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Item 19 FPRs & COVID-19

Justin Klein
Marks & Klein
Red Bank, New Jersey

Breton Permesly
Greenberg Traurig
New York, New York

Sandy Wall
DLA Piper
Chicago, Illinois

Nathan Quigley
Washington Department of Financial Institutions
Tumwater, Washington

I. Introduction¹

The COVID-19 pandemic has brought unprecedented impacts to franchise systems across the nation. In many states, as well as in non-US locations, governments imposed wide-ranging and drastic measures to stem the spread of COVID-19, forcing some businesses to shut down entirely for certain periods and to operate under severe restrictions throughout much of 2020. Demand for certain businesses such as in-house dining, hotels, and retail shopping experiences (especially those located in shopping malls) plunged. Franchise systems may have been forced to make significant layoffs, reduce purchasing to better align with existing demand, spend additional amounts in making changes to layout, design, and service and to provide PPE to employees, and some systems have had to make wholesale adjustments to the manner in which they operate (increasing take-out and delivery options, as just one example). While many franchises, like businesses everywhere, experienced a significant decline in 2020 revenues—the “COVID slump”—there are also some systems that experienced unprecedented and unexpected increases in revenues based on the demand for their particular product (hardware stores, grocery chains, fast-food concepts) during the pandemic—a “COVID bump.”

The impact of the pandemic in 2020 has forced franchisors, and their counsel, to give serious consideration to how, or whether, to report 2020 financial performance results in Item 19 of their Franchise Disclosure Document (“FDD”). According to what are now well established rules and guidance, franchisors must take particular care in connection with financial performance (“FPRs”) or face potential registration issues and/or the risk of litigation down the road. But an FPR based on 2020 results alone is likely to show an anomalous year that is not representative of historical performance, nor indicative of potential future performance in a non-COVID world. While the North American Securities Administrators Association (“NASAA”) issued some guidance on how to address FPRs in June 2020, such guidance has not been updated for 2021, and it is likely that this topic will receive significant attention from regulators in reviewing 2021 FDD submissions.

This Article explores the considerations franchisors should take into account in making FPRs in 2021 and beyond. It reviews applicable Federal Trade Commission (“FTC”), NASAA, and state regulatory guidance to date, and considers how the rules generally applicable to FPRs might apply to the post-COVID disclosure context. It also contains practical suggestions on various ways franchisors might address FPRs in their FDDs, including the pros and cons of each. As this is a rapidly developing subject area, it is possible that additional guidance may be published following the date of this Article that is not considered herein. As always, franchisors should carefully consider their

¹ Disclaimer: The views and opinions expressed in this paper are those of the authors, and do not purport to represent or reflect any policy or position of the Securities Division of the Washington Department of Financial Institutions, the North American Securities Administrators Association, Inc., or any law firm, and in any particular respect the contents of this article may be for discussion and do not necessarily reflect views of all the authors.

FPRs for 2021 and beyond with the guidance of counsel and taking into account all applicable guidance.

II. General Background on Item 19

Franchisors are by now well familiar with “Item 19” of the FTC’s Rule on Franchising (as amended in 2007) (“Franchise Rule”)², which sets out certain requirements concerning the provision of financial performance information to prospective franchisees. While a franchisor is free to provide certain financial performance information to prospective franchisees, as a general rule, it may only do so in Item 19 of its FDD. Because financial performance information is of such relevance to franchisees, and given the inherent risk of inaccuracies, misrepresentation, or even inadvertent disclosure of such information to prospects in the sales process, the Franchise Rule, as well as similar state laws, regulate the form and substance of FPRs.

Section 436.1(e) of the Franchise Rule defines a “financial performance representation” as:

[A]ny representation, including any oral, written, or visual representation, to a prospective franchisee, including a representation in the general media, that states, expressly or by implication, a specific level or range of actual or potential sales, income, gross profits or net profits. The term includes a chart, table, or mathematical calculation that shows possible results based on a combination of variables.³

An FPR may be based on (i) historic results or (ii) future projections. It essentially includes any form of financial information that permits the prospective franchisee to assess the sales, income or profits other units in the system have achieved or they may achieve. Franchisors are not obligated to include an FPR in Item 19 of its FDD; the FTC ultimately decided to leave this decision to franchisors. If a franchisor does choose to make an Item 19 disclosure, then it must adhere to the strict rules on the type of information permitted and prohibited in Item 19. The Franchise Rule requires that a franchisor making an FPR “must have a reasonable basis and written substantiation for the representation at the time the representation is made and must state the representation in the Item 19 disclosure.”⁴ Franchisors that make FPRs must provide written substantiation of the statement to prospective franchisees upon reasonable request.⁵ The Rule also requires franchisors to “disclose the bases and

² Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunities; Final Rule, 72 Fed. Reg. 15444, 15478, n.350 (March 30, 2007), codified at 16 C.F.R. § 436.

³ 16 C.F.R. § 436.1(e) (emphasis added).

⁴ 16 C.F.R. § 436.5(s)(3). The accompanying Compliance Guide states that “the quality and quantity of information constituting a reasonable basis [in support of an FPR] will vary from case to case,” but that this information “must reasonably support the representation” and be “the sort of information upon which a prudent businessperson would rely on in making an investment decision.” Franchise Rule Compliance Guide, <https://www.ftc.gov/system/files/documents/plain-language/bus70-franchise-rule-compliance-guide.pdf> (“Compliance Guide”).

⁵ 16 C.F.R. § 436.5(s)(3)(v).

assumptions underlying the representation in Item 19”⁶ and to issue a statement that a prospective franchisee’s actual earnings may differ. Notably, the version of the Rule as amended in 2007 eliminated a requirement of the original rule that stated that an earnings claim had to be geographically relevant to the prospective franchisee and its proposed location.⁷

Given that the Franchise Rule itself does not provide detailed commentary on what constitutes a “reasonable basis,” NASAA adopted the NASAA Commentary on Financial Performance Representations (“FPR Commentary”) on May 8, 2017.⁸ Some of the guidance discussed further below is based on the FPR Commentary, and franchisors must consider the Franchise Rule, the FTC Compliance Guide accompanying the Franchise Rule,⁹ the FPR Commentary, and any applicable state laws in making any FPR. Furthermore, Section 436.7(d) of the FTC Rule¹⁰ specifically states that franchisors are required to notify prospective franchisees of any material changes that it knows or should have known occurred in the information contained in Item 19. This section makes clear that the fact that an FPR is historically correct is not enough—the franchisor has an on-going obligation to assure that this information is updated and relevant.

