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Certain issues related to laws regulating franchise contracts, with special regard to their economic aspects

Theses of the PhD Dissertation

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1. Brief summary of the research work

1.1.The status of jurisprudence prior to this study[1]

In the *Hungarian legal literature*, relatively few studies were written in the subject of franchise contracts, in contrast to the wide coverage internationally. The few Hungarian studies include the work of György Csécsy, Lénárd Darázs, Tekla Papp, Miklós Rátky, Tibor Tajti and Szabolcs Váradi. The last comprehensive study in this field was published in 2011,[2] and the last comprehensive research analysing a specific sub-area (the obligation to give information prior to the conclusion of the contact) was published in 2013[3] .

On the other hand, *in foreign legal literature*, numerous studies have dealt with this topic. Legal scholarship stills actively researches this area of the law (primarily in the United States of America). Among foreign authors, the work of Richard E. Caves, Robert W. Emerson, Lorelle Frazer, Martin Mendelsohn, and Craig Tractenberg has had an orienting influence on the current research activities.

Relatively few studies have been written on the analysis of a single type of contract in terms of legal economics. Among Hungarian *works on legal economics*, the works of Péter Cserne, Károly Mike, Ákos Szalai and Attila Menyhárd have had a fundamental influence.

Among the foreign legal economics literature on franchise contracts, Uri Benoliel, Roger D. Blair, James A. Brickley, Anthony W. Dnes, Francine Lafontaine, G. Frank Matthewson, Paul H. Rubin, Ralph A. Winter should be emphasised.

1.2.How can this thesis contribute to jurisprudence, what is the scope of research work? [4]

The main scope of the research work is a comprehensive review, analysis and structuring of the Hungarian *legal literature* on franchising. It also include the examination and structuring of the extensive foreign legal literature to identify the research questions and the possible guidelines regarding its possible contribution to Hungarian jurisprudence.

[1] For details, see Part I, chapter 1.1.5. Timeliness, literature embeddedness

[2] Katalin Mandel - Lénárd Darázs*: Franchise Enterprise*, Hungarian Franchise Association, Budapest, 2011

[3] Szabolcs Váradi: *Preparing the conclusion of franchise contracts* (PhD thesis), University of Miskolc, Faculty of Law and Political Sciences, Deák Ferenc School of Law and Political Sciences, Miskolc, 2013

[4] For details, see Part I, Chapter 1.2.1. The issues under examination in the relationship between substantive law and case law

Considering that this research is based to a large extent on legal economic considerations,[5] it did not avoid a comprehensive study of the *basic principles and* paradigms of *legal economics*, and, specifically, the review of previous legal economic analyses of franchising. As the relationship between legal economics and the franchise contract had not been researched in Hungarian jurisprudence, the research could not build on previous studies in this area. Therefore it was particularly important to review trends and opinions and compare them with domestic legal doctrines. This can be an incentive to perform further research and study in this field.

In my research, I put emphasis on the study *of foreign legal systems*, taking into account the American roots of franchising. Therefore, I analysed the legal system of the United States of America (at the federal level and at the level of the individual member states of the USA, in particular Washington, North Dakota, Minnesota, Illinois, California, New York), the legal systems of certain European countries (France, Italy, Estonia, Romania, Lithuania, Albania, Belarus, Moldova), certain Asian countries (Russia, China, Japan, Malaysia) and Australia in a comprehensive manner. The primary focus was on those states where the franchise has been codified,[6] as it is Hungary. My goal was not to make a detailed, comprehensive comparison of the law, including a detailed analysis of judicial practice, but to find the main similarities and the common core. This is meant to be a functional comparison of the law. Consequently, the primary aim of the research was not to compare laws, but to examine the Hungarian legal environment and to illustrate contrasts and alternative approaches that emerge at a major aspects of franchise contracts.

The research has focused on *six* main *research questions* in an attempt to analyse franchise contracts: I paid particular attention to the how the answers to these questions can be used as a guide for future legislation.[7]

2. Brief description of the research and analysis, and the working methods

After the definition of the scope of the research, the thesis starts with the presentation of the features of the franchise contracts and its historical and social context. Then the franchise contract is defined and it is differentiated from other types of contracts. This is followed by the

[5] For details, see Part I, Chapter 1.2.2. The role of legal economics, the thesis hypothesis
[6] This is why the German legal system was not examined.
[7] For a description of the research questions, see Part III. Chapter 3.

examination of research questions along the phases of contract life. The methods used in the research are described below, each adapted to the specific issues of each question.

I examined the function, role and importance of rules and regulation pertaining to franchise contract, as well as the reasons for the establishing and applying such rules.
In addition to the application of methods to the research traditions of classical "dogmatic" jurisprudence, which focuses on citing and examining the relevant literature issues, analysing and contrasting the opinions of authors, and, as a result, developing my own position on controversial issues), the thesis also included a comparative methodical analysis of different legal systems. The methodology also included a contextual approach to certain issues and the use of argumentative and explanatory methods of research.

3. A brief summary of the scientific results and their potential applications

In this chapter, I summarise the main findings of the research along the lines of each research question.

3.1. Along the different phases of the franchise contract, what are the issues and sources of conflict either in the relationship between the franchisor and the franchisee, or between the parties and third parties? Is there social or economic need for the legislator to establish standards and norms?

Franchise contracts are not made between opposing parties, but both parties wish to operate the franchise efficiently and successfully. Translated into the language of economics, a franchise contract is a *cooperative idiosyncratic investment*.[8] On the one hand, it is cooperative in the sense that the parties are interdependent. On the other, it is idiosyncratic in the sense that the parties are expected to effect a huge initial investment and they fear they would lose if they terminate the contract prematurely.

