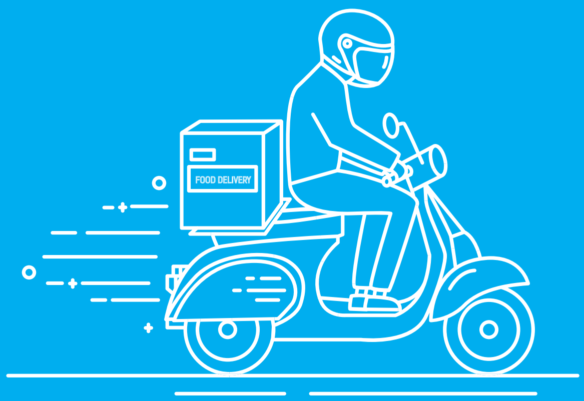


Third-Party Food Delivery Services:
Navigating the Ever-Changing Waters

CHENG COHEN

A report generated by the analysts at Morgan Stanley in July 2016 calculated that the restaurant industry in the United States generates nearly $500 billion per year in revenue comprised of dine-in, carry-out, and delivery orders. Of this $500 billion, the delivery market carves out a $30 billion share, of which $11 billion is generated from online orders. This $11 billion estimate is only the tip of the iceberg, with Morgan Stanley estimating that the total food delivery market should be valued at $210 billion. Entrepreneurs and investors have certainly taken note of this potential, resulting in a tremendous amount of growth for companies that offer food delivery services. But in a sea of investment and development, the question remains – how does changing market for food delivery affect restaurants? Restaurant owners, both large and small, are now shifting their business practices to make room for these new food delivery services, and those changes have led to new benefits, struggles, challenges and costs.

As online ordering and app-based delivery services have become more sophisticated, the "food delivery market" has diverged into three distinct business models: (i) self-managed delivery services; (ii) third-party restaurant aggregation services; and (iii) third-party full-service platforms. Self-managed delivery services have been the hallmark of delivery in the past – a restaurant hires its own delivery staff and manages the delivery process internally. But the focus of this paper is on the two third-party food-delivery models and how the arrival of these third-party services has changed the food-delivery landscape – good and bad – for single-unit restaurants, restaurant chains, and franchise systems. It also discusses ways of navigating some of the murky waters, including tips for negotiating a relationship with the third-party delivery provider.

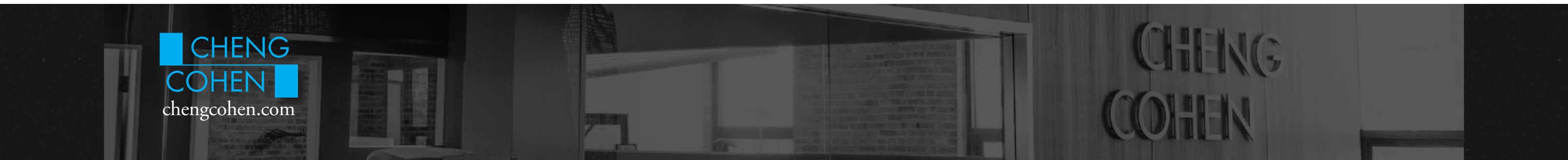
WHAT ARE THIRD-PARTY FOOD DELIVERY SERVICES?

To start, let's clarify how third-party food delivery services operate. Historically, and driven mostly by the pizza segment, restaurants that offered their customers at-home delivery did so using their own resources. Many quick-serve restaurants in other segments scrambled to find ways to compete with the pizza operators but faced resource and quality-control constraints.

The delivery market began to change roughly 15 years ago, when third-party delivery services started to appear on the scene. The idea was simple - provide consumers with a one-stop-shop for food delivery by offering access to various restaurants through an online or app-based ordering platform. The platforms compile restaurant menus, prices, and customer reviews for multiple restaurants and provide them to consumers in a robust searchable format with a single consolidated check-out process. From this fundamental idea, two models have emerged: the aggregator model and the full-service model. How do they differ?

