

## **Hotel Franchise Agreements and Comfort Letters: Legal Challenges for Real Estate Lenders**

Negotiating Comfort Letters; Addressing Franchise Provisions in Hotel Loan Documents

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# Hotel Franchise Agreements And Comfort Letters Challenges For Hotel Lenders

April 16<sup>th</sup>, 2020 Webinar

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Jonathan Falik is the Founder and Chief Executive Officer of JF Capital Advisors. Jonathan leads the firm's hospitality business, which includes equity and debt placement, asset acquisitions and dispositions, portfolio transactions, JV structuring, asset management, management company and brand evaluation, and strategic and capital markets advisory services.

Jonathan was a Senior Managing Director and the Head of Hospitality Capital Markets at BGC Real Estate Capital Markets. Simultaneously, Jonathan was the Head of Hotel Investment Sales for Newmark Grubb Knight Frank. Previously, Jonathan was a Managing Director and Head of the Lodging and Leisure Investment Banking group at Cantor Fitzgerald & Co.

Prior to joining Cantor Fitzgerald, Jonathan was the founder and CEO of JF Capital Advisors, a lodging advisory and principal investment firm. While at JF Capital, Jonathan led the acquisition or development of 25 hotels with over 5,500 keys and an aggregate cost of approximately \$1 billion. Additionally, Jonathan was the CEO of Eagle Hospitality Trust, a 13 hotel-property private REIT. Jonathan has led the sales of single assets and portfolios of 88 hotels for over \$2.2 billion of value. Before founding JF Capital in 2004, Jonathan was an investment banker at Bear Stearns in the Gaming, Lodging and Leisure Group. Jonathan began his career as a CPA at Price Waterhouse.

Jonathan has over 25 years of experience in the real estate and lodging sector. He has worked on numerous M&A and financing transactions involving well over 2,000 hotels and over \$35 billion of transaction value. Of the \$35 billion, \$34 billion was completed as an advisor and \$1 billion was completed as a principal. He has been actively involved with mergers and acquisitions of public and private companies, portfolio sales and single asset sales, equity financings, high yield financings and mortgage financings. Jonathan has extensive hospitality experience as an agent, advisor, principal, owner, borrower, guarantor, franchisee, lender and asset manager.

Jonathan received a BA in economics with high honors from Rutgers College and an MBA from Columbia Business School with a concentration in Real Estate Finance. Jonathan has been an adjunct professor at NYU's Real Estate Institute and is an active lecturer and panelist at industry events.

**Tara K. Gorman**  
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Tara K. Gorman focuses her practice on hotel acquisitions, operations, development and finance, general commercial real estate transactions, including commercial real estate acquisitions and sales, and office retail leasing.

Tara prepares and counsels clients, both domestically and internationally, regarding hotel acquisitions, financing, operations, development and finance, condo-hotels, hotel management agreements, license and branding agreements, restaurant management agreements, water park and casino agreements, real estate finance documents, purchase and sale agreements, property management agreements, corporate formation, business improvement districts, vendor agreements, marketing management agreements, website service agreements, telecommunications license agreements, and commercial office and retail leases. Tara has represented institutional investors such as life insurance companies and pension funds in connection with their real estate investments, as well as governmental and quasi-governmental agencies with respect to their real estate holdings.

Tara is a graduate of University of Maryland, where she received a B.A. and M.B.A. and she holds a J.D. from Georgetown University of Law.

