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Practice Update

Avoiding Trouble with Franchise Fees, DSPs, and Your Franchise Agreement

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In the ever-evolving world of franchising, and where third party delivery services and providers are playing a more active role in assisting franchisees to distribute franchisee services, there's a simmering question that's on the cusp of boiling over: does a franchisee pay royalties on the third party provider gross price charged to a customer, or merely on the net amount that the franchisee actually receives? This might sound like a wonky, insider-baseball kind of issue, but this debate could make or break the profit margins of thousands of small business owners across the country as we move toward the 2025 Franchise Disclosure Document (FDD) renewal cycle.

The Delivery Services Boom. Let's start with a simple observation: third-party delivery platforms (DSPs)—think Uber Eats, DoorDash, Grubhub, Postmates, Amazon, and more—have, for better or worse, changed the way we live and how we buy. According to the USDA, third-party delivery spending in the United States tripled during the Covid-19 pandemic, from $0.4 billion in December 2019 to about $1.4 billion three years later in October 2022. In the same way streaming services changed how we watch TV, DSPs have revolutionized how we get our meals,

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groceries, and even our pet supplies. Driving this revolution is the convenience factor as people love the idea of tapping their phone to have something land on their doorstep minutes later.

But with this convenience comes complexity, especially for franchise operators who never anticipated that a chunk of their sales revenue might be siphoned off by a third party before they ever see a dime. The central issue boils down to a question that might keep you up at night if you are a franchise owner: What's my "real" revenue? Is it the gross amount that the DSP charges the customer, or is it the amount the DSP decides I get after taking out its fees? Even after consulting the franchise agreement the answer is not always clear.

A Snapshot of the Problem. Consider a typical delivery transaction: a customer orders a burger-and-fries combo from the franchisee for $10 through, say, Uber Eats. Uber then withholds 20%—that's $2—and deposits $8 into the franchisee account. Traditional franchise agreements, in many cases, would treat that $10 as the base figure for calculating royalties. So the franchisee pays a royalty to the franchisor on the full $10, even though $2 never reached its pocket.

A sample "Gross Sales" definition from a franchise agreement which can lead to this result provides:

> "'Gross Sales' means the total of all revenue from the sale of all products and services offered at or from the Franchised Business (whether or not identified by the Marks), including all revenues (1) for cash or credit, (2) resulting from orders placed through third-party platforms, whether the franchisee directly receives the funds or not, and (3) any other income of any kind related to the Franchised Business. Gross Sales shall be calculated before deduction of any fees or commissions charged by credit card processors, third-party delivery service providers, or any other costs or

expenses. The only amounts excluded from 'Gross Sales' are sales taxes collected from customers and paid to the appropriate taxing authority."

Under this sample provision, royalties apply to the entire $10 charged to the consumer—not the $8 the franchisee actually receives. This is unsettling for franchisees. And the more a franchisee relies on DSPs, the greater that revenue disparity. Under older franchise agreements, if you do $1 million in annual sales through these platforms, you might be coughing up royalties on $1 million even though you only receive $800,000. And that difference can snowball into a real financial burden.

This conundrum is not new, but it's become more urgent because DSPs are no longer the exception, they're often utilized and, in some cases, a lifeline to doing business. It's not just restaurants, either. Retail businesses selling through Amazon, service-based franchises using specialized delivery apps, and a slew of other concepts are dealing with the same puzzle: who's controlling the sale, and how does that affect what the franchisee actually earns?

We're heading into the season for franchise agreement renewals and FDD updates, and there's a growing call to modernize franchise agreement definitions of "gross revenue" so that they reflect today's realities. If franchisors and franchisees do not have a frank conversation about this, both sides could face messy legal battles.

Topic 606: A (Partial) Guiding Light. If you're an accounting aficionado, you're probably familiar with "Topic 606," the Financial Accounting Standards Board's (FASB) directive on revenue recognition. In layman's terms, Topic 606 attempts to provide a consistent framework for figuring out whether an entity is acting as a "principal" or an "agent" in a transaction. The principal recognizes revenue as if it sold the goods or services directly. The agent, however, only recognizes what it actually receives in commission or fees. Applying that to our burger-and-fries example: If a DSP has the final say on menu pricing, collects the customer's payment, decides whether the order can or should be canceled, and manages the entire delivery process, it is often considered the principal. The restaurant (or the franchisee), in that scenario, functions as the agent. Agents (franchisees) only record the net amount of revenue left after the principal (DSP) takes its cut.

So, from an accounting standpoint, many franchisees would say: "Hey, I'm just an agent when it comes to these DSP orders. Topic 606 backs me up. I should only have to account for the $8 I actually receive as my revenue—and shouldn't my royalty fee reflect that?" That's a strong argument. Proponents cite how large brands and certain franchise networks are already inching in this direction. It's not a fringe idea that only a few mom-and-pop operators are testing. Even some big corporate players have started to realize that forcing franchisees to pay royalties on money they never actually handle is unfair—perhaps even untenable.

