Negotiating Comfort Letters in Hotel Loans

A Practical Guidance® Practice Note by Donald A. Shindler, Clark Hill PLC

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This practice note discusses what lender comfort letters (LCLs) are, their role and applicability in hotel financing transactions, how LCLs work in practice, and the importance of various terms and provisions commonly found in LCLs.

For guidance on hotel purchase and sale transactions, see Hotel Purchase and Sale Agreements, Letter of Intent for Hotel Acquisitions, Hotel Acquisition Due Diligence Request List, Hotel Financing Diligence and Closing Checklist, Hotel Purchase and Sale Closing Checklist, and Hotel Franchise Agreements. For a form of comfort letter, see Hotel Franchisor Comfort Letter. For a form of hotel purchase and sale agreement, see Purchase and Sale Agreement (Hotel).

What is an LCL?

Given the current adverse economic impact of the COVID-19 global pandemic on the hospitality industry worldwide, hoteliers, managers, owners and operators, franchisors, and lenders are reviewing their respective financial exposures. One issue requiring careful consideration by all interested parties is the potential imposition and handling of liability by each. Lenders, specifically, often possessing less knowledge about the nuts and bolts of hotel operations, are reviewing both their documentation for existing loans and are considering concerns brought to the fore by the current hotel performance downturn.

Hotel loan transactions can be more complicated than financing transactions on other types of commercial real estate, such as, for example, a loan secured by a mortgage on industrial property occupied by a single, creditworthy tenant under a triple-net lease. Just as operating a hotel (an overnight, often labor-intensive business cloaked in an expensive, fixed asset requiring constant refurbishment, maintenance, upkeep, and adherence to promulgated operating and appearance standards and protocols) is not for the unknowing, neither is making and managing a hotel loan successfully. In addition to the typical loan documentation most lawyers would recognize, hotel loans require a number of additional documents and terms in order to define the roles, duties, and obligations of the relevant parties, including the “waterfall” flow of funds and allocations of potential liabilities. Understanding terms such as RevPAR (revenue per available room), ADR (average daily rate), OCC (occupancy rate), radius restrictions, brand standards, and a host of others common to the industry is necessary; understanding the working interaction of hotel transaction documents such as Franchise Agreements, MTAs (Master Technology Agreements), TSAs (Technical Services Agreements) and, to the point of this practice note, LCLs constitute fundamental elements of a hotel transaction and the ability of the parties to negotiate and close a hotel financing transaction.

So, what are LCLs and how do they fit into a hotel loan? Simply put, LCLs are tri-party agreements among hotel owners, lenders, and franchisors providing the brand nameplate or flag for the property (as well as a number of additional deemed benefits such as reservation systems,

loyalty programs, operational standards and protocols, and rights to use the brand's intellectual property). They are structured to provide the lender with certain comforts, including the right to maintain in place:

- The franchise agreement
- Brand identification
- Current operation and procedures
- Its security interest in the real property and the results of the business operations thereon

Since franchise agreements are typically non-assignable and franchisees must be accepted by a franchisor, the hotel brand or franchisor has leverage over a lender seeking to foreclose and assert its rights over the collateral in the case of a default by a borrower/hotel owner. From a franchisor's point of view, it prefers not to have a loss of an outpost of its chain of franchised and branded hotels nor suffer a loss of a payment stream of franchise fees. To facilitate continuation of its brand at the location in question and viability of security for the underlying loan transaction, both franchisors and lenders seek the contractual rights and privileges encompassed in LCLs. The third party to the LCL, the owner, usually has the least amount of negotiating leverage and is a signatory to provide for various covenants and representations to the other two parties to tie together its separate documentation with each, such as the franchise documentation with the brand and the loan package with the lender.

