Ghost Kitchens: A Leasing Perspective

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The phenomenon of ghost kitchens has increasingly sparked the interest of many in the restaurant industry. With Covid-19 especially, delivery represents a large and growing proportion of the food service industry. For restaurants, this presents both an opportunity and a challenge. Covid-19 has disrupted travel patterns and an increasing number of people have embraced working from home. There are fewer workers in the central business districts of cities and malls are down significantly in total customer traffic.

As a result, many restaurants are looking at their location footprint and finding that their locations are no longer optimized for serving their customers. Embracing delivery has helped many restaurants retain sales during the Covid-19 pandemic, but a central challenge persists: Are your locations where your customers want you to be?

The flip-side of this question is the opportunity. For multi-unit restaurant groups and franchises, there is a significant opportunity for brands that are able to expand their service areas and reach new customers.

Ghost kitchens are one possible tool for restaurants looking to accelerate their growth and expand into new markets. There is a great deal of variation within ghost kitchen operating models – this article will focus on many of the most common leasing issues that arise in connection with leasing premises to cloud kitchens and managed cloud kitchens.

What are ghost kitchens?

The term "ghost kitchen" is problematic because it has been used indiscriminately to describe a number of different business models. In fact, many participants in the rapidly expanding food delivery ecosystem avoid using the term "ghost kitchen" and use their own nomenclature instead. Two well known participants in this part of the delivery market are named Ghost Kitchens Brands and Cloud Kitchens, which only adds to the confusion of this terminology used to describe this business model. This makes it challenging to discuss the leasing issues and implications of ghost kitchens because there is no consistent terminology that is universally accepted.

For purposes of this article, we will adopt the following terminology to refer to different business models within what are broadly described as "ghost kitchens":

- "Dark kitchens" are restaurants that operate to fulfill delivery orders only and do not have the typical customer-facing elements, including exterior signage and in-restaurant dining rooms. Dark kitchens are typically operated by single or multi-brand restaurant operators and have been constructed and equipped to optimize fulfillment of delivery orders. Dark

[1] The author gratefully acknowledges the incredible contribution of Alexandra DiCenzo, an associate at WeirFoulds LLP, in researching and writing this article.

kitchens as a business model pre-date the rise of online ordering apps and third-party delivery aggregators but continue to evolve.

- “Cloud kitchens” are foodservice establishments that are purpose-built to allow multiple brands and restaurant operators to operate in a facility designed specifically for fulfilling delivery orders. They may be constructed as a large commissary-style kitchen with multiple workstations or may be subdivided with demising walls into separate kitchens. Cloud kitchens provide a capital-light way for restaurants to expand into new geographic markets without constructing a brick-and-mortar restaurant location, but require the franchisor, or its franchisee, to staff and operate the kitchen. Cloud kitchens are beneficial to restaurants because they expand their capacity and reach for fulfilling delivery orders without committing to long-term leases or time-consuming or costly restaurant build-outs. This allows restaurants to expand quickly and to potentially test new geographic markets in advance of committing capital on building out a new restaurant.

- “Managed cloud kitchens” are cloud kitchens that are operated and staffed by a foodservice operator. Rather than renting kitchen space, managed cloud kitchens staff the kitchens and fulfill delivery orders under license from the brand owner. Restaurant operators who wish to expand through managed cloud kitchens will license their trademarks and proprietary recipes, specifications and procedures. In essence, managed cloud kitchens operate as non-traditional franchisees or licensees of the brand owner.

- “Host kitchens” are existing foodservice establishments such as restaurants, hotel kitchens, catering kitchens and commissaries that supplement their primary business by fulfilling delivery orders using another concept, typically under license from the brand owner. In the majority of instances, host kitchens operate like managed cloud kitchens, with the operator of the host kitchen staffing the kitchen and fulfilling delivery orders using the brand and proprietary recipes, specifications and procedures of the franchise system.

This article will focus on the primary leasing issues associated with cloud kitchens and managed cloud kitchens.

With any lease, a landlord's or tenant's standard form agreement must be amended to fit the terms of the business deal. However, cloud kitchens and managed cloud kitchens bring an entirely new business model which does not fit as easily into these standard forms. Given that this business model remains a relatively new development, all the stakeholders involved are still learning and adapting the logistics of it, including, how their respective leases should be drafted. There are unique considerations when it comes to drafting a lease for a cloud kitchen or managed cloud kitchen.