According to the FTC, a typical financial performance representation states or specifies a particular level or range of actual or potential earnings. The FTC adds that financial performance representations also include implied representations that suggest, or from which a prospective franchisee easily can infer, a specific level or range of income, sales, or profits. Financial performance information that differs from that included in Item 19 may be given only if: (1) they are the actual records for an existing outlet being purchased directly by the franchisee¹¹ or (2) a franchisor supplements the information provided in the Item 19, for example, by providing information about performance at a particular location or under particular circumstances.¹²

Assuming the reasonable basis and written substantiation requirements are met, franchisors have significant discretion as to the form and content of their FPRs. Generally speaking, projection FPRs are subject to greater scrutiny, and are less frequently used, than historical FPRs.¹³ The FPR Commentary contains various requirements as to the content of projections.¹⁴

⁶ 16 C.F.R. § 436.5(s)(3)(ii).

⁷ Amended Rule Statement of Basis and Purpose, 72 Fed. Reg. 15444, 15497-15501 (Mar. 30, 2007).

⁸ NASAA, NASAA Franchise Commentary Financial Performance Representations, <http://www.nasaa.org/wp-content/uploads/2017/05/Financial-Performance-Representation-Commentary.pdf> (“FPR Commentary”).

⁹ See *supra* note [6].

¹⁰ 16 C.F.R. § 426.7.

¹¹ 16 C.F.R. § 436.5(s)(4); Compliance Guide, *supra* note [4], at 93. This is only available to prospects that are legitimately interested in purchasing the outlet.

¹² 16 C.F.R. § 436.5(s)(1). A supplemental FPR must be in writing, explain how it is a departure from the FPR in the FDD, and be prepared in accordance with the other requirements of Item 19.

¹³ See, Compliance Guide, *supra* note [4] at 135-136 for commentary on making reasonable projections of future performance.

¹⁴ FPR Commentary, *supra* note [6] at 19.19 and 19.20.

A franchisor making a historic FPR must state certain material facts underlying the FPR, which are set out in the Compliance Guide.¹⁵ To state them briefly here:

- Clear identification of the “group measured.” It is not required to provide data for the entire system, but any smaller grouping of outlets must have a “reasonable basis.” The FPR Commentary provides further guidance on this subject. Of note, a franchisor making an FPR that includes data from both franchised outlets and company-owned outlets must disclose the data from each category of outlets separately in many cases and must provide sufficient information to reflect differences between company-owned outlets and operational franchise outlets.
- Clear statement regarding over what period of time the measurement occurred. The time period measured must have relevance to the facts and circumstances at play at the time the representation is made.
- Number of franchisees being measured as compared to total number in the system. If not all system franchisees are included, there must be a justification as to why this is the case.
- Number of outlets that actually reported financial information compared to the total system franchisees.
- Disclosure of the number and percentage of outlets that achieved the stated performance. This requirement is meant to ensure that franchisees can clearly identify whether the averages are skewed by several high volume locations. The FPR Commentary further clarifies that that a franchisor cannot include an average in an FPR without including the corresponding median, and vice versa.¹⁶
- Distinguishing Characteristics.¹⁷ This is the catch-all requiring franchisors to identify any other material information, which if known, would add or retract from the likelihood that a prospective franchisee might achieve similar performance to that stated in Item 19. For example, franchisors should ask themselves whether the stated performance level varies by geography, weather conditions, seasonality, urban or suburban environments, and other numerous factors.

In addition to these requirements, the franchisor is precluded from including disclaimers that might negate the franchisee’s ability to rely on the information presented. While franchisors are required to include an “admonition” in Item 19 that

¹⁵ See generally, Compliance Guide, *supra* note [4], at 87-91.

¹⁶ FPR Commentary, *supra* note [6] at 19.16 and 19.17.

¹⁷ Compliance Guide, *supra* note [4], at 90.

warns prospective franchisees that their performance may differ from the stated level,¹⁸ a franchisor is prohibited from including any other disclaimers that arguably negate a prospective franchisee's ability to rely on the information presented. The FPR Commentary lists specific permitted admonitions, which must be presented in a separate paragraph from the rest of the FPR and must be in bold type.¹⁹

It is estimated that more than half of all franchisors now included FPRs in their FDDs.²⁰ Item 19 disclosures are valuable in that they increase transparency and provide franchisees with valuable information in considering an investment in the system. On the other hand, FPRs may increase the risk that regulators will question the FPR provided or issue comments that are not easily resolved. They also increase litigation risk. FPRs based on 2020 results are particularly fraught and must be managed with particular care.

a. Mandatory FPRs?

At this time, no franchisor is required to include an FPR in their FDD. This issue was vetted when the FTC Rule was initially enacted and again when the FTC Rule was revised in 2007.²¹ The FTC concluded that FPRs should remain voluntary by stating that there was no assurance that by mandating FPRs there would be a reduction in false claims. The FTC further reasoned that because there is no single performance disclosure that would be relevant across all industries and therefore, the FTC could not mandate such a single format, it would be best to leave it to franchisors to decide whether to include such information as long as such information was reasonable, non-misleading, and accurate. The FTC also determined that mandating FPRs would also impose substantial new accounting, data collection, and review costs on all franchise systems, and could potentially expose existing franchisees, upon whose data the franchisor would rely, to more extensive audits.

On November 10, 2020, the FTC conducted a Public Workshop Examining the FTC Rule,²² where one of the three issues that was addressed was whether FPRs should be made mandatory. The panelists provided many of the same arguments as found in the Statement of Basis and Purpose—both for and against making FPRs mandatory. Time will tell whether this will be a focus if and when the FTC decides to revise the FTC Rule, but at least for now, it does not appear that they will be made mandatory anytime soon. There was a franchise relationship bill proposed in the Oregon legislature during 2021²³ which included one provision, stated in Section 3(2)(b) that a person, in advertising or offering a franchise, may not misrepresent or fail to disclose the financial performance or forecasted financial performance of existing

¹⁸ 16 C.F.R. § 436.5(s)(3)(iv); FPR Commentary supra note [6] at 19.3.

