

Franchising Opportunism

Canada Small Business Financing Act
Program Review

Submitted to:

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EXECUTIVE SUMMARY

1. Modern franchising creates opportunism by separating ownership from control.
2. Economic theory indicates fraud is likely to occur with credence goods or services. Franchise industry system owners, lenders, consultants and lawyers provide credence services.
3. Franchisors sell franchises not only to the public but to their industry peers. A sophisticated fraud model has been developed. Franchisors licence their franchisees' opportunism to financial institutions and consultants.
4. Fraud requires a tolerant environment.
5. Malfeasance is minimized with a free flow of information regarding material investment risks. The Canadian franchise industry is characterized by high levels of information flow on the all levels with the dramatic exception of the small business investor.
6. The most accurate, independent reputation data is held by those with the greatest barriers of communication.
7. There is sufficient internal and external evidence to warrant halting franchised loan claims and to notify the appropriate federal and provincial agencies for evaluation.
8. Further research is warranted.

Reality, in fact, is always something you couldn't have guessed.
C.S. Lewis

The purpose of this paper is to present a framework to assist in the evaluation of policy alternatives as they relate to *Canada Small Business Financing Act, CSBFA*. A franchising relationship model will be presented.

Systems can be run in many ways that range, crudely, from:

- * sustainable -conservative, prudent and long term, to
- * non-sustainable -reckless, exploitative and intentionally "created to fail".

The Tragedy of the Commons

Applying this metaphor to franchising seems fairly straightforward: the dominant parties must be practicing responsible management because the visible evidence points to success and profits for all. Since the revenue appears to come from shearing, the health of the sheep is of the highest importance. It's a safe investment.

Upon further study, a much different picture emerges.

The franchisor is paid not by the wool merchant but by the slaughterhouse. Focus on rapid cycling (flow), maximize the number admitted and reduce their resistance through starvation. The industry will never collapse, as long as the word doesn't get out.

Relational Characteristics

Franchising has evolved from the time industry pioneers such as Ray Kroc, Harlan Sanders and Dave Thomas shook a franchisee's hand and asked them to sign a four-page agreement.

These are reliance relationships: a relatively superior, experienced franchisor entering into an exchange with an inexperienced franchisee. As the litany of franchisor abuse

has been documented, franchising observers have realized that the danger of abuse is actually "hard-wired" into the structure of franchising.

1. Imbalance of Information and Economic Power

For the efficient allocation of resources in our economy, long-term investment decisions require reliable information. The economy suffers if an environment is created that fosters fraud.

While there is risk in business, the unique hazards in franchising are not known outside the industry.

Soon after entering the franchise relationship, the small business owner realizes he or she is virtually defenceless in protecting their interests. They are aware of their dilemma but have few realistic remedy alternatives.

...the franchisee has invariably invested time and money, and he knows that he will lose it all if the franchise comes to an end. Naturally, he is prepared to be servile, and if not, he is generally not long for the franchise family. *Grange Report*, p. 4

Franchisees seldom achieve justice from our court system.

2. Modern franchise agreements

If real estate is all about "location, location, location", franchising is all about "the agreement, the agreement, the agreement". A prospective franchisee is presented with a sixty to eighty page document that had been characterized by Ontario Justice Samuel Grange as "masterpieces of deceptive wording and artful omission." In Ontario and Alberta, they get a 40 to 50 page disclosure document.

These are highly incomplete contracts. Franchisees do not know what standards they will be asked to adhere to in the future. The franchisee's obligations are extremely precise while the franchisor supports the system as he sees fit. The franchisor defends against low quality (free-riding), the franchisee against opportunism.

Unfair dealings arise from the very nature of the exchange with the franchisor's exercise of discretion within the, admittedly necessary, incomplete nature of the contract.

3. Churning cycle

Churning is the rapid creation and destruction of individual franchised businesses. The assets are purchased at a steep discount and resold to the next franchisee prospect.

The non-sustainable franchise system makes almost thirty-nine per cent (38.9%) more than a sustainable franchisor. There is a substantial cash flow benefit in destroying your own franchises. In this case, cannibalization pays \$280,000 more over a ten year period. For one location.

