our newsletter focusing on issues unique to our practice that we don't think are addressed anywhere else with respect to franchising: valuation and damages, cyber crime, expert testimony and tax nexus –the issues we know best, that matter to our clients - franchise executives and the consultants, attorneys and other professionals who advise them. We hope you find information that warns, informs and benefits you.

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Valuations

Impairment Write Downs and Loan Guarantee Ratios – A Problem?

Many VC firms and other buyers of franchise companies over the past decade used substantial leveraging in their acquisitions. Many of these loans have certain financial ratios that must be maintained often involving the net worth of the acquired company. In some instances there are also personal guarantees.

As we have written often, FASB 141 and 142 require purchasers of intangible

property (IP) – as opposed to owners of self-created IP – to test their IP assets (including “goodwill”) at least annually for impairment. If, as in many cases, the value of purchased franchise agreements, distributorship, or dealership agreements has been reduced (“impaired”) such as may be the case with Chrysler dealerships purchased within the past 10 years, prudent auditors will be asking whether franchise company management is honestly valuing their IP in light of potential loan problems that could affect them personally. Beware!

Damages Decisions

Lost Future Royalties: Must Expenses Be Proven? Is There A Mitigation Defense?

Recently a franchisor's claim for lost future royalties was denied because it failed to

submit any evidence as to its own operating expenses. Under Colorado law, future royalties, like all future damages, are subject to the “rule of certainty”.

On that basis a district court ruled that the claim for lost future royalties was basically a claim for lost profits and that without evidence of both, revenues and expenses, the court was left to speculate about the amount of the franchisor's net lost future royalties.

Additionally, the court left open the possibility of a mitigation defense against a future royalties claim based on imminent franchisee failure. The court noted that it was not clear that the franchisor would have been entitled to future damages even if it had provided evidence of expenses because the franchisee cast doubt at trial on its continued financial viability by virtue of its persistent operating losses.¹

CyberCrime

FTC Announces Expanded Business Education Campaign on 'Red Flags' Rule

To assist small businesses and other entities, the Federal Trade Commission staff has announced it will redouble its efforts to educate them about the "Red Flags" Rule by providing additional resources and guidance to clarify whether businesses are covered by the Rule and what they must do to comply.

The American Bar Association recently threatened suit against the FTC if it held the rules applied to lawyers.

To give creditors and financial institutions more time to review the guidance and develop and implement written Identity Theft Prevention Programs, the FTC will delay enforcement of the Rule until November 1, 2009.

The Red Flags Rule is an anti-fraud regulation, requiring "creditors" and "financial institutions" with covered accounts to implement programs to identify, detect, and respond to the warning signs, or "red flags," that could indicate identity theft.

The financial regulatory agencies, including the FTC, developed the Rule, which was mandated by the Fair and Accurate Credit Transactions Act of 2003 (FACTA). FACTA's definition of "creditor" includes any entity that regularly extends or renews credit – or arranges for others to do so – and includes all entities that regularly permit deferred payments for goods or services.

However, accepting credit cards as a form of payment does not, by itself, make an entity a creditor. "Financial institutions" include entities that offer accounts that enable consumers to write checks or make payments to third parties through other means, such as other negotiable instruments or telephone transfers.

Play it safe! Our FTRM division can help with designing your Identity Theft Prevention Program. Call us at 212.689.0400 or e-mail Henry@FTRM.biz or Henfree@FTRM.biz.

¹ *Rocky Mountain Chocolate Factory v. SDMS*, DC Colo., CCH Business Franchise Guide ¶14,093

A Free Test of Your Website Security

As we have previously reported, Payment Card Industry Data Security Standards, apply to any business that swipes VISA, MasterCard, Discover or American Express as payment, and stipulates that a company must take special steps to secure its web applications. Sensitive financial data must be safeguarded or companies face fines, penalties and possibly yearly mandated government audits.

PCI DSS also requires that companies install an application layer firewall in front of Web applications, or have all custom application code viewed for vulnerabilities by an organization that specializes in application security, such as our FTRM division. The recent PCI DSS update, 1.2, recommends taking both steps simultaneously.

Henfree and Henry Chan, our network security experts, have been testing an interesting product, dotDefender, from Applicure Technologies. Designed for businesses that accept credit card payments on their websites, dotDefender creates a security layer in front of the application, detecting and protecting against internal and external attacks that could compromise the server, steal credit card and other sensitive data, or hack into internal systems.

Nexus Notes

DANGER! New York Tax Law Requires Information from Franchisors

As we have reported repeatedly, all franchise practitioners should be aware that the State of New York recently passed a budget bill amending Section 1136 of the

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MORE REASONS TO BE FRIGHTENED!

Links to Recent Articles on Cyber-Crime

Ex-Goldman Programmer Detailed His Code Downloads to FBI Agent

<http://www.bloomberg.com/apps/news?pid=20601087&sid=aSDxSdMIPTXU>

Marines Ban Social Networking, Citing Potential Security Risk

<http://www.foxnews.com/story/0,2933,536647,00.html?test=latestnews>

Twitter Overwhelmed by Web Attack

<http://bits.blogs.nytimes.com/2009/08/06/twitter-overwhelmed-by-web-attack/?hp>

Security experts warn of dangers of rogue Wi-Fi hotspots

<http://m.cnn.com/cnn/ne/tech/detail/347159/full>

Tax Law to mandate that all franchisors file information returns giving the names and addresses of all their franchisees in the State. The legislation also provides that information on all payments from franchisees to franchisors and records of all

sales from franchisors to their franchisees will be required soon.

Under the statute the first returns are due September 20, 2009 covering the period March 1 to August 31. However, the IFA has negotiated a provision whereby franchisors can apply for a 90 day extension.

This is, arguably, a selective audit of a singled out sector of the economy. The New York tax authorities are asking for the information to be provided in a digital and computer-sortable format which will clearly be used as a template for audits of the following:

1. Sales tax by franchisee
2. Sales tax by franchisor
3. Income tax by franchisor (royalties and fees, nexus)
4. Income tax by franchisor (company-owned units to make sure there is compliance with New York's royalty add-back provision)
5. Income tax by franchisee (comparison of gross revenues with sales tax)
6. Sharing of tax information with other states