California Adopts First-of-its-Kind Commercial Financing Disclosure Regime

By Lawrence D. Kaplan & Lauren Kelly D. Greenbacker

California became the first state to mandate specific disclosures for a broad array of commercial financings under amendments to the California Financing Law (“CFL”) adopted on October 1, 2018 that are expected to become fully effective no earlier than 2020 (the “California Disclosure Law”).¹ As described below, these new disclosure requirements apply to a broader subset of financial services providers than those previously subject to the CFL’s licensing requirements and would broadly apply to providers of commercial financing in amounts equal to or less than $500,000.

Consumer lenders have been long required under federal law to provide a prescribed set of disclosures to borrowers in connection with the loan products they offer under Regulation Z of the Consumer Financial Protection Bureau,² but historically there has been no parallel set of requirements applicable to commercial loan transactions. The California Disclosure Law seeks to impose similar requirements to a wide range of providers of commercial financings for the purpose of providing small businesses with more information about the cost and terms of their financings prior to becoming contractually obligated.

I. Existing Regulation of Small Business Financing in California

The CFL³ historically has been a licensing regime for non-bank providers of credit originated in California or to borrowers in located California. A key benefit of maintaining a CFL license is that a licensee is exempt from California’s 10% Constitutional usury limitation.⁴

Unlike the lender licensing laws of most states, subject to specific exemptions, California imposes licensing requirements on entities engaged in commercial lending.⁵ Entities exempt from CFL licensure include depository institutions, trust companies, broker-dealers and insurance companies. Moreover, providers of alternative forms of financing, such as factoring and merchant cash advances, generally are not within the scope of the CFL licensing requirements, as the products they offer typically do not meet the definition of a “loan” (although care must be taken to avoid such products from being re-characterized as loans in legal proceedings).⁶
II. Overview of the California Disclosure Law
   A. Applicability and Exemptions

   When effective, the California Disclosure Law will impose broad disclosure requirements on non-exempt providers of "commercial financing" and not just CFL licensees who are already subject to the CFL. Substantially broader than the definition of "commercial loan" under the CFL, the definition of a "commercial financing" under the California Disclosure Law includes each of the following types of products, if “intended by the recipient for use primarily for other than personal, family, or household purposes”:

   - commercial loan;
   - commercial open-end credit plan;
   - accounts receivable purchase transaction;
   - factoring;
   - lease financing transaction; and
   - asset-based lending transaction.

   Accordingly, commercial financiers, such as factors and merchant cash advance originators, while not required to obtain a CFL license, will be required to make specific and detailed disclosures about their financing products, as described below.

   Similar to the CFL, the California Disclosure Law exempts from its requirements commercial financing entities that are:

   - depository institutions;
   - lenders regulated under the federal Farm Credit Act;
   - commercial financing transactions secured by real property;
   - commercial financing transactions in which the recipient is a motor vehicle dealer or its affiliate or a vehicle rental company or its affiliate, as specified;
   - any person who makes no more than one commercial financing transaction in California in a 12-month period; and
   - any person who makes five or fewer commercial financing transactions in California in a 12-month period, where the commercial financing transactions are incidental to the business of the person relying on the exemption.

   In addition, the California Disclosure Law exempts commercial financing transactions over $500,000 by limiting its requirements to those extending commercial financing offers to a “recipient,” defined in turn to mean “a person who is presented a specific commercial financing offer by a provider that is equal to or less than $500,000.”
B. New Disclosure Requirements

Commercial financing providers subject to the California Disclosure Law will be required to disclose all of the following information at the time the provider extends a commercial financing offer:

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

In addition, the commercial financing provider is obligated to obtain the recipient’s signature on the disclosure documents prior to consummating the financing transaction and retain such documentation during the term of the financing and for a period thereafter.

In apparent recognition that certain of the required data points would be impossible to accurately disclose in connection with certain alternative forms of financing, disclosures are permitted to be provided in a different format for purposes of such financing options. However, as described further below, the drafting of this provision of the California Disclosure Law may limit its effectiveness.

