

# Client Alert

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## California Enacts a First-of-Its-Kind Commercial Financing Disclosure Law

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On September 30, 2018, California Governor Jerry Brown signed into law [SB 1235](#) (the Act),<sup>1</sup> which requires disclosures of key terms in connection with certain commercial financing by non-banks and could impact bank/non-bank arrangements as well. With the passage of the Act, California became the first state to require consumer-style disclosures for commercial financing. The Act is intended to facilitate comparisons of financing options by recipients of covered financing offers. It establishes a general framework for the disclosure requirements, but requires the California Department of Business Oversight (DBO) to establish the details through the adoption of implementing regulations. The Act becomes effective once the DBO issues final regulations.

### SCOPE OF THE ACT

Although the Act has been characterized as a small-business loan disclosure law, it is actually the size of the financing offer, rather than the size of the business seeking financing, that triggers the disclosure obligations. Specifically, the Act applies to commercial financing offers of \$500,000 or less to entities in California by any entity that extends a specific offer of commercial financing, including non-depository institutions that arrange commercial financing as part of a bank partnership arrangement.<sup>2</sup> Thus, the Act applies more broadly than the existing California Financing Law (CFL)<sup>3</sup> in imposing disclosure obligations on non-bank partners, such as online lending platforms, that currently are not covered by the CFL.

The Act applies to “commercial financing,” which includes commercial loans of \$5,000 or more, commercial open-end credit plans, lease financing transactions, account receivable purchase transactions, asset-based lending transactions, and factoring.<sup>4</sup> The following entities and transactions are exempted from the Act’s requirements:

- Banks;
- Lenders regulated under the federal Farm Credit Act;
- Commercial financing transactions secured by real property;
- Certain commercial financing transactions where the recipient is a dealer, vehicle rental company, or their affiliates; and
- Persons either engaged in no more than one commercial financing transaction a year, or who make no more than five commercial financing transactions a year and the transactions are incidental to that person’s business.<sup>5</sup>

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<sup>1</sup> Stats. 2018, Ch. 1011, Sec. 2 (adding Cal. Fin. Code Div. 9.5, §§ 22800–22805).

<sup>2</sup> *Id.* (adding § 22800(m), (n)).

<sup>3</sup> Cal. Fin Code §§ 22000–22780.

<sup>4</sup> Stats. 2018, Ch. 1011, Sec. 2 (adding Cal. Fin. Code § 22800(d)(1), (e)).

<sup>5</sup> *Id.* (adding § 22801).

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Although the Act exempts banks, it applies to non-banks whose lending through bank partnerships has not previously been subject to the CFL requirements.

## DISCLOSURE REQUIREMENTS

Entities covered by the Act will be required to provide commercial financing applicants with the specified disclosure at the time of extending a specific commercial financing offer. In addition, the disclosure must be signed by the recipient before the commercial financing transaction is consummated.<sup>6</sup> The disclosure itself must contain:

- The total amount of funds provided;
- The total dollar cost of the financing;
- The term or estimated term;
- The method, frequency, and amount of payments;
- A description of prepayment policies; and
- The total cost of financing expressed as an annualized rate.<sup>7</sup>

The requirement to express financing as an annualized rate is in effect only until January 1, 2024.<sup>8</sup>

The Act specifies that for factoring or asset-based lending, the disclosure can be provided as an example of a transaction that could occur under a general agreement for a given amount of accounts receivables.<sup>9</sup>

After legislators tried and failed to come up with a workable cost-of-credit metric in previous versions of the bill, they decided to leave the details to the DBO. Specifically, the Act directs the DBO to adopt regulations to implement the disclosure requirements, including:

- Definitions, contents, or methods of calculations for each of the disclosure items;
- Requirements concerning the time, manner, and format of the disclosures; and
- A determination of the appropriate method of expressing the annualized rate disclosure and the types of fees and charges to be included.<sup>10</sup>

## EFFECTIVE DATE AND ENFORCEMENT

Covered providers are not required to comply with the disclosure requirements under the Act until the effective date of final regulations issued by the DBO.<sup>11</sup> And the Act does not provide a deadline by which the DBO must adopt implementing regulations. We would expect the DBO to specify an effective date in the regulations that provides covered entities with time to comply.

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<sup>6</sup> *Id.* (adding § 22802(a)).

<sup>7</sup> *Id.* (adding § 22802(b)).

<sup>8</sup> *Id.* (adding § 22802(c)).

<sup>9</sup> *Id.* (adding § 22803).

