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Ghost Kitchens' and Virtual Kitchens' Intersection with Franchising

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Introduction: The History and Nomenclature

The roots of online food ordering, considered one of the early disruptors in the restaurant business, can be traced back to a 1995 Silicon Valley startup called World Wide Waiter (now Waiter.com). As the first company on the internet to offer diners an aggregation of available local options for delivery, it sparked a flame of ingenuity in adding convenience and access to the restaurant industry that has continued to gain velocity at exponential rates. There have been countless other order aggregators, delivery services, and spinoff ideas spawned from this early disruptor. But what was the impact of this new sales channel for restaurants on infrastructure and brand development?

Over the years, many restaurant operators have innovated, experimented, and optimized their brands for success on the digital forefront. As objectives began to diversify, so too did the development of ingenious solutions to explore their possibilities. We have seen the creation of delivery services to provide scale where it did not exist for restaurants, the development of kitchens without serving facilities, and a rash of technology solutions for problems we did not know existed. What was seen as a cottage industry barely two decades ago has become by all accounts the greatest frontier ever encountered in commercial foodservice.

Over the past ten years, the growing adoption of technology, coupled with the rise in consumers dining outside their home, has contributed to rapid development in the restaurant and franchising industries. As the fight for market share, variety, and sustained profitability took center stage, we saw a growing battle for innovation with incredible heights achieved leading up to (and during) the Covid-19 pandemic. From established titans to startups, a variety of individuals and companies have contributed to the ever-growing lexicon of the restaurant industry. Much of today's innovation in the restaurant space is centered around businesses with a primary focus on delivery or off-premise food consumption. Restaurant franchisors and franchisees will likely find themselves considering how to best address needs in these areas. The authors of this paper have attempted to define the various models with the most commonly understood characteristics and will refer to them as such in the later sections of this paper. "**Ghost Kitchens**" will refer broadly to each of the first four models described below as the umbrella category that each such model falls within. Each component of the food delivery ecosystem is supplemented with an example of how a given restaurant brand, franchisee, or independent, *Restaurant X*, may potentially exist within each category.

- "**Cloud Kitchens**", often used interchangeably with "dark kitchens" and "ghost kitchens", are facilities that have been designed solely as kitchens without any in-person dining facilities. Orders are received in advance from a digital format, including Aggregators (as defined below) or the restaurant's own digital platform. Cloud Kitchens may or may not have their own delivery drivers, contracts with delivery services, pick-up areas, or drive-through windows. In no instance are they to have an area for customers to dine on premises or order at the site. These facilities tend to be unmarked and located in inconspicuous neighborhoods with easy access to a dense delivery radius. The original intent of Cloud Kitchens was to offer a way for brands to gauge demand in new markets, conduct promotional pop-ups, or test new concepts with a low-risk, short-term residency. The objective was public relations, marketing, or research and development, not profitability. Historically, factors that affected long-term or significant profit-generating opportunities included high rents, low beverage sales, all sales incurring delivery fees, limited visibility, and a singular revenue channel. More recently, these opportunities have evolved to shared facilities with varying degrees of services offered by developers and operators to ease the burden faced by a single tenant. For example, an owner of a Cloud Kitchen facility may negotiate lower rent, lower delivery fees, or offer labor support services to their tenants as a component of the rent and fees. These facilities are now also being used or considered across other industries such as retail and grocery.

Restaurant X is considering entering a new market but is unsure of the likelihood of success of their concept. It may rent a space for a short-term period in the market with the delivery area most representative of its target audience. The brand may even operate under a code name to conceal its identity. If the tests achieve the desired metrics, Restaurant X may choose to develop permanent store locations in this market.

- "**Managed Cloud Kitchens**" are Cloud Kitchens which are not available for rent by outside tenants or operators. They serve a similar purpose to a standard cloud kitchen; however, the owner/leaseholder operates either their own brand(s), a collection of franchised or licensed brand(s), or provides catering services for high-volume applications. Typically, these are in dense, high-population locations with a consistent frequency of sustained demand. There may be dozens of concepts operating in one facility.

  Restaurant X desires to enter a new country. Establishing operations may be too challenging to operate directly. To introduce itself to a new market while generating sales and avoiding the costs and inefficiencies of entering a new country for testing, Restaurant X may grant a license to a managed cloud kitchen operator to produce and sell its items and report back results. Restaurant X may decide to develop in that market or continue to exist in a limited capacity through the managed cloud kitchen.

- "**Host Facilities**" (such as the Host Kitchen® concept owned by Franklin Junction) are existing foodservice operations such as restaurants, hotels, grocery stores, convenience stores, venues, commissaries, etc. that supplement their primary operation with additional concepts for delivery-only. Their objective is revenue optimization as Host Facilities typically do not require capital investment and are not purpose-built for delivery-only concepts. From the perspective of branded concepts, Host Facilities offer an opportunity for restaurant/foodservice development in new areas without investment in new brick and mortar stores.

Restaurant X has conducted an analysis of its store locations and found that existing equipment, infrastructure, and labor are not maximized on a consistent basis. Restaurant X partners with other brands who want to grow in the same locales and have a menu that can be produced on the same equipment Restaurant X is underutilizing. Restaurant X supports its stores in becoming a Host Kitchen® for these other brands and producing food for delivery-only to generate incremental revenue at a substantially higher margin while maximizing its existing infrastructure to drive company-wide profits. The hosted brands would not have any presence in Restaurant X's premises other than the production of their branded products in the kitchen for delivery services to pick up for order fulfillment.

- "**Brand Platforms**" are companies serving as creators and incubators of new content for use in a virtual capacity. Sometimes referred to as virtual restaurants, ghost restaurants, or virtual concepts, these are specially designed concepts that exist only online, most often as Aggregators, and may be produced out of a Cloud Kitchen, Managed Cloud Kitchen, or Host Facility.

  Restaurant X may employ the services of a Brand Platform to help develop a virtual concept that can be created using the same menu items or ingredients that already exist in its space. Restaurant X knows that chicken wings are popular on their menu. They may take this subset of their menu and create a wing-centric brand with the assistance of a brand creator and then offer it for delivery-only as a separate listing on the Aggregator services.

In addition to the abovementioned categories of Ghost Kitchens, there are also two additional terms that are often used in the Ghost Kitchen lexicon that warrant explanation here:

- "**Aggregator**" services primarily function to collect the availability of restaurants in a given area; provide information to customers such as menus, pictures, ratings, reviews, promotions, etc.; and, more recently, take delivery or pickup orders, reservations for dine-in, and/or consolidate orders between multiple restaurant sources.

  Restaurant X would enlist the services of Aggregators to list the availability of their restaurant and also originate orders from various digital channel. This would serve as the primary source that consumers use to learn about the restaurant's availability of options, how to access them, and the consensus on the quality and value of Restaurant X from other customers. Some well-known Aggregators include UberEats, DoorDash, and Postmates.

