CALIFORNIA FINANCE LENDERS LAW PART I:

APPLICABILITY OF THE LICENSING REQUIREMENTS OF THE CALIFORNIA FINANCE LENDERS LAW TO COMMON COMMERCIAL PERSONAL PROPERTY FINANCING TRANSACTIONS (I.E. DO WE NEED A LICENSE TO DO THAT DEAL?)[1]

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California's Financial Code §22000 et seq., known as the California Finance Lenders Law (the "CFLL") requires "finance lenders," with some exceptions, to obtain a finance lenders license (a "License"). A "finance lender" is defined in Cal. Fin. Code § 22009 (West 1994) as "any person who is engaged in the business of making consumer loans or making commercial loans." While that sounds like a simple requirement, there may be some confusion as to which types of financing transactions will trigger the licensing requirements of the CFLL.[2]

PRIOR LAW

The CFLL was enacted by the California legislature to be effective on July 1, 1995, and for the most part consolidated and replaced the Personal Property Brokers Law, the Consumer Finance Lenders Law and the Commercial Finance Lenders Law which were previously applicable to personal property brokers, consumer finance lenders, and commercial finance lenders, respectively. Even though the CFLL is a relatively recent statute, it is based upon predecessor statutes each with much longer history that have been interpreted by cases, attorney general opinions, and California Commissioners opinions. Based on the legislative history of the CFLL, such prior authority remains applicable to an analysis of the corresponding issues under the current CFLL. Therefore, throughout this article, some of the case law and other authority referenced will include interpretations of prior law.

LICENSE REQUIREMENTS APPLY TO FINANCE LENDERS

Cal. Fin. Code § 22100 (West 1994) provides that "[n]o person shall engage in the business of a finance lender or broker without obtaining a license from the commissioner."[3] Therefore, it becomes important to understand which transactions entered into by a finance company will constitute engaging in the business of making loans in California. The term "engaged in the business of making consumer loans or making commercial loans" is not precisely defined in the CFLL. The Internet web-site operated by the California Department of Corporations[4] briefly explains the CFLL and provides that "[i]n general, 'non loans' such as factored transactions, leases, automobile sales finance contracts (Rees-Levering) and conditional sales contracts governed by the Unruh Retail Sales Act (the "Unruh Act") are not subject to the provisions of the CFLL." Except for such "non-loans," the CFLL it is applicable to both secured and unsecured loans.[5] The focus of this article is to analyze which types of financing transactions would be considered to be "loans" and would trigger the licensing requirements of the CFLL.

APPLICABILITY OF LICENSING REQUIREMENTS TO COMMON FINANCING TRANSACTIONS

a. Traditional Loans Made in California

It should be noted that the CFLL and its regulatory effect applies to loans made in California and is primarily intended to protect citizens of California and members of the public in California.[6] Therefore, if a finance company makes a loan to a customer in California, whether such loan is unsecured or secured by collateral located in California or elsewhere, the licensing requirements of the CFLL would be triggered and the finance company would be required to obtain a License unless an exception to the licensing requirements is applicable. The CFLL does not apply to a situation where the customer is not in California even if personal property collateral is located in California.[7]

b. True Leases Although no direct judicial or administrative precedent was found holding specifically that a finance company entering into true leases only in California is not a finance lender and does not require a License, Cal. Fin. Code § 22009 (West 1994) provides, in pertinent part, that a "[F]inance lender" includes any person who is engaged in the business of making consumer loans or making commercial loans." (Emphasis added.) Therefore, by negative implication, the definition of "finance lender" should not apply to a finance company entering into only true leases in California and such finance company should not be required to obtain a License. A true lease is typically a lease either without a purchase option or a lease with purchase option exercisable by the lessee for a purchase price equal to the

fair market value of the leased property determined at the time the option is exercisable, but see below for other applicable factors.

c. Quasi Leases (Leases Intended as Security)

It is possible, of course, for parties to enter into transactions documented as leases which a court will construe as "leases intended for security" which are really secured loans under California law. It is likely that a finance company entering into such quasi-leases in California would be deemed to be making loans in California and required to obtain a License under the CFLL. Cal. Unif. Com. Code § 1201(37) provides in pertinent part:

> ...whether a lease is intended as security is to be determined by the facts of each case; however, (a) the inclusion of an option to purchase does not of itself make the lease one intended for security, and (b) an agreement that upon compliance with the terms of the lease the lessee shall become or has the option to become the owner of the property for no additional consideration or for nominal consideration does not make the lease one intended for security.