C. Implementation of the California Disclosure Law

Governor Jerry Brown approved the California Disclosure Law on October 1, 2018; the law will become effective as of January 1, 2019, but will likely not be fully implemented until at least 2020 (upon the promulgation of the necessary implementing regulations). During this year-long implementation period, the California Department of Business Oversight (“DBO”) will be charged with promulgating implementing regulations setting forth, among other things, required definitions, methods of calculating the figures that must be disclosed, and time, manner, and format of the required disclosures.

As further described below, due to the wide variety of financing products covered by the California Disclosure Law, this implementation process likely will prove to be quite challenging, as traditional forms of disclosure mandated for loans frequently are ill-suited to alternate financing products that are structured differently and are not necessarily based on common or uniform measurement periods. For example, the effective “annual percentage rate” that may ultimately apply to a given merchant cash advance transaction will depend on the time period within which the merchant delivers the purchased receivables to the financing provider; the more promptly such purchased receivables are delivered, the higher the effective APR will be. In any event, the APR for such a transaction is impossible to determine until after the purchased receivables are ultimately delivered to the financing provider (at which time the applicable financing period is known). While many providers can estimate the pay-off date based on past practices of their customers, there is not a way to accurately project a pay-off date or the annual rate that would be charged if the transaction was actually a credit transaction.
Moreover, California will be electing a new governor in November, and a new DBO Commissioner is expected to be appointed and confirmed by early 2019. This new DBO Commissioner will likely play a substantial role in guiding this process, which due to the complexity of the necessary regulations is unlikely to be complete until 2020.

III. Key Takeaways and Challenges

- **State Requirement or a Presumptive National Standard?**: Given the significant percentage of financing activities conducted that involve California financing providers and borrowers, the requirements under the California Disclosure Law will affect a substantial portion of the credit market. However, the question remains as to whether other states will follow California’s lead in implementing similar requirements, effectively making the California Disclosure Law a national standard.

- **Disclosure Regime vs. Licensing Regime**. As noted above, the California Disclosure Law subjects to its disclosure requirements a much broader set of financing providers than those currently covered under the CFL; however, the new law does not modify the scope of parties required to obtain a CFL license. As such, when in effect, the California Disclosure Law will cause a segment of the commercial credit market to be subject to the new disclosure requirements, but not required to be licensed.

- **Licensing Considerations**. The California Disclosure Law demonstrates an enhanced focus by California legislators on alternative forms of financing provided to small businesses. As such, these changes may alter the internal analysis conducted by providers of factoring, merchant cash advances and other financing as to whether obtaining a license in California would be prudent, even if just as a backstop in the event the financing provided is re-characterized as a loan subject to the CFL’s licensing provisions. As a licensed finance lender under the CFL is exempt from California’s usury limitations,\(^\text{14}\) providers of alternative financing could mitigate a significant risk of their financing products being found to be usurious loans in the event of an adverse court decision, by obtaining a CFL license.

- **Calculating the Cost of Credit**. As noted above, traditional measures of calculating the cost of credit to a borrower are not easily applied to alternative financing products such as merchant cash advances. As such financing arrangements are structured as purchases of receivables and not borrowing funds to be repaid over a set term, it is not possible—at the time the financing is offered to the merchant—to disclose with accuracy the anticipated cost of the credit (e.g., as an annualized rate). As noted above, the DBO is now tasked with crafting regulations that are workable across the wide range of financing options captured by the California Disclosure Law. However, the fundamental differences in how such financing arrangements are structured may make a standardized set of disclosures necessary to effectuate the California Disclosure Law’s goal of promoting comparison shopping difficult to develop. Likewise, limitations in the language of the California Disclosure Law may likewise make it difficult for regulators to craft the flexibility in the disclosure standard that is needed to make the new requirements workable. For example, a provision of the California Disclosure Law that seeks to introduce flexibility in a disclosure standard for “asset-based lending and factoring transactions” does not expressly extend this flexibility to providers of merchant cash advance financing.\(^\text{15}\)
• **Preparation for Disclosure Requirements.** Commercial financing providers subject to the California Disclosure Law should begin preparing for providing the required form of disclosure when DBO regulations and requirements ultimately are promulgated. A review of financing forms and applications should be undertaken and preparation of forms of disclosure should be drafted as soon as possible so that providers can identify any challenges to their information systems that could arise in connection with complying with these new requirements.

