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Hospitalitas

The Hospitality Industry Newsletter from Baker Donelson

Technology Upgrade Refusal and Busted Transfer Produce Large Recoveries for Hotel Franchisors

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Franchisees often are led to believe that franchisors cannot recover their contracted liquidated damages unless the franchisee defaults under monetary payment or quality standard requirements in the franchise agreement. Two recent decisions underscore the fallacy behind that thinking.

A U.S. District Court in Kentucky awarded a hotel franchisor a significant recovery for termination of a hotel franchise agreement after

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Greetings from *Hospitalitas*

Hospitalitas is the Baker Donelson newsletter for our clients and friends in the hospitality industry – hotels, restaurants and their suppliers. It is published several times a year when we believe we can deliver first class, useful information for your business. Please send us your feedback and ideas for topics you would like to know more about. True to our Southern heritage of hospitality, we'll work hard to make each visit with us something special, and worth repeating.

Infringement Puts Profits at Risk

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The Seventh Circuit U.S. Court of Appeals, which sits in Chicago, recently handed down a decision which could significantly impact hotel and restaurant franchisors and terminated franchisees. In *WMS Gaming Inc. v. WPC Gaming Products Limited*, the court addressed the damages that can be awarded in trademark infringement cases. WMS sued WPC for wrongful use of its trade marks "Jackpot Party" and "Super Jackpot Party." WMS had used these registered trade marks for a number of years for gaming machines and devices that it manufactured. The lower court found that the

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Country of Origin Labeling Law Takes Effect

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Thinking about adding a little grocery area to your business to cash in on the "green" movement, or to leverage space freed up by the economic slowdown? Consider the recent change in Federal law governing the sale of perishables. Country of origin labeling (COOL) requirements first were enacted in 2002 with the passage of Title X of the Farm Security and Rural Investment Act of 2002 (known as the 2002 Farm Bill). Retailers, meaning any person engaged in the business of selling any perishable agricultural commodity at retail, must inform their customers of the origin of certain commodities, including muscle cuts of beef (including veal), lamb and pork; ground beef, ground lamb and ground pork; wild and farm-raised fish and shellfish; perishable agricultural commodities; and

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Technology Upgrade Refusal and Busted Transfer Produce Large Recoveries for Hotel Franchisors, *continued*

the franchisee refused to install required new technology. After repeated attempts at resolution and notices of default, Baymont Franchising LLC terminated the franchisee in Shepherdsville, KY. The franchisee refused to remove its Baymont livery, and La Quinta Corporation filed suit to enforce termination and compel the franchisee to remove its Baymont marks and stop holding itself out as a Baymont Inn & Suites. After nearly $400,000 in legal fees, La Quinta (which retained the case when the Baymont brand was sold to Wyndham Hotel Group), won a judgment for unpaid royalties, liquidated damages of $111,000, and treble damages for the willful and unjustified holdover infringement, approximately, $120,000. Instead of the gross profit standard discuss above, the Court applied the standard from *Ramada v. Gadsden Hotel*, a leading case on this issue, which takes the franchise agreement royalty formula applied to the gross room revenue royalty calculation base for the period of infringement. The franchisee was able to exclude ancillary revenue, which is consistent with the franchise agreement royalty formula, so revenue derived from guests who mistakenly thought the hotel remained affiliated with the Baymont chain remained as a windfall for the franchisee. Such derivative revenue generation rewards an infringer, so the remedy fashioned by the Seventh Circuit produces a result with less benefit to the intentional infringer. However, coming on the heels of the Eighth Circuit decision in the Domino's case reported in our last issue, franchisees who refuse to adopt technology changes mandated by franchisors do so at the peril of their franchises and equity.

