

What FIN 46R Means for the Franchise Industry

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In 2003, the Financial Accounting Standards Board (FASB) introduced a new gateway, FIN 46R, to determine which entities must be included in consolidated financial statements. Officially known as FASB Interpretation No. 46,¹ FIN 46R, which interprets Accounting Research Bulletin No. 51, Consolidated Financial Statements, represents a significant change in accounting standards.² FIN 46R uses broad accounting principles to correct perceived abuses rather than mandates compliance with detailed rules.³

With FIN 46R, FASB is taking aim at its key target, special purpose entities (SPEs), which, at the heart of some of the most notorious corporate scandals in recent years, have allegedly been used to hide losses from auditors and investors. As applied, FIN 46R consolidates the financial results of SPEs and other variable interest entities (VIEs) onto the balance sheets and into the operating and cash flow statements of their sponsoring business enterprises.⁴ The broad brush of FIN 46R goes beyond basic SPEs, requiring that a variety of business arrangements, associations, and relationships be examined for potential consolidation.

FIN 46R affects every franchisor in the United States, whether publicly or privately held, because all franchisors must include their audited financial statements, prepared in accordance with generally accepted accounting principles (GAAP), in their Uniform Franchise Offering Circulars (UFOC).⁵ From its Norwalk, Connecticut, headquarters, FASB sets the rules that become GAAP. And, as efforts continue to narrow the differences between GAAP and international financial reporting standards that take effect in the European Union this year, the extension of consolidation rules outside the United States remains a distinct possibility.⁶

The Original Proposal

The proposal originally adopted by FASB in early 2003, FIN 46, gave accountants license to apply a complex quan-



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titative and qualitative analysis to business relationships involving equity investment, debt, and contractual ties to determine who was in charge of a VIE and who was the most likely party to suffer the greatest cumulative losses or realize the most residual gain.⁷ FIN 46 was written so broadly that basic contractual relationships, including virtually all franchise arrangements, could qualify for compliance.

Moreover, the potential consequences of FIN 46 posed an accounting nightmare: franchisors dictating financial statement principles to franchisees and franchisees having to share the most intimate details of their individual businesses with franchisors and the franchisor's accountants.⁸ A particularly troublesome provision of FIN 46 would have in effect required those CEOs and CFOs of public franchisors who are required to provide certifications under the Sarbanes-Oxley Act to assume personal liability for the integrity of the accounting records and internal controls over financial reporting of potentially thousands of franchised businesses over which neither they nor the public franchisors had responsibility.⁹

The balance sheet impacts of this proposed consolidation mainly included accounts receivable and fixed assets and current and long-term liabilities. If the franchisor sold products to its franchisees, inventories would surely be affected. Even such items as deferred taxes would be touched by consolidation. Line items from the top to the bottom of the operating statement, including critical measuring sticks such as revenue, gross margin, OSG&A, and net operating income, would be dramatically altered by consolidation.¹⁰

Franchisors and franchisees alike raised concerns about FIN 46's impact on business relationships, increased costs, and financial reporting. The International Franchise Association (IFA) staff organized a task force, assisted by counsel and interested IFA members, which used every available opportunity to bring the looming crisis to the attention of FASB, the Securities and Exchange Commission (SEC), and members of Congress.¹¹ The results of this effort were positive. First, FASB staff issued an interpretation (FIN 46-f) that officially acknowledged some of the points that the franchise community had raised.¹² Then, on the morning of December 24, 2003, as a Christmas present to the franchise world and others, FASB issued a new version of FIN 46, now called FIN 46R.¹³ For FASB, the R stands for "revised." For the franchise community, it means "relief." That relief, however, is not complete. Although it is less likely that most franchisors will have to consolidate under FIN 46R than under the initial draft, franchisors and franchisees still did not fully escape the consolidation issue. An analysis is required to determine whether and, if so, how FIN 46R might apply.

FIN 46R, like many accounting principles, is a matrix of decision points with major yes/no decisions based upon qualitative and quantitative subdecisions.

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Hurdle #1: Business Scope Exclusion

Is There a Business?