- "**Kitchen Technology Solutions**" often get conflated with Aggregators and Brand Platforms. These technology solutions are hardware and/or software products that are used to manage the ecosystem of food delivery. There are companies that aggregate sales from other Aggregators such as combining the inflow of orders from multiple delivery service companies. There are also products that help manage standard business needs such as point of sales systems ("**POS**"), labor/HR management, food cost/inventory management, and accounting services. Kitchen Technology Solutions are rapidly evolving and has many sub-layers in itself. These may or may not be bundled with infrastructure solutions.

Restaurant X uses a point-of-sale device with integration services to manage the various sales channels into a singular order management system. This allows for consolidated revenue accounting while providing for the store operations teams to receive orders from various concepts, sales channels, and aggregators to arrive at a common terminal in the kitchen for production and routing.

As these categories get crowded with various players and new categories are born, it is of the utmost importance to conduct due diligence to understand competencies, services, and any potential conflicts that may exist due to shared ownership or investment across the various verticals. It is also quite possible the competitors in one area may serve as clients or partners in another area.

From a business perspective, it is a matter of survival for restaurant companies, whether franchised or not, to seek out the best fit for their strategic growth. This growth can be divided into market share, profitability, and accessibility. While not every opportunity is a fit for every brand, the changing need-state of consumers will dictate which method of fulfillment they choose. It is incumbent on franchisors and their franchisees to collaborate on if and how they will have a strategy to defend (or grow) their market share based on shifting consumer needs.

Partnering with Franchisor Business Units and Getting Key Stakeholders Involved

Ghost Kitchens represent a new frontier in the franchising and restaurant industries, and pose unique business and legal considerations. This section of the paper will examine certain practical considerations that impact how businesses interact with Ghost Kitchens, and will be followed by an examination into the legal considerations at play. Recognizing that the considerations for Ghost Kitchens in the non-franchised space are an entirely different conversation, this paper will focus on the intersection between Ghost Kitchens and franchising, although in some instances that might include expansion through corporate or affiliate-owned units. In the following section, we will also review some key business terms likely to be included in any franchise agreement that will likely need to be re-evaluated to suit the Ghost Kitchen context.

A. Different Operator Models

Different Ghost Kitchen providers ("**Providers**") will have different operating models, as briefly described above. Some Providers will want to function as the franchisee themselves, and to actually operate the restaurant (the "**Operator Model**"). Others will be interested in licensing or leasing space to a franchisor or its existing franchisees to operate their business (the "**Landlord Model**"). Both of these models will involve different considerations for a franchisor. With the Landlord Model, a franchisor will need to review the lease agreement and determine whether there are any objectionable clauses or terms that differ from its normal expectations (some of which are described below, including but not limited to length of term or restrictions on product offerings). The franchisor may have 'standard' terms and conditions that it requires in all of its leases. Do those provisions still make sense in a Ghost Kitchen context? For instance, if a franchisor requires all franchisee leases to include a provision whereby the franchisor can assume the lease in the event of a franchisee default, is that still relevant in the Ghost Kitchen context? Do not try to automatically apply standard thinking here. As just one such example, the content of a co-tenant's lease may be relevant in this analysis, as there may be provisions that prevent this standard arrangement, like negotiated rights of first refusal in favor of the other co-tenants for additional space within the Ghost Kitchen.

A franchisor may have the option to lease directly from the Provider and then sublease to selected franchisees, or the franchisor may require its franchisees to lease directly from Provider. It is important for the franchisor to understand the Provider's lease agreement even if the franchisor is not contracting directly with the Provider and instead is approving the relationship as an option for its franchisees. Will the franchisees potentially experience direct competition from within their Ghost Kitchen? Will all tenants be on the same form of lease?

Frequently, the Provider may include some brand licensing considerations in its form of lease agreement. For instance, the Provider may require the franchisee to sublicense the franchisor's marks to the Provider for some usage on its website, signage, or marketing materials. The franchisor must either permit this, and ensure the franchise agreement permits the franchisee to sublicense its marks, or enter into a separate agreement with the Provider to directly license its marks for these purposes.

The Provider may also include the right to utilize menu items for its own use – perhaps to sell the menu items under different names on its own behalf, or to create new recipes using the franchisor's available ingredients – or other provisions that the franchisor may not be used to seeing. In these situations, which amount to a Brand Platform within a Cloud Kitchen, it may be desirable for the 'lease' to be a multi-party agreement between Provider, franchisee, and franchisor.

If the Provider uses the Landlord Model, there is also the question of which franchisees are approved to operate a Ghost Kitchen. The franchisor must consider whether it wants to offer this option only to experienced franchisees who understand the franchisor's existing business model, or whether this option will be available to new franchisees who are learning the franchisor's business through this experience. Existing franchisees who already have experience with the franchisor's brand will understand the franchisor's brand expectations, which may facilitate a standardized consumer experience whether purchasing from a Ghost Kitchen or a 'traditional' location. Existing franchisees may also serve as good 'test' partners as they may be more willing and able to work through new issues and surprises that come up as the franchisor first enters into new territory with Ghost Kitchens. There is also a known track record with existing franchisees, which provides for better comparative analysis.

On the other hand, the franchisor may envision Ghost Kitchens – with some of their lower investment costs and nonstandard competition considerations as discussed later in this paper – as a good opportunity to reach a pool of prospective franchisees who would not otherwise be eligible to operate a 'traditional' site. For example, a franchisor may determine that it has lower liquidity requirements to approve a franchisee to operate a Ghost Kitchen, since the investment costs may be lower, or the franchisor may be comfortable approving franchisees who operate competitive brands to operate a Ghost Kitchen where they would not otherwise be able to operate a 'traditional' site. Determining which franchisees are approvable for the Ghost Kitchen opportunity will also play a key role in determining whether exemptions from disclosure requirements may be available, as we will discuss later in this paper. A franchisor should also consider whether it wants to be the exclusive operator of its Ghost Kitchens – or to do business exclusively with Providers under the Operator Model – until the franchisor better understands the model and how it can translate to franchisee operations (this approach may also be helpful in building the franchisor's franchise disclosure document ("**FDD**")). This is also particularly advantageous when one franchised brand owner offers multiple different brands and can test all of its sister brands under one Ghost Kitchen roof.

