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### Commercial Lenders Brace for Consumer-Style Disclosures in California and Beyond

*By Clinton R. Rockwell, Kathryn L. Ryan, Moorari K. Shah and Frida Alim*

One year ago, California became the first state to require consumer-style disclosures similar to those required for consumer loans under federal laws. The requirements of Senate Bill 1235 signal a sea change likely to affect other states as well. This article, the first of two, explains the implications for the equipment leasing and finance industry.

### Privacy Puzzle — Grappling with the Patchwork of New State-Specific Data Privacy Laws

*By Andrew Baer and Matthew Klahre*

Lessors conducting business in California must pay attention to the evolving and sometimes puzzling amendments to the California Consumer Protection Act. The act affects both business-to-business and business-to-consumer transactions. Several other states also are enacting laws that signify compliance challenges for national and international businesses.

### Blockchain: Transforming Public Data for Improved Financial Success

*By Raja Sengupta*

Blockchain has the potential to help states establish and demonstrate transparency, speed up processing times, and cut operational costs related to commercial lending. That augers well for states vying to attract new businesses. Advances such as "smart UCCs" will benefit lenders, too. Where they can conduct due diligence easily, they will be more apt to do business.

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# Commercial Lenders Brace for Consumer-Style Disclosures in California and Beyond

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One year ago, California became the first state to require consumer-style disclosures similar to those required for consumer loans under federal laws. The requirements of Senate Bill 1235 signal a sea change likely to affect other states as well. This article, the first of two, explains the implications for the equipment leasing and finance industry.

In September 2018, California became the first state to enact commercial financing legislation requiring consumer-style disclosures similar to those required for consumer loans under the federal Truth in Lending Act (TILA) and Regulation Z.[1] Senate Bill 1235, the common shorthand for the new statute referring to its assigned legislation number in the California senate, has been effective for approximately a year, as one of the final acts signed into law by outgoing Governor Jerry Brown. Ever since, commercial lenders have been grappling with how to implement the new disclosure requirements.

Fortunately for many of the affected businesses, S.B. 1235 expressly delayed compliance pending issuance of final regulations by the California Department of Business Oversight (DBO).[2] Nonetheless, many nonbank commercial lenders in the equipment leasing and finance marketplace are bracing for the anticipated sea change this law, along with the inevitable copycat legislation likely to emanate from other jurisdictions, will bring.[3]

This article addresses the requirements imposed by S.B. 1235, explores the policy objectives underlying the legislation, discusses the implications of this legislation for the equipment leasing and finance industry, and it provides practical recommendations for companies to comply.

## OVERVIEW OF S.B. 1235

In contrast to the absence of commercial lending regulation in most states, commercial lending has been a regulated activity in California for quite some time.[4] To date, California has primarily regulated finance lenders and brokers engaging in commercial transactions by, among other things, requiring licensure.[5] Although California is not the only state to require licensure for commercial lenders and brokers, it is among the most aggressive in its enforcement of licensure laws for commercial lenders.[6]

However, in recent years concerns have grown that unlicensed lenders were finding new ways to circumvent the requirements by making loans through those exempt from licensure, such as banks.[7] Ostensibly to combat this disparity and to level the playing field, S.B. 1235 will require licensed *and unlicensed* entities (defined as "providers")[8] that extend offers of commercial financing of $500,000 or less to disclose certain information to a recipient at the time the offer is extended, and to obtain the recipient's signature on the disclosure before consummating the commercial transaction.[9]

Significantly, banking institutions themselves remain exempt from S.B. 1235's requirements, while nonbanks bear the burden of compliance with the new law.[10] To that end, a nonbank provider must disclose to the recipient:

- 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

*Editor's Note: This is part 1 of a two-part article. Part 2 will be published in a later issue of the Journal once California's regulations are final. (See endnote 2.)*

Because of this narrow definition of a "lease financing," true leases that, for example, either have no end-of-term purchase option or a fair market value purchase option are not subject to S.B. 1235.