The parties heavily rely on their contractual partner for the performance of the contract. This duty of cooperation is different from the general obligation of cooperation, which merely requires the parties to enable the other party to perform the contract as intended. Franchise

[8] Detailed in Part I. Chapter 3.1.3. Benefits and detriments

contracts put a higher degree of expectation on the parties, and *each party is expected to actively assist the other in achieving the other's purposes.*[9]

There are *businesses with opportunistic approach* on both sides of the contract, whose interest is to maximise their profit. However, a franchisee would likely demonstrate "*free-riding behaviour"*, which could jeopardise the franchise contract. [10]

The exercise - or non-exercise - *of rights and obligations* under a franchise contract *affects not only the parties to a franchise contract.* Although the franchisees to the same franchise system do not have any contractual relationship with each other, the exercise of their rights or the breach of their obligations may have an impact on the franchise network as a whole and thus indirectly on each franchisee. [11]

Please also note the feature described by Tibor Tajti *as Janus-faced dichotomy* [12], which is a source of conflict, given that the franchisor owns information and economic power, which is guaranteed by the legal system, and that the franchisee is completely exposed to the mercy of the franchisor's pleasure.

3.2. Does the Civil Code provide a predictable response to the social and economic needs arising in connection with franchise contracts?

In my view, it is unlikely that the permissible rules of the Civil Code regarding franchise contracts would apply as gap fillers of the franchise contracts, as the parties typically enter into a detailed, comprehensive agreement where the application of the Civil Code is expressly excluded. However, I do not believe that this should necessarily be the case. If the permissive rules created by the legislator were in line with the practice, *the gap-filling* role of these *rules* could actually be applied to franchise contracts. [13]

[9] For details, see Part II, chapters 6.3 Obligations on both sides and 7.8 Training, assistance
[10] Detailed in Part II, chapter 7.7.2. *Free-riding behaviour*
[11] In detail, Part I, Chapter 3.1.2. The private law concept /inderdependent relationships
[12] Detailed in Part II, Chapter 3.3.2. The franchisor's dominant position
[13] In detail in Part II, Chapter 2.2. Model nature, the importance of permissive regulation

I believe that the rules and regulations laid down in the Civil Code are predictable, with two exceptions.[14] The rights of the parties are precisely known ex ante as they are regulated by the Civil Code, and the rules of codes do lead to a predictable result.

The fundamental problem is rather that the effective rules and regulations of the Civil Code *are incomplete* and do not reflect the issues described in Section 3.1 above.
In my opinion, the difference between the laws of the USA and other foreign countries, which reflect the needs of the parties to franchise contract, and the Hungarian laws, which ignores them, is partly because the Hungarian law contains primarily rules and regulations governing product distribution type franchise contracts, and do not address the issues related to business format franchising, although they are extensively used in the practice. [15]

We have also seen that *general terms and conditions* are frequently used in franchising. In this respect, the fundamental problem is not that franchisor set aside the permissive rules in their *general terms and conditions* used by franchisors to the detriment of the franchisee, but that the legal practice pertaining to franchise contracts are detrimental to the franchisee per se. Since the general rules do not protect the franchisee, there franchisors need not deviate from any rules protecting the franchisee, as there are no such rules.[16]

3.3. How the social and economic needs can be translated into the language of law and what lessons can be drawn from this?

In my opinion, the obligation to strive for fair business practice and obligation of loyalty between the parties do not correspond to the provisions of Article 6:62 (1) of the Civil Code,[17] as the degree of cooperation expected from parties to a franchise contract is higher, therefore, the application of "long-term cooperation" as a term of art could potentially lead to confusion in judicial practice. I propose to use the term “obligation of mutual support” instead.[18]

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[14] The first exception is the 6:376.§ (1) of the Civil Code (Part I, Chapter 3.4.2.) the second is 6:381.§ (1) (Part II, Chapter 9.2.5. termination for convenience). Furthermore, at this stage of legal development, the attempt to modify terminology (jogbérlet) may even be confusing in certain respects (Part II, Chapter 2.1. On terminology).
[15] Detailed in Part I, Chapter 3.3.2 Product Distribution Franchising - Business Format Franchising
[16] For details, see Part II, Chapter 5.3 General terms and conditions
[17] Ptk. 6:62 (1) The parties shall be required to cooperate during contract negotiations, upon the conclusion of the contract and during its existence and termination, and shall inform each other with respect to any material circumstances concerning the contract.)
[18] Detailed in Part I, chapter 3.4.2 Conceptualisation experiments

In this context, it should be noted that breach of contract is less likely to occur in long-term business relationships and recurring contracts, because if one party should breach the contract once, the counterparty will no longer do business with the breaching party. Furthermore, the parties, in particular the franchisor, have to take into account their own goodwill, as a breach of contract may deprive the franchisor of further potential partners and franchisees. [19]
The law does not include the obligation to provide advice and support among the obligations of the franchisor. It is questionable whether the obligations to provide advice, assistance and training, which are expressly laid down in the ethical rules, amounts to the obligation to cooperate, which general requirement in contract law. In my view, the obligation to provide ongoing assistance and to update know-how is an essential element of franchises, and it would be necessary to name this obligation in the laws.[20]

With regard to *free-riding behaviour and the protection of third parties, including sub-franchisees,* it can be criticised that the Civil Code does not contain any provisions regarding either the manner of control or the failure to control. Therefore, this obligation should be elaborated in more details in the law in order to reduce systemic losses resulting from such free-riding behaviour.[21]

In the context of *Janus-faced dichotomy*, I'd like to note the important difference between the Civil Code and the PEL CAFDC, which is the model of the Civil Code, is that the PEL CAFDC also contains mandatory provisions, because the parties are required to make very substantial investments in order to perform such type of contracts, both at the beginning and during the term of the contract. These investments are so specific that they cannot be recovered if the business becomes less profitable than expected or if the other party terminates it prematurely.
It would be necessary to regulate *the obligation to give information prior to the conclusion of the contact* as mandatory requirement in detail, including the exact scope of this obligation. This would encourage the parties to provide all the information necessary before entering into a contract. This would also reduce information asymmetry as the parties would be able to conclude more efficient contracts, which would help the parties to avoid several potential disputes.[22]

[19] Details Part II, Chapter 8.2 Collateral
[20] Details Part II, Chapter 7.8 Training, assistance
[21] Details Part II Chapter 7.7 Controls
[22] Details Part II, chapter 5.5.1.The obligation to give information prior to the conclusion of the contact

I also suggest that the *prohibition of encroachment* should be codified in order to ensure that the franchisor cannot disregard the requirements of good faith and fair dealing in the course of drafting the contract. Encroachment is typically used by franchisors when they intend to make the economic viability of a particular franchisee impossible.[23]