¹⁹ FPR Commentary, supra note [6] at 19.22.

²⁰ FranCompare, 20-Page Survey of Item 19 Submissions for 2018, at 6 (Feb. 2019), <https://www.francompare.com/Item-19s-White-Paper.pdf>. Indicates that about 57% of franchisors currently include FPRs in their FDDs.

²¹ Amended Rule Statement of Basis and Purpose, 72 Fed. Reg. 15444, 15497-15501 (Mar. 30, 2007).

²² 85 Federal Register 55850

²³ HB 2946 Oregon State Legislature,

franchisees. The bill failed to advance out of committee in the Oregon House of Representatives but similar state attempts to mandate FPRs could be on the horizon, particularly if the FTC does not elect to proceed with a review of the FTC Rule at this time.

III. 2020: Heightened Awareness and Focus on FPRs due to COVID-19

When the pandemic began in earnest in March 2020, many franchisors were in the midst of preparing their annual updates to their FDDs for 2020. Those which were early filers (historically filed within ninety 90 days of their fiscal year end), were only beginning to recognize the impact of the pandemic on their systems. For the March, 2020 filers, most franchisors didn't even think to address the impact of COVID-19 on their FPRs, because clearly, at that time, the impact of COVID-19 was a complete unknown. Most franchisors were in preservation mode and just doing what they could to support existing operations and dealing with the myriad of issues surrounding closings, disruptions to supply chain, and keeping customers and employees safe during unprecedented times. At that time, few people could even begin to understand the long-term impact of COVID-19 and franchisors, along with the rest of the world, were just taking things on a "week by week" basis. Those early filings generally included the normal process for updating their FPRs to include 2019 information.

a. Franchisor Responses/Differing Impact on Franchise Systems

By the time that the majority of franchisors began considering their 2020 updates, the long-term ravaging impact of COVID-19 was already being felt among most franchise systems. Franchisors basically fell into three buckets at this point: (1) those franchisors, due to their existing business model, were experiencing an unexpected boom in business; (2) those franchisors which had experienced an almost complete system shut-down due to the nature of their business; and (3) the majority of franchisors, which were experiencing significant impact to their businesses but had at any point in time, some portion of the franchise system open and operational.

We will address all three of these types of systems in terms of the decision-making process they needed to go through to determine what should be done to their FPRs. As to the businesses which were actually experiencing a growth in sales, these types of franchises fell into the following categories: (a) restaurant businesses which primarily offered delivery or pick-up services to customers, with very little or no in-person dining room; (b) restaurant businesses with a significant number of drive-thru facilities; and (c) sellers of products and services deemed essential by the Center for Disease Control ("CDC") and not subject to closures and shut-down orders. For businesses in these three categories, there was not really a serious need to consider impact of COVID-19 on the FPRs. While certain establishments might have had a momentary business downturn, once customers started dealing with the reality of life under COVID-19, sales grew and the biggest problem many of these systems experienced was maintaining a sufficient labor force and keeping sufficient inventory of products in their businesses. For these "lucky" businesses, determining whether there

was a reasonable basis to continue using 2019 numbers in their FPRs, was a total non-issue.

As to the second category, where a franchisor's System was basically shut-down, these franchisors faced a dramatically different landscape. Examples of these types of businesses included sit-down restaurants, gyms, health clubs, day care centers and hair salons (especially those in shopping malls). First of all, many of these franchisors did not focus on their franchise renewals at that moment. In addition, because the state agencies were also on shut down and figuring out how to deal with pandemic realities, most states provided grace periods for filing dates in 2020. For many of these franchisors, imminent franchise sales activities were the farthest things from their minds. Instead, they focused on how to support existing franchised and company-owned operations with no business operations to keep them operational and profitable—helping to negotiate deals with landlords, providing royalty relief, developing protocols for keeping customers and employees safe upon reopening, and trying to come up with innovative ways to transform existing business models to the realities of a COVID-fixated world. Some of these franchisors pulled their FPRs entirely knowing it would be impossible to justify use of 2019 numbers when much of the system's businesses remained completely shut-down or subject to severe capacity limits. Others included their 2019 numbers in order maintain the continuity of franchise registrations for the post-COVID world but were cognizant of risks of using these numbers to sell franchises in the current environment.

The third category of businesses faced the most difficult decisions in determining what to do with their 2020 filings. Many of these companies were spending significant time in helping their existing businesses survive, attempting to reduce corporate G&A, but also continuing to promote franchise sales activities. Like the second category, some of these franchisors removed their FPRs from their FDDs entirely if they were concerned about the ability to demonstrate a "reasonable basis" for 2019 numbers. Instead, they were forced to rely on existing franchisees to provide financial information to prospective franchisees. Others included 2019 information but also updated the FPR with current 2020 information. Again, the latter approach would only work if the numbers were not significantly different from 2019 numbers – if they were, it would be difficult to justify a "reasonable basis" for the 2019 numbers unless the franchisor was certain that the 2020 numbers would continue to rebound to 2019 numbers.

b. NASAA COVID-19 FPR Guidance

The state franchise examiners around the country were well aware of the uncertainty surrounding FPRs and COVID-19 and once it became clear that COVID-19 would be with us for some time, several state franchise administrators asked NASAA for guidance in reviewing pre-COVID-19, historical FPRs in light of COVID-19. It is our understanding that one of the reasons for addressing these issues is that state examiners were having conversations with franchisors and their attorneys who lacked understanding of Section 436.7 of the FTC Rule and believed that as long as the Item

19 information was correct when filed, there was no obligation to update until the next renewal.

Prior to the issuance of the COVID-19 FPR Guidance certain states were asking in comment letters for franchisors to demonstrate that they had a reasonable basis for continuing to use 2019 FPR data in their 2020 FDDs. For example, the state of Washington started making the following (or similar) comment in April 2020:

In Item 19, we note that the franchisor presents a financial performance representation based on the past performance of outlets prior to the COVID-19 pandemic. We further note that to slow the spread of COVID-19, many businesses have been closed or are operating on a limited basis this year. These events may significantly impact the performance of the franchised business. In your response letter, please explain why the franchisor believes it is reasonable and not misleading to present a financial performance representation based solely on results from a period prior to the COVID-19 pandemic.