Cloud kitchens explained

Cloud kitchens have gained popularity throughout North America in the last three years and are operated by rapidly maturing start-ups such as Kitchen Hub, Kitchen United, Virtual Kitchen Co and Cloud Kitchens. These cloud kitchens are centralized commercial food production facilities where anywhere from one to two dozen restaurants license space to prepare food only for the purpose of delivery or take-out orders.[2] In this model, multiple restaurants are housed under one large roof often located outside of the primary high rent retail area, but near densely populated areas within delivery distance of targeted customers. These restaurants are provided turn-key kitchen space optimized for delivery and take-out so that they can expand their off-premises sales.[3] The kitchens are already equipped with the necessary kitchen equipment in which each restaurant needs to cook their food: "Picture a large warehouse with numerous stations (mini-restaurants) of stainless steel prep tables, hood vents, stoves, ovens, and sinks, each with its own orders coming in direct from customers."[4] Kitchen Hub has opened up three of these cloud kitchens in Toronto, and licenses kitchens to restaurants such as Pai Northern Thai Kitchen, Chubby's Jamaican Kitchen, Piano Piano, Cabano's Comfort Food, Gusto 101, Greenhouse Juice and the Cheescake Factory Bakery.[5] Customers in the areas outside of the central business district can now enjoy the same quality food from restaurants located in downtown Toronto by ordering take-out or delivery from the "Kitchen Hub Food Hall" via any of the major delivery apps.

Cloud kitchen operators lease the physical space directly from a landlord, and license out the kitchens they house to individual restaurants for use. These operators act more like a landlord to these individual restaurant brands, rather than as a food producer themselves. In addition to kitchen space, storage space, equipment, driver parking, waiting areas and check-in stations, reduced delivery fees and the general infrastructure provided, each cloud kitchen operator provides restaurant licensees with additional services that make the food distribution centres run smoothly. Such services may include: customer service; maintenance; security services; marketing; acting as the middle person between restaurants and delivery apps/drivers; receiving, managing and packaging orders; dealing with order pickups; and maintaining food standards by ensuring proper packaging, correct orders, food safety and food quality. By focusing solely on the production of the food itself, restaurants are able to save money with respect to staff, real estate and expenses (including overhead costs such as furniture, tableware, parking spaces, décor and signage), and not incur the risk that comes with operating a full-fledged restaurant location. It's a quicker and cheaper way for existing brands to launch in different locations and expand their existing business, while allowing them to cut down on the cost of equipment, deal with less legal paperwork and start selling their food almost immediately.[6] In return, cloud kitchen operators are able to experiment with different dining concepts that can easily be switched out with little cost if they aren't as success in a particular location.

Leasing considerations for cloud kitchens

Given the unique business model of the cloud kitchens and managed cloud kitchens, certain standard lease provisions commonly found in restaurant and foodservice leases must be varied to

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[2] Ashley Colpaart, *Everything You Need to Know about Cloud Kitchens (a.k.a. Ghost Kitchens) in 2020* (December 2019), online: The Food Corridor < https://www.thefoodcorridor.com/2019/12/05/everything-you-need-to-know-about-cloud-kitchens-aka-ghost-kitchens-in-2020/> [*Food Corridor*].

[3] *What we do*, online: Kitchen Hub < https://kitchenhubfoods.com/what-we-do?> [*Kitchen Hub*].

[4] *Food Corridor*, *supra* note 1; See also Amelia Lucas, *Delivery is stretching restaurant resources. Ghost kitchens can be the answer* (August 2019), online: CNBC < https://www.cnbc.com/2019/08/14/ghost-kitchens-can-be-the-answer-when-delivery-stretches-restaurant-resources.html>.

[5] *Kitchen Hub*, *supra* note 2.

[6] Roaming Hunger, *Guide to Ghost Kitchens (2020): All You Need to Know* (February 2020), online: <https://roaminghunger.com/blog/15623/ghost-kitchens-everything-you-must-know>.

accommodate the cloud kitchen business model, which includes providing flexibility for the potential turnover of restaurant licensees operating within the cloud kitchen.

At the same time that a cloud kitchen, as tenant, requires revisions to certain lease provisions that are commonly found in restaurant/foodservice leases to accommodate their business model, cloud kitchens also act as sublandlord with respect to their restaurant licensees and need to be capable of pushing down lease obligations to their restaurant licensees.

The Lease

Outlined below are the key issues that should be considered by commercial leasing lawyers when drafting a lease between a landlord and a cloud kitchen tenant.

