Ghost Kitchens Present Unique Leasing Considerations

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A ghost kitchen, also known as a cloud kitchen, virtual kitchen, dark kitchen or test kitchen, is a professional-grade food preparation and cooking facility often intended to house multiple groups of operators simultaneously.

Most ghost kitchens not only serve as research and development labs for Michelin chefs and at-home dabblers alike, but also serve as a food delivery hub for meal subscription services, online-only businesses, catering companies and late-night delivery options for established brick-and-mortar restaurants.

Although ghost kitchens have been a widely used and invaluable resource for decades — and some say centuries, with origins dating back to 1889 Campania, Italy, when King Umberto requested that his pizzas be delivered from the village directly to his chambers — the ghost kitchens of today are experiencing a revolutionary boom.

This boom is in part a result of social media's intersection with transportation — think Uber Eats, DoorDash, Bite Squad, GrubHub — and in part due to the COVID-19 pandemic, which forced restaurateurs and food-service visionaries to come up with creative ways to provide sustenance in an economically feasible manner.

Ghost kitchens are typically located in industrial warehouse districts, parking garages, manufactured homes and other low-rent areas. However, as the pandemic brought government-regulated shutdowns, many inside dining establishments and their landlords were forced to consider creative ways to adapt otherwise high-rent, single restaurants into multi-tenant or multi-licensee facilities.

This article focuses on the unique leasing issues that arise in the growing use of nontraditional spaces as the ghost kitchen business expands from an underutilized niche market into a booming and prevalent industry.

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As there is no need to provide a customer view or experience in a ghost kitchen, there is no need to expend resources on dining rooms, wait staff, bar areas, decor and furniture, or premium storefront rent. Thus, food providers can instead channel resources toward quality food, recipe testing and social media marketing.

Established chefs with well-known, high-end brands have also developed and run other delivery-only concepts out of their brick-and-mortar restaurants to help subsidize costs of operations during the COVID-19 pandemic.

Not only have ghost kitchens provided an opportunity to existing food companies and landlords to maintain revenue streams, but they have also provided a new avenue for restaurant testing and expansion, both in commercial ghost kitchens and established restaurant kitchens.

For example, Jeff Crivello, the CEO of Famous Dave's of America Inc., announced in 2019 that the barbeque chain planned to open a chain of delivery-only fried chicken restaurants. These are independent entities, but they exist and operate solely out of the Famous Dave's kitchens, and they are delivered exclusively through GrubHub.

Famous Dave's serves as the landlord for these new fried chicken franchises and apportions part of its existing kitchens to franchise operations. This idea will allow Famous Dave's, and many other restaurants, to experiment with new restaurant and menu concepts while maintaining or even increasing revenue under an existing square footage and kitchen footprint.

With new opportunities come new legal questions and concerns, particularly when there are three or more levels of players in a ghost kitchen leasing scenario. Below, we assess the pertinent legal issues any landlord, tenant or licensee of a ghost kitchen should consider before contracting for kitchen space.

Term of Lease

The landlord, tenant and third-party licensee will need to determine the most profitable and appropriate term of lease.

If the tenant is using the space for its own operations, maybe a short 30-day renewable lease with the landlord is appropriate.

On the other hand, if the tenant intends to lease the space to multiple third-party licensees, maybe a longer-term lease with the landlord is appropriate for the tenant, but shorter 30-day leases or licenses are appropriate for each of the third-party licensees.

Third-Party Licensing

As discussed above, not all tenants are exclusively utilizing the ghost kitchen, and some tenants will not use the kitchen at all. Hence, insert the third-party licensee or licensees.

This opens the ghost kitchen to multiple different in-house brands under one roof, and increases rental income for the tenant and, in turn, for the landlord, if the lease is so negotiated.

Further, a license relationship as opposed to a tenancy provides greater control to landlords and creates fewer hurdles for landlords to overcome in the event that a licensee needs to be removed from the premises.

For tenants whose business structure does not currently include hosting third-party licensees, it's an advisable idea, as it could allow the tenant to offset its rental obligations to the landlord and provide additional income to the tenant's business.

Before engaging with potential third-party licensees, tenants should carefully read the terms of the underlying lease to determine whether such activities would be permitted.

Ability to Adjust Concepts

Tenants and third-party licensees will want to ensure their lease at the ghost kitchen has minimal to no permitted use restrictions regarding types of cuisine to ensure adaptability of food concepts and competitiveness in the food service market.

Tenants considering the third-party licensee arrangement should confirm that there are no restrictions or exclusives in their underlying lease that could create a default.

