

FRANCHISE LOANS MADE IN CALIFORNIA BY FRANCHISOR TO FRANCHISEE ARE EXEMPT FROM CALIFORNIA FINANCE LENDERS LAW¹

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In 2003, the California legislature passed Assembly Bill 2921³ that added § 22063 to the California Finance Lenders Law (the “**Finance Lenders Law**”).⁴ Cal. Fin. Code § 22063 essentially provides that the Finance Lenders Law does not apply to a franchise loan made by a franchisor to a franchisee on or after September 10, 2004.⁵

Regulation of Finance Lenders in California

License Required for Finance Lenders

The Finance Lenders Law requires “finance lenders,” with some exceptions, to obtain a license under the Finance Lenders Law and comply with the licensing and regulatory requirements of the Finance Lenders Law.⁶ A “finance lender” is any person or entity engaged in the business of making consumer loans or commercial loans in California.⁷ While there are exemptions in the Finance Lenders Law for any person who makes five or fewer loans in a 12-month period, these loans are commercial loans as defined in Section 22502, and the loans are incidental to the business of the person relying upon the exemption⁸, for certain institutional lenders and for certain other particular types of loans,⁹ prior to the passage of Assembly Bill 2921, a franchisor making more than five franchise loans in a 12-month period in California was usually ineligible for such other exemptions and would be required to obtain a license under the Finance Lenders Law to be in compliance with California law.

License Application

To obtain a license under the Finance Lenders Law, finance lenders must submit an application to the California Department of Business Oversight and allow the Department of Business Oversight to determine whether the applicant or its principals have a criminal record or a history of non-compliance with regulatory requirements.¹⁰ Beginning on July 1,

2006, applicants must also submit fingerprint images and related information required by the Department of Justice for purposes of obtaining information as to the existence and content of a record of state or federal convictions, state or federal arrests, and information as to the existence and content of a record of state or federal arrests for which the Department of Justice establishes that the person is free on bail or on his or her own recognizance pending trial or appeal. The application must include financial statements of the applicant prepared in accordance with generally accepted accounting principles indicating a net worth of at least \$25,000.¹¹ Upon filing of an application and the payment of fees, the Commissioner of the Department of Business Oversight will investigate the applicant and its general partners, persons owning or controlling 10% or more of the outstanding stock of the applicant or its parent and any person responsible for the conduct of the applicant's lending activities in California.¹² In addition, once licensed, a finance lender must continue to comply with all of the regulatory requirements of the Finance Lenders Law which include filing an annual report¹³ along with an annual assessment fee,¹⁴ complying with minimum \$25,000 net worth requirement,¹⁵ maintaining a surety bond¹⁶ and complying with strict recordkeeping requirements.¹⁷

Penalties

There are significant penalties for finance lenders making loans in California without complying with the Finance Lenders Law including suspension of license,¹⁸ surrender of license,¹⁹ cease and desist orders,²⁰ injunctions, claims for relief and civil penalties,²¹ revocation of license,²² possible declaration that a loan contract is void and that the lender cannot collect or receive any principal, charges or recompense in connection with the transaction (for willful overcharging or other willful violations),²³ forfeit of interest and charges (for overcharges for any reason other than a willful act of the licensee),²⁴ fines of up to \$10,000 and imprisonment in a county jail for up to one year or in the state prison, or by both that fine and imprisonment (for willful violations with knowledge of the rule).²⁵

Purpose of Cal. Fin. Code § 22063

Cal. Fin. Code § 22063 provides that the Finance Lenders Law does not apply to a franchise loan made by a franchisor to a franchisee or subfranchisor, as those terms are

defined in Cal. Fin. Code § 22063. The intent of the California Legislature in creating this exception was expressed in § 2 of Assembly Bill 2921 where the Legislature declared:

The Legislature finds and declares that it is not necessary or appropriate in the public interest or for the protection of borrowers to regulate franchise loans made by franchisors to franchisees or subfranchisors or by subfranchisors to franchisees under the limited circumstances described in Section 16 of this act.²⁶

Franchisors often provide some financing to their franchisees in the form of one or more loans for the purpose of assisting franchisees in the acquisition, construction, operation, development or equipping of a franchised business. They may also make loans to subfranchisors from time to time. This statute makes doing business in California a little bit easier for franchisors that only make franchised loans to franchisees.

