

# The Banking Law Journal

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# A Look Inside California's Commercial Financing Disclosure Regulations

*By Nancy R. Thomas and Calvin Dennis Funk\**

*This article looks at the core disclosure requirements of the regulations recently issued under California's new commercial financing disclosure law and some of the key issues that providers will need to navigate as they prepare compliant disclosures.*

The California Office of Administrative Law has approved the Department of Financial Protection and Innovation's ("DFPI's") final regulations implementing California's first-of-its-kind commercial financing disclosure law (the "Act"). The regulations take effect on December 9, 2022. This article looks at the core disclosure requirements and some of the key issues that providers will need to navigate as they prepare compliant disclosures.

## DISCLOSURE DELIVERY REQUIREMENTS

The Act requires a provider to give disclosures "at the time of extending a specific commercial financing offer."<sup>1</sup> The Final Regulations provide further details, stating that this "time" includes: (1) any time a specific commercial financing offer is quoted to a recipient, or (2) the time a recipient selects a specific commercial financing offer, if the recipient was given multiple offers at one time.<sup>2</sup> A "specific commercial financing offer" is a written communication to a recipient based on information from or about the recipient of specified financing information.<sup>3</sup>

In response to comments, the DFPI explained that it intentionally deviated from and required disclosure earlier than the Truth in Lending Act ("TILA"), which requires disclosures prior to consummation. The DFPI acknowledged that this timing could require financiers to provide multiple disclosures to the extent that financing terms change over time. The DFPI asserts that multiple disclosures to the same recipient will not create confusion because only the final

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<sup>1</sup> Cal. Fin. Code § 22802(a).

<sup>2</sup> Cal. Code Regs. tit. 10, § 900(a)(5)(A).

<sup>3</sup> *Id.* § 900(a)(29).

version must be signed.<sup>4</sup> However, the DFPI chose not to do any testing of the disclosures despite calls for it to do so, leaving the agency without any basis for this and other responses to comments as discussed further.

In addition, the Final Regulations require amended disclosures anytime terms of an existing commercial financing contract are amended, supplemented or changed if the changes result in an annual percentage rate (“APR”) increase and the change is not made to resolve a recipient’s default.<sup>5</sup> This re-disclosure requirement goes beyond what is required by TILA and will require providers of commercial financing to develop policies and procedures that ensure these disclosures are provided during any contract modification process.

Although the Final Regulations expressly permit the disclosures to be provided and signed electronically, they are silent on implementation. For example, the Final Regulations require that the disclosures be presented as a “separate document,” but allow the disclosures to be mailed or transmitted in a package that contains other documents. It is not clear whether this means that disclosures transmitted electronically must be, for example, in a separate PDF file or can be provided on a separate page of a larger PDF file.

## DISCLOSURE FORMAT AND CONTENT REQUIREMENTS

The Final Regulations include detailed formatting requirements, including specific requirements for font sizes, a safe harbor column-width ratio, disclosure cell formatting and even a definition of the maximum number of words where the Final Regulations require a “short explanation.”<sup>6</sup>

The Final Regulations also detail specific disclosure requirements and the methods of calculating the disclosed Funding Provided, APR, Finance Charge and Prepayment Penalties. Depending on the type of financing offered, other terms are required, such as the Average Monthly Cost, Term or Draw Period. The specific disclosure requirements vary for:

- Closed-end transactions;
- Open-end credit plans;
- Factoring transactions;
- Sales-based financings;

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<sup>4</sup> California Department of Financial Protection and Innovation, Response to Comment 1.4.1, Final Statement of Reasons at 42–44 (PRO-18), <https://dfpi.ca.gov/wp-content/uploads/sites/337/2022/06/PRO-01-18-Commercial-Financing-Disclosure-Regulation-FSOR.pdf>.

<sup>5</sup> Cal. Code Regs. tit. 10, § 900(a)(5)(B).

<sup>6</sup> Cal. Code Regs. tit. 10, § 901.

- Lease financings; and
- General asset-based lending transactions.

General disclosure requirements apply to any commercial financings that do not fall into one of those six categories.

