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Department of Financial Protection and Innovation *By e-mail to regulations@dfpi.ca.gov*
Legal Division
Attn: DeEtte Phelps, Regulations Coordinator
2101 Arena Blvd.
Sacramento, CA 95834

Re: **Second Draft Text of Proposed Regulations; Debt Collection Licensing Act PRO 05-21**

Dear Ms. Phelps,

This letter is written on behalf of my client base. I am a California attorney who has been practicing in the area of consumer finance since 1982. My clients include approximately 60 banks, savings banks, California Finance Lenders, California Deferred Deposit Transaction Law lenders, retail installment sellers and retail installment sales financing entities, fintechs, residential solar system providers and financiers, servicers of performing portfolios of consumer obligations, and various other entities engaged in offering consumer and commercial financial services.

I do not represent any collection agencies, debt buyers, or other third-party collectors of delinquent debt portfolios. Nonetheless, many of my clients' activities are, *ipse dixit*, subject to regulation under the Debt Collection License Act (the "Act" or the "DCLA"). However, the consumer finance ecosystem is more nuanced than a noncontextual reading of the Act would indicate; this has led to significant misunderstandings, inefficiencies, and the fitting of round pegs into square holes in the implementation of the Act.

For this reason, I welcome both the contents of the current proposed regulation (the "Proposal") and the opportunity to comment on it. In an effort to make it easier to absorb my comments, I will set forth each portion of the text of the Proposal and my comments below it.

SECTION 1.
§ 1850. Definitions.

ADD: (i) "Employee" means an individual whose manner and means of performance of work are subject to the right of control of, or are controlled by, a person and whose compensation for federal

income tax purposes is reported, or required to be reported, on a W-2 form or international equivalent, issued by the controlling person.

Comment: Please refer to my comment to proposed Section 1850.1(a), below. For the reasons set forth there, I would recommend revising this provision to read: "Employee means an individual whose manner and means of performance of work are subject to the right of control by the controlling person as set forth in applicable law."

ADD: (j) "Engage in the business of debt collection": A person engages in the business of debt collection and is required to be licensed pursuant to section 100001, subdivision (a) of the Financial Code if the person (A) engages in debt collection for a profit or gain, and (B) the activity is of a regular, frequent, or continuous nature. Advertising or otherwise offering the service of debt collection for remuneration constitutes engaging in the business of debt collection.

Comment: This definition, like that set forth in the Act, is circular. However, if followed logically and in light of experience and business practice, it can be the basis for a helpful and reasonable distinction in evaluating the dichotomy between (1) servicers of performing first-party obligations and (2) third-party collectors of delinquent debts. There should be a clear servicer exception from the Act. The most reasonable approach would be to exclude entities that are in the business of servicing obligations that are performing at the time of origination or servicing transfer. That would recognize the reality of the mechanics of the consumer finance marketplace; of the relationship between the servicer and the consumer in a performing obligation; and the fact that such servicers are not engaging in debt collection for profit or gain. (In fact, it is common for such servicing contracts to provide that the servicer is ***not*** responsible for collection activities of delinquent obligations, as specified, but that collection of those nonperforming obligations must be transferred to another entity for collection.) This approach would also be consistent with the Federal Fair Debt Collection Practices Act and will thus allow the Department's licensing and enforcement efforts to be focused where they are needed: on collectors of delinquent debt.

This issue is further discussed below.

ADD: (o) "Law firm" means a law partnership, a professional law corporation, a lawyer acting as a sole proprietorship, or an association authorized to practice law.

Comment: Although every California attorney is required to have a basic understanding of the rules applicable to the practice of law, I do not present myself as an expert in that area. However, I have encountered, on numerous occasions, entities engaged in the unauthorized practice of law in California with regard to debt collection. That has included unscrupulous collection agencies; unscrupulous entities reporting to act on behalf of consumers, that were in reality profit-making enterprises, seeking to charge the consumer for defense of collection efforts by obliges; and other entities engage in the unauthorized practice of law in California, who may or may not have been licensed to practice law in other states, but were not so licensed in California.