As it relates to franchisors, the first decision point is whether the franchisee is a business.¹⁴ A business is deemed to be a self-sustaining, integrated set of activities and assets conducted and managed for the purpose of providing a return to investors.¹⁵ A business consists of the following:

- inputs, i.e., all of the material tangible and intangible assets, capital, and labor needed to make a product or provide a service;¹⁶
- processes, i.e., the processes that are applied to those inputs (processes include business systems such as strategic management, operations management, and resource management);¹⁷ and
- outputs, i.e., in a business, the resulting outputs are used to generate revenue by obtaining customers.¹⁸

If the franchisee is not a business as defined in FIN 46R, then further FIN 46R analysis is required (see Hurdle #2). If the franchisee is a business, the relationship of the franchisor and franchisee still needs to be considered to confidently claim exclusion from FIN 46R as a qualified business.

*Is the Business Conducted for the Franchisor or Does It Rely upon the Franchisor's Subordinated Financial Support?*¹⁹

If the franchisee is a business, a review of the franchisee's business structure is in order. A franchisor must consider the following questions:

Q #1: Do substantially all of the franchisee's activities involve, or are they conducted on behalf of, the franchisor and its related parties?²⁰

A #1: Although an analysis is needed, most franchised businesses are unlikely to have such a close relationship with a franchisor. In private discussions, audit firms have advised us that such a relationship will be deemed to exist when there is a "closed loop" system, such as one in which the franchisor either controls the franchisee's input and processes or takes all (or almost all) of the output created by the franchisee. That situation is rare among franchise companies, where inputs may be available from a variety of acceptable sources and where output, in the form of products and services, is typically sold to third-party customers. Dealerships and some distributorship arrangements could have difficulties, but most franchise networks will not involve activity that falls under this category.

Q #2: Did the franchisor or its related parties provide more than 50 percent of the total equity, subordinated debt, and other forms of subordinated financial support measured at fair value?²¹

A #2: These factors are the most likely trips over the first hurdle.

• *Related Party Equity*

Direct or related party investment in franchisees will trigger further analysis under FIN 46R. For this purpose, related parties include franchisor management (and family members), subsidiaries, sister companies, and parents.²² If a related party owns a franchisee, the business will be subject to a FIN 46R evaluation.

Franchisors that enter into joint ventures to form franchisees need to consider whether their equity involvement

will trip the consolidation hurdle. An investment that gives the franchisor or a related party over 50 percent of the franchisee's total capitalization will bring the franchise under the consolidation rules, as will material subordinated financial support.²³ Although joint ventures are not commonplace in domestic franchise arrangements, they are frequently used as a vehicle in international franchise structures. Franchisors may not be required to consolidate the results of their joint ventures under other aspects of GAAP, but FIN 46R may require that the joint ventures be consolidated.

• *Subordinated Financial Support*

Subordinated financial support is any variable interest, meaning any pecuniary interest in an entity that varies with changes in the value of the entity's net assets (other than the variable interest), that will absorb some or all of the entity's expected losses.²⁴ In other words, if a franchisor or a related party is actively involved in the business of a franchisee, has an investment in a franchise, or provides credit enhancement to a franchisee, it can expect to have to step into the FIN 46R evaluation.²⁵

Subordinated financial support may also include guarantees a franchisor gives on the franchisee's behalf; the interpretation includes situations where the franchisor will absorb the franchisee's losses through financing mechanisms such as subleasing real property or leasing equipment to the franchisee.²⁶

*Is the Franchisee's Activity Primarily Related to Securitization, Asset-Backed Financing, or Single-Lessee Leasing Arrangements?*²⁷

Such activity is unlikely to occur in a franchise setting. If the answer is yes to any of these questions, even though the franchisee is a business, the business scope exclusion will not apply and the franchisor must proceed through the FIN 46R matrix.²⁸ If the answers are no, no further evaluation is necessary.

Hurdle #2: VIE Interest

So far, at this hurdle all that has been determined is whether franchisees qualify for the business scope exclusion under FIN 46R. Failing to so qualify is not the end of the consolidation-free world; it is just the start of a deeper analysis.

Is There Sufficient Equity?