In terms of the *obligation to supply products*, the law should include a provision that the franchisor has an obligation to ensure that the ordered quantity is available, as disruptions in supply could be highly detrimental to the franchisee.[24]

As regards the scope of the *right to instruct*, it is a question whether any activity cannot be linked to the manufacturing of the product and the provision of services, which is directly connected to the subject of the contract, and, at least indirectly, to the goodwill of the franchisor. This broad definition of the right to instruct may lead to the opportunistic behavior of the franchisor. The broad scope of the right to instruct and compliance with this obligation can impose the same financial and other burdens on franchisees as the excessive right to unilaterally modify the contract.[25]

It is also a matter of great concern that the legislator imposes *an obligation* to the franchisee *to warn* the franchisor of inappropriate (unsuitable) or unprofessional (unreasonable) instructions, as well as penalty for breach of this obligation, though franchisees may often be unable to determine whether the instructions have been inappropriate or unprofessional.[26]

Concerning the judicial practice regarding cancellation of the franchise contract, the parties typically reserve the right to cancel the contract by including a provision in the contract that, within a certain period of time after the execution of the contract, a party may step back from the contract, and the contract will be terminated with retroactive effect as of the date of the execution of the *contract.* This is called *cooling off period*. This practice certainly benefits the franchisee, as it gives it the opportunity to unmake a contract that had been made without through consideration. This allows the franchisee to avoid being required to maintain a contract

[23] Details in Part II, Chapter 5.6.4 Encroachment
[24] Details Part II Chapter 7.2 Obligation to supply
[25] Details Part II, Chapter 7.6.3 Contents of the instruction
[26] For details, see Part II, Chapter 7.6.4 Refusal to follow an instruction

for a long period of time when it is no longer beneficial and the parties may avoid investing in a joint venture that is no longer profitable for one of the parties. This can balance the information asymmetry and the limited insight of the franchisee to the consequences of the franchise contract. However, the current legal rules do not contain any provision to this effect.[27]

In view of the currently effective competition law and economic considerations, the preference given to *indefinite term* is unfavourable to the franchisee. Maintaining indefinite term as a model rule should not be sustained by judicial practice. [28]

As regards the *grounds for termination for breach*, I propose to clarify the possible grounds in view of the position of both parties in advance.[29]

The franchisee is typically unable to resell the *remaining stock of products*, and very often no longer has the right to do so due to competition restrictions, whereas the franchisor can sell this stock without any difficulty, so a buy-back obligation on the franchisor would be reasonable.[30]

However, the adoption of the *registration requirement* for franchisors, which is a practice in certain jurisdictions, is not justifiable in my opinion. On the one hand, excessive administrative burden and state supervision reduce entrepreneurial spirit and competitiveness, which is one of the basic ideas of franchising. On the other hand, if the franchisor's position can be terminated on account of regulatory compliance, then it would be detrimental to all franchisees, even those whose rights had not been violated by the franchisor in connection with the franchise contract. [31]

The *requirement of a trial unit/trial operation* should be regulated under public law,[32] since the trial has no relevance in the relationship of the parties if the franchise operates successfully. [33]

[27] Details in Part II, Chapter 9.2.4. Cancellation
[28] For details, see Part II, Chapter 9.2.5. Termination for convenience
[29] Details Part II, Chapter 9.2.6. Termination for breach
[30] Details Part II, Chapter 9.3.3. Accounting obligation
[31] Details Part II, Chapter 2.3. Requirement of registration
[32] Where an appropriate system of sanctions and/or registration obligations could prevent the franchisor from disadvantaging a larger number of franchisees due to weaknesses in the untested franchise system.
[33] Details Part II, Chapter 5.2 Content requirements

3.4. How do contractual self-regulation and the concept of codification relate to each other in franchise contracts?

Please note that franchising is an *economic and legal relationship* between the parties subject to the privity of contract, of which the franchise contract is only one element.[34]

Furthermore, franchise creates a *long–term* relationship, so-called "*relational contract"* between the parties, where the parties have a fundamental interest in maintaining the relationship and develop processes and methods of cooperation to resolve any dispute eventually arising between the parties. However, as we have seen, if the transaction costs are too high, then franchisor will tend to apply vertical integration instead of actual franchising. [35]

This does not mean that certain *mandatory rules* cannot be introduced in the Civil Code, or even in public law, to protect the weaker party, which is the franchisee in this case, by analogy with consumer protection, but also taking certain competition law aspects into consideration. However, strictly mandatory rules and regulations would be an obstacle to the development of the law and, therefore, would have adverse effect in terms of efficiency.

Of course, it is useful to examine the effectiveness of certain mandatory rules, but it does not mean that franchising should be regulated only by mandatory rules covering each and every aspect of the contract, as this would be contrary to the spirit of the Civil Code and private law.

Similarly, it would be unreasonable to ignore the already established and still evolving jurisprudence pertaining to franchise contracts, as this area of the law is governed by *soft law*.[36]

Darázs stresses that although ethical norms can only be considered "soft" sources of law, their indirect legal relevance is considerable, as they create a kind of minimum standard or set of criteria Given that these norms have become part of business practice, they have a legally significant role in defining the requirements of good faith and fairness, the circumstances of the parties and the conclusion of the contract, as well as the legal assessment of the "given circumstances " and "reasonableness", not to mention legal definition of unfair business

[34] Details Part I. Chapter 1.1.2. Complex economic phenomenon and Chapter 1.1.3. Legal Relationships
[35] Detailed in Part I. Chapter 3.1.3. Advantages and disadvantages for the parties
[36] Details in Part II, Chapter 1.3. Ethical rules

practices. [37] In contrast, in Tibor Nochta's view, the standard contractual clauses that have evolved in domestic and international practice into quasi "customary law". [38] If we accept Tibor Nochta's view, both the standard contractual clauses and ethical norms and guidelines have become, in particular, part of the contract in view of Article 6:63. (5) of the Civil Code.[39] . As a result of this, it is necessary to examine the relationship of the norms to the relevant provisions of the Civil Code. If their provisions complement the provisions of the Civil Code, legal practitioners can easily apply them, however, if they conflict with the laws, the application of such provisions may become difficult.