Assumptions:

(1) One store operated by one franchisee over ten years.

Contribution margin (CM) to franchisor

-Construction: \$120,000

-Operating (rent, product, other): \$60,000

Total Contribution Margin (TCM): \$720,000 over ten years

(2) One store sold once and resold four more times over ten years.

Contribution margin (CM) to franchisor

-Construction: \$120,000

-Operating (rent, product, other): \$60,000

-Resale (to new owner): 2nd \$100,000, 3rd \$80,000, 4th \$60,000 & 5th \$40,000

Total Contribution Margin (TCM): \$1,000,000 over ten years

Differential Total Contribution Margin: +\$280,000 or 38.9% more

NOTE: these assumptions are very conservative.

There is a very high return to the franchisor for opening new units and a corresponding low risk of financial loss. The model, assuming traditional microeconomic theory, would predict widespread pre-sale misrepresentation and unlawful lending since franchisees are virtually defenceless.

CSBFA loan availability inflates the mean sale price of franchise offerings and amplifies the "boom/bust" cycle. Some franchise systems are not operating entities at all. Their sole purpose is to suck the maximum cash in the minimum time; the franchisee's signature is all that they want.

If the franchise industry has fallen or will fall into disrepute, there will be the same numbers of lenders chasing fewer sales. More marginal loans will be granted, there will be greater fraud and more defaults.

Since franchisees and landlords are not organized, an intentional insolvency of the trademark neatly clears the way for the next concept development. I have been told that a major national system is intentionally made insolvent every two years and that there are three or small ones a year.

4. Academic research

There is surprisingly little academic publication regarding franchising and that it is almost entirely from the United States. In 1996, Professor Timothy Bates found that when he compared franchised and non-franchised cohorts, franchised businesses:

- went out of business faster,
- were less profitable, and
- required a substantially higher investment.

Further, he found that buying a used franchise posed a higher risk than a new one.

Franchisor survivability is a concern also. If a franchisor ceases franchising, the value of evaporates and in many cases triggers widespread franchisee failure. At franchise trade shows you often hear the phrase: "We are the McDonald's of the...[substitute a vertical market] industry". This is an attempt to paint a picture of franchisor stability where one does not exist.

Professor Scott Shane found that over 75% of the franchise systems started in 1983 were dead by 1993.

The Economics of Opportunism

Standard microeconomic analysis should be applied very carefully in franchising. Often, most of the assumptions are inappropriate and dangerously misleading.

There are no "many buyers and sellers" (franchise agreements are almost identical within vertical markets, nationally and internationally), credence goods characteristics distort the marketplace in several dimensions (especially in legal services), the information and economic disparity is very large, sunk costs, etc.

Microeconomic theory indicates that since the profit maximizing franchisor makes more money by practicing bad faith franchising than sustainable franchising, we should expect its incidence to increase. There are few practical constraints on this behaviour.

1. Ownership and control

The franchise relationship is quite unique in commerce. Franchisees own most of the assets but franchisors control them. This is the source of opportunism.

Although the franchise relationship may appear unremarkable on the surface, it has in fact a highly distinctive structure. Unlike either an employment relation or an ordinary independent contracting relation, the franchise relationship is characterized by the fact that franchisees own

the bulk of the capital assets of the franchise and franchisors retain the right to determine how franchisees will use those assets. *Problematic Relations*

Franchisors create opportunism within the franchise relationship and then, in a very real sense, "franchise" that vulnerability to other stakeholders (ie. suppliers, contractors, financial institutions). This usually long-term, symbiotic relationship requires high levels of information sharing, trust and co-operation.

The best test for opportunism is: if the ownership of the assets were reversed, would that decision likely have changed? If yes, an unfair advantage was used to strip value.

Statements such as: "We don't care, it's not our money" are the strongest assurance of opportunism being present.

2. Idiosyncratic sunk costs

Many franchisee assets can be classified as idiosyncratic. They have little value to the borrower after the relationship ends (non-compete covenant) but a high value to the franchisor at all times. Opportunism risk increases substantially when idiosyncratic sunk costs make up most of the total assets.