The franchisor's site approval process will also need to be considered when engaging with Ghost Kitchens. The franchisor's standard site approval process may not be readily translatable to the Ghost Kitchen context, and must take into account certain considerations – such as delivery radius and proximity to competitive brands – differently than might be considered for a traditional location. There may also be different considerations for site approval depending on whether the Operator Model or the Landlord Model is used. Under the Operator Model, the Provider may operate the franchisor's brand out of multiple sites. It will be easy for the Provider to have a 'birds-eye view' of which products are selling well in which trade areas, and if they have multiple Ghost Kitchens set up, it may be relatively cost efficient for the Provider to shift a franchisor's brand to another location. The franchisor must consider its level of comfort with this: should it permit complete flexibility to the Provider, pre-approve relocations within a certain radius, pre-approve a specified list of locations, or retain advance approval rights over each relocation? Under the Landlord Model, the franchisor's site approval process may still be impacted. The Provider may offer certain franchisees opportunities to relocate or expand to their other Ghost Kitchen sites. The franchisor must determine whether or how to update its normal site approval process in order to support franchisees in being able to quickly take advantage of these opportunities. This flexibility will require thinking through issues such as proximity (can Ghost Kitchens be located closer to one another than a franchisor would typically permit for its traditional locations?) and cannibalization (if the franchisor pre-approves a site list, and a traditional location is subsequently added to the area, how might that traditional location cannibalize the Ghost Kitchen's sales, and vice versa? Will the existing Ghost Kitchen's sales suffer or will delivery orders continue to flow through the Ghost Kitchen, while in-person orders flow through the traditional location?).

B. Development and Relationship Provisions

In order to encourage franchisees to adopt a new Ghost Kitchen model, franchisors may need to offer additional flexibility not only in its site approval process, but also in other existing policies and procedures. Examples include multi-unit development, site closure approvals, approved transfers of ownership, and noncompetition/exclusivity provisions.

Granting multi-unit development rights in a single document may facilitate franchisees' ability to take advantage of the benefits of certain Ghost Kitchen formats. For instance, when working with a Provider that has multiple physical assets already in place, like in the Host Facility or Managed Cloud Kitchen models, an operating kitchen can likely get up and running very quickly. A franchise agreement which includes multi-site development rights empowers franchisees to move quickly on these opportunities. If a franchisor typically issues single-unit franchise agreements, making multi-unit agreements available may necessitate a significant adjustment in some of the franchisor's processes. Multi-site development rights may be an incentive for franchisees to embark on a Ghost Kitchen when it is still relatively new or untested with the franchisor's brand.

In addition to expansion and relocation efforts, franchisors must consider their closure policies and procedures. Approving a closure of a Ghost Kitchen location may involve different considerations than those for a traditional location. Leases may have shorter terms, the Provider agreement may have different requirements, and the economics of running a Ghost Kitchen location are likely to be different. Franchisors must be prepared to evaluate closure requests in the modified context of a Ghost Kitchen location rather than comparing them against a traditional location. In addition to reviewing their closure approval policies and procedures, franchisors will also be pressed to consider granting franchisees unilateral or restricted rights to close the location without the franchisor's approval. Even if the franchisor does not typically permit franchisees to terminate the franchise agreement (or, under a multi-unit agreement, the operating rights for a given site) unilaterally, it may need to consider doing so in order to give franchisees more comfort, especially if the franchisor is testing a Ghost Kitchen concept for the first time. Similarly, it may make sense to grant a shorter overall term of operating rights than the franchisor would normally grant for a traditional location. Contemplating such a shorter term is due to the uncertainty of the model, especially if it is new to the franchisor's system, and the fact that Provider leases are typically shorter than a commercial lease found at a traditional type of location, as discussed later in this paper.

Depending on the franchisor and its relationship with the franchisee in question, it may make sense to modify the franchisor's franchise agreement provisions related to franchisee assignment of operating rights/transfer of ownership. If the franchisee is new to the franchisor's system and only operates Ghost Kitchen locations, the franchisor may consider more restrictive transfer provisions, since the franchisor has specifically chosen this particular franchisee to operate Ghost Kitchen locations and wants to continue that specific business relationship going forward. On the other hand, if the franchisee is a Provider, the franchisor may need to be more flexible than usual with contractual provisions related to transfers of ownership as the ownership of the Provider may be in flux depending on the investment backing into the Provider's concept. If the franchisor's existing franchisees seek to operate Ghost Kitchen locations as well as traditional locations, no change may be needed.

Other relationship clauses to consider are the franchisor's positions on noncompetition – both during and after the term of the franchise agreement – and exclusivity. If the franchisor does not typically grant exclusive development or operations territories to its franchisees, the franchisor may reconsider this position as it relates to Ghost Kitchens, especially if the franchisor grants multi-unit development rights or if the franchisee is a Provider that is already well-entrenched in a specific region. However, this will ultimately limit the franchisor's ability to contract with other Providers in the region with slightly different Ghost Kitchen models.

Regarding noncompetition provisions, this is likely to be an area that requires a lot of internal discussion and planning for the franchisor. The franchisor is likely to have certain brands or categories of competitive offerings that it normally does not permit franchisees to operate during the term of a franchise agreement – and possibly also for some limited term after the franchise agreement expires or is terminated. For example, an ice cream franchisor may restrict its franchisees from 'doing business with' any other concept that serves mainly desserts, as a standard clause in its franchise agreement. In a Ghost Kitchen context, this restriction may impact multiple aspects of operations. A franchisee who is also a Provider is likely to operate many concepts as part of its business model – and out of the same address or kitchen. A Provider is not likely to be willing (or possibly able, depending on its existing operations) to enter into a contract that proves to be so limiting. Even if a Provider does not itself operate competing concepts, the Provider may nonetheless wish to lease space to another operator of these concepts which would still violate the hypothetical noncompetition provision in this case.

C. Design and Construction

Franchisors will need to re-consider almost every aspect of the traditional model when moving into Ghost Kitchen operations, almost from the ground up. Most franchisors provide standard design specifications to franchisees, to ensure consistency in customer experience across varying locations. In some Ghost Kitchen models, like Cloud Kitchens and Managed Cloud Kitchens, there may be no customer interaction whatsoever occurring on site, so the cosmetic aspects of design and branding for customer experience become less relevant. Knowing whether there will be direct consumer access to the Ghost Kitchen, or whether only delivery service providers or brand personnel will have access, will impact the design choices the franchisor makes.

Additionally, the physical assets of the building will likely be owned by the Provider rather than the franchisee, and the franchisee will have limited ability to affect the design and construction process regarding back of house layout. In most models, the space available for the brand operations will be reduced as compared to standard brick and mortar locations, which may lead to the need to redesign the actual equipment layout. Franchisor design and construction teams will need to understand the restrictions of the new space, and will need to work cooperatively with their franchisees in order to provide a design that accounts for the practical realities of the Ghost Kitchen model. Depending on whether specialized equipment is required for brand operations, in some instances the franchisor may defer completely to the Provider or to the franchisee as to the design of the Ghost Kitchen.

The design of the brand's operations within a Ghost Kitchen context will be affected by the particular Ghost Kitchen model. In some models, it may make sense to have a limited menu for operational simplicity, and therefore the equipment needed in the space may be different from what is needed in a traditional brick and mortar location. In other models, the Provider may include certain equipment or building elements in the kitchen rental package – such as HVAC or electrical hookups or even certain types of proprietary equipment such as sinks and walk-in fridges – and the franchisor will need to integrate its design expectations into the existing functionality of the space provided.

