

Microfranchising: A Business Approach to Fighting Poverty

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Imagine a franchise network that trains, guides, and supports hundreds of poor women with little or no business experience to become successful business owners. Such “microfranchise” efforts, though relatively small in number, have been gathering steam in the development community and, recently, attracting the attention of the mainstream franchising industry. Advocates have seized on microfranchising as a natural complement or follow-on to the widely acclaimed successes of the “microfinance” sector, which provides small-scale finance services to over 150 million of the world’s poor.¹

Microfranchising today is where microfinance was a decade or more ago. It is appropriate at this juncture, then, to ask: What guidance can microfranchising usefully draw from the microfinance experience? The first section of this article examines lessons learned from the microfinance sector and then traces the origins of microfranchising. The second section explores whether mainstream commercial franchising practices are relevant for franchising that takes place with those living at the base of the economic pyramid. The final section recommends the legal and regulatory environment that can best facilitate microfranchising.

LESSONS FROM MICROFINANCE

Nearly half the world (approximately 3 billion people) lives at the base of the economic pyramid.² Of those, around 1.4 billion people live in extreme poverty with incomes of less than \$1.25 a day.³ As shocking as these numbers are, the good news is that, over the last three decades, poverty rates have been falling globally.⁴ The bad news, however, is that the recent financial crisis has slowed the pace of poverty reduction. Worse still, the continuing effects of the crisis are expected to push yet another 64 million people into extreme poverty by the end of 2010.⁵

There is no silver bullet for moving people out of poverty. There are tools, however, that show striking success in



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spurring poverty reduction and improving the lives of those living at the base of the economic pyramid. One of these is microfinance, which has steadily gained worldwide recognition.⁶ Today, over 150 million poor people in the world enjoy access to microcredit, that is, loans as small as \$25.⁷ Microcredits typically are used as working capital by people, often poor women, with little or no credit history and limited, if any, physical collateral that might be pledged to secure their debt obligations.

Champions of microfinance can be found around the world. Many would agree with former Secretary General Kofi Annan of the United Nations that “[m]icrofinance has proved its value, in many countries, as a weapon against poverty and hunger. It really can change peoples’ [sic] lives for the better—especially the lives of those who need it most.”⁸

But is microfinance living up to its promise? Do poor people who gain access to microcredit actually grow their microenterprises into successful businesses?

Data suggests that microenterprises rarely grow into small- or medium-size businesses, even where the owners of these microenterprises have access to microcredit.⁹ Critics of microfinance point to the lack of employment opportunities stimulated by microfinance. Some even go so far as to suggest that the sizable financial resources now devoted to the microfinance sector might be better spent on other, more effective poverty-alleviation interventions.¹⁰

There may be sound reasons, however, why so many microentrepreneurs keep their enterprises “micro.” Microentrepreneurs may prefer to diversify their income-producing activities among several microenterprises instead of growing a single business that would be more vulnerable to factors outside of the microentrepreneurs’ control (including corrupt local government officials). The microentrepreneur may fear that a larger enterprise, particularly one that employs paid labor, will demand more entrepreneurial expertise and skills than the microentrepreneur currently commands.¹¹

Another important reason that so many of these enterprises stay “micro” is that microentrepreneurs may have chosen to invest profits into feeding and educating their children rather than expanding their businesses; in short, these microentrepreneurs are betting on their children, rather than on their businesses, to improve their families’ social and economic condition.

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This is a strategy shared by parents the world over. Unfortunately, however, it appears that microentrepreneurs' investments in the education of their children are not generating the hoped-for returns because their working-age children often find it difficult to secure jobs in the formal sector. This was documented by FINCA International, a global network of twenty-one microfinance institutions serving over 700,000 clients.¹² In 2004, FINCA International conducted a survey of 1,500 microfinance clients in Mexico, Guatemala, Honduras, El Salvador, and Haiti. Of the surveyed clients' children who had completed all or part of their secondary education, only one in six was employed in the formal sector (defined by FINCA as commanding a salary of at least \$8 a day). The other working-age children of FINCA clients were unemployed or employed in the informal sector where they were earning less than \$3 a day.¹³ If the FINCA study is representative of the microfinance sector as a whole, then the investment that many microentrepreneurs worldwide are making in the education of their children is not paying off.

There is good reason to think that this is a pervasive issue that reaches far beyond FINCA's network of microfinance providers. The world is facing a youth employment crisis. The International Labor Organization (ILO) reports that "of the 1.1 billion young people aged 15 to 24 worldwide, one out of three is either seeking but unable to find work, has given up the job search entirely or is working but living on less than \$2 a day."¹⁴ Moreover, ILO data indicates that youth unemployment is a growing problem. In the decade between 1995 and 2005, the number of unemployed youth aged 15 to 24 increased by approximately 15 percent, from 74 million to 85 million.¹⁵

FROM MICROFINANCE TO MICROFRANCHISE

What can be done to bring scalable business opportunities to the base of the economic pyramid, in particular to microentrepreneurs and their working-age children? One possible answer is to look to commercial franchising models and practices. After all, a franchise network trains, guides, and supports individuals with little or no business experience to become successful business owners.

Is it a pipe dream to think that a franchise network could do the same for hundreds of poor women? Not if you were to step back in time to the 1890s to talk with former domestic servant Martha Matilda Harper. Harper established the first Harper Hairdressing Parlor in Rochester, New York, in 1891 and then extended her hair parlor into a business format franchise that trained and employed thousands of poor women. By 1928, there were 500 Harper Hairdressing Parlors around the world.¹⁶

If Martha Matilda Harper could build scalable business opportunities for poor women at the turn of the nineteenth century through the use of one of the earliest business format franchises, how might franchise practices and business models be enlisted to build scalable business opportunities at the base of the economic pyramid in today's world? Standardized business systems; strong brand identity; valuable

know-how and experience; financing assistance; training and start-up support; establishment of supply channels; marketing services; research and development; and continuing franchisee support, including peer learning opportunities for franchisees, are but some of the hallmarks of commercial franchising that might be enlisted and adapted to grow scalable business opportunities so that more microentrepreneurs can bridge the gap between microenterprises and small enterprises while also providing improved employment opportunities for their working-age children.

