Chapman and Cutler LLP

Chapman Client Alert

November 1, 2018 Current Issues Relevant to Our Clients

Borrower Disclosures Now Required for Commercial Loans Made in California

On September 30, 2018, the Governor of California signed into law Senate Bill No. 1235, which amends the California Financing Law (CFL) (previously known as the Finance Lenders Law) to impose new disclosure requirements on licensed commercial lenders and brokers including for online lending programs doing business in California. Under the new law, a provider that offers commercial financing in the amount of $5000 to $500,000 is required to obtain the recipient's written signature on disclosures containing the the following information before consummating the transaction:

1. The total amount of the funds provided;
2. The total dollar cost of the financing;
3. The term or estimated term;
4. The method, frequency, and amounts of payments;
5. A descriptions of prepayment policies; and
6. The total cost of the financing expressed as an annualized rate (this disclosure requirement sunsets on January 1, 2024).

The CFL provides for the licensure and regulation of finance lenders and brokers by the Commissioner of Business Oversight and prohibits anyone from engaging in the business of a finance lender or broker in California without obtaining a license. Among other things, the CFL prohibits a licensee from making a materially false or misleading statement to a borrower about the terms or conditions of a loan. Violations of the CFL can result in injunctions and/or civil penalties and willful violations can result in criminal penalties.

The new law applies generally to all persons who "extend a specific offer of commercial financing to a recipient"—a broad category that would seem to include not only lenders but also brokers and other intermediaries operating both on- and off-line. In addition, the law contains specific language extending the disclosure requirements to online platforms that facilitate the origination of commercial financings by depository institutions under a bank program agreement. Presumably, a provider needs to be a licensee or at least meet the standard for "doing business in California" in order to be subject to the new disclosure requirements. However, whether a non-licensee that makes targeted solicitations into California from outside the State (without more) is doing business in California or would be subject to these requirements is unclear as is whether the Department of Business Oversight (DBO) will use this rulemaking as an opportunity to extend its jurisdiction.

The new law does not apply to:

- A provider that is a depository institution.
- A provider that is a lender regulated under the federal Farm Credit Act.
- A commercial financing transaction secured by real property.
- A commercial financing transaction in which the recipient is a dealer, as defined by Section 285 of the California Vehicle Code, or an affiliate of such a dealer, or a vehicle rental company, or an affiliate of such a company, pursuant to a specific commercial financing offer or commercial open-end credit plan of at least $50,000, including any commercial loan made pursuant to such a commercial financing transaction.
- Any person who makes no more than one commercial financing transaction in California in a 12-month period or any person who makes five or fewer commercial financing transactions in California in a 12-month period that are incidental to the business of the person relying upon the exemption.

The law otherwise applies generally to offers of commercial financing, which is defined broadly to include accounts receivable purchase transactions, such as factoring, merchant cash advances, asset-based loans, commercial loans, commercial open-end credit plans, and lease financing transactions intended by the recipient for use primarily for other than personal, family, or household purposes. The law authorizes providers to rely on written statements regarding intended use of the proceeds and specifically states that providers are not required to ascertain whether the proceeds are actually used in accordance with such intended use.

Each of these enumerated categories is defined—sometimes with important implications.

For example:

- Lease-financing only includes a lease for goods if the lease includes a purchase option that creates a security interest in the goods leased. This definition would exclude most "true" leases, which should offer some comfort to commercial equipment finance companies doing business in California.

- The catch-all category of "commercial loans" is defined to include only loans with a principal amount of five thousand dollars or more (or any loan under an open-end credit plan). However, note that loans with a principal balance of less than five thousand dollars are already considered "consumer loans" under the CFL and therefore separately regulated.[1]

- "Factoring" includes the true purchase and sale of accounts receivables, not just sales disguised as loans.

- Asset-based lending is defined as a transaction in which advances are made by the lender in exchange for the borrower "forwarding payments received" from third parties for goods provided or services rendered. It is unclear whether this definition encompasses any and all loans secured by accounts receivables that are also subject to cash dominion arrangements or only those in which the funds advanced are tied directly to the amount of the receivables whose payments are being "forwarded."

- We also note that there is no explicit exception for transactions between affiliates (such as a sale of receivables by an originator to its financing subsidiary). Unless further clarified by regulation, affiliates engaged in repeat transactions may need to rely on the $500,000 threshhold or the 5 or fewer transactions exemption.

The law allows providers of factoring and asset-based loans to make disclosures based on an example of a transaction, if they offer the recipient an agreement that describes only general terms and conditions. The legislative history suggests that this exception for factoring and asset-based lenders was included because in a typical factoring arrangement "there is no set term or repayment amount; the purchase price of the accounts is paid to the small business up front, and the factor collects receipts over time as customers of the business make payments on the underlying accounts."[2] Therefore, the only possible disclosure that could be made by the factor would be based on an example of a possible financing. Hopefully, the implementing regulations will clarify what types of disclosures are required for other types of transactions that do not have fixed payment terms or fixed advances.

The DBO is charged with adopting implementing regulations, which among other things, will govern the appropriate method for expressing the annualized rate disclosures. Although the law has an effective date of January 1, 2019, providers of commercial financing in California are not required to comply with the new disclosure requirements until the final regulations are adopted. The DBO's website has not been updated with any information about the newly enacted law.

For More Information

If you would like further information concerning the matters discussed in this article, please contact any of the following attorneys or the Chapman attorney with whom you regularly work:

Marc P. Franson	**Melanie J. Gnazzo**	**Matthew C. Stone**	**Peter Bach-y-Rita**	**Joseph E. Silvia**
Chicago	San Francisco	Charlotte	San Francisco	Chicago
312.845.2988	415.278.9020	980.495.7308	415.278.9037	312.845.3705
franson@chapman.com	mgnazzo@chapman.com	mstone@chapman.com	bachyrita@chapman.com	silvia@chapman.com

1 The Cal. Fin. Code § 22204.

2 Senate Rules Com., Off. of Senate, Floor Analysis, Rep. on Sen. Bill No. 1235 (2017-2018 Reg. Sess.), May 11, 2018, p. 5.

Chapman and Cutler LLP

Attorneys at Law · Focused on Finance®