

CHINA

# Hotel Management Agreements



# Introduction



One cannot discuss the evolution of hotel management agreements (HMAs) without first talking about the separation of hotel ownership and hotel operations; a transformation of the major chains' business models, more commonly known as an "asset light" strategy. Today the form taken by hotel operators in HMAs is an important factor in the effective working of the market in hotel investment. DLA Piper's Hospitality and Leisure Sector Group has negotiated HMAs for a myriad of different clients across the H&L landscape (owners, investors, operators (both branded and white label) and lenders) in all of the world's key jurisdictions.

Many consider hotel management agreements to be borne out of a modified lease for the Hong Kong Hilton back in 1963, and the main terms included in it underpin most HMAs to this day. All major chains today have, to one degree or another, expanded nationally and internationally through a combination of franchise and management, and all have their own "form" or template agreements. In summary, over the last few years, we have found that trends that started as a result of the financial crisis of the last decade have continued to develop. In many markets the advent of recession made operators more risk averse. Traditionally HMAs were a means to limit operators' exposure to fixed rental payments when revenues were dropping. In less developed markets, even with a degree of economic recovery, operators have continued to use HMAs in this way. In more developed markets, such as Spain and the United Kingdom, we have seen increased complexity in agreements, a symptom of owners becoming more knowledgeable and seeking more control and input on the operation of their hotel, although owners continue to take the lion's share of commercial risk in developments.

Another important factor, as with any real estate investment, is the attitude of those who are providing the money, be it equity or debt. Leases were the traditional mainstay of hotel developments and indeed Germany remains a country where hotel deals are commonly based around leases. However, as investors have started to see the increased returns from ownership, the boom in arrangements like ground leases and other market changes is essential to have an understanding of investors and be able to work with them in a scenario of increasingly complex legal arrangements.

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## General

**Are Hotel Management Agreements (HMAs) common in the jurisdiction?**

Yes.

**If not HMAs, what are the alternatives / what is commonly used?**

Franchise agreements (either a hybrid of a management/franchise agreement or a management agreement that converts into a franchise agreement after a certain number of years) are common alternatives.

**Is it common or usual for the HMA to be governed by (i) local laws; (ii) the laws of one of the parties' country of incorporation; or (iii) an alternative jurisdiction?**

This is subject to negotiations. In practice, it is more common to have PRC laws govern the HMA, although some operators are able to get owners to agree to Hong Kong laws. However, if the contracting parties to the HMA are both Chinese entities, no choice of laws will be allowed, and the HMA will be required to be governed by PRC law.

**Are there any significant or unusual points to note in respect of tax on HMA payments in the jurisdiction?**

Where the HMA is a cross-border charge, it is likely to be treated as income derived from a China permanent establishment, and therefore be subject to China corporate income tax on a deemed profit basis. If the HMA is provided offshore, there should be clear segregation of the HMA charge from licensing fee charge. Otherwise, the HMA payment could be subject to China withholding income tax.

## Term and termination

**Is there a standard contract period of an HMA?**

Yes, usually 10-15 years for budget and midscale brands; and 20-30 years for luxury and upscale brands.

**Is the term usually fixed? Are early exit or similar options included (contractual or implied)?**

Yes, the term is fixed. Parties negotiate termination for cause in the HMA. Termination at will/without cause is not common, except for rights of termination upon sale of the hotel.

**Is it usual to include fees / liquidated damages for early termination?**

Yes. Liquidated damages are generally enforceable in China as long as the liquidated damage is not unreasonably higher or lower than the actual losses incurred to the non-breaching party.

**What is the usual position in respect of renewal?**

Renewal is normally by mutual agreement.

## Fees

**Is there a standard fee structure for HMAs (eg base + incentive)?**

A mix of a base fee (percentage of gross revenues) and cascaded incentive fees (percentage of gross operating profits) is the typical fee structure. (Base fees for budget/ midscale hotels tend to be higher because of the lack of food and beverage and other revenue streams offered in full-service hotels.)

**What other fees and charges are there (such as royalties, accounting, marketing, license fees, etc.)?**

License fees (percentage of total revenue), centralized services fee (calculated against the services provided), and marketing service fees (percentage of gross room revenue).

**Are owners typically required to set aside funds for fixtures and fittings?**

Yes.

## Performance and operations

**What is the usual standard imposed on an operator in respect of the operation of the hotel?**

The standard is negotiated in the HMA and will be commensurate to brands of the same standard in the country.

**What performance measures are commonly used in the jurisdiction?**

A standard performance test would consider actual profitability against annual budgeted profitability and provide the owner a right to terminate if for multiple years (normally two consecutive years) the hotel fails to materially meet the budgeted profitability projections.

**Is an operator or owner guarantee common in the jurisdiction?**

No. However, relative to owners elsewhere in Asia Pacific, owners of Chinese hotels are more likely to get operators to guarantee a minimum gross operating profit and to top up any shortfall amount in any operating year.

**What is the usual position in respect of employees? With whom does the liability for the employees sit?**

The owner usually employs the hotel employees, including the GM. However, considering the complexity of the situation, the determination of who is the employer can be very tricky. Therefore, the terms of the employment agreement and the HMA shall be carefully reviewed and drafted.

**Is it usual to have a non-compete clause, eg that no other property with that brand can open within a certain radius?**

Yes. Non-compete clauses are common and may include a radius restriction which varies, depending on the market and brand.

**Who is responsible for insurance?**

The owner. However, the operator may seek to obtain operational insurance in the owner's name.

**Does the HMA give rights in real estate in the jurisdiction?**

No.

**Does the HMA need to be recorded against the property, if this is possible in the jurisdiction?**

No.



Where financing is taken, is it standard to obtain a Non-Disturbance Agreement (NDA) as part of a management or lease agreement?

No. It is very hard to negotiate with the creditor (eg banks) with dominating bargaining power to enter into any NDA.

What other agreements usually sit alongside an HMA in the jurisdiction?

A License Agreement and a Technical Consultancy Agreement, and depending on the operator, a Centralized Services and Marketing Agreement.

## Transfers and assignments

What are the standard rights / restrictions in respect of transfer / sale of the hotel?

Operators will require consent to any change in the ownership structure, and consent can be withheld for a number of reasons, including if the owner fails the operator's compliance checks or is deemed a competitor to the operator.

When a managed hotel is sold (either asset or share deal), is it usual in the jurisdiction that either the Operator's consent is required for the sale, or that the hotel may only be sold if the HMA transfers with the hotel?

Yes.

Do HMAs commonly include a right of first refusal for the operator to purchase the hotel?

No, except for luxury branded hotels in major gateway cities such as Shanghai or Beijing, where laws are less restrictive on foreign ownership.

Is it usual to include provisions which enable the sale of the property with vacant possession ie without the brand?

Yes, provided that the operator is entitled to compensation for such terminations.

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