Based on the foregoing and irrespective of other facts concerning the transaction, a purchase option alone is not determinative and a lease agreement will definitely be a lease intended for security if it contains an option to purchase "for no additional consideration or for nominal consideration."

Further, it is clear in California that a court determining whether a transaction constitutes a true lease or a lease intended as security will consider the substance of the transaction rather than its form or the terminology used by the parties.[8] In *Triple C. Leasing, Inc. v. All-American Mobile Wash*[9], the California Court of Appeals upheld a determination that a lease with a ten percent purchase option was properly characterized as a true lease under California law because the purchase option was not nominal. The court emphasized that the facts of each case must be reviewed to show whether the parties intended to create a security interest or a true lease. The court outlined the following factors to consider when determining whether a lease is intended as security: (i) reservation of title in a lease or option to purchase appurtenant to or included in the lease does not in and of itself make the lease a security agreement, (ii) lease agreement which permits the lessee to become the owner at the end of the term of the lease for a nominal or for no additional consideration is deemed to be a lease intended as a security agreement as a matter of law, (iii) the percentage that option purchase price bears to the list price, especially if it is less than 25% is to be considered as showing the intent of the parties to make a lease intended as security, (iv) where the terms of the lease and option to purchase are such that the only sensible course for the lessee at the end of the lease term is to exercise the option and become the owner of the goods, the lease was intended to create a security interest, and (v) the character of a transaction as a true lease is indicated by: (A) provision specifying purchase option price which is approximately the market value at the time of the exercise of the option, (B) rental charges which are not excessive and option purchase price which is not too low, and (C) facts showing that the lessee is acquiring no equity in leased article during the term of lease. These factors and others have been used by California courts to determine that transactions documented as leases were in reality leases intended as security or leases intended to be secured loans.[10] Based on the foregoing, if a finance company enters into quasi-lease transactions in California which would be determined to be leases intended as security under California law, such finance company would most likely be engaging in the business of making loans in California and would be required to obtain a License.

d. Sale/Leaseback (True Lease)

While it does not seem to follow the reasoning of the authority described above, based on a California Supreme Court decision known as Burr v. Capital Reserve Corporation,[11] it is possible a sale/leaseback that would otherwise be treated as a true lease based on the factors described above, might be treated as a lease intended as security in California just because of the sale/leaseback structure. The Burr decision is the only California Supreme Court case found directly reviewing a lease that would otherwise appear to be a true lease using a traditional analysis but for the sale/leaseback structure and in the Burr case, the California Supreme Court held that the lease reviewed was actually a disguised loan subject to usury laws. It is important to note that Burr has not been overruled and has been cited as controlling precedent for general purposes although no California Supreme Court case was found citing Burr for the principle noted herein. It is not clear how the California Supreme Court would hold today if faced with the same issue. Cases decided by California lower courts before the Burr case have held that a sale leaseback can be a true lease based upon standard principles of analysis described above.[12] Other California lower courts both before and after the Burr case have analyzed the same types of traditional factors noted above for determining whether a lease should be treated as a lease intended as security without overwhelming emphasis on the sale/leaseback issue.[13] However, based upon the Burr decision, which is the only California Supreme Court cases ruling on this issue, it is possible that a finance company entering into true lease sale/leaseback transactions in California might be required to obtain a License under the CFLL even if all of the leases involved in the sale/leasebacks are structured as a true leases using a traditional analysis. Therefore, a finance company that enters into sale/leaseback transactions in California might be deemed to be engaging in the business of making loans in California for purposes of the CFLL and might be required to obtain a License even if the lease transactions are structured very carefully to be true leases

under California law.

e. ale/Leaseback (Quasi Lease - Lease Intended as Security)

As noted, above, the CFLL is clear that a finance company that is engaging in the business of making loans in California is a finance lender required to obtain a License under the CFLL.[14] As further noted above, there is a California Supreme Court case holding that a sale/leaseback might be treated as a secured loan under California Law even though the lease described in that case had characteristics of a true lease.[15] Therefore, it is clear that a finance company entering into sale/leaseback transactions with the characteristics of leases intended as security with customers in California will be required to obtain a License.

