

Inside The Expansion Of Commercial Lending Regs In Calif.

By **Nancy Thomas and Calvin Funk** (April 13, 2023, 11:05 AM EDT)

California has been at the forefront of efforts to regulate commercial lending.

In September 2018, California passed a first-of-its-kind commercial financing disclosure law. The law requires disclosure of key terms in connection with certain financing transactions by nonbanks, including specified bank partners.

The law took effect in December 2022 after the California Department of Financial Protection and Innovation issued final implementing regulations in June 2022.

Shortly after issuing those final regulations, the DFPI took the next step in expanding its regulation of commercial financing when it issued draft regulations that would (1) provide authority to identify and bring enforcement actions based on alleged unfair, deceptive, or abusive acts or practices, or UDAAP, engaged in by covered providers of commercial financing transactions to small businesses and other entities, and (2) impose reporting requirements on covered providers.

In February 2023, the DFPI issued modified proposed regulations.[1] If these regulations become final, they will once again broaden the DFPI's supervisory and enforcement authority over nonbank providers of commercial financing.

And where California goes, so go other states. We highlight the key proposed modifications and what covered providers can do to get ready for the DFPI's new authority.

Original Proposed Regulations

Despite its title, the California Consumer Financial Protection Law, or CCFPL, contains one provision regarding commercial financing.

This provision authorizes the DFPI to define UDAAP in connection with the offering of commercial financing or other financial products and services to small businesses, nonprofits and family farms.[2]

It also authorizes the DFPI to promulgate rules requiring data collection and reporting on the provision of commercial financing or other financial products and services.

The DFPI issued its initial proposed regulations in June 2022.[3]



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The initial proposed regulations addressed: the scope of the DFPI's UDAAP authority over providers of commercial financing products, including the definitions of covered providers and small businesses; the definition of UDAAP, which the DFPI lifted verbatim from federal law and then added practices that are unfair or deceptive under the California Unfair Competition Law; and enforcement provisions that add remedies that are not authorized by the CCFPL.

They also set out annual reporting requirements for covered providers.[4]

The DFPI then issued modified proposed regulations in February. Although the DFPI stated that it issued the modified proposed regulations after considering comments on the original proposed regulations, the agency did not explain the rationale for the proposed changes.[5]

Proposed Changes in Scope

The modified proposed regulations would make three changes to coverage of the UDAAP regulations.[6]

First, the proposed definition of "covered provider" would state expressly that entities exempt from the CCFPL are exempt from the proposed regulations. These exempt entities include licensed finance lenders and state and federally chartered financial institutions.[7]

There is no harm in including this provision, but there is nothing in the CCFPL that could authorize the DFPI to issue regulations purporting to apply to entities that are exempt from the statute itself.

Second, the DFPI proposes to address its original awkward definition of "consumer," which in the original proposal was defined to mean the opposite of "consumer," namely, corporations, partnerships, and all other organizations or legal or commercial entities. The DFPI proposes to change the terminology in the regulation from "covered consumer" to "covered entity."

Third, the DFPI proposes to expand the definition of "small business" to include larger business entities. The modified proposed regulations would define "small business" to include for-profit business entities with annual gross receipts of up to \$16 million or as adjusted for inflation by the California Department of General Services pursuant to Government Code Section 14837(d)(3), whichever is greater.

The initial proposed rule would have used the definition of "small business" found in California Code of Civil Procedure Section 1028.5(c), which is limited to businesses that are independently owned and operated, are not dominant in their field, and do not exceed lower gross receipt thresholds that vary by type of business activity.

Proposed Change to UDAAP Definition

The DFPI proposes a minor change to the definition of UDAAP. References in the proposed regulations to unfair and deceptive acts and practices under the Unfair Competition Law would now include an express reference to case law decided under the Unfair Competition Law.

Proposed Change to UDAAP Enforcement

The modified proposed regulations would clarify that UDAAP under the regulations applies "in connection with the offering or provision of commercial financing or another financial product or service

to a covered entity."

This proposed change corrects the overbreadth in the language in the original proposed regulations, which would have prohibited "any" UDAAP, regardless of whether it occurred in connection with a financial product or service.

The DFPI does not propose any change to the enforcement provisions, even though those provisions purport to add remedies not authorized under the CCFPL. In particular, among other enforcement authority, the CCFPL authorizes "ancillary relief" — meaning contract rescission, refunds, restitution, disgorgement, damages, etc. — only for a violation "with respect to consumer financial products," as that term is defined in the CCFPL.[8]

However, the proposed regulations purport to authorize the DFPI to seek ancillary relief for any UDAAP against any covered provider, including covered entities providing commercial financing products and not consumer financial products.