With this comment and comments issued by other states, state regulators were not outright rejecting use of 2019 data in FPRs, but being cognizant of franchisor misunderstanding of possible FPR updating requirements, they required franchisors to justify continued use of these numbers. The state regulators generally accepted a statement in the response to a comment letter that the franchisor was monitoring its 2020 data and had determined it continued to have a reasonable basis for use of the 2019 data. Some franchisors updated their FPRs to include monthly 2020 sales information to provide such justification. This information often showed that while sales clearly dipped in the second quarter of 2020, by the third quarter sales were rebounding and these franchisors could demonstrate that 2020 numbers were likely to be lower than 2019 numbers but not significantly so to justify the removal to the 2019 numbers.

In June 2020, the NASAA Franchise Project Group issued guidance concerning financial performance representations and the impact of the COVID-19 pandemic.²⁴ While the Guidance was specifically directed to state examiners, the Guidance was shared with the franchise industry by means of NASAA's website and the ABA franchise listserv. The NASAA COVID-19 FPR Guidance reminds the reader that state anti-fraud laws make it unlawful 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. The Guidance concludes that, in some cases, "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."²⁵ The same day as the Guidance was issued, Washington issued its own notice informing franchisors and their counsel

²⁴ Disclosing Financial Performance Representations in the Time of COVID-19, NASAA Franchise Project Group (June 10, 2020), at <https://www.nasaa.org/wp-content/uploads/2020/06/FPRs-in-the-time-of-COVID-19.pdf> [hereinafter "NASAA COVID-19 FPR Guidance" or "Guidance"].

²⁵ *Id.* at 2.

that the Securities Division would follow the NASAA COVID-19 FPR Guidance in reviewing FPRs.²⁶

The COVID-19 FPR Guidance noted that, as usual, in spring 2020 many franchisors updated their FDDs, and the Item 19s in those FDDs were based on performance in 2019, before the pandemic. The Guidance noted that “Franchisors that already provided FDDs to prospective franchisees may have to provide updated information, including revised FPRs, to reflect material changes in the information provided. State franchise disclosure laws require franchisors to continue to update all material disclosures in their FDDs, including FPRs. . . FPRs that disclose historically accurate data may still omit a material fact, or may contain an untrue statement of material fact, if material changes occurred to the FPR by the time it is provided to a prospective franchisee.”²⁷ The Guidance further stated that “If outlets represented in an FPR had material changes in financial performance, the franchisor may not make a historical FPR that is not updated to reflect the changes.” The Guidance, first and foremost, recognized that each franchise system is unique, no specific guidance could be provided to franchisors to identify exactly what needed to be done to individual FPRs and the timing of such decisions. Instead, the COVID-19 Guidance discussed factors that a franchisor should consider in determining whether a franchisor could continue to use a historical FPR in light of COVID-19.

IV. 2021

a. Approaches for Franchisors in 2021

In light of the NASAA COVID-19 Guidance and general state and federal requirements, franchisors making historical or projection-based FPR in 2021 will want to consider a variety of factors, discussed in turn below.

i. Should the Franchisor Make an Item 19 Disclosure?

Many franchisors may be tempted not to provide an Item 19 disclosure in light of the skewed results of 2020, reasoning that 2020 is not a historically representative year nor a basis on which to project future results. This is not unreasonable on its face: as discussed above, making a financial performance representation is optional, and a franchisor might well reason that such representation would be fraught with risk and inappropriate in such an off-market year.

The practical risk associated with this strategy is that the number one question on prospective franchisees’ minds is how much money they will generate from the

²⁶ Notice Regarding Historical Financial Performance Representations During the COVID-19 Pandemic, Washington Department of Financial Institutions (June 17, 2020), *at* <https://dfi.wa.gov/sites/default/files/notice-nasaa-fprguidance.pdf>.

²⁷ See, NASAA Franchise Project Group, Disclosing Financial Performance Representations in the Time of COVID19, NASAA (June 10, 2020) (“COVID-19 Commentary”) <https://www.nasaa.org/wp-content/uploads/2020/06/FPRs-in-the-time-of-COVID-19.pdf> (last visited April 4, 2021).

franchise, and studies consistently show that franchisors which provide Item 19 disclosure sell more franchises. Franchisees are likely to ask many questions related to purchasing in post-COVID-19 circumstances, and the absence of a clear and well-thought-out Item 19 disclosure might result in an increased number of the type of “casual” conversations that could lead to improper financial disclosure outside of the Item 19 confines. Franchisees may also take it upon themselves to try to predict future performance and ask the franchisor for clarity or confirmation of their numbers, which could lead to an inadvertent financial performance representation as responding to those inquiries with commentary that goes to the accuracy of the numbers is prohibited by federal and state law.²⁸ Lenders considering loan approvals for new franchisees may want to see financials based on the 2020 fiscal year in order to make lending decisions, thus further increasing the pressure for franchisor and/or franchisees to provide such numbers.

On the other hand, while removing the FPR from Item 19 (and therefore avoiding presentation of 2020 results all together) arguably reduces the chances of registration being denied or delayed due to regulatory scrutiny, for the reasons listed above, this may make it much more difficult for a franchisor to sell franchises and also runs the risk that the sellers are more likely to present information outside of the FDD. We will focus instead on how best a franchisor can provide balanced information and demonstrate a reasonable basis in 2021.

Because FPRs in 2020 will likely take many different forms, and because it will be difficult to ensure accurate collection of data from franchisees, there is significant risk that 2020 FPRs will be subject to significant regulatory scrutiny in the near term and potential litigation scrutiny in later years for franchises sold during or shortly after the pandemic. And, because disclaimers are generally prohibited (see discussion below), franchisors cannot simply minimize these risks with FPRs laced with heavy caveats and disclaimers.