Therefore, I would recommend that this definition, and the rules set forth in proposed Section 1850.1(j), below, be reviewed carefully and expanded, in consultation with the State Bar to encompass any person purporting to practice law, whether or not so authorized by California law. In this regard, *quaere* as to whether a regulatory prohibition by the Department of licensed attorneys from representing their clients in court for a bandwidth of legal subject matters (here, debt collection) would not conflict with the State Bar Act.

SECTION 2. Section 1850.1 is adopted to read:
§ 1850.1 Scope of Licensing requirement.
(a) Employees of debt collectors and employees of entities exempted by Financial Code section 100001, subdivision (b)(1), are not required to be licensed under the Debt Collection Licensing Act when acting within the scope of their employment with a debt collector licensed pursuant to Division 25 of the Financial Code, commencing with Section 100000, or with an entity exempted by Financial Code section 100001, subdivision (b)(1). Employees of subsidiaries and employees of parent companies of a licensed debt collector are not required to be licensed while working on a temporary basis for the licensed debt collector.

Comment: I do not present myself as an expert on California employment law. However, I do not believe this proposed language is consistent with California statutory or case-based employment law, or with widespread business practice. My concern is that the practical effect of this language is to act as a limitation that preclude licenses from utilizing temporary employees, contract employees, leased employees, shared employees, gig workers, or other non-W-2 personnel in connection with DCLA-licenseable activities workers. Therefore, I believe the Department should be bound by general California employment, law, and any definition of "employee" should be consistent with such general California law, as set forth in my comment to proposed Section 1850(i), above. The crucial issue here should just be whether the licensee has the right of control over personnel working on collection activities regulated by the Act.

Further in this regard, the U.S. Department of Labor has just released a new rule modifying its Wage and Hour Division's regulations to replace its analysis for determining employee or independent contractor classification under the Fair Labor Standards Act with an analysis that is intended to be more consistent with judicial precedent and the Act's text and purpose (https://www.federalregister.gov/documents/2024/01/10/2024-00067/employee-or-independent-contractor-classification-under-the-fair-labor-standards-act). It would therefore would seem appropriate that the regulatory definition of "employee" under the DCLA also be consistent with this new federal rule. The point here is not what the rule should be: rather, that whatever rule the Department adopts should be consistent with applicable federal and California wage and hour law so that DCLA licenses are not faced with inconsistent compliance requirements.

(b) The licensing exemption in section 100001, subdivision (b)(1) of the Financial Code applies to the listed entities and their employees acting within the scope of their employment only. The exemption does not apply to parent entities, subsidiaries, or to affiliates.

Comment: First, this language seems to describe well the intent of the proposed Section 1850.1(a), discussed above. Perhaps it could be included there.

Second, I would suggest adding the following language to this section: "This does not preclude licenses licensees from entering into employee-sharing or -leasing agreements with parent entities, subsidiaries, or other affiliates. Such agreements must be memorialized in written form." This would create helpful flexibility for licenses, and the requirement of a writing would provide the examination trail that the Department needs for enforcement of this portion of the Act.

(c) Original creditors: A creditor, including a provider of non-financial services, seeking, in its own name, repayment of consumer debt arising from a consumer credit transaction between itself, in its own name, and a customer, is not engaged in the business of debt collection, for purposes of licensure under the Debt Collection Licensing Act, unless it meets one or more of the following criteria:

Comment: This preamble is a major positive step toward recognizing the complexity of the consumer finance environment. The distinction between (1) servicers of performing first-party obligations and (2) third-party collectors of delinquent debts is crucial to the way the credit system operates, and important for promoting the availability and affordability of consumer finance activity in California.

