

Impact of Shifting Market and Economic Factors on Franchise Disclosures¹

Economic and market changes² may cause fluctuations in prices and disruptions in supply chains, thereby impacting the franchisor-franchisee relationship and disclosures in Franchise Disclosure Documents (“FDDs”) provided to prospective franchisees. The NASAA Franchise Project Group has been asked for guidance by industry on how potential price fluctuations and supply chain disruptions may affect disclosures in FDDs. More specifically, the request seeks guidance on how to disclose considerations that may impact information accuracy regarding franchisee costs and development timelines. The short answer is that compliance with the Federal Trade Commission (“FTC”) Franchise Rule is never excused by changing market conditions, economic challenges, or volatility. The compliance obligation is absolute.

Background

The FTC requires franchisors to provide FDDs to prospective franchisees before they sign any binding agreements or make payments. The purpose of an FDD is to provide prospective franchisees with clear, transparent, and comprehensive information about a franchise opportunity so that prospective franchisees can make informed investment decisions. Some important information in the FDD includes the estimated costs of establishing and operating the franchise—such as fees imposed by franchisors and the costs of goods and services. The FDD may also include financial performance representations reflecting a specific level or range of actual or potential sales, income, gross profits, or net profits. Disclosures made in FDDs reflect market conditions as of the date of preparation. However, franchisors should reasonably anticipate that costs and development timelines may change due to evolving market conditions.

The NASAA Project Group notes that lessons on market fluctuations and economic uncertainty can be drawn from its COVID-19 guidance titled, “Disclosing Financial Performance Representations in the Time of COVID-19” (“COVID-19 Guidance”), which was issued when an unforeseen event triggered a global economic shift. The COVID-19 Guidance concluded that, for purposes of making a financial performance representation, franchisors cannot avoid the obligation to update a disclosure to reflect a material change by stating that the disclosure is “not representative of what prospective franchisees can expect [as a result of the unforeseen event],” that the franchisor “cannot predict how the franchise system will be affected,” or otherwise suggest that “prospective franchisees should not rely on the disclosure.”³ The COVID-19 Guidance also noted that, while franchisors may argue that well-meaning cautionary language like the examples above is 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.”⁴ Accordingly, this guidance explores potential approaches that franchisors may consider in addressing uncertainty in their initial and amended FDD disclosures.

Discussion

FDDs

Market and economic changes may affect various elements of the franchise law disclosure requirements that are required for FDDs and related filings. Among the required FDD disclosures that may be affected are the following:⁵

- *Item 5:* Item 5 requires franchisors to disclose initial fees, including fees for goods and services received from the franchisor or its affiliate, and conditions under which they are refundable.⁶ Franchisors that do not charge uniform fees must also disclose the low-high range or formula used to calculate those initial fees.⁷ As a result of changing market conditions, and questions regarding increases in franchisor costs, franchisors may argue that it is difficult to charge uniform fees or to disclose a precise range within which fees may vary. Their guiding principle should be transparency: to the extent that initial fees may be impacted, franchisors should provide (i) a low-high range or (ii) a formula that allows franchisees to understand how economic factors may affect the fee calculation.
- *Item 6:* Similar to Item 5, Item 6 requires franchisors to disclose other fees that the franchisor or its affiliates collect for themselves or a third party.⁸ This disclosure includes the type of fee, the amount, the due date and additional remarks. Such remarks may include (i) whether the fees are only payable to the franchisor, (ii) whether the fees are imposed and collected by the franchisor, (iii) whether and when the fees are non-refundable, and (iv) whether the fees are uniformly imposed.⁹ As above, if such fees or their ranges may change, then franchisors should provide formulas used to derive any fees for transparency.
- *Item 7:* In Item 7, a franchisor must disclose the franchisee’s entire estimated initial expenses in a table in Item 7.¹⁰ This includes all expenses required by the franchise agreement and all other costs necessary for a franchisee to commence business.¹¹ If the payment amount is unknown, then franchisors may use a low-high range or formula approach based on the franchisor’s current experience.¹² Most of the expenses to be disclosed in Item 7 cover only the period before the franchise opens its outlet, except for the “additional funds” category that includes required expenses that franchisees will incur both before operations begin and during the initial period

of operations. This initial period varies from franchisor to franchisor. In general, the FTC Franchise Rule Compliance Guide states that a reasonable period is at least three months. Franchisors may use a longer period that is reasonable for the industry.¹³

- *Item 11:* In Item 11, the franchisor must disclose the typical length of time between the earlier of the signing of the franchise agreement or the first payment to the franchisor, and the opening of the franchise outlet.¹⁴ The franchisor must describe the factors that may affect the time to open a franchise outlet. As part of such disclosures, franchisors are encouraged to consider whether specific market conditions may be material factors affecting the time to open, and to include such factors in Item 11 where appropriate.
- *Item 19:* In Item 19, if the franchisor elects to include an FPR, it must have a reasonable basis for the representation at the time it is made.¹⁵ The determination of what constitutes a reasonable basis, and what information is necessary to substantiate an FPR, is fact-specific and varies from case to case, depending on the nature of the representation made. In every case, however, written factual information in the franchisor's possession must reasonably support the representation, as the FPR is likely to be understood by a reasonable prospective franchisee.¹⁶