There is no common definition of *microfranchise*.¹⁷ Some have called it "a scaled down franchise with a small enough price tag that low income people can afford it."¹⁸ Others have described microfranchising as "a variety of franchise types . . . [that aim] to impact poverty by facilitating job creation, economic activity and distribution of goods and services to the base of the pyramid markets."¹⁹ In this article, the term *microfranchise* means a business model that, although adopting many of the business practices employed in mainstream commercial franchising, involves businesses that are affordable enough to be owned and operated by people living at the base of the economic pyramid. Even this definition, however, leaves much room for interpretation, particularly as one tries to determine what an "affordable franchise" is from the point of view of the world's poor. To this point, Jason Fairbourne, author of *MicroFranchising: Creating Wealth at the Bottom of the Pyramid*, founder of the Fairbourne Consulting Group, and Peery Fellow at the Ballard Center for Economic Self-Reliance at Brigham Young University's Marriott School of Management, has offered some loose boundaries, noting that although ". . . the average US franchise costs roughly \$250,000 . . . microfranchises range from \$25 to \$25,000."²⁰

Microfranchising, as used in this article, is distinct from the related concept of "social franchising." Social (sector) franchising typically is aimed at bringing products and services, like education and health care, to people living at the base of the economic pyramid through the use of business format franchise practices. Some researchers have suggested that social franchising necessarily does not generate profit.²¹ This assertion has been contested vigorously by others, however, who cite a network like The HealthStore Foundation's CFWshops in Kenya as an example of a social sector franchise that aims to be profitable. This Kenyan chain of 80 microfranchised drug shops and clinics served over 540,000 patients and customers in 2009, according to its program sponsor, The HealthStore Foundation.²²

Perhaps a more relevant differentiation between social franchising and microfranchising is not that of profitability but rather of who is the target franchisee. To put it differently, unlike social franchising, microfranchising may or may not deliver goods and services to the poor, but it will always aim to build franchisable business opportunities that are affordable for the poor. In contrast, social sector franchising may or may not draw its franchisees from the poor, but it will always aim to deliver needed products and services to the poor.

Microfranchise networks are still relatively few in number. Although no single repository purports to have a complete list, one source recently listed over sixty microfranchise opportunities in twenty countries.²³ Some of these opportunities are relatively large, such as SPOT City Taxis, which reportedly has grown into the largest taxi operator in Bangalore, India, with more than 300 cars, each owned by a microfranchisee;²⁴ and Fan Milk, which is listed on the Ghana stock exchange and is reportedly the leading distributor of dairy products in Ghana with some 8,500 microfranchisees selling milk, ice cream, yogurt, and popsicles from carts and bicycles.²⁵

As previously noted, microfranchising today is where microfinance was a decade or more ago. Many microfranchises have yet to demonstrate that they are financially sustainable at the network level and even, at times, at the unit level.²⁶ Transparency in measuring the performance of microfranchise networks lags far behind that of its cousin, the microfinance sector.²⁷ And like microfinance of ten or more years ago, microfranchising activity generally appears to be taking place off the radar screen of any regulatory or legal authority.²⁸

WHAT LESSONS CAN MICROFRANCHISING LEARN FROM COMMERCIAL FRANCHISING?

All organizations that begin franchising face a steep learning curve; in fact, it is often said that franchising organizations are entering a whole new business because the business of franchising is so different from the business concept that is being franchised. Persuading a customer to part with money for a desired good or service is a very different exercise from persuading a prospective franchisee to invest money and time in building a franchise. It is hard and unfamiliar work to market a franchise opportunity, recruit prospective franchisees, screen applicants, train successful candidates, and complete all of the other steps necessary to help these franchisees open for business.

And the franchisor's job does not end when the franchise opens. The new franchisor might not be prepared for the full weight of franchisees' expectations, namely, the expectation that the franchisor has expertise in the business model that the franchisees are trying to execute; that the franchisor can teach that expertise and will be available to share it at all hours; that the franchisor will provide ongoing support in the form of product research, marketing research, sourcing of inputs, etc.; that the franchisor will enforce system standards to promote uniformity of image and consistency of operations; and that the franchisor will demonstrate overall leadership of the brand.

So franchising is a leap for any organization, but microfranchising by an organization with little or no experience in commercial franchising is likely a much longer leap. A variety

of microfranchise sponsors, ranging from nongovernmental organizations (NGOs) to foundations to for-profit entities, have launched microfranchise networks with varying levels of the skills needed for key franchisor functions such as creating a supply chain, assessing business talent, enforcing system standards, and managing relationships for commercial success.

To what extent can sponsors of microfranchise networks look to commercial franchising for guidance? Microfranchising and commercial franchising may have less in common than meets the eye. First, the objectives of microfranchisors

and mainstream commercial franchisors are likely to be very different. Some start microfranchise networks in order to bridge the gap between microbusinesses and small businesses, that is, to provide a financially sustainable model that will

permit microentrepreneurs to "graduate" into small-business owners. Others start microfranchise networks (or social sector franchise networks) as a distribution channel to sell products and/or services to the economically disadvantaged. In either case, the focus of the microfranchise network is likely to be on the financial performance of the microfranchisee and the resulting economic impact of the microfranchising operations at the local level, be it through increasing employment opportunities or increasing unit sales.²⁹ Generating financial returns for the microfranchisor appears to be a secondary consideration for many microfranchise networks, although financial sustainability at the network level is a long-term goal of many microfranchise networks—even those initially funded by donor grants.³⁰

Commercial franchisors, of course, similarly must be mindful of the financial performance of franchisees if the system is to succeed. But the emphasis is different; put simply, commercial franchisors launch franchise programs primarily to benefit themselves, with potential side benefits to franchisees, whereas many of today's microfranchisors appear to be launching their microfranchise programs primarily to benefit the poor.