One example of a conflict of norms is that, in the context of the Civil Code, *a contract between two non-independent businesses may be considered a franchise contract*, whereas they are not regarded as franchise contract in view of the Directives. However, even we accept that the Directive also binds the parties, this conflict will not lead to problems in practice, since the Directive merely states that franchise contracts may only be concluded between so-called associate members of the Hungarian Franchise Association, and the violation of the independence criterion is not penalised.[40]

A similar divergence can be seen in relation to the obligation to give information prior to the conclusion of the contact and the duty to provide support and assistance, is this is not required by the Civil Code, only by the Codes of Ethics.

On the other hand, if we compare the definition of "franchise *know-how*" of jurisprudence and the Code of Ethics' with the earlier definition of business secret in the Civil Code[41] and the current definition in Act LIV of 2018, I am of the opinion that the two concepts are compatible.[42]

With *definition of franchise contract*, the Code of Ethics lists many more essential elements than the Civil Code. In my view, this difference should not lead to the non-existence of the

[37] Lénárd Darázs: *Title XIX*, In: Wellmann György (ed.): Civil Law VI/VI - Law of Obligations Parts Three, Four, Five and Six, HVG-ORAC Lap-és Könyvkiadó Kft., Budapest, 2021, 477-500, 481.

[38] Tibor Nochta: *Franchise and franchise contract (sketches on the basic private law issues of an institution)*, In: Tanulmányok Benedek Ferenc Tiszteletére, Janus Pannonius University of Pécs, Faculty of Law and Political Sciences, Pécs, 1996, 222-236, 230.

[39] Ptk. 6:63 (5) Any custom having been agreed between the parties in their earlier business relationship and any practice having been established by them shall become a content of the contract. Any custom widely known and regularly applied by parties to contracts of similar nature in the relevant business sector shall become a content of the contract, unless its application would be unjustified considering their earlier relationship. (Jogszabályszöveg)

[40] Detailed in Part I, Chapter 3.4.2 Conceptualisation experiments

[41] That is, for the period 15 March 2014 to 7 August 2018

[42] Details Part II 4.2.1. Chapter on know-how

contract in the absence of the missing elements. The Franchise Association did not presumably intend that, in the absence of these other elements, the contract concluded by the parties should be considered non-existent and thus that the parties' contract should not give rise to rights and obligations, and, therefore, for example, the idiosyncratic investments made by the franchisee should not be recovered.[43]

In conclusion, the ethical standards currently supplement the rules that do not - at present - protect the franchisee. However, it is a question is whether or not these ethical norms have legal binding force. Regrettably, no guidelines have yet been developed in domestic judicial practice to this effect.

3.5.Is the codification in line with the features of the franchise contract?

The category of *"franchise contract"* should be understood as *a combination of* at least *three different types of legal relationship*: firstly, a franchise contract itself, secondly, a contract for the supply of goods, setting forth the delivery of products to be sold in the franchise, and thirdly certain other contracts.[44] It is important to keep this in mind in codification, since many of the rules on which the legal scholarship has based its criticisms, such as the defect in the product supplied by the franchisor under the supply obligation, are not related to the franchise contract. Therefore, these issues must be solved in connection with those other contracts rather than franchise contracts.

In the classification of the *master franchise agreement,* we can identify certain dogmatic features. From a dogmatic point of view, in my opinion, the relationship is more similar to the landlord-tenant-subtenant relationship,[45] where the landlord (franchisor) assigns to the tenant (franchisee) the temporary exercise of rights (the right to conclude further franchise contracts). Such a classification could lead to an interesting outcome regarding the franchise contract. Thus, under Article 6:334 (2) of the Civil Code[46], as an analogy, the master franchisee would be liable for the conduct of its own franchisee vis-à-vis the master franchisor. Although

[43] Details Part II, Chapter 5.2 Content requirements
[44] Details Part I, Chapter 1.1.3. Legal Relationships
[45] Furthermore, if the right to enter into further franchise agreements is perceived as a profitable title, it may also be the case that the rules of the Contract for usufructuary lease apply.
[46] Ptk. According to § 6:334 (2) If the lessee sub-leased the property or abandoned it for use by another person with the consent of the lessor, he shall be liable for the conduct of the sub-lessee and the user as if he himself had used the thing.

currently the rules of the franchise contracts are permissive in nature, if certain implied norms protecting the franchisee were introduced, the correct classification would play an even greater role, whereas it may be problematic regarding the current rules applicable to master franchise agreement[47]

Many franchise contracts include a ″pre-emption right″ *for the franchisor* if the franchisee wishes to sell the franchise rights. It is dogmatically incorrect to use the term “pre-emption right” in the context of a contract. In contrast, the Civil Code has introduced a new legal concept, the transfer and assignment *of the contract*, which provides adequate protection for the franchisor.[48]

If the franchise contract is subject to the Statute of Frauds[49] (requirement to make the contract in writing), then problems may arise concerning the application of Article 6:94.§ (1) of the Civil Code, [50] and the legal consequences of invalidity, as it would be questionable to determine what can be considered executed. This is because the franchisor's obligation is to ensure the uninterrupted exercise of the rights granted by him during the term of the contract, so the original condition cannot be restored (since the service already rendered cannot be unmade), and the continuous performance would make the contract valid to the extent of the executed portion. Obviously, if the franchisor wished to unilaterally terminate the franchise contract, this is possible on the grounds of invalidity for the future, and the premature termination would deprive the franchisee of the possibility to recover its investments, which would not necessarily enrich the franchisor, so recovery of unjust enrichment would not be applicable. In order to avoid this situation, it may be advisable to consider the application of the consequences of relative nullity regarding oral contracts if the transaction is indeed subject to the Statute of Frauds.[51]

[47] Detailed in Part I, Chapter 3.3.4. The master franchise relationship
[48] In detail, see Part II, Chapter 3.2.3. The franchisor’s right of "pre-emption"
[49] Of course, the problem described here can arise for all grounds for invalidity. However, in the case of invalidity due to the error in the contractual intention or to the error in the intended legal effect, it is unlikely that the franchisor would be able to recover the settlement resulting from the invalidity, since it is much "harder" to raise these grounds of invalidity at the time of the conclusion of the contract than it is to fail to put them in writing. Likewise, the Civil Code does not provide for any such grounds of invalidity. 6:94 (1) would not apply either.
[50] The Civil Code. According to Article 6:94 (1) of the Civil Code, a contract which is void for breach of formality becomes valid upon acceptance of performance to the extent of the part performed. If the law provides for the inclusion of a notarial deed or a private deed with full evidentiary effect, or if the contract is for the transfer of ownership of immovable property, performance does not remedy the invalidity due to the failure to observe the mandatory formality.
[51] Details Part II, Chapter 5.1.