Important Definitions

It is important to understand the very specific definitions used in this seemingly simple law because some loans may not qualify for the exemption. The exemption in Cal. Fin. Code § 22063 applies only to a franchise loan made by a franchisor to a franchisee or subfranchisor or a franchise loan made by a subfranchisor to a franchisee.

Franchise loan

A “franchise loan” is defined in Cal. Fin. Code § 22063, subdivision (b)(8) as a commercial loan, as defined in Cal. Fin. Code § 22502, made by a franchisor to a current or prospective franchisee or subfranchisor or a commercial loan by a subfranchisor to a current or prospective franchisee for the acquisition, construction, operation, development, equipping, expansion, contraction, consolidation, merger, recapitalization, reorganization, or termination of a franchised business provided that the following conditions are satisfied:

(A) The franchisor or subfranchisor making the franchise loan shall comply with all applicable federal and state franchise disclosure and registration laws, regulations, rules and orders, including, but not limited to, the California Franchise Investment Law (Division 5 (commencing with *Section 31000*) of *Title 4 of the Corporations Code*) and the Federal Trade Commission Franchise Rule: Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures (Code of Federal Regulations,



Title 16, Chapter 1, Subchapter D, Part 436 (16 CFR 436), as amended) in connection with the offer or sale of any franchise, area franchise, or subfranchise to which the franchise loan relates.

(B) The proceeds of the franchise loan are intended by the borrowing franchisee or subfranchisor for use primarily for other than personal, family, or household purposes.

(C) The loan, if secured, is secured solely by the assets of the franchised business to which the franchise loan relates. Property used by the borrower primarily for personal, family, or household purposes, including the borrower's personal residence, shall not be taken as security for the loan.

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

(E) The lender shall fully and clearly disclose to the borrower, at or before the time the loan is made, the rates of interest, charges, and costs of the loan.

For purposes of determining whether a loan is a franchise loan, a franchisor may rely on any written statement of intended purposes signed by the franchisee.²⁷ The statement may be a separate statement signed by the borrowing franchisee or subfranchisor or may be contained in another document signed by the borrowing franchisee or subfranchisor.²⁸ The franchisor is not required to independently confirm that the proceeds of the loan are used in accordance with the statement of intended purposes.²⁹

Franchisor

A "franchisor" is defined in Cal. Fin. Code § 22063, subdivision (b)(3) as a "franchisor," as defined in *Section 31007 of the Corporations Code*. Cal. Corp. Code § 31007 provides that a "franchisor" is a person who grants a franchise.

Franchisee

An "franchisee" is defined in Cal. Fin. Code § 22063, subdivision (b)(2) as a "franchisee," as defined in *Section 31006 of the Corporations Code*. Cal. Corp. Code § 31006 provides that a "franchisee" is a person to whom a franchise is granted.

Franchise

A “franchise” is defined in Cal. Fin. Code § 22063, subdivision (b)(1) as a “franchise,” as defined in *Section 31005 of the Corporations Code*. Cal. Corp. Code § 31005 provides that a “franchise” means a contract or agreement, either expressed or implied, whether oral or written, between two or more persons by which: (1) a franchisee is granted the right to engage in the business of offering, selling or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor; and (2) the operation of the franchisee’s business pursuant to such plan or system is substantially associated with the franchisor’s trademark, service mark, trade name, logotype, advertising or other commercial symbol designating the franchisor or its affiliate; and (3) the franchisee is required to pay, directly or indirectly, a franchise fee.

Franchised Business

A “franchised business” is defined in Cal. Fin. Code § 22063, subdivision (b)(7) as a business operated pursuant to a franchise or area franchise by a franchisee or pursuant to a franchise, area franchise or subfranchise by a subfranchisor.

Subfranchisor

A “subfranchisor” is defined in Cal. Fin. Code § 22063, subdivision (b)(6) as a “subfranchisor,” as defined in *Section 31009 of the Corporations Code*. Cal. Corp. Code § 31009 provides that a “subfranchisor” is a person to whom a subfranchise is granted.