If a franchisee does not qualify for the business scope exclusion, the next step is to determine whether the franchisee has sufficient total equity at risk to carry out its business without additional subordinated financial support. Total equity at risk includes equity that shares in profits and losses. It excludes equity interests issued in exchange for subordinated interests in other entities (VIE swaps), amounts paid to the equity investor by the franchisee or others, and amounts financed for the equity investor by the franchisee or other persons involved in the franchisee.

A franchisee with insufficient total equity at risk is a consolidation candidate. The total equity at risk is deemed to be insufficient if it is less than 10 percent of the franchisee's total assets.²⁹

However, the inverse is not the case. Rather, when a franchisee has total equity at risk that is greater than

10 percent of its total assets, the franchisor must first consider qualitative factors such as proven financial ability and comparability of equity invested to businesses having similar assets and not requiring additional subordinated financial support.³⁰ Then, if the qualitative tests are not met, a quantitative test that measures total equity against estimated expected losses must be undertaken.³¹

Who Makes Decisions, Absorbs Losses, and Realizes Gains?

Assuming that the franchisee has cleared the equity sufficiency hurdle, the next evaluation is an analysis of control. Who are the decision makers? Who is obligated to absorb expected losses? Who has the right to receive the expected residual returns?³² If the answer to any of these questions is anyone other than the equity investor group, the franchisee is a consolidation candidate.³³

FASB staff provided guidance via an FASB staff position paper, FSP FIN 46R-3, issued at the same time as FIN 46:³⁴

The FASB staff believes it was not the Board's expectation that all franchise arrangements would be variable interest entities. Rather, the FASB staff believes it was the Board's expectation that franchise arrangements with equity sufficient to absorb expected losses would normally be designed to provide the equity group (the franchisee) with key decision-making ability to enable it to have a significant impact on the success of the entity (the franchise).³⁵

FSP FIN 46R-3 helped to clarify the question of just who is the decision maker. This pronouncement acknowledged the arguments advocated by the IFA task force, i.e., that the decisions relevant to the consolidation question are those that affect day-to-day operations and fundamental matters such as hiring and firing employees and amount and character of capital.³⁶

The franchisee's decision to sign a franchise agreement, and therefore adopt and adhere to franchisor-required business standards designed to protect the assets of a franchisor and all of its franchisees, does not confer upon the franchisor the control needed to transform the franchisor into the decision maker and render the franchisee a VIE.³⁷ However, FSP FIN 46R-3 also notes that if, as a condition of providing financial support, a franchisor requires that it be given control over the organic decisions of the franchisee, the franchisor might become the decision maker.³⁸

Relief has also been provided in determining who absorbs what amount of expected losses and who is to receive anticipated residual returns. Expected losses and residual returns are measured on the basis of changes in the fair value of net assets determined by quantifying expected cash flows from operations.³⁹ In other words, the analysis is based on variations from financial projections, not a measurement of actual results. Expected losses can be attributed to equity owners, guarantors, lenders, and others who may suffer from a decline in the value of the net assets of the franchisee.⁴⁰ Thus, a franchisor who has no equity interest in a franchisee may be attributed expected losses if the franchisor has provided credit enhancement to the franchisee either alone or as part of a group program (such as

loan guarantees, lease guarantees, or subleases).⁴¹ Fortunately, it is now clear that customary franchise and license fees payable to the franchisor are not included in the equation.⁴²

Hurdle #3: Primary Beneficiary

Moving through the matrix, we have now determined that the franchisee does not qualify for the business scope exclusion and that the franchisee is a VIE because: (1) it does not have sufficient equity by FASB standards, in which case consolidation occurs; or (2) someone other than its equity owners has control over day-to-day and fundamental decisions, or shares in expected losses or residual returns. In either case, FIN 46R analysis continues. This analysis brings us to the final matrix decision point to be considered:

Who Is the Primary Beneficiary?

Every VIE has one and only one primary beneficiary. The primary beneficiary is the party that absorbs a majority of a VIE's anticipated losses, recognizes a majority of the entity's residual returns, or both.⁴³ Only the primary beneficiary is required to consolidate with the VIE.⁴⁴ The primary beneficiary can be an equity owner, a lender, a credit enhancer, or a contracting party, depending upon the determinations of expected losses, expected residual returns, and amounts at risk. A de facto agent or two can tip the scales when the interests in the VIE are fractionalized.⁴⁵ Many franchisors have subsidiary and sister companies involved with franchisees and often permit management and employees to invest or otherwise participate in franchisees; thus, the potential for de facto agency combinations can be serious.