Food storage design is also likely to be affected, and will differ depending on the Ghost Kitchen model. In some models, food supplies may be stored off-site at a separate commissary facility and will need to be delivered or picked up several times a day. In other models, food supplies may be stored on site, but the storage may not be included in the franchisee's designated kitchen space. Instead, there may be communal storage or a designated brand storage area at a separate location in the building. Other practical issues regarding food safety and potential cross contamination must be considered.

If food storage in a Ghost Kitchen facility is communal, the franchisor must consider whether any of its products are proprietary and need to be kept confidential or in some way protected from access by other tenants in the facility. Franchisees that are not also Providers are very unlikely to have control over who the co-tenants are in a multi-concept kitchen space. Franchisors must work with franchisees <u>and</u> the Provider to understand the level of access that other tenants may have to a franchisee's supplies and whether there are remedies available if supplies are intentionally or unintentionally accessed by other tenants.

D. Site Access and Franchisor Inspections

Franchisors typically will retain some inspection or audit rights over the physical location of a franchised business for quality assurance purposes such as food safety inspections and brand protection. In a Ghost Kitchen, franchisors will need to work with both franchisees and the Provider to ensure that the Provider will grant the franchisor's representatives access as needed for these purposes. Franchisors may be required to give advance notice to the Provider to access a site even if it is accustomed to unannounced visits to its franchisees' businesses. Additionally, the franchisor, franchisee, and Provider must have a joint understanding as to which areas the franchisor will be permitted access, as most Ghost Kitchen models will have multiple brands operating within a single location. All franchisors will have confidentiality considerations and Providers will likely have an interest in ensuring that the franchisor's representatives only have access to certain brand operation and/or food storage areas. Imagine the practical challenges if one franchisor is permitted to inspect a site that also contains operations of a competitor, and gains access to the competitor's proprietary information. Furthermore, a franchisor must understand which areas franchisees will have actual control over so that it does not evaluate a franchisee's compliance with its policies and procedures based on areas that the franchisee does not in fact monitor. Finally, certain 'key points' of an inspection may differ among the different Ghost Kitchen models. For example, in a shared space, the actions of one tenant may impact the operations of all tenants (for instance, an open condiment bottle in one brand's designated 'kitchen' space may attract pests which affect all other tenants in the space). It is important that the franchisee, franchisor, and Provider work together at the beginning of the relationship to understand where the responsibility lies for enforcing standards in communal spaces.

E. Other Operating Standards

If a franchisor relies on an operating manual or other written policies to enforce operations standards, the franchisor should revisit each of these policies to determine whether they are applicable to the various Ghost Kitchen models in which it permits franchisees to operate. For instance, if the Ghost Kitchen space used by a franchisee is also used by other brands, can consumers order from multiple brands at once such that the order is ultimately packaged together? If so, a franchisor that normally requires branded outer packaging may need to change that policy so that items sold under the franchisor's brand can be efficiently delivered to the consumer without waste from separate packaging.

Certain operational requirements may also need to be revised under the various Ghost Kitchen models. For instance, if franchisees are typically required to organize the food preparation line in a certain manner that the Ghost Kitchen space does not permit, a separate operating standard will need to be developed for use in the Ghost Kitchen model to ensure food preparation runs smoothly and efficiently.

If a franchisor recommends certain staffing levels or hours of operations, these should also be re-evaluated. It may make sense for Ghost Kitchen models, which rely on delivery, to remain open for longer hours of operation than the franchisor's traditional locations which rely on in-person consumer orders, or to allow different hours of operation to reflect different busy times than a traditional location. If the franchisor is too bound by tradition and does not permit, or encourage, flexibility in these policies, it may suffocate its budding Ghost Kitchen operations.

Franchisors may need to increase the typical insurance minimums for franchisee coverage depending on various considerations related to the shared space, including, most importantly, the increased risk of incidents due to the increased number of brands operating under one roof. The responsibility for maintaining certain types of insurance may also be shifted entirely to Providers instead of franchisees, such as for data privacy issues, as discussed below.

F. Technology Integration and Information Access

The POS is an integral a source of real-time information for any franchisor. The POS may deliver sales information directly to the franchisor for aggregation and analysis, or the franchisor may be able to access the POS directly and obtain information for particular locations at will. The information available through the POS is not limited to sales but also includes other performance data and even customer statistics. Even if the franchisor typically mandates a particular POS for its franchisees, however, that POS may not be available for use in certain Ghost Kitchen models. The Provider may have its own

POS that is mandated for use in its Ghost Kitchen space, or the franchisor's POS may not integrate well with the system necessary to operate the Ghost Kitchen due to other reasons; for example, the POS may exclusively rely on third party delivery service apps to receive orders at the Ghost Kitchen location. Franchisors, franchisees, and Providers must work together to understand the technology options available under each Provider's model, and how the franchisor's existing technology requirements – including integration with the franchisor's own mobile applications, or electronic couponing or loyalty program, if any – may or may not be supportable under the Provider's model.

When using Aggregators like third-party delivery services, the Aggregator will likely collect or have access to sales and consumer information. If sales are run through the Aggregator's POS instead of the franchisor's POS, the franchisor must determine whether, and how, the Aggregator can provide the data that the franchisor would normally have access to through the POS. Depending on how well developed the franchisor's Ghost Kitchen relationships are, the franchisor may even wish to collect *more* operations data from Ghost Kitchen locations than it normally would from a traditional location. In doing so, the franchisor can use those metrics to improve Ghost Kitchen operations and guide the franchisor in considering future offerings under different Ghost Kitchen models. Access to that data also may encourage the franchisor to more actively engage in analysis of the data that it already has access to.

When third parties collect and report sales and consumer data, the franchisor must freshly consider any liability issues related to data breaches, failure to comply with consumer privacy and data protection laws, and liability for failure to share accurate data with the franchisor. This may involve negotiating separately with third parties such as Aggregators or Providers even if the franchisor would not otherwise directly contract with those parties. Also, and potentially most importantly, the franchisor should consider questions regarding ownership of data generated through a POS that is not owned or managed by the franchisor. There is tremendous value in the aggregated information that franchisors collect and maintain through their POS, and franchisors should be certain there is a clear understanding of the ownership of the data generated through the various Ghost Kitchen models.

G. Menu and Marketing

As mentioned above, in some Ghost Kitchen models, it may make sense to have a limited menu for operational simplicity, especially during a trial period or when the franchisor is just starting to branch out into Ghost Kitchens models. This has the potential to cut down on food storage, equipment, and staffing needs, in addition to providing valuable data as to which of the franchisor's menu items are desirable in the delivery area.

In addition to potentially simplifying the menu for the Ghost Kitchen location, the franchisor should consider whether a modified marketing strategy is desirable. It may be beneficial to sponsor different promotions with Aggregators, whether on a local, regional, or national level. If the franchisor has a marketing fund to which franchisees are required to contribute, the franchisor should consider whether Ghost Kitchens benefit from the marketing activities supported by the fund, and to what degree, and whether the marketing activities targeted at promoting Ghost Kitchens are permitted by the existing franchise agreements. If Ghost Kitchen locations benefit more from local marketing, the franchisor should consider whether the operators of Ghost Kitchen sites should be required to contribute to the fund on the same level as other operators, or whether it is more effective to require Ghost Kitchen brand operators to spend more on local marketing efforts (which may or may not include promotional efforts coordinated with Aggregators).

