



# Four Key Takeaways from the NASAA & Washington Commentaries on COVID-19 Disclosures

June 22, 2020

On June 10, 2020, the North American Securities Administrators Association (NASAA) penned new commentary titled, "Disclosing Financial Performance Representations in the Time of COVID-19" (Commentary). Shortly thereafter, Washington issued its own press release on June 17. The Commentary addresses concerns regarding the use of historical financial performance representations (FPRs) in Item 19 of a franchise disclosure document (FDD) in light of the economic downturn due to COVID-19. While the Commentary primarily restates existing policy, NASAA reminds franchisors of the FDD material change obligations and voices its concerns that a significant economic impact in 2020 may be grounds to amend FPRs from 2019 and earlier. Here are four takeaways from the NASAA and Washington communiques:

## **1. Amend Item 19 if franchisees have experienced material changes in financial performance**

The Commentary states that franchisors must amend their FDD if there are material changes to the franchise system, including Item 19. NASAA recognizes that COVID-19 has impacted franchise systems differently - some systems may be thriving, others may have experienced a short-term drop in revenue but pivoted and are operating at the same levels than before the COVID-19 pandemic arrived, but other systems have been negatively impacted. Therefore, NASAA has taken the new position that "franchisor may no longer make a Historical FPR that is not updated to reflect" material changes in financial performance of those outlets that are currently included in Item 19, even if the facts and figures in Item 19 are purely historical and there has been no changes in the historical information provided.

*If you have an Item 19 that includes historical financial performance information of some or all of your franchised units, and those franchised units have been negatively impacted by COVID-19, then your FDD may need to be amended to either add additional financial performance information in Item 19 or remove Item 19 altogether.*

## **2. Failure to update Item 19 may be considered deceptive, misleading or fraudulent**

The Commentary reminds franchisors that "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." A franchisor's failure to include all



material information or omission of material information in the FDD could be considered deceptive, unfair or even fraudulent. In our view, the Commentary conflates the material change rules and the anti-fraud rules, with the precise Item 19 instructions for historical FPRs (as opposed to a forecast of future financial performance), and suggests that a failure to amend Item 19 may be deceptive.

*Closely review your FDD to determine whether your FDD accurately discloses the franchise opportunity currently being offered and consider whether any additional information needs to be included to more wholly describe the franchise offering, including Item 19.*

### **3. Amend the FDD to reflect material changes to the franchise system**

Franchisors must amend their FDD if there is a change in system operations, costs, number of outlets, fees, etc., that a prospective franchisee would deem material. Many franchise systems are making system changes in response to COVID-19 or consumer demands - some temporary, some experimental and some permanent. NASAA provides a few examples of how franchise systems have adapted to COVID-19, such as a higher reliance on third-party delivery platforms for food service franchises, and fitness franchises may limit the number of members in the facility at one time, and uses the Commentary to remind franchisors of the obligation to amend the FDD for materials changes.

*If you and your franchisees have changed certain business practices to meet the new challenges brought on by COVID-19, and a new franchisee will be expected to operate in the same way, particularly if the changes impact disclosures in the FDD, then your FDD needs to be amended to reflect those expectations.*

### **4. Despite attempts of uniformity, registration states are acting on their own**

In the wake of the Commentary, Washington issued its own statement warning franchisors to anticipate comment letters requesting an explanation as to why the FPRs comply with federal and state law. Washington also reminded franchisors of the duty "to update all material disclosures they include in their FDDs, including FPRs . . . as soon as reasonably possible and in any case, before the further sale of any franchise." While Washington is currently the only state that has issued a statement in the wake of the Commentary, other states may follow suit.

*Be prepared for stricter scrutiny from Washington and other registration states in their review of your FDD, and be prepared to explain why any aspect of your FDD is compliant with federal and state laws in light of COVID-19.*

### **Next Steps?**

We suggest you review your FDD closely, evaluate changes you are making in your system as well as the impact of COVID-19 and the economy on your franchisees. FDD changes may be appropriate to accurately



describe the franchise offering.

Contact us if you are unsure about whether and what changes may be needed to your FDD. Our team of franchise lawyers can work with you to evaluate your current FDD, and whether, how and when to amend your FDD in the face of ongoing economic challenges and operational changes. For more information, please reach out to Mark Kirsch or your regular Lathrop GPM contact.