Is There a De Facto Agent?

A de facto agent of a franchisor is a party that cannot finance its operations without subordinated financial support from the franchisor, e.g., a sister company to the franchisor or another franchisee of which the franchisor is the primary beneficiary.⁴⁶ It may also be any person who receives an interest in the franchisee as a contribution or loan from the franchisor. A de facto agent could be an officer, employee, or director or equivalent of the franchisor. A close service provider to the franchisor, such as a lawyer or accountant, also could be a de facto agent. Finally, a de facto agency situation could apply if the franchisor can constrain another party's ability to sell, transfer, or encumber that party's interest in the franchisee.⁴⁷

However, FASB has made it clear that usual and customary franchise agreement transfer restrictions are not included in such determinations.⁴⁸ The risk of a de facto agency combination is the potential for combining loss absorption and residual return interests of minority parties to create a single de facto principal, the franchisor, which would be deemed the primary beneficiary.

Testing VIE Status

The decision points described above quite significantly narrow the number of franchisee relationships that could constitute VIEs consolidated with the franchisor. But

what about existing relationships? What about changes in relationships after a franchise relationship has already been established?

For the most part, FIN 46R evaluations are performed at the time the franchisee begins operations. Franchisee relationships created and beginning operations before December 31, 2003, must be evaluated,⁴⁹ but if the franchisor, “after making an exhaustive effort,” cannot obtain the information necessary (e.g., the franchisee’s financial statements) to determine whether the franchisee is a VIE or whether the franchisor is a primary beneficiary, or to perform the accounting required to consolidate, then the franchisee will be excluded from being a consolidation candidate.⁵⁰ However, fairly extensive financial statement footnote disclosure of the franchisor’s interests in a franchisee is required, and continuous efforts to obtain the necessary information must be made.⁵¹

Once a FIN 46R evaluation is made, the franchisor need not revisit its decision if, for example, the franchisee suffers actual losses that exceed its expectations.⁵² Revisiting the decision not to consolidate is only required if the franchisee’s governing documents or contractual arrangements with the franchisor change the character or adequacy of the equity investment at risk, or if there is a return of investment to the equity investors so that other pecuniary interests become exposed to losses.⁵³ If the franchisee undertakes additional activities or acquires additional assets beyond those anticipated at the inception of an evaluation, reconsideration is required only if the additions increase the franchisee’s expected losses. Finally, a revisit may also be called for if the franchisee takes in additional equity investments or curtails its activities in a way that decreases its expected losses. However, troubled debt restructurings are not intended to warrant a revisit to the FIN 46R evaluation.⁵⁴

Implementation

Public companies with interests in the VIEs previously recognized as SPEs must apply FIN 46R after December 31, 2003.⁵⁵ For all other public company purposes, FIN 46R considerations apply to financial periods ending after March 15, 2004,⁵⁶ except that disclosure requirements begin after December 31, 2003, “if reasonably possible.”⁵⁷ Small business issuers must apply FIN 46R no later than the first reporting period after December 15, 2004.⁵⁸ For nonpublic companies, FIN 46R applies to newly created VIEs after December 31, 2003, and all other SPEs after December 15, 2004.⁵⁹

Caveat Franchisors & Franchisees

Franchisors and franchisees ignore FIN 46R at their peril. The relief granted by FIN 46R when compared to the original interpretation is helpful and, for the most part, means that most franchise relationships fall into the business scope exclusion, or do not trip all of the hurdles leading to consolidation. However, because many franchisors have related party franchisees, make loans to franchisees, provide debt or lease guarantees to franchisees, or sublease to franchisees, they must be alert to the decision points that could lead to consolidation considerations.

If consolidations are to occur, the franchisor should plan in advance, especially in its franchise agreements. For example, among other things, franchisors should require that their franchisees provide audited financial statements prepared by an outside auditor acceptable to the franchisor (in some cases, this may end up being the same audit firm that the franchisor uses), maintain its financial records according to the dictates of GAAP, and either allow franchisor control over financial reporting or access to records so the franchisor can conduct its own assessments.