f. pen Ended Leases (Leases with Terminal Rental Adjustment Clauses)

An "open ended lease," also known as a "TRAC Lease" is a "qualified motor vehicle operating agreement" containing a "terminal rental adjustment clause," which is a provision in the agreement permitting or requiring the rental price to be adjusted upward or downward by reference to the amount realized by the lessor under the agreement upon sale or other disposition of the leased vehicle, and such agreement is treated as a true lease for Federal income tax purposes if the lease is structured with characteristics of a true lease but for the fact that it contains a terminal rental adjustment clause."[16] In practice, TRAC leases set forth the parties' agreement as to the anticipated residual value of the leased vehicle at the end of the lease. If, at the end of the lease, the vehicle's actual value is less than the anticipated residual value, the lessee is required to pay the lessor the difference and if the vehicle's actual value is more than the anticipated residual value, the lessee receives a refund equal to some or all of the difference. Sometimes the TRAC lease will require the lessor to actually sell the vehicle to a third party to determine the vehicle's actual value. Other TRAC Leases allow the parties to obtain an appraised value of the vehicle at the end of the lease in order to determine the amount of the required payment. This payment, whether by the lessor or the lessee, is often called the "rental adjustment payment." Sometimes a TRAC Lease will allow the lessee to purchase the leased vehicle as well, but a properly drafted TRAC Lease will not allow the lessee to purchase the leased vehicle for the anticipated residual amount because such an agreement would give the lessee a fixed price purchase option. It is possible that a fixed price purchase option will be treated as a bargain purchase option if the purchase price is lower than the anticipated residual value at the time the purchase option is exercisable which would make the TRAC Lease more likely to be deemed to be a lease intended as security. A properly drafted TRAC Lease will allow the lessee to purchase the vehicle for its fair market value at the end of the lease and allow the TRAC provision to operate independently of the purchase option. Nonetheless, even in a properly drafted TRAC Lease, the effect of the TRAC provision and a separate fair market value purchase option might result in effectively a bargain purchase option which would allow the lessee to acquire economic equity in the leased vehicle throughout the term of the lease. For purposes of California law, equity in leased property by a lessee is a characteristic of a lease intended as security as described above. Another characteristic of a true lease generally is that the lessor must bear the burden of the downside risk and receive the benefit of the upside potential with respect to the residual value of leased property.[17] This is not the case in a TRAC lease because the lessee has agreed to pay the lessor if the actual value of the leased vehicle is lower than an agreed anticipated residual value so the lessee is bearing some of the downside risk and the lessor does not receive the benefit of all of the upside potential.

It is unclear in California whether an open ended lease would be treated as a secured loan for purposes of California's usury laws and the CFLL.[18] Although no direct authority was found discussing this issue with respect to the CFLL, the California Court of Appeals has indicated that an open ended lease might be determined to be a lease intended as security for purposes of California law, especially if the lease requires the finance company to sell the leased vehicle at the end of the lease.[19] Therefore, the facts, circumstances and language of each open ended lease should be carefully reviewed to determine whether the parties intended it to be a lease intended as security. If so, a finance company office entering into such leases would be required to obtain a License.

g. Conditional Sale Contracts.

A conditional sale contract is generally an agreement whereby a seller agrees to sell property at a designated price for cash or at a higher price on credit and so long as such agreement is bona fide, such a contract is not a loan subject to the usury laws.[20] Section 22064 of the CFLL provides specifically that the CFLL does not apply to bona fide conditional contracts of sale. In addition, when a seller finances the purchase of real or personal property by extending payments over time, the usury laws do not apply because valid conditional sale contracts are exempt from the usury laws under the time-price doctrine.[21] It is important to note, however, that even though bona fide conditional sale contracts are expressly excluded from coverage by the CFLL, it is still possible if a court determines that a transaction documented as a conditional sale contract is in substance a secured loan, that such transaction would be deemed to be a secured loan covered by the CFLL[22] A finance company entering into a transaction deemed to be a secured loan would be engaging in the business of making loans in California and would be required to obtain a License. Therefore, the facts, circumstances and language of each conditional sale contract should be carefully reviewed to determine whether it is a bona fide conditional contract of sale or whether it might be treated as a

secured loan.

