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Hotel Financing Series, Part 4: Deciphering the Pitfalls in Dealing with Franchise and Non-Disturbance Agreements

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In this part 4 of our hotel financing series, we discuss some of the most important hotel agreements, why they are key to the value of the hotel, and the tools which lenders often use when liaising with franchisors and hotel managers to protect the value of their security.

Franchise Agreements

Where a hotel is operating under a franchise model, the franchise agreement with the franchisor is arguably the most important document. The franchise agreement grants a licence to the hotel operator/franchisee (being OpCo) to run the hotel under its brand name, under conditions prescribed by the franchisor. The hotel operator will need to ensure they meet the set of conditions, as failure to do so may give rise to termination rights by the franchisor and the removal of the hotel as a branded hotel. We discuss below some of the key conditions and issues which arise in a typical hotel financing transaction.

One of the key prerequisites in obtaining a franchise arrangement is availability of funding. Running a hotel is a capital-intensive business, and operating a hotel within a franchise model requires additional prescribed costs set out in the franchise arrangements to keep up with the brand requirements. It is common for franchisors to review the financial status of the ultimate sponsor to ensure the hotel operator has sufficient financial backing to meet many expenses, such as ongoing capital expenditure, licence fees, central system fees/contributions, marketing costs and so forth. Sometimes franchisors would also require parental guarantees from the sponsor. The lender needs to understand these arrangements, and to the extent any cash collateral has been provided by the borrowing group in favour of the franchisor, a priority arrangement may be required.

Where the hotel owner requires the assistance of a professional hotel manager, the franchise agreement usually requires such appointment to be first approved by the franchisor. The franchisor may have a list of criteria the hotel managers need to meet, in terms of experience, track record, etc.

In addition to funding arrangements, other key conditions the hotel owner needs to adhere to are the brand standards. In short, these require the hotel to be operated and marketed in a way that adheres to the general standard of hotels under the same brand. This includes, among other things: 1) maintaining the fittings and furnishings of the hotel, which requires ongoing investment in refurbishments and commitment to capital expenditure with respect to upgrades; 2) adhering to particular brand requirements, including staff training, the provision of specific furnishings and décor, the availability of particular services, maintenance of a minimum customer satisfaction rating, etc.; and 3) security and other regulatory requirements. The franchisor would monitor this by having periodic inspections as well as regular reporting by the franchisee, and often these are documented in reports (as most branded hotel groups are quite stringent and have a set process for an ongoing assessment of its hotels across the world). It is important for the lender to obtain copies of these reports (or at least sufficient information) so that the lender is aware of the issues flagged and therefore need to be addressed. Failure by the hotel owner to rectify the issues may lead to termination by the franchisor in the most severe scenarios.

Non-Disturbance Agreement

It is common practice for the lender, franchisor and hotel owner to enter into a non-disturbance agreement (“NDA”) with respect to the franchise agreement. This is usually in the franchisor’s prescribed form, with some amendments tailored to the transaction. The terms of this document vary between transactions but generally it would cover the following:

1) Acknowledgement of lender's security over hotel owners' assets as well as agreed priority. The franchise agreement usually prohibits the hotel owner from granting security, and the NDA provides consent for this for the financing. To the extent there are competing financial interests (for example, if the obligors give a guarantee or payment bond to the franchisor under the terms of the franchise agreement), then priority is agreed between the lender and the franchisor.

2) An agreement not to exercise termination rights until the lender is notified. This provision is to avoid terminating the franchise agreement by the franchisor and therefore significantly decreasing the value of the hotel (as the brand is so important). It is often agreed between the lender and franchisor that the franchisor provides notice to the lender of any material breaches by the hotel owner, and gives the lender an opportunity a right to cure such default prior to terminating the franchise agreement.

3) Lender's step-in rights. Along with the termination rights point above, the lender has the right to "step in" to the shoes of the borrower and rectify any default to avoid termination of the franchise agreement, or upon an event of default under the facility, as a tool to take over the franchise agreement and operate the hotel in exercising its enforcement rights.

4) Agreed procedure regarding sale of hotel/change of hotel manager. In circumstances where a change of hotel manager is necessary (for example, if the hotel manager is not performing in a satisfactory manner, or in a distress scenario where the lender is looking to sell the hotel and the purchaser has their own hotel manager), it is important to establish pre-agreed procedures with respect to approval from the franchisor. As mentioned above, often the franchisor has a right to approve the appointment of the hotel manager, and the NDA may set out the pre-agreed requirement which should minimise any procedural hold-up in appointing a new hotel manager and therefore speed up any sale process.

The hotel lender also needs to understand the other costs associated with the hotel management and franchise agreements, how these issues impact the value of its collateral, and how these agreements impact its rights and remedies as a hotel lender.

In the next part of this series, we will examine hotel management arrangements.