- the total cost of the financing expressed as an annualized rate.[11]

S.B. 1235 will also require the foregoing disclosures for two types of products that have not expressly been regulated to date under the California Financing Law: merchant cash advances and factoring.[12] In addition, S.B. 1235 will apply to other accounts receivable purchase transactions, commercial loans, commercial open-end credit plans, and lease financing transactions that the recipient intends to use primarily for *other than* personal, family, or household purposes.[13]

## EXEMPTION FOR TRUE LEASES

As noted above, S.B. 1235 applies to a "lease financing," which is defined as a lease for goods "if the lease includes a purchase option that creates a security interest in the goods leased, as defined in paragraph (35) of subdivision (b) of Section 1201 and Section 1203 of the Commercial Code."[14]

Because of this narrow definition of a "lease financing," true leases that, for example, either have no end-of-term purchase option or a fair market value purchase option are not subject to S.B. 1235. As a result, some practitioners have noted that equipment lessors may seek to forgo purchase options on leases in some cases, and may also find it beneficial to shift the process of lease-return sales to auction companies that specialize in such sales.

## APPLICABILITY TO BANK SUBSIDIARIES

The DBO's draft regulations exclude nondepository subsidiaries or affiliates from the definition of a depository institution.[15] As a result, if this definition is finalized in the same form, nondepository subsidiaries or affiliates will be subject to S.B. 1235. Notably, this definition would be at odds with the DBO's long-standing position with respect to bank subsidiaries in the commercial lending context.

Specifically, the DBO has previously published regulations clarifying that bank subsidiaries are not exempt from the definition of a finance lender in the context of *consumer* lending, but this limitation on the exemption does not apply in the commercial lending context.[16]

S.B. 1235 also takes aim at banks that partner with financial technology companies to generate loans. The definition of a provider expressly includes a nondepository institution that enters into a written agreement with a depository institution "to arrange for the extension of commercial financing by the depository institution to a recipient via an online lending platform administered by the nondepository institution."[17]

Likely in response to industry concern over the ambiguity of this requirement, the DBO's draft regulations attempt to clarify that the phrase "administered by" excludes an arrangement whereby a nondepository institution provides technology or support services for a depository institution's branded commercial financing program so long as the nondepository institution has no interest, or arrangement or agreement to purchase any interest in the commercial financing extended by the depository institution in connection with such program.

As a result, in some instances, a depository institution's nonbank partner will still be obligated to comply with S.B. 1235's disclosure requirements. Whether a nondepository institution must comply with S.B. 1235 will depend upon whether it "arrange[s]" for the extension of credit through an online lending platform that it administers.

As contemplated by S.B. 1235, it appears that nondepository institutions would not be subject to S.B. 1235 only if: they (1) never present material terms to the applicant, (2) provide only technology or support services to the depository institution's branded commercial financing program, and (3) take no interest in the commercial financing.[18]

While the legislature likely exempted depository institutions because these institutions are already subject to federal regulation, this exemption may nonetheless create additional disparities and costs for nonbanks relative to banks. Further, S.B. 1235 may ultimately have the unintended consequence of limiting entrance into the commercial financing space by requiring nonbanks to comply with significant and costly disclosure requirements.[19]

## ADAPTING TO TILA AND REGULATION Z

Unlike TILA, which applies to a subset of consumer financing, S.B. 1235 applies to a variety of divergent commercial financings. Rather than embedding disclosure requirements in the licensing laws that are applicable to each type of financing, the legislature used S.B. 1235 as a vehicle to create an entirely new law to apply substantially the same disclosure obligations to a variety of commercial financings.[20]

However, this approach may somewhat compromise the objective of keeping borrowers informed. For example, the various permutations of commercial financing, developed

specifically to meet the unique objectives of small business borrowers, will likely result in disclosures that are complicated to understand and burdensome to produce.

Furthermore, borrowers may struggle to meaningfully compare disclosures from different types of commercial financing products. For example, the disclosures mandated by S.B. 1235 may not capture the tax and accounting implications or maintenance fees associated with a lease that creates a security interest pursuant to Section 1-203 of the Uniform Commercial Code.