Microfranchising and commercial franchising also differ markedly in the nature and capabilities of the franchisees. Microfranchisees are drawn from poor populations. They are likely to have very little, if any, money to invest in a microfranchise. They may have little or no education. They may live in remote areas and have no reliable means of transportation. They may not have access to technology or even to electricity. Moreover, they are unlikely to have significant business experience other than on a subsistence level.³¹ For these reasons, traditional product distribution franchises, which require less capital and are far less complex than business format franchises, have dominated microfranchising thus far.³²

Despite these significant differences, commercial franchising can contribute much to microfranchising efforts. First, as unlikely as it may seem today, mainstream commercial franchisors might consider offering their own microfranchise

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brands. The development community and the mainstream franchising community are rapidly learning more about each other, and one result is a heightened focus on profitability of the microfranchise brand at the network level. This focus might eventually offer mainstream franchisors a profit opportunity that they instinctively dismiss today. Even if significant profit is not on the near horizon, a mainstream franchisor might be willing to offer a microfranchise opportunity in order to lay the groundwork for its brand in a developing country that shows promise or to gain a jump on its competitors or simply as a charitable endeavor to enhance its reputation. The franchisor might wish to tout itself to its customers as a do-gooder in developing countries even if it means taking a small loss on microfranchising.³³

A mainstream franchisor could contain its investment and risk by developing the microfranchise as a second brand, perhaps with little or no public association with its primary commercial brand but with the ability to leverage the back-end support of the principal brand. Under this approach, if the secondary microfranchise brand fails, its failure would not taint the primary brand in the market. The information box accompanying this article provides mainstream franchisors with some reference works and organizations to consult for more information on how to get started in microfranchising.

Second, and more likely, commercial franchising can contribute to microfranchising by providing ideas and reference points for structuring and managing microfranchised brands. A microfranchisor can readily draw from the vast body of materials and resources developed in franchising over the last thirty or forty years. But the information sharing could also take place through direct mentoring relationships whereby established commercial franchisors actively mentor franchisors that are working with the economically disadvantaged. Just as the microfinance sector has benefited from mentor relationships with the commercial banking sector, so too could microfranchising benefit from similar arrangements with commercial franchisors.

Even if, in some ways, commercial franchising might instruct more effectively by contrast than by similarity, it can offer useful lessons. The following paragraphs provide a few examples.

Brand Management

A threshold question is who should serve as the “brand manager” for a microfranchise brand in a particular market. In commercial franchising, foreign brands typically, though not always, enter a market through master franchising, in which a local party is appointed to fulfill the role of the “franchisor.” The master franchisee, as brand manager, grants subfranchises, provides training and opening assistance, supervises marketing efforts, and supports ongoing operations of the subfranchisees. By contrast, if the brand is homegrown, master franchising typically is unnecessary (the brand owner knows its own market) and potentially even detrimental (because it inserts a middleman between the brand owner and the ultimate operator).

Microfranchisors can draw from these commercial

practices by performing a similar self-analysis of their internal capabilities to grow and manage the microfranchise brand in a particular market. The microfranchisor might lack the business expertise to maximize its brand, particularly if the microfranchisor is an NGO or development agency. Or the microfranchisor might lack the organizational scale and resources to fulfill the franchisor support functions for an expanding network of small-scale, intensely local microfranchised businesses. In either case, a master franchising model could offer a solution. It would permit the microfranchisor to retain sponsorship of the program as well as an in-country connection to the ultimate operators.³⁴ At the same time, the microfranchise brand owner could hand off day-to-day implementation to a better-qualified brand manager. Conceivably, that brand manager might even be a mainstream franchisor with a primary commercial brand that is looking to do some good in the world, gain a foothold in a new market, or both.

Of course, the microfranchisor has other alternatives; for example, it could simply hire employees or consultants with the necessary franchising expertise. However, this alternative requires the microfranchisor to have sufficient funds to hire the required talent, whereas the appointment of a master franchisee assumes that the master franchisee will use its own resources to manage the brand in exchange for the lion’s share of the revenue stream from subfranchisees.

Experience has taught that the success of master franchising in the commercial context depends greatly on choosing the right local partner. The challenge would be no less for a microfranchisor. For example, the brand owner might be reluctant to grant a master franchise to a commercial enterprise that it suspects would not fully embrace its poverty-fighting mission or that has little experience in dealing with a subfranchisee pool comprising those living at the base of the economic pyramid. Nevertheless, the master franchise structure and the considerations that underlie its use could be instructive for microfranchising, particularly for those aiming to develop a global or regional footprint.

Contracts

In commercial franchising, the franchisor typically presents prospective franchisees with a long, detailed franchise agreement spelling out the respective rights and obligations of the parties. The goals of these franchise agreements have evolved over time. Although franchisee advocates believe that these agreements continue to be largely protective of the franchisor at the expense of the franchisee, there has been some movement toward more balanced terms governing the creation, operation, and termination of franchise relationships.

Given the characteristics of prospective microfranchisees and the very different risks inherent in a microfranchise from those encountered in a mainstream commercial franchise, standard commercial contracting practices may not be appropriate for microfranchises. Microfranchisees may not have the ability to read, let alone understand the legal complexities of, a lengthy written agreement. In fact, in some circumstances one could argue that individualized contracts

should not be used at all.

This is not to say that there should not be franchisee protections built into the microfranchisor-microfranchisee relationship. Indeed, one might argue that the inherent power and information asymmetries between a microfranchisor and its microfranchisees make franchisee protections even more important than in the commercial context. Microfinance experts have noted, “Not only may low-income consumers be more vulnerable to misconduct by providers [of microfinance services and products] and less able to protect themselves, the consequences of their financial missteps may be more severe, resulting in lost income, assets, and consumption.”³⁵ If this is true of microfinance borrowers, it is likely to be true of microfranchisees too.

On the other hand, at this early stage of development of the microfranchise sector, it may be more appropriate to advance microfranchisee protections outside of an individual contract, given the limitations of the microfranchisee to understand its terms and, ultimately, the challenges of enforcing such a contract in any meaningful manner.

Maturation of the Network

The current literature on microfranchising rarely provides more than a glimpse of the business terms between the microfranchisor and its microfranchisees. To some extent, this may be a function of the dominance in microfranchising of simple product distribution business models. When

the microfranchisor-microfranchisee relationship involves only the purchase and resale of tangible products, along with instructions for the microfranchisee’s use of the brand in downstream sales to consumers, elaborate business terms are not necessary.

If microfranchising begins to reach meaningful scale, however, even relatively simple microfranchise networks are likely to encounter new challenges, such as (1) growing pains from expansion of their networks, (2) competition from rival brands for microfranchisees and end customers, and (3) migration into the more complex arrangements of business format franchising.