A Florida U.S. District Court enforced the liquidated damages clause in a hotel franchise agreement when the hotel was sold and the buyer and franchisor could not agree on terms for the franchise. After the franchisor passed on its right of first offer, the buyer completed the purchase and reflagged the property. The franchisor immediately terminated the franchise agreement to pursue the seller and guarantor for damages. The parties stipulated that Florida law applied, even though the franchisor was based in Minnesota. The seller and its guarantor were unsuccessful in their challenge to both the liquidated damage provision, requiring the payment of three years of royalties and marketing fees, and the standard transferee approval rights retained by the franchisor as a condition to avoiding termination for unauthorized transfer. The court held that the franchise agreement's requirement of franchisor approval of the buyer, and the buyer's entry into a new franchise agreement with the franchisor, were reasonable and did impose undue restraints on selling the real estate asset. The court found that allowing the franchisee to sell the hotel and the franchise to anyone would have "gutted" the franchise for the franchisor, so making unauthorized sale an event of default was reasonable. The franchisor's claim for $341,000 in liquidated damages was upheld. The opinion was silent as to whether the ultimate liability for this amount rested with the seller and guarantor, or the buyer under an allocation of risk in the sales contract for the hotel. As the case arises in the Orlando area, hotel buyers and sellers are advised to understand and allocate "brand continuity/change" risk in their contracts of sale for existing franchised hotels.

Mr. Buckberg is an attorney in our Nashville office.

Hospitality Briefs

Think Franchise Regulatory Compliance is Expensive? Arbitrator Awards Former Franchisee Claim at 26 Times Franchisor's Net Worth in Buyer's Remorse Case

A Midwest franchisor of retail stores had a steady growth pattern and some good success stories among its franchisees. A sales person transmitted a one line claim about profit margin on the primary store produce that did not comply with Item 19 requirements. The prospects who were MBAs with lots of business savvy. The CEO was unaware of the document until the termination of a store franchise that was not successful and another store under development. The franchisees filed for arbitration of their claims against the franchisor over the failures of their franchise investment. The arbitrator found that the document and the franchise sale violated state franchise law, which the sophisticated franchisee prospects relied on the earnings claim document despite all of the other diligence that they undertook, and awarded rescission. He also found the CEO had no knowledge of the document and was not personally liable for its use and the consequences. The award, which is extremely difficult to challenge on appeal because of the narrow scope of arbitration appeals allowed by law, amounted to 26 times the franchisor's disclosed net worth, 67% of its gross sales and 4 times its disclosed current assets. In this case, even buying back the underperforming store did not relieve the franchisor from liability.

For franchisees, those little pieces of paper may or may not equate to a lottery ticket or a "get out of jail free" card. Rather than undertake a franchise development project that is ill advised and based on faulty data, franchisees would be well served by confirming that the franchisor stands behind those bits of extra information. Show them to the most senior person introduced to you. Find assurances that your reliance is well placed and appropriate, and not based on the words or documents received from just one person. If you receive contradictory materials, get clarity!

The case points out the importance

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Infringement Puts Profits at Risk, *continued*

illegal use of these registered trade marks by WPC for its internet gambling business was well documented, frequent and persistent. The lower court awarded damages of $2.7 million, which represented the court's calculation of only those profits WPC derived from the use of the infringing marks.

The Seventh Circuit reversed the trial court's damage calculation. The appeals court noted that relief under the relevant Federal trademark statute, the Lanham Act, 15 U.S.C. § 1117(a) for trade mark infringement, is supposed to include all profits realized by the infringer during the period of infringement. In construing the Lanham Act, the court held that the trademark owner need only offer evidence of gross sales of the infringing goods or services. The infringer then has the burden to offer evidence of appropriate elements of costs or deduction. Should the infringer fail to meet that burden, the trademark owner is entitled to damages in the full amount of the infringer's gross sales.