Notwithstanding the differences between TILA and S.B. 1235, some industry members have requested that the DBO commissioner allow for compliance with TILA and Regulation Z for certain types of commercial financings. One commenter advocated for use of the TILA and Regulation Z disclosures.[21]

Other commenters have requested that the regulations adopt certain concepts from TILA and Regulation Z (e.g., annualized rate calculation, establishing tolerance thresholds). However, Regulation Z did not contemplate certain types of products, such as purchasing of accounts receivable or revenue-based loans, which do not have fixed repayment terms. As a result, reliance on TILA and Regulation Z may work for some types of commercial financings but not for others.

In particular, equipment finance industry members may face difficulties in determining how to capture the terms of equipment financings in the disclosures related to the myriad of acquisition costs and fixed and variable payment options typically available under the commercial leases.

The initial draft regulations provide little clarity and indicate only that the provider should calculate the amount of funds provided in one of two ways: (1) if the finance company does not select, manufacture, or supply the goods to be leased, the price the finance company will pay to acquire the property to be leased, or (2) if the finance company selects, manufactures, or supplies the goods to be leased, the price that the finance company would sell the goods in a cash transaction.[22]

Absent further direction in the proposed regulations, it appears that equipment financing companies will need to become fluent in the application of Regulation Z in order to determine which types of costs they must include in the finance charge calculation required under the S.B. 1235 disclosures — for example, the cost of insuring the collateral, the cost of filing UCC financing statements, loan commitment fees, and other administrative fees.

## CONTINUING CREEP OF CONSUMERISM INTO COMMERCIAL FINANCING

Small business lending has been in the crosshairs of the federal regulatory agenda for years. In 2010, Congress passed Section 1071 of the Dodd-Frank Act, which amended the Equal Credit Opportunity Act to require financial institutions to comply with certain data collection and disclosure obligations in connection with business loan applications.[23]

In 2015, the Federal Reserve Board of Governors and the Federal Reserve Bank of Cleveland published a report studying the impact of online lenders on the small-business credit environment.[24] Among other findings, the report found that, although small business owners initially said it was "easy" to evaluate credit products, when presented with several options, "many expressed uncertainty or answered questions incorrectly when making specific product comparisons, particularly on cost."[25]

Further, many of these small business owners wanted disclosures showing product features and costs in a way that made it easier to compare product offerings.[26] Most recently, the Federal Trade Commission has signaled its desire to regulate the merchant cash advance industry, citing its concern over the "unfair and deceptive marketing, sales and collection practices in the small-business finance market."[27]

The passage of S.B. 1235 offers additional evidence of consumer-style policy priorities and protections creeping into commercial transactions, although this time at the state level.[28] To wit, S.B. 1235 has sparked many comparisons to TILA, which Congress enacted in 1968 to "protect the consumer against inaccurate and unfair credit billing and credit card practices" and "assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him [and] avoid the uninformed use of credit."[29]

To this end, TILA requires that a creditor disclose "all relevant loan terms," including the amount financed, the finance charge, and the annual percentage rate. Much like TILA's disclosure objectives, the legislature enacted S.B. 1235 with the objective of "help[ing] small businesses better understand the terms and costs of the financing available to them in the commercial financing market."[30]

The passage of S.B. 1235 offers additional evidence of consumer-style policy priorities and protections creeping into commercial transactions, although this time at the state level.

Companies can take certain steps now to begin preparing for the eventual impact of S.B. 1235, including by evaluating their transactions and business models.

## STRIKING THE RIGHT BALANCE

While the disclosures mandated by S.B. 1235 are meant to "help small businesses better understand the terms and costs of the financing available to them," ironically, some of the staunchest consumer protection advocates have questioned the efficacy of inundating borrowers with disclosures.[31]

Senator Elizabeth Warren (D-Mass.), a central figure in the Bureau of Consumer Financial Protection's formation, argued against a disclosure-focused regime in a 2010 speech, stating:

> Instead of creating a regulatory thicket of "thou shalt nots," and instead of using ever more complex disclosures that drive up costs for lenders and provide little help for consumers, let's measure our success with simple questions. … Can customers understand the product, figure out the costs and risks, and compare products in the marketplace?[32]

While some would argue that S.B. 1235's central purpose is to provide the clarity Warren was referring to in her speech, opponents of commercial financing disclosures have an equally valid counterpoint that such a one-size-fits-all view attempts to paint all commercial finance transactions, including complex lease financing with tax, accounting, and strategic planning implications, with a broad brush that likely could cause just the confusion that Warren rails against.