In several instances, the Final Regulations reflect a more streamlined approach to the disclosures in eliminating requirements for explanations from earlier versions of the regulations in favor of short statements specified in the Final Regulations.<sup>7</sup> For example, the Department eliminated a requirement that a provider explain how the contract's initial interest rate was used to calculate the finance charge and instead requires a statement indicating that the interest rate will adjust so the actual finance charge will vary.<sup>8</sup>

If the amount financed is greater than the net amount given to the recipient in the form of cash, check or electronic funds transfer, then the provider must provide an additional, separate disclosure with an Itemization of Amount Financed that is similar to that required by Regulation Z.<sup>9</sup> The Itemization of Amount Financed must be immediately following the other disclosures, but must be provided as a separate document.<sup>10</sup>

The DFPI declined requests that it conduct testing to determine the effectiveness of the disclosures, so there is no basis for the detailed requirements.<sup>11</sup> The DFPI also rejected a request that it provide template forms.<sup>12</sup> Throughout the rulemaking process, commenters expressed concern that certain aspects of the disclosures would cause recipient confusion, such as the requirement to disclose the "average monthly cost" for all products regardless of whether the payments are made on a monthly basis or at some other frequency.<sup>13</sup> Because the DFPI has not done any testing, it remains to be seen how customers may react to these disclosures, and providers should plan for the possibility that customers may have questions.

The Final Regulations allow a provider to deviate from the font requirements (but not the column-width requirements) if the provider makes a good-faith

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<sup>7</sup> See Final Statement of Reasons at 11–14, including discussion of Sections 910(a)(2)(C), 911(a)(3)(C), 912(a)(2)(C), 913(a)(3)(C), 914(a)(2)(C), 915(a)(2)(C), 916(a)(3), 917(a)(3)(C), 910(a)(4)(C)(ii), 911(a)(5)(C)(ii), 916(a)(5)(C)(ii).

<sup>8</sup> See Final Statement of Reasons at 11, discussing Sections 910(a)(4)(C)(ii), 911(a)(5)(C)(ii), 916(a)(5)(C)(ii).

<sup>9</sup> Cal. Code Regs. tit. 10, § 956(a).

<sup>10</sup> *Id.* § 956(c).

<sup>11</sup> Response to Comments 1.2.17, 1.29.1, Final Statement of Reasons at 37, 96–97.

<sup>12</sup> Response to Comment 2.21.2, Final Statement of Reasons at 133.

<sup>13</sup> Response to Comments 2.6.2, 2.19.11, Final Statement of Reasons at 112–113, 131.



determination that the deviation is necessary “for clarity based upon the medium (e.g., mobile device).”<sup>14</sup> But the DFPI did not provide any guidance on how to present the disclosures and meet the other disclosure requirements for mobile devices.

## APR AND FINANCE CHARGE COMPUTATIONS

The DFPI has consistently elected to require disclosure of an APR, rejecting other measures such as annualized cost of capital.<sup>15</sup> In response to comments that APR will confuse recipients of merchant cash advances, factoring and other financing for which the provider does not charge interest, the DFPI opted for a statement in the disclosures that the cost is based on fees rather than interest.<sup>16</sup>

Although the DFPI relied heavily on the Regulation Z methodology for computing APRs and finance charges, the Final Regulations diverge from Regulation Z in several key areas. For example, the Final Regulations require calculation pursuant to the closed-end APR calculation methodology set forth in Appendix J of Regulation Z for all APR calculations.<sup>17</sup> This means that providers of open-end credit transactions cannot use the open-end APR calculations under Regulation Z.<sup>18</sup>

For open-end credit transactions, then, the Final Regulations require providers to include all finance charges in the APR calculation, including certain transaction-based fees, one-time fees or fees that depend on borrower behavior that would not be included in the APR calculation under TILA. For example, an open-end credit plan that imposes a fee for each draw made would not include that fee in the APR calculation under TILA, but the Final Regulations require the provider or financier to assume that the borrower makes a single draw of the full credit limit and to include the fee associated for the draw in its APR calculation.<sup>19</sup>

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<sup>14</sup> Cal. Code Regs. tit. 10, § 901(a)(7)(D)(ii).