Sunk costs compel franchisees to stay in a money-losing situation even when experiencing consistent negative gross margins (ie. variable costs > revenue). Franchisor control of sales specials programs and tied product provisions extracts economic rents from the captive investor. Consumers may enjoy a 50% discount on a pizza but the franchisee still pays 100% for his products, royalties, rent, etc. The higher their revenue, the more their cash flow falls.

Business format franchisors have learned from the petroleum and grocery product franchisors. They operate as vertically integrated firms, controlling both wholesale and retail prices in myriad ways while sometimes defeating franchisees in their pursuit of a reasonable return for their capital and effort.

Franchisees remain operating long after any independent business would have simply abandoned the activity. The franchisee is deemed "stupid" when in fact they are behaving in a perfectly rational manner. Franchisees are frequently labeled as disgruntled, lazy or, my favourite, scum.

3. Credence good

Economists define a credence good if it is provided by an expert who:

...also determines the buyer's needs. Buyers of credence goods are unable to assess how much of the good or service they in fact need; nor can they assess whether or not the service was

performed or how well. This puts buyers at risk of opportunistic behavior on the part of sellers: they may be sold too much of a service or billed for services not performed or performed badly.
The Price of Law, p. 24

Professor Hadfield goes on:

Theoretical work on markets for credence goods predicts that markets for credence goods may be characterized by fraud (billing for unnecessary services or services not performed) and a price mark-up over cost.

4. Externalities

For every loan claim, there are additional losses by private and public bodies. These externalities are real but seldom considered for policy discussions. They include, among others bad debts to G.S.T., P.S.T., salaries, W.S.I.B., etc. Of course, a loan failure is almost always a bankruptcy with its cascading destruction on marriages, children, mental and physical health services, etc.

5. Required conditions

There are over 140 different franchisor behaviours that arise from their opportunistic exercise of their discretionary powers. These are all additional threats that franchisees face, when compared to non-franchised businesses. In combination, they create a vortex or perfect storm.

Monopolies can happen not only in goods and services but also on information. It is a possibility that, for the uninitiated, virtually all franchises are too risky and should therefore not be purchased. That is a material fact and, indeed, the most important disclosure information for investors. However, only a few people may hold that knowledge.

If systemic malfeasance were planned the losing party's ability to communicate would need to be destroyed. It would be helpful if they exit thinking the fraud were perpetrated by a gunman (franchisor) rather than a sophisticated network of conspiring professionals stretching horizontally across several corporations and associations which enjoy the policy protection of the largest national corporations.

The returns on this type of economic conspiracy are exceptional and the chance for detection very low.

6. Futility of private action

If a franchisor, consultant and specialized banker (credence service providers) decide to conspire, there appears to be a high probability that fraud would occur. Capturing public funds is possible by duping an unsuspecting borrower. This requires keeping the

investing public and agency unaware of the true nature of the franchise relationship and its attendant opportunism hazard.

In the rare case when a franchisee can contract for competent franchise law services, he compounds the risk of fraud since the lawyer's services are a credence good.

Franchisors buy 95% of all legal fees and are repeat customers. When the industry says: "use a franchise lawyer", it may be the simple promotion of their members' services or an attempt to keep information within the community.

Manufactured Imperfect Information

1. Reputation

Free markets require relatively free flow of information. Sustainable long-term commitment is impossible without accurately assigning the likelihood of good faith dealings.

A business operates and that activity generates a reputation of high or low quality work. The business responds to this feedback and adjusts its practices in order to enhance its reputation because lower quality work will be punished and high value rewarded.

This feedback mechanism is absent within franchising. There is an extrinsic disincentive for achieving high standards in the management of a franchise system. Overall, much more energy is spent in damage control than improving quality standards in franchisor management.

Former franchisees are the greatest source of reliable information. Although reasonably applied in independent business, confidentiality agreements are used punitively. Current franchisees know that they risk their life savings by speaking honestly.

Material facts that would influence investment decisions are routinely suppressed. A vacuum of information has always favoured the dominant party.

The greatest risk in buying a franchise may actually be that it is a franchise. Understanding of the interdependent and complex relationships takes years to acquire.

