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Time May Not Solve Compliance Issues With NY Lending Law

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On Dec. 31, 2021, the [New York Department of Financial Services](#) announced that commercial finance providers doing business in New York state will receive additional time to comply with the New York state Commercial Finance Disclosure Law, which requires certain commercial finance providers to provide business borrowers with lending disclosures.^[1]

Although the CFDL became effective on Jan. 1, recent department guidance makes clear that CFDL compliance will not be required until the implementing regulations are final, expected to occur later this year.^[2]

Commercial finance providers — particularly nonbanks, fintech companies and other finance companies that provide small business loans, merchant cash advances and asset-based loans — may want to use this delay to make changes to their business practices in order to comply with the new law, which may prove vexing for many lenders.

Background

Traditionally, federal law has not regulated disclosures for financings that are primarily for a business or commercial purpose. To address the fact that there is no standardized federal framework for lenders to provide information in connection with commercial financings, New York state proposed the CFDL.

The CFDL will require finance providers to give standardized, consumer-like disclosures similar to those required under the federal Truth in Lending Act and its implementing regulation, Regulation Z, to commercial borrowers in connection with financings in an amount equal to or less than \$2.5 million.

Once finalized, providers under CFDL compliance will need to disclose to business borrowers specific financing terms when a specific offer is extended. These include the cost of the financing as a dollar amount and the annual percentage rate.

The cost of finance under the CFDL is referred to as the finance charge, which is broadly defined as “any charge payable directly or indirectly by the recipient … as an incident to or condition of the extension of financing.” Additional fees, costs and expenses must also be disclosed to the recipient if the provider makes a specific offer,

such as the total amount of the commercial financing or any fees deducted from the amount disbursed to the recipient.

Moreover, providers need to disclose a description of the collateral requirements for the commercial financing transaction, if any.

Impact

The CFDL seems squarely aimed at nonbank lenders providing alternative financing. It applies generally to providers of open-end financing, closed-end financing, sales-based financing, factoring transactions and merchant cash advances.

There are no exemptions for small commercial loan transactions, even where the intent is to bundle them into a substantial financing or securitization transaction.

Traditional banks, certain service providers and lessors are exempted from complying with the CFDL. Section 802 of the CFDL exempts from the requirements of the statute, among other things, the following:

- Financial institutions, which include most regulated banking or lending institutions, such as banks, trust companies, industrial loan companies, federally chartered savings and loan associations, federal savings banks or federal credit unions, savings and loan associations, savings banks or credit unions that are organized or authorized to transact business in the state of New York;
- Persons acting in an intermediate capacity with regard to the provision of services to an entity otherwise exempt from the CFDL, such as software licensing companies, support services or other technology service providers;
- Lenders regulated by the federal Farm Credit Act; and
- Lessors under a lease, as defined in Section 2-A-103 of the Uniform Commercial Code.

Moreover, the CFDL does not apply to commercial financings secured by real property and financings to car dealers and rental vehicle companies. There is also an exception for commercial finance providers that transact five or fewer financing transactions in New York state in a 12-month period.

Some commercial finance providers were troubled by the potential impact of the CFDL before it was passed into law.^[3] Nonregulated entities, almost all of which fall within its coverage, may find it particularly challenging to comply with the disclosure requirements of the CFDL and may be at risk of noncompliance as a result.

The disclosure requirements are complicated for nonregulated entities because the quality and quantity of disclosures required by the CFDL vary with the complexity of the transaction. Disclosures may be reasonably simple in a traditional transaction, but are more involved in connection with transactions such as sales-based financings.

As a result, a factor or merchant cash provider may be subject to different disclosure requirements under the CFDL, given the disparate nature of the underlying transactions.

For example, providers of sales-based financings — such as providers of merchant cash advances — will need to include calculations of the estimated term of repayment and projected periodic payment amounts. This level of disclosure would require providers of sales-based financings to conduct a historical review of the sales of a recipient to determine the projected amount of sales and the receivables arising therefrom that the provider would purchase, along with the discount and other finance charge from such sale.

Some providers may not have these historical records, either because a recipient does not have a fulsome sales history or because it lacks business records. Even if the payments under a sales-based financing are expected to be variable, the provider must be sure to include, along with the specific offer, a “payment schedule or a description of the method used to calculate the amounts and frequency of payments, and the amount of the average projected payments per month.”^[4]

Alternatively, merchant cash advance providers may use a simpler opt-in method to determine the annual percentage rate, which allows providers to elect the manner in which the provider estimates sales volume for each disclosure.

