COMMERCIAL BRIDGE LOANS MADE BY VENTURE CAPITAL COMPANIES TO OPERATING COMPANIES ARE EXEMPT FROM CALIFORNIA FINANCE LENDERS LAW

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In 2003, the California legislature passed Assembly Bill 169 that added § 22062 to the California Finance Lenders Law (the “Finance Lenders Law”). The new Cal. Fin. Code § 22062 essentially provides that the Finance Lenders Law does not apply to a commercial bridge loan made by a venture capital company to an operating company on or after January 1, 2004.

Regulation of 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. A “finance lender” is any person or entity engaged in the business of making consumer loans or commercial loans in California. While there are exemptions in the Finance Lenders Law for any person who makes five or fewer loans in a 12-month period that are commercial loans as defined in Section 22502 and such loans are incidental to the business of the person relying upon the exemption, for certain institutional lenders and for certain other particular types of loans, prior to the passage of Assembly Bill 169, a venture capital company making more...
than one commercial bridge loan in a 12-month period was usually not eligible for such exemptions and was required to obtain a license under the Finance Lenders Law to be in full compliance with California law.

To obtain a license under the Finance Lenders Law, finance lenders must submit an application to the California Department of Corporations and allow the Department of Business Oversight 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

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 by 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]

comply with all of the regulatory requirements of the Finance Lenders Law which include filing an annual report\(^{11}\) along with an annual assessment fee,\(^{12}\) complying with minimum net worth requirements,\(^{13}\) maintaining a surety bond\(^{14}\) and complying with strict recordkeeping requirements.\(^{15}\)

There are significant penalties for finance lenders making loans in California without complying with the Finance Lenders Law including suspension of license,\(^{16}\) surrender of license,\(^{17}\) cease and desist orders,\(^{18}\) injunctions, claims for relief and civil penalties,\(^{19}\) termination of license,\(^{20}\) 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 violations involving consumer loans),\(^{21}\) forfeit of interest and charges (for violations not resulting from willful act of licensee),\(^{22}\) fines of not more than $10,000 and imprisonment in a county jail for not more than one year or in the state prison, or by both that fine and imprisonment (for knowing willful violations involving consumer or commercial loans).\(^{23}\)

**Purpose of the New Law**

New Cal. Fin. Code § 22062 makes it clear that the Finance Lenders Law does not apply to a commercial bridge loan made by a venture capital company to an operating company, as those terms are defined in the new law.\(^{24}\) The intent of the California Legislature in creating this new exception is expressed in § 2 of Assembly Bill 169 where the Legislature declared:

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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 § 1 of this Act.\textsuperscript{25}

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 loan 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 Cal. Fin. Code § 22062, there were few, if any, exemptions from the licensing requirements of the Finance Lenders Law that would be applicable to a venture capital company making a commercial bridge loan. Therefore, to be in full compliance with California law, venture capital companies were required to obtain a license under the Finance Lenders Law when they made more than one commercial bridge loan to operating companies in a 12-month period.

\textbf{Important Definitions}

It is important to understand the very specific definitions used in this seemingly simple new law because some loans may not qualify for the new exemption. It is important to remember that the exemption in Cal. Fin. Code § 22062 applies only to a commercial bridge loan made by a venture capital company to an operating company.\textsuperscript{26}

\textbf{Commercial Bridge Loan}

A “commercial bridge loan” is defined as a loan that meets ALL of the following criteria:

\textsuperscript{25} Stats 2003 ch 163 § 2 (AB 169).
\textsuperscript{26} Cal. Fin. Code § 22062, subdivision (a).
(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 § 1655 of the Civil Code.27

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.28 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.29 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.30

Venture Capital Company

A “venture capital company” is defined as a person other than an individual or sole proprietorship that meets ALL of the following:

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28 Cal. Fin. Code § 22062, subdivision (c).
29 Cal. Fin. Code § 22062, subdivision (c).
(A) Engages primarily in the business of promoting economic, business, or industrial development through venture capital investments\(^{31}\) 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.\(^{32}\)

Operating Company

An “operating company” is defined as 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.

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\(^{31}\) A “venture capital investment,” for purposes of the definition of a venture capital company, is defined in Cal. Fin. Code § 22062, subdivision (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.

\(^{32}\) Cal. Fin. Code § 22062, subdivision (b)(1).
(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.33

**Practice Tips**

If a lender intends to make a commercial bridge loan to a borrower and intends for the bridge loan to be exempt from the requirements of the Finance Lenders Law under the new exemption contained in Cal. Fin. Code § 22062, 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 not apply to loans made by a lender who does not qualify as a “venture capital company” 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.34

First, a lender must carefully review the requirements in Cal. Fin. Code § 22062(b)(1) to make sure that the lender meets ALL of the applicable criteria to be considered a “venture capital company.”35 Note in particular that an individual or sole proprietorship may not be a venture capital company for purposes of this exemption.36 Also, to qualify as a venture capital company, the primary

34 Cal. Fin. Code § 