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Guy Maisnik has over three decades of commercial real estate transactions with an expertise in hotels, finance and workout. He is a partner and Vice Chair of JMBM's Global Hospitality Group®, a senior member of JMBM's Chinese Investment Group, and a partner in the Real Estate Department. Guy advises clients on hospitality matters, with both a practical business and legal focus, representing buyers, sellers, lenders, opportunity funds, debt purchasers, special servicers, receivers, REITs and developers in hotel related matters, joint ventures, hotel management and franchise agreements, buying, selling and ground leasing of hotels and complex mixed used development. Guy has also assisted lenders, mezzanine lenders and private equity with structuring their hotel lending and investing programs and documentation. Guy's practice is equally domestic and foreign, where he advises on matters in major markets throughout the United States, Mexico, Canada, South America, Caribbean, United Kingdom, Eastern and Western Europe, Australia, Middle East and Asia. Guy also has significant experience in structuring capital raises through Qualified Opportunity Zone, Chinese, EB5 investments, and structuring workable condo hotel and resort trust solutions for domestic and foreign buyers and investors. He has been recognized in The Best Lawyers in America®, California Real Estate Journal's Best Real Estate Lawyers, Super Lawyers® for both Real Estate and Business Law, Los Angeles magazine's Top Southern California Lawyers, as well as a Top Real Estate Lawyer in Real Estate Southern California magazine.



# Strafford Webinar

Our panel will:

- Review standard features of hotel franchise agreements and the provisions of most concern to lenders, especially within the COVID-19 landscape
- Discuss how early termination, PIP and other franchise conditions can be addressed in the loan documents.
- Enable lender's counsel to review, evaluate, and negotiate hotel franchise comfort letters.

We will also review other key lender issues:

- Which provisions in the franchise agreement are most important to the lender?
- What provisions should be included in loan documents to address early termination, PIP, reserves, modification, and other issues?
- What are the critical elements of the franchise comfort letter in hotel finance?
- What lender protection provisions should be included in the comfort letter?
- What issues are being considered by lenders in the current environment?

# Franchise Agreement Popularity

Franchise agreements have become the most common means of branding most hotels in the US, except luxury brands.

Popularity of franchising has made comfort letters more important than ever and partially satisfies the lender's desire to get certain protections from the franchisor.

For purposes of this webinar, franchise agreements and license agreements are treated the same.

**Which provisions in the franchise agreement are most important to the lender?**

# What is Actually Negotiable in a Franchise Agreement?

Most franchise agreements are long documents with lots of fine print. They are presented to owners as “non-negotiable.”

- The franchisor’s position is justified on the basis of need for uniformity in agreements and ensuring that hotel guests will have a consistency of amenities, operations and experience, and the requirements of state laws.
- Franchisees are told by franchisors that franchise agreements are not negotiable, then learn that others have negotiated certain terms.
- Franchise agreements are not nearly as negotiable as hotel management agreements, so owners should understand what can and cannot be negotiated in order to realize the greatest value.
- The ideal time to negotiate key economic terms is prior to negotiating a letter of intent and prior to submitting a franchise application.

# Franchise Agreement Provisions Important to Lenders

**Franchise and Royalty Fees** A “ramp up” in fees over the initial years of the agreement, particularly for a newly built or re-branded hotel, can often be achieved.

- While other chain fees are more difficult to negotiate, it may be possible to obtain some temporary relief there as well.

**Area of Protection or Non-Competition** Brand opening a competing hotel within their property’s market area. The term and scope of the restriction varies, but some protection is usually granted.

**Ownership Transfer** Most franchise agreements are still based on a simple ownership model, contemplating a single owner (or investment group) of a single hotel.

- Transfer provisions should consider the structure of the owner and flexibility for transfers to certain related parties or affiliates.
- While a sale of a hotel often precipitates a property improvement plan or PIP, the owners should not trigger a new franchise agreement negotiation, set of franchise application fees and PIP when the transfer is to a related/affiliated corporate entity or to another family member or trust set up for estate planning purposes.

## Franchise Agreement Provisions Important to Lenders (Continued)

**Independent Management and Changes in Management** The essence of franchise structure is providing the power of a brand with the greater flexibility and responsiveness of an independent operator (i.e. an operator unrelated to the brand).

- A strong independent operator can push back on the brand's demands for operating and capital expenditures, implementation of new and expensive brand standards, property improvement plans, and certain brand programs which may not make sense.
- The management company should be the owner's choice, and should have primary loyalty to the owner, not to the brand.
- Important to prevent a franchisor from having absolute veto power over change in manager.