Moreover, assuming 2020 financial performance is significantly lower than other years, franchisors could have significant difficulty selling a franchise based on 2020 results. Thus, franchisors making a 2020 FPR may be incentivized to try to sub-group or stratify results to present a picture that most accurately reflects the results of a business *not* subject to a heavy local regulatory regime and in which the customer base has not significantly changed due to the pandemic. Such categorization, discussed further below, increases the risk and regulatory scrutiny, and must be performed in accordance with existing guidance. Finally, it can be said that while 2020 performance may show numbers not “as good” as previous years, because everyone is aware of the impact of COVID-19 on businesses generally, it may be easier in 2021 for franchisors to present information in an FPR reflecting a down-turn in performance, without having a significant impact on franchise sales.

ii. What Considerations Should the Franchisor Take Into Account In Making an Item 19 Disclosure for 2020?

²⁸ 16 C.F.R. § 436.5(s)(3)(v).

If franchisors do decide to make an FPR in their 2021 FDDs, they must consider how to do so in a way that complies with the Franchise Rule's requirement that the disclosure have a "reasonable basis" and be supported by "written documentation."

1. Gathering Accurate Data from Franchisees

As discussed above, a franchisor is permitted to make a historical FPR only if the franchisor has a reasonable basis and written substantiation for the representation, and the franchisor discloses the material bases for the representation. The franchisor must maintain and be prepared to provide the written substantiation upon request. This means that a franchisor must gather reliable, accurate data from its franchisees, and be able to substantiate this data.

With respect to 2020 results, there may be wide divergences in franchisee experience and data. Depending on location, local law requirements, ability to access PPE or make accommodations to their business to account for COVID-19 risk, personal risk assessment, attitude and approach of customer base to COVID-19 restrictions, and a variety of other considerations, the performance of franchisees across the system is likely to have varied drastically, and franchisees may have performed well outside the range of their typical annual earnings results. This means that the universe of results historically relied upon will likely need to be carefully re-assessed and updated. Some franchisors may have historically relied upon data from a certain group of franchisees, but will now need to consider whether these results could present a skewed or inaccurate picture in 2020 based on the individual circumstances of those franchisees. Moreover, franchisors may need to ask questions of franchisees additional to or different from those posed in the past. For example, they may need to survey franchisees to understand the particular restrictions on their ability to serve customers, periods of total shut-down, actual customer foot traffic, and other related considerations. This may allow franchisors to place the actual results in a proper context.

2. Relying on 2019 Results

Some franchisors may attempt to include an Item 19 disclosure but rely only on 2019 results, on the basis that 2020 is an anomalous year. In doing so, they would argue that the representation meets state regulatory guidance that the FPR be based on "results that have been achieved in th[e] system in the past and could be achieved by franchisees in the future."²⁹ Under the Compliance Guide, a franchisor must consider how a historical performance representation is "likely to be understood by a reasonable prospective franchisee" and whether the representation is the "typical experience of the system's franchisees."³⁰ Many franchisors may take the position that 2020 will not be representative of the typical experience of the system's franchisees, and that 2019 is a more accurate representation of future performance.

²⁹ FPR Commentary, *supra* note [6].

³⁰ Compliance Guide, *supra* note [4].

The COVID-19 Commentary seems to warn against only including 2019 results: “If outlets represented in an FPR had material changes in financial performance, the franchisor may not make a Historical FPR that is not updated to reflect the changes.” However it is not clear whether this guidance – issued in mid-2020 and reflecting the possibility that *2019 results* that had just been reported in April 2020 FDDs should be updated to capture any material changes – was also meant to apply to 2021 disclosures that make clear on their face that they are only considering 2019 financial performance. Arguably such a statement to franchisees is not on its face misleading and fully advises the franchisee that 2020 is not being taken into account in the results. Franchisors may argue that a representation of past results from 2020 that are not indicative of future performance do not ultimately have a reasonable basis. Moreover, even in the context of the mid-2020 guidance, the COVID-19 Commentary appears to recognize that a historical FPR may need to be amended if there are long-lasting *changes* to the franchise system: “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.” However, some registration states could take the position that a franchisor’s decision to omit 2020 data from an FPR, while including 2019 data, is an omission of a material fact that could violate state anti-fraud requirements.

In deciding whether to disclose only 2019 results, the franchisor may be guided by the typical factors that play into a reasonableness determination. In making any FPR, franchisors should take into account the financial experiences of the franchisees in the system but also what the franchisor in good faith thinks those experiences will be going forward, including any particular unique conditions or circumstances that may have contributed to the results being used in the representation. The franchisor must make a good faith, reasonableness determination as to whether future performance is more likely to track 2019 results or 2020 results.

In doing so, the franchisor must also give careful consideration to whether it is fair to assume that the changes that the business suffered during 2020 will be permanent or long-lasting, or that future earnings and spending are more likely to return to pre-COVID levels? This is an extremely fact specific inquiry: some argue that many systems will undergo permanent, long-lasting changes to the way they do business and cannot be expected to return to 2019 results. The COVID-19 Commentary acknowledges that this is a highly fact intensive and franchisor-specific inquiry:

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.

Franchisors relying on 2019 results should also be prepared to explain to state regulators why they believe that no material, long-lasting change has occurred. They

should also be prepared to respond to comments from examiners asking them to explain how the FPR complies with federal and state requirements. Recently, a state examiner made the following comment in reviewing a 2021 FPR submission:

[In] Item 19, we note that the franchisor presents a financial performance representation based on the past performance of outlets prior to the COVID-19 pandemic. We further note that to slow the spread of COVID-19, many businesses have been closed or are operating on a limited basis this year. These events may significantly impact the potential performance of the franchised business. In your response letter, please explain why the franchisor believes it is reasonable and not misleading to present a financial performance representation based solely on results from a period prior to the COVID-19 pandemic.

A fair compromise position involves reporting both 2019 and 2020 results, or going back further in time to provide several years results prior to 2020. There is no prohibition on including multiple years in an FPR, and this gives the franchisee a picture of how 2020 may be anomalous compared to the historical performance. This must be done carefully, however. If 2020 results are overly selective or not indicative of the system's performance as a whole (or if they present a different grouping or different manner of presentation than 2019), the presentation of the 2020 results may lead the franchisee to argue that they were led to believe that 2020 was not as significant of a downturn as it truly was, for example. And, the franchisor may have to be prepared to respond to questions about whether some or all of the changes experienced in 2020 are likely to be with the franchise on a longer-term basis. One regulator included the following comment in response to an Item 19 disclosure that contained 2018, 2019 and 2020 results:

Please explain why this franchisor has a reasonable basis for including Financial Performance Representation (FPR) based on pre-COVID-19 data. Please review guidance recently published by the NASAA Franchise Project Group regarding franchisors making financial performance representations in the time of COVID-19 Explain how this FPR complies with that guidance, including how the franchisor has determined that future revenues will not be significantly impacted by the COVID-19 pandemic. Please also discuss whether the franchisor has made or intends to make changes to its own business model to adapt the business to consumer demands post-COVID and, if so, how those changes may impact the historical FPR that currently appears in Item 19.