Subfranchise

A “subfranchise” is defined in Cal. Fin. Code § 22063, subdivision (b)(5) as a “subfranchise,” as defined in *Section 31008.5 of the Corporations Code*. Cal. Corp. Code § 31008.5 provides that a “subfranchise” is any contract or agreement between a franchisor and a subfranchisor whereby the subfranchisor is granted the right, for consideration given in whole or in part for that right, to sell or negotiate the sale of franchises in the name or on behalf of the franchisor.

Area Franchise

An “area franchise” is defined in Cal. Fin. Code § 22063, subdivision (b)(4) as an “area franchise,” as defined in *Section 31008 of the Corporations Code*. Cal. Corp. Code § 31008 provides that an “area franchise” means any franchise between a franchisor and a franchisee whereby the franchisee is granted the right to operate more than one unit within a specified geographical area.

Practice Tips

If a franchisor intends to make a franchise loan to a franchisee or subfranchisor and intends for the loan to be exempt from the requirements of the Finance Lenders Law under the exemption contained in Cal. Fin. Code § 22063, 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 Finance Lenders Law. For example, the exemption will apply only to loans made by a lender who is a “franchisor” and only if the loan itself qualifies as a “franchise loan” and only if the loan is made to a “franchisee” or “subfranchisor” as such terms are defined in the statute.

Franchise Loan Must be a Commercial Loan

Cal. Fin. Code § 22063, subdivision (b)(8) provides that a loan must be a commercial loan to qualify as a “franchise loan.” Cal. Fin. Code § 22502 provides the following definition of “commercial loan”:

“Commercial loan” means a loan of a principal amount of five thousand dollars (\$5,000) or more, or any loan under an open-end credit program, whether secured by either real or personal property, or both, or unsecured, the proceeds of which are intended by the borrower for use primarily for other than personal, family, or household purposes.

It is standard practice for a commercial loan agreement to contain language where the borrower certifies that the proceeds of the loan are intended for business or commercial use and not for personal, family or household purposes. A lender may rely on such

certifications regarding intended purposes by the borrowing franchisee or subfranchisor either in a separate statement or in another document signed by the franchisee or subfranchisor and the lending franchisor is not required to actually confirm that the proceeds of the franchise loan are actually used in accordance with the statement of intended purposes.³⁰

Purpose of Loan

Cal. Fin. Code § 22063, subdivision (b)(8) provides that the loan must be for the acquisition, construction, operation, development, equipping, expansion, contraction, consolidation, merger, recapitalization, reorganization, or termination of a franchised business to qualify as a “franchise loan.” This is typically the case when a franchisor makes a loan to its franchisee. The loan agreement or a separate written statement should contain a certification from the franchisee borrower specifically providing that the proceeds of the loan will be used for these qualified purposes. Again, generally, a lender may rely on such certifications regarding intended purposes and does not need to independently confirm that the proceeds of the franchise loan are actually used in accordance with the statement of intended purposes.³¹

Compliance with Other Franchise Disclosure and Registration Laws

Cal. Fin. Code § 22063, subdivision (b)(8)(A) provides that the franchisor must comply with all applicable federal and state franchise disclosure and registration laws, regulations, rules and orders in connection with the offer or sale of any franchise, area franchise, or subfranchise to which the franchise loan relates in order for the loan to qualify as a “franchise loan.” This requirement is interesting in that it ties the applicability of the exemption of the loan for purposes of the Finance Lenders Law to the franchisor’s compliance with other state and federal laws applicable to the sale of franchises. It would seem that even a small unintentional technical violation of such other laws by the franchisor might result in the loan not qualifying as a “franchise loan” which would mean such a loan might no longer be exempt for purposes of the Finance Lenders Law. This could lead to the result that the lender making a loan to a franchisee might unintentionally be in violation of the Finance Lenders Law if (i) the loan is made by a franchisor who does not have a license in reliance on this exemption, and (ii) if the franchisor fails to fully comply with all other

federal and state franchise laws. Therefore, franchisors who make loans to franchisees in California and intend to use this exemption as justification for not obtaining a license under the Finance Lenders Law should exercise great care to fully comply with all other applicable federal and state franchise disclosure and registration laws, regulations, rules and orders in connection with the offer or sale of any franchise or subfranchise to which the franchise loan relates.