CHART ON APPENDIX

To assist in an initial analysis of whether engaging in a particular type of transaction by a finance company may trigger the licensing requirements of the CFLL, the chart contained on the Appendix to this article briefly summarizes the analyses contained in this article. In conjunction with each chart, the reader should refer to the corresponding explanations and authority in the text of the article. When reviewing the summaries contained on the attached charts, it is important to note that in California a court will not take at face value the name that the parties have attached to a particular transaction, but will carefully analyze the transaction to determine the substance of a transaction. The substance of the transaction will be determinative over the form of the transaction. Also, many real life transactions often involve situations that include combinations of the fact patterns that are described on the chart. Of course, those situations will require further analysis by an attorney familiar with the CFLL, but the information in this article, the chart, and the explanatory footnotes should help to focus the issues that need to be addressed in the additional analysis and provide a guide toward some useful precedents.

APPENDIX

Is a California Finance Lenders License Required for a Finance Company Entering Into the Following Types of Transactions?

(Please Refer to Complete Analysis in Accompanying Text)

Type of Transaction	Customer in CA	Customer NOT in CA even if personal property collateral located in CA
Traditional Loans (Promissory Notes - Secured and Unsecured)	Yes	No
True Lease (No Purchase Option or Fair Market Value Purchase Option)	No	No
Quasi Lease (Lease Intended as Security)	Yes	No
Sale/Leaseback (True Lease)	Maybe	No
Sale/Leaseback (Quasi Lease – Lease Intended as Security)	Yes	No
Open Ended Lease (TRAC Lease)	Maybe	No
Conditional Sale Contract	NO if a true conditional sale contract	No

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2 - Cal. Fin. Code § 22000 (West 1994) et seq.

3 - Notwithstanding the broad provisions of Cal. Fin. Code § 22100 (West 1994), there are numerous exemptions from the licensing requirements of the CFLL for certain specific persons or entities and for loans made under certain specific circumstances. The CFLL does not

apply to: (i) "any person doing business under any California or federal law relating to banks, trust companies, savings and loan associations, industrial loan companies, credit unions, small business investment companies, California businesses and industrial development corporations, or licensed pawnbrokers," [Cal. Fin. Code § 22050, subdivision (a) (West 1994)] (ii) "broker-dealers acting pursuant to a certificate, then in effect, issued pursuant to § 25211 of the [California] Corporations Code," [Cal. Fin. Code § 22050, subdivision (b) (West 1994)] (iii) "a college or university making a loan for the purpose of permitting a person to pursue a program or course of study leading to a degree or certificate," [Cal. Fin. Code § 22050, subdivision (c) (West 1994)] (iv) "a check cashier who holds a valid permit issued pursuant to § 1789.37 of the [California] Civil Code when acting under the authority of that permit," [Cal. Fin. Code § 22050, subdivision (d) (West 1994)] (v) "any person who makes no more than one loan in a 12-month period as long as that loan is a commercial loan as defined in Cal. Fin. Code § 22502 (West 1994)," [Cal. Fin. Code § 22050, subdivision (e) (West 1994)] (vi) "any public corporation as defined in § 67510 of the [California] Government Code, any public entity other than the state as defined in § 811.2 of the [California] Government Code, or any agency of any one or more of the foregoing, when making any loan so long as the public corporation, public entity, or agency of any one or more of the foregoing complies with all applicable federal and state laws and regulations," [Cal. Fin. Code § 22050, subdivision (f) (West 1994)] (vii) "any nonprofit cooperative association organized under Chapter 1 (commencing with § 54001) of Division 20 of the [California] Food and Agricultural Code that loans or advances, money in connection with any activity mentioned in that chapter," [Cal. Fin. Code § 22051, subdivision (a) (West 1994)] (viii) "any corporation, association, syndicate, joint stock company, or partnership engaged exclusively in the business of marketing agricultural, horticultural, viticultural, dairy, livestock, poultry, or bee products on a cooperative nonprofit basis that loans or advances money to its members or in connection with those businesses," [Cal. Fin. Code § 22051, subdivision (b) (West 1994)] (ix) "any corporation securing money or credit from any federal intermediate credit bank organized and existing pursuant to the provisions of an act of Congress entitled "Agricultural Credits Act of 1923" that loans or advances money or credit so secured," [Cal. Fin. Code § 22051, subdivision (c) (West 1994)] (x) "any corporation created pursuant to the provisions of part 5 of Division 3 of title 1 of the [California] Corporations Code," [Cal. Fin. Code § 22051, subdivision (d) (West 1994)] (xi) any loan of credit made by a person not licensed under the CFLL pursuant to a plan involving credit cards having certain characteristics, [See Cal. Fin. Code § 22052 (West 1994)] (xii) bona fide conditional contracts of sale, [See Cal. Fin. Code § 22054 (West 1994)] (xiii) "premium financing as defined in Cal. Fin. Code § 18563," [Cal. Fin. Code § 22055 (West 1994)] (xiv) "the Department of Commerce or the California Integrated Waste Management Board," [Cal. Fin. Code § 22056 (West 1994)] (xv)" any loan that is made or arranged by any person licensed as a real estate broker by the state and secured by a lien on real property, or to any licensed real estate broker when making such loan," [Cal. Fin. Code § 22057 (West 1994)] (xvi) "any cemetery broker licensed under the Cemetery Act (Chapter 19 (commencing with § 9600) of Division 3 of the Business and Professions Code," [Cal. Fin. Code § 22058 (West 1994)] (xvii) "any loan made or arranged by a licensed residential mortgage lender or servicer when acting under the authority of that license," [Cal. Fin. Code § 22060 (West 1994)] and (xviii) "any nonprofit church extension fund," [Cal. Fin. Code § 22061 (West 1994)].

