THE NEW COMMERCIAL FINANCE DISCLOSURE LAWS

By Ken Greene, AACFB Legal Counsel July 2022

I. STATE LAW UPDATES

A. CALIFORNIA

See Part 2 of this outline. For now, suffice it to say that the commercial finance regulations have been finalized and approved. They take effect on 12/9/22.

B. NEW YORK

1. Its *Commercial Finance Disclosure Law* was signed into law by former Gov. Cuomo on 12/23/20, intended to take effect on 1/1/22.
2. On 12/31/22, the *Dept. of Financial Services* ("DFS") issued a "guidance" stating that "the [disclosure] obligations do not arise until the DFS issues final implementation regulations and those regulations take effect." As of the date of this handout, this has happened. At this point, it appears that the soonest these laws and regulations will become operative is the summer of 2022.

C. NEW JERSEY

New Jersey's commercial finance disclosure bill was introduced for the fifth time on 1/18/22. Contrary to the information provided in at least one publication I have read, this is a *general* commercial finance disclosure bill, not one directed primarily towards sales-based financing. The bill is in legislative review with no projected effective date.

D. CONNECTICUT

A commercial financing disclosure bill was introduced back in March, died in the Senate, and was reintroduced in May of this year, where it stalled again. It appears that the proposed law will return in 2023.

E. UTAH

Senate Bill 183 was introduced in 2/22. The bill, entitled "*Financial Services Modifications*," became law in 3/22. It will take effect on 1/1/23.

F. MARYLAND

Senate Bill 825 was introduced in 2/22 and passed the Senate in March. It was, and remains, very controversial. The bill died in the Senate in 4/22 but is likely to be resurrected next session, albeit in a revised form.

G. MISSISSIPPI

Senate Bill was introduced in early 2022 but died in the Senate on 2/1/22. *House Bill 1178* was also introduced early 2022 and it too died, but in committee.

H. MISSOURI

Senate Bill 963 was introduced in 1/22 to become effective 8/28/22, but it appears to remain under consideration for refinement and, as best I can tell, has not passed as of this date.

I. NORTH CAROLINA

Introduced on 5/11/21, North Carolina's "*Small Truth in Financing Act*", was slated to go into effect on 5/1/22. I've been advised, however, by

representatives of the Commissioner's office that this bill apparently is still stuck in committee.

J. SUMMARY

There are new, operative, disclosure laws in California, but the bills in the other eight states have either failed or are still under consideration.

II. CALIFORNIA DISCLOSURE OBLIGATIONS

A. INTRODUCTION

1. On 9/30/18, California enacted *Senate Bill 1235*, introduced by Sen. Stephen Glazer, and signed into law by then Gov. Jerry Brown. Not until 6/9 of this year did the *Department of Financial Protection and Innovation* ("DFPI"), finalize the implementing regulations, rendering the bill effective on **12/9/22**.
2. The impetus behind the new law and attendant regulations was to better equip California small businesses with an understanding of the costs and benefits of commercial financing and to enable them to compare different offers to make informed decisions.
3. This law and the disclosures will probably be the first-in-the-nation to take effect. As discussed in the first half of this presentation, similar laws are pending in other states, but have not overcome certain hurdles necessary to garner support for passage or operational enactment.
4. *SB1235* is only eight pages but the final regulations are 48 pages. Here are the most important takeaways, including things that you absolutely must know, and some potentially unresolved questions that hopefully will be resolved by the effective date or soon thereafter.

B. TAKEAWAYS AND UNRESOLVED ISSUES:

1. Let's start with some definitions so we are clear on what we are talking about.
   - **Commercial Financing**: Includes commercial loans, commercial open-end credit plans, lease financing, accounts receivable purchase transactions ("*factoring*"), asset-based lending transactions and sales-based transactions ("*merchant cash advances*"), used by the recipient for other than personal, family or household purposes (i.e. business).
   - Note the definition of commercial financing says "*includes*," meaning it is technically not limited to the listed categories of finance. That leaves open for interpretation whether certain other financial products, those that do not readily fall into these categories, require disclosures.
   - There is a specific exemption for true leases, largely as a result of very effective lobbying done by the ELFA and other trade groups. True leases are generally those without a discounted purchase option and ones in which the term of the lease does not exceed the economic life of the leased equipment.

- The CA disclosure law only applies to CA recipients, which means those whose business are principally directed or managed from CA.
- The financial range of transactions covered by the disclosure laws is from $5k to $500k.
- Depository institutions (generally, banks) are exempt. This does include banks, trust companies, savings and loans, and credit unions chartered under state or federal law. Also exempt are:
    - Commercial transactions secured by real property;
    - Lenders regulated under the federal *Farm Credit Act*;
    - Dealers under *Section 285* of the *Vehicle Code*; or
    - Persons making no more than one commercial financing transaction in a 12-month period or five or fewer commercial financing transactions in a 12-month period that are "incidental to the business of the person relying on that exemption", generally interpreted to mean that the person relying on this exemption is not in the business of making loans.
- **IMPORTANT-UNRESOLVED:** It is unclear whether subsidiaries of depository institutions are exempt. Bank subs are exempt from CFL licensing requirements, but there is nothing in the disclosure laws that mentions bank subs or states that they are exempt. Consider that, however, the CFL licensing laws do not contain such language either. This was decided in an opinion of the DBO Commissioner years ago, and is now accepted law. It is possible that the same thing will occur with regard to the disclosure laws but, for now, at least, I have to caution bank subs to not assume they are exempt unless and until we learn otherwise.
- Providers are defined as those who "extend specific offers of commercial financing to a recipient." Provider also includes a nondepository institution (meaning, generally, one that is not a bank) which enters into a written agreement with a depository institution for an extension of commercial financing by the bank "via an online platform administered by a nondepository institution."
- Generally, the following must be disclosed:
    - 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 the
    - APR.
- There are alternatives for these disclosures for factoring and sales-based lending that enable you to use examples rather than specific numbers. This is intended to address industry concerns that it is

difficult, perhaps impossible, to provide some of this information based on the variables involved in these types of transactions.