Legal Considerations Regarding Ghost Kitchen Partnerships

There are many important considerations to address in establishing the Ghost Kitchen partnership among the franchisor, franchisee, and Provider. This section of the paper examines some of the key legal considerations to account for when establishing or maintaining a Ghost Kitchen relationship. The authors will also point out some key legal differences that are apparent among the various Ghost Kitchen models described in the first section of this paper.

A. Who is the Franchisor?

While a seemingly simple and obvious question, careful consideration should be paid to the organizational structure of the Ghost Kitchen offering. Many franchisors will choose to leverage their existing corporate structures and offer the Ghost Kitchen model integrated with its existing franchise offering, while others will choose to separate the Ghost Kitchen offering and create a new franchisor entity to contract directly with its Ghost Kitchen franchisees and Providers. In determining which entity to utilize as the franchisor of the Ghost Kitchen offering, consideration should be paid to the following issues:

1. Tax and Accounting: A franchisor's financial advisors should be involved in the decision-making process to ensure the franchisor utilizes a structure that is most advantageous from a tax and accounting perspective. Additionally, changes to the franchisor structure may impact the financial statements that are required to be disclosed in the franchisor's FDD.

2. Existing Contractual Limitations: Franchisors should review their franchise agreements currently in use with existing franchisees, and determine if the reserved rights and territorial protections currently in place will even allow them to expand the Ghost Kitchen program in their desired manner.

3. Marketing and Branding: Franchisors may wish to utilize existing goodwill and branding to add the Ghost Kitchen to its existing franchised model, although the expansion of Ghost Kitchens may also provide franchisors with an opportunity to rebrand and separate the Ghost Kitchen offering from the traditional franchised model.

4. Disclosure Implications: The Ghost Kitchen offering will need to be reflected in the FDD. Franchisors should determine if they want to disclose the Ghost Kitchen in their standard form FDD (if they are able to do so under applicable law), or if they wish to separate the offering and only make it available through a separate FDD with a separate franchisor entity.

B. Contractual Considerations

Determining the identity of the franchisor entity will of course directly impact the form of franchise agreement to be utilized for the Ghost Kitchen offering. However, regardless of the franchisor's identity, the structural components of the Ghost Kitchen franchise agreement will share many common facets. For existing franchisor entities that utilize the same corporate structure as their standard franchise offering, an addendum or rider to the existing long-form franchise agreement is likely the most practical approach for the Ghost Kitchen offering, although an entirely separate form of agreement tailored to the Ghost Kitchen model is also an option. For franchisors that utilize a new structure, they will be required to create an entirely new standalone franchise agreement specifically drafted for the Ghost Kitchen offering. The sections that follow will analyze some of the key contractual considerations to bear in mind when drafting either approach to the Ghost Kitchen franchise agreement.

1. Structure of the Franchise Agreement: Rider vs. New FA

When drafting a Ghost Kitchen franchise agreement, a franchisor should consider whether it wishes to approach the agreement as a separate standalone contract, or whether it will utilize its existing contractual structure in conjunction with a separate Ghost Kitchen rider or addendum. While the determination discussed above regarding the Franchisor's identity will impact the route selected for contractual structure, the end result of either approach here is a separate agreement that governs the Ghost Kitchen offering, either by way of an amended form, or an entirely new form.

Franchisors that wish to provide certain franchisees with the ability to operate both a Ghost Kitchen and a standard franchise within one operating territory will likely opt for the Ghost Kitchen rider approach, as it will be important to maintain the standard contractual provisions for a traditional franchise, and then add or amend those specific provisions that address the Ghost Kitchen relationship, as needed.

Additionally, the type of Ghost Kitchen being contemplated, whether a Cloud Kitchen, or Host Facility, for example, may also impact the form of agreement. The underlying rationale is that the more dissimilar the Ghost Kitchen is to the franchisor's standard franchise offering, the higher the likelihood that it will need to utilize an entirely different form of franchise agreement for the Ghost Kitchen offering. The less that needs to be amended, the more practical it will be to use a rider or addendum format.

2. Amendments to Key Provisions

As noted above, regardless if the franchisor elects to utilize a rider approach or a new agreement, the resulting contract will be a new form that is crafted specifically towards the applicable Ghost Kitchen model. This subsection highlights specific clauses in a standard franchise agreement that will require variation in a Ghost Kitchen format. They include:

- The Term

While there is nothing preventing a franchisor from offering its standard length of initial term, most franchisors at this stage sign much shorter term agreements, as certain models are still being tested for certain businesses and in particular geographic markets. This is likely a result of franchisors testing the waters at this early stage in the Ghost Kitchen market and not desiring to commit to unproven arrangements or partnerships. As the market evolves, and franchisors become more familiar and comfortable with certain models that allow for long-term partnerships, like Host Facilities, and more importantly, they become familiar with the well-known Providers, it is possible that the length of Ghost Kitchen agreements will begin to increase.

In contrast to those models that may allow for more long-term partnerships, for certain Ghost Kitchen models, like the Cloud Kitchen, the short-term nature of the relationship is part of the appeal of the Ghost Kitchen model. In Cloud Kitchens, franchisors elect to utilize this model as they investigate new geographic markets for short-term research analysis. The Cloud Kitchen in this instance, is just a form of market research, and not a long term or permanent solution to servicing a new market.

When discussing the length of the term of a Ghost Kitchen agreement, it is crucial to also understand the way in which the agreements can be terminated. While standard franchise agreements rarely contain a mutual termination right, some Ghost Kitchen franchise agreements can contain limited rights for a franchisee to terminate, particularly when the agreement is a short term contract (i.e., less than a year), and the agreement may include an automatic renewal provision. The technique of utilizing a short term contract with auto-renewals is an optional middle ground for franchisors testing a new Ghost Kitchen model without committing to a longer term agreement. However, with the short term nature of most Ghost Kitchen agreements, franchisors might unfortunately lose the practical effect of certain standard post-term covenants, as a standard one or two year post-term noncompete provision might be required to be reduced to a few months or even weeks only, as courts will insist on proportionality in the length of term as compared to the length of certain post-term covenants

- The Territory

The territorial rights section of both the existing standard form of franchise agreement, as well as the Ghost Kitchen franchise agreement, requires careful consideration. Before a franchisor develops its Ghost Kitchen franchise agreement, it must first comprehend how the Ghost Kitchen model interacts with its existing franchise agreements and protected territories. Important considerations in this regard include:

- Can a Ghost Kitchen be located in a protected territory of an existing traditional franchised business?
- Can a delivery that departs from a Ghost Kitchen be delivered to its final destination within an existing traditional franchised business's protected territory?
- How does a franchisor control the boundaries that its Aggregators must adhere to for the Aggregator's delivery zones? What happens if an Aggregator encroaches on a franchisee's territory?
- Do Ghost Kitchens require any form of protected territory?