Collateral Restrictions

Cal. Fin. Code § 22063, subdivision (b)(8)(C) provides that the loan, if it is secured, may only be secured by the assets of the franchised business to which the franchise loan relates in order for the loan to qualify as a “franchise loan.” The statute specifically provides that property used by the borrower primarily for personal, family or household purposes, including the borrower’s personal residence, may not be taken as security for a franchise loan.³² Although not stated specifically in the second sentence of Cal. Fin. Code § 22063, subdivision (b)(8)(C), the general requirement that only assets of the franchised business may be collateral for a franchise loan would also prohibit a franchisor from taking as collateral for a franchise loan any property used by a guarantor primarily for personal, family or household purposes, such as a guarantor’s personal residence.

Covenant of Good Faith and Fair Dealing

Cal. Fin. Code § 22063, subdivision (b)(8)(D) provides that a franchise loan is subject to the implied covenant of good faith and fair dealing under Cal. Civ. Code § 1655. Even though a franchisor is not required to obtain a license under the Finance Lenders Law if it only makes franchise loans to franchisees, a franchisor should be aware of the implied covenant of good faith and fair dealing that will arise under California Civil Code § 1655 with respect to all franchise loans.

Disclosure Requirements

Cal. Fin. Code § 22063, subdivision (b)(8)(D) provides that the lender must fully and clearly disclose to the borrower, at or before the time the loan is made, the rates of interest, charges, and costs of the loan in order for the loan to qualify as a “franchise loan”

Generally, such information should be set forth in the loan agreement and/or the promissory note for any loan that the franchisor intends to qualify as a franchise loan.

Franchise Loans Still Subject to Other California Laws Designed to Protect Borrowers

Cal. Fin. Code § 22063, subdivision (d) makes it clear that nothing in Cal. Fin. Code § 22063 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. It is beyond the scope of this article to discuss all of the other laws designed to protect borrowers, but note the following important issues.

Franchisor May Still Need a California Finance Lenders License if it Makes Other Non-Exempt Loans

It is important to remember that only franchise loans made by a franchisor to a franchisee have been exempted from the coverage of the Finance Lenders Law. If a franchisor only makes qualified franchise loans to franchisees as described in Cal. Fin. Code § 22063 and makes no other loans, the franchisor should not need to obtain a license under the Finance Lenders Law. However, it is important to remember that the franchise loans have been exempted from the coverage of the Finance Lenders Law — not the franchisor itself for any other loans it makes in California. Therefore, if a franchisor makes some loans that qualify as franchise loans to franchisees and subfranchisors in California that would be exempt from the Finance Lenders Law under Cal. Fin. Code § 22063 and also makes more than five loans in California to franchisees, subfranchisors or others in any 12-month period that would not qualify for this exemption or any other exemption under the Finance Lenders Law, the franchisor will be required to comply with the Finance Lenders Law and obtain a license.

Usury

California's usury law is contained in the California Constitution, art. XV, § 1. For lenders making commercial loans that are not licensed or otherwise exempt from the usury limitations, the interest rate which may be charged on a loan or forbearance may not exceed

the higher of 10% or 5% per annum plus the rate prevailing on the 25th 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 § 13 and 13a of the Federal Reserve Act.³³ However, loans made by lenders licensed under the Finance Lenders Law are exempt from California's usury limitations so licensed lenders may make commercial loans for any interest rate agreed by the parties.³⁴ This is a strong incentive for any lender making loans in California to obtain a license if the marketplace will allow higher interest rates for the types of loans made by the lender than would be allowed by California's usury law. Therefore, while the Finance Lenders Law is not applicable to a franchise loan made by a franchisor to a franchisee or subfranchisor, such loan will still be subject to California's usury law unless the franchisor obtains a license under the Finance Lenders Law or another exemption to California's usury law is applicable. Therefore, a franchisor will still need to make sure that its franchise loans and any other loans it makes comply with California's usury law.