As regards the jurisprudence concerning *the delivery of a franchise operations manual*, in my view, this obligation can be derived from the Article 6:124 of the Civil Code.[52]

The provision of the Civil Code that only provides for the *obligation to pay fees* as the main obligation of the franchisee is an oversimplification of the franchise contract. In this case, the failure to pay either the initial franchise fee or the royalty could, in certain situations, give rise to challenging the contracts on the grounds of gross disparity between the values exchanged. Furthermore, if mandatory rules were adopted to protect the interest of the franchisee, the classification of the contract as a franchise contract would be more relevant, since if the classification leads to the conclusion that it is a franchise contract, the mandatory rules would be automatically applicable. In such a case, franchisors would be interested in applying a classification other than a franchise contract, even by calling the consideration differently from franchise fee and royalty, thus avoiding compliance with the mandatory rules. [53]

The Civil Code does not name the duty of *loyalty to third party franchisees*. With reference to the observation made in connection with the principle of the Civil Code that contractual relations are essentially defined by the Code as a contract between two parties in the spirit of the privity of contracts, relationship with third parties not fit into the doctrinal system of the Civil Code. It would, however, be desirable to include this obligation in the relationship between the franchisor and the franchisee.[54]

In the context of the franchisor's obligation to protect the goodwill, we may presume that franchisees other than the franchisee under the contract may be classified as *vicarious agents* of *the franchisor*, since the franchisor can fulfil its obligation to maintain reputation through the units operated by each franchisee, and the franchisor can control that.[55] In this case, a franchisee suffering damages may take legal action against the franchisor under Article 6:148 (1) of the Civil Code [56] on account of the conduct of the (other) franchisee who caused the

[52] Details in Part II, Chapter 5.4 The franchise operations manual
[53] Details Part II, Chapter 6.6. Obligation to pay fees
[54] Details Part II Chapter 6.3 Obligations on both sides
[55] Which argument is supported by the 6:380.§ (1) of the Civil Code.
[56] Ptk. 6:148 (1): A person using the contribution of another person to perform an obligation or to exercise a right shall be liable for the conduct of such person in the same way as if he had acted himself.

damage. If this interpretation were adopted, the exercise of the franchisor's right of supervision would also become more important.

The Civil Code does not include *the franchisor's obligation to provide advice and support* among the special rules (lex specialis) pertaining to *franchise* contracts. In the absence of such rules, is difficult to determine how to differentiate between franchise contracts and licence agreements by merely focusing on the franchisor's main obligation. We must not forget that Article 6:62 (1) of the Civil Code[57] lays down, among the general rules of contracts, the obligation of the parties to cooperate and inform each other during the term of the contract, which is not identical with this obligation, but covers less obligations. Contrary to the obligation to cooperate and provide information, which is the basic principle, the training and support provided by the franchisor are district and typical services to be provided by the franchisor. The scope of such obligation is much broader than the general obligation to cooperate and provide information, which is generally applied in all other contracts.[58]

The rules pertaining to *product warranty* mean that consumers do not benefit from additional protection in case of business format franchise, as no franchise mark may be attached to the provided services, while the franchisor in a product distribution franchise must also consider the risk of a warranty for defects when choosing the franchisor.[59]

3.6. Can the tools of legal economics be used, and if so, how, as a yardstick for regulating franchise contracts?

Our theoretical starting point, the *Coase theorem*, means that if the rights of the parties to an agreement are precisely known and regulated prior to entering into a contract and the transaction costs are zero, then the parties will reach an efficient outcome through bargaining freely, which is finally included in the contract.[60]

[57] Ptk. 6:62 (1), The parties shall be required to cooperate during contract negotiations, upon the conclusion of the contract and during its existence and termination, and shall inform each other with respect to any important circumstances concerning the contract

[58] Details Part II, Chapter 7.8 Training, assistance

[59] Details in Part II, Chapter 8.11. Product Warranty and Product Liability

[60] Stigler, G.J.: *The Theory of Price*, 3rd ed., Macmillan, New York, 1966 113.However, the original idea originated with Coase See Coase, R.H.: *The Problem of Social Cost*, In: The Journal of Law and Economics, 1960, No. 3, 1-44

The ex-ante knowledge and precise description of the parties' rights means that each party knows exactly what is in its possession and what must be obtained from the other parties. This criterion can be an obstacle in the fragmented regulation of franchise contracts. The parties may be oblivious as to what norms and what business practices they need to know from what source. They are also unsure whether the ethical norms, have generally binding effect on them. This problem may be even more acute where there is a contradiction between the provisions of different sources of law (such as the Civil Code and the Code of Ethics), which may undermine the transparency and predictability of the legal system.

The franchise agreement definition of the Civil Code also needs some clarification, as it does not refer to the independence of the parties and a long-term legal relationship or cooperation. The lack of a precise definition could lead to potential problems arising from the definition of the contract type. This could give rise to application of the law different from that intended by the legislator. Translated into the language of legal economics, it means that if the classification of a contract causes difficulty, there will presumably be uncertainty as to the rules to be applied. This will lead to uncertainty as the rights of the parties are not defined before entering into the contract.[61]

We have described the view of Oliver E. Williamson,[62] that the *level of transaction costs* will that prevents an agreement from being reached if the idiosyncratic investment is high and the parties cannot enter into a contract and the counterparty is threatened by opportunistic behaviour of the other party. It can be concluded that both parties have a high level of idiosyncratic investment and demonstrate opportunistic behaviour, especially the franchisor. Therefore, transaction costs must be reduced to achieve agreements that are beneficial to society. One of the means to reduce transaction costs is create permissive legal rules and regulations which are clearly known to the parties. This obviously calls for detailed legal regulations, so that potential parties can know their rights and obligations before entering into contracts.