**Liquidated Damages** Liquidated damage provisions in the franchise agreement give the franchisor the ability to collect damages on the early termination of the franchise agreement.

- Liquidated damages amounts have increased substantially in recent years to as much as five times the average combined franchise fees and sometimes marketing fees or reimbursements paid to the franchisor.
- There are usually ways to reduce the amount of the damages as well as restrict the potential circumstances that might trigger payment.

## Franchise Agreement Provisions Important to Lenders (Continued)

**Capital Investments** Franchise agreements usually give the brands the ability to require substantial additional capital investments by owners to meet new physical brand requirements.

- There are ways to reduce owner's exposure, including restricting time periods and clarifying the types and timing of capital improvements that can be required, especially for a newly built property or an acquired property that may have recently undergone renovation.

**Personal Guarantees** Most franchisors require guarantees. Owners should seek to eliminate, or at least restrict, the scope of guarantees.

- Is the franchise guarantor the same as the loan guarantor?
- Sometimes the ownership entity will suffice as the franchise agreement guarantor.

**Key Money** Key money from the brands is a means of securing franchise agreements.

- Key money is generally structured as an unsecured loan with a 0% interest rate whose principal balance is forgiven ratably over the term of the agreement.
- Key money is typically only paid after the hotel opens; it doesn't provide funds for construction. Key money is usually the most expensive money an owner will get; in return brands typically will be even less willing to negotiate important franchise agreement provisions.
- Lenders generally want to govern whether the key money can be distributed to the Borrower or remains in escrow for capital improvements or operating needs.

## **Other Critical Issues for a Lender Include:**

**PIP / Rebranding Reserves**

**Early Termination**

**PIP / Capital Expenditures**

**Franchise Replacement**

**Management Company Replacement**

**Cash Flow Waterfall Payments**

**FFE Reserves**

**Casualty/ Condemnation**

**Insurance**

**Union Issues**

**Financing Restrictions in Franchise Agreements**



**What provisions should be included in loan documents to address early termination, PIP and other issues?**

# Provisions to Address Early Termination

In order to address early termination of a franchise agreement, loan agreements will generally include the following:

- Default provision if a replacement franchise is not secured within a defined period.
- Lender or servicer consent rights over execution of new franchise agreement.
- Borrower requirement to escrow funds required for any new brand PIP or re-flagging.
- Lender requirement that any key money be used to enhance the collateral and not as a distribution to Borrower.
- Approval by Lender or Servicer of the new franchise agreement and sometimes a no-downgrade letter from applicable rating agencies.

# Provisions to Address PIPs- Property Improvement Plans

In order to address PIPs, loan agreements will generally include the following:

- Lenders will generally require 120-125% of the estimated PIP budget to be escrowed and only used pursuant to draw/release requests for actual PIP items.
- Failure to complete the PIP work by the required timeline may result in a loan default. Deferred capital projects may violate loan requirements.
- Lenders may require a PIP completion guarantee to ensure the work is done timely; these guarantees may come into play in the near future
- Depending on size and scope, Lender may engage a consultant to monitor PIP progress, and to evaluate modifications to the PIPs
- Loans usually have an FF&E reserve provision, requiring 4-5% of gross revenue be escrowed to address future FF&E needs.
  - Lenders may require a separate funded PIP reserve or may require portions of future cash flow be swept into a reserve to fund a future expected PIP.
- Lenders may require periodic status reporting of the PIP amounts spent versus budget and any changes in estimates or in scope.
- Lenders may require that any material change in scope of the PIP be subject to Lender approval and may require a write-up with the rationale and financial impact.

# What is a Comfort Letter

A comfort letter is, essentially, a pre-negotiated form of assignment of the franchise agreement.

It governs the ability of a lender (which subsequently becomes an owner) to operate a hotel property under a franchise agreement after a foreclosure, receivership or other loan default.

