

Client Alert

March 10, 2014

Expanded Commercial Loan Exemption Under California Finance Lenders Law

By Bill Veatch and Dina Kushner

As a result of the passage of Assembly Bill No. 1091 ("**AB 1091**"), persons¹ that make only occasional commercial loans in California may be able to take advantage of an expanded licensing exemption under the California Finance Lenders Law (the "**CFLL**"), §§ 22000 *et seq.* of the California Financial Code.

FINANCE LENDER LICENSING REQUIREMENT IN CALIFORNIA

Under California law, "finance lenders" (subject to certain limited exceptions) making loans in California are required to obtain a license from the California Department of Business Oversight² and comply with the licensing and regulatory requirements of the CFLL and the regulations thereunder. A "finance lender" is broadly defined in Cal. Fin. Code § 22009 as "any person who is engaged in the business of making consumer loans or making commercial loans."

DE MINIMIS COMMERCIAL LOAN EXEMPTION

One of the limited licensing exemptions available under the CFLL is a *de minimis* commercial loan³ exemption that, prior to the passage of AB 1091, exempted from licensing any person making just one commercial loan in a 12-month period. Effective January 1, 2014, the CFLL has been amended to, among other things, exempt from licensing any person making *five or fewer* commercial loans in a 12-month period, as long as the loans are incidental to the business of the person relying on the exemption.⁴ AB 1091 does not explain when a commercial loan will be deemed "incidental to the business of the person relying upon the exemption," which is a prerequisite to the use of the exemption. However, the Assembly Floor Analysis dated August 21, 2013 specifically refers to "bridge loans" as the type of commercial loans that could qualify for the exemption. In any event, the language of the exemption makes it clear that any person relying thereon cannot be engaged in the business of making loans.

GOOD NEWS FOR VENTURE CAPITAL FUNDS

The revised *de minimis* commercial loan exemption is a welcome change for venture capital funds which may wish to occasionally provide conventional loans to their California portfolio companies. Venture capital funds may qualify under this exemption because they are in the business of investing in equity securities (not lending), and such loans may be

¹ The term "person" refers to both entities and individuals.

² Formerly the California Department of Corporations.

³ A "commercial loan" is a loan with a bona fide principal amount of \$5,000 or more, or any loan under an open-end credit program, the proceeds of which are intended by the borrower for use primarily for other than personal, family, or household purposes. The definition applies regardless of whether the loan is secured or unsecured, and regardless of the nature of any security for the loan. For purposes of determining the purpose of the loan, the lender may rely on any written statement of intended purposes signed by the borrower. Cal. Fin. Code § 22502.

⁴ See Cal. Fin. Code § 22050(e).

Client Alert

incidental to their primary business, as required by Cal. Fin. Code § 22050(e).

In the recent past, venture capital funds have availed themselves of a different licensing exemption, the commercial bridge loan exemption, when making certain types of bridge loans to portfolio companies.⁵ The commercial bridge loan exemption is useful for traditional venture capital bridge loans that “bridge” a company to its next round of equity financing. The criteria to qualify for this exemption, however, are restrictive and technical, as described in more detail below. Accordingly, in a scenario where, for example, a venture capital fund wants to provide longer-term financing to a distressed portfolio company, or to provide a loan that does not contain equity conversion features, the broader *de minimis* commercial loan exemption may offer an alternative exemption under the circumstances.

As a practical matter, if a venture capital fund exceeds the five-loan maximum in any 12-month period (and absent any other CFLL exemption), it will have to structure any loans beyond such maximum within the technical confines of the commercial bridge loan exemption in order to be exempt from CFLL licensure. Strategically, it is advisable for the venture capital fund to rely on the commercial bridge loan exemption whenever possible in order to “save” the *de minimis* commercial loan exemption for unique circumstances where a loan structure would fall outside the scope of the commercial bridge loan exemption.