If choosing the opt-in method, the provider must provide lending data to the department annually and undergo an annual review. However, if the provider chooses one method — opt-in or historical — it must continue to use that method for all transactions, restricting its flexibility. This complexity of disclosure may represent an administrative burden for many providers.

Failure to comply with CFDL disclosure requirements could bring stiff penalties for providers. The CFDL mandates civil penalties up to \$10,000 for each willful violation, and up to \$2,500 for each other violation. If these penalties are applied across a portfolio of transactions, then the penalties could aggregate quickly for nonbank lenders.

The justification for the byzantine disclosure requirements given by the sponsors of the statute is that there is significant variation in the quality of information about financing that nonbank lenders provide to small businesses, especially related to costs.^[5]

As a result, New York state is seeking to provide increased transparency to small businesses regarding the cost of financing that is lacking under federal law similar to the disclosures required by the TILA. As the primary federal law regulating consumer credit, TILA requires creditors to make disclosures to consumers regarding loan cost, finance charges in credit transactions or in offers to extend credit. TILA and Regulation Z do not apply to extensions of credit primarily for a business or commercial purpose.

New York legislators feared that some commercial lenders overcharge or engage in predatory lending practices, and the required disclosures under the CFDL will provide business owners with the information to make an informed, financially responsible decision when choosing a product and a provider.

Although laudatory in its goal, for the CFDL to regulate small business lending like consumer lending is problematic. Businesses are assumed to be sophisticated parties to a contract, as opposed to consumers, and are

held to a different set of standards than consumers based on the freedom to contract with a counterparty of their choosing. Business are assumed to have been aware of what was bargained for and read — or should have read — and understood — or should have understood — the terms of a written agreement.[6]

This paradigm creates predictability and certainty in a contract-based system. The courts have reiterated that parties are free to make a bad deal if they are sophisticated parties in an arm's length transaction. To remedy any unjust circumstances, courts may find that a contract between an unsophisticated party and a sophisticated party should not be enforced.

In the absence of an asymmetrical contract, courts are loath to rewrite deals. By regulating small business lending like consumer lending, New York state has created a broad public policy exception to the assumption that small businesses are sophisticated parties to contracts, instead of relying on the courts to take a more measured approach.

This may lead to insecurity in the market.

Takeaways

The CFDL is targeted at nonbank lenders providing alternative financing. CFDL compliance will not be required until the implementing regulations are final, expected to occur later this year. Nonbank lenders should use the delay to make changes to their business practices in order to comply with the new law, because noncompliance may prove costly over a loan portfolio.

Practitioners should discuss with their clients how they can best comply with the complex disclosure requirements required under the CFDL designed to protect small business in a similar fashion as consumers.[7] Practitioners should consider preparing such disclosures for their clients in a consistent and standardized fashion.

That said, attorneys representing commercial finance providers should also be wary of adopting standardized forms that may not be well-suited for the specific transactions in which their clients are involved. Practitioners and their clients should keep in mind that, while a goal of the CFDL is to provide higher quality information and greater transparency to allow small companies to better evaluate financing options, differences in calculating fees can result in comparisons that are not apples-to-apples.

Practitioners should carefully discuss these considerations with their clients so they can properly assess their ability — or appetite — for compliance. Commercial finance providers may well decide that the cost of compliance with the CFDL is prohibitive, and cease offering financings in New York state that would be subject to the CFDL.

An unintended outcome may be that alternative finance providers would leave the market, where they once stepped in to alleviate small business' lack of access to capital during the last financial crisis.

[1] See [here](#).

[2] For the full text of the CFDL, please see <https://legislation.nysenate.gov/pdf/bills/2019/S5470B>.

[3] See Sean Murray, New York State Legislature Passes Law That Requires APR Disclosure On Small Business Finance Contracts (Even If They're Not Loans), *deBanked* (Jul. 24, 2020),

<https://debanked.com/2020/07/new-york-state-legislature-passes-law-that-requires-apr-disclosure-on-small-business-finance-contracts-even-if-theyre-not-loans>. Others, however, including many business owners, have strongly supported this new law. See Chelsea Diana, New state law magnifies the fine print on small business lending, *Albany Business Review* (Dec. 29, 2020), <https://www.bizjournals.com/albany/news/2020/12/29/small-business-truth-in-lending-act-new-york.html>.

[4] See § 803(f)(ii) of the CFDL.

[5] <https://www.nysenate.gov/legislation/bills/2019/s5470>.

[6] Miller, Meredith R., Contract Law, Party Sophistication and the New Formalism (August 9, 2009). Missouri Law Review, Vol. 75, No. 2, 2010, Available at SSRN: <https://ssrn.com/abstract=1468647>.

[7] See 15 U.S.C. §§ 1601 to 1667f.

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