

Disclosing Financial Performance Representations in the Time of COVID-19

Several state franchise administrators have asked the NASAA Franchise Project Groupⁱ for guidance in reviewing historical financial performance representations based on data from 2019 in franchise disclosure documents filed with state franchise authorities in 2020, when a COVID-19 pandemic has significantly impacted many businesses and the entire global economy.

Background

Beginning in March of 2020, the COVID-19 pandemic, and government responses to the pandemic, started having a significant impact on business and the economy. In most of the United States, many businesses have had to cease operations for several months in 2020 and others have had to change how they deliver goods and services to customers. These changes may continue for many months, even after states begin allowing more businesses to resume operations. The pandemic has already altered consumer attitudes and, indeed, our everyday lives. The long-term impact of the COVID-19 pandemic is unknown. It is possible that some franchise businesses may need to change their business models permanently, and some may cease operating entirely. Although franchising has weathered other economic upheavals and natural disasters in the past, the COVID-19 pandemic's impact on franchise systems appears to be unprecedented.

As required by the FTC Franchise Rule and applicable state franchise laws, many franchisors updated their franchise disclosure documents ("FDDs") in the spring of 2020, and those FDDs include information from the franchisor's last fiscal year end, which, in most cases, is December 31, 2019. Franchisors filed those FDDs with state franchise authorities requiring registration or a notice filing. Many franchisors included in Item 19 of those FDDs a financial performance representation based on historical data ("Historical FPR") from franchisee or company-owned outlets from fiscal year 2019 and previous periods that predate the impact of the COVID-19 pandemic.

State franchise administrators reviewing FDDs of franchisors that have applied for registration have asked for guidance on whether franchisors can make Historical FPRs in 2020 considering the significant impact the COVID-19 pandemic has had on many franchise businesses and what, if anything, franchisors must do in the future to ensure that the information contained in a Historical FPR meets the requirements of federal and state franchise law.

Discussion

Under federal and state franchise disclosure laws, a franchisor is permitted to make a Historical FPR if the franchisor has a reasonable basis and written substantiation for the representation, and the franchisor discloses the material bases for the representation.ⁱⁱ Under the FTC Franchise Rule, franchisors that have already provided FDDs to prospective franchisees may have to provide updated information, including revised FPRs, to those prospective franchisees to reflect material changes in the information provided.ⁱⁱⁱ Franchisors have an affirmative obligation under state franchise disclosure laws to continue to update all material disclosures they include in

their FDDs, including FPRs. Specifically, under state franchise laws, franchisors must amend a registration to reflect any material changes in the information contained in a registered FDD.^{iv}

Franchisors also must comply with anti-fraud provisions in state franchise registration and disclosure laws in states where those laws apply. These state franchise laws make it unlawful, generally, for a franchisor, in connection with the offer or sale of a franchise, to make an untrue statement of material fact or to omit to state a material fact that would make a statement not misleading.^v Whether a statement of fact or omission of fact is “material” is factbased and viewed from the standpoint of a reasonable prospective franchisee.^{vi}

Under some circumstances, an FPR that discloses historically accurate data may contain an omission of a material fact, or an untrue statement of material fact, if material changes have occurred to that FPR by the time it is provided to a prospective franchisee. Whether a franchisor can make and continue to use a Historical FPR in 2020 (and beyond) without amending that disclosure depends on a number of factors, including:

- Whether the franchise business has been significantly impacted by the COVID-19 pandemic;
- The type of data the franchisor includes in the FPR;
- The reasonable inferences a prospective franchisee can draw from the FPR;
- When the franchisor estimates a prospective franchisee can expect to open for business after entering into a franchise agreement;
- Whether and how the franchisor adapts the franchise business to account for current market conditions resulting from the COVID-19 pandemic; and
- Whether and how the franchisor adapts the franchise business to account for future market conditions resulting from the COVID-19 pandemic.

Not all franchise businesses have been negatively impacted in a significant way by the COVID-19 pandemic. In fact, some franchise businesses have experienced an increase in revenues with no material modification to the operations of the franchise system. Other franchise systems have experienced reductions in revenues or increased costs because of the pandemic, but those changes may not be material.

If outlets represented in an FPR have experienced material changes in financial performance, the franchisor may no longer make a Historical FPR that is not updated to reflect those changes. Therefore, franchise systems that have been significantly impacted by the COVID-19 pandemic should consider whether they can continue to make a Historical FPR in 2020 that does not include updated disclosure reflecting the impact of the COVID-19 pandemic on the franchise business.