(a) Transfers:

Typically, the right of the tenant to assign or sublease a leased premises is subject to the landlord's consent. The typical transfer provisions may require the tenant to: (i) provide the landlord with information with respect to the proposed transferee, including without limitation, the transferee's financial background and business history; (ii) provide the landlord notice within a specific time period; (iii) enter into a written agreement with the landlord and transferee with respect to the transfer; (iv) pay an administrative fee or such other fees as the landlord requires or any costs the landlord may incur; (v) only transfer to a business with a specific use; (vi) pay increased rent as of the date of the transfer; and (vii) pay the landlord an amount equal to any cash, goods or services the tenant receives from the transferee as consideration for the transfer. In addition, the transfer provisions may provide the landlord a right of termination if the tenant requests that the landlord consent to a transfer. As such, the transfer process can be quite onerous and time consuming for tenants.

Cloud kitchens are based on a model which provides for the replacement of restaurant brands licensing kitchens in their space. Because cloud kitchens are designed with tech in mind and analyzing data with respect to consumer preference and demand, cloud kitchen operators require the flexibility to switch out restaurant brands who use their space based on such data, and also due to the possibility of a brand choosing to stop licensing a kitchen due to its individual business needs.[7] For example, brands may only license space in a cloud kitchen for a season in order to take advantage of seasonal demand. These business choices cannot be restricted by a landlord's consent requirements. While the typical provisions requiring the landlord's consent for a transfer may be included in a cloud kitchen lease with respect to the whole of leased premises, there must be a carve-out with respect to the operator licensing out the individual kitchens within the leased premises without the landlord's consent. The typical transfer provisions are designed to account for a transfer to an individual transferee, rather than multiple licenses or sublets. Requiring operators to request the landlord's consent based on the requirements outlined above every time a kitchen is to be licensed out would make it difficult to carry out the cloud kitchen business and would pose many risks for operators. The carve-out may require a new licensee to use the kitchen for food production purposes, however, the landlord cannot require the licensee to produce a specific cuisine.

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[7] See *Food Corridor*, *supra* note 1.

(b) Use:

With any lease, the use clause is a fundamental provision. When drafting this provision, the landlord and tenant have conflicting goals: the tenant is concerned with the right to use the premises for its business and ensuring it has flexibility to evolve its business, while the landlord is concerned with controlling the uses within its property and restricting the tenant's use of the premises to a specific purpose. Cloud kitchen operators have the same concerns as the typical tenant, however, they require an even broader use clause to ensure they can license space out to multiple different restaurant brands and adapt to meet consumer demand/preference. A narrow use clause would restrict the entire business model.

While a landlord may insist on their precedent narrow use clause, it must consider that the control of a tenant's use is mainly necessary in the context of balancing multiple tenants and competing exclusives to ultimately protect tenant mix within a development. Given that cloud kitchens often rent out the entirety of industrial spaces in less popular areas, landlords must understand that the same issues that exist when negotiating these clauses with tenants of shopping centres or other multi-tenant properties do not exist when negotiating with cloud kitchen operators. That being said, cloud kitchens are increasingly working with shopping centre landlords to re-imagine how space can be used and the tension between a landlord's desire to control the uses, right down to the specific cuisine of a restaurant, and the cloud kitchen tenant's desire for flexibility will inevitably be the subject of negotiation.

In cloud kitchen leases, use clauses must account for the fact there are multiple different restaurant uses in the leased premises and that cloud kitchens are designed to evolve based on consumer data. Given this, in such a deal, there are two things that must be considered when drafting such a use clause: (i) restaurant licensees may be switched out; and (ii) restaurant licensees may want to change their menu to suit business needs. Similar to the concerns with transfers outlined above, cloud kitchen operators will not want to seek consent every time there is a new restaurant use, as restaurant brands/uses will always be changing. In these deals, the use and transfer provisions are intertwined, as every new restaurant licensee brings a potentially new restaurant use as well.

Typically, a restaurant use clause will state that "the tenant will use the leased premises solely for the purpose of conducting the business of a restaurant serving [blank] cuisine, under the advertised name [blank]". The clause is tied to a specific brand and may state that the food is for onsite consumption, and possibly as ancillary to such use, delivery/take-out. In contrast, a use clause for a cloud kitchen will be drafted for the purpose of general restaurant use and will not specify the specific cuisine being served or the specific brand serving it. Instead, the use clause will provide that: (i) multiple restaurant brands will be using the leased premises to prepare different types of cuisine; (ii) the restaurant brands and cuisines are subject to change; and (iii) the leased premises is for the purpose of the production of food for off-site consumption (i.e. take-away or delivery), although some cloud kitchens may also contemplate limited on-site consumption.