Comfort letters will become critical in the current challenging environment, but may not provide the comfort lenders anticipate.

# Comfort Letter Forms

- Most hotel brands have a standard form of comfort letter.
- Brands usually insist on negotiating from their standard form.
- When parties ask a brand to use a different form of comfort letter, the brand will usually refuse or, at best, it will delay loan closing until the negotiation over the form of comfort letter is concluded.
- It is critical to start the negotiation process early in the acquisition or refinancing process.

# What's the Challenge?

- Comfort letters, while a key requirement for most lenders, are challenging to borrowers because they require the lender and franchisor to agree on matters (and do so quickly) that have no immediate effect on them (or on the borrower).
- Some brand comfort letters will not only not protect the lender but can hurt the lender if not modified appropriately.
- Lender and franchisor may have a different agenda than facilitating the closing of the owner's/borrower's financing transaction.
- Lender may have other outstanding underwriting or negotiating issues with the borrower, and the borrower may be in the process of finalizing the franchise agreement.
- Borrower counsel is often trying to negotiate a comfort letter that his or her client has little future interest in, and trying to mesh the sometimes different and sometimes opposing interests of the lender and the franchisor.
- In the current environment everyone should be highly focused what the comfort letter actually says.

**What are the critical elements of the franchise comfort letter in hotel finance?**

# Why Lenders Want a Comfort Letter

- Lenders lend against branded hotels because they believe that a hotel is more valuable if operated (and sold) as a branded property.
- If the hotel franchise agreement is terminated, the value of the property could drop significantly. This is a significant fear in the current environment.
- Even where there is no foreclosure, the lender may want the ability to be able to “step into the shoes” of the borrower and continue to operate the property in the shoes of the borrower or receiver under the existing hotel franchise agreement.
- Lenders will want the ability to sell the hotel after foreclosure (or in connection with a receivership or similar action), and often believe that transferring the franchise to a buyer will increase its recovery.
- Franchisor consent can impede Lender foreclosure/assignment remedy.



## Why Lenders Want a Comfort Letter (Continued)

- Lenders utilize SNDAs, Subordination and Non-Disturbance Agreements to deal with their rights and obligations for Hotel Management Agreements.
- Lenders utilize comfort letters to deal with their rights with respect to franchise agreements.
- Lenders who take security interests in a franchised property will want a “comfort letter,” - an agreement between the lender and the franchisor that defines the rights of lenders and franchisors if the hotel owner defaults on its loan obligations, the franchise agreement or other related arrangements.
- While lender’s rights under the comfort letter are limited, most institutional lenders have been willing to accept the comfort letter as providing the lender with sufficient “comfort” that it will have the ability to maintain the franchise relationship and the value of its collateral in specified events of owner/borrower default.

# Lender Mind-Set

A comfort letter theoretically 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.

Prior to 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 loan default by the hotel owner.

CMBS market requires a comfort letter as a closing condition.

Over time, with the increasing strength of some of the brands, comfort letters have shifted from protecting lenders in the event of an owner default to imposing obligations on lenders and potentially exposing them to financial and legal liability for the benefit of the franchisors.

Sometimes a lender might be better protected without a comfort letter.

**What lender protection provisions should be included in the comfort letter?**

# Key Components of a Comfort Letter

The primary components of any comfort letter are:

- 1. Notice:** Lender needs notice of owner defaults under the franchise agreement with an opportunity to cure such defaults. The lender is usually given an additional cure period beyond the owner's cure period. Usually, the additional cure period is shorter for monetary defaults (10 days) and longer for non-monetary defaults (30 to 60 days).
- 2. New License Agreement:** Franchisor gives the lender the right to a new franchise agreement and often will waive an application fee. Sometimes Franchisor will also waive PIP renovation requirements (which can be quite costly for the borrower).
- 3. Time:** Lender wants time to work out a defaulted loan, appoint a receiver, and/or foreclose on the property without losing the flag/franchise. This may require a short-term interim license agreement with the franchisor.
- 4. Loan or Hotel Sale:** Lender is given comfort that it can sell the loan with the comfort letter in place or the hotel after a foreclosure or with a replacement letter or franchise agreement.
  - Note: By standard form terms, comfort letters are rarely transferable; however, franchisor will usually agree to issue a replacement comfort letter upon request, subject to certain conditions.
  - New buyers can always apply for a new franchise on current market terms.