Importantly, the FTC Franchise Rule entitles a prospective franchisee to regard as material any statement made in an FDD.¹⁷ Moreover, franchisors must comply with anti-fraud and similar provisions in state franchise registration and disclosure laws in states where those laws apply.¹⁸ 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.¹⁹

Amended FDDs

As market forces evolve, some disclosures may need to be amended to avoid omitting a material fact or making an untrue statement of material fact. This is necessary if material changes have occurred, such as changes to franchisee costs and development timelines at the time the FDD is provided to a prospective franchisee. Whether a franchisor can continue to use an FDD without amending disclosures depends on various factors, including:

- Whether the franchisor, in Items 5, 6 and 7, used a low-high range for costs that could be impacted by economic and market factors and upon the franchisor's current experience was able to accurately estimate these changed costs in the FDD.
- Whether the franchisor, in Item 7, under the "additional funds" category, disclosed in the FDD a reasonable period of time before operations begin and during the "initial period of operations" budgeted for potential changes caused by evolving economic and market factors in the FDD.
- Whether the franchisor, in Item 11, was able to disclose the time to open a franchise with a range that accurately estimated delays from shortages of inventory, or delayed installation of equipment, fixtures, furniture and signs.
- Whether the franchisor, in Item 11, accurately disclosed the factors that affect the period of time it takes to open an outlet.
- Whether the franchisor elected to make an FPR in Item 19, and whether the FPR still has a reasonable basis given changes to outlet sales, costs, net profits or other relevant metrics.
- In franchise registration state filings, the laws of each state should be consulted to determine whether the franchisor's FDD may or must be amended, and to what extent.

The above shall not be construed to limit the franchisor's obligations to amend its FDDs (and file the amended FDDs in states that require registration) as required under applicable law, including when any other material adverse change occurs.

Concluding Remarks

While economic and market changes have the capacity to create uncertainty for businesses, franchisors retain their obligation to provide complete and accurate disclosures, without disclaimers, as follows:

- The guiding principle for a franchisor should be transparency and specificity in its disclosures. For example, if a franchisor discloses a range of estimated costs or expenses to account for shifting market or economic conditions, the franchisor

should clearly explain in the FDD which specific economic and market conditions were considered when calculating the range. Franchisors can explain how different economic and market conditions could result in different costs or expenses within the estimated range but should not include information about economic or market conditions the franchisor did not consider when calculating the estimated range.

- Any language suggesting that prospective franchisees cannot rely on a disclosure in the FDD is a prohibited disclaimer.²⁰ For example, evolving economic and market factors must not be used as a blanket disclaimer. Stating that information provided may vary in the future due to economic or market changes or that information does not account for economic or market changes would likely constitute a disclaimer.
- Franchisors should not make general disclosures about evolving economic or market factors if they are not materially impacted by them.

To conclude, if a franchise system is materially impacted by potential economic or market shifts, it may need to (i) account for these developments in its FDD or (ii) amend the FDD and file an amendment in registration states. Market and economic changes and uncertainties do not excuse compliance with the FTC Franchise Rule. Ultimately, prospective franchisees must be provided with disclosures that are accurate, clear, and not misleading.

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The NASAA Franchise Project Group

¹ 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 or federal franchise administrator.

² Economic and market changes can be caused by changes to tariffs, natural disaster, inflation, war and unrest, epidemics and pandemics, labor disputes, recession, economic growth, and new technology, among other factors.

³ Disclosing Financial Performance Representations in the Time of COVID-19, NASAA (June 10, 2020), p. 3, available at <https://www.nasaa.org/wp-content/uploads/2020/06/FPRs-in-the-time-of-COVID-19.pdf>.

⁴ *Id.*

⁵ Franchisors must determine whether other required disclosures are affected by economic factors.

⁶ 16 CFR § 436.5(e).

⁷ *Id.*

⁸ 16 CFR § 436.5(f).

⁹ *Id.*

¹⁰ 16 CFR § 436.5(g).

¹¹ Federal Trade Commission Franchise Rule Compliance Guide (2008), pp. 48-50.

¹² *Id.*

¹³ *Id.*

¹⁴ 16 CFR § 436.5(k).

¹⁵ 16 CFR § 436.5(s). *See also* NASAA Franchise Commentary on Financial Performance Representations, NASAA (May 8, 2017), p.1, *available at* <https://www.nasaa.org/wp-content/uploads/2017/05/Financial-Performance-Representation-Commentary.pdf>.

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¹⁷ Federal Trade Commission Amended Franchise Rule FAQ's at Q&A 21, *available at* <https://www.ftc.gov/business-guidance/resources/amended-franchise-rule-faqs>.

¹⁸ The laws of any individual state should be consulted for FDD and related registration requirements.

¹⁹ *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 Sales Act, N.Y. GEN. BUS. LAW, ART. 33 § 687 *et seq.*

²⁰ Federal Trade Commission Franchise Rule Compliance Guide, *supra* note 11, at 140-41.