Percentage Rent Provisions

A tenant whose lease contains a percentage rent provision will want to make sure that they understand how adding additional users' income will affect their rental obligations, and provide for a financial sales reporting mechanism from other income generators within the premises.

This begs the question: Will this be more challenging with less sophisticated operators who may not have the same systems in place to capture accurate sales?

Hours of Operation

Landlords, tenants and licensees will want to carefully consider the hours of permitted use of the kitchen, not only to ensure optimal customer connection, but also to mitigate overhead costs.

As one can imagine, this is a polarizing concept for the licensee and the landlord.

Most ghost kitchen licensees will want to operate out of a 24/7 kitchen to ensure late-night concepts as well as mainstream food service are possible.

Conversely, a landlord will see the increased utility cost associated with round-the-clock operations, and may want mandatory closure during certain times or days. They may also require the tenant to reimburse such utility costs if the tenant is not otherwise responsible for the costs already.

Indemnification

Multiple users operating simultaneously out of the same kitchen, coupled with constant third-party delivery service interactions, breeds potential for liability.

Questions abound, including: Who is on the hook if something goes wrong? Who is liable if food temperature or cleanliness standards are not adhered to and a customer gets sick? Who is liable if a ghost kitchen tenant or licensee is injured in the kitchen?

Landlords should consider requiring approval over any third-party licensee leases with the tenant, and they also should negotiate indemnification clauses in their lease with the tenant to include broad breach-of-lease provisions that cover all operations on the premises, any licensees and any third-party deliver company interactions.

The landlord may also want to require licensees to provide landlord indemnification in the licensee's lease with tenant.

Allocation of Maintenance and Repair Obligations

The lease should clearly state the party or parties responsible for relevant kitchen repair, inclusive of premises utilities as well as kitchen fixtures such as stoves, refrigerators and sinks; maintenance; regulatory obligation; permits; and tenant build-out of the kitchen space.

O**ccupants and Landlord Insurance**

The landlord should consider requiring both the tenant and licensees to provide proof of insurance prior to occupying the premises.

Further, the landlord and tenant should carefully assess appropriate insurance coverage and thresholds required for renting space in the kitchen.

Signage

The landlord should determine the appropriateness of signage at the ghost kitchen facility.

Questions to consider include: Does the facility have the signage of the landlord or of the tenant? Is each licensee permitted to place commercial signage on the premises? If so, does the landlord wish for there to be a uniform signage scheme?

Fees and Utilities

Streamlining all ghost kitchen operating costs into a single, all-inclusive monthly rate is an appeasing feature, allowing licensees to focus on the creation of food without having to worry about variable additional costs such as utilities, maintenance, cleaning services and insurance.

However, the landlord and the tenant must weigh the appeal of a flat monthly rate against projected operating costs to ensure profitability.

These costs should be carefully considered and negotiated prior to lease signing.

Early Termination Rights

At the heart of the ghost kitchen concept is the idea and appeal of a transient, easily accessible kitchen.

It is imperative that tenants and licensees have a clear understanding of their termination rights under their lease, whether termination is simply after a month of playing with ingredients, or after several years of developing a menu to be transitioned into a brick-and-mortar establishment.

Lessees will want to negotiate terms for termination of their lease, as well as early termination penalties.

Due Diligence

Landlords, tenants and licensees should inquire into and fully understand the condition of the premises as it will be delivered for use.

If the kitchen will be used in collaboration with food delivery services, the tenant and licensee should ensure there are adequate loading docks and parking to transfer food to the drivers.

Further, the tenant and licensee should ask themselves the following questions:

- Are the utilities on the premises adequate for a commercial kitchen? What about kitchen fixtures, such as stoves, refrigeration, storage and specialty cooking stations?
- Will the space meet local, state and federal regulatory standards?
- Are any permits or signoffs required before the tenant and/or licensee can begin operations? If so, who is responsible for obtaining such permits and signoffs?
- Does the zoning of the property allow this type of use from the premises?

A negative answer to any of the above inquiries could severely hinder a ghost kitchen business model. Negotiating the specifics of the kitchen's operational capacity should be carefully considered before any lease is signed.

Despite their name, ghost kitchens are tangible, accessible and creative havens for foodies and restaurateurs to not only invest in the quality of their menus, but also to stay afloat during trying times in the hospitality industry.

While the COVID-19 pandemic has increased the need for commercial, nontraditional kitchen space, this need is far from temporary.

As illustrated by the new Famous Dave's fried chicken model, ghost kitchens provide an economical business model for restaurants, as long as liabilities and allocated costs are carefully negotiated before lease signing.