Commercial franchising offers some approaches to adjusting and expanding the business terms as challenges like these arise. For example, microfranchisors must be prepared to deal with intrabrand conflicts if and when the number of microfranchises in operation approaches a saturation point in a particular geographic area. Commercial franchisors try to avoid such conflicts through market studies that estimate how many franchises a market will support and/or by assigning territories, locations, or customers in a way that will assure that each franchisee has a viable business opportunity.³⁶

Listed below in summary form are further examples of problems that maturing microfranchise networks might encounter that may not be addressed in their original business terms, along with corresponding potential adjustments or expansions drawn from the commercial franchising world:

Copycat businesses, especially those started by former or breakaway franchisees	<ul style="list-style-type: none"> • Confidentiality clauses that prohibit franchisees from using proprietary information outside of the franchise • Noncompete clauses • Ability to cut off inputs or repossess key equipment
Dilution of management quality	<ul style="list-style-type: none"> • Owner/operator requirement • Restrictions on transfer of the franchise • If the business is large enough, right to approve manager(s) of the franchise
Inconsistent marketing	<ul style="list-style-type: none"> • Pooled contributions from franchisees to be used for brand advertising controlled by the franchisor • Formation of franchisee advisory council to provide coordinated input
Failure to comply with operating requirements	<ul style="list-style-type: none"> • Reporting obligations, including direct electronic access by franchisor to franchisee data, if feasible • Inspection and audit rights • Franchisee peer pressure
Failure to pay amounts owed	<ul style="list-style-type: none"> • Requirement of payment by direct debit to account established by or for franchisee • Inspection and audit rights • Self-help remedies, such as ability to cut off supplies or require cash on delivery
Implementing updates to the business model	<ul style="list-style-type: none"> • Unilateral right to update operations manual that franchisees must follow • Shorten term of franchise • Requirement of franchisee’s agreement to then-current terms at key milestones (e.g., renewal or transfer of the franchise)

This list is by no means exhaustive. Moreover, it begs the questions how effectively these adjustments can be made in the absence of written contracts between the microfranchisor and its microfranchisees and how effectively they can be enforced absent a stable and transparent legal system in the microfranchisee's country.

Putting specific business terms aside, the single most important lesson of commercial franchising is that successful franchising always depends on good relationships. As franchise networks expand, however, it is increasingly difficult to manage the brand by direct contact with individual franchisees. Distances grow, schedules conflict, personnel change, and voices multiply, all of which present obstacles to maintaining the quality of communication that the franchise system knew in its earlier life.³⁷ Microfranchisors will need to construct channels of communication (from the outset, if possible) that ensure microfranchisees receive important microfranchisor communications in a consistent form at the same time and thereby avoid distortions that can undercut brand image. The reach of mobile technology into rural areas potentially makes this goal achievable where it would not have been a decade ago.

Microfranchisors also must embrace the notion that complaints from microfranchisees are not necessarily destructive. Just as microfinance providers have grown increasingly aware of the importance of developing effective grievance and redress mechanisms for consumers of microfinance products and services, so too should microfranchisors develop effective channels for microfranchisees to lodge complaints and criticisms. In fact, complaints show that the complainer cares enough to bring the matter to the microfranchisor's attention. What is more dangerous for any franchisor, commercial or micro, is silence, which could signify either a lack of complaints or, alternatively, that unexpressed complaints are festering into something even less healthy. Encouraging complaints, of course, is easier said than done when working with the poor. Microfinance providers have found that these populations, even when made aware of their right to complain, often fear expressing their views due to age, gender, societal position, language, or undue deference to authority figures, to name just a few factors.³⁸

Accordingly, another useful technique that could be borrowed from commercial franchising is the formation of a franchisee advisory committee (FAC). The FAC gives the franchisee community a common outlet to express opinions, share ideas, and vent criticism about marketing, franchisor support, and other aspects of business operations. At the same time, the FAC gives the franchisor a venue to float trial balloons and adjust strategy with less risk of provoking anxiety in the franchisee community. For example, the franchisor might go to the FAC with a presentation on a new product or service before staking out a systemwide position from which it will be difficult to back away.³⁹ An FAC might be even more important and useful in the microfranchise context as it offers a way to mitigate at least some of the power and information asymmetries that are likely to exist between microfranchisors and microfranchisees. Although a single microfranchisee may be reluctant to lodge a complaint or

raise a criticism directly with the microfranchisor, it may be less intimidating to speak up within the FAC, particularly if other microfranchisees share the concern being voiced.

There is another reason why the establishment of FACs may be wise for microfranchisors: the creation of social capital among participating microfranchisees. FACs could serve some of the functions that village banking groups have served in the microfinance context. Village banking groups, which can range in size from ten to thirty borrowers or even more, provide opportunities for village leadership and peer learning and support, among other things.⁴⁰ A significant challenge in establishing such an FAC, however, will be overcoming the physical distance likely to exist between microfranchisees, particularly those who live in rural areas.

Franchisor Support

As noted previously, microfranchisors with limited commercial experience might not be prepared for the full weight of ongoing microfranchisee expectations. Perhaps it is true that microfranchisees at the base of the economic pyramid, also inexperienced with franchising, will have few expectations at the beginning and that they will be relatively easy to satisfy.⁴¹ Over time, however, microfranchisors should expect (and even hope) that their microfranchisees will evolve in the same way that they do in maturing commercial networks, namely, that microfranchisees will become empowered and likely more demanding of the microfranchisor.

In a maturing franchise system, it is not uncommon to hear two types of complaint. The first complaint is that the franchisor simply does not understand the franchisee's problems, especially if the franchisor operates no or only a few company-owned businesses of the type operated by the franchisee. The franchisor's directives come across to the franchisee much like the parent's dreaded "do as I say, not as I do."⁴²

The second type of complaint is that the franchisor is no longer "earning" the royalty that the franchisee must pay to be in the system. To the franchisor, this comes across as a flippant "what have you done for me lately?"