IN SOME CASES, CFLL LICENSING MAY STILL BE THE BEST OPTION

Persons who are able to take advantage of the expanded *de minimis* commercial loan exemption or the commercial bridge loan exemption may nonetheless wish to consider obtaining a license under the CFLL. The CFLL affords a licensed finance lender an important exemption from the broad reach of the California usury law and also provides an exemption from the licensing requirements of the California Real Estate Law when making real estate-secured loans.

* * *

TECHNICAL REQUIREMENTS OF THE COMMERCIAL BRIDGE LOAN EXEMPTION

Under Cal. Fin. Code § 22062, the CFLL’s licensing requirements do not apply to “a commercial bridge loan made by a venture capital company to an operating company.”

“**Commercial bridge loan**” is any loan that:

- Has a principal amount of \$5,000⁶ or more, or any loan under an open-end credit program, whether secured by personal property or unsecured;
- Has proceeds which are intended to be used by the operating company other than for personal, family, or household purposes⁷;

⁵ See Cal. Fin. Code § 22062.

⁶ The principles set forth in Cal. Fin. Code § 22551 shall be used to determine whether the specified amount of a commercial bridge loan is a bona fide principal amount.

⁷ A venture capital company may rely on any written statement of intended purposes signed by the operating company. The statement may be a separate statement signed by the operating company or may be contained in another document signed by the operating company, but in each case it shall be approved by its board of directors, executive committee, or similar policy body. The venture capital company may not be required to ascertain that the proceeds of the loan are used in accordance with the statement of intended purposes.

Client Alert

- Matures in one year or less;
- Is made in connection with, or in contemplation of, an equity investment in the operating company;
- Is secured, if at all, solely by the operating company's personal property business assets (but not by real property); and
- Is subject to the implied covenant of good faith and fair dealing arising under Section 1655 of the California Civil Code.

“**Venture capital company**” means a person (other than an individual or sole proprietorship) that:

- Engages primarily in the business of promoting economic, business, or industrial development through “venture capital investments” (defined below) or the provision of financial or management assistance to operating companies;
- At all times maintains at least 50 percent of its assets in venture capital investments or commitments to make venture capital investments;
- Maintains or, assuming consummation of the equity investment to which a commercial bridge loan relates, will maintain a material equity interest in the operating company;
- Approves each loan made to an operating company through the venture capital company's board of directors, executive committee, or similar policy body, based on a reasonable belief that the loan is appropriate for the operating company after reasonable inquiry concerning the operating company's financing objectives and financial situation; and
- Complies, when making the loan, with all applicable federal and state laws and rules or orders governing securities transactions including, but not limited to, the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Corporate Securities Law of 1968.

“**Operating company**” means a person (other than an individual or sole proprietorship) that:

- Primarily engages, wholly or substantially, directly or indirectly through a majority-owned subsidiary or subsidiaries, in the production or sale, or the research or development, of a product or service other than the management or investment of capital;⁸
- Uses all of the commercial bridge loan proceeds for the operations of its business; and
- Approves the bridge loan through its board of directors, executive committee, or similar policy board, in the exercise of its fiduciary duty, based on a reasonable belief that the loan is appropriate for the operating company after reasonable inquiry concerning the operating company's financing objectives and financial situation.

⁸ This does include a person that has no specific business plan or purpose or has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or companies or other entity or person.

Client Alert

“**Venture capital investment**” means “an acquisition of securities in an operating company that a person, an investment adviser of the person, or an affiliated person of either, has or obtains management rights to.” The statute does not provide a definition of the term “management rights,” but the term is well defined in other places. See definition of “venture capital operating company” under the Employee Retirement Income Security Act of 1974 and under Rule 260.204.9 of the California Code of Regulations, which deals with the regulation of investment advisors.

* * *

Contact:

Bill Veatch

(415) 268-6914

wveatch@mofo.com

Dina Kushner

(213) 892-5786

dkushner@mofo.com

About Morrison & Foerster:

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life science companies. We’ve been included on *The American Lawyer’s* A-List for 10 straight years, and *Fortune* named us one of the “100 Best Companies to Work For.” Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations. Prior results do not guarantee a similar outcome.