Having said that, this exclusion is unfortunately binary. The consumer finance world does not merely consist of a duality of first-party creditors and collectors of delinquent debt. Rather, it is a continuum. Thus, for example, there are at least four categories of entities that should also be treated as first-party creditors, rather than parties engaged in debt collection within the meaning of the Act:

(1) Entities engaged in servicing non-delinquent obligation portfolios (as addressed in proposed subsection 1850.1(d), discussed below);
(2) Affiliates to whom first party creditors routinely transfer ownership of non-delinquent obligations in the normal course of business;
(3) Non-affiliates to whom first party creditors routinely transfer ownership of non-delinquent obligations in the normal course of business;
(4) Owners, servicers, and trustees of securitized non-delinquent obligations where such securitization is made in the normal course of business;
(5) Owners and persons servicing debts on behalf of investors of non-delinquent obligations that were purchased in the secondary market in the normal course of business; and
(6) Lessors, and assignees and servicers of consumer leases.

All of these entities should be excluded from the definition of "collector," as none of these structures implicate the intent of the Act nor the necessity of licensing under the Act.

(1) Five percent or more of the creditor's annual revenue generated from consumer credit transactions with California consumers over the previous calendar year, constitutes collection fees,

late fees, or any other charges added to the original consumer credit transaction that created the debt.

Comment: Generally, the better rule would be that a first-party creditor is a first-party creditor or servicer of a first-party obligation, so that the only issue would be whether that purported status is a subterfuge. Of course, the Department has the authority to examine for subterfuges to avoid coverage of the Act. Having said that, the concept of a percentage test for determining whether a particular portfolio of obligations consists of first-party performing obligation, or a portfolio of delinquent third-party obligations may be reasonable as a shorthand mechanism for beginning to search for subterfuge, provided that such percentage test is set at a reasonable and realistic level. Thus, in turn leads to three additional questions:

(1) Where does the proposed 5% standard come from? It seems generally low. Has the Department's market research team explored this issue, and has it found data to support the proposed 5% standard? My feeling is that this is exactly the kind of metric that needs to be supported by specific hard data. The Department has made numerous public statements asserting that it wishes its decisions, priorities, and regulatory activities to be data-driven, and this is precisely a situation that calls for such an approach;

(2) Is a single percentage test appropriate for all industries and all types of credit? I'm pretty sure that there are some categories of obligations for which a 5% default rate is insignificant, and some for which the obligee is out of business. Again, has the Department's market research team explored this issue? This, too, is a metric that needs to be supported by specific hard data;

(3) What happens if the viscissitudes of the marketplace cause a portfolio to fall below the level of the percentage test? We have just come through an unforeseen event that suddenly and significantly affected default rates in consumer credit portfolios: the Covid-19 pandemic. If something like this recurs, or if lesser events lead to higher-than-anticipated default rates, what is the effect on the "collector?" Is the "collector" in violation of the Act? Does the "collector" thereafter have some grace period in which to apply for a license? We should be thinking two steps ahead as to this question now, before the next crisis occurs.

Accrued interest which was a part of the original transaction, and which is charged under the contract regardless of whether the consumer has met the consumer's obligations under the contract, does not constitute a collection fee, late fee, or other charge added to the original consumer credit transaction.

Comment: This is a good provision, although "collection fee" should be a defined term. (First-party creditors and servicers of performing obligations generally do not impose any additional fee that could be so described.)

(2) During the previous calendar year, an average of ten percent or more of the creditor's California inventory was repossessed at least once, either by the creditor directly or through a third-party.

Comment: Please refer to the comments to subsection (1), above, which apply *mutatis mutandis* here.

(3) The creditor has a monthly average over the previous calendar year of twenty-five percent or more of the gross amount of its California consumer accounts receivable ninety or more days past due.

Comment: Please refer to the comments to subsection (1), above, which apply *mutatis mutandis* here.

(d) A person solely servicing debts on behalf of an original creditor, as described in subdivision (c), that are less than 90 days past due and have not been charged off, is not engaged in the business of debt collection for purposes of licensure under the Debt Collection Licensing Act. For purposes of this section, a debt is 90 days past due when at least one payment has not been fully paid within 90 days of the date that the payment was originally scheduled to be paid on the debt. For purposes of this section, "charged off" means a debt that has been removed from a creditor's books as an asset and treated as a loss or expense.