In this case, the infringer chose not to appear in the trial court and offered no evidence in its defense. The infringing defendant is based in Gibraltar and, by the time of trial, had ceased most U.S. operations. Its failure to appear in the case was a tacit assertion that the U.S. District Court lacked jurisdiction over the foreign company. However, both the lower court and the appellate court found that the infringing defendant had been properly served and was properly before the court. The infringer is likely to pay dearly for its decision not to appear and defend. The Appeals Court remanded the case to the trial court for a new damage calculation based on its ruling. Rather than a $2.7 million judgment, the infringing defendant now faces exposure in the full amount of its gross sales for the relevant period - $287 million.

Claims for trademark infringement under the Lanham Act frequently arise in franchise disputes. Typically, these claims are brought when a franchise agreement terminates or expires and the franchisee fails to "de-identify" its business by removing signage, trade marks and trade names. This case simplifies and streamlines the proof that a franchisor must present to the court to recover damages from an infringing former franchisee. Franchisees who fail to promptly "de-identify" also face larger potential exposure for trade mark infringement.

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Hospitality Briefs, *continued*

of three key issues for franchisors. First, the choice of arbitration for domestic dispute resolution should be carefully made, where awards cannot be readily appealed, and which requires the upfront payment of a filing fee based on the amount in dispute and payment of fees for the time expended by the arbitrator. Second, the compliance training and close supervision of staff engaged in franchise selling activity is highly important for the financial health of the franchisor. Third, the use of a closing acknowledgment form or another means of verification that the franchisee is only relying on the Franchise Disclosure Document and authorized collateral material, which forces franchisees to attach any extraneous communications on which they are relying, is vitally important for the franchisor's protection against sales law violations of sales staff. Some franchisors make a video recording of the franchise sale closing at which the franchisee is asked about any earnings claim type material they may have received and relied upon in making their decision. The outcome of this case differs from recent decisions where the closing acknowledgment prevented franchisee claims of reliance on unauthorized earnings claims documents.

If you are interested in comprehensive compliance training for your staff at your offices, please contact Joel Buckberg, 615.726.5639 or jbuckberg@bakerdonelson.com.

— Joel Buckberg

Federal Trade Commission Announces Six Month Delay of Red Flags Rule Enforcement

The Federal Trade Commission announced on October 22, 2008 that it would delay enforcement of the new "Red Flags Rule" until May 1, 2009, from the original November 1, 2008 date. The reason for the delay is to give creditors and financial institutions more time to develop and implement identity theft prevention programs.

The purpose of the Rule is to reduce consumer exposure to identity theft. We believe the Rule is sufficiently broad in scope to cover certain franchise system

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Country of Origin Labeling Law Takes Effect, *continued*

peanuts. Food service establishments are specifically exempted. "Perishable agricultural commodity" refers to fresh or frozen fruits and vegetables. Thus, a butcher shop would not be subject to the COOL requirements as it does not engage in the business of selling any perishable agricultural commodities.

Mandatory labeling, though initially enacted in 2002, was delayed until September 30, 2008. The Food, Conservation and Energy Act of 2008 (the 2008 Farm Bill) extends the definition of covered commodities to include chicken, goat, macadamia nuts, pecans and ginseng. The 2008 Farm Bill further provides for labeling products of multiple origins. With the passage of the 2008 Farm Bill, Congress left unchanged the September 30, 2008 implementation date decreed by the 2002 Farm Bill. The United States Department of Agriculture (USDA) has stated, however, that COOL requirements do not apply to covered commodities produced or packaged prior to September 30, 2008.

Proponents of COOL requirements argue that such labeling will provide customers with accurate and readily-available information as to the source of the products they are consuming. The requirements, they argue, advance the broad-spectrum goal of affording consumers the knowledge of whether their food is imported or originates from domestic sources. Knowledge of food source is increasingly of concern to consumers as news of contaminated food spreads and fears of bioterrorism rise. As different countries have different regulatory schemes and cultures about food safety, and thus varying levels of food safety regulations, knowledge of a product's origin has become of vital importance to some consumers.