Briefly, a LCL customarily allows a lender to foreclose or accept a deed in lieu of foreclosure (or otherwise take over a mortgaged hotel property which serves as collateral for the loan) in the event of a default under the loan and continue its operations under the franchise agreement between a defaulting owner/franchisee and the franchisor. A franchisor wants the lender or its buyer in a foreclosure auction or sheriff's sale to accept the franchise agreement and cure any outstanding defaults (usually, other than nonpayment of past-due franchise fees) as well as continue to comply with the terms of the franchise agreement. Without a LCL in place, neither a lender nor its buyer have any rights to continuation of the franchise agreement, effectively undercutting the ability to operate under it and denying access to the value of the brand provided by the franchise agreement. Even with a LCL in place, the lender or buyer must ensure that management of the hotel location is or remains acceptable to the franchisor.

Each major hotel brand has its own LCL form and procedures governing terms and provisions as well as acceptable negotiated revisions to its form. However, most are very similar as to the primary content of its LCL and it is important that the lender and its counsel understand the terms and how they are applied. The general terms and provisions found in LCLs are summarized below.

Parties

The hotel franchisor produces the LCL on its letterhead and it is addressed to the lender with the owner/franchisee joining the lender as signatories in acceptance of the terms of the LCL. The introductory section will reference the franchise agreement, identify the property, and establish the purpose of the LCL as connected to the grant of the proposed loan. If lender is the lead of an affiliated group or a consortium of two or more lender entities, that fact situation may be raised here but should be addressed later specifically in the body of the letter.

Franchisee Default

This provision states the operative elements of the LCL and grants the lender the right to require the franchisee to provide notice of any franchise default and the opportunity, but not the obligation, to cure same if the franchisee fails to do so. The LCL grants the lender cure periods. A lender should seek 10 to 30 days from notice (preferably receipt of notice) for monetary defaults, at least 30 days for non-monetary defaults with the right to extend 90 to 180 days if the default is not susceptible of cure in the shorter time frame but the lender has commenced and is (diligently) pursuing cure.

Usually, the franchisor indicates it can extend time frames as it determines in its sole discretion, without triggering further default issues under the franchise agreement, allowing the parties more time to attempt negotiated resolutions prior to any acquisition by the lender which might be deemed a sale, thus imposing potentially other adverse impacts upon the franchise and the lender. Additionally, this section should also contain provisions regarding defaulted payments, franchise transfer arrangements, and fees if the lender elects, within a given time frame (30 to 45 to 60 days), to accept and continue the franchise agreement. Alternatively, it will establish the short window for the lender to elect to terminate the franchise agreement without it being subjected to the franchise termination fees. In such event, the owner remains liable therefor. If the lender elects to terminate the franchise agreement, this section of the LCL will reiterate the strict duties and obligations of the parties, and likely establish a short time frame to accomplish the same, which will include de-identification of the property from the franchise. If the lender's acquisition of the property is delayed due to the pendency of foreclosure proceedings,

then the franchisor will grant the lender additional time provided the operation of the property is continued in accordance with the franchise agreement and, at the very least, non-monetary defaults are brought current. Following acquisition of title to the property by the lender or its buyer and acceptance regarding ongoing management of the hotel by the franchisor, a new franchise agreement would then be executed.

Non-Assignability

This provision clearly declares that the lender has no rights to assign, transfer, sell or convey the LCL or any rights thereunder but will often address the situation of limited rights to transfer to related, creditworthy affiliates of the lender and other similar entities or co-lenders provided that sufficient information regarding the specific parties and interests involved is given to the franchisor within a strict time frame depending on the specific situation. For example, if the transfer of the loan or allocation of portions thereof is planned to occur post-closing, then the LCL may grant a right to do so and assign the ongoing benefits of the LCL to a designated party or party within a defined period of time, often within six months of the loan closing and issuance of the LCL. Additionally, it may provide for such an assignment upon a subsequent acquisition of the lender by a qualifying financial entity.

