

## CALIFORNIA LEGISLATURE PASSES LAW EXEMPTING COMMERCIAL BRIDGE LOANS MADE BY VENTURE CAPITAL COMPANIES TO OPERATING COMPANIES FROM CALIFORNIA FINANCE LENDERS LAW

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### NEW EXEMPTION TO CALIFORNIA FINANCE LENDERS LAW

The California legislature has recently passed Assembly Bill 169 that added Section 22062 to the California Finance Lenders Law (the "CFL") and essentially exempts from the CFL requirements any commercial bridge loan made by a venture capital company to an operating company on or after January 1, 2004.

### EXISTING REGULATION OF FINANCE LENDERS

The CFL requires finance lenders, with some limited exceptions, to obtain a California finance lenders license and comply with the licensing and regulatory requirements of the CFL. A finance lender is any person or entity engaged in the business of making consumer loans or commercial loans in California. While there were and are exemptions in the CFL for persons who do not make more than one commercial loan in any 12-month period and for certain institutional lenders such as banks and insurance companies, prior to the passage of Assembly Bill 169, venture capital companies making commercial bridge loans were not eligible for such exemptions and were required to obtain a CFL license to be in full compliance with California law.

To obtain a license, finance lenders must submit an application to the California Department of Corporations and allow the Department of Corporations to determine whether the applicant or its principals has a criminal record or a history of non-compliance with regulatory requirements. The application must include financial statements of the applicant, a description of the proposed business and personal information regarding the directors, officers and any person or entity that owns or controls 10% or more of the outstanding stock of the applicant or its parent. In addition, once licensed, a finance lender must continue to comply with all of the regulatory requirements of the CFL which include filing an annual report along with an annual assessment fee, complying with minimum net worth requirements, maintaining a surety bond and complying with strict recordkeeping requirements. There are significant penalties for finance lenders making loans in California without complying with the CFL.

### PURPOSE OF THE NEW LAW

Assembly Bill 169 makes it clear that commercial bridge loans made by venture capital companies to operating companies, as those terms are defined in the new law, are not subject to the CFL. The intent of the California Legislature in creating this new exception is expressed in Section 2 of Assembly Bill 169 where the Legislature declared "it is not necessary or appropriate in the public interest for the protection of borrowers to regulate commercial bridge loans made by venture capital companies to operating companies under the limited circumstances described in Section 1 of this Act." Venture capital companies generally provide investment capital to start-up companies in exchange for the ownership of a portion of the company's equity. Equity financing is often provided by venture capital firms in stages, based on the start-up company's progress toward achieving its business plan goals. In some instances, interim financing is in the form of one or a series of commercial bridge loans to keep the company running until the company is financially strong enough for long term equity or debt financing. Prior to the enactment of Assembly Bill 169, there were few exemptions from the licensing requirements of the CFL that would be applicable to a venture capital company making commercial bridge loans. Therefore, to avoid the severe penalties for non-compliance and to be in full compliance with California law, venture capital companies were required to obtain a license under the CFL.

### IMPORTANT DEFINITIONS

It is important to understand the very specific definitions used in this seemingly simple new law because some bridge loans may not qualify for the exemption.

#### **Venture Capital Company**

A "venture capital company" is defined in Section 22062(b)(1) to mean a person other than an individual or sole

proprietorship that meets ALL of the following:

(A) Engages primarily in the business of promoting economic, business, or industrial development through venture capital investments or the provision of financial or management assistance to operating companies.

(B) At all times maintains at least 50 percent of its assets in venture capital investments or commitments to make venture capital investments, and maintains or, assuming consummation of the equity investment to which the commercial bridge loan relates, will maintain a material equity interest in the operating company.

(C) 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 operating company after reasonable inquiry concerning the operating company's financing objectives and financial situation.

(D) 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.

A "venture capital investment," for purposes of the definition of a venture capital company, is defined in Section 22062(b)(4) to mean an acquisition of securities in an operating company that a person, an investment advisor of the person, or an affiliated person of either, has or obtains management rights to.

### **OPERATING COMPANY**

An "operating company" is defined in Section 22062(b)(2) to mean a person that meets ALL of the following:

(A) 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. This shall not include any of the following:

(i) A person that is either an individual or a sole proprietorship.

(ii) 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.

(B) Uses all of the proceeds of the commercial bridge loan for the operations of its business.

(C) Approves each commercial 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.

### **COMMERCIAL BRIDGE LOAN**

A "commercial bridge loan" is defined in Section 22062(b)(3) to mean a loan that meets ALL of the following criteria:

(A) A loan of a principal amount of \$5,000 or more, or any loan under an open-end credit program, whether secured by personal property or unsecured, the proceeds of which are intended by the operating company for use primarily for other than personal, family, or household purposes.

(B) Is made with a maturity date not to exceed one year, and in connection with or in bona fide contemplation of, an equity investment in the operating company.

(C) Is secured, if at all, solely by the operating company's business assets, exclusive of any real property.

(D) Is subject to the implied covenant of good faith and fair dealing under Section 1655 of the Civil Code.

For purposes of determining whether a loan is a commercial bridge loan, 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. Section 22062(c).