4 - See "www.corD.ca.qov/Dub/lender.htm."

5 - Cal. Fin. Code § 22009 (West 1994).

6 - People v. Fairfax Family Fund, Inc., 47 Cal.Rptr. 812 (Cal. Ct. App. 1964).

7 - See Commissioners Opinion File No. OP 6547CFLL.

8 - See Milana v. Credit Discount Co., 163 P.2d 869 (Cal. 1945).

9 - 64 Cal.App.3d 244, 134 Cal.Rptr 328 (Cal. Ct. App. 1976).

10 - The following are some examples of leases which have been determined to be leases intended as security under California law: (i) The California Court of Appeals has held that a lease which granted the lessee the right to purchase the leased property at the end of the lease term for $1.00 was a lease intended as security. See Blodgett v. Rheinschild, 206 P. 674 (Cal. 1922); (ii) The California Court of Appeals has held that a lease which required the lessee to purchase the leased property at end of the lease was a lease intended as security. (Golden State Lanes v. Fox, 42 Cal.Rptr. 568 (Cal. Ct. App. 1965). See also Fox v. Peck Iron & Metal Company, Inc., 25 B.R. 674 (Bankr. S.D. Cal. 1982), where the Bankruptcy Court, construing California law, held that a sale/leaseback which contained a provision requiring the lessee to purchase the leased equipment on the lessor's demand was really a secured loan. (iii) The Ninth Circuit Court of Appeals has held that a lease where the lessor was required to apply all rentals paid by the lessee toward the purchase price of the leased property was a lease intended as security. See In re J.A. Thompson & Son, Inc. 665 F.2d 941 (9th Cir. 1982). (iv) The United States District Court for the Southern District of California has held that a lease granting to the lessee an option to renew the lease at a rental amount equal to 91/PA, of total rent paid with the lessee to become the owner of the leased property at the end of the renewal period was a lease intended as security. See In re Washington Processing Co., Inc., 1966 U.S.Dist. LEXIS 3194, 3 U.C.C. Rep. Serv. (Callaghan) 475 (Bankr. S.D. Cal. 1966). (v) The Bankruptcy Court for the Southern District of California, construing California law, has held that a lease in which the lessor initially funded only half the value of the leased property is an indication that the lease was not a true lease but was intended to create a security interest. See Fox v. Peck Iron and Metal Company, Inc., supra, 25 B.R. 674.

11 - 458 P.2d 185 (Cal. 1969).

12 - In 1966, the California Court of Appeals held that a lease without a purchase option in a sale/leaseback transaction would be treated as a true lease. See Associates Discount Corp. v. Tobb Co., Inc. , 50 Cal.Rptr. 738 (Cal. Ct. App. 1966). While the California Supreme Court in the Burr case did not refer to or overrule the Associates decision, the value of the Associates case as precedent for this issue is not clear after the Burr decision.

