

PUBLICATION

Franchise Disclosure Documents and COVID-19 Impact

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Franchisors renewing their Franchise Disclosure Documents (FDD) for 2020 with the intent of actively resuming franchise sales activity may be wrestling with how best to disclose the impact of the COVID-19 Pandemic on their business. While some jurisdictions have started the process of reopening businesses, substantial limitations, shelter in place or safe at home quarantine orders are in effect almost everywhere in the United States. The official pathway and guidance announcements on when these orders will be lifted detail many steps that could take many months. Every FDD is virtually an educated guess at what evolution will take place in the franchisor's business model during the continuance and aftermath of the pandemic health emergency.

Franchisors should consider organizing disclosure changes around what are possibly the three main phases of impact on the franchised business as a result of COVID-19:

Phase 1: During the public health emergency, under the shelter in place/stay at home orders issued federally¹ and by various state² and local³ government authorities affecting essential and non-essential activities.

Phase 2: Immediately after the lifting of the Phase 1 orders/guidance, allowing for the restart of business activities outside of essential services, before a COVID-19 vaccine becomes widely available and while social distancing, facial masking and hand washing hygiene measures remain in effect.

Phase 3: After a COVID-19 vaccine becomes available and its implementation begins on a large scale, as a community health preventive measure. The Phase can be broken down into an initial part when the vaccine first becomes widely available but before its efficacy on a large scale is proven, and thereafter, a second part when the combination of the vaccine and effective remedial modalities for those for whom the vaccine is not effective make COVID-19 the equivalent of a nasty variant of flu, affecting populations at the same rate and mortality but with minimal impact on behavior.

Disclosure under these circumstances will be nuanced and subject to updating when short term and long term regulatory and business restrictions are enacted or promulgated. State regulators have indicated the intention of exercising more vigilance about against inappropriate claims that would prey upon vulnerable prospective franchisees who are seeking refuge from the economic ravages of the COVID-19 emergency in franchise ownership. As franchise systems experience the ravages themselves, the obligation to update disclosures for material changes, particularly in Item 19 financial performance representations and Item 20 outlet census information becomes paramount.

Franchisors need to be focused on changing business models and related disclosure at two levels – how to deliver services to franchisees, particularly new franchisees, and how to deliver goods and services to retail customers, particularly when in-home services are the core business.

Key Questions for Franchisors to Ask that Impact Disclosure Documents

- Is your franchised business an essential business or non-essential business under relevant federal⁴ and state declarations⁵?
- If your franchised business is designated by the Department of Homeland Security or state emergency declarations as essential, and your franchisees can continue to operate, what precautions and procedural changes have you mandated in your operations to assure that franchisees observe applicable CDC rules and guidelines for social distancing, personal protective equipment (PPE) and personal hygiene?
- If your franchised business is not designated as essential, what changes in your franchise business model will you need to implement when non-essential businesses are given the go-ahead to reopen? If your business needs PPE to meet CDC guidelines, what is the source of the supply and when will you get the supplies into the hands of franchisees?

Specific Questions by Item Number in the Franchise Disclosure Documents:

Item 1: How would you describe the regulations affecting your business at both the franchise services and the retail level? You will need to disclose if your business is affected differently than other businesses, either on a temporary or permanent basis.

Items 5 & 6: Are you reducing, waiving, deferring or otherwise changing your initial or on-going fees?

Item 7: Will your estimated initial investment in Item 7 increase to cover PPE or higher service costs in the first three months from observing CDC guidelines?

Item 8: Does your supply chain disclosure in Item 8 need to include sourcing or standards for PPE?

Item 11: How will you change your approach to pre-opening activities such as site inspection, site selection and training? Does the current emergency cause you to advance your time table to switch to more remote service delivery to franchisees or retail customers via electronic means? If you pursue that approach, how would you communicate the firm's culture and values? Experiencing the culture and values in person likely inculcates them more effectively and deeply than watching a video or participating in a video conference. Will you require upgrades to the technology capability of franchisees to implement business model changes for remote communication, for remote ordering of goods and services, or upgrades to mobile applications and websites?

Item 12: Will you need to enhance your restrictions on territorial activity given social distancing and no-contact delivery? Do differing governmental orders impact the ability to deliver services in different jurisdictions of a territory?

Item 16: Do you need to describe changes and limitations in retail business operations to account for newly implemented no-contact delivery models and enhanced protection methods of protecting employees of franchisees and home or business customers?

Item 19: Do these regulatory and business model changes impact a financial performance representation that is based on 2019 financial performance? Do you have a reasonable basis for the 2020 Item 19 given the observed changes in the financial performance of your franchised and company outlets after the emergency affected the retail environment? Regulators caution against excessive use of disclaimers and non-reliance language beyond what the NASAA guidance permits.

Item 20: Have your system outlet counts changed materially from permanent outlet closures? Maryland lists in its regulations a yardstick for terminations of 10 percent in state and 5 percent overall as a material change. That regulation is a useful benchmark for material change generally.⁶

Item 21: Have the finances of the franchisor had a material turn for the worse since December 31, 2019 that makes disclosure of unaudited, year-to-date financial statements appropriate? At a minimum, consideration should be given to disclosure of a Paycheck Protection Program loan, an Economic Injury Disaster Loan or a Main Street Business Lending Program loan.

For a comprehensive questionnaire covering the potential changes you may want to contemplate for your FDD, please contact [Joel Buckberg](#) or your [Industry Service Team member](#).

¹ https://www.whitehouse.gov/wp-content/uploads/2020/03/03.16.20_coronavirus-guidance_8.5x11_315PM.pdf

The original guidelines ended April 30, 2020. The White House issued guidelines for states to reopen their economies: <https://www.whitehouse.gov/briefings-statements/president-donald-j-trump-beginning-next-phase-fight-coronavirus-guidelines-opening-america/>

² <https://www.tn.gov/governor/news/2020/3/12/gov--bill-lee-issues-executive-order-declaring-state-of-emergency-in-response-to-covid-19.html>

³ <https://www.asafenashville.org/safer-at-home-order/>

⁴ <https://www.ferc.gov/media/coronavirus/Guidance-update.pdf>

⁵ <https://www.tn.gov/governor/covid-19/essential-services.html>

⁶ COMAR Sec. 02.02.08.01(9).