For these reasons and others, competent prospective franchisee due diligence is impossible to do. Government has a role to support low cost information flow.

2. Influence

The grocery, petroleum and automotive sectors have heavily franchised distribution channels. Their interests are extremely influential while franchisee investors have a very weak collective voice. There are many extremely qualified businesspeople who have concluded that any franchise is too risky.

Blocking for the industry would embolden opportunistic franchisors, lenders, consultants, lawyers, associations, etc. Their economic success feeds more and more predatory action.

3. Divide-and-conquer

Franchisors and franchisees know that one-on-one, the franchisor will win. If the franchisees pool their resources in an independent franchisee association they can gain information balance and stand some chance. An expert witness at the *Wishart Act* hearings stated bluntly: "there's only one reason there aren't any independent franchisee associations: franchisors don't want them."

The right to associate provisions of Ontario's 2000 law have been interpreted to mean franchisees have a right to associate and franchisors have a right to harass.

4. Credibility (social proof and authority)

The *CSBFA* program provides an important non-monetary benefit to the franchise industry. A series of horror stories were published in Ontario since 1993 that portray the industry to be the "wild west" of the business world. Investor confidence has been shaken.

When a bank approves the loan, this establishes an important social proof for the prospect. The psychology goes: "if the consultant, banker and the Dominion think this is a good investment, who am I to disagree with those experts?" The authority of the federal government is used before and after the sale.

The purchasers of franchises are almost always consumers. Only after it is purchased (franchise agreement) is a commercial relationship formed. A brief reading of the industry's marketing magazines show they are looking for unsophisticated, first time business investors. The financial stability of banks is used to build confidence in the investing public.

Canadians believe they live in a stable country and that the most conservative elements of it are chartered banks and federal programs. Prospective franchisees tend to

associate *CSBFA* loans with the security of CMHC-insured mortgages, Canada Savings Bonds, etc.

They believe that our banking system is competent, stable and ethical. They reasonably rely on the accuracy of projected earnings they write on government forms.

Actual sales often turn out to be 25 to 35 per cent of projections.

5. Silence

A prospective franchisee's comparative high level of education is frequently an automatic disqualification in most systems. Independent franchisee associations threaten franchisors mostly because they are able to contract with professionals, access knowledge and then make more informed decisions. The blatant contract prohibitions against talking to "outsiders" (eg. media, politicians, etc.), during and after the term, supports this.

What the industry requires above all else is silence.

Successful crime is dignified with the name of virtue; the good become the slaves of the impious; might makes right; fear silences the power of the law. *Seneca*

6. Immigrants as prey

New Canadians lack discernment if they are unfamiliar with British common law, English language, sophisticated misrepresentations, the psychology of persuasion, intimidation and deceptive metaphor. They often come from cultures with no experience in contract law, are understandingly deferential to authority and feel isolated.

Some franchisors hire salesmen from the same ethnic background as are immigrating at the time. Trust is much easier to establish and then betray if a common language is shared. They can also go to the country of origin and sign them up there.

It is beyond their imagination, outside the realm of possibilities that an advanced western democracy such as Canada appears to condone what they have come to believe is a form of authorized slavery.

Stakeholder Analysis

Professor Hadfield presents that the relational structure of franchising is one of reliance (superiority and inexperience), intimacy, interdependence and conflict. My attention will now focus on the relationships leading up to the CSBF loan, namely, a draft description of the roles played by the franchise consultant and the specialized CSBF banker.

In 1997, a senior franchise banker told me that franchise banking is the most lucrative form of commercial lending. When I asked him if that was because the loans were guaranteed and the unit was churned, he just smiled.

Please see the attached *Systemic CSBF Lending Opportunism*, Appendix A

1. Franchise Consultant and Prospective Franchisee

Franchise consultants are essentially a contracted out marketing function of the franchisor. That they are a "mini-franchisor" has been recognized in U.S. and Ontario law, expressed by calling them a franchisor associate. The hazard for investors is very great in this cat's-paw arrangement.