Comment: As noted above, this is an excellent approach to a portion of the consumer finance ecosytstem, but is unduly binary. This exclusion should be applicable to entities engaged in servicing non-delinquent obligation portfolios, as set forth in this proposed subsection, and also to:

- Affiliates to whom first party creditors routinely transfer ownership of non-delinquent obligations in the normal course of business;
- Non-affiliates to whom first party creditors routinely transfer ownership of non-delinquent obligations in the normal course of business; and
- Owners, servicers, and trustees of securitized non-delinquent obligations where such securitization is made in the normal course of business.

All of these entities should be excluded from the definition of "collector," as none of these structures implicate the intent of the Act nor the necessity of licensing under the Act.

Further, it appears from the current language that a person solely servicing debts on behalf of an original creditor falls out of this definition if a single debt being serviced becomes 90 days past due. This cannot have been the intention here. Again, here, a data-based percentage test or multiple data-based percentage tests for different categories of obligations seems appropriate.

In addition, this approach would alleviate the current double-examination burden for licensees under the Residential Loan Mortgage Act, the California Financing Law, and the California Deferred Deposit Transaction Law. Those entities' Department sections have examined them for collection compliance for decades, and have thus achieved high levels of compliance in this area. Even as to those entities that are statutorily exempt from the Act, there has been at least some DCLA examination activity that has crossed licensing lines. This, of course, is not only

inefficient from the Department's viewpoint but is unnecessarily costly and burdensome for licensees. This unfortunate situation could also be alleviated by regulatory recognition of the difference between performing first-party obligations and third-party collectors of delinquent debt.

(e) Notwithstanding subdivision (c), a healthcare provider, healthcare facility, or hospital is not engaged in the business of debt collection for purposes of licensure under the Debt Collection Licensing Act if the only debt it collects is on its own behalf and is payment for medical or other services or products it provided.

Comment: While my clients include purchasers of some healthcare providers' receivables, I do not work in the area or hospital or healthcare facility receivable financing. However, I suggest that this exclusion is, in its current form, insufficiently nuanced. For example, it is unclear whether or how this language would apply to receivables processed by a hospital's accounting department for services performed by a physician with hospital privileges; ancillary healthcare services performed under the auspices of a hospital, such as physical therapy or palliative care, emergency room services, etc.; or medications provided to a consumer by a third party through a hospital's distribution system.

(f) Notwithstanding subdivision (c), a local, state, or federal government body of the United States is not engaged in the business of debt collection for purposes of licensure under the Debt Collection Licensing Act when collecting debt owed to a government body. For the purposes of this division, "government body" includes: a state, county, city, tribal, district, public authority, public agency, judicial branch public entity, public institution of higher education, and any office, officer, department, division, bureau, board, or commission thereof.

Comment: The exclusion of activities of the federal government or tribal entities, merely reiterates existing law, and is thus unnecessary. However, it is difficult to see why debt collection activities of state, city, district, public authority, public agencies, etc., should be excluded from coverage of the Act. Numerous historical and ongoing examples of inappropriate or oppressive examples of debt collection by each of those types of entities are an established part of the public record, and should be prohibited and subject to regulation by the Department. For example, scandals over municipal governments' abuse of traffic and parking citations, and the concomitant personal tragedy that can result from such overreach as the unrecoverable towing and impound of a private automobile, are well-known and unfortunately continue to this day. While it may be cumbersome, unnecessary, or even inappropriate for the Department to license public agencies or local government entities for such activities, the Department should have oversight as to the substance of those entities' activities under the Act to the extent that such activities may be noncompliant with the Act. At a minimum, the Department should be available as a resource to assist consumers adversely affected by such public agencies' noncompliance with the Act.

(g) A person whose debt collection activity is limited exclusively to debt collection regulated pursuant to Division 12.5 of the Financial Code is not required to obtain a debt collector license.

(h) A public utility is not engaged in the business of debt collection for purposes of licensure under the Debt Collection Licensing Act when acting under the supervision of the California Public Utilities Commission in accordance with its authority under Public Utilities Code section 701.

Comment: Skepticism, but no specific comment. Does this include residential solar plans? Guidance as to this point would be helpful.