Critics of COOL argue that the regulations are both confusing and expensive to implement. Many critics argue that the definition of "covered commodities" is at best, illogical, and at worst, incoherent. For example, the 2002 and 2008 Farm Bills exempt "processed" foods from labeling requirements. The USDA has defined "processed foods" a retail items derived from a covered commodity that have undergone specific processing resulting in a change in the character of the covered commodity, or that has been combined with at least one other covered commodity or other substantive food component, except that the addition of a component that enhances or represents a further step in the preparation of the product for consumption would not in itself result in a processed food item. Thus, salad mixes containing more than one type of lettuce, meatloaf, meatballs, sausage, breaded chicken tenders and mixed fruits or vegetables are not covered. Creating more confusion, peanuts are covered while roasted peanuts are not. The definition of "retailer" and "perishable agricultural commodity" excludes some businesses that might otherwise, and logically, be subject to labeling requirements. Furthermore, the costs of implementation, though currently unknown, may potentially further increase the ever-rising costs of food.

Despite the arguably confusing definition of "covered commodities" and risk of increased costs, retailers can find a silver lining in the cloud of COOL requirements. As consumers are interested in both locally-grown and exotic food products, retailers may use the labeling requirements for marketing purposes. Further, labeling can potentially foster a retail culture of shared information as increasingly sophisticated consumers are given more facts about where the food they consume originates.

Ms. Bailey is an attorney in our Johnson City office.

Hospitality Briefs, *continued*

transactions between a franchisor and its franchisees, and between franchisees and their retail customers. The key element of coverage involves the extension of credit for a covered account. By definition, cash and discrete single credit card payments are not covered by the Rule, nor, generally, are transactions with franchisees and retail customers that are legal entities making payments through corporate accounts. But routine, monthly royalty payment and open account transactions with individual franchisees, common in many franchise systems, could cause the franchise relationship to fall within the scope of the Red Flags Rule. Likewise, franchisee transactions with consumers that allow for payment of the purchase price for goods or services over time under open accounts, even by credit card in pre-authorized installment payments, could cause the franchisee to be covered under the Rule.

How could the Rule apply to a franchise environment? Probably the most common way it could apply is as follows. An individual franchisee with multiple locations routinely orders supplies and some retail inventory from the franchisor's purchasing program on open account, billed and paid by check or Electronic Funds Transfer (EFT) monthly. The store manager responsible for the ordering is selling the inventory and supplies "out the back door," so the franchisee's reports of gross sales reflect inconsistencies with the orders placed by the franchisee's staff for supplies and inventory. In other words, the ratios are outside normal parameters. Under the Red Flags Rule, this fairly common scenario means that the franchisor should identify this circumstance and notify the franchisee that unusual activity is occurring in the account. Since much of this activity is automated, the connection between wholesale and retail sales levels should be programmed and calculated to produce a "red flag."

For more information on Red Flags Rule compliance and computer security issues, contact Betty Steele in Nashville at 615.726.5741 or bsteele@bakerdonelson.com.

—Betty Steele

ADA Amendments Act of 2008: Summary and Current Status

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In the midst of the proposed economic legislation being negotiated in Washington, D.C., *the ADA Amendments Act of 2008* was enacted into law. The ADA Amendments Act will significantly expand the definition of "disability" under the ADA, limiting consideration of mitigating measures in determining whether a person is disabled under the ADA. This will result in ADA protection extending to a large number of employees who would not have been considered disabled under the prior construction of the ADA. The original bill, named the "ADA Restoration Act," would have entirely eliminated the "substantial limitation" language in the ADA. The original bill stalled in the Senate last year.

The ADA Amendments Act retains the "substantial limitation" requirement to establish a disability, but makes it easier to meet that standard. "Substantially limits" would mean "materially restricts." The ADA Amendments Act instructs that courts are to "construe broadly" the definition of a disability.