In addition, as a result of the COVID-19 pandemic, some franchise systems have changed or will change how they deliver goods and services to the public. For example, dine-in food service establishments may have started or expanded take-out and delivery services. Fitness

franchises may limit the number of members allowed in a facility at one time. Some of these adaptations may be temporary, but some franchisors may alter their business models permanently to adapt to new consumer demands and attitudes in a post-COVID world. Once management of a franchisor concludes that it will make changes to its franchise system or business model that will materially impact a Historical FPR, the franchisor no longer may include a Historical FPR that is not updated to reflect those changes and their impact on the FPR.

It is impossible at this time to provide more specific guidance to franchisors about making a Historical FPR in 2020 and beyond. Each franchise system is unique, and the determination of whether a franchisor has a reasonable basis to make an FPR is based on the specific facts and circumstances relating to the franchise offering. Therefore, franchisors making Historical FPRs in the FDDs they file with state franchise regulatory authorities should be prepared to respond to comments from state examiners asking for them to explain how the FPR complies with federal and state requirements.

If franchisors do make a Historical FPR in 2020 (and beyond) based on pre-COVID-19 data, they cannot avoid the obligation to update that disclosure to reflect a material change by stating that the Historical FPR is not representative of what prospective franchisees can expect as a consequence of COVID-19, that the franchisor cannot predict how the franchise system will be affected by COVID-19, or otherwise suggest that prospective franchisees should not rely on the disclosure.^{vii} Although some franchisors may argue that statements like these are purely factual and accurate, the language can only be viewed by a prospective franchisee as a further admonition not to rely on the information presented.

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The NASAA Franchise Project Group

ⁱ This document represents the position of the NASAA Franchise and Business Opportunities Project Group and does not necessarily represent the views of the North American Securities Administrators Association, Inc., or of any state franchise administrator.

ⁱⁱ FTC Franchise Rule, 16 CFR Part 436.5(s). The states that require registration of franchise offerings adopted the disclosure requirements of the FTC Franchise Rule, including the Item dealing with FPRs. *See* NASAA's 2008 Franchise Registration and Disclosure Guidelines, <https://www.nasaa.org/wpcontent/uploads/2011/08/6-2008UFOC.pdf>.

ⁱⁱⁱ *See* 16 CFR Section 436.7(b) and (d); *see also* FTC Franchise Rule, 16 CFR Parts 436 and 437, Statement of Basis and Purpose, 72 Fed. Reg. 15520 (March 30, 2007) (“At the same time, we are persuaded that the final amended Rule should retain the original Rule’s continuing update requirement for financial performance information. The original Rule required franchisors to notify prospective franchisees of any material changes in a financial performance representation before the prospective franchisee pays a fee or signs the franchise agreement. We believe this provision is sound, recognizing the particular materiality of financial data to prospective franchisees. Any false impression created by stale data at the time of sale is likely to cause significant injury to prospective franchisees who rely on financial data in making their investment decision”).

^{iv} *See, e.g.*, Section 14-220 Maryland Franchise Registration and Disclosure Law, MD. BUS. REG. CODE ANN. § 14-201 *et seq.*; Section 19.100.070(3) Washington Franchise Investment Protection Act, WASH. REV. CODE ANN., §19.100 *et seq.*

^v *See, e.g.*, California Franchise Investment Law, CAL. CORP. CODE §§31200-04; Hawaii Franchise Investment Law, HAW. REV. STAT. §482E-5(b); New York Franchise Act, N.Y. GEN. BUS. LAW, ART. 33 §687.

^{vi} *See, e.g.*, ILL. ADMIN. CODE, Tit. 14, Subsection A, Part II, §200.110 (“[a statement or omission of material fact is material within the meaning of the Act if there is a substantial likelihood that a reasonable prospective franchisee would consider it significant in making a decision to purchase or not purchase a franchise.”); VA. ADMIN. CODE § 5-110-10 (“material change” includes a fact, circumstance, or condition that would have a substantial likelihood of influencing a reasonable prospective franchisee in the making of a decision relating to purchase of the franchise.”).

^{vii} NASAA Franchise Financial Performance Representation Commentary (May 8, 2017), Item 19.23.