From the viewpoint of an experienced practitioner, these tensions seem to be inherent in franchising. But when they arise, microfranchisors can reduce tensions by embracing two business principles borrowed from the commercial context:

1. Continuously strive to add value to the microfranchisee's operations
2. Make a sound business case for microfranchisor-imposed requirements

The microfranchisor can add value by, for example, offering ongoing training and undertaking product development, marketing research, and operations analysis for which microfranchisees have neither the time nor the resources. The microfranchisor can make a sound business case by, among other things, using data collected from microfranchisees (preferably on an aggregate basis that protects individual results) to benchmark each microfranchisee's performance against the network and derive best practices. In commercial

franchising, these activities typically are not obligations in the franchise agreement, but they are assumed in practice by a responsible franchisor. Responsible microfranchisors should consider doing the same.

HOW (OR WHETHER) TO REGULATE MICROFRANCHISING: ARE THERE LESSONS TO BE LEARNED FROM REGULATION AND SELF-REGULATION OF FRANCHISING?

For more than thirty years, commercial franchisors have been accustomed to operating under the franchise sales laws at the federal level and in fifteen of the United States. Twenty years ago, however, commercial franchisors faced considerable uncertainty in taking their franchise systems abroad. Absent express statutory or regulatory recognition of the franchise method of doing business, commercial franchisors could not be sure whether or how their franchise offerings would be regulated and in some cases whether franchising was permitted at all.

Today, almost two dozen countries have adopted statutes governing the offer and sale of franchises, including several countries with significant populations of the poor: Brazil, Indonesia, Malaysia, Mexico, and South Africa. In other countries, such as India, commercial franchising has thrived without the imprimatur of a franchise law.

Self-regulation also plays a role in commercial franchising, though some franchisee advocates question whether it is more than a public relations exercise. The International Franchise Association (IFA), for example, takes a four-step approach to self-regulation: (1) a code of conduct, (2) a streamlined code enforcement mechanism, (3) an ombudsman program, and (4) educational programs. This commitment to self-regulation is intended to provide an “effective alternative to litigation and legislation, both of which are costly, time consuming, and potentially destructive to franchising.”⁴³

One can imagine that self-regulation will be equally important, perhaps even more so, in building, structuring, and maintaining healthy microfranchise relationships. This is in part due to the disparity of negotiating power and the potential for misunderstandings between even well-intentioned, socially motivated microfranchisors and their respective microfranchisees. It also is due to the costs and time involved in pursuing court-led dispute resolution in markets where microfranchising is likely to take place. The lack of efficient and well-functioning court systems makes litigation an unlikely solution for either the microfranchisor or the microfranchisee.⁴⁴

Microfranchising, as noted above, appears to be taking place beneath the radar of any regulatory authority. In fact, most microfranchise programs have appeared in countries that do not have franchise sales laws. This is not surprising: franchise laws generally have arisen in jurisdictions where they were preceded by a substantial amount of commercial franchising activity, and commercial franchisors generally have not entered developing countries marked by extreme poverty, at least not beyond the major metropolitan markets.

Yet one can legitimately ask: Would microfranchising be further along today if it had experienced explicit regulatory recognition in poverty-stricken countries? More pointedly, would express recognition stimulate or impede microfranchising going forward?

The concept of regulation as promotion has precedent in both commercial franchising and microfinance. In commercial franchising, for example, the introduction of franchise regulation in China answered the question of whether franchising was legally permitted. In that sense, the Chinese regulation could be viewed as “enabling.” Similarly, in microfinance, “providing an explicit regulatory space . . . may very well have the effect of increasing the volume of financial services delivered and the number of clients served.”⁴⁵ In the last ten years, specialized laws and regulations have been adopted to promote microfinance, many of which are aimed at prudential regulation of deposit-taking microfinance providers.⁴⁶ However, as commentators in microfinance have noted over the years, any discussion of an explicit new regulatory space must weigh potential unintended consequences, in particular, the risk that the political process of regulatory change might stymie innovation and competition.⁴⁷

Franchising is well enough known worldwide that, as a general matter, it should not need enabling legislation beyond the general law of contracts in any jurisdiction. If enabling regulations were proposed, however, they would likely mimic existing franchise laws and regulations, which are built on an investor protection model that was borrowed originally from regulation of the sale of securities. In both franchising and securities, regulation was a response to fraudulent conduct by fly-by-night operators. So, one must ask: Do investors in microfranchises (that is, the microfranchisees) need the protection of the type of franchise sales laws that regulate commercial franchising?

Nothing in the literature on microfranchising suggests that microfranchisees have been victimized by widespread fraud to date. It is certainly possible that unscrupulous parties could try to exploit potential microfranchisees with empty promises, and a pattern of such abuse might make it necessary to create a regulated channel as a marker of legitimacy. But the mere possibility of future fraud is not an adequate basis for regulation of microfranchising.

Moreover, the traditional approach to investor protection in commercial franchising is mandated disclosure of detailed information to the prospective franchisee, sometimes accompanied by a requirement to register the franchise offering with government authorities. Consider, for example, the Franchise Act 1998 of Malaysia, which requires the franchisor, before making an offer or sale of a franchise, to register a disclosure document, a sample franchise agreement, the operations manual, the training manual, and audited accounts and financial statements with a Registrar of Franchises.⁴⁸ Registered franchisors must file updated disclosures in an annual report. Violations of the law are punishable by fine, and a court can declare the agreement void and order a refund of all payments by the franchisee.

Would microfranchisors, faced with the compliance

burdens of Franchise Act 1998, be inclined to launch a microfranchise program in Malaysia? The compliance costs seem likely to overwhelm the modest financial and social returns to be expected from microfranchising.

Worse, the Malaysia statute confirms the danger that creating a regulatory space will invite interference in business terms. For example, the Malaysian law requires that franchise agreements have a term of at least five years and prohibits termination except for good cause. Moreover, the franchisor must compensate the franchisee if it refuses to renew or extend the franchise at the end of its term. The law contains no exception that would apply to microfranchises, although it authorizes the supervising ministry by order to exempt any person or class of people from part or all of the act.⁴⁹

On the microfranchisee side, it is questionable whether the receipt of a detailed set of disclosures would be of real benefit to poor populations living in Malaysia or elsewhere. The recipients may not have the ability to read or the business sophistication to understand the information presented. On the other hand, the obligation to prepare (and possibly register) a disclosure document can have a disciplining effect on the franchisor regardless of whether franchisees actually read it.

