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Do Lenders Really Get Any Comfort From Hotel Comfort Letters?

By Rori H. Malech



Introduction

It is customary in a hotel finance transaction for a mortgage lender to seek a “comfort” or “recognition” letter from the licensor or franchisor of the hotel brand. A comfort letter is a tri-party agreement among the owner, the lender, and the licensor, which purportedly provides a lender with reasonable assurances that in the event of a foreclosure of the hotel it will be able to maintain the license of the hotel brand. This chapter will discuss the purpose, background and components of a comfort letter, as well as an analysis of whether, in some instances, the obligations imposed on a lender outweigh the benefits of obtaining a comfort letter.

Background

Prior to the beginning of the economic downturn in 2008, the vast majority of lenders providing financing secured by hotels obtained a comfort letter as a “check the box” requirement to obtain “comfort” from the licensor that the lender would have certain rights in the event of a default by the hotel owner under the loan documentation. In particular, the commercial mortgage-backed securities (CMBS) market required a comfort letter as a closing condition in the majority of hotel lending transactions, and often viewed it as a value-add to the underwriting of a mortgage loan. Over time, comfort letters have shifted from protecting lenders in the event of an owner default to imposing obligations on lenders and potentially exposing them to liability for the benefit of the franchisors. The potential exposure to the lender is addressed in more detail below, but as the commercial lending market digs out of the global recession of the past several years, lenders and their counsel should recognize that in some circumstances a lender may be better protected without a comfort letter at all.

A hotel with a large national brand affiliation has either a license agreement, whereby the name is solely licensed to the hotel owner, or a management agreement, whereby the brand is also responsible for the day-to-day management of the hotel. The hotel owner is willing to pay the hotel brand royalty and various other fees (even if it is not managing the hotel) for its name recognition, marketing reach, and use of its central reservation system. In many instances, the brand is as an essential benefit to the hotel and something that the lender may want to preserve in the event it forecloses on the hotel. Accordingly, lenders customarily require a comfort letter prior to or simultaneously with the closing of any financing secured by a hotel.

Key Components of a Comfort Letter

*2 The primary components of any comfort letter are:

1. The lender is provided notice of owner defaults under the license agreement and afforded the opportunity to cure such defaults. The lender is usually given an additional cure period beyond the owner's cure period. Customarily, the additional cure period is shorter for monetary defaults (i.e., ten days) and longer for non-monetary defaults (i.e., thirty to sixty days).
2. The brand gives the lender the right to enter into a new license agreement and agrees to waive its application fee. Sometimes the licensor will also waive the requirement under the license agreement that the licensee complete renovations to the hotel at a specific time and in specific ways that are typically imposed on all hotels under the same flag or hotel brand (known as a property improvement plan (PIP)).
3. The lender is given time to work out a defaulted loan, appoint a receiver, and/or foreclose on the property without losing the flag. This may require that the lender negotiate and enter into (or the receiver will enter into) a short-term interim license agreement with the licensor.
4. The lender is given comfort that it can sell the loan, or the hotel after a foreclosure. The lender may also attempt to obtain the consent of the licensor to the transfer of the comfort letter or the license (as applicable) to the buyer of the loan or hotel. Comfort letters are rarely transferable; however, the licensor will usually agree to issue a replacement comfort letter upon request, subject to certain conditions. Similarly, a new buyer can apply for a new license on current market terms.

Conditions Imposed in Comfort Letters

It is important to keep in mind that comfort letters are issued by the brands on their standard form and are largely non-negotiable (although lenders that do a substantial amount of repeat business with a brand may have a negotiated form that varies from the standard form). It is also important to remember that comfort letters are not a de facto assignment of the license agreement to the lender and they do not serve as a pre-approval of the lender as a substitute licensee under the license agreement. Lenders and their counsel should carefully review the conditions imposed in the standard comfort letter, and pay particular attention to the following issues:

1. Although the lender is customarily afforded notice and cure rights beyond the cure period given to the owner, the extra time is usually not enough for a lender to make an informed decision about whether it is in the lender's best interests to cure a default. In addition, many brands impose conditions on a lender's right to cure. Among the more onerous conditions are bringing current all fees due to the licensor, such that if a lender were inclined to cure a non-monetary default they would effectively be obligated to cure a monetary default as well to the extent royalty or other fees were past due. Unpaid, accrued fees can be significant when a hotel is in trouble, and it is not a quick and simple task to obtain information from the borrower or the licensor to determine exactly how much is due and owing to the brand. This serves to further delay a lender's ability to make an informed decision about whether to enter into an interim or new license agreement with the brand.