These questions are just a just a few of the important considerations to be undertaken when launching a Ghost Kitchen platform in conjunction with a traditional franchise offering that must be accounted for in drafting a Ghost Kitchen agreement. Although the answers to these questions are fact-specific and require careful analysis, this section will strive to provide some guidance in approaching these analyses.

Traditional franchise agreements typically preserve for a franchisor the right to distribute products through "alternative channels of distribution". In the restaurant context, this typically includes telephone orders, internet sales, catering, mobile food trucks, supermarkets, hospitals, airports, and schools, to name just a few of these alternative channels of distribution. Franchisors should perform a review of the existing franchise agreements already in use within the system to determine if the particular Ghost Kitchen model in question is included in the existing alternative channel of distribution provision. Further, on a go forward basis, it might be prudent to explicitly reference Ghost Kitchens or a similar concept as an alternative channel of distribution reserved to the franchisor in future franchise agreements, to allow for the greatest flexibility with regard to future expansion plans. If a franchisor determines that Ghost Kitchens cannot be located within the existing territory of any franchisee, then the franchisor will have to carefully plan its geographic expansion plans to ensure that there is no encroachment on existing territories.

In determining the protected territory, if any, for the Ghost Kitchen, the same considerations that would be undertaken for a traditional franchise should be implemented for the Ghost Kitchen analysis. Some franchisors currently offer the same types of protected territories that they would typically provide, while some others do not provide any protected territory. The determination is likely to be impacted by a number of factors, including: (i) term of agreement; (ii) geographic location of Ghost Kitchens; (iii) locations of existing franchisee network; (iv) existing territorial protections in traditional franchise agreements; and (v)the type of Ghost Kitchen model considered (for instance, Cloud Kitchens are more likely to be transient, with short term agreements and less required territorial protections).

- The Approved Products

As noted above, franchisors must rethink the approved products and menu offerings that will be permitted for sale within Ghost Kitchens under the Ghost Kitchen franchise agreement for a number of reasons. First, franchisors need to investigate the physical premises of the Ghost Kitchen to see if there are any space constraints that would prevent some of the standard equipment from being utilized. Perhaps the kitchen is smaller and some of the standard equipment will not fit within the reduced footprint. Second, franchisors need to appreciate the differences in packaging and wait times that are inherent in the Ghost Kitchen context. The authors of this paper will commend any business that is able to invent packaging to enable French fries to remain crispy after a 20-minute ride in an Aggregator's backseat. Third, franchisors may be prevented from staffing Ghost Kitchens with their standard operating team. A reduced team may necessitate a reduced product offering. Finally, the Ghost Kitchen is potentially going to be located in a space with other brands that offer other similar food offerings, and the franchisor may wish to focus on those menu offerings that are not already available within the existing Ghost Kitchen. For example, if a chicken chain sublets space in an existing Managed Cloud Kitchen that already contains an ice-cream concept, the chicken chain may opt to delete ice-cream menu items from the Ghost Kitchen model to limit direct competition with the other subtenants and to focus on the differentiated menu offerings.

- Trademark Usage

Partnering with a Ghost Kitchen means usage of a franchisor's trademarks in new and different ways as compared to the traditional franchise model. In all cases, this means permitting certain types of desired branding, while preventing many others. While some brands wish to tout their usage of Ghost Kitchens, others actually try to shy away from that fact. Some Ghost Kitchen agreements will include specific provisions that limit a franchisee's ability to brand themselves, or to otherwise reference, that it is in fact a Ghost Kitchen.

This branding decision, which is reflected in strict trademark usage provisions in the Ghost Kitchen agreement, could be due to a number of reasons. Perhaps until there is increased consumer trust in the Ghost Kitchen model, some franchisors might not want their customers to know that the order was in fact serviced by a Cloud Kitchen as opposed to a brick and mortar location. Or perhaps consumers feel they should pay less for their products if it costs the franchisor less to make the same menu item in a Ghost Kitchen due to the reduced overhead costs as compared to a traditional kitchen.

Additionally, with Providers being added to the mix, there is potentially another party that franchisors will seek to control with regard to their usage of the trademarks. If the Provider requires that all subtenants in a Cloud Kitchen or Managed Cloud Kitchen include signage outside the Ghost Kitchen storefront, the franchisor should consider if and how that requirement will interact with its existing signage and trademark usage provisions. Finally, although not unique to the Ghost Kitchen market, franchisors also need to be cognizant of the contractual provisions that enable third-party delivery services, like Aggregators, to use and display their trademarks on third-party websites and applications.

- Personal Covenants

The personal covenants typically included in a standard form franchise agreement, such as noncompetition, non-solicitation, and confidentiality, require close consideration in the context of a Ghost Kitchen agreement. Due to increased restrictions (and prohibitions) in the United States in recent years in relation to non-solicitation provisions in the restaurant context, this section will focus its analysis on the noncompete and confidentiality provisions of a Ghost Kitchen agreement.

Confidentiality provisions typically bind the franchisee entity and the personal guarantor, and franchisors will often request that all other key employees execute a template form of confidentiality agreement. In the Ghost Kitchen context, Providers will certainly have access or visibility to confidential information, and so too might other operators within the Ghost Kitchen. Many Ghost Kitchen models have multiple different concepts operating in close proximity to each other. Franchisors should utilize a similar type of third-party confidentiality agreement, and revise the standard confidentiality provision to require Providers and other subtenant operators to sign the additional form, as well. Of course, there are real and challenging practical concerns with this approach. Providers can be obligated to sign the agreement as part of the arrangement with the franchisor, but the franchisor has no privity of contract with third-party subtenant operators, nor any means to require them to sign any form of agreement. And even if so, would a franchisor really feel comfortable allowing a competitor’s employees to see what’s in the proverbial secret sauce, even if they had signed a confidentiality agreement? The challenges with regard to other brands and operators sharing one physical premises may prove to be a sticking point for many franchise systems entering into any of the various Ghost Kitchen models. But, with thoughtful contractual drafting, enhanced systems and protections, and perhaps the right set of co-operators within any given model, these concerns regarding confidentiality may be overcome.

As franchisors embrace the Ghost Kitchen model, competition covenants should be reexamined as well. The definition of what is or is not considered a competitive business, both during the term, and post-term, will be instrumental in allowing franchisees to flourish, while still protecting the franchisor’s system. A Managed Cloud Kitchen alleviates some of these concerns, as they are typically operated by the brand owner, and have already carefully addressed the impact of the sister-brands on each other. Some Cloud Kitchens and Managed Cloud Kitchens on the other hand potentially exacerbate these concerns, as multiple competitive brands that are often unaffiliated share a single roof. Further, some franchisees might operate multiple brands within a single Ghost Kitchen, and case-specific carveouts for competitive behavior may be required in certain instances. Also, with the short term nature of most Ghost Kitchen agreements, franchisors might lose the practical effect of the post-term noncompetition provision, as a standard one or two year post-term noncompete provision might be required to be reduced to a few months or even only a few weeks, as courts will insist on proportionality in the length of term as compared to the length of the noncompete.