It should go without saying that there is a real risk that more regulation and enforcement efforts, including through disclosures designed to correct purported behavioral market failures, could in fact lead to unfavorable outcomes in commercial lending.[33] But there can be no dispute that many financial products and services suddenly subject to S.B. 1235 have historically been useful and popular among small businesses, in particular, absent the need for legislative or regulatory protections typically reserved for consumer transactions.

## KEY TAKEAWAYS AND NEXT STEPS

Companies can take certain steps now to begin preparing for the eventual impact of S.B. 1235, including by evaluating their transactions and business models. For example, a company may:

- Evaluate the commercial financings offered by the company to determine whether these financings would fall under S.B. 1235. This assessment may involve considering the nature of the transactions (e.g., retail installment sale or commercial loan), the purpose of the transactions (e.g., personal or business purpose), and whether these transactions would meet the applicable thresholds.
- Evaluate the disclosures that are currently being provided to customers. This assessment may involve considering the type of information that is contained in these disclosures, the timing in which the disclosures are provided, and how material terms are calculated and presented. Comparing disclosures currently provided with the DBO's draft regulations and sample disclosures may help the company better prepare for compliance with S.B. 1235.
- To the extent the company hosts an online lending platform that arranges for the extension of commercial financing by a depository institution, consider whether the company may be considered a provider of commercial financing subject to S.B. 1235. This assessment may involve evaluating any service agreements with the depository institution to determine whether the services provided could be considered "arrang[ing] for the extension of commercial financing by the depository institution" and whether the company "administer[s]" the online lending platform through which the offer is extended.

## CONCLUSION

S.B. 1235 puts commercial lenders and equipment financing companies on notice that potentially burdensome disclosure requirements are on the horizon. In addition to monitoring developments surrounding S.B. 1235, companies should remain apprised of legislative developments concerning commercial financing in other states, as S.B. 1235 will likely continue to serve as a model for future legislation in other jurisdictions.

### Endnotes

1. 15 U.S.C. § 1640 et seq; 12 C.F.R. Part 1026.

2. The DBO issued an initial draft of the regulations in July 2019. The regulations are subject to a comment period, after which it is expected that the DBO will issue a revised draft of the regulations. The timing of the revised draft and final regulations is uncertain, but compliance requirements are not expected to be effective until mid-2020 at the earliest.

3. Other states, such as New Jersey and New York, are also moving to regulate small business financing. In New Jersey, the Senate passed a copycat bill in 2018.

4. California enacted the California Finance Lenders Law in 1995, combining three separate licensure laws — the Personal Property Brokers Law, Consumer Lenders Law, and the Commercial Finance Lenders Law — into one. These three laws previously required lenders to obtain three separate licenses to conduct full-service lending in California, including for commercial lending. The California Finance Lenders Law was subsequently renamed the California Financing Law in 2017.

5. See, e.g., Cal. Fin. Code § 22100 ("No person shall engage in the business of a finance lender or broker without obtaining a license from the commissioner."); Ibid. at § 22009 (defining "finance lender" to include any person who is engaged in the business of making commercial loans).

6. Some states have licensure laws that explicitly apply to commercial loans. See, e.g., N.Y. Banking Law § 340 ("No person or other entity shall engage in the business of making loans in the principal amount of […] [$50,000] or less for business and commercial loans, and charge, contract for, or receive a greater rate of interest than the lender would be permitted by law to charge if he were not a licensee […] without first obtaining a license[.]"). Other states have licensure laws that are sufficiently broad so as to capture certain types of commercial loans. See, e.g., S.D. Codified Laws Ann. § 54-4-52 (a license is required to engage in the business of lending money); N.M. Stat. Ann. § 58-15-3(A) (a person must be licensed to engage in the business of lending in amounts of $2,500 or less for a loan.).

