Summary of SB 869 (Glazer) - Commercial Financing

Small businesses are struggling to access the responsible capital they need to grow, especially in the post-COVID recovery. SB 869 plugs several holes in California's legal framework that are currently allowing some brokers and financing companies to take advantage of small businesses. It will improve access to capital and innovation in small business financing by establishing a level playing field of competition and transparency.

SB 869 addresses three topics: (1) The wild west of small business brokering, (2) Unfair practices in the financing shadows, and (3) Loopholes in our disclosure regulations ask bad actors to slap their own wrists.

Topic 1: The "wild west" of small business brokering			
	Problem	**Proposed Solution**	**Location in bill**
1	**No oversight over small business financing brokers** - Echoing the leadup to the subprime mortgage crisis, irresponsible small business lending is now being fueled by brokers who earn higher fees for steering small businesses into costlier, more dangerous financing.[1] Without a licensing framework, bad actor brokers are able to avoid accountability while good brokers struggle to compete.	Establish a licensing requirement for brokers of small business financing, so that bad actors can be monitored by DFPI and small businesses are able to seek accountability if mistreated.	22100.6
2	**Broker market opacity** - While small business financing brokers generally appear similar to their potential clients, import distinctions exist. Some brokers offer the full range of financing options customers expect, while other brokers are "merchant cash advance mills" that focus on placing applicants into high-rate financing.	Require brokers to clearly disclose and identify on their websites the average, min, and max APRs for the financing they placed clients into in the previous calendar year.	22663(a)
3	**Broker steering** - Small business financing brokers are often paid fees of up to 15% of the financing amount to place small business into high-priced financing. In contrast, a broker may earn 1% for placing a small business into a low-cost SBA loan. A broker's financial incentives are thus often to "steer" applicants into financing that costs the borrower more but pays the broker higher fees.	Require brokers to disclose the lowest approximate APR for commercial financing that they believe the borrower could reasonably obtain, based on their industry knowledge.	22663(2)(b)

[1] See e.g. "Brokers Get Big Commissions for Selling Entrepreneurs Costly Loans," Bloomberg Businessweek, (2014). https://www.bloomberg.com/news/articles/2014-03-31/brokers-get-big-commissions-for-selling-entrepreneurs-costly-loans

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Topic 2: Unfair practices in the financing shadows			
	Problem	**Proposed Solution**	**Location**
4	**Licensing loophole for non-loan financing products** - Alternative financing products that argue they are not loans are able to avoid CA's licensing framework, despite often being associated with higher risks for small business borrowers. (For example, Federal Reserve researchers described merchant cash advance and factoring specifically as "potentially higher-cost and less transparent forms of credit."[2]) This exemption from licensing puts these products at an advantage compared to traditional financing products and shields them from appropriate oversight by DFPI.	Extend CA's financing licensing framework to providers of products that purport not to be loans including some merchant cash advances, factoring, and lease financing that works like a loan.	22100.6
5	**Taking small businesses' money without recourse or due process** - In 2022, California joined several other states in prohibiting the use of a legal device called a "confession of judgment."[3] This formerly obscure legal document allows financing companies to take all money they feel they are owed in a default straight from a small business's bank account, without regular legal process with a court. The practice became notorious after Bloomberg Businessweek published an expose titled, "Sign Here to Lose Everything: The Predatory Lending Machine Crushing Small Businesses Across America."[4] Unfortunately, the merchant cash advance industry has found loopholes by employing functionally similar tools to the same effect, such as the "Connecticut Clause."	Extend the prohibition on confessions of judgment California passed in 2022 to similar legal devices that are being used which are circumventing the prohibition.	22659
6	**Confidentiality clauses -** Standard language in high-cost financing contracts threatens small business owners with lawsuits and legal fees if they tell an outside party the outrageous prices and terms they are being charged.[5]	Prohibit these "confidentiality clauses."	22660(b)

[2] "Small Business Credit Survey Report on Minority-Owned Firms," Federal Reserve Bank of Atlanta, at p. IV (Dec. 2019). https://perma.cc/XA9B-WRAG
[3] SB 688 (Wieckowski) https://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=202120220SB688
[4] Faux, et. al, ""Sign Here to Lose Everything," Bloomberg Businessweek. (2018) https://www.bloomberg.com/confessions-of-judgment
[5] Here is one example of such a clause: "***Confidentiality.*** *Merchant understands and agrees that the terms and conditions of the products and services offered by Company including this Agreement and any other Company documents (collectively "Confidential Information") are propriety and confidential information of Company. Accordingly unless disclosure is required by law or court order, Merchant shall not disclose Confidential Information of Company to any person other than an attorney, accountant, financial advisor or employee of Merchant who needs to know such information for the purpose of advising Merchant ("Advisor"), provided such Advisor uses Confidential Information solely for the purpose of advising Merchant and first agrees in writing to be bound by the terms of this section. A breach hereof entitles Company to not only damages and legal fees but also to both a temporary restraining order and a preliminary injunction without bond or security."*