### **PRACTICE TIPS**

If a venture capital company intends to make a commercial bridge loan and intends for the bridge loan to be exempt from the requirements of the CFLL, it is important to remember that all of the requirements for the exemption must be satisfied for the loan to be exempt from the requirements of the CFLL. For example, the exemption will not apply to loans made by lenders who do not qualify as "venture capital companies" under the definition noted above even if the loan itself qualifies

as a “commercial bridge loan” and it is made to an “operating company” as defined in the statute. Therefore, a lender must carefully review the requirements in Section 22062(b)(1) to make sure that it meets ALL of the applicable criteria to be considered a “venture capital company.” Note in particular that an individual or sole proprietorship may not be a venture capital company for purposes of this exemption. Also, the primary business of the lender must be promoting economic, business or industrial development through capital investments or the provision of financial or management assistance to operating companies, the company must at all times maintain at least 50 percent of its assets in venture capital investments and the lender must comply, when making the loan with all applicable federal and state securities laws. Section 22062(b)(1)(C) requires the venture capital company’s board of directors, executive committee or similar policy body to approve the loan 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. Therefore, the venture capital company should carefully document in writing, perhaps in the recitals to its board or committee resolutions, its analysis of the operating company, the requested commercial bridge loan, the due diligence performed concerning the operating company’s financing objectives and financial situation and its determination regarding why the loan is appropriate for the operating company.

Assuming the lender qualifies as a venture capital company, the lender must make sure that the loan will be made to an “operating company” under the definition contained in the new law. The venture capital company must perform reasonable due diligence concerning the borrower to make this determination. To be an operating company, the borrower must be primarily engaged in the production or sale or the research or development, of a product or service other than the management or investment of capital. An operating company cannot be an individual or a sole proprietorship and it must have a specific business plan that does not involve a merger or acquisition with an unidentified company or companies. The proceeds of the bridge loan must be used for the operations of the operating company’s business so the loan agreement or promissory note should contain a provision restricting the use of the loan proceeds to that purpose. Section 22062(b)(2)(C) requires the operating company’s board of directors, executive committee or similar policy body, in the exercise of its fiduciary duty, to approve the loan based on its reasonable belief that the loan is appropriate for the operating company after reasonable inquiry concerning the operating company’s financing objectives and financial situation. Note that this requirement for board, committee or other policy board approval is similar to the requirement for the board of the venture capital company. The lender should require a certified board resolution from the operating company as a condition to making the loan that contains all of the required determinations set forth in the statute.

Even if the loan is to be made by a venture capital company to an operating company, the exemption will only apply to the loan if the venture capital company makes a “commercial bridge loan” to the operating company. A “commercial bridge loan” must be a loan in a principal amount over \$5,000 and the proceeds cannot be intended for use primarily for personal, family or household purposes. The loan agreement or promissory note should contain language where the operating company certifies that the proceeds of the loan are not intended for use for personal, family or household purposes. The loan must not be for a period longer than one year and must be made in connection with or in bona fide contemplation of an equity investment in the operating company. The board resolutions for both the venture capital company and the operating company should recite that the loan is being made in connection with or in bona fide contemplation of an equity investment by the venture capital company in the operating company. The loan may be secured or unsecured, but cannot be secured with real property. Commercial bridge loans are subject to the implied covenant of good faith and fair dealing under Section 1655 of the California Civil Code.

#### **COMMERCIAL BRIDGE LOANS STILL SUBJECT TO OTHER CALIFORNIA LAW DESIGNED TO PROTECT BORROWERS**

Section 22062(f) makes it clear that nothing in this new law is intended to abrogate or diminish the application of any other laws that are designed to protect borrowers, including, but not limited to, laws pertaining to licensing, unfair competition, usury and conflicts of interest.

#### **USURY**

California’s usury law is contained in the California Constitution, art. XV, § 1. Loans made by lenders licensed under the CFLL are exempt from California’s usury limitations so licensed lenders may make commercial loans for any interest rate agreed by the parties. This is a strong incentive for lenders to obtain a license. For lenders that are not licensed or otherwise exempt from the usury limitations making commercial loans, the interest rate which may be charged on a loan or forbearance is not to exceed the higher of 10% or 5% per annum plus the rate prevailing on the 25<sup>th</sup> day of the month preceding the earlier of (i) the date of execution of the contract to make the loan, or (ii) the date of making the loan established by the Federal Reserve Bank of San Francisco on advances to member banks under Section 13 and 13a of the Federal Reserve Act. Therefore, while commercial bridge loans made by venture capital companies to operating companies are exempt from the requirements of the CFLL, such loans will still be subject to California’s usury law unless the venture capital company obtains a license under the CFLL or another exemption is applicable.

#### **VENTURE CAPITAL COMPANY MAY STILL NEED A LICENSE UNDER CFLL IF IT MAKES NON-EXEMPT LOANS**

It is important to remember that only commercial bridge loans made by a venture capital company to an operating company have been exempted from the coverage of the CFLL. If a venture capital company only makes commercial bridge loans to operating companies as described in Section 22062 and makes no other loans, the venture capital company should not need to obtain a license under the CFLL. However, it is important to remember that the commercial bridge loans have been exempted from the coverage of the CFLL - not the venture capital company itself for any other loans it chooses to make in California. Therefore, if a venture capital company makes some loans that qualify as commercial bridge loans to operating companies that would be exempt under Section 22062 and also makes more than one loan in California that would not qualify for the new exemption, the venture capital company will be required to comply with the CFLL and obtain a license.

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