Franchise consultants or development agents manage the selling cycle for franchisors. They charge the franchisee very little or nothing at all for hundreds of man-hours of work stretching over a six to eight month period. They act to psychologically disarm prospects.

The relationship is based on expertise and trust. They financially qualify prospects and lead those through the selling cycle, delivering a financed and signed franchise agreement. Powerful techniques of persuasion are used to achieve compliance (ie. liking, reciprocation, commitment and consistency, social proof, authority and scarcity, etc.).

The blue chip systems make a very clear point of saying they have never used, do not use them now and will never use agents. A negative inference may be drawn

That the consultant fills out the bank's commercial credit application for the prospect indicates the reliance nature of the relationship.

2. Franchisor and Prospective Franchisee

The amount of interaction varies among systems. The purpose is to show the system as successful and to leave the details to the franchise consultant. They create the tools of

persuasion. Some franchisors will not sign the franchise agreement until after the loan is approved.

3. Prospective Franchisee and Specialized CSBFA banker

There exists a statutory privacy obligation that cannot be met if information is shared with anyone outside of this relationship.

Projected earnings claims for new stores are changed to pass *CSBFA* Guidelines. Inadequate security description is taken so that used equipment can be substituted for new. This frees over \$100,000 per loan for potentially fraudulent purposes.

These bankers are off the organization chart of the main franchise-banking group.

Once everything is approved, the consultant tells the franchisee to go to a certain bank, at this address and time and meet with a specific loans officer. The documents are signed and their only meeting is over.

Financial institutions have organized themselves into franchise groups, usually within their small business division. They all belong to the Canadian Franchise Association and maintain lists of franchise systems that they will not provide CSBF loans to.

4. Franchise Consultant and Specialized CSBFA banker

The franchise consultant and the special banker act behind the scenes after the credit application has been filled out. Within twenty-four hours the loan can be approved.

The intimacy and interdependence of this relationship is substantial. The cheque(s) get made out to the franchisor and not the borrower.

5. Franchise Consultant and Franchisor

There is an arrangement to sell franchises for certain consideration. Prospective franchises are not informed of this. These are highly personal relationships and one consultant represents 100% needs of the one system. Consultants have been used as liability shields.

6. Franchisor and Franchisee

Ontario Superior Court Justice James Farley said in 1993 that franchise contracts are so one-sided and complex; they are breached the moment they are signed. The franchisor gains visible contribution margin from franchise fees, royalties and advertising fund and secret value from: rent, sometimes grotesquely inflated products

sales, kickbacks, listing fees, renovations, computer software, centralized order systems, rebates, unilateral fines, etc.

As the franchisee reacts to 75% of his sales not showing up, the franchisor starts issuing termination threats. Within six months, they are often told to abandon their store. Debt is used to gain compliance. The franchisee descends into a vortex of intimidation, fear, self-recrimination and, finally, shame. As the nightmare continues, defensive abilities crumble.

7. Terminated or Bankrupt Franchisee

Everyone has emotional, physical and financial limits. The franchisor gets the keys, staffs the store with his people, operates it and re-sells it. The franchisor buys the assets for 10% and sells for 100%, or more accurately put, for as much as the second franchisee plus loans can afford. To get the 10%, you have to sign a confidentiality agreement and waiver of legal rights.

8. Claim on Loan

The main franchise section of the bank issues a claim notice to the CSBF Program that is approved.

9. New Loan on New Franchisee

Franchisee 2 applies for new *CSBFA* loan either independently or with a consultant. There is no information available on the first business.

10. Ongoing Information Sharing

The franchisor exercises their discretion if a problem franchisee is identified. As a failsafe, the consultant visits the franchisee and applies pressure. If the complaint is escalated through the bank's complaint process and into the office of the Ombudsman for Banking Services and Investments the greatest pressure is brought to bear for the franchisee to abandon their complaint.

These include: termination threats, threats of calling trade debt, anonymous and menacing telephone calls to the franchisee's wife and physical threats.

Within that Banking Group there are account troubleshooters. They intervene when a franchisee is seen to be in trouble and secure the bank's position. This information can come from internal sources, the franchise consultant or the franchisor. This sometimes means, for example, telling the franchisee to pay down their unsecured credit line and not the *CSBFA* loan. They add value by informing franchisors about franchisees financial state.