• **Opportunity for Communication to the DBO.** Now that the California Disclosure Law has been enacted, submissions to the DBO setting forth key considerations for regulators to bear in mind when drafting the required regulations would be prudent for industry groups seeking to ensure that such regulations do not present operational or other issues for their business unforeseen by regulators. Given that certain forms of financing falling within the scope of the California Disclosure Law have not previously been regulated by the DBO, educational submissions as to types of covered financing and what disclosures are possible for each may be particularly helpful.

• **Opportunity to Lobby the California Legislature.** As the California Disclosure Law has a mandatory sunset date of January 1, 2024, commercial finance providers should be prepared to address with California legislators any challenges raised as a result of the law’s implementation and identify changes that should be made if the California Disclosure Law is renewed.

Paul Hastings attorneys actively represent clients seeking CFL licenses and exemptions thereunder. A summary of the existing provisions of the CFL and the scope of their applicability, is available through a previously published Paul Hastings client alert “The California Finance Lenders Law: Gaining Traction with Both Lenders and Regulators.”

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

**Atlanta**
Lauren Kelly D. Greenbacker
1.404.815.2105
laurenkellygreenbacker@paulhastings.com

**San Francisco**
Thomas P. Brown
1.415.856.7248
tombrown@paulhastings.com

**Washington, D.C.**
Lawrence D. Kaplan
1.202.551.1829
lawrencekaplan@paulhastings.com

Molly E. Swartz
1.415.856.7238
mollyswartz@paulhastings.com
New Section 22780.1 will be added to the California Finance Code. The text of the bill is available at

See 12 C.F.R. Part 1026.
Cal. Fin. Code §§ 2200 et seq.
Cal. Fin. Code § 22002; see also Cal. Const. art. XV, § 1.
Cal. Fin. Code § 22502. These provisions further provide that: “For purposes of determining whether a loan is a
commercial loan, the lender may rely on any written statement of intended purposes signed by the borrower.
The statement may be a separate statement signed by the borrower or may be contained in a loan application or other
document signed by the borrower. The lender shall not be required to ascertain that the proceeds of the loan are used
in accordance with the statement of intended purposes.” Id.
As the California Disclosure Law does not impose licensing obligations on alternative finance providers, the new law
effectively confirms existing industry practice that entities offering alternative finance products, such as merchant cash
advances, are not subject to the licensing requirements of the CFL.
Similar to the language set forth under the existing commercial loan provisions of the CFL, the California Disclosure Law
specifies: “For purposes of determining whether financing is commercial financing, the provider may rely on any written
statement of intended purpose signed by the recipient and is not required to ascertain whether the proceeds of the
commercial financing are used in accordance with the recipient’s statement of intended purposes.”
This exemption is consistent with the current exemption from licensure requirements under the CFL. See Cal. Fin. Code
§ 22050.5. We note, however, that Section 22050.5, which expires on January 1, 2022, has in the past expired and
then later been added back into the CFL—most recently as of January 1, 2017.
This exemption is consistent with the exemption from licensure requirements under the CFL. See Cal. Fin. Code
§ 22050(e).
California Disclosure Law, § 22800(n).
The California Disclosure Law does not impose any new requirements on consumer lending, which remains subject to
the disclosure regime under federal Regulation Z, See 12 C.F.R. Part 1026.
These new requirements are currently scheduled to sunset on January 1, 2024.
Cal. Fin. Code § 22804(c) ("A provider shall not be required to comply with the disclosure requirements of this division
until the final regulations are adopted by the commissioner pursuant to this section and become effective on the
applicable date described in Section 11343.4 of the Government Code.")
Cal. Fin. Code § 22002; see also Cal. Const. art. XV, § 1.
See Cal. Fin. Code § 22803(a) ("As an alternative to the disclosures required in subdivision (b) of Section 22802,
a provider who offers commercial financing that is factoring or asset-based lending and that offers the recipient an
agreement that describes the general terms and conditions of the commercial financing transaction that will occur under
the agreement, may provide the following disclosures as an example of a transaction that could occur under the general
agreement for a given amount of accounts receivables . . . ").