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California Bill Would Cap Some Deregulated Interest Rates And Address Unconscionability Issue

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A bill introduced last week in the California State Assembly could change the consumer lending landscape in California considerably. The bill, AB 539, would change several aspects of the California Financing Law (CFL), including setting new interest rate caps, imposing new rules governing loan duration, and prohibiting prepayment penalties. Additionally, AB 539 would change the CFL to make clear that a loan's rate cannot be used as the sole factor in determining whether a loan is unconscionable. According to the bill's authors, these changes are necessary because of the "looming threat of a potential ballot initiative," and due to the uncertainty caused by the California Supreme Court's recent *De La Torre* decision which opened the door for borrowers to claim that high-rate consumer loans are unconscionable.

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AB 539 would make these changes to the CFL:

- At present, the CFL does not set a maximum interest rate on loans of $2,500 or more. AB 539 would cap the interest rate at 36% plus the federal funds rate (2.4% as of today) on loans of $2,500 or more but less than $10,000.
- The CFL provides certain factors to determine whether a loan is of a "bona fide principal amount" or if there has been some artifice to evade regulation under the CFL. AB 539 would apply these factors to loans of $2,500 or more but less than $10,000.
- At present, the CFL prohibits loans of at least $3,000 but less than $5,000 from having a term greater than 60 months and 15 days. AB 539 would increase this upper limit from $5,000 to $10,000.
- At least for loans in excess of $2,500 up to $10,000, AB 539 would prohibit CFL licensees from issuing a loan with a term of less than 12 months.
- AB 539 would add a section to the CFL providing that no licensee may impose a prepayment penalty for any loan not secured by real property.

California's unconscionability doctrine is incorporated into the CFL. Although it was once widely thought that loans with no interest rate cap under the CFL could not be unconscionable, in *De La Torre* the California Supreme Court held that consumers could use California's Unfair Competition Law to claim that high-rate loans were unconscionable and therefore violated the CFL. AB 539 expressly provides that a CFL-regulated loan cannot be found unconscionable based on the interest rate alone. In our view, this provision is theoretically unnecessary. In *De La Torre*, the California Supreme Court held that courts must consider all the circumstances of the loan before declaring that a loan's rate is unconscionable. Specifically, courts must consider "the bargaining process and prevailing market conditions," which is "highly dependent on context" and "flexible" according to the Court. In other words, courts properly following *De La Torre* could not solely consider a loan's rate to determine unconscionability in any event. That said, the bill would be helpful in that it would foreclose unconscionability arguments based on the rate alone.

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