(i) A person is not engaged in the business of debt collection for purposes of licensure under the Debt Collection Licensing Act when acting under the authority of the Private Investigator Act, Chapter 11.3 of Division 3 of the Business and Professions Code, commencing with § 7512.

Comment: This is an appropriate exclusion.

(j) An attorney or law firm engaged in the business of debt collection must hold a debt collection license under this division.
(1) For purposes of determining whether an attorney or law firm engages in the business of debt collection, the following activities do not constitute debt collection:
(A) The representation of a creditor in an action initiated by a debtor plaintiff;
(B) An attempt by an attorney or law firm to collect legal fees and/or costs from its current or former client;
(C) The provision of legal advice regarding debt collection that does not involve communication with any debtor. Allowing others to use attorney or law firm letterhead in communications with debtors constitutes communication with a debtor for purposes of this paragraph.
(2) A debt collection license does not entitle the holder to practice law. A person licensed under this subdivision who references the person's status as an attorney in communications with debtors must be entitled to practice law and must disclose in communications with debtors whether the attorney is licensed to practice law in this state. A law firm licensed under this division who communicates with debtors must employ at least one attorney authorized to practice law.
(3) Revocation or suspension of an attorney's debt collector's license shall not operate to prohibit the attorney from practicing law, including debt collection practice, before any court in the State of California they are otherwise permitted to practice before.

Comment: Provided above. This is a matter that urgently calls for input from the State Bar.

(k) A student loans servicer, as defined by Financial Code section 28104, subdivision (m), is exempt from debt collection licensure for its student loan servicing activities. However, a student loan servicer that collects or attempts to collect defaulted student loans as defined in Financial Code section 28104, subdivision (m), must obtain a debt collection license.

(*l*) A private nonprofit postsecondary institution is exempt from debt collection licensure.

Comment: While possibly unobjectionable in concept, this exclusion seems inappropriately broad. One is reminded of the time before the implementation of the IRS's "unrelated income" rule pertaining to profit-making activities of nonprofit entities, when a private university purchased and operated a spaghetti factory, and paid no tax on its profits from that enterprise. This exclusion should be limited to nonprofit postsecondary institutions' collections of their own direct student loans.

(m) A person is not engaged in the business of debt collection for purposes of licensure under the Debt Collection Licensing Act when acting as a licensed repossession agency under the authority of the Collateral Recovery Act, Chapter 11 of Division 3 of the Business and Professions Code, commencing with§ 7500).

Comment: This is an appropriate exclusion.

SECTION 3. Section 1850.2 is adopted to read:
§ 1850.2 Consumer credit transactions.
(a) The following types of debt are not consumer debt within the meaning of section 100002, subdivision (f) of the Financial Code:
(1) Residential rental debt, except COVID-19 rental debt as defined in Section 1179.02 of the Code of Civil Procedure.
(2) Debt owed pursuant to a Homeowners' Association Declaration of Covenants, Conditions, and Restrictions or other equivalent written agreement.

Comment: These are appropriate exclusions that help to mitigate the overreach of the Act.

(b) Debt arising from a consumer's acquisition of healthcare or medical services, where payment is deferred, is presumed to be consumer debt within the meaning of section 100002, subdivision (f) of the Financial Code.
(c) The failure of a personal check to clear does not create a consumer credit transaction under the Debt Collection Licensing Act.

Comment: This is an appropriate exclusion. It should also apply to other types of payments, *such as electronic payments for goods and services, that are the functional equivalent of checks in modern commerce.*

SECTION 5. Section 1850.71 is adopted to read:
§1850.71 Document Retention.