[61] More precisely, the rules of the franchise contract will be known ex ante, but it will not be known whether these rules apply to the relationship in question. For details, see Part I, Chapter 3.4.2. Conceptualisation experiments
[62] Williamson, Oliver E.: *Transaction-Cost Economics: The Governance of Contractual Relations*, in Harmathy Attila - Sajó András (eds.): Studies in Economic Law, Volume II, Economic Analysis of Law, Közgazdasági és Jogi Könyvkiadó, Budapest, 1984, pp. 171-201, 171.

We have also shown that the economics of law argues that law can promote *long-term relationships* by protecting the aggrieved party from the other party's hunger for royalty. [63]
The asymmetry of information and dominance in franchise contracts is a crucial issue that arises from the position of the parties. This can be balanced to achieve efficiency and to consider reducing the limited rationality on the part of the franchisee, for example by defining a cooling off period[64] or by imposing formal requirements to facilitate the understanding regarding the obligation to give information prior to the conclusion of the contact [65] .
In general, there are four arguments commonly used in legal economics in favour of the mandatory rules and regulations: (1) if the transaction involves a third party, (2) if the relationship between the two parties is characterised by informational asymmetry, (3) if the rationality of one party is limited, (4) if the two parties are not in equal positions, for example, one party has a dominant position over the other.[66] As we have seen, in the case of a franchise contract the first three grounds are certainly present, and the fourth ground is sometimes present.[67]

Legal economics is on the view that the legislator can affect *how much information is collected and how much is passed on between the parties.* The obligation to provide information can reduce the rent-seeking and also reduce the costs of obtaining information. This can also eliminate information asymmetry. This could be achieved by imposing on obligation regarding franchise contracts to provide information prior to entering into the contract. It would also be desirable, in order to reduce transaction costs, to set out by way of example what information the franchisor is required to provide tot the franchisee during the performance of the contract. [68]

Our legal system does not provide guidance to the parties regarding *whom they should choose as their partner after how much search*, nor is it particularly interested in reducing the cost of finding a partner. However, since the private law is based on the freedom to choose a partner,

[63] Williamson, Oliver E.: *Transaction-Cost Economics: The Governance of Contractual Relations*, In Governance, Public Finance, Regulation, 2007, no. 2, 235-255, 253.
[64] Details in Part II, Chapter 9.2.4. Withdrawal
[65] Details Part II, chapter 5.5.1. Obligation to give information prior to the conclusion of the contact
[66] Attila Menyhárd - Károly Mike - Ákos Szalai:*The ineffectiveness of prohibition.* Századvég, 2006, No. 41, 3-46, 32-35.
[67] Detailed in Part II, Chapter 3.3 Regulatory issues from the paties' perspective
[68] Details Part II, Chapter 5.5. Obligation to provide information

it cannot be expected to regulate this aspect, nor is it appropriate to do so. Effective regulation can be achieved by not imposing barriers to entering into transactions.

The Civil Code also does not specifically provide for giving a “pre-emption right" to the franchisor, which is extensively applied in practice but dogmatically incorrect, but the in view of the rules in effect concerning the transfer and assignment of contracts, is unnecessary from both a legal economic and a doctrinal point of view. [69]

The legal system can also affect the *level of detail and precision with which* parties *draft their contracts*. If the model rules do not fit in practice, the parties need to devote additional resources to deviate from them and to draft their contract in a more detailed and precise manner. With respect to legal economy, it is also important to point out that if ambiguous or unresolved issues remain in the contract, the effectiveness of the court's interpretation of the law is enhanced by properly drafted gap-filling rules. If such rules, and consequently the interpretation of the contract, are ineffective, then contracts that were otherwise intended to be long-term will be split up by the parties to reduce their losses in the event of a dispute, thus reducing the level of idiosyncratic investment. [70]

As the very subject matter of franchise can lead to confusion of interpretation, the legislator will encourage the parties to be as precise as possible in their contracts, which leads to increased transaction costs.[71]

Similarly, if the provisions of the contract were drafted in writing, the economic efficiency of the contract would be improved.[72]

The legislator can also influence *how* the parties *share the risk.*

Cooter and Ulen argue that[73] parties very often leave uncertainties in contracts. The basic economic explanation for this is that if the parties agree to share a particular risk at the time of contracting, they must surely be aware of transaction costs associated with it. Conversely, if they do not allocate the risk between them, they will only need to decide on the allocation of the loss between them if such event occurs. It can be seen that the parties can save transaction

[69] In detail, see Part II, Chapter 3.2.3 The franchisor's right of "pre-emption"

[70] Ákos Szalai, *Economic Analysis of Hungarian Contract Law*, L'Harmattan Publishing House, Budapest, 2013, 486.

[71] Details Part II Chapter 4.2 Indirect object of the contract

[72] Details Part II, Chapter 5.1.

[73] Cooter, Robert - Ulen, Thomas: *Law and economics*, Nemzeti Tankönyvkiadó Rt., Budapest, 2005, 228-231.

costs by leaving uncertainties whenever the costs of negotiating the contractual terms of the risk exceed the expected costs of filling the gap.[74] However, parties are able to leave uncertainties and gaps in the contract only if the permissive rules are in accordance with the legal practice, otherwise parties will have to bear transactional costs to deviate from this rule each time.

It may be possible, that if there are more detailed permissive rules, parties would enter into more detailed contracts regulating their relationship, in which they would deviate from the rules of the Civil Code for the benefit of both parties. But it should be noted that permissive rules are sticky, meaning that if a contract does not clearly regulate the relationship between the parties, they have a significant gap-filling role. It is also important to take into account the status quo effect created by permissive rules, which means that the party initiating the deviation from the permissive rules will disclose additional information about itself to its counterpart by initiating the modification.[75]

In the context of franchise contracts, the Civil Code is admittedly intended to serve *as a model for* practice. In my opinion, the current legal rules, without the requisite clarification, either does not serve as a model or perhaps only as a 'bad example'. Furthermore, the reasons calling for codification, such as the protection of the franchisee's interest or the facilitation of the court's work, have not been sufficiently taken into account in the law-making process. As the law does not support legal and judicial practice, it may as well render the resolution of disputes more difficult rather than facilitating it.