In short, franchisors are far better off with FIN 46R than with the original version of the standard. But the new standard still compels franchisors and franchisees to pay attention to the financial statement implications arising from the structure of their relationships.

Endnotes

1. See Financial Accounting Standards Board, FASB Interpretation No. 46, at 1 (revised Dec. 2003) [hereinafter FIN 46R].

2. See Financial Accounting Standards Board, FASB Interpretation No. 46, Summary, at unnumbered page 3 (revised Dec. 2003) [hereinafter FIN 46R Summary].

3. FASB has outlined a broad commitment to exploring use of principles-based approaches in accounting methods, stating thus:

The Board believes that an approach focusing more clearly on the principles in accounting standards is necessary to improve the quality and transparency of U.S. financial accounting and reporting. Also, a principles-based approach is similar to the approach used by the International Accounting Standards Board (IASB) in developing International Financial Reporting Standards (IFRS). Thus, adopting such an approach could facilitate convergence as the FASB works with the IASB and other national standard setters in developing common high-quality accounting standards.

Linda A. MacDonald, *Principles-Based Approach to Standard Setting*, THE FASB REPORT (Financial Accounting Standards Board, Norwalk, Conn.), Nov. 27, 2002, available at www.fasb.org/project/principles-based_approach.shtml.

4. FIN 46R Summary, *supra* note 2, at unnumbered pages 3–4.

5. UFOC Guidelines Item 21, reprinted in Bus. Franchise Guide (CCH) ¶ 5773. The Federal Trade Commission’s (FTC’s) staff also addressed the issue of GAAP financial statements in its report to the Commission concerning the proposed amendments to the FTC Franchise Rule. See FED. TRADE COMM’N, STAFF REPORT TO THE FEDERAL TRADE COMMISSION AND PROPOSED REVISED TRADE REGULATION RULE (Aug. 2004) [hereinafter STAFF REPORT], available at www.ftc.gov/os/2004/08/0408franchiserulerpt.pdf.

For example, under the current FTC Franchise Rule, data used to prepare an earnings claim must be prepared in accordance with GAAP, 16 C.F.R. §§ 436.1(c)(4), 436.1(e)(2). The FTC Staff Report recommends elimination of this requirement from the amended rule. See STAFF REPORT, *supra*, at 166–67.

The FTC staff also reconsidered the issue of whether U.S. GAAP financial statements should be required in a franchisor’s *Uniform Franchise Offering Circular* (UFOC). Staff concluded that a more flexible approach was advisable and suggested that the requirement for disclosure of a franchisor’s financial statements require either GAAP from the United States or another country but with the financial statements adapted to provide additional disclosure in the format permitted by the U.S. Securities and Exchange Commission (SEC). See STAFF REPORT, *supra*, at 200–02.

6. See generally D.J. Gannon & Alex Ashwal, *Financial Reporting Goes Global*, J. ACCT., Sept. 2004, at 43 (regarding the adoption of International Financial Reporting Standards [IFRS], which became mandatory in the European Union as of January 1, 2005). The issues surrounding adoption of IFRS are outside the scope of this article.

7. See FIN 46R, *supra* note 1; News Release, Financial Accounting Standards Board, FASB Issues Guidance to Improve Financial Reporting for SPEs, Off-Balance Sheet Structures and Similar Entities (Jan. 17, 2003), available at www.fasb.org/news/nr011703.shtml.

8. See INT'L FRANCHISE ASS'N, EXECUTIVE SUMMARY: FASB FIN 46 AND ITS EFFECT ON THE FRANCHISE COMMUNITY [hereinafter IFA EXECUTIVE SUMMARY], available at www.franchise.org/govrelations/tfin46.asp (last visited July 7, 2004). These requirements pose particular challenges for franchisors, which are already restricted by state and international laws as well as franchise agreements that limit their legal rights to obtain this financial information. See Int'l Franchise Ass'n, *FASB on Consolidation of Variable Interest Entities* [hereinafter *FASB on Consolidation*], available at www.franchise.org/govrelations/fasb.asp.