Food aggregators, like GrubHub and Eat24, focus on aggregating offerings from many restaurants onto a single consolidated platform, but once the consumer places an order the aggregator forwards it to the restaurant for fulfillment and delivery by the restaurant's own staff. Full-service platforms, like Postmates, DoorDash, and UberEats, play a dual role - they compile restaurant options in much the same manner as the aggregators, but they also have their own staff of delivery drivers that pick-up and deliver orders to consumers directly from the restaurant. Not only do the full-service platforms provide a complete outsourcing opportunity for the restaurant, they create new options for consumers, as many restaurants are willing to offer carry-out orders but do not offer their own delivery services.

In terms of participation, most food delivery providers actively reach out to local restaurants and national restaurant chains to negotiate contracts that will dictate the terms of the relationship between the restaurant and the service. But not all restaurants elect to sign these contracts, and that does not necessarily stop the delivery provider from including the restaurant on its platform. Many full-service platforms, however, have determined that restaurant participation is not needed because once the order has been placed by the customer, the food delivery service can simply call it in to the restaurant as a carry-out order and the restaurant will fulfill it in its ordinary course of business. The service then simply has to send a driver to pick up the carry-out order and deliver it to the customer. In many cases the restaurant may not even know that a delivery order was placed through a third-party service. This uncontrolled participation creates some unique challenges for restaurants described further below.



DO THE PROS OUTWEIGH THE CONS?

Food delivery services each pose their own benefits and drawbacks, which present restaurants with some challenging decisions. The benefits of using delivery providers are obvious to most restaurant owners, including increased visibility and reach, incremental sales and new customers, reduced stress on restaurant resources, and available tracking and analytic data. But despite these many advantages, not all experiences with food delivery services are positive for the restaurant or the customer. Many restaurants have opted out of affirmative participation in food delivery services altogether, claiming that these services are either too expensive, ineffective, or not aligned with their brand.

COST OF SERVICE

The most direct burden imposed on restaurants by food delivery services has been increased costs. Most food delivery services collect a percentage fee on each order, which is deducted from the price consumers pay for their order before the payment is remitted to the restaurant. These fees can be as much as 20-30% of the order amount, which dramatically affects the bottom line for restaurant owners. Further complicating this pricing structure is the fact that many restaurants' highest margin products, such as alcoholic beverages and novelty offerings, are less frequently ordered for delivery (and often, are not included by the food delivery services in the menu options at all). Ultimately, many restaurants simply cannot afford to work with these food delivery services due to the material financial impact on their business.

LOSS OF CONTROL BY RESTAURANT

Another common complaint associated with food delivery services is that the restaurant no longer controls how its own food is offered and handled. As a result, it is difficult to guarantee the quality, temperature, or state of the food as it arrives to the customer and, as noted above, the restaurant gets tagged with those deficiencies even after the food has been placed in the hands of the third party. This loss of control is particularly frustrating for restaurants that are not voluntarily participating in these food delivery services. There are also health and safety concerns associated with breaking the chain of custody over the food – for example, contamination with other foods may cause allergic reactions, and failure to store at correct temperatures could cause food borne illness. Some restaurants have started to test tamper-proof food packaging to ensure that their food arrives in the same condition that it departed the restaurant.

A similar challenge arises when it comes to control over the use of trademarks, logos, and other proprietary materials such as menus. Intellectual property laws require that the owner exert a reasonable level of control over how its intellectual property is used, otherwise the owner may lose its right to protect that intellectual property. As a result, many non-participating restaurants have attempted to prevent food delivery services from using their trademarks and menus. For example, in 2015 DoorDash began offering delivery for the California-based restaurant chain In-N-Out Burger without entering into any agreement with In-N-Out. In doing so, DoorDash displayed In-N-Out's well-known and trademarked logo on its website without authorization. In-N-Out demanded that DoorDash cease using In-N-Out's trademarks. When DoorDash failed to comply, In-N-Out sued DoorDash for trademark infringement. This case was ultimately settled by the parties on confidential terms, but we note that In-N-Out is no longer offered on the DoorDash app. Restaurant owners should always take notice of whether and how their trademarks are being used by third-party food delivery services, particularly where there is no agreement in place.

Another area where food delivery services have taken some liberties without restaurant authorization is the menu prices. Because these food delivery services wish to reduce the appearance of service fees to customers, they have in many cases instead simply inflated the price of food. The platform will charge $8 for a sandwich that may sell for $6 at the restaurant and will keep the $2 difference as their fee. This practice of price inflation is particularly prevalent for non-participating restaurants, where the food delivery service does not have the option of charging a direct commission from the restaurant on the sale.