What is most telling about this comment is that it seems to question the very inclusion of 2018 and 2019 results as possibly not representative of future performance following the pandemic. The examiner is interested in understanding whether there will be changes to the business model going forward that will make 2018 and 2019 results no longer applicable to future expectations. This fails to take into account, however, that even if the system has undergone some changes (for example, increasing online or

take-out options), this does not necessarily mean that 2020 is itself a representative year. 2020 is likely to be an anomaly under any measure, given the number of months effected by the pandemic restrictions and the fact that it took several months for franchises to implement business changes. Thus, even if certain structural changes may remain, pre-2020 results may still provide franchisees with deeper insights into the business than would providing solely 2020 results.

3. Adjusting or Subgrouping 2020 Data to Account for the Pandemic

Another option franchisors may consider is to include 2020 data, but to make adjustments to the data to reflect the COVID-impact. The FPR Commentary affirmatively calls for adjustments to be made to historical data in some circumstances, including when a franchisor changes its franchise agreement, changes its fees, or changes some other material aspect of its franchise, thus making the historical results not fully indicative of future performance.³¹

Adjustments may be called for in 2020 where not all franchises were able to be opened for the same portion of the year or where different restrictions were in place at their locations. For example, the franchisor may decide to exclude from data stores that were closed for a certain percentage of the year due to local regulations, or to adjust the results from those stores to show a full year of results. It is unlikely that any state would permit a franchisor to extrapolate a full year of sales for locations which were shut-down for a significant period of time due to COVID-19. This effort would, in effect, be an attempt by the franchisor to “project” what sales would be had COVID-19 not appeared. It would be difficult to imagine circumstances where a franchisor could establish a reasonable basis for doing this. In addition, a franchisor must determine what period of time would be appropriate for determining that the location has been closed for such an extended period of time as to make inclusion of these units inappropriate. Whatever decision the franchisor makes as to excluding certain units, the COVID-19 Commentary makes clear that the omitted must be specified in the FPR.³² It might be suggested to identify the temporarily-closed due to COVID-19 outlets separately from other excluded outlets (and identify the time frame during which these outlets were closed), in order to avoid a comment from the examiners. In the end, the ability to make such decisions will rely heavily on accurate data gathering and reporting from franchisees.

Moreover, there is risk associated with adjustments because the franchisor ultimately must be able to justify and substantiate the changes made and show why there was a reasonable basis for making such changes. If making adjustments to financial performance results, it is highly recommended to take particular care with the Rule’s requirement of “written substantiation.” Decisions made should be recorded in writing with their justification at the time they are made, so that substantiation can later be provided to franchisees upon reasonable request, as require by the Rule. Strong record-keeping of decisions will also be useful in the event of later litigation.

³¹ FPR Commentary, *supra* note [6], § 19.10.

³² FPR Commentary, *supra* note [8], § 19.18.

As an alternative to making wholesale adjustments to data, some franchisors may choose to show results by sub-groups or find other ways to categorize 2020 data in order to give franchisees a fuller picture of the likely effects. Some franchisors break down revenue or expenses into smaller categories or ranges. For example, some franchisors provide data in categories of franchises whose revenues are within one of three ranges: a defined low range, a defined high range, and a defined middle range between the low and high ranges. For 2020, franchisors may also consider other types of subgroupings: they may show results for the system as a whole, but then also show a subset of franchises that have remained open the entire year or subject to less strict local regulations and compare their results. Or, to avoid the appearance of cherry-picking the more successful locations, franchisors may choose to show data by region or territory, thus allowing franchisees to draw their own conclusions regarding the impact of local regulation on performance within that region.

There is support for such subgrouping in the FPR Commentary, which permits franchisors to make an FPR based on a subset of outlets so long as the FPR based on the subset has a reasonable basis, is accurate, and is not misleading.³³ However, in making any such adjustment or subgroupings, Franchisors must also take into consideration guidance that already exists in the FPR Commentary about how to represent specific data. For example, the FPR Commentary states that any time a franchisor presents an average of a set of data, the franchisor must also present the median of that same set of data. And, any such groupings must still comply with the FTC Rule (expanded upon in the Compliance Guide) that the franchisor provide each of the material facts underlying the representation discussed in the Background section above, including items such as the group measured, the time period measured, number of outlets reporting, distinguishing characteristics of the outlets that achieved the performance, etc.

4. As A Result of COVID, Have Permanent Changes Been Made to the System?

One other area to be explored by franchisors is whether permanent changes have been made to the franchise system to address COVID-19 and will be maintained once the System resumes “normal” business activities. For example, if as a result of COVID-19, a restaurant franchisor has decided to permanently reduce the size of restaurant dining rooms and focus instead on carry-out and delivery, there may be no reasonable basis for including pre-COVID results of restaurants which contain large dining rooms with little or no emphasis on carry-out or delivery business. In such event, the sales information of the pre-COVID locations really would not be predictive of the future performance that a prospective franchisee is likely to experience. This may be a situation where the franchisor will have no alternative but to remove its FPR until it has sufficient experience with the new System model. In addition, if a franchisor is requiring implementation of costly safety measures (which were not required of pre-COVID locations) such as plexiglass separations, enhanced sanitation standards requiring the

³³ FPR Commentary, *supra* note [8], § 19.12.

purchase of significant cleaning equipment and expense information is included in a historical FPR, the historical expense information will most certainly need to be adjusted to reflect the costs a new franchisee will face on a going forward basis.

