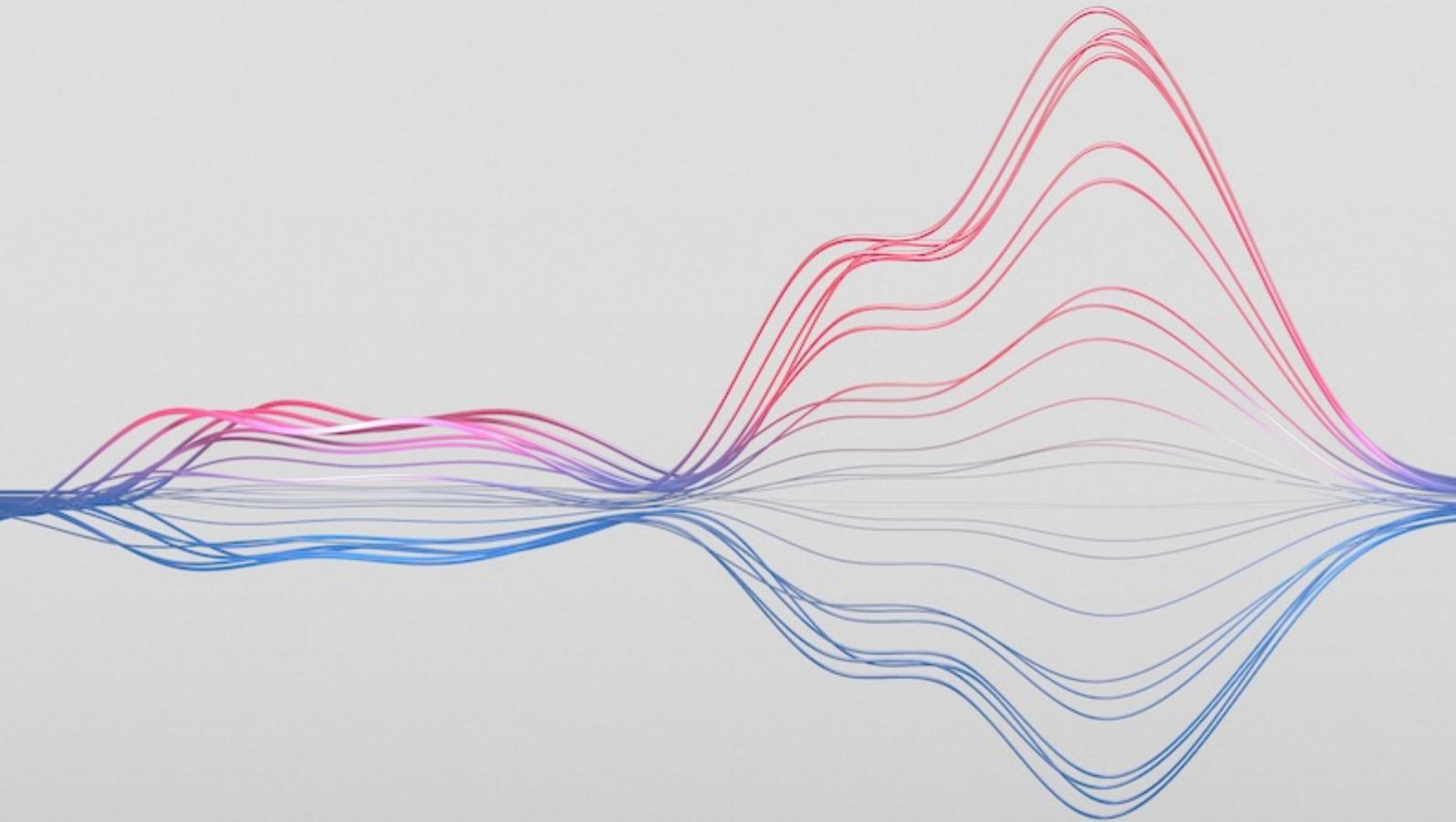


HONG KONG

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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Hong Kong

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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 are a common alternative, particularly for international operators with strong records managing hotels in Hong Kong.

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?

Hong Kong laws normally govern the HMA.

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

No.

Term and termination

Is there a standard contract period of an HMA?

HMAs usually have a term of 10 years or longer with an option to extend.

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

Yes, the term is usually fixed. Parties negotiate early exit options such as termination for cause rights in the HMA, which commonly includes the owner's rights of termination upon the operator failing to meet performance standards as agreed under the HMA. Termination at will/without cause is not common.

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

Yes. Most operators will seek lost management fees that otherwise were owed for the duration of the unfulfilled operating term in the event of any early termination.

What is the usual position in respect of renewal?

Renewal is normally at the option of the operator.

Fees

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

A typical fee structure is usually comprised of a base fee (a percentage of gross revenue) usually of 3-4% and incentive fees (percentage of gross operating profit or adjusted gross operating profit) usually ranging from 3-7%.

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 technology 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 commonly benchmarked against hotel brands of similar quality and price and with a similar market focus in Hong Kong.

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 with a right to terminate if the hotel materially fails to meet the budgeted profitability projections for multiple years (normally three consecutive years). For some luxury and upscale hotels, the performance measures are benchmarked against other luxury and upscale hotel brands of similar quality and price and with a similar market focus in Hong Kong.

Is an operator or owner guarantee common in the jurisdiction?

This would depend on the scale and reputation of the operator and owner. A reputable owner or a well-performing operator would not usually provide such a guarantee.

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

Subject to the owner's approval rights, the operator has discretion and authority with respect to the selection of key managerial roles (such as the general manager, the director of finance and business support, the director of human resources and the director of sales and marketing). The owner usually employs the other employees.

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

No. An HMA containing a non-compete clause should be carefully drafted to ensure it doesn't breach the Competition Ordinance (Cap. 619 of the Laws of Hong Kong) by preventing, restricting or distorting competition in Hong Kong.

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. Some operators will want the benefit of an NDA to secure the enforceability of the HMA by requiring the owner to enter into a Deed of Non-Disturbance in the event the owner provides any security to a lender in respect of the hotel.

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

A License Agreement and a Transfer 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?

An operator will require approval rights with respect to any assignment or transfer of assets or shares in relation to the hotel. Assignment or transfer of the hotel is usually acceptable in the event of the internal restructuring or rebranding of the owner.

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, usually the operator will want to include such a right and the owner will try to restrict the right of the operator to a certain extent.

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

It is not common, but some HMAs do include a right of first refusal.

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 in such circumstances.

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