7	**Slow-walking refinances to keep borrowers trapped** - When a small business tries to refinance to lower their costs, they often need their current lender to provide a payoff letter naming the amount to be paid off on a given day. If the lender withholds that letter or does not provide it promptly, it can prevent the borrower from refinancing.	Require refinance information be provided within three business days after written request	22661(g)(2)
8	**Anti-competitive charges for refinancing** - Some financing providers require a higher cost to pay them off if the payoff funds are coming through a refinance. This penalizes borrowers for finding a more affordable option and prevents competition between financing providers.	Establish that the payoff amount should not differ based on the party paying off the owed funds.	22660(d)
Topic 3: Loopholes in our disclosure regulations ask bad actors to slap their own wrists California's small business truth in lending framework lacks key protections provided in New York State. New York's law was inspired by California's, and fixed some gaps that we left.			
9	**Loophole in disclosure accountability -** California's truth in lending regulations may allow merchant cash advance companies to make up unreasonably low Estimated Payment amounts, Estimate Terms, and Estimated APRs, without DFPI ever knowing. The current regulations ask merchant cash advance companies to police themselves for honesty in deriving their estimates, and slap their own wrists if they catch themselves cheating. DFPI acknowledged the need to correct this problem five times in its Statement of Reasons for the SB 1235 rulemaking.[6])	The solution already in use in New York, and acknowledged by DFPI, is to require merchant cash advance companies choosing to use the flexible option for establishing the estimates they use for price disclosures to report to DFPI on the accuracy of those estimates.[7] This way, DFPI will know if the financing company abused the regulation's flexibility by manipulating the pricing disclosure to appear unreasonably low.	22665

[6] e.g. "The Department does not disagree that periodic reporting to the Department from providers who use the underwriting method may be appropriate to ensure providers are not misleading their customers…" DFPI, "Final Statement of Reasons PRO 01/18 Commercial Financing Disclosures," Pgs 63, 88, 101, 101-2, 136.

[7] California's truth in lending framework establishes 2 ways for merchant cash advance companies to produce their projections for the small business borrower's sales volumes. These sales projections in turn determine the Estimated Term, Estimated Payment amount, and Estimated APR of the financing that is disclosed.
The first option for estimating these sales projections is the "historical method." The financing company simply projects forward the borrower's average historical sales volume, from a defined period over the last several months. This is how most merchant cash advance companies derive the sales projections they use. This method also has the benefit of being difficult to manipulate by financing providers who may want to display low prices. However, it's not very flexible.
Financing companies desiring more flexibility are given a second option. Using the "opt-in method," the financing company can derive their sales projection in whatever way they want. This can accommodate rising or falling trends in sales, seasonality, etc.
However, this flexible method was intended to be paired with a system of accountability for accuracy when it was proposed by a coalition of small business groups and lenders. New York's truth in lending law and regulation includes that reporting method. California's currently does not, and instead relies on a complex system where companies choosing the "opt-in method" self-audit to monitor their own accuracy. DFPI has recognized in writing the benefit of this reporting.

10	**Transparent pricing getting lost in the "fine print"** - California's small business truth in lending law was groundbreaking, establishing transparency standards for small business financing similar to what the federal Truth in Lending Act has provided to consumers since 1968. CA SB 1235 requires a pricing disclosure form that small businesses see when a financing offer is first presented. However, that single disclosure form may be the only time small business owners see their pricing described transparently. It is also only half of the federal Truth in Lending Act's transparent pricing framework. Federal TILA also requires, in addition to a disclosure form with APR, that the APR be disclosed alongside any other pricing metric or terms when those are used.	Require that APR or Estimated APR be stated whenever a commercial financing provider states a rate of finance charge or a financing amount during an application process. This is already required in New York. It is more narrow than the requirements of federal TILA, which also applies to advertising.	22666(c)
11	**Misleading pricing metrics** - Today, small business financing companies often describe their pricing using "novel" price metrics that look and feel like interest rates but are generally a lower number than the actual interest rate. For example, Federal Reserve researchers show that a loan with "9% simple interest" may have an effective annual interest rate or APR of 46%, but that this metric misguided small businesses into believing the loan was *less* expensive than a credit card with a 22% interest rate.[8]	Adopt the prohibitions, already in law in New York, to ensure that terms that look and feel like the interest rate or APR are used only to describe an actual interest rate or APR.	22666(a-b)
12	**Double charging fees while renewing a borrower's financing** - High-cost financing providers sometimes use a reviled practice called "double dipping" to double-charge small businesses renewing their financing.[9] This can happen frequently because short-term, high-cost financing is often refinanced repeatedly, similar to a consumer payday loan.[10]	Require a disclosure at the time a loan or merchant cash advance is being refinanced or renewed, of the excess finance charges that would be double charged. This is already required in New York law.	22667

[8] Board of Governors of the Federal Reserve System, "Uncertain Terms: What Small Business Borrowers Find When Browsing Online Lender Websites," December 2019. https://www.federalreserve.gov/publications/files/what-small-business-borrowers-find-when-browsing-online-lender-websites.pdf

[9] For explanation, see e.g. "Double Dipping," The Business Backer. https://www.youtube.com/watch?v=k62kCK5tZwo

[10] For example, For example, the CEO and founder of a one financing company celebrated on stage at an industry conference that "customers take 20 loans over four to five years, four to five loans every year." Zachary Miller, "Behind Amex's use of Kabbage as 'the heartbeat' of its strategy to help SMBs with cash flow," Tearsheet, Sept 2022. https://tearsheet.co/podcasts/behind-amexs-use-of-kabbage-as-the-heartbeat-of-its-strategy-to-help-smbs-with-cash-flow.