Rather than a comprehensive registration-and-disclosure regime, microfranchising would be better served by a self-regulatory structure that is simpler for both the microfranchisor and its microfranchisees. The basic elements would include the following:

- A *registry* in which microfranchisors would simply give notice of their intention to offer a microfranchise program (similar to the one-page “notice” registration that franchisors make in the states of Indiana, Michigan, and Wisconsin). A registry could be voluntary or mandatory, and it could be government-managed or privately run. The registry would help to distinguish legitimate microfranchise programs from any fraudsters that might seek to exploit poor people. To determine who may or must register, the registry would necessarily have to define *microfranchise* as appropriate for the jurisdiction.
- *Annual reporting* to provide very basic information on the performance of microfranchise networks, such as the number of microfranchises granted, microfranchisee turnover (i.e., numbers dropping out or terminated by the brand owner), and perhaps certain economic results such as impact on employment (if such data can be collected from microfranchisees).⁵⁰ The transparency of this information would (1) foster competition between microfranchise brands as potential microfranchisees learn to use the information to decide among particular systems; and (2) help identify the business sectors in

which microfranchising is successful or not successful, which would help microfranchise sponsors target their efforts and perhaps help governments tailor incentives or policies.

- A basic *code of practice* to which members of the registry would subscribe. This would be similar to the codes that IFA and other commercial franchising trade groups have established for their members. The code of practice would informally govern relationships between microfranchisors and their microfranchisees by reference to a set of business norms. The code would not be regulatory or contractual in the sense that it could be enforced by government authorities or privately, other than by affecting membership in the registry. However, to some extent, the code of practice would stand in for the private contract terms found in commercial franchise agreements but sometimes lacking in microfranchising. Moreover, if signatories of such a code of practice were made public, then market forces (which are likely to include funders of microfranchise networks, namely, their donors and investors) could be brought to bear on the signatories.

This is akin to the approach that microfinance recently has taken with the adoption of the microfinance sector’s Client Protection Principles, which describe the minimum protection that microfinance clients should expect to receive from microfinance providers. These Client Protection Principles for microfinance are focused on the particular risks that low-income clients are likely to face when procuring financial services.⁵¹ A growing number of providers of financial services, microfinance networks, donors and investors, and individuals working in microfinance have endorsed these principles since they were first announced in 2009.⁵²

So what would a code of practice look like in the microfranchise context? For starters, it likely would include all of the five basic value statements now found in the IFA Code of Ethics: (1) trust, truth, and honesty—foundations of franchising, (2) mutual respect and reward—winning together as a team, (3) open and frequent communication—successful franchise systems thrive on it, (4) obey the law—a responsibility to preserve the promise of franchising, and (5) conflict resolution.⁵³

The challenge is that the expression of these values may need to shift significantly to accommodate the needs of a microfranchisee population comprising those living at the base of the economic pyramid. Take, for example, the absence of any ombudsman framework to facilitate dispute resolution between microfranchisors and microfranchisees. Or, even stickier, consider the challenges in determining the suitability of potential microfranchisees in a world where credit bureaus are largely absent and even national identity

Microfranchising appears to be taking place beneath the radar of any regulatory authority.

cards are sometimes nonexistent. Yet these challenges must be faced. And, importantly, transferable learnings should be shared amongst microfranchise networks.

The IFA Code of Ethics reminds us:

The public image and reputation of the franchise system is one of its most valuable and enduring assets. A positive image and reputation will create value for franchisors and franchisees, attract investment in existing and new outlets from franchisees and from new franchise operators, help capture additional market share, and enhance consumer loyalty and satisfaction. This can only be achieved with trust, truth, and honesty between franchisors and franchisees.⁵⁴

For microfranchising to build on the success of microfinance and to grow to an equally meaningful scale, upholding a similar positive reputation will be crucial.

CONCLUSION

Increasing the poor's access to financial services is a necessary, but not the only, ingredient in reducing poverty in the world. Increasing the poor's access to scalable business opportunities is another critically important ingredient. For a man or woman living on one or two dollars a day, owning a microfranchise may prove to be a critical first step toward building a more sustainable livelihood. Both microfinance and mainstream franchising have much to teach those who are working to advance franchising at the base of the economic pyramid. Although the challenges of microfranchising are significant and the issues complex, the rewards could be extraordinary. At stake are the lives and livelihoods of billions, including, it is important to note, the world's next generation.

ENDNOTES

1. See Sam Daley-Harris, State of the Microcredit Summit Campaign 2009, at 4 (2009), available at www.microcreditsummit.org (as of Dec. 31, 2007, the report reached 154 million clients).

2. The approximately three billion people who live at the base of the economic pyramid have daily incomes of less than \$2 a day. See generally Daley-Harris, *supra* note 1, at 4.

3. See Press Release, The World Bank, New Data Shows 1.4 Billion Live on Less Than \$1.25 a Day, but Progress Against Poverty Remains Strong (Aug. 26, 2008).

4. *Id.* The number of people living in poverty has fallen by 500 million since 1981.

5. World Bank, Global Economic Prospects: Crisis, Finance and Growth 2010 (released Jan. 21, 2010); see also Robert B. Zoellick, President, The

World Bank Group, Address at Thomson Reuters Building, Canary Wharf, London: Seizing Opportunity from Crisis: Making Multilateralism Work (Mar. 31, 2009).

6. The United Nations named 2005 "The International Year of Microcredit." U.N. General Assembly A/RES/53/197 (International Year of Microcredit); see also U.N. General Assembly A/RES/58/221 (Resolution on the Programme of Action for the Year of Microcredit) (adopted by the General Assembly). In 2006, the Nobel Peace Prize was awarded jointly to the founder of microfinance, Professor Muhammad Yunus, and the microfinance lender he created, the Grameen Bank. See Press Release, The Nobel Peace Prize for 2006 (Oct. 13, 2006), available at <http://nobelprize.org>.

7. See Daley-Harris, *supra* note 1, at 3.

8. Kofi Annan, Sec'y Gen., United Nations, Secretary-General Message on the Launch of the International Year of Microcredit (Nov. 18, 2004).