## Key Components of a Comfort Letter (Continued)

**5. No New Fees:** Lender wants the ability to assume the franchise agreement and avoid the payment of the application and other initial fees charged to prospective franchisees.

- Hotel chains will often charge a lender a “processing” or administrative fee, which is substantially less than the initial application fee usually charged to a new franchisee.

**6. Receiver:** Lender wants the ability to appoint a receiver to operate the property under the terms of the existing franchise agreement, at least for a short period of time to create oversight during the foreclosure process.

- Most hotel brands are generally willing to allow the receiver to operate the hotel under the “franchise flag” for a relatively short period, provided: (i) any monetary and non-monetary defaults are cured promptly; and (ii) the hotel continues to maintain the insurance coverage required by the franchise agreement.
- Note, franchisors often want the lender to guaranty the obligations of the receiver under any short term franchise issued. Lender’s are extremely reluctant to provide any guaranties.

**7. Liability Release:** Lenders want to be released from financial and legal liability under the franchise agreement upon sale.

**8. Replacement Franchise.** Most franchisors are willing to acknowledge that, in the event of a sale of the hotel to a third party, the buyer can then apply for a new franchise agreement and such application will be processed in accordance with the franchisor’s then existing requirements and procedures.

# Important Conditions Imposed in Comfort Letters

Comfort letters are issued by the brands on their standard form.

- Lenders that do a substantial amount of repeat business with certain brands may have negotiated forms that vary somewhat from the standard form.

Comfort letters are not a *de facto* assignment of the franchise agreement to the lender and do not serve as a pre-approval of the lender as a substitute franchisee under the franchise agreement.

Lenders and their counsel should carefully review the conditions imposed in the standard comfort letter, and pay particular attention to the following specific issues:

1. Although the lender is customarily afforded notice and cure rights beyond the owner cure period, the extra time is usually not long enough for a lender to exercise its full loan document remedies or to make an informed decision about whether it is in the lender's best interests to cure a default. Usually, Lenders lack current critical information.
2. Brands will require that lenders bring current all fees due to the licensor, so that if a lender were to cure a non-monetary default they would be obligated to cure a monetary default as well.
3. Unpaid, accrued fees can be significant and difficult to determine.

# Comfort Letters in Mezzanine Loan Financing

Mezzanine lender will usually review the same due diligence materials as the first mortgage lender.

- Mezzanine lender wants assurances from hotel franchisor if mezzanine lender exercises its loan default remedies.
- In a first mortgage loan, the comfort letter will address the change in ownership of the hotel property resulting from the lender's exercise of its foreclosure default remedies.
- For the mezzanine loan, the comfort letter will address the issues raised by the change of control of the borrower/licensee entity resulting from the lender's exercise of its loan default remedies.
- Mezzanine lender requires its own comfort letter, separate from the comfort letter given to the first lien holder.
- Franchisor may not have a form of comfort letter for a mezzanine loan. Borrower's counsel must negotiate a comfort letter that addresses the unique issues of concern to the mezzanine lender.
- If the franchise agreement requires consent to a change in either the control of the borrower, the mezzanine lender will require a comfort letter providing for such consent to the mezzanine lender acquiring control and equity ownership of the borrower.