Franchisee Acknowledgment

A franchisee or licensee under the franchise agreement (the borrower under the loan) acknowledges that the LCL is provided at its request to effectuate completion and funding of the desired loan and in consideration provides a broad release of the lender and the franchisor from any and all actions, claims, etc. arising from the lender's exercise of any rights granted by the LCL. It also grants he franchisor the ability to rely on any notices provided by the lender under the LCL in the exercise of any rights held by the lender without reference to the owner which is the franchisee/borrower. This protects both the lender and the franchisor under the LCL vis-à-vis the owner.

Notice Provisions

This provision provides that the lender agrees to give the franchisor prompt notice of any exercise of the lender's rights to institute foreclosure or receivership actions against the owner, accepting a deed in lieu of foreclosure or otherwise taking ownership. The timing of this notification is frequently subject to negotiation since lenders do not always track these timing requirements accurately. Establishing a reasonable time frame for delivery of such a notice is negotiated providing that the lender will deliver such notice within 5 to 10 business days of any of the foregoing actions. This should be acceptable and is advisable to avoid the risk of triggering a default in timing due to the delivery not occurring simultaneously with taking any such actions. Requiring a lender to deliver such notices prior to the action to be taken is not recommended from a lender's perspective. Other elements of notice provisions in LCLs include establishing:

- Notice addresses and addressees for the parties
- Timing and effectiveness of notices of changes
- Manner of provision of notices
- Requirements for notices regarding material modifications or satisfaction, cancellation, sale, or assignment of the loan

Confidentiality

LCLs contain confidential information and provisions limiting disclosure privileges to need-to-know parties are typical. Violations can lead to termination of the LCL and loss of the rights and protections granted. Generally, little leeway exists regarding negotiation of confidentiality provisions.

Governing Law

Unlike loan documents, wherein governing law except for location of real property pledged to a lender is determined and selected by the lender, in LCLs, franchisors establish the governing jurisdiction and, to the extent permitted by applicable law, require enforcement of all rights, remedies, duties, and obligations in and under the franchisor's selected jurisdiction. These provisions typically include waivers regarding service, personal jurisdiction, forum non conveniens claims, and jury trials. The jurisdiction chosen by the franchisor usually is one that has adopted legislation deemed favorable to a franchisor's perspective and needs.

Miscellaneous

LCLs generally end with a variety of miscellaneous provisions dealing with some or all of the following:

- Mutuality of negotiation
- Legal consultation by the parties
- Call for strict adherence to terms and provisions
- Provide for execution in electronic form
- Address multiple counterparts and PDF copies and validity thereof

- Establish deadlines for complete execution and delivery by all parties upon penalty of expiration or termination of the LCL –and–
- Provide for severability

Each party usually has some favored clauses it wishes to include and, unless any party becomes too prolix, can negotiate for those to be added. Further, note that the franchisor often insists on receipt of executed, scanned copies of the negotiated LCL by email before it will release its signed counterpart LCL. That must be considered in coordinating timing of a loan closing.

It is worth noting that LCLs are distinguishable from Subordination, Non-Disturbance and Attornment Agreements (SNDAs). SNDAs in hotel transactions are tri-party agreements among the owner, lender, and a tenant or, in the case of a brand management company, the hotel manager. SNDAs with a tenant do not provide any material rights regarding a brand to a lender although SNDAs, if crafted well, can provide a comfort to a lender from the brand managing the property similar to that provided by LCLs (e.g., the brand manager will remain in place on the condition that the lender undertake the owner's obligations under the brand management agreement). For guidance on SNDAs generally, see Subordination, Non-disturbance, and Attornment Agreements in an Acquisition Loan and Provisions in a Subordination, Non-Disturbance, and Attornment Agreement. For a form of SNDA, see Subordination, Non-Disturbance, and Attornment Agreement (Landlord/Lender).

Obviously, hotel loans and their documentation and loan closing as well as management and enforcement include much more than simply obtaining a useful LCL. However, without an effective LCL in place as part of the loan package, serious gaps would exist in the collateral security desired by and underwritten by a lender. Understanding the components of LCLs and negotiating a reliable and workable LCL thus is critical to a lender underwriting and funding a loan on a franchised hotel property.

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