9. FINCA International, a global microfinance network with

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- Microfranchise Ventures, LLC, www.microfranchises.org.
- *Microfranchising: Creating Wealth at the Bottom of the Pyramid* (Jason S. Fairbourne, Stephen W. Gibson & W. Gibb Dyer, Jr., eds., Edward Elgar Publ'g Ltd. 2007).
- Microfranchisor, www.microfranchisor.org.

operations in twenty-three countries, conducted research to map the growth of the self-employed businesses of its microentrepreneurs. According to FINCA's research, nine of every ten clients stopped growing their businesses after three to four consecutive loans. See John Hatch, *Microfranchise Theory—Opportunities for Partnership: How Microfinance and Microfranchising Complement Each Other, in Microfranchising: Creating Wealth at the Bottom of the Pyramid 102* (Jason S. Fairbourne, Stephen Gibson & W. Gibb Dyer, Jr. eds., BYU 2007).

10. See, e.g., A. Karnani, *Microfinance Misses Its Mark*, Stan. Soc. Innovation Rev. (Summer 2007).

11. Zoltan Acs, director of the Center for Entrepreneurship and Public Policy at George Mason University, coined the term *necessity entrepreneurs* to capture those people who are self-employed because they see no better employment option. This is in stark contrast to *opportunity entrepreneurs*, or people who are eager to find and exploit opportunities in the market. See Lisa Jones Christensen, David Lehr & Jason Fairbourne, *A Good Business for Poor People*, Stan. Soc. Innovation Rev. 44, 46 (Summer 2010). The authors of "A Good Business for Poor People" go on to note that in developing countries "not only is it difficult to find a job, it is also difficult to envision a new business—especially one that employs other people or adds new products or services. Lacking both employment opportunities and ideas for new businesses, necessity entrepreneurs often wind up copying other businesses." *Id.*

12. See FINCA International's website at www.finca.org.

13. See Hatch, *supra* note 9, at 103.

14. Press Release, ILO, New ILO Study Says Youth Unemployment Rising, with Hundreds of Millions More Working but Living in Poverty (Oct. 27, 2006) (announcing release of ILO Report, *Global Employment Trends for Youth 2006*).

15. *Id.*

16. See National Women's Hall of Fame, www.greatwomen.org.

17. Microfinance practitioners are likely to point out that definitional issues have also plagued the microfinance sector. There is still no widely accepted definition of *microcredit*, for example. Some have tried to define *microcredit* by describing attributes and features of the loan product, e.g., its maximum size, intended use (working capital, income generation, other), duration, and absence of physical collateral. Still others have tried to define *microcredit* by also describing the intended target customer, e.g., gender, poverty level, etc. In sum, *microcredit* means many different things to many different people depending on the context. See generally What Is Microcredit? (Apr. 2010), www.grameen-info.org (suggesting that there is a need to develop classifications of microcredit).

18. See, e.g., What Is Microfranchising?, www.microfranchises.org.

19. See Dalberg Global Dev. Advisors, Franchising in Frontier Markets: What's Working, What's Not and Why 77, Annex 1 (Common Definitions—Microfranchising) (Dec. 2009).

20. Microfranchising: Creating Wealth at the Bottom of the Pyramid 8 (Jason S. Fairbourne, Stephen Gibson & W. Gibb Dyer, Jr. eds., BYU 2007).

21. See Dalberg, *supra* note 19, at 77, Annex 1 (Common Definitions—Social Franchising).

22. See www.cfwwshops.org/statistics.html.

23. See the Resources tab at www.microfranchises.org, the website of Microfranchise Ventures, LLC. Even using an expansive

definition of *microfranchise*, there are relatively few (less than 100) microfranchise networks in the world as compared to the over 10,000 microfinance providers existing today. See Dalberg, *supra* note 19, Annex 5 (Sample Set of Micro-franchises) (lists sixty-eight microfranchises drawn from Kirk Magleby, Microfranchise Opportunity Catalogue, referenced on www.microfranchises.org); see also Daley-Harris, *supra* note 1, at 3.

24. See Steve Beck, Woulter Deelder & Robin Miller, *Franchising in Frontier Markets*, 42:5 Franchising World 80 (IFA May 2010) (by the authors of the Dalberg report, *supra* note 19).

25. See Christensen et al., *supra* note 11, at 44.

26. See generally Dalberg, *supra* note 19, at 25. This, too, echoes the microfinance story as, a decade or so ago, debates raged not only on whether microfinance providers could reach financial sustainability but also on whether such sustainability should be a goal of microfinance providers. Today, fifteen years later, both of these debates have quieted as sustainable microfinance providers serve nearly 75 percent of the world's microfinance clients (not counting those served by state banks). See Alexia Latortue, Microfinance in 2010 (May 17, 2010), www.cgap.org (Latortue is the acting CEO of the Consultative Group to Assist the Poor (CGAP)).

27. See Latortue, *supra* note 26. Like microfranchising, microfinance in its early days was marked by very little transparency, making it hard to measure or compare the performance of microfinance providers. In part, this was due to the lack of consensus on how to benchmark and evaluate performance. Today, by comparison, some 1,700 microfinance providers regularly report on their financial performance to the Microfinance Information Exchange (MIX Market). Audited financial reports are common in the microfinance sector. Rating agencies have also become part of the microfinance landscape. MicroRate, Planet Rating, Microfinanza Rating, and M-Cril specialize in rating microfinance providers on their financial and, increasingly, on their social performance.

28. Today, by contrast, specialized laws and regulations have been adopted around the world to promote microfinance, particularly deposit-taking microfinance providers. See, e.g., CGAP, Law Library, www.cgap.org, which aims to meet the needs of banking regulators and supervisors, microfinance providers, national microfinance networks, and other stakeholders seeking to understand the optimal mix of regulation and supervision for microfinance. See also Basel Comm. on Banking Supervision, Microfinance Activities and the Core Principles for Effective Banking Supervision (issued for public comment Feb. 9, 2010).

29. Indeed, microfranchising experts sometimes lapse into "employment" language when describing the relationship with the microfranchisor. See Christensen et al., *supra* note 11, at 46 (stating that a nineteen-year-old Fan Milk franchisee "likes his employers" and that Fan Milk "employs" 8,500 franchisees). In commercial franchising, the distinction between a franchisee and an employee is a sensitive legal issue, and commercial franchisors take pains not to mix the concepts.