7. Senate Comm. on Banking and Fin. Inst., California Financing Law: Commercial Financing: Disclosures at p. 8 (April 16, 2018), https://leginfo.legislature.ca.gov/faces/billAnalysisClient.xhtml?bill_id=201720180S.B.1235# (noting that S.B. 1235 "attempts to skirt the pre-emption issues that typically plague attempts to regulate bank partnership lending models by placing its disclosure requirements on the nondepository partner rather than the actual bank lender.").

8. Cal. Fin. Code § 22800(m) (defining "providers" as a person who extends a specific offer of commercial financing to a recipient, and also includes "a nondepository institution, which enters into a written agreement with a depository institution to arrange for the extension of commercial financing by the depository institution to a recipient via an online lending platform administered by the nondepository institution. The fact that a provider extends a specific offer of commercial financing or lending on behalf of a depository institution shall not be construed to mean that the provider engaged in lending or originated that loan or financing.").

9. Ibid. at § 22802 (effective *until* January 1, 2024), 22800(n) (defining a "recipient" as a person who is presented a specific commercial financing offer by a provider that is equal to or less than $500,000).

10. Cal. Fin. Code § 22801(a) exempts depository institutions from the disclosure requirements of S.B. 1235, which are defined under § 22800(h) to mean any of the following: (1) A bank, trust company, or industrial loan company doing business under the authority of, or in accordance with, a license, certificate, or charter issued by the United States, this state, or any other state, district, territory, or commonwealth of the United States that is authorized to transact business in this state. (2) A federally chartered savings and loan association, federal savings bank, or federal credit union that is authorized to transact business in this state. (3) A savings and loan association, savings bank, or credit union organized under the laws of this or any other state that is authorized to transact business in this state.

11. Ibid. at § 22802 (effective until January 1, 2024). Effective January 1, 2024, a provider will no longer be required to provide the total cost of the financing, but will be required to provide all other categories of information identified above. Ibid. (effective as of January 1, 2024).

12. Ibid. at § 22800(d)(1). "Factoring" means an accounts receivable purchase transaction that includes an agreement to purchase, transfer, or sell a legally enforceable claim for payment held by a recipient for goods the recipient has supplied or services the recipient has rendered that have been ordered but for which payment has not yet been made. Ibid. at § 22800(i). "Accounts receivable purchase transaction" means a transaction as part of an agreement requiring a recipient to forward or otherwise sell to the provider all or a portion of accounts, payment intangibles, or cash receipts that are owed to the recipient or are collected by the recipient during a specified period or in a specified amount. Ibid. at § 22800(b).

13. Ibid. at § 22800(d)(1). Note also that while S.B. 1235 does not impose any additional disclosure requirements on consumer lending transactions, existing provisions of the California Financing Law require licensed finance lenders to provide certain disclosures to borrowers at the time a consumer loan is made. See, e.g., Cal. Fin. Code § 22337(a); Cal. Code Regs. tit. 10, § 1454.

14. Ibid. at § 22800(j)(1).

15. Cal. Dep't of Bus. Oversight, Proposed Regulations at Cal. Code Reg. tit. 10, § 2057(a)(9).

16. See Cal. Code Regs. tit. 10, § 1422.3.

17. Ibid. at § 22800(m).

18. S.B. 1235 defines a "commercial financing" to mean an accounts receivable purchase transaction, including factoring, asset-based lending transaction, commercial loan, commercial open-end credit plan, or lease financing transaction intended by the recipient for use primarily for other than personal, family, or household purposes. Ibid. at § 22800(d)(1).

19. Apart from depository institutions, S.B. 1235 also provides a limited but specific exemption in connection with recipients that are motor vehicle dealers and vehicle rental companies that receive a specific commercial financing offer or commercial open-end credit plan of at least $50,000. Ibid. at § 22801(d).

20. Senate Comm. on Banking and Fin. Inst., California Financing Law: Commercial Financing: Disclosures at p. 6 (April 16, 2018), https://leginfo.legislature.ca.gov/faces/billAnalysisClient.xhtml?bill_id=201720180S.B.1235#.

21. Affirm, Re: PRO 01-18 – Comments on Proposed Rulemaking Commercial Financing Disclosures (Jan. 22, 2019), https://dbo.ca.gov/wp-content/uploads/sites/296/2019/04/PRO-01-18-Affirm-Inc.pdf.