(c) Operating Hours:

Because cloud kitchens are designed with tech and consumer data in mind, not being tied to a physical location means you can change operating times to suit business needs. Using consumer data, restaurants can determine what types of foods to produce for specific neighborhoods, but also when the demand is likely to be greatest. [8] For example, hot wings tend to be really popular between 11pm-2am near college campuses. [9] A cloud kitchen lease will have to account for the fact that a cloud kitchen's operating hours may not match the standard business hours of a typical brick and mortar restaurant and are subject to variation. Each restaurant licensees' hours of operation may vary as well.

Typically, a lease will state that "the tenant shall occupy the Leased Premises throughout the term and the Leased Premises shall be continuously, actively and diligently operated, fully fixtured, stocked and staffed on such days and during such hours as the landlord determines from time to time." If the tenant does not carry on its business during such hours and on such days as the landlord requires or permits, the tenant may be required to pay as additional rent to the landlord "as liquidated damages and not as a penalty" a certain daily fee for every day that the tenant is in default.

A cloud kitchen lease cannot restrict the operator's or licensees' hours/days of operation, as the times of operation will constantly fluctuate based on the data received. Licensees may not operate continuously due to this.

As typically required in leases, the cloud kitchen tenant must satisfy itself that the zoning of the lands comprising the leased premises permit its intended use and operating hours, and more specifically, unrestricted operating hours.

(d) Demised Premises and Common Areas:

One of the defining characteristics of cloud kitchens is that they are designed to operate in both the physical world and the digital world. The focus of cloud kitchens on delivery and on-site consumption means the cloud kitchen operators use physical space differently than other restaurant or foodservice tenants.

In a typical commercial lease, the tenant will be entitled to use certain common areas serving the building its leased premises is located in. These common areas include areas, facilities, utilities, improvements, equipment and installations of the building which are not leased out by the landlord to any tenant and are meant for the benefit of all tenants of the building. Common areas may include parking areas, access roads, package pick-up stations, loading areas, stairways, washrooms, janitor rooms, security systems, plumbing, any central HVAC system benefiting leasable premises, storage facilities, etcetera. As previously mentioned, the landlord is typically responsible for the maintenance and repair of the structure of the building and the common areas.

By accommodating multiple licensees within a single commissary style facility, cloud kitchens are designed to operate with more employees and higher revenues per square foot. The entire

[8] *Food Corridor*, *supra* note 1.
[9] *Food Corridor*, *supra* note 1.

model is based upon maximizing the productivity of the given space. This impacts not only the cloud kitchen tenant's use of its own demised premises, but also impacts the landlord's common areas. For their efficient operation, cloud kitchens require high accessibility for delivery driver and customers. Not only is the number and location of parking stalls critical, but stalls turn over with high frequency. Whereas a typical dine-in customer may use a parking stall for anywhere from 30 minutes to 1.5 hours, a delivery driver is unlikely to use the stall for more than 10 minutes. This frequent turnover leads to more traffic in and out of the landlord's centre and may impact other aspects of the landlord's design of its parking lot, access points, in-lot signage, etcetera.

(e) Operating Costs and Utilities

Typically, in a net lease, a tenant is required to pay its proportionate share of operating costs incurred by the landlord with respect to the leased premises, the building it is located in and common areas. Operating costs include the costs and expenses incurred in owning, operating, maintaining, managing and administering the building and the common areas, including without limitation, taxes, insurance, cleaning, waste disposal, utilities, security, supervision, traffic control, salaries of personnel employed in connection with the building, the cost of providing parking and all capital/non-capital repairs, replacements and maintenance of the building and common areas, including the equipment, fixtures and facilities comprising the building and common areas. While these standard provisions may be included in a cloud kitchen lease, the corresponding license agreements must account for how these operating costs incurred by the tenant can be distributed fairly to licensees. Cloud kitchen operators must consider that all kitchens in the leased premises may not be licensed out at certain times as well.

With respect to utilities, in a typical lease the tenant is responsible for all charges with respect to heat, water, gas, electricity or any other utility used or consumed in the leased premises. The charges are based either on separate meters, or if no separate meters are possible, on the basis of an equitable allocation determined by the landlord. There are many issues that arise with respect to the distribution of charges for utilities to licensees in the case of cloud kitchens. Is it possible to separately meter utilities between kitchens? If the kitchens are not separately metered, how will the cost of utilities be allocated to licensees? Will the cloud kitchen operator simply charge utilities based on each restaurant's proportionate share (which is in turn based on the identical square footage of each kitchen)? Will licensees be charged a pro rata share of all utilities consumed in the leased premises depending on how many licensees are occupying the kitchens? Or will the operator equitably allocate the utilities? Does the operator have the expertise to make this equitable allocation, or do they have to hire a consultant (who's charges must in turn be charged to the licensees)? These are important questions to ask as certain restaurants will consume different amounts of utilities based on the way they prepare food. For instance, some restaurants may consume more electricity by plugging in more appliances or consume more water in their food preparation techniques.