Proposed Changes to Reporting Requirements

The modified proposed regulations contain a few clarifying changes, including that (1) the reporting requirement would begin in 2025 (reporting on activity during 2024); (2) the dollar amount of the transaction is the "amount financed" under the commercial financing disclosure regulations; and (3) there is no obligation to report annual percentage rate for financing types and intervals for which the covered provider did not provide disclosures during the applicable period.

In addition, the DFPI proposes to eliminate reporting on transactions for which the amount financed exceeds \$500,000, which is consistent with the scope of the commercial financing disclosure law.

Finally, the DFPI proposed that covered providers that are California Financing Law licensees would not need to include in the CCFPL report any information for activity conducted under the CFL license.

Takeaways

These proposed modifications are best described as tweaks rather than any effort to grapple with the challenges of defining UDAAP for commercial entities rather than consumers.

The definition of "small business" that would be covered by the modified proposed regulations has the benefit of an easy-to-measure flat amount of annual gross receipts, regardless of the type of business.

But as with the original proposed regulations, the DFPI does not identify any basis for its definition. In its initial statement of reasons accompanying the original proposed regulations, the DFPI tried to connect lending to consumers with lending to organizations by claiming these organizations are "managed and operated by individuals and consumers of financial products and services just like individual consumers." [9]

This justification ignores the corporate form entirely and turns a blind eye to the legal and practical distinctions between business organizations and the individuals who own those organizations. This disconnect is amplified by the modified proposed regulations, which would significantly increase the size — and likely the sophistication — of small businesses that are covered entities as compared to the original proposal.

The DFPI's broad, general approach reflects an assumption that the DFPI will "know it when they see it."

Covered providers would be left attempting to read the tea leaves, trying to understand the UDAAP framework based on DFPI consent orders. And until those consent orders start arriving, covered providers may want to consider adopting a consumer-minded framework for products offered to covered entities, such as:

- Reviewing all marketing, advertising, disclosures and customer service scripts with a consumer-focused UDAAP perspective, even though they are used for business transactions;
- Regularly evaluating and reviewing new and existing products and services — and the manner in which they are offered and provided — for potential UDAAP issues;
- Monitoring customer complaints and analyzing complaint trends that may indicate potential UDAAP issues;
- Considering the amount of fees collected for products offered to small businesses, with particular focus on any products for which the DFPI could find that the covered provider earns a significant percentage of its revenue from fees;
- Assessing whether the target customer for a particular product or service may be perceived by the DFPI to be a particularly vulnerable population, which may attract particular scrutiny from the DFPI;
- Monitoring state and federal UDAAP enforcement trends to identify hot-button UDAAP issues; and
- Proactively remedying any UDAAP issues that are identified.

In considering next steps, covered providers also should consider what is becoming an increasingly complex patchwork of commercial financing disclosure laws in California and other states that have followed California's lead.

The Consumer Financial Protection Bureau's recent determination that these state laws are not preempted by the Truth in Lending Act^[10] heightens the compliance risks and obligations in offering certain commercial financing transactions that may be subject to differing requirements under these state laws.

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[1] Notice of First Modification to Proposed Action, PRO 02-21 (Feb. 24, 2023), <https://dfpi.ca.gov/wp-content/uploads/sites/337/2023/02/PRO-02-21-Notice-of-First-Modification.pdf>.

[2] Cal. Fin. Code § 90009(e).

[3] Notice of Proposed Action, PRO 02-21 (June 24, 2022), <https://dfpi.ca.gov/wp-content/uploads/sites/337/2022/06/PRO-02-21-Notice-of-Proposed-Action.pdf>.

[4] Text of Proposed Regulations, PRO 02-21 (June 24, 2022), <https://dfpi.ca.gov/wp-content/uploads/sites/337/2022/06/PRO-02-21-Text-of-Proposed-Regulations.pdf>.

[5] Notice of First Modification to Proposed Action, *supra* n.1.

[6] First Modified Text of Proposed Regulations, PRO 02-21 (Feb. 24, 2023), <https://dfpi.ca.gov/wp-content/uploads/sites/337/2023/02/PRO-02-21-First-Modified-Text.pdf>.

[7] Cal. Fin. Code §90002.

[8] Cal Fin. Code §§90015(e), 90012(b).

[9] Initial Statement of Reasons, PRO 02-21 (June 22, 2022), <https://dfpi.ca.gov/wp-content/uploads/sites/337/2022/06/PRO-02-21-Initial-Statement-of-Reasons.pdf>.

[10] CFPB, Truth in Lending; Determination of Effect on State Laws (California, New York, Utah, and Virginia), issued March 28, 2023, https://files.consumerfinance.gov/f/documents/cfpb_truth-in-lending-determination-of-effect-on-state-laws_2023-03.pdf.