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Franchise Agreements and Loans: The Comfort Letter and Beyond

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When negotiating the franchise agreement for a hotel, the franchisee's counsel should consider the interaction between the franchise agreement and any financing documents that may create issues – and opportunities – for the franchisee/borrower. Some of these issues, but not all, are called out in the comfort letter and counsel should be alert for those issues created by the conflicts between the franchise agreement and the loan documents.

I. COMFORT LETTERS

The franchise agreement is between the hotel franchisor, which provides the hotel brand and associated products such as the reservation system and marketing programs, and the hotel owner, who pays fees to the franchisor in exchange for the use of the brand and the associated programs and services. Most hotel franchise agreements require the hotel franchisor's consent for a transfer of the hotel to a third party, including a lender, and prohibit a collateral assignment of the franchisee's rights under the franchise agreement. If a hotel lender wants the opportunity to keep the benefits of the franchise agreement upon a foreclosure or acceptance of a deed to the hotel in lieu of foreclosure, it will need to enter into an agreement with the hotel franchisor. This agreement is commonly called a comfort letter.

Generally, a comfort letter provides that (1) in the event of a loan default and the exercise by the lender of its remedies on such a default, the lender has the choice to either enter into a new franchise agreement and keep the hotel brand in place (provided the lender or its designee meets certain basic criteria) or to take over the hotel without the franchise agreement in place and (2) in the event of a franchise agreement default, the hotel franchisor will provide notice to the lender and an opportunity for the lender to cure the franchisee's default in order to preserve the existing franchise agreement.

The comfort letter arrangements between the lender and the hotel franchisor impact the franchisee/borrower in several ways. First, if the lender elects to terminate the existing franchise agreement, the hotel franchisor will still have a claim against the franchisee/borrower (and guarantor) for termination damages, including any liquidated damages provided for in the franchise agreement. Second, even if the lender elects to keep the existing flag (brand) on the hotel, the hotel franchisor almost always requires that the lender enter into a new franchise agreement, resulting in the termination of the existing franchise agreement. In this case, it is not always a clean, easy and inexpensive termination because the hotel franchisor may not have agreed to waive the termination damages against the franchisee/borrower in these circumstances. Third, if the lender elects to cure franchise agreement defaults by the franchisee, the franchisee/borrower will be responsible for the lender's cure costs, which are not within the franchisee/borrower's control. Fourth, comfort letters may require that the franchisee/borrower provide copies of any loan default notices to the hotel franchisor. When dealing with a loan default, franchisee's counsel should be mindful to review the comfort letter to ensure that franchisee is not inadvertently creating a default under the franchise agreement.

Practice Note: The franchise agreement, loan documents and comfort letter should be reviewed together to ensure that, if the franchise agreement is terminated in connection with a loan default, either the lender is responsible for the de-identification obligations or the exiting franchisee/borrower retains sufficient rights to access the property to complete the de-identification obligations.

II. CONFLICTS BETWEEN THE FRANCHISE AGREEMENT AND LOAN DOCUMENTS

Beyond the comfort letter, there are several common conflicts between the requirements of a franchise agreement and the requirements of the loan documents that can create significant issues for the franchisee/borrower.

Casualty: Under a franchise agreement, the franchisee/borrower will be required to rebuild the hotel after a casualty that results in loss or damage below a threshold. This obligation to rebuild is generally not conditioned on the availability of insurance proceeds, so that the franchisee/borrower must come out of pocket for the restoration costs if insurance proceeds are not available. For casualties above the threshold, the franchisee/borrower may terminate the franchise agreement; sometimes upon payment of a liquidated damages amount, sometimes with no liquidated damages but with a surviving provision that reinstates the franchise agreement if the franchisee/borrower or its affiliates plan to build a new hotel on the site within a certain number of years. However, most loan documents allow the lender to apply insurance proceeds to repayment of the loan in the event of a casualty that results in loss or damage above a certain threshold. If the thresholds in the franchise agreement and the loan documents do not match up (and they seldom do), a franchisee/borrower may be left with the obligation to rebuild the hotel and without insurance proceeds to do so. As hotel franchisors and lenders often take the position that these thresholds are non-negotiable, the franchisee's counsel should identify this issue at the beginning of the deal negotiations and work to resolve the issue as early as possible.

Payment of Operating Expenses/Cash Traps: Many hotel loans today provide for a "cash trap" during periods when the hotel is not meeting financial covenants such as debt-service-coverage ratios. During a cash trap, operating revenues from the hotel are collected in an account controlled by and pledged to the lender and then used to pay costs of the hotel in a set order. Hotel lenders often require that debt service and other current payments due to the lender be paid before operating expenses of the hotel. The reason for this approach is that lenders want loan payments to have priority over all other obligations of the borrower. However, when operating expenses are paid after debt service, there may be insufficient revenues left to pay franchise fees and other amounts due to the hotel franchisor, such as group service charges. In that case the hotel may no longer be able to meet brand standards which could result in a franchise default and termination which then may trigger a loan default. As further discussed below, termination of the franchise agreement may also be a recourse event under the loan, with either the lender's losses or the entire loan amount then due from the loan guarantor.

Replacement of Management Company: Some franchise agreements allow the hotel franchisor to require that the franchisee/borrower replace the management company if the hotel franchisor determines that the management company no longer meets the franchisor's criteria or is responsible for franchise defaults at the hotel. However, most hotel loans require the lender's consent for a replacement of the management company. To avoid being pinned between a franchise default and a loan default (taking into account that the lender's consent to a replacement management company can be a months-long process if the loan has been securitized), a franchisee/borrower may prefer to negotiate pre-approved replacements with either the hotel franchisor or the lender or to ask the lender to waive consent for any replacement management company approved by the hotel franchisor.