The remainder of this handout deals with the 48 pages of regulations.

- First, a few more definitions (taken from the regulations):
    - **Financer** is the person who provides the financing to the recipient.
    - **Provider** means a person who extends a specific offer of commercial financing to a recipient. **A provider includes a financer when the financer communicates a specific offer directly to a recipient or to a broker with the expectation that the broker will share the offer with a recipient.**
- There are disclosures for each type of commercial financing. They are extremely specific and differ depending on how the transaction is classified.
- All disclosures must be made "at the time of extending a specific commercial financing offer." That means any time an offer is quoted to a recipient, and certainly before funding.
- Disclosures must also be made when the terms of a consummated contract are amended or supplemented if those changes result in an increase to the APR, regardless of whether the possibility of that increase was disclosed in the contract. This does not apply to increases in the APR due to the recipient's default.
- The disclosures must be signed by the recipient, returned to the broker or provider, and retained for four years.
- Brokers are not responsible for the content of disclosures, but are responsible for relaying the disclosures from the provider to the recipient, obtaining signatures, delivering the signed disclosures back to the provider, and retaining records.
- If a broker is involved, the financer must provide a copy of compliant disclosures whenever the financer provides a broker with a specific financing offer.
- The financer must retain a copy of the evidence of the transmission to the broker and the signed disclosures for four years.
- The financer must also develop procedures designed to ensure that recipients receive the disclosures, and for timely investigation to provide the financer with notice if the broker has not provided the disclosures. This might include warranties in the broker agreement and internal compliance roles. Financers are required to discontinue relationships with brokers who engage in a pattern of noncompliance with these rules.

- The broker's duty is to timely transmit the unaltered disclosures to the recipient and provide timely evidence of the transmission to the financer.
- Brokers are not required to evaluate the accuracy of the disclosures and the regulations do not impose any liability on the broker due to the financer's failure to provide accurate disclosures.
- The disclosures have to be on a separate document but may be transmitted with other documents, including the offer itself.
- The disclosures can be transmitted and signed electronically, but the electronic signatures must be compliant with the *California Civil Code*, using safeguards such as *DocuSign* to ensure the authenticity of the signatures.
- There are general requirements for ALL disclosures including formatting, font sizes, columns, rows, cells, and certain mandatory language. For instance, numeric values must be expresses numerically and not alphabetically.
- There are product specific disclosure requirements for closed-end transactions, open-end credit plans, factoring and sales-based financing (both of which allows the use of examples), lease financing (not true leases), and asset-based lending transactions.
- There is also a "catch-all" section for disclosure formatting and contents for "all other transactions." This is what strongly suggests to me that virtually any form of commercial transaction, however denominated (other than true leases), will be governed by the disclosure laws.
- There are examples of what constitutes the $500k threshold, depending upon the type of transaction.
- The APR is to be calculated in accordance with *Reg Z.* The provider has a choice to utilize the *United States Rule* or the actuarial rule, both of which are found in *Reg Z, Appendix J.*
- The APR must include all finance charges but assumes that all payments are made on time and there are no subsequent draws.
- There are allowed tolerances for incorrect APR's, which permit minor disclosure errors, usually within the range of 1/8% and 2 ½%, depending upon the transaction.
- There is no liability for inadvertent error if, within 60 days of discovering the error, it is corrected and adjustments are made to rectify any error. This discovery must be made by the provider, not the recipient, and must occur before any action is instituted.

- There is no liability if the disclosures exceed the amount the provider is required to disclose.
- **IMPORTANT-UNRESOLVED:** Whether you have to be a CFL licensee to be subject to these laws. It appears not, as the prefatory language of the statute says "the CFL authorizes the commissioner to bring an action to enjoin, any person who has violated the CFL."
- **UNRESOLVED**: Whether there is liability on behalf of a third party who acquires a commercial financing contract. I believe it depends on where the funds come from. If a third party funds the deal and takes an assignment of the contract, they are almost certainly bound by the disclosure obligations. If a third party acquires the paper post-funding, it is probably not liable, but it might want to incorporate into its due diligence confirmation of compliance with the disclosure laws, lest it find itself opening a can of worms if the borrower's counsel raises this as a claim or a defense.

C. CONCLUSION

Lenders in particular should retain a compliance specialist or hire outside counsel to assist in navigating these laws. The DFPI has broad authority to regulate its licensees and other commercial finance providers in the state. That means fines, penalties, cease and desist orders, and the like. On top of that, a willful violation of the CFL is a crime. **I urge you to prepare now for compliance in California well in advance of the 12/9/22 operative date, as this will require a great deal of work, particularly for lenders.**