LEGAL UPDATES

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California Finalizes UDAAP Rule for Small Business Financing

Service

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On August 2, 2023, the California Department of Financial Protection and Innovation (DFPI) issued a final rule that prohibits certain persons from engaging in unfair, deceptive, or abusive acts or practices (UDAAP) in connection with offering or providing commercial financing or other financial products or services to small businesses, nonprofits, or family farms. Notably, the final rule applies the federal abusiveness standard to small business financing and is part of a trend to extend consumer-style protections to small business financing. The final rule also establishes an annual reporting requirement for certain persons offering commercial financing. The DFPI issued this final rule under its rulemaking authority in the California Consumer Financial Protection Law (CCFPL), a statute that established a so-called “mini CFPB” in California.

UDAAP prohibition

The final rule adopts the general standards for unfairness, deception, and abusiveness under federal law without prohibiting any particular conduct. With respect to the unfairness and deception standards, the rule also states that an act or practice is unfair or deceptive in accordance with the California Unfair Competition Law and California case law under that law. In comments accompanying the final rule, the DFPI said the rule “provides general guidelines through longstanding standards that are familiar to the regulated community.”

The persons and products covered by the new UDAAP rule are more limited than they initially appear. While the term “covered provider” includes a person offering or providing commercial financing or financial products or services to small businesses, nonprofits, or family farms, the term excludes those persons exempt from the CCFPL, including but not limited to, banks, credit unions, California-licensed finance lenders, and California-licensed brokers.

For the new UDAAP rule to apply on its terms, the recipient of the financing, product, or service must be a small business, nonprofit, or family farm whose activities are principally directed or managed from California. The DFPI adopted a somewhat simple definition of "small business," which includes business entities organized for profit with annual gross receipts of no more than $16 million or the annual gross receipt level as biennially adjusted under California law, whichever amount is greater. A covered provider may rely on a business's written representations regarding both its annual gross receipts and whether its activities are principally directed or managed from California.

The types of products covered by the new UDAAP rule include "commercial financing," as defined in California's Commercial Financing Disclosures statute, and an array of financial products or services offered to small businesses, nonprofits, or family farms for use primarily for a purpose other than personal, family, or household purposes. As such, the rule applies to traditional loans as well as alternative commercial finance products, such as factoring and revenue-based finance.

Annual reporting requirement

The rule also sets forth a new annual reporting requirement applicable to a narrow set of covered providers. Beginning in March 2025, a covered provider offering commercial financing must file a verified report to the DFPI that includes certain information regarding the covered provider and certain information regarding its commercial financing transactions during the preceding calendar year. "Commercial financing transactions" mean a consummated commercial financing transaction for which disclosures were provided as required by the Commercial Financing Disclosures statute.

Why this new rule matters

California's new UDAAP rule is notable in a couple of respects. First, the rule prohibits abusive acts or practices in connection with financial products or services to small businesses. On the federal level, the Federal Trade Commission (FTC) has applied the prohibition on unfair or deceptive acts or practices (UDAP) under the Federal Trade Commission Act to small businesses. However, the FTC's UDAP authority does not extend to abusive acts or practices. The new California rule prohibits abusiveness. Other states have alleged that small business funding providers engaged in conduct that could be deemed abusive. For instance, earlier this year, the New Jersey Attorney General announced a nearly $28 million settlement with a revenue-based finance provider based on conduct that the Attorney General described as "unconscionable, misleading, and abusive lending, servicing, and collection tactics."

The new California rule is also notable because it adopts the abusiveness standard set forth in the federal Dodd-Frank Act and primarily enforced by the Consumer Financial Protection Bureau (CFPB) in connection with consumer financial products or services. In April 2023, the CFPB issued a policy statement that provides guidance on the abusiveness standard and illustrates the broad contours of the standard. Since issuing the policy statement, the CFPB has identified and alleged abusiveness in its Supervisory Highlights publication and in enforcement actions. It remains to be seen how much the CFPB's interpretations of the abusiveness standard in the consumer context influences California's interpretation of the same abusiveness standard in the small business funding context.

Finally, as a large, pro-consumer state, California tends to be a first mover on state regulation. Other states like New York may follow suit and expand their state trade practices statutes in a similar manner. Overall, the new California rule is a part of a growing trend to extend consumer-like protections to small business financing.

Special discussion

In September, Susan Seaman will moderate a timely panel at the American Bar Association's Business Law Section Meeting on federal and state compliance risks after the CFPB's abusiveness policy statement. Panelists from the Consumer Financial Protection Bureau and Pennsylvania Office of the Attorney General will participate in the discussion. California's new UDAAP rule will be part of the discussion.

Contact us

We regularly advise small business funding providers on the growing body of federal and state regulations that apply to them, including state commercial financing disclosure statutes and the Section 1071 small business data collection rule. If you have questions about California's new small business UDAAP rule or other small business funding regulations, contact Christopher Friedman, Susan Seaman, Daniel Wilkinson, or your Husch Blackwell attorney.