(a) Each licensee shall make and preserve a record of any contact with, or attempt to contact, anyone associated with a debtor account, regardless of who initiated the contact and whether the attempt at contact is successful. The record shall include, at a minimum:

(1) the name of the employee making the attempt or who received contact from a person regarding the debtor account, and the name of the person who contacted the licensee (if available).
(2) the date and time of contact.
(3) the name and contact information of the person the licensee is attempting to contact.
(4) a summary of the substance of the contact or message conveyed.
(5) if a call was recorded, the recording shall be retained.
(6) the date, amount, and method of any payments made on the debt.
(b) Subdivision (a) does not apply to contacts made between licensees and debt buyers or creditors.
(c) Each licensee shall keep and maintain the following information:
(1) All employee records related to training, performance, and interactions with debtors.
(2) The records created pursuant to subdivision (a).
(3) All records of fees, interest, and any charges on debtor accounts accrued since acquisition of the account by the licensee.
(4) Records establishing that the licensee is no longer attempting to collect on accounts that have been resolved and that the consumer has been informed of the resolution and that no further collection efforts will be made.
(d) Each licensee shall retain the information in subdivision (c), in a form readily accessible, for at least three years after any of the following, whichever occurred last:
(1) The account has been resolved, and the consumer has been informed that they no longer owe the debt and that no further contact or collection attempts will be made by the licensee, or
(2) the account has been returned to the creditor whether or not payments have been made, or
(3) the account is sold and all collection attempts by the debt collector have ceased.
(e) Where a record is subject to both this section and the regulations adopted pursuant to Division 24 of the Financial Code, the longer retention period applies.

Comment: My clients appreciate the clarity provided by this proposed section.

Additional Concerns

There are two further items for which my client base would appreciate regulatory guidance from the Department:

Scope of CFL/RML Exemptions: While the Act provides that California Finance Lenders ("CFL's") and Residential Mortgage Lenders ("RML's") are exempt from its coverage, the scope of that exemption is unclear. Does it mean that any entry that holds the CFL license is fully exempt from the Act, or does that exemption only apply to activities of the entity that are licensable activities under the CF Law or the RML Law? Based on Section 10001(b) of the Debt Collection Licensing Act, arguably, there is a blanket licensing exemption as there is no limiting language; however, I note in this regard that there have been no regulations issued on this point, and it has been difficult to obtain informal guidance on this issue from either the CFL Section or the RML Section.

It is further noted that those sections of the Department have been examining CFL's and RML's or compliance with applicable laws pertaining to collections for decades. Entities holding CFL and RML licenses should not be subjected to the costs of multiple, unnecessary, examinations in this area: the cost of which can be in the tens of thousands of dollars. In addition, I have been informed that at least some DCLA examiners have been demanding information - sometimes in an unfortunately antagonistic manner - pertaining to servicing our collection of transactions that are directly subject to the CF Law or the RML Law. I respectfully submit that this is a matter that the department needs to resolve internally, in consultation with industry and other stakeholders, as appropriate, to provide kind of clarity that is necessary for business operations to proceed in a compliant and orderly matter. Industry understands that the Department has a lot on its plate at the moment with the implementation of the act, but the Department should likewise understand that industry entities have investors and shareholders to whom they are they accountable, and on short time frames. Accordingly, the Department's approach in this area should be to seek amicable cooperation with industry to implement the new Act.

Annual Report: Finally, on behalf of my client base, I wish to express concern pertaining to the content of the DCLA Annual Report form (the "Report Form") recently directed to licenses. I have previously communicated my concerns pertaining to the substance of the Report Form directly to the Department's intake portal. However, those concerns as expressed were substantive, pertaining to the fact that much of the Report Form is either inapplicable to first-party creditors and/or servicers of performing portfolios, or is impossible for first-party creditors and/or servicers of performing portfolios to respond to specific guidance from the Department as to the ambiguous reporting questions. Here, I will further note that the Report Form appears to have been developed and released to licenses without compliance with the notice and comment portions of the California Administrative Procedures Act)(the "APA"). (It appears that the contents of the Report Form were put out for comment, but never promulgated.) By this comment, I am requesting that the Department comply with the APA with regard to the Report Form; formally notifying the Department and the Office of Administrative Law of the impossibility of compliance with the Report Form; and suggesting that any licensee whose response to the Report Form, is deemed by the Department to be inaccurate or inadequate, will surely have recourse to the administrative hearing provisions of the APA.

Thank you very much for the consideration of these comments.

Sincerely,

/s/ *R. P. Soter, Jr.*

R. Paul Soter, Jr.