The determination of whether an impairment substantially limits a major life activity "shall be made without regard to ameliorative effects of mitigating measures . . . ." For example, the Act specifically states that "medication, prosthetics, hearing aids, assistive technology, learned behavior or adaptive neurological modifications" are not to be considered in determining whether there is an impairment that causes a substantial limitation on a major life activity. Only ordinary eyeglasses and contacts may be considered as a mitigating measure. The Act also prohibits a court from considering whether the manifestations of the disability are "episodic, in remission or latent" when determining if a person has an impairment that would qualify as a disability.

The Act specifically defines a "major life activity" to include, but is not limited to, "caring for oneself, performing manual tasks, seeing, hearing, eating, sleeping, walking, standing, lifting, bending, speaking, breathing, learning, reading, concentrating, thinking, communicating and working." A major life activity also includes "major bodily functions," which includes "functions of the immune system, normal cell growth, digestive, bowel, bladder, neurological, brain, respiratory, circulatory, endocrine, and reproductive functions."

The Act will likely result in more individuals making claims under the Act. In addition, there is the distinct possibility that individuals whose claims were denied in the courts based upon the construction of the original ADA will attempt to bring their claims a second time under the new definitions established under the ADA Amendments Act.

The amendments result in a whole new segment of employees being classified as disabled under the ADA who did not meet the definition of having a disability under the prior ADA. This in turn may result in additional individuals to whom employers will need to offer reasonable accommodations at work. Employers and their legal counsel will have to address what types of accommodations are reasonable and must be extended to this new class of disabled individuals.

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1031 Exchanges of Residential Property: IRS Issues New Safe Harbor Guidelines

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Rev Proc 2008-16, 2008-10 IRB

A new IRS Revenue Procedure provides a safe harbor under which the IRS will not challenge whether a dwelling unit qualifies as property held for productive use in a trade or business or for investment under Code Sec. 1031. Rev. Proc. 2008-16 sets rental standards, establishes a qualifying use period and concludes that limited personal use will not prevent a dwelling unit from qualifying under the holding purpose test of the tax-free exchange rules. This Revenue Procedure comes on the heels of *Moore v. Commissioner*, T.C. Memo. 2007-134 (the recent vacation home case).

Personal residences cannot be exchanged tax-free under Code Sec. 1031 because they are not held for productive use in a trade or business or for investment. The question challenging taxpayers has been "How much rental is needed to meet the holding purpose test?" Rev. Proc. 2008-16 squarely answers this and also provides indirect guidance on the issue of converting a principal residence into qualifying relinquished property prior to an exchange, or converting replacement property into a personal residence after an exchange.

New safe harbor, but just a safe harbor. IRS now provides taxpayers with a safe harbor under which a dwelling unit (real property improved with a house, apartment, condominium, or similar improvement that provides basic living accommodations including sleeping space, bathroom and cooking facilities) will qualify as property held for productive use in a trade or business or for investment for Code Sec. 1031 purposes even though it is occasionally used for personal purposes. The safe harbor is effective for exchanges occurring on or after March 10, 2008. No inference is intended with respect to the federal tax treatment of such exchanges taking place before March 10, 2008.

IRS will not challenge whether a dwelling unit satisfies the holding purpose test under Code Sec. 1031 if:

- the taxpayer owns both properties for the qualifying use period (for the relinquished property, at least 24 months immediately before the exchange; for the replacement property, at least 24 months immediately after the exchange); and
- within the qualifying use period, in each of the two 12-month periods immediately preceding and following the exchange, (i) the taxpayer rents the dwelling unit to another person(s) at a fair rental for 14 days or more, and (ii) the period of the taxpayer's personal use of the dwelling unit doesn't exceed the greater of 14 days or 10 percent of the number of days during the 12-month period that the dwelling unit is rented at a fair rental.