5. Disclaimers, Caveats, and Footnotes

A further question is whether the FPR can be addressed by including a warning, comment or disclaimer to note potential effects of COVID-19. Disclaimers are generally prohibited, with the FPR Commentary making clear in its Item 19.3 that “franchisors may not include additional language that serves to disclaim the financial performance representation that they have just made or state that a franchise may not rely on the information provided.” To this end, the FPR Commentary is in fact quite specific, requiring franchisors disclosing in the normal course to use the following admonition in a separate paragraph, for historical representations:

Some outlets have [sold] [earned] this amount. Your individual results may differ. There is no assurance that you'll [sell] [earn] as much.

And, for projections:

These figures are only estimates of what we think you may [sell] [earn]. Your individual results may differ. There is no assurance that you'll [sell] [earn] as much.

The franchisor may not vary this language and may not include any other disclaimers.

With respect to COVID-19 results, the COVID-19 Guidance specifically addresses disclaimers, noting:

Franchisors that make a historical FPR in 2020 and beyond based on pre-pandemic data are not permitted to avoid the obligation to update the disclosure by stating the historical FPR is not representative of what prospective franchisees can expect due to 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.

Taking this guidance into consideration, it is fair to assume that a disclaimer that 2020 results are not indicative or should not be relied upon will be rejected by state regulators. However, this does not mean that no form of qualifying language is appropriate. For example, one commentator has suggested a statement such as “*the financial data was compiled prior to the time of the COVID-19 pandemic and the temporary local and state governmental restrictions on operations*” may be appropriate. The commentator notes that this reminds the prospective franchisees of the origin of the

data without renouncing the performance representations.³⁴ Comments that explain the nature of the financial data and any subgroupings or limitations on it may also be appropriate, but will likely be scrutinized by regulators.

b. State Review of FPRs in 2021

As of the date this paper was finalized, the NASAA Franchise Project Group had not identified a need to issue updated FPR guidance for examiners or franchisors for the 2021 renewal season; however, examiners will continue to review FPRs in 2021 consistent with the principles underlying the COVID-19 Guidance, namely, that the historical accuracy of an FPR is not necessarily sufficient to meet state anti-fraud requirements. In lieu of issuing updated guidance and in the interest of promoting uniformity, the Franchise Project Group hosted a virtual training for examiners on the topic of reviewing FPRs in 2021. This training was held on March 30, 2021, and was attended by 75 examiners and other staff, including at least one examiner from all “full review” registration states. In addition, the Franchise Project Group regularly discusses trends in FPRs and shares concerning issues with examiners around the country.

In the early weeks of the 2021 renewal season, members of the Franchise Project Group and examiners in registration states noted and discussed several FPR trends and issues that were identified as potentially problematic. The following is a non-exhaustive list of “COVID-19/FPR issues” that examiners may comment on during the 2021 renewal season:

- FPR disclaimers.
 - Example: “The FPR presents results from 2019 and 2020. We cannot guarantee when, or if, the results of franchisees will return to 2019 levels.”
- FPRs based **only** on 2019 financial performance data.
- FPRs based on a subset of outlets that were not as heavily impacted by COVID-19 (i.e., the FPR excludes outlets that were temporarily closed or excludes outlets operating in states with more severe restrictions on businesses).
- FPRs based on partial 2020 data.
- FPRs that do not comply with the requirements of Section 19.18 of the NASAA FPR Commentary “Omission of Outlets that Have Closed,” requiring the franchisor to disclose in the FPR the number of outlets that closed during the time period if the franchisor excludes data from those outlets.
- FPRs that do not reference material and permanent changes to the franchise system or business model that are referenced in other sections of the FDD (i.e., Item 1 explains the system was permanently modified in 2020 to stop offering a particular product or service, but Item 19 does not “reflect those changes and their impact on the FPR”).
- FPRs that do not clearly and separately distinguish between PPP loan funds and revenue earned from operating the franchised business.

³⁴ See Eleanor Vaida Gerhards, *FDD Item 19 Financial Performance Representations in the Age of COVID-19* (April 14, 2020), available at <https://franchiselaw.foxrothschild.com/2020/04/articles/drafting-tips/fdd-item-19-financial-performance-representations-in-the-age-of-covid-19/> (last visited April 9, 2021).

In addition, already this year state examiners have noted that several franchisors have made significant structural changes to their FPRs. These structural changes may have been made to avoid an examiner comment regarding COVID-19 or to present data in a more strategic manner in light of COVID-19. For example, some franchisors have decided to present an FPR that discloses 2, 3, or even 4+ years of financial performance data (including 2020 data), perhaps to show a consistent history of results preceding an unsurprising dip in financial performance in 2020. Regulators typically do not object to the inclusion of financial performance data for several years in an FPR unless the data is stale, potentially misleading, or has been presented in a confusing manner. In fact, many regulators see the value to a prospective franchisee of receiving data for several years. However, franchisors that determine to disclose data for several years should take steps to avoid presenting an FPR based only on a subset mature outlets. For example, examiners sometimes observe and comment on FPRs that disclose data only for outlets that have been in operation for 24 or more months.³⁵

The potential issues with an FPR based only on a subset of mature outlets has been described as follows:

An FPR that is based on results from only mature outlets may raise questions about reasonableness or reasonable basis in their application to a potential new franchisee. This is because of the length of time that may be required for a new franchisee to become mature in its operation, the possibility that the conditions under which the presently mature franchisee operated years earlier may not exist for a new franchisee at the present time, and the risks that a new franchisee may never achieve such results. Franchisees that have operated for relatively short times most likely have not achieved the same level of financial performance as more mature outlets. Excluding results from those newer franchise outlets in favor of more mature franchise outlets could skew the results in an FPR, making it potentially inaccurate or misleading.³⁶

A franchisor that presents an FPR based only on a subset of mature outlets will likely receive the following (or a similar) comment from a number of registration states:

Please revise the FPR to include all outlets that have been open for more than 12 months. The franchisor may present information for outlets that have been open for more than 24 months separately from those that have been open for more than 12 months but less than 24 months.

³⁵ In most cases, state examiners will allow franchisors to exclude data from franchise and company-owned outlets that have been open less than twelve months in an FPR. The FPR Commentary can be read to suggest that franchise outlets open less than a full year are not yet “operational” because that FPR Commentary defines “operational franchise outlets” as those outlets open at least one full year or, where applicable, one full season.