Practice Note: The transfers permitted as of right under franchise agreements and the transfers permitted as of right under loan documents will likely not match up. Preparing a clear and comprehensive description of the transfers that need to be permitted as of right and those that will require lender and franchisor consent, which can then be added in to both the franchise agreement and the loan documents as exceptions to the standard restrictions, will prevent confusion and complicated negotiations down the road.

III. NON-RECOURSE CARVE-OUT GUARANTIES

Recent trends in non-recourse carve-out guaranties for hotel loans can result in unexpected and adverse interactions with the franchise agreement.

Non-recourse carve-out guaranties have become a standard part of the lending landscape, guarantying payment of the lender's losses in the event of so-called "bad boy" acts by the borrower and guarantying payment of the entire loan in the event of a borrower bankruptcy and certain other events such as unpermitted transfers. Recently, termination of the franchise agreement has made its way onto the non-recourse carve-out list for commercial-mortgage-backed securities (CMBS) loans, as either a losses-only event or as a full-recourse event, creating serious issues for franchisee/borrowers. Consider the following scenarios:

1. A partial casualty results in a $5,000,000 loss, below the termination threshold in the franchise agreement but above the threshold in the loan documents for application of the insurance proceeds to repayment of the loan. The lender applies the insurance proceeds to the $50,000,000 loan and the franchisee/borrower does not have $5,000,000 in reserve to repair the damage. The hotel franchisor terminates the franchise agreement for default and the non-recourse carve-out guaranty is triggered as a result of the lender's decision to apply the insurance proceeds to the loan. If a losses-only trigger, the lender may argue that the

loss of the franchise agreement had a negative effect on the hotel's revenues or value. If a full-recourse trigger, the loan guarantor would now be liable for the full amount of the loan.

2. The hotel is operating with a cash trap, with debt service and default interest paid before operating expenses, and the remaining cash flow is not sufficient to operate and maintain the hotel up to the hotel franchisor's brand standards. The hotel franchisor terminates the franchise agreement for default and the non-recourse carve-out guaranty is triggered as a result of the lender's requirement that debt service be paid before operating expenses.
3. Following a loan default, the lender forecloses on the hotel and exercises its right under the comfort letter to terminate the existing franchise agreement. The non-recourse carve-out guaranty is triggered by the termination, potentially allowing the lender to make a deficiency claim against the guarantor (if the franchise trigger was full-recourse). If the hotel's financial situation deteriorates without the flag, the lender may also claim its losses from the removal of the flag under the non-recourse carve-out guaranty (if the franchise trigger was losses-only).

IV. FRANCHISE GUARANTIES

Although the interaction of franchise agreements and non-recourse carve-out guaranties can be challenging, interactions between these agreements may provide new avenues for franchisee's counsel to explore when negotiating guaranty terms with the franchisor or the lender.

Some hotel franchisors require a guaranty of all of the franchisee's obligations under the franchise agreement, including (but not limited to) the obligation to pay liquidated damages on termination and the obligation to indemnify the hotel franchisor for losses arising out of the ownership and operation of the hotel. A franchise guaranty can be a powerful protection for a hotel franchisor in circumstances where the franchisee is in bankruptcy or is working out a distressed loan with its lender, providing incentive for the franchisee to keep the flag on the hotel. The criteria most frequently advanced by hotel franchisors in selecting a franchise guarantor are the financial strength of the proposed guarantor or having individual "warm-body" guarantors who are expected to be motivated by the guaranty to prevent the termination of the franchise agreement by the franchisee or the lender.[1]

Lenders' concern with substantive consolidation, where the borrower and its assets are pulled into an affiliate's bankruptcy and the lender's collateral is exposed to claims of creditors for another entity or person, may offer a fruitful avenue for consideration in negotiating a franchise guarantor. Hotel franchisors have not traditionally evaluated whether their preferred guarantors (and those guarantors' assets) are at risk for substantive consolidation with the franchisee/borrower in selecting the franchise guarantor, but a hotel owner's counsel might direct attention to this criteria as an alternative to financial strength or a "warm body" guarantor preference if it weighs in an argument for or against a particular guarantor.

The same entity or person often ends up providing both the franchise guaranty and the non-recourse carve-out guaranty. However, a non-recourse carve-out guaranty where termination of the franchise agreement is a full-recourse event can lead to the guarantor being liable for both the entire loan amount and the franchise liquidated damages at the same time. Depending on the circumstances, this consideration might encourage the hotel franchisor to join the franchisee/borrower in advocating for the removal of the franchise termination trigger from the non-recourse carve-out guaranty.

As a final consideration, if a franchisee/borrower must accept termination of a franchise agreement as a trigger in the non-recourse carve-out guaranty, franchisee's counsel might consider asking the hotel franchisor to waive the requirement for a franchise guaranty on the grounds that the guarantor is already sufficiently incentivized through the non-recourse carve-out guaranty to avoid the termination of the franchise agreement.

Hotel franchise agreements and hotel loan documents are often negotiated several months apart and by different counsel. Comfort letters, where the two sets of documents formally intersect, are often negotiated in a short time-frame right before the loan closing and without extensive involvement of the franchisee's counsel. However, there are significant interactions between the hotel franchise agreement and the loan documents that can negatively impact the franchisee if not carefully navigated.

[1] For a "point-counterpoint" on personal franchise guaranties, see "Traditional and Avant-Garde Uses of Personal Guarantees in Franchise Relationships" by Rupert M. Barkoff (23 Franchise Law Journal 137, Winter, 2004) and "What Do Personal Guarantees Offer the Franchisor? Be Careful What You Wish For" by Andrew C. Selden (23 Franchise Law Journal 138, Winter, 2004).