IRS pointed out that the new safe harbor applies only to the determination of whether a dwelling unit is held for productive use in a trade or business or for investment under Code Sec. 1031, and that a taxpayer using the safe harbor also must satisfy all other requirements for a like-kind exchange under Code Sec. 1031 and the Regulations. An exchange may still fall outside the safe harbor parameters and meet the statutory requirements, but increased scrutiny may be triggered. We do not yet know if Rev. Proc. 2008-16 will result in changes to the exchange reporting Form 8824.

Broad definition of personal use. The taxpayer is deemed to have used a dwelling unit for personal purposes on any day the dwelling unit is used by: (A) the taxpayer or any other person who has an interest in such unit (including a tenant in common), or by any member of the family of the taxpayer or such other person; (B) by any individual who uses the unit under a reciprocal arrangement which enables the taxpayer to use some other dwelling unit (whether or not a rental is charged for the use of such other unit); or (C) by any individual if rented for less than a fair market value rental. A taxpayer may rent the dwelling unit to a family member if the family member uses it as a principal residence (and not a vacation home) and the family member pays fair market rent. Some taxpayer usage may be allowed for repairs and annual maintenance as well. See Code Sec. 280A(d)(2) and (3).

Failing personal use test for replacement property. A taxpayer may file a federal income tax return and report a swap of dwelling units as a tax-free exchange, based upon meeting the qualifying use standard for the relinquished property and the expectation that he will meet the qualifying use standard for the replacement property, but ultimately he may fail to meet the latter standard. If necessary, in this situation the taxpayer should file an amended return and not report the transaction as an exchange under Code Sec. 1031.

Conclusion. To meet this safe harbor, the taxpayer must address the new qualifying use periods both 24 months before the exchange for the relinquished property, and 24 months after the exchange for the replacement property. In each of these four 12-month periods, personal use as defined above must be severely limited, and the property must be rented to a qualifying user for at least 14 days. Overall, taxpayers should be pleased to have such a liberal standard to qualify residential property for Code Sec. 1031 tax deferral.

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NASAA Issues FDD Commentary Proposal

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As franchisors made the transition from the Uniform Franchise Offering Circular (UFOC) to the Franchise Disclosure Document (FDD), many questions arose regarding the new disclosure requirements. These questions persist even though the disclosure requirements under the Federal Trade Commission's (FTC) Amended Franchise Rule are very similar to those under the 1993 UFOC Guidelines. In an effort to update their guidelines, the North America Securities Administrators Association, Inc. (NASAA) adopted the 2008 Franchise Registration and Disclosure Guidelines as a model for the registration states. Recently, NASAA produced a commentary proposal to their 2008 Registration and Disclosure Guidelines addressing several frequently asked questions. This article provides an overview of the NASAA Commentary proposal.

Cover Pages

The FTC cover page has been modified under the new guidelines and NASAA requires that no unnecessary modifications be made. NASAA does not allow any additional clarifying information to be included regarding the total investment or allow adjustments to the totals taken from Items 5 and 7. NASAA does not provide much guidance regarding additional risk factors to be included in the state cover page. If a state examiner requires the disclosure of additional risk factors, it is not readily apparent whether the additional risk factor should be included in the franchisor's FDD form or in a state specific addendum. The safest route is to include the risk factor in all FDD's and provide guidance to the examiners that it was required by a particular state.

Item 1

NASAA allows more freedom to include information in Item 1 than in the Cover Sheet. The franchisor can provide a corporate family tree that represents numerous parent companies. NASAA's guidelines clarify that foreign affiliates that offer franchises or provide products or services must be included in Item 1. NASAA's commentary also clarifies the issue of change of control of a franchise and predecessor. According to NASAA's commentary, a franchisor must disclose a predecessor from whom the franchisor acquired directly or indirectly the major portion of the franchisor's assets; this does not necessary include a former controlling owner. A predecessor does not mean a mere equity owner but instead means that the person contributed operating assets to the franchisor and it operated or franchised a similar business.