9. IFA EXECUTIVE SUMMARY, *supra* note 8. This requirement would force franchisees to restructure their internal financial systems at great expense in order to conform to the franchisor's standards, despite the real business purposes that have led to differences. It would also be likely to lead to requirements that franchisees use the same outside auditor as franchisors, despite the difficulties small business owners would face paying for an audit by an international accounting giant. See generally *Financial Accounting Standards Board and Small Business Growth, Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs, Subcomm. on Securities and Investment*, 108th Cong. (Nov. 12, 2003) (testimony of Peter A. Salg [a Wendy's restaurant franchisee from Colorado] on behalf of the International Franchise Association).

10. The potential financial statement impacts of consolidation are strong enough to create significant concerns for the SEC: consolidation of franchisees who currently pay a 5 percent royalty would lead to a twentyfold increase in reported sales for the franchisor. See *FASB on Consolidation*; *supra* note 8; letter from American Hotel & Lodging Ass'n and others to Robert H. Herz, Chairman, FASB, and Scott A. Taub, Chief Accountant, SEC, Sept. 11, 2003, available at www.franchise.org/govrelations/fasb2.asp.

11. See generally *FASB on Consolidation*, *supra* note 8.

12. See Financial Accounting Standards Board, FASB Staff Position on No. FIN 46 (Dec. 19, 2003).

13. See News Release, Financial note 1, at 44 (rejecting proposal to use the definition of a business in EITF Issue 98-3 to carve out a broader business scope exclusion).

14. See FIN 46R Summary, *supra* note 2, at unnumbered page 1 (stating that "[t]his Interpretation . . . addresses consolidation by business enterprises . . ."). But see FIN 46R, *supra* note 1, at 44 (rejecting proposal to use the definition of a business in EITF Issue 98-3 to carve out a broader business scope exclusion).

15. FIN 46R, *supra* note 1, at 35.

16. *Id.* at 36.

17. *Id.*

18. *Id.*

19. See *id.* at 5.

20. See *id.* at 10-11.

21. See *id.* at 64-65.

22. See Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 57, Related Party Disclosures (Mar. 1982).

23. See FIN 46R, *supra* note 1, at 4.

24. See *id.* at 2.

25. See *id.* at 6, 79 (referencing FASB Emerging Issues Task Force, Issue No. 96-16, Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights (1996)).

26. Cf. Letter from Matthew R. Shay, Executive Vice President, International Franchise Association, to Financial Accounting Standards Board (Dec. 8, 2003), available at www.franchise.org/govrelations/International%20Franchise2.pdf.

27. FIN 46R, *supra* note 1, at 4.

28. *Id.*

29. *Id.* at 7-8.

30. *Id.*

31. *Id.* at 8.

32. *Id.* at 5-6.

33. See *id.* at 5.

34. Financial Accounting Standards Board, FASB Staff Position No. FIN 46(R)-3 (Feb. 12, 2004) [hereinafter FIN 46R-3], available at www.fasb.org/fasb_staff_positions/fsp_fin46r-3.pdf.

35. *Id.* at 2-3.

36. See Letter from Matthew R. Shay, Executive Vice President, International Franchise Association, to Financial Accounting Standards Board 2 (Nov. 21, 2003).

37. See *id.*; IFA EXECUTIVE SUMMARY, *supra* note 8.

38. FIN 46R-3, *supra* note 35, at 4.

39. See FIN 46R, *supra* note 1, at 23-25 (illustrating the computation of expected losses and expected residual returns).

40. See *id.* at 10-11; Int'l Franchise Ass'n, *Impact of FIN 46 on Franchise Companies*, available at www.franchise.org/govrelations/fin46.asp.

41. See FIN 46R, *supra* note 1, at 10-11.

42. See *id.* at 4 n.4.

43. See *id.* at 10.

44. *Id.*

45. *Id.* at 10-11, 73.

46. *Id.* at 11.

47. *Id.*

48. See FIN 46R-3, *supra* note 35 (discussing the "right to approve a sale of the franchise").

49. See FIN 46R, *supra* note 1, at 15.

50. *Id.* at 3.

51. *Id.* at 14, 18.

52. See *id.* at 68.

53. See *id.* at 10.

54. *Id.*

55. *Id.* at 14.

56. *Id.* at 15.

57. *Id.* at 14.

58. *Id.* at 15.

59. *Id.* at 16.