(f) Repair, Maintenance and Improvements

In a typical lease, tenants may not make any alterations, additions or improvements, including, the installation of equipment, fixtures and improvements in the leased premises, without the consent of the landlord. All alterations, additions or improvements made by the tenant remain the tenant's property and must be removed from the leased premises upon the expiration or earlier termination of the lease at the option of the landlord. However, all leasehold improvements erected or installed by the tenant which cannot be removed without damage to the leased premises become the property of the landlord and cannot be removed, unless required or allowed by the landlord. In designing its facility, a cloud kitchen operator needs to be mindful of making its physical space flexible and adaptable, so that restaurant equipment can be moved and appliances that use electricity, gas and water can be "plug and play" and capable of being relocated without damaging the premises and without requiring landlord consent.

In a cloud kitchen, each restaurant licensee's kitchen will include standard equipment. Kitchens could include: reach-in coolers and freezers, prep tables, ranges, grills, fryers, stoves, etcetera. However, restaurants use many different methods of food production and may require different equipment, fixtures or appliances to do so. The tenant, as licensor, must consider whether licensees are allowed to make further alterations, additions or improvements to the kitchens, and whether these alterations, additions or improvements remain the property of the landlord once they leave. Given the potential quick change of licensees, will the landlord want to allow licensees to remove these improvements once they leave and take time to repair any damage from such removal?

In addition, typically a tenant will be responsible for the maintenance and repair of the leased premises, and all fixtures and equipment therein, while the landlord is only responsible for the maintenance and repair of the structure of the building and the common areas. Given that the cloud kitchen operator is licensing out existing kitchen equipment, will the operator want the licensee to be responsible for the repair of such equipment? Will the operator be responsible for all maintenance and repairs? If the licensee installs additional equipment and appliances, is the licensee responsible for the repair and maintenance of such equipment and appliances?

(g) Insurance

Typically, a lease will set out the insurance obligations of the landlord and the tenant, and allocate risk between each party. In most cases, a mutual release is provided for where each party releases the other with respect to damages and losses that are covered by the insurance of the releasing party. For example, if the tenant is required to insure its personal property in the leased premises, the landlord will be released from any damage to such personal property. If the landlord is required to ensure the building, the tenant will be released from any damage to the building. It's important to consider the insurance coverages and limits the cloud kitchen will need as a tenant itself, but also, what insurance licensees will be required to hold and what risk they will be responsible for.

(h) Percentage Rent

Some commercial leases require a tenant to pay percentage rent. Percentage rent is paid in addition to minimum rent and is an amount equal to a certain percentage of the tenant's gross sales. Percentage rent is paid as consideration for the landlord providing a shopping environment that will generate gross sales for a tenant. The landlord wants a share of the financial success it contributed to. A landlord may agree to a lower minimum rent in return for percentage rent.

Given that cloud kitchens are often located in industrial or lower-rent areas, and not in a multi-tenant development, percentage rent may not be a requirement of the landlord as they have done nothing to contribute to the success of the cloud kitchen. That said, cloud kitchens are increasing found in the types of facilities that have traditionally included percentage rent clauses. Given that the cloud kitchen business model is designed to generate higher sales per square foot, cloud kitchen tenants are likely to resist agreeing to percentage rent in their lease. In their role as sublandlords, however, cloud kitchen operators offer a multitude of benefits and services to restaurant licensees, as described above, and the licensees incur very little costs or risk in terms of an investment. As such, cloud kitchen operators will typically require licensees to report sales and pay percentage rent in addition to a base monthly fee (which includes minimum rent, operating costs and the cost of renting out the kitchen equipment).

Conclusions

When negotiating a cloud kitchen lease, the biggest mistake is to assume that cloud kitchens are simply another restaurant or foodservice user. The failure to recognize the differences between cloud kitchen and restaurants is likely to lead to frustrating, drawn-out negotiations. In the same way that drive-thrush have unique leasing considerations that are different from those of dine-in restaurant, lawyers and leasing professionals should seek a greater understanding of how cloud kitchens operate and the unique challenges associated with high-frequency delivery pickup.

In addition to the considerations outlined above that must be taken into account when drafting the lease between a landlord and a cloud kitchen, as tenant, cloud kitchen operators must consider, as sublandlords, the considerations that must be taken into account when drafting license agreements with restaurant brands, as licensees. In essence, cloud kitchen operators function as both tenants and sublandlord and must reconcile the requirements of each role.