Conclusion

Cal. Fin. Code § 22063 has exempted franchise loans made by a franchisor to a franchisee on or after September 10, 2004 from the requirements of the Finance Lenders Law. This exemption will allow a franchisor to make a franchise loan to a franchisee without going through all of the procedures to obtain and maintain a license under the Finance Lenders Law or risk violating the Finance Lenders Law if it does not obtain a license. However, to make sure a loan qualifies for the exemption, it is important for the franchisor to make sure that the proposed loan qualifies as a franchise loan. It is also important for a franchisor making loans in California to review other applicable California law designed to protect borrowers to make sure that the franchisor and all of its loans are in full compliance with California law.

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³ Stats 2004 ch 458 (AB 2921).

⁴ Cal. Fin. Code § 22000, et seq.

⁵ Cal. Fin. Code § 22063, subdivision (a).

⁶ Cal. Fin. Code § 22100, et seq.

⁷ Cal. Fin. Code § 22009.

⁸ Cal. Fin. Code § 22050, subdivision (e)

⁹ The California Finance Lenders Law 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)] (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)] (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)] (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)] (v) to any person who makes five or fewer loans in a 12-month period, these loans are commercial loans as defined in Section 22502, and the loans are incidental to the business of the person relying upon the exemption [Cal. Fin. Code § 22050, subdivision (e)]; (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)] (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)] (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)] (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)] (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)] (xi) any loan of credit made by a person not licensed under the California Finance Lenders Law pursuant to a plan involving credit cards having certain characteristics, [See Cal. Fin. Code § 22052] (xii) bona fide conditional contracts of sale which are discussed in more detail in this article, [See Cal. Fin. Code § 22054] (xiii) “premium financing as defined in Cal. Fin. Code § 18563,” [Cal. Fin. Code § 22055] (xiv) “the Department of Commerce or the California Integrated Waste Management Board,” [Cal. Fin. Code § 22056] (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] (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] (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] and (xviii) “any nonprofit church extension fund,” [Cal. Fin. Code § 22061]; (xix) a commercial bridge loan made buy a venture capital company to an operating company on or after January 1, 2004, [Cal. Fin. Code § 22062]; (xx) a franchise loan made by a franchisor to a franchisee on or after September 10, 2004,” [Cal. Fin. Code § 22063]; (xxi) a program-related investments defined in subsection (c) of Section 4944 of the Internal Revenue Code and United States Treasury Regulations Section 53.4944-3 that is made by a private foundation, tax-exempt organization within the meaning of Section 509(a) of the Internal Revenue Code and loans, guaranties or investments made by a public charity, tax-exempt organization within the meaning of paragraph (1), (2), or (3) of subsection (a) of Section 509 of the Internal Revenue Code that meets certain requirements [Cal. Fin. Code § 22064, subdivision (a)]; and (xxii) insurance companies operating under a certificate of authority issued under the provisions of Article 3 of the Insurance Code are exempt from California Finance Lenders Law licensing requirements. [See Cal. Ins. Code § 1100.1]

¹⁰ Cal. Fin. Code § 22105.

¹¹ Cal. Fin. Code § 22104.

¹² Cal. Fin. Code § 22105.

¹³ Cal. Fin. Code § 22159.

¹⁴ Cal. Fin. Code § 22107.

¹⁵ Cal. Fin. Code § 22104.

¹⁶ Cal. Fin. Code § 22112.

¹⁷ Cal. Fin. Code § 22156, § 22157, § 22158.

¹⁸ Cal. Fin. Code § 22710, § 22714, § 22715.

¹⁹ Cal. Fin. Code § 22711.

²⁰ Cal. Fin. Code § 22712.

²¹ Cal. Fin. Code § 22713.

²² Cal. Fin. Code § 22710, § 22714, § 22715.

²³ Cal. Fin. Code § 22750.

²⁴ Cal. Fin. Code § 22751.

²⁵ Cal. Fin. Code § 22753 and § 22780.

²⁶ Stats 2004 ch 458 § 2 (AB 2921).

²⁷ Cal. Fin. Code § 22063, subdivision (c).

²⁸ Cal. Fin. Code § 22063, subdivision (c).

²⁹ Cal. Fin. Code § 22063, subdivision (c).

³⁰ Cal. Fin. Code § 22063, subdivision (c).

³¹ Cal. Fin. Code § 22063, subdivision (c).

³² Cal. Fin. Code § 22063, subdivision (b)(8)(C).

³³ California Constitution, art. XV, § 1.

³⁴ Cal. Fin. Code § 22002.