The assumption seems to be that franchisees have no privacy rights.

Recommendations

Please find below the most immediate recommendations.

A conceptual framework exists now that better explains both Industry Canada's own quantitative analysis and reality. A loan fraud case history is available for explanation and criminal charge evaluation. Enough doubt has been raised to question the conventional wisdom.

Economic theory would predict high levels of unchecked opportunism that are expressed in several ways, one of which is systemic loan fraud. *CSBFA* loans are at high risk because the banks, while lacking ownership, have control (assuming a successful claim).

Claims payments

The prudent decision is to suspend claims payments for franchised loans.

What assurance from non-biased sources shows that fraud is not widespread? If not widespread, what, then, is the acceptable percentage? The anguish of those caught is almost beyond belief.

All *CSBFA* claims payments should be scrutinized to make sure franchised loans are not classified as non-franchised.

Consumer education

Modern franchising relationships, while complex and changing should be clearly understood to be a consumer investment product. It's not just that the risks can't be assessed in a pre-sale setting; they are, by their very nature, (1) unknowable, (2) changing and (3) very frequently fatal to life savings.

Franchisors who do not exercise their discretion in a good faith manner should be identified. This is critical investment information that is currently unavailable. This makes investor pre-sale due diligence irrelevant. Whether a franchisor is opportunistic or simply incompetent, the outcome is the same.

The *CSBFA* Program and other agencies should support private reputation registries: a franchising *Better Business Bureau*.

Education

Industry Canada's knowledge of modern franchising may need improvement. Consideration should be given to creating a franchise industry-specific capability. The CSBFA Program has the greatest opportunity to learn about franchising.

Further, officials require this knowledge to discharge their duty. Perhaps industry practices have become so predatory that no franchise offering poses a reasonable chance for adequate investor return. Commercial history speaks of industries that have collapsed from their own excesses. What assurance is there that this isn't the case now?

Accept report

Evaluate the recommendations of a private corporation created to determine the conditions necessary for the resumption of franchise lending.

Administrative discretion

The Director should be given more flexibility to deal with a rapidly moving industry. Program goals cannot be achieved without rapid response based on a comparable knowledge base.

Claim rating

Analysis of the lending practices (franchised and non-franchised) will yield a range of lending quality. Why should those lenders who approve appropriate and sustainable loans suffer a marketplace handicap? Generally, rewarding bad and good behaviour equally tends to decrease outcomes.

Exit interviews

An extremely brief telephone interview should be conducted on, at least, a portion of the claimants. Loan applications should be amended to ensure contact during and after the relationship. A unique identification number should be assigned at the loan approval and followed through for research purposes. The questions should focus on earnings representations but expand if opportunism is suspected. There were 230 claims in 2002 - 2003.

Field work

Some interests don't want Industry Canada communicating with franchisees. It is my experience that former franchisees are extremely willing to talk, although they are a bit wary at first.

Government of Canada

Experienced anti-rackets investigators say you should follow the cash flow upstream. With over 1,300-trademark systems serving forty-six vertical markets, franchising crosses many jurisdictions. As private delivery/public funding increases, the likelihood of malfeasance will increase.

Opportunism is possible wherever public money is being controlled. If other stakeholders can "pile on", fraud not only takes root, it thrives. Vigilance is the only defence.

Other

Some other areas may include the following: internal audit, development, information flows, interprovincial issues, international lessons, rising franchised claims, consumer claim reports by: franchise system and institution.

Les Stewart received a B.A. from The University of Western Ontario in political science and an M.B.A. from the Ivey Business School. He has run six independent and one franchised small businesses. Stewart founded the Canadian Alliance of Franchise Operators, CAFO in 1998. He has been an active member of the American Franchise Association, has been exposed to franchising for over 33 years and consults with groups and individual franchisees. Stewart was an expert witness at the public hearings leading up to Ontario's Arthur Wishart Act (Franchise Disclosure), 2000.

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Systemic CSBF Lending Opportunism Canadian Franchise Industry

Appendix A