LOSS OF LOYALTY

The loss of personal interaction between customers and the brand and its personnel, and the increasing number of available restaurant options on these delivery platforms, makes it difficult for restaurants to build brand loyalty. Additionally, the food delivery services do not always share customer data with each individual restaurant, which limits the restaurant's ability to market directly to these customers in the future. This leads to further separation from the restaurant and its customer base and reduces the likelihood that customers will develop brand loyalty.

WHAT CHALLENGES ARE PRESENTED FOR FRANCHISE SYSTEMS?

When a restaurant is part of a franchise system, the use of food aggregators may result in additional complications. Franchise brands should consider not just the practical impact of these issues, but also whether their franchise agreements are properly drafted to account for each of these unique considerations.

GROSS SALES AND ROYALTY CALCULATIONS

The use of a food delivery service may complicate a franchisor's ability to determine the amount of royalties due from a franchisee. Typically, royalties are based on a certain percentage of a restaurant's gross sales, and often the franchisor also has the ability to directly access the franchisee's point-of-sale system to retrieve the sales data firsthand. However, for sales made through food delivery services, the food delivery service will typically collect the revenue from the customer and remit the restaurant only the restaurant's net portion of the revenue. This issue is further complicated because some food delivery platforms operate through an independent point-of-sale terminal, that does not necessarily integrate with the restaurant's standard point-of-sale system to which the franchisor has access. This then begs the question, is the franchisor obtaining a proper accounting of gross sales from these delivered orders?

Absent a specific agreement with the provider, the franchisor could lose access to and transparency around the transactional data between the restaurant and the customer. If franchisors do not have access to accurate gross sales numbers, it will be challenging to accurately track and calculate royalty and other sales-based payments from franchisees. Additionally, it could be more difficult for a franchisor to fully analyze each restaurant's and the system's performance. It could also strain the automatic inventory replenishment system used by many restaurant systems.

Even if the franchisor obtains accurate sales records, there may be some question as to how to count "gross sales" for the purposes of the franchise agreement. This is particularly true when the food delivery service inflates prices that are charged to customers. If the franchisor's definition of gross sales includes all revenue generated through the operation of the restaurant, it could include the escalated prices charged to the customer, thus forcing the restaurant franchisee to pay royalties and other sales-based fees on the portions retained by the third-party delivery provider. On the other hand, if the definition of gross sales is based on revenue actually received by the restaurant, it could deprive the franchisor of revenue it intended to capture for purposes of the calculation of sales-based fees. This analysis could be further complicated based on how the contract between the restaurant and the food delivery service describes commissions and payments.

STANDARDIZATION AND CONTROLS

To maintain a cohesive brand image and consistent experience for consumers, a franchisor must set and enforce system standards designed to control the brand. These system standards may regulate anything from physical appearance of the restaurant, to minimum food quality standards, to food packaging and pricing. As described above, when working with a food delivery services, most restaurants lose some control over the method of food delivery, the manner in which its food is advertised, and even the prices charged for its food. This loss of control wreaks havoc with the franchise system. In addition to a lack of cohesiveness for customers, it raises serious question for franchised locations that are not voluntarily participating in the food delivery services. Does that franchisor expect each franchised location to monitor how its food is handled and delivered after it leaves the restaurant? Ultimately, unless the franchisor negotiates a national contract with a food delivery service to dictate standardization terms for participating restaurants, or otherwise controls the terms under which its franchisees use third-party delivery providers, it will have a limited ability to control food delivery operations from its restaurant locations.

Customer experience is not the only area that a franchisor may prefer some amount of standardization. For example, many franchisors are in the practice of auditing or tracking franchisee performance metrics across their system. However, many standard metrics such as gross revenue or costs of goods sold will be materially different for delivery sales than traditional restaurant sales. If different franchisees are participating in different food delivery services and on different terms, or some are not participating at all, then the revenue and cost data will vary, making it difficult for franchisors to understand franchisees' performance data.