³⁶ Dale Cantone, Lulu Gomez, & David Gurnick, *Promises, Promises: Financial Performance Representations -Advanced Issues*, 43rd ABA FORUM ON FRANCHISING, W-16, at 17 (2020).

Moreover, as franchisors make other structural changes to their FPRs, they should not overlook the requirements of the NASAA FPR Commentary.³⁷ When making significant revisions to an FPR, even an experienced practitioner could forget some of the detailed requirements of the FPR Commentary, including but not limited to requirements related to distinguishing between franchise and company-owned outlets, requirements related to the use of subsets, and requirements related to disclosing averages and medians. And of course, franchisors are reminded to avoid disclaimers. While much in the world has changed over the last 12 months, disclaimers continue to be a consistent source of comments from examiners.

In drafting a response to an FPR comment, franchisors and their counsel should remember that examiners are receptive to well-reasoned explanations. In preparing this paper, members of the NASAA Franchise Project Group were asked about what they find to be compelling in a response to an FPR comment related to the pandemic, and what information is routinely provided that they do not find to be persuasive. Here are some of the thoughts and suggestions provided by those surveyed to consider when responding to an FPR comment:

- Avoid generalities about the franchisor's industry, but include specifics about the financial performance of the franchised or company-owned outlets, with data if possible. Data provided in response to examiner comments should be clearly presented, but can be presented more informally than it would be presented in an FPR itself.
- Avoid speculation about how the financial performance of system outlets will improve in the future or when the system will return to "normal"; instead, focus on the historical and current financial performance of outlets and consider filing a post-effective amendment to update the FPR if financial performance improves in the future.
- Avoid telling an examiner that no other state made a comment on a particular issue in lieu of providing a substantive response to the comment (this is particularly true if the franchisor is filing the application in only one registration state!).

During the 2020 renewal season, there were some novel discussions between examiners and franchise counsel concerning FPRs. There will undoubtedly be novel issues concerning FPRs in 2021. However, all sides benefit when examiners and counsel work together to resolve FPR comments because we all want FPRs that provide prospective franchisees with valuable information and that comply with state and federal law.

c. Federal Trade Commission Amended Franchise Rule FAQ #38

³⁷ NASAA Franchise Commentary Financial Performance Representations (2017), *available at* www.nasaa.org/wp-content/uploads/2017/05/Financial-Performance-Representation-Commentary.pdf.

One more cautionary note involves Amended Franchise Rule FAQ #38.³⁸ The question addressed in this FAQ was if a franchisor is unable to register a franchise offering in a state without removing or altering an FPR, may the franchisor use the unaltered FPR in the FDD it delivers to potential purchasers in other states? The FTC responded that when the franchisor revises its FDD at the direction of a registration state, it ordinarily should incorporate the same revisions in the FDDs it uses in the other states to ensure that its disclosures are complete and accurate.³⁹ The FTC continues by stating that any failure to do this will call into question whether an FPR meets the requirement that a franchisor have written substantiation demonstrating that its FPR had a reasonable factual basis at the time it was made. Acknowledging that it is the franchisor's burden to prove that it has written substantiation of the FPR, failure to use the same FPR in all states may expose the franchisor to the risk of heightened scrutiny by federal or state franchise law enforcers. Therefore, even if an FPR passes muster in the majority of registration states the franchisor is not home free. If the FPR received a comment from Washington but no comments are made by the other registration states, the franchisor will have to consider whether in light of FAQ #38, the franchisor is willing to except this "higher level of scrutiny" or will need to amend its filing in all other states to address the Washington comments to the FPR.

V. Conclusion

In sum, there will be no one-size-fits-all approach to post-COVID Item 19 disclosures. We have been told by state examiners that they did not see a significant number of post-effective amendments filed by franchisors in late 2020 to update FPRs. What does this mean? It could mean that many franchisors ceased selling activity in late 2020 and did not want to invest resources in updating their disclosure document until the planned to actively offer and sell franchises. It could also mean that some franchisors were offering and selling franchises using a disclosure document that contained an outdated FPR or did not disclose all material information to prospective franchisees. If a franchisor did not update its FDD in 2020 and the 2021 FPR shows a significant impact in performance in 2020, a franchisor may want to consider addressing this issue in its cover letter to the states. For example, if no franchise sales activity occurred in that particular state in 2020, the franchisor might want to state that in the cover letter. While the examiner can determine whether franchise sales activity occurred through analysis of the Item 20 tables, by raising this as an issue, the franchisor may be able to demonstrate to the state examiner that it understands the concern about 2020 performance and potentially ward off a comment on this issue.

In addition, even if an FPR is not flagged by the state examiners and a franchisor is issued a permit to offer and sell, there may be potential exposure down the road if a franchisee is unhappy with the franchise opportunity. While the FPR may have not been the reason the franchisee entered into the franchise agreement, if the franchisee

³⁸ Amended Franchise Rules FAQs <http://business.ftc.gov/documents/amended-franchise-rule-faqs> (Issued: July 2, 2014).

³⁹ 16 C.F.R. § 436.1(d) (definitions of "[d]isclose, state, describe, and list each mean to present all material facts accurately, clearly, concisely, and legibly in plain English").

seeks the advice of counsel and the counsel reviews the FDD and FPR and determines that an argument can be made that there was no reasonable basis for the FPR when it was made (reviewing the current sales of the franchisee and the system as a whole), franchisors must ensure that when the FPR was created that they have substantiation for this “reasonable basis”. Since FPRs in light of COVID-19 have received so much attention, you can be sure that franchisee attorneys will be scrutinizing these FPRs when they are approached by unhappy franchisees in the future.

It is safe to say that franchisors should expect to face regulatory scrutiny and should be prepared to respond to questions and provide written substantiation where necessary. With careful planning and thought to the disclosure, franchisors should be able to present results that are fair, accurate, and reasonable and that will withstand regulatory scrutiny and litigation challenges. What COVID-19 has made clear in the last year is that franchisors need to keep in mind that creating an FPR and getting it registered in the various states is not a “one and done” process. Franchisors should continuously ask questions about the relevance of the FPR information contained in the FDD and if for any reason, there is no longer a reasonable basis for this information, franchisors need to take appropriate steps to either update the information through the amendment process or remove the information for which there is no longer a reasonable basis.