- Approved Sales Formats

The model of Ghost Kitchen will directly impact these provisions, as they will inevitably require modification for the Ghost Kitchen concept as compared to a traditional franchise model. Some formats might only allow for sale through Aggregators without any consumer access to the physical premises while others might also allow for Aggregator walk-in orders. In addition to whom the products may be sold, franchisors must also be cognizant of *how* the products are sold. Will existing point-of-sale machines work in the same fashion in a Ghost Kitchen? If no walk-ins are permitted, are POS terminals even required? These are important issues that must be accounted for in drafting the applicable Ghost Kitchen agreement.

Ghost Kitchen models that require franchisees to use an entirely different form of point-of-sale system (POS) pose an entirely different and important set of concerns. The contractual provisions need to address the plethora of concerns regarding a third-party Provider mandating a different POS. Franchisors will want to ensure access to the information on the system in real time, as it would with any other franchised restaurant. If store audits need to be conducted, the franchisor will need to ensure it has visibility into all of the relevant sales metrics it typically reviews. One centralized POS also causes issues by aggregating the sales information from all subtenants, adding further challenges to gaining access to desired information, or to assessing the value of the information therein. And lastly and most importantly, the Ghost Kitchen agreement must address who *owns* the important and useful data that is being collected and who has permission to use that data from the various Ghost Kitchen models, regardless of whose POS system or terminal is utilized.

C. Disclosure Obligations

If the grant of rights to operate a Ghost Kitchen amounts to the sale of a franchise under applicable law, then it is very likely that presale disclosure (i.e., an FDD) must be provided to the prospective franchisee prior to the execution of the Ghost Kitchen franchise agreement. Unlike the preceding sections of this paper, the following analysis regarding disclosure obligations, together with potential exemptions from requiring the delivery of an FDD, will be subdivided as between the United States and Canada, as the different legislative schemes require separate and distinct attention.

1. Disclosure Obligations – United States

- Franchise Disclosure Document

Similar to the question of whether to have a separate standalone contract or to have a Ghost Kitchen rider or addendum, franchisors should consider whether to prepare a separate Ghost Kitchen-only FDD or to incorporate the Ghost Kitchen offering into its standard form of FDD. While a traditional brick and mortar unit and a Ghost Kitchen unit operate differently, the disclosures in the FDD may have significant overlap due to the requirements under the Federal Franchise Rule 16 CFR 436 (the “FTC Rule”).

There are several FDD Items, notably Items 7, 11, and 19, or parts within those Items, that are all but certain to differ between a standard unit and a Ghost Kitchen:

> Item 7 in an FDD is the franchisee's "Estimated Initial Investment", which is used to show all of the reasonably estimated expenses that a franchisee is anticipated to incur prior to opening and during the first three months of operations. Real estate and lease improvements are usually the most expensive line items in Item 7 for any brick and mortar concept. As discussed in earlier sections of this paper, the real estate required for a Ghost Kitchen is drastically different than that required for traditional restaurants, and can lower the cost of entry. However, a franchisor that offers multiple types of Ghost Kitchen offerings, which may require having a franchisee construct their own commercial kitchen versus operating out of another company's existing restaurant, may warrant multiple columns or charts in Item 7 to note the vast differences in estimated initial investments.
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> Item 11 in the FDD, "Franchisor's Assistance, Advertising, Computer Systems, and Training", will also need to have specific Ghost Kitchen disclosures. The initial training program for a Ghost Kitchen is likely to be a shortened version of the franchisor's full program, as it can cut out, or greatly diminish, front-of-the-house training. Without having to interact with customers, franchisors can focus on training in the kitchen and other system standards. Systems commonly offer or require the franchisor to provide on-site training in connection with a restaurant's grand opening. If offered, it is unlikely that the franchisor would need to provide the same length of on-site grand opening training as a traditional unit. The Ghost Kitchen-specific initial training program must be disclosed in Item 11 so that prospective Ghost Kitchen franchisees, especially those that would be new to the franchisor's system, understand the extent to which franchisors will train them in opening and operating a Ghost Kitchen.
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> Other aspects of Item 11 that may differ from a franchisor's standard FDD include the site selection process and the computer/POS system for reasons discussed earlier in this paper, as well as advertising requirements. Because Ghost Kitchens rely solely on take-out and delivery services, the franchisor may require franchisees to spend some or all of their local advertising expenditure requirements on online and mobile app advertisements.
>
> Finally, franchisors that include financial performance representations should present separate information for Ghost Kitchens due to the different methods of operation, revenue streams, and expenses. The North American Securities Administrators Association (NASAA) and state examiners for registration states have become more conservative in what they view as constituting a reasonable basis for a financial performance representation. This is likely to come into play if franchisors combine financial performance representations for traditional and brick and mortar outlets. While this paper will not address potential administrative law issues triggered by NASAA's closed-door process of establishing guidelines that are treated like law by state examiners, it is important to note that franchisors may face hurdles when filing in a registration

state if financial performance representations of traditional outlets are not separated from Ghost Kitchen outlets.

In any event, franchisors are likely to consider cost and efficiency in determining how to comply with disclosure requirements while initiating sales. Franchisors that are looking to offer Ghost Kitchens as soon as possible given the current climate may wish to incorporate the Ghost Kitchen offering when they update their FDD in the spring while also avoiding the cost of paying for a new FDD. However, franchisors may be able to accomplish these goals faster and cheaper if an exemption applies.

- Exemptions under U.S. Federal/State Laws

Franchisors should always examine whether they can take advantage of any federal and state exemptions from disclosure and registration (where applicable). Not all states accept all exemptions under the FTC Rule, so franchisors seeking exemptions in registration states should conduct a state-by-state analysis to determine which exemptions are available to them. This section of the paper focuses on the two exemptions that are likely to apply to one or more Ghost Kitchen models: the fractional franchise and the large/seasoned franchisee.

In general, a fractional franchise exemption applies when the franchisee has at least 2 years' experience in the same type of business, and the franchisor and franchisee have a reasonable basis to anticipate that the sales arising from the new or expanded relationship will not exceed 20% of the franchisee's total dollar volume in sales during the first year of operation. Franchisors that offer a Ghost Kitchen model to existing franchisees should consider whether they can rely on this exemption because it will be easy for their franchisees to meet the two-year requirement. A unit economic analysis will still be necessary, however, to determine whether the anticipated gross revenue generated through the Ghost Kitchen in the first year will remain under the threshold of the second prong.