<sup>15</sup> See, e.g., Response to Comments 1.1.2, 1.2.2, 1.2.16, 1.4.2, 3.5.1, Final Statement of Reasons at 26–27, 29, 36–37, 44, 140.

<sup>16</sup> Response to Comment 1.2.15, Final Statement of Reasons at 36.

<sup>17</sup> Cal. Code Regs. tit. 10, § 940(a). For factoring transactions, the Final Regulations specify additional assumptions that must be used when calculating APRs. See Cal. Code Regs. tit. 10, § 941.

<sup>18</sup> Response to Comments 1.1.5, 1.4.11, 1.34.7, 3.14, Final Statement of Reasons at 27–28, 49, 100, 158.

<sup>19</sup> Cal. Code Regs. tit. 10, § 940.

The Final Regulations also do not address how to treat certain finance charges that may depend on the borrower's choice. For example, if an open-end credit plan imposes foreign exchange transaction fees, the Final Regulations do not address whether the provider should assume that the borrower will incur foreign exchange transaction fees or not.<sup>20</sup>

In addition, the DFPI declined to respond to a commenter's request that the DFPI state that providers and financiers can rely on the Official Staff Commentary to Regulation Z, which contains a significant amount of information relating to the determination of the finance charge for purposes of that regulation.<sup>21</sup>

The Final Regulations specify what estimates must be made in order to calculate APRs for transactions for which APRs have not historically been computed, such as sales-based financing transactions. The DFPI acknowledged that for these transactions, the disclosed APR and effective APR may vary substantially. The agency rejected comments questioning the effectiveness of the disclosures and ability to compare costs across different financing options, finding it sufficient to require a statement in the disclosures that the estimate may vary from the effective APR.<sup>22</sup> Similarly, the DFPI rejected comments that pointed out that identical merchant cash advance products could have different disclosed APRs if the providers or financiers used different permissible estimates in the APR calculations.<sup>23</sup>

## APR TOLERANCES AND SAFE HARBORS

The Final Regulations include APR tolerances and error cure provisions similar to those provided by TILA. Providers and financiers are not subject to liability if the APRs disclosed diverge from the actual APR by a permissible amount. The Final Regulations also include a safe harbor for errors corrected within 60 days of discovery and before an action is filed as long as the recipient receives notice and any needed account adjustments. This protection is similar

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<sup>20</sup> This issue was raised in various comment letters, but the DFPI did not clarify this issue. *See, e.g.*, Letter from Max Behlke, Director, State Government Relations, Electronic Transactions Association, to Sandra Sandoval, Regulations Coordinator, California Department of Financial Protection and Innovation (August 24, 2021), <https://dfpi.ca.gov/wp-content/uploads/sites/337/2021/09/Electronic-Transactions-Association-ETA-8.24.21.pdf>.

<sup>21</sup> Response to Comment 2.5.6, Final Statement of Reasons at 111.

<sup>22</sup> Response to Comment 1.4.8, Final Statement of Reasons at 48.

<sup>23</sup> Response to Comment 1.2.8, Final Statement of Reasons at 31.

to the TILA safe harbor. Unlike TILA, however, the Final Regulations do not provide a safe harbor for errors discovered through an examination.<sup>24</sup>

Throughout the rulemaking process, numerous commenters requested that other safe harbor provisions be included in the Final Regulations, such as a safe harbor for unintentional bona fide errors (similar to the safe harbor under TILA) and larger error tolerance for sales-based financing and asset-based lending. Despite recognizing that the disclosure obligations in the regulations are new and untested, the DFPI rejected these requests.<sup>25</sup>

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<sup>24</sup> Compare 15 U.S.C. § 1640(b).

<sup>25</sup> *E.g.*, Response to Comments 1.4.15, 1.4.16, 1.7.1, 1.19.3, 1.21.1, 1.31.1, 1.34.3, 2.4.6, 3.5.3, Final Statement of Reasons at 51, 51, 58, 91, 92–93, 97, 99–100, 110, 140–141.