22. Cal. Dep't of Bus. Oversight, Proposed Regulations at Cal. Code Reg. tit. 10, § 2066(b).

23. In 2016, we discussed the implications of Section 1071 of Title 10 of the Dodd-Frank Act, which extended certain consumer credit type requirements to business lending and, more broadly, to any entity engaged in financial activity. See John Redding, Moorari K. Shah, Kathleen C. Ryan, and Mitchell M. Grod, "The Impending Impact of Section 1071 and Creeping Consumerism on Equipment Finance," *Journal of Equipment Lease Financing*, vol. 34, no. 1 (Winter 2016).

24. Fed. Reserve Board of Governors & Fed. Reserve Bank of Cleveland, "Alternative Lending through the Eyes of 'Mom & Pop' Small-Business Owners: Findings from Online Focus Groups" (Aug. 25, 2015). In 2018, the Federal Reserve Board and the Federal Reserve Bank of Cleveland expanded on their 2015 study with a subsequent one. See Fed. Reserve Board of Governors & Fed. Reserve Bank of Cleveland, "Browsing to Borrow: 'Mom & Pop' Small Business Perspectives on Online Lenders" (June 2018), https://www.federalreserve.gov/publications/files/2018-small-business-lending.pdf. According to the 2018 survey, numerous participants noted that even though a borrower's actual interest rate may vary, "they wanted at least some information upon which to compare options and to make decisions on whether to apply." Ibid. at 14.

25. Ibid. at 3.

26. Ibid.

27. See Zachary R. Mider, "FTC Commissioner Calls for Review of Small-Business Loan Practices," *Washington Post* (May 9, 2019), https://www.washingtonpost.com/business/on-small-business/ftc-commissioner-calls-for-review-of-small-business-loan-practices/2019/05/08/149b8650-71a9-11e9-9331-30bc5836f48e_story.html?utm_term=.93d545d80433.

28. New Jersey's S.B. 2262 would impose certain disclosure obligations on an entity (whether a bank or nonbank) that provides a commercial loan in the amount of $100,000 or less to a small business located in New Jersey. S.B. 2262, New Jersey (2018-2019). It would require a covered entity to disclose information such as the annual percentage rate, the interest rate, the finance charge, the amount financed (for a term loan), the borrowing limits (for a revolving credit loan), and any third-party agreements entered into between the entity that provides the small business loan and any broker or other third party involved in the loan. In New York, S5470 was recently referred to the Committee on Banks. See S5470, New York (2019-2020). The bill would also require disclosure of certain terms, such as the amount financed and total cost of the financing. Ibid. In

contrast with California's S.B. 1235, S5470 takes a more nuanced approach by providing disclosure requirements for certain types of commercial financings (e.g., accounts receivable purchase, closed-end commercial financing). Ibid.

29. 12 C.F.R. § 1026.1(b); 15 U.S.C. § 1601(a).

30. Commercial Financing: Disclosures Report, California Senate Committee on Banking and Financial Institutions (Aug. 31, 2019), https://leginfo.legislature.ca.gov/faces/billAnalysisClient.xhtml?bill_id=201720180S.B.1235#.

31. Senate Comm. on Banking and Fin. Inst., California Financing Law: Commercial Financing: Disclosures at p. 4 (April 16, 2018), https://leginfo.legislature.ca.gov/faces/billAnalysisClient.xhtml?bill_id=201720180S.B.1235#.

32. David Lawder, "Consumer Czar Warren Says Wants Banks' Help on Rules," Reuters (Sept. 28, 2010), https://www.reuters.com/article/us-financial-warren/consumer-czar-says-wants-banks-help-on-rules-idUSTRE68T0AB20100930.

33. Jialan Wang and Benamin J. Keys, "Perverse Nudges: Minimum Payments and Debt Paydown in Consumer Credit Cards," Wharton Univ. of Penn: Public Policy Initiative, vol. 2, no. 4 (April 2014), https://publicpolicy.wharton.upenn.edu/issue-brief/v2n4.php.


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