The large/seasoned franchisee is a state-specific exemption that generally applies to franchisees with a minimum net worth of approximately $5,000,000, and that have been in business for several years. In states like California and Illinois, this exempts a franchisor from disclosure and registration requirements, but additional filings may be required.

Should a federal exemption and state exemption (where necessary) apply, franchisors can likely avoid the disclosure process, and, where necessary, the registration process as well. However, as a best practice, disclosing a prospective franchisee with a FDD that contains information about the Ghost Kitchen offering can help mitigate liability exposure from potentially disgruntled franchisees.

2. Disclosure Obligations – Canada

Presently, six of Canada’s ten provinces have franchise laws, including Alberta, British Columbia, Ontario, Manitoba, New Brunswick, and Prince Edward Island. While the six provincial statutes are all slightly different from each other, they all share several common features, including the obligation to provide pre-sale franchise disclosure to prospective franchisees, through an FDD that is compliant with that province’s franchise law (unless one of the very narrow exemptions apply). Notably, and unlike certain franchise laws in the United States, there is no requirement that a franchisor register its FDD with any government franchise registry.

The applicable pre-sale franchise disclosure requirements dictate that an FDD must be delivered where the franchise, or Ghost Kitchen in this case, is to be wholly or partly operated in any of the provinces with a franchise law. If the franchisor intends to offer franchises in any of the regulated provinces, or if the governing law of the franchise agreement is chosen to be a province with a franchise law, then an FDD must be provided in accordance with the applicable law.

Like the United States, an FDD that complies with Canada’s various provincial statutes must include a list of enumerated required disclosures. However, in contrast with the United States, an FDD that complies with Canada’s various provincial statutes must also include any and all "material facts". The definition of a material fact includes “any information about the business, operations, capital or control of the franchisor or franchisor’s associate, or about the franchise system, that would reasonably be expected to have a significant effect on the value or price of the franchise to be granted or the decision to acquire the franchise”. The clear and important ramification of this “catch-all” requirement to include all material facts means that a Canadian FDD needs to be reviewed and evaluated prior to each unique disclosure, to ensure it includes all material facts, including those that might only apply to the single franchisee in question.

Accordingly, a generic Canadian FDD that does not contemplate a Ghost Kitchen addendum or rider, or the unique facts specific to the offering in question, would likely not comply with Canada’s applicable franchise laws if utilized for a Ghost Kitchen agreement. The FDD would need to contemplate the contracts that are being signed either in addition to, or in place of, the standard franchise agreement. The FDD would need to include a summary of the applicable agreement, as well as all of the standard disclosures that a franchisee would typically receive in an FDD, including but not limited to: i) a separate initial costs chart to address the required investment for a Ghost Kitchen, ii) a separate ongoing costs chart to address the required payment structure pursuant to the Ghost Kitchen agreement, iii) information about the Provider and the applicable Ghost Kitchen that would be considered a material fact, and iv) any additional material facts about the particular Ghost Kitchen offering in question.

Clearly, careful consideration should be paid to the applicable Canadian franchise laws for those who wish to sell Ghost Kitchen franchises in Canada to ensure franchisors are acting in a way that complies with applicable laws. It is worth noting that there are some exemptions that apply in narrow circumstances that may exempt the franchisor from having to provide an FDD in certain, limited instances.

The exemption that is most likely to apply in Canada in the context of Ghost Kitchens is the “fractional franchise” exemption or “franchise within a franchise” exemption. The language of the exemption varies from province to province, and due attention should be given to those minor differences, but generally speaking, if the total sales from the Ghost Kitchen business are not anticipated to exceed 20% of the total sales of the existing business that it is operating within, then the fractional franchise exemption may apply. However, franchisors should proceed with great caution prior to relying on any exemption as the ramifications for failure to comply with applicable Canadian franchise laws can be very severe. Expertized Canadian franchise counsel is integral to the launch of any Ghost Kitchen model in Canada.

3. The Accidental Franchise

Certain models of Ghost Kitchens potentially run the risk of being classified as a “franchise” under applicable laws, even if the franchisor does not believe that the relationship is a “franchise” on its face. For example, a Managed Cloud Kitchen that permits third parties to utilize its space is an illustrative example. Under that model, franchisors (or their franchisees) sublet space within an existing premises and share a kitchen with several other different brands. The Provider, the operator of a Cloud Kitchen or Managed Cloud Kitchen, is the landlord, but also the consumer-facing arm of the business. In doing so, the Provider manages the POS, sells the products to customers, and is listed by the Aggregators as the seller, featuring the menu offerings of its various subtenants.

While franchisors may be cognizant of their relationship with their franchisees or Ghost Kitchen operators, it is important to also analyze the relationship between the franchisor and Provider, as there may be a relationship between those parties that satisfies the definition of a “franchise” under applicable laws. If so, and absent an applicable exemption from having to provide an FDD, franchisors may find themselves in an accidental franchise relationship, and could potentially open themselves up to risk or liability under the applicable franchise laws. In Canada and registration states in the United States, selling a franchise to a franchisee without providing pre-sale disclosure can provide franchisees (or Providers, as the case may be) with significant remedies, including rescission of the applicable agreement and damages relating thereto.

Conclusion

Ghost Kitchens are rapidly becoming an instrumental aspect of the global franchise system. Like any new commercial model, innovators and disruptors will continue to shape and revise the models at play, and will thereby impact the legal infrastructure that supports the foundation of the Ghost Kitchen model.

Choosing to sit on the sidelines can be a death sentence for a brand. Recognizing that there is a demand and a need-state for the delivery consumer will be key to growth and survivability. The creation of virtual concepts on a daily basis proves that expendable competition will constantly be chopping away at the market share built by traditional restaurant brands. What was once considered protected territory may now look vulnerable. The hotel, convenience store, and independent restaurant on the average franchisee's block may soon become Host Kitchens® selling the exact chicken sandwich and fries menu the franchisee has built their business on. It may be a tenth of the quality (at best), but can a franchisee keep the doors open with a 30% decrease in sales? For those other locations, it is all profit because it is not derived from their core business or traditional revenue stream; it is simply incremental profit. What will the franchisee do next? Will they add virtual concepts with the permission of their franchisor? Will the franchisor support the core business with marketing? What if the franchisee decides to walk away and invest in a Ghost Kitchen location where they have more freedom to profit? These are the questions facing franchisors and franchisees today. Franchisors have an obligation to deliver solutions that generate profit for their franchisees who have invested money, blood, sweat, and tears in dedication to a franchise that may now be choking their ability to deliver a return on an infrastructure investment.

Despite the quickly evolving model of Ghost Kitchens, a few evident truths have emerged in the early years of Ghost Kitchens: i) business and consumer needs will continue to shape the way in which franchisors get their product to market, allowing for new models, new concepts, and new commercial structures to flourish; ii) the legal infrastructure will continue to chase the evolutions in business models, with business needs leading first, and legal concerns trailing behind to optimize the offering; and iii) most importantly, Ghost Kitchens, in one form or another, are here to stay, and the sky is the limit for their success.