<sup>10</sup> *Id.* (adding § 22804(a), (b)(1)).

<sup>11</sup> *Id.* (adding § 22804(c)).

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A violation of the Act by a CFL licensee is a violation of the CFL, and CFL licensees will be subject to examination and enforcement by the DBO relating to the obligations under the Act.<sup>12</sup> The Act does not appear on its face to carry any penalties for violations by non-licensees under the CFL even though the obligations under the Act would apply to non-CFL licensees. Similarly, there does not appear to be a mechanism for imposing examination or enforcement for non-CFL licensees. The DBO may address the scope of enforcement in the implementing regulations.

## RULEMAKING

The California Administrative Procedure Act specifies the procedures for the DBO's promulgation of the implementing regulations required by the Act.<sup>13</sup> The DBO first will engage in preliminary rulemaking activities, researching and gathering information needed to develop proposed regulations. The DBO is required to involve entities subject to the regulations if the proposed rulemaking action involves complex proposals.<sup>14</sup>

The DBO will initiate the formal rulemaking process by publishing: a) the text of the proposed regulations; b) a notice of proposed action; c) an initial statement of reasons; and d) an economic and fiscal impact statement.<sup>15</sup> The Office of Administrative Law will publish the notice of proposed action in the California Regulatory Notice Register. The DBO will mail the notice to persons who have requested notice and post the notice on its website.<sup>16</sup>

The DBO must provide a minimum 45-day notice-and-comment period.<sup>17</sup> It may, but is not required to, hold a hearing on the proposed regulations. The DBO can then make changes to the initial proposal. If it does so, the DBO must classify the changes as nonsubstantial, substantial and sufficiently related, or substantial and not sufficiently related.

- Changes are nonsubstantial if “they clarify without materially altering the requirements, rights, responsibilities, conditions or prescriptions contained in the original text.”<sup>18</sup> If the changes are deemed nonsubstantial, no further notice is required.<sup>19</sup>
- Substantial changes are sufficiently related if “a reasonable member of the directly affected public could have determined from the notice that these changes to the regulation could have resulted.”<sup>20</sup> Changes that are sufficiently related require notice of opportunity to comment on the changes and a 15-day notice-and-comment period.<sup>21</sup>

<sup>12</sup> *Id.* (adding § 22805).

<sup>13</sup> Cal. Gov't Code §§ 11340–11361.

<sup>14</sup> *Id.* § 11346.45. Note, though, that these public input obligations are not subject to judicial review or review by the California Office of Administrative Law. *Id.* § 11346.45(d).

<sup>15</sup> *Id.* §§ 11346.5, 11346.2, 11346.3.

<sup>16</sup> *Id.* § 11346.4(a).

<sup>17</sup> *Id.*

<sup>18</sup> 1 Cal. Code Reg. § 40.

<sup>19</sup> See Cal. Gov't Code § 11346.8(c).

<sup>20</sup> 1 Cal. Code. Reg. § 42.

<sup>21</sup> Cal Gov't Code § 11346.8(c).

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- Substantial changes that are not reasonably foreseeable based on the notice of proposed action require the DBO to publish another 45-day notice in the California Regulatory Notice Register. The California Office of Administrative Law notes that it is “uncommon” for agencies to designate changes as substantial and not sufficiently related.<sup>22</sup>

The DBO will have one year from the date when the notice of proposed action is published in the California Regulatory Notice Register to complete the process.<sup>23</sup>

## CONCLUDING THOUGHTS

The Act is a noteworthy development, as California becomes the first state to adopt commercial financing disclosure requirements. However, there are many open issues that will need to be addressed by regulation. For example: What constitutes an “offer” that requires disclosure? When does the disclosure have to be given in writing? How is the annualized rate calculated? We will have to wait to see whether the DBO takes an approach similar to that of the Truth in Lending Act or opts to take a different approach.

The open issues reflect the challenges of creating a standardized regulatory regime for very different products. Stating the cost of credit as an annualized rate for multi-year loans repayable in regular installments is one thing; expressing an annualized rate for products that can be short term, such factoring arrangements, or otherwise for non-conventional lending products is another. The devil is in the details, which have been left to the DBO. Companies impacted by the Act should consider participating in the rulemaking process.

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<sup>22</sup> [https://oal.ca.gov/rulemaking\\_participation/](https://oal.ca.gov/rulemaking_participation/) (visited Oct. 5, 2018).

<sup>23</sup> § 11346.4(b). If the DBO cannot complete the process in one year, it must start again with the publication of a new notice. *Id.*

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