TERRITORIAL RIGHTS

When adding new restaurants to its platform, food delivery services must designate a specified delivery area for customers of that restaurant. That delivery area is typically selected based on a combination of market conditions and practical considerations, such as the distance a driver can reach before the food is at risk of growing cold. Of course, both restaurants and the food delivery services want to offer delivery areas as large as possible, so as to maximize the reach of each restaurant to its available network of customers. However, this creates some confusion in franchise systems where multiple restaurants of the same brand are operating within the same or overlapping delivery areas. Which restaurant will have priority in search results for customers in that area? Can one restaurant pay to be prioritized over its neighboring competitor?

Franchisors must also consider how the delivery area aligns with the protected territory granted by many franchisors to its franchisees. The protected territory is typically intended to prevent a franchisor from placing additional competitive restaurants too close to an existing restaurant, so as to avoid cannibalization of customers. However, these pre-determined protected territories may not align with delivery areas, thereby allowing franchised restaurants to indirectly solicit and deliver to customers from another franchisees' protected territory. It also means that franchised restaurants may cannibalize each other's delivery customers, in some cases inadvertently if the restaurants are not knowingly participating in the food delivery services.

NEGOTIATING THE FOOD DELIVERY CONTRACT

When it comes to negotiating an agreement with a food delivery service, restaurant owners should consider all of the terms that will be meaningful for their continued success – not just price. For example, consider negotiating for: (i) a specific delivery area; (ii) control over the menu offerings, menu prices, and fees charged by the delivery provider; (iii) priority on the delivery route; (iv) a specific method of delivery, such as insulated carrier for hot/cold items; (v) black-out periods or limited run menu items; (vi) use of trademarks and logos (note also that many franchise agreements prohibit franchisees from granting their own licenses of the franchisor's trademarks); (vii) methods of advertising; and (viii) methods of calculating and administering payments and commissions. Of course every business is different, and each restaurant owner should carefully consider what is important to its customers and its brand.

Exclusivity is also often heavily negotiated, with each food delivery service trying to incentivize restaurants to work exclusively with their platform. Some restaurants, including large chains, have agreed to exclusive contracts specifically so that they can standardize and control the delivery process for their customers. Other restaurants want to broaden their reach by accessing multiple platforms with varying customer databases. Typically, however, food delivery providers will be more likely to negotiate more favorable terms in exchange for exclusivity. If agreeing to exclusivity, restaurant owners should be sure to consider the scope and duration of that exclusivity and be sure to negotiate the right to terminate that exclusivity if the food delivery service falls short of satisfying its obligations. Conversely, each restaurant brand should consider whether to negotiate exclusivity that would apply to the food delivery provider so that it cannot offer the same services for restaurants that are directly competitive.

Each restaurant owner should also ensure that the risk for any liabilities is fairly allocated between the restaurant and the food delivery provider. For example, if the food delivery provider hires its own drivers, the restaurant should not be responsible for any harm or damages caused by the driver or to the driver in the course of their services; whereas, the reverse may be true if the restaurant retains its own drivers. With respect to the food itself, who is responsible for refunding the customer if the food arrives cold? What if the customer contracts food poisoning? These issues and the appropriate allocation of risk should be considered and addressed in each instance. Restaurant owners using third-party delivery providers should also carefully review their own insurance policies to ensure that the liabilities they retain are insurable and covered.

Understanding customers is critically important to future growth. While negotiating a contract with a third-party delivery provider, be sure to consider what data and analytics the food delivery service is willing to share about the restaurant's customers, including, for example, the customers' contact information, the types of orders they place, their geographic spread, and the positive and negative feedback they submit about their experience.

CONCLUSION

Notwithstanding the various pros and cons, it is still unclear who benefits most from the growth in food delivery. Restaurants and third-party food delivery service companies will likely share in the gains from this expanding market, and it is clear that the best progress will happen when both sides engage and work together. If delivery companies grow more quickly than the restaurants providing their food, then restaurants might lose control of the consumer experience, similar to the way that airlines and hotels have lost bookings to online and app-based travel agencies. Ultimately, this industry is still rapidly evolving and may be hard to predict in the future. Independent restaurant operators and franchisors of restaurant brands will be well served by staying informed on industry trends and using that knowledge to craft a well-considered strategy that allows them to leverage the trend in a way that works for their restaurants or their systems while eliminating confusion and protecting the brands.

CHENG COHEN

311 N. Aberdeen, Ste 400, Chicago, IL 60607
Phone: 312-243-1701 | Fax: 312-277-3961