# COVID-19



Borrowers are asking lenders for relief and are simultaneously asking franchisors for relief. Lenders should ensure that they understand what their borrowers are agreeing to with the brands and that the lenders remain protected:

- Emergency planning within a franchise system is challenging. It can require buy-in from other franchisees, who can be widely dispersed and affected differently by events, and some changes may not be able to be accommodated.
- Franchisors are adding additional protocols to deal with viruses and health issues, and are looking at their franchise agreements for updates. Some of these additional protocols add financial and operating costs. These are being introduced now and will continue to be refined.
- Certain provisions of the franchise agreement will need to be waived, deferred or modified, such as permitted revenue adaptations, including takeout and delivery or remote delivery of services, uses of other areas within the hotel for additional needed guest uses (e.g., office space, co-working space, etc).
- Many franchisors are considering suspension or extension of PIP and new hotel opening deadlines. Force majeure and related provisions must be reviewed carefully to determine whether they address pandemic like circumstances, including government required shutdowns.
- Lenders need to understand the temporary suspension of specific “brand standard” obligations under the franchise agreement, such as operating hours, staffing, minimum fees, required products and service requirements, and how they impact collateral.
- Insurance counsel should carefully review insurance requirements, particularly business interruption insurance and exclusions. Counsel should also review coverages for change in use and different operations than those in normal course.

# COVID-19: Lender Responses to Brand Related Issues

Lender and servicer responses to borrower requests related to franchise agreement modifications will vary widely.

In almost all mortgage loans, making a modification, amendment, or change to a franchise agreement requires lender approval.

Modifying, deferring, or eliminating items, timeline, or the scope of any PIP- property improvement plan may seem like a good idea but triggers several issues for lender consideration:

- PIPs are attached to and are a part of the franchise agreement and therefore a change to the PIP may be a modification of the franchise agreement and require Lender approval.
- Appraised values and Lender values were predicated on certain capital improvements and specific quality level of the underlying collateral.
- Capital improvements that are deferred will impact the future sale and refinancing of the hotel as capital needs, including FF&E investment, will need to be funded or contemplated at that time.

# COVID-19: Lenders Treatment of FF&E Reserves

Many Lenders are being asked by Borrowers to utilize existing FF&E reserves:

- **Balance Sheet Lender Response:** To fund payroll or critical operating expenses, FF&E reserves can be utilized for a period of time.
- **CMBS Servicer Response:** Please submit the request in writing and it can be evaluated. The request once submitted may need to be forwarded to the Special Servicer.
- **Special Servicer Response:** Please submit a detailed request of how much, how long, and when the funds would be replenished. Perhaps provide a personal guaranty that the FF&E reserve utilized will be replenished.

Special Servicers will need to evaluate whether the request is in the best interest of the collateral and the CMBS bond holders.

Special Servicers are currently overwhelmed by requests and may not respond quickly.

# COVID-19: Brand Reaction During Future Recovery

During the current crisis, the major hotel brands have relaxed or abandoned almost all operating and brand standards.

- The brands are dealing with their own cashflow and operating challenges
- Quality Assurance inspections are on hold, brand marketing has been largely suspended, support services such as national sales, digital marketing, loyalty marketing, and revenue management have come to a halt

When hotels reopen and/or the industry relaunches it's unclear how stringent the brands will be.

- Brands are unlikely to waive their fees, but may defer a small amount
- Brands will be highly focused on fire and life safety systems for hotels that are reopening which may add timing and expense to a reopening
- Brands will move back to mandating compliance with operating standards
- Brands will be relatively lenient with franchisees on capital condition and PIP compliance, but within several years will become much more aggressive
- Brands will be focused on the replenishment of diverted FF&E reserve funds

## COVID-19: Foreclosure/ Deed-In Lieu Surprises

There are a number of issues that Lenders should pay attention to when contemplating or implementing a foreclosure or deed in lieu

- Evaluation of what the comfort letter actually says, as discussed earlier
- Evaluation of any accrued and un-accrued but accumulated unpaid fees to the franchisor
- Evaluation of any required liquidated damages or termination fees payable to the franchisor
- Evaluation of any outstanding key money unsecured loans
- Evaluation of financial costs necessary and the timeline involved to return to compliance with brand standards
- Ability of the lender to exit liability under the franchise agreement



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