Where Franchisors Stand. The franchisor perspective might go something like this: "Our brand is what's driving demand, even on a DSP. We build the name recognition and marketing power that brings customers to your store—physically or virtually." Plus, they might say, if a franchisee is able to mark up its menu prices to offset the DSP's fees, the extra revenue that results should be counted toward gross revenue. Why should the franchisor lose out on royalty payments if the franchisee is effectively recouping the DSP fee by charging the customer more?

That's a fair question—but it's also delicate. What if the DSP, in turn, controls that final upcharge or discount to the consumer, or pockets the difference themselves? The lines can blur quickly. For every scenario where a franchisee's upcharge might offset DSP costs, there might be another scenario where the DSP just sets the price, keeps the difference, and never funnels that additional money to the franchisee at all.

Third-party deliveries are a reality, and if a franchise system penalizes owners for tapping into this reality, the franchisees might lose money or avoid the platform altogether. That can translate to lost revenues (for both franchisees and franchisors), aggravate franchise relations, and the brand image might suffer if it does not keep up with consumer demands for convenience. For franchisors, the fear is that if they concede on DSP fees, they might be leaving money on the table or, worse, open the door to more exclusions under the "gross revenue" definition. Brand owners worry about a slippery slope: "If we allow an exception for third-party fees, what about credit card fees, marketing surcharges, or other charges? Where does it end?"

The reality is that the DSP scenario is a different animal. Where credit card fees simply skim a small fee off the top in a mostly frictionless transaction, DSPs often control or influence the very essence of the transaction—pricing, delivery, customer data, refunds, the whole package. That's a deeper level of involvement, suggesting that a more nuanced approach is warranted.

So, how do we fix this? Let's talk about a possible blueprint as the 2025 FDD renewal season approaches.

Explicitly Define "Revenue." Typical franchise agreements likely have a broad, catch-all definition of "gross revenue," sometimes excluding only taxes or returns, shipping costs. A new, modernized definition might say something like:

> '"Gross Revenue means' all amounts actually received by the franchisee for goods and services sold, excluding any commissions, fees, or charges withheld at the point of sale by third-party delivery services platforms (DSP) or other

> intermediaries acting as principals in the transaction."

This language makes it clear that money never received by the franchisee will not be treated as part of its revenue base upon which it pays a royalty.

Include a Caveat for Markups. If a franchisee is jacking up its DSP prices beyond in-store prices—and actually receives that markup or a percentage of it—the franchisor should get its fair share. That should also be spelled out clearly:

> "However, if the franchisee receives revenue above standard in-store prices on DSP orders, such additional revenue amounts must be reported as Gross Revenue, and associated royalties will apply."

Open the Lines of Communication. It's easy for franchisors to assume that including DSP fees in the "gross revenue" definition is the only way to prevent loopholes. But a more collaborative approach can benefit both sides. Franchisors who want to preserve strong relationships with their franchisees should consider open forums, surveys, or working groups to evaluate how best to handle these fees. After all, a healthy, profitable franchisee is far more likely to keep renewing and expanding. Indeed, one option to consider is whether there should be a different royalty on the added revenue received by a franchise to pay for the DSP services.

Stay Informed About the Law and Accounting Standards. Topic 606 is still relatively new in the grand scheme of things. Not every franchisor executive is reading the latest FASB updates over her morning coffee. But ignorance is no excuse. When the standard highlights the distinction between principal and agent, it offers a roadmap for figuring out who really owns the transaction. There's no reason to ignore this just because the standard is a bit dense.

Don't Wait Until It's Too Late. Franchisors that keep kicking the can down the road risk legal wrangling and potential class-action suits if enough franchisees feel they are being nickel-and-dimed. By addressing the issue head-on in the 2025 FDD cycle, you lower the risk of confrontation and build goodwill.

It's worth emphasizing that while much of the talk centers on food delivery (because that's where we've seen the biggest explosion of activity), these questions relate to any franchise concept using third-party platforms. Retailers selling on Amazon, service-based franchises that contract out to courier apps, or e-commerce affiliates—anyone who doesn't directly control the point-of-sale and final pricing—should be watching how the restaurant industry addresses these challenges. If one sector can find a fair and functional blueprint, it could spread across the broader franchise world.

If we want to preserve the spirit of mutual benefit and protect the sustainability of the franchise model, we should strive for clarity on how to handle DSP fees. Topic 606 and the logic behind it say that if you don't control the sale, you don't get to count the full amount as your revenue. That principle, when applied to franchising, points toward excluding DSP fees from "gross revenue" if those fees never touch the franchisee's ledger. For franchisors who worry about losing out on extra cash, there's a straightforward counterbalance: if the franchisee actually profits from charging higher prices to account for DSP fees, that profit should count toward royalty calculations. With the 2025 FDD updates and renewals fast approaching, franchisors and franchisees should work to modernize the revenue definition upon which royalties are based in a way that's both fair and transparent.