In terms of franchise contracts, we have concluded that the currently effective laws are unfavourable for third parties, including the buyers of products or services through a franchisee, as any direct action against the franchisor would improve the likelihood of their claims being satisfied, as they are presumably wealthier in other respects. The product warranty could provide a partial solution to this. This vicarious liability will encourage the principal (in this case the franchisor) to develop an appropriate governance structure towards its vicarious agents. However, in the case of franchise contracts, the scope of the right of supervision monitoring

[74] That is, if the cost of sharing the risk is greater than the product of the cost of loss sharing and the probability of loss, the parties will choose to leave the gap (cost of risk sharing > cost of loss sharing X probability of loss => leave the gap). However, it is not always possible to determine or measure this precisely at the time of contracting.
[75] In detail in Part II, Chapter 2.2. Model nature, the importance of dispositive regulation

does not include day-to-day control of all activities, so it would be unreasonable to hold the franchisor liable for any damage caused by the franchisee. [76]

The legislation may also have an impact on *whether* the parties *keep their promises in the contract.* The franchisee has a fundamental interest in maintaining the reputation of the franchise system and rendering the business more successful, but the key to the success rests to a larger extent with the franchisor. If the franchise fee is high but the royalty rate is low, then problems may arise in connection with the incentive effect of the franchise. The initial franchise fee, which is considered sunk cost for the franchisee, gives the franchisee an incentive to succeed, but the franchisor, once it has received this amount, will no longer be interested in developing the business.[77]

With regard to the collateral behind the contract, the parties have several means of preventing the breach of contract, but the reputation of the business partner, in particular the franchisor, and the term and recurring nature of the legal relationship are often a sufficient deterrent to breach.

It is also important to emphasise the coordination game problem. In order to protect the goodwill of the franchise system, both parties have an interest in avoiding heavily investing to maintain and generate goodwill, but encourage the other party to invest because it will be the most optimal outcome for the aforementioned party . The worst case scenario for both parties is that neither party invests to preserve the franchise system's goodwill. However, if the combined profits of the parties are taken into account, it is not difficult to see that it is primarily the franchisor, who can be active and cost-effective in protecting the reputation of the franchise system, for whom the costs of being active are lower, therefore, the franchisor should be incentivised in this respect from an efficiency point of view. [78]

The *legal economics reason of* the franchisee's failure to assert its rights is the so-called *collective action problem*:[79] while all franchisees have an interest in supervising the franchisor's decisions, no individual franchisee has an interest in being the one to bear the cost of control. If another member of the franchisor's system takes over the control, such franchisee will enjoy

[76] Cf. Part II, chapters 8.6 Liability towards third parties; 8.10. Universal liability in relation to the transferee; 8.11. Product warranty and product liability

[77] Details in Part II, Chapter 6.6.2. Types of charges

[78] Details Part II Chapter 7.5 Protecting goodwill

[79] Cf. Ákos Szalai, *Economic Analysis of Hungarian Contract Law*, L'Harmattan Publishers, Budapest, 2013, 278.

the benefits (preventing the franchisor from making bad decisions)[80] but does not have to bear the cost of the control. [81]

Regarding franchisees, the lower quality of service provided by a particular franchisee will affect the reputation of the entire system, as the customers will not only have a negative opinion of the unit but of the whole network because of the low quality of service. Unfortunately, the right of supervisionalone is not sufficient to solve this problem. Generally, sometime will elapse between the deterioration of the services and the date of the inspection, and by the time the franchisor becomes aware of the breach of contract, the deterioration in goodwill will have already occurred. Therefore, the legal consequence of such a breach of contract is usually the provision that allows the franchisor's to terminate the contract with immediate effect. However, the right of termination with immediate effect would also be insufficient in itself if it were not accompanied by an additional *economic loss* on the part of the franchisee which exceeds the profit resulting from the provision of the inferior quality. This could be, on the one hand, an additional sanction (penalty for failure to perform, claim for damages), or, on the other hand, the loss of profit or sunk costs (irrecoverable idiosyncratic investment) on the part of the franchisee alone may be sufficient.[82]

The legislator can also encourage the parties *to exercise care*. The economics of law also looks at how norms affect the *steps* parties *take to mitigate damages.* In this context, it is pointed out that the application of the foreseeability may be difficult to determine liability, but that this is a problem for all long-term legal relationships, not only franchises. In the area of mitigation of damages, the permanence of the legal relationship is also a specific feature, whether it is the breach of the obligation to supply or the loss of goodwill. However, each franchise system is unique so it is impossible to create abstract rule to address this issue.

The rules of our legal system also affect *how much* the parties *invest in the expectation of the fulfilment of the contract.*

The requirement of a fixed term would be an incentive to the parties to conclude contracts, as this would ensure the return on their investment, while the one, two or three months' notice period provided by the Civil Code is not practicable to ensure the interests of the franchisee and to guarantee the return on its investment. The absence of termination without case and the

[80] Or if this is not possible, at least to reduce the adverse legal consequences.
[81] Details Part II, Chapter 8.2 Collateral
[82] Detailed in Part II Chapter 7.7.2 *Free-riding behaviour*

penalty for premature termination would be useful to eliminate franchisee's risk and limited rationality.

The legislator presumably took into account the issue of efficient breach of contract, and therefore provided for a notice period. However, in the current regulatory environment, which does not allow for efficient breach of contract, it might be reasonable to provide for an alternative way of termination for franchise contracts. Examples of such an alternative termination, albeit not on the basis of efficient breach of contract, is present in the current legal practice, for example in contracts for care and maintenance.[83] One such alternative could be, for example, to allow the parties to request the court to terminate the contract if the purpose of the contract cannot be achieved by amending the contract (Article 6:184 of the Civil Code). However, the examination of whether the purpose of the franchise contract can no longer be achieved would impose a significant additional burden on the courts.[84]

The legal economics also analyses how the legal system can influence whether parties *are willing to renegotiate a contract* in the case of unanticipated, unresolved problems.