13 - (i) The California Court of Appeals held in 1922 that a lease entered into in a sale/leaseback structure which granted the lessee an option to purchase the leased property for $1.00 was in reality a loan subject to the usury laws. See Blodgett v. Rheinschild, supra, 206 P.2d 674. (ii) The California Court of Appeals held in 1965 that a sale/leaseback where the lease required the lessee to buy back the leased property should be treated as a loan subject to usury laws. See Golden State Lanes v. Fox, supra, 42 Cal. Rptr. 568. (iii) The California Court of Appeals held in 1970 that a sale/leaseback transaction where the lessee had an option to renew a lease for a nominal renewal rental amount was actually a loan secured by chattels even though the lessee was not granted a purchase option and that the lease-back disguised the true

nature of the transactions. See Rochester Capital Leasing Corp. v. K & L Litho Corp., 91 Cal. Rptr. 827 (Cal. Ct. App. 1970). The Court specifically stated that the absence of a purchase option was not determinative in view of the particular facts of that case. (iv) The U.S. Bankruptcy Court for the Southern District of California, interpreting California law, held in 1982 that a sale/leaseback where the lessor had the right to force the lessee to purchase the leased property was not a bona fide lease and was subject to usury laws. See Fox v. Peck Iron and Metal Company, Inc., supra, 25 B.R. 674.

14 - See Cal. Fin. Code § 22009 (West 1994), and Cal. Fin. Code § 22100 (West 1994).

15 - See Burr v. Capital Reserve Corporation, supra, 458 P.2d 185.

16 - 26 U.S.C. §7701(h) (1999).

17 - See Triple C. Leasing, 134 Cal.Rptr. 328 (Cal. Ct. App. 1976).

18 - One California case was found which addressed the issue of whether an open ended lease should be treated as a true lease or a secured loan. In Addison v. Burnett, 49 Cal.Rptr. 2d 132 (Cal. Ct. App. 1966), the California Court of Appeals reviewed a case involving the lease of a Ferrari where the lessee did not have a purchase option, but at the expiration of the lease term or upon the surrender of the vehicle, the lessor had the option of selling the vehicle or having it appraised at its wholesale value. In either case, the lessor was obligated to credit the lessee with the excess of the sale proceeds or "appraised value" over its depreciated value. If the depreciated value exceeded its appraised value or the sale proceeds, then the lessee would owe the difference to the lessor as additional rent. After a detailed analysis of the Cal. Unif. Com. Code § 9102 (West 1984) which outlines the factors that indicate a particular transaction was intended to be a secured sale rather than a true lease, the Court held that the parties intended to create a lease rather than a security interest under the circumstances. The California Court of Appeals in the Addison case discussed two federal decisions, Matter of Tillery, 571 F.2d 1361 (5th Cir. 1978) and In re Tulsa Port Warehouse Co., Inc. 690 F.2d 809 (10th Cir. 1982) relied upon by the lessee which each involved leases where the lessee agreed to bear any loss and receive any gain upon the final mandatory disposition of the vehicle and were determined to be secured transactions and not true leases. However, the California Court of Appeals in Addison distinguished the leases involved in the Tillery and the Tulsa cases from the lease involved in the Addison case by reasoning that in the Tillery and Tulsa cases, the lessor was required to sell the vehicles at the end of those leases, but in the lease reviewed in the Addison case, the lessor was not required to sell the vehicle. The lessor could retain the vehicle by just having an appraisal done. Therefore, the court reasoned, the lessor had not given up permanent possession or its reversionary interest in the vehicle.

19 - See Addison, supra, 49 Cal. Rptr. 2d 132.

20 - See Verbeck v. Clymer, 261 P. 1017 (Cal. 1927).

21 - See Verbeck v. Clymer, supra, 261 P. 1017.

22 - If a court determines that a credit sale is a "disguised interest bearing loan," then the usury laws would be applicable. See Glaire v. La Lanne-Paris Health Spa, Inc., 528 P.2d 357 (Cal. 1974), which holds that an apparent credit sale may really be a concealed interest bearing loan subject to the usury laws.