Item 2

NASAA clarified the disclosure standards for third parties with management responsibilities. Franchisors must disclose independent contractors or other persons that have management responsibilities on behalf of the franchisor that relate to the sale or operation of the franchises offered and must provide the required disclosure information for Items 3 and 4.

Item 3

One interesting change in terminology involves the new term "held liable." The UFOC required disclosure if a person had been the subject of a material action involving securities, franchise or deceptive practices. Disclosure is now required if the person was "held liable." NASAA takes the position that this is not a change in the standard but goes on to state that "held liable" means the person must pay money or take an action adverse to its interest. So it appears the standard has changed despite NASAA's position to the contrary.

NASAA clarified the issue of whether or not material litigation involving intellectual property must be disclosed twice. Disclosing trademark, copyright and patent litigation in Items 13 and 14 does not relieve the franchisor of also disclosing the same litigation in Item 3 if the litigation meets the Item 3 disclosure requirements.

Item 8

NASAA creates a bright line rule for Item 8 and requires all revenue a franchise or its affiliates derive from purchases and leases of products and services to franchisees must be disclosed. A franchisor must also disclose all of franchisee's obligations to purchase or lease goods from the franchisor, its affiliates, designees or suppliers, or under the franchisor's specifications. This makes disclosure necessary if rebates are paid by designated or approved suppliers or by suppliers that comply with the franchisor's specifications.

Item 17

Under the UFOC, the franchisor was required to include a list of franchise relationship laws. Not only is this list is no longer required to be provided by the franchisor but the franchisor is no longer even permitted to include such a list in its FDD. A state that requires a summary of its franchise relationship law allows the summary to be included in its state addendum to the FDD.

Item 19

NASAA focuses on financial performance representations in the commentary and provides answers to several outstanding questions. Although Item 19 no longer includes absolute value costs in the definition of a financial performance representation, including cost information as a percentage of revenues constitutes a financial performance representation and therefore must comply with Item 19. NASAA also condemns submitting a blank "pro forma" profit and loss statement to demonstrate a franchise's cost structure, but goes further and notes that in-

NASAA Issues FDD Commentary Proposal, *continued*

cluding cost information alone in a pro forma may constitute advertising under state franchise statues.

If the franchisor opts to include a financial performance representation in Item 19, the franchisor may not include disclaimers of the financial performance representation or state that the franchisee may not rely on the information contained in Item 19.

Item 20

Many questions have arisen regarding franchise system census disclosure in Item 20.

Unopened Franchisees

If a franchisee has signed a franchise agreement but has not opened its unit, the franchisee should be listed in Table 5 and their information should be provided franchisee contact list identified as "not yet opened." If the franchisee has signed a franchise agreement, never opened a location and have not communicated with the franchisor within 10 weeks of the FDD issuance date, then the franchisee should not be included in any chart but listed as a terminated franchisee.

Area Developers and Representatives

Information about area developers is not required and may not be provided in Item 20. However, area development information must be included in Item 1. Franchisors must be careful to ensure that these arrangements are not considered subfranchises, which mean additional disclosure at two levels.

Confidentiality Clauses

If franchisees have signed confidentiality clauses within the prior three fiscal years, the franchisor must make two disclosures. The first disclosure must state that some of its franchisees have signed confidentiality clauses. The second disclosure the franchisor must make is to include the mandated language in Item 20(7) to the effect that discussions with franchisees who have signed such agreements may not produce candor.

Amendments

The FTC and NASAA have not reached a consensus on how to deal with amendments to the FDD. The FTC requires the franchisor to amend the FDD quarterly if there has been a material change, and by supplement instead of amending the core document. Some states require the franchisor to amend the FDD immediately upon the occurrence of a material change and to cease selling in those particular states. This incongruity between state franchise laws and the Amended Franchise Rule forces franchisors to follow the more restrictive state law, and negates the more liberal federal policy. Until a consensus is reached, franchisors will not realize any benefit from the FTC's quarterly amendment concept in registration states.

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