30. Here, too, one can see a parallel with the evolution of the microfinance sector. In recent years, the microfinance sector has begun to attract new entrants whose primary aim is to return a profit to their investors. The deliberate commercialization of microfinance has been controversial, causing some, including the founder of microfinance, Dr. Yunus, to ask how much profit is appropriate for a microfinance provider to generate, particularly when those profits are not reinvested

in the microfinance provider or shared with microentrepreneur clients.

31. Microfranchising experts observe that these factors make microfranchising a better business model in poor communities than entrepreneurship-building efforts, which “assume that poor people would like to be entrepreneurs, if only their lack of education and capital were not standing in the way.” Christensen et al., *supra* note 11. In fact, “research has long indicated that many newly minted entrepreneurs turned to self-employment as a last resort, not because of their desire to be small business pioneers.” *Id.*

32. See Beck et al., *supra* note 24. The authors cite Fan Milk (Ghana), Kegg Farms (India), Natura (Brazil), and Coca-Cola’s Manual Distribution Centers (Africa) as examples of “traditional format” franchises. They also cite SPOT Taxi of Bangalore, India, although the SPOT Taxi program would more properly be characterized as a “business format” franchise.

33. Dalberg, *supra* note 19. The Dalberg report points out, however, that homegrown commercial franchise concepts are better positioned to succeed than Western concepts because of better alignment with local tastes, pricing, cost structure, and enabling or disabling environments.

34. In commercial franchising, the franchisor, whether a foreign or domestic company, tightly controls the intellectual property notwithstanding the appointment of a master franchisee. Among other things, the commercial franchisor typically becomes the registered owner of the relevant trademarks or service marks in each country and retains contractual control of other brand elements, such as trade dress and recipes or other trade secret information.

35. Laura Brix & Katharine McKee, *Consumer Protection Regulation in Low-Access Environments: Opportunities to Promote Responsible Finance*, CGAP Focus Note No. 60, at 3 (Feb. 2010).

36. Some laws would limit the microfranchisor’s freedom to restrict intrabrand competition between microfranchisees. For example, the European Union Block Exemption on Vertical Restraints does not allow the franchisor to prohibit “passive” selling outside of the franchisee’s territory. See Commission Regulation 330/2010 of 20 Apr. 2010, art. 4(b), available at <http://ec.europa.eu/competition/antitrust/legislation/vertical.html>. It should also be noted that the data needed for reliable market studies and to map territories may not be available for communities at the base of the economic pyramid.

37. See Kay Marie Ainsley, Debra A. Harrison & David W. Koch, *The Evolving Franchise System: How to Guide an Emerging System from “Baby Steps” to a “Grown-Up” System*, 43d Annual Legal Symposium 15 (IFA 2010) (conference workshop paper).

38. See Brix & McKee, *supra* note 35, at 3.

39. See generally Andrew C. Selden & Rupert M. Barkoff, *Counseling Franchisees*, in *Fundamentals of Franchising* 303–05 (ABA Forum on Franchising, 3d ed. 2008).

40. To learn more about village banking, see *What Is Village Banking?*, www.finca.org.

41. For example, see the comments of the Fan Milk franchisee profiled in Christensen et al., *supra* note 11.

42. Ainsley, Harrison & Koch, *supra* note 37, at 18.

43. See IFA Self-Regulation Program, www.franchise.org.

44. For example, according to a recent newsletter from a law firm in New Delhi, the time that the average case spends in Indian courts is fifteen years, and more than thirty million cases are pending. Kundra & Bansal *Indian Legal and Business Update* (June

1–30, 2010), available at www.kundrabansal.com/database/IBU/ILBUJUNE2010.pdf.

45. Robert Peck Christen, Timothy R. Lyman & Richard Rosenberg, *Microfinance Consensus Guidelines: Guiding Principles on Regulation and Supervision of Microfinance 4* (CGAP/The World Bank Group 2003), available at www.cgap.org.

46. See *supra* note 28.

47. See generally Robert Peck Christen & Richard Rosenberg, *The Rush to Regulate* (CGAP Occasional Paper No. 4, Apr. 2000); see also Christen et al., *supra* note 45.

48. See generally Franchise Act 1998, reprinted in *Bus. Franchise Guide* (CCH) ¶ 7185.

49. *Id.* art. 58. Several franchise laws in the United States contain de minimis exemptions for very-low-investment franchises. The theory behind these exemptions is that the investor does not need protection when the investor is not risking much money. That theory is inapposite to the poor who invest in microfranchises, however. The amount of money that they risk is small in an absolute sense but likely to be large relative to their net worth and income.

50. Arguably the most effective activity that IFA has undertaken to advance the interests of franchising in recent years is commissioning professional studies on the economic impact of franchising. See, e.g., 2 *The Economic Impact of Franchised Businesses* (IFA Feb. 2008), available at www.franchise.org (study prepared for the IFA Educational Foundation by PricewaterhouseCoopers).

51. See *The Client Protection Principles in Microfinance*, available at www.cgap.org. The six areas addressed by the Client Protection Principles are (1) Avoidance of Over-Indebtedness, (2) Transparent and Responsible Pricing, (3) Appropriate Collections Practices, (4) Ethical Staff Behavior, (5) Mechanisms for Redress of Grievances, and (6) Privacy of Client Data.

52. Endorsement of the Client Protection Principles brings varying responsibilities, depending on the particular role of the endorser. These include the following:

For microfinance institutions: Endorsement begins with (1) a self assessment of each Institution’s own policies and practices to identify areas for improvement and (2) active promotion of Smart Microfinance and the core Client Protection Principles among staff.

For networks and associations: Endorsement is a commitment to engage with affiliated organizations to endorse, promote and support The Smart Campaign and the implementation of the six core principles of client protection.

For investors and donors: Endorsement is a commitment to support providers of financial services that adequately protect their clients by incorporating Smart Microfinance into their screening, due diligence, audits, funding agreements, monitoring, reporting, and governance roles.

For supporting organizations and individuals: Endorsement is a commitment to personally practice Smart Microfinance and to work within their own organizations to implement the core Client Protection Principles throughout their operations when applicable.

See *What Does It Mean to Endorse the Smart Campaign?*, www.smartcampaign.org.

53. See IFA Code of Ethics, available at www.franchise.org.

54. *Id.*