As franchise contracts are typically concluded for a longer but fixed term, the parties may request an extension of the franchise when it expires. For the franchisee, the ideal situation is that the franchisor renews the contract on the same terms and for the same fees, whereas the franchisor has an interest in ensuring that the franchisee pays the increased franchise fee upon the extension of the contract in view of the increased goodwill.[85] *From an economic point of view, the issue of contract amendment and renegotiation is closely linked to the hold-up problem.*[86] In the interests of *efficiency and* in order to tackle the problem of *rent-seeking*, it would be desirable to draw up contracts which do not require renegotiation. While the Hungarian legal system, based on the principle of pacta sunt servanda, encourages idiosyncratic investment during the life of the contract, since the other party cannot escape from it, the

[83] Ptk. 6:495.§ (3) If the purpose of the contract cannot be reached through its amendment, any of the parties may request the court to terminate the contract

[84] So is the creation of a system to state accounts after the termination of the contract.

[85] Cf. Tractenberg, Craig - Calihan, Robert - Luciano, Ann-Marie: *Legal Considerations in Franchise Renewals*, In: Franchise Law Journal, Vol. 23 No. 4 (2004), 198-205, 207-210, 205.

[86] The hold-up problem starts from the fact that the idiosyncratic level of investment of the parties in a given relationship is low: the obligor does not invest enough to ensure that the value of the service does not increase for him, the obligee does not try to reduce his costs. This problem is due to the fact that, although idiosyncratic investments would increase the benefits of the contract, they will be sunk costs when the contract is modified. This is because, if there is a possibility of contract modification or renegotiation, the opportunistic counterparty may demand an even higher consideration than in the original agreement, and the obligor will therefore be less willing to make such investments. See Ákos Szalai, *Economic Analysis of Hungarian Contract Law*, L'Harmattan Publishers, Budapest, 2013, 128-129.

problem recurs when the contract expires. *The transaction costs* of contract modification should also be mentioned. In the default case, one might assume that the transaction costs are lower, as the parties are already familiar with each other and a large part of the contract remains unchanged, but we still face higher transaction cost, as the parties have to decide how to share the resulting quasi-profit.[87]

Finally, it should be remembered that the rules governing the franchise contract are a good starting point for a long-term cooperation between the parties, but the *procedural rules that* the parties draw up to settle any disputes and renegotiate the contract are just as important. Franchise contracts are recurring agreements with mixed idiosyncratic investment elements. This leads to the conclusion that the agreement between the parties requires the creation of a so-called relational contract. Classical contracting, however, increase the expected lifetime of the relationship and may reduce the benefits that can be obtained from a breach of contract. Contracts can contain elements that commit the parties to long-term cooperation (e.g. making it more difficult to terminate the contract with long notice periods or high penalties for failure to perform), and penalties can be a safeguard against opportunism on the part of the other party. Written contracts can also be used to lay the foundations for dispute resolution procedures. [88]

By examining the hypothesis, it can be concluded that the use of the tools of legal economics can be used to create a *more efficient* legal regulation of the subjects of franchise contracts, the conclusion of the contract, the payment of fees, the master franchise agreement, and the termination of the contract. The concept of efficiency in legal economics can be used as a benchmark for regulating franchise contracts.

3.7.Conclusion

Lajos Vékás once said: "Inclusion in the Code is not a status symbol, so there is no need to strive for the inclusion of as many legal institutions as possible.."[89] I believe that franchise contracts are currently codified as status symbol, because the law does not respond to questions raised by the legal and business practice.

[87] Details Part II Chapter 9.1 Modification of the contract
[88] Cf. what was said about the relational contract. See Part I, Chapter 3.1.3. Advantages and disadvantages for the parties
[89] Lajos Vékás: *On the Historical Timeliness of a New Civil Code*, In: Hungarian Science, 2001, No. 12, 1396-1403, 1398.

In Cserne's view, economic analysis of law can be useful for both the legislator and the practitioner, as it can help to identify alternative legal solutions to specific micro- or macro-societal problems, to compare and evaluate these solutions in terms of their likely consequences, and to play a role firstly in law making and secondly in teleological application of law. [90]

I hope that this paper can serve as a guideline for the legislator for future law making in connection with franchise contracts.

4. Publications of the doctoral candidate on the topic of the thesis

1. János Reines: "Examining the Codification of Franchise Contract in the United States of America" (forthcoming), JÖSz Intézet
2. János Reines: "Some Legal-Economic Aspects of the Obligation to Give Information prior to the Conclusion of the Contact" Marianna Fazekas (ed.): Jogi Tanulmányok, (Legal Studies), 2024, ELTE Faculty of Law and Political Science, Doctoral School of Law and Political Science, Budapest, 2024, pp.468-479.
3. János Reines: "Franchise Contract - Rights and Obligations from a Legal Economics Perspective": Erdélyi Jogélet vol. 2023, no. 4, pp. 87-102.
4. János Reines: "The regulation on the termination of franchise from a legal economic perspective" Magyar Jog vol. 2021, no. 4, pp. 209-215.
5. János Reines: "Some Legal Economic Issues of Franchise Contracts - Reflections on the Issue of Efficient Breach of Contract" Marianna Fazekas (ed.): Jogi Tanulmányok 2021, ELTE Faculty of Law and Political Science, Doctoral School of Law and Political Science, Budapest, 2021, pp. 564-576.
6. János Reines: "The Regulation on the Subjects of Franchise and the Conclusion of Contracts from the Point of View of Legal Economics" Magyar Jog vol. 2020, no. 12, pp. 685-698.
7. János Reines "The Franchise Contract" Tamás Sárközy (ed.): Magyar Jogászegyleti Értekezések, vol. 2018, no. 9-10, Budapest, 2018, pp. 11-47.

[90] Péter Cserne: *Economic Analysis of Law*, In András Jakab - Miklós Sebők (eds.): Empirical Legal Research, Osiris Publishing House, Budapest, 2020, 169-188, 186-187.

8. János Reines: “The Franchise Contract: Reflections on the Renewal of the Codification of the Franchise Contract in Act V of 2013 on the Civil Code” Magyar Jog, vol. 2018, no. 10, pp. 529-547.