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Coverage of Franchise Financing Under the Equal Credit Opportunity Act, Including the Small Business Lending Rule

Franchising constitutes a significant portion of the small business ecosystem. This document communicates the extent to which the Equal Credit Opportunity Act (ECOA) and its implementing Regulation B apply with respect to franchisees seeking credit to finance their businesses.

Under ECOA and Regulation B, much of franchise financing is likely “credit” and “business credit.”¹ Franchisees generally obtain credit either directly from the franchisor or from third-party finance companies, which could be independent of the franchisor or brokered by or affiliated with the franchisor. Regardless of whether the credit is provided directly by the franchisor itself, an entity affiliated with the franchisor, or an entity unrelated to the franchisor, the creditor is granting franchisees the right to defer payment for debts they incur. Notably, ECOA and Regulation B generally apply to business credit—which is defined as “extensions of credit primarily for business or commercial (including agricultural) purposes,” with limited exclusions²—as well as to other credit extended primarily for personal, family, and household use.³

Creditors, including franchisors, providing financing to franchisees are thus subject to ECOA

¹ See 15 U.S.C. § 1691a(d) (“The term ‘credit’ means the right granted by a creditor to a debtor to defer payment of debt or to incur debts and defer its payment or to purchase property or services and defer payment therefor.”); 12 C.F.R. § 1002.2(j) (“Credit means the right granted by a creditor to an applicant to defer payment of a debt, incur debt and defer its payment, or purchase property or services and defer payment therefor.”); 12 C.F.R. § 1002.2(g) (“Business credit refers to extensions of credit primarily for business or commercial (including agricultural) purposes...”). On the other hand, franchise financing might not constitute “credit” or “business credit” if, for example, it takes the form of factoring or a true lease, *see* Regulation B, comments 104(b)-1 and -2, or an investment.

² 12 C.F.R. § 1002.2(g). The exclusions are for public utilities credit, securities credit, incidental credit, and government credit, as defined in 12 C.F.R. § 1002.3.

³ See Regulation B, comment 2(j)-1 (noting that Regulation B covers credit transactions “regardless of whether the credit is for personal or commercial purposes”). Regulation B distinguishes business credit from consumer credit only in the context of requirements for notifications following adverse actions, *see* 12 C.F.R. § 1002.9(a)(3), and record retention. *See* 12 C.F.R. § 1002.12(b).

and Regulation B’s core prohibitions against discrimination. For example, creditors may not discriminate against an applicant on a prohibited basis regarding any aspect of a credit transaction,⁴ and they are barred from taking a prohibited basis into account in any system of evaluating the creditworthiness of an applicant.⁵ These proscriptions are enforced by an array of federal agencies, including the CFPB, the Small Business Administration, the prudential banking regulators, the Farm Credit Administration, the Department of Justice, and the Federal Trade Commission.⁶ ECOA also provides “aggrieved applicants,” including small business lending applicants, with a private right of action.⁷

The small business lending rule, like ECOA and Regulation B as a whole, generally covers “business credit.”⁸ As the CFPB explained in the preamble to the final small business lending rule, rather than provide an exhaustive list of all conceivable types of business credit, the rule covers any type of business credit that is not specifically excluded.⁹ The rule also does not exclude any particular types of financial institution.¹⁰ Consequently, entities providing credit to franchisees—which, as noted above, offer a product that meets the definition of “business credit”—would generally be financial institutions subject to the rule’s data collection and reporting requirements to the same extent as any other provider of business credit, unless they are subject to one of the narrow exclusions from coverage. The CFPB would thus expect many entities providing franchise financing will be required to collect and report data under the rule if they meet the origination threshold for coverage.¹¹

In particular, the CFPB anticipates that third-party entities providing credit to franchisees that meet the origination threshold for coverage will be required to collect and report data under the small business lending rule regardless of whether that company is affiliated with the franchisor. Under certain circumstances, however, franchisors that themselves directly provide credit to franchisees may be subject to the rule’s exception for “trade credit.” The rule defines trade credit

⁴ 15 U.S.C. § 1691(a); 12 C.F.R. § 1002.4(a).

⁵ 12 C.F.R. § 1002.6(b)(1).

⁶ 15 U.S.C. § 1691c; 12 C.F.R. § 1002.16(a).

⁷ 15 U.S.C. § 1691e.

⁸ See 12 C.F.R. §§ 1002.102(d); 1002.104(a).

⁹ See Small Business Lending under the Equal Credit Opportunity Act (Regulation B) 150, available at https://files.consumerfinance.gov/f/documents/cfpb_1071-final-rule.pdf.

¹⁰ *Id.* at 232. 12 C.F.R. § 1002.105(a) defines a “financial institution” to mean any partnership, company, corporation, association (incorporated or unincorporated), trust, estate, cooperative organization, or other entity that engages in any financial activity.

¹¹ Under 12 C.F.R. § 1002.105(b), a covered financial institution—*i.e.*, a lender required to collect and report data under the rule—is one that originated at least 100 covered credit transactions for small businesses in each of the two preceding calendar years.

as a “financing arrangement wherein a business acquires goods or services from another business without making immediate payment in full to the business providing the goods or services.”¹² Accordingly, if a franchisor—rather than a third party providing credit to franchisees—is providing goods and services (such as inventory, marketing rights, or licensing) and allowing the franchisee to repay it for those goods and services over time, that transaction could meet the definition of trade credit such that reporting would not be required under the rule. In the preamble to the final rule, the CFPB explained that this exclusion was appropriate because “trade creditors generally extend credit as a means to facilitate the sale of their own goods or services, rather than offering credit as a stand-alone financial product or as [a] more general credit product offered alongside the sale of their own goods or services. . . . [T]hey are not primarily financial services providers, nor do they have the infrastructure needed to manage compliance with regulatory requirements associated with making extensions of credit.”¹³

Even if a franchisor is providing trade credit to franchisees and thus is not required to collect and report data under the small business lending rule,¹⁴ it remains subject to ECOA and Regulation B’s prohibitions against discrimination. Furthermore, to the extent that a franchisor is providing credit that could be used for purposes other than the purchase of its own goods or services, such as general operating expenses, purchase of the premises in which the franchise will operate or cash register funds, that aspect of the transaction would not constitute trade credit. That franchisor would thus be required to collect and report data under the rule if it meets the origination threshold for coverage.

¹² 12 C.F.R. § 1002.104(b)(1).

¹³ Small Business Lending under the Equal Credit Opportunity Act (Regulation B) 172, available at https://files.consumerfinance.gov/f/documents/cfpb_1071-final-rule.pdf. In contrast, the CFPB declined to extend the exclusion to cover “affiliates and facilitators of trade creditors that provide financing, even if only for the trade creditor’s products and not for competing or unrelated products,” because “unlike trade creditors themselves, such providers offer stand-alone credit products in the same way as other financial institutions and are not retailers or merchants with limited regulatory compliance experience. . . . The trade credit exclusion does not extend to affiliates and facilitators of trade creditors that provide financing, even if only for the trade creditor’s products and not for competing or unrelated products.” *Id.* at 172-173.

¹⁴ Trade creditors are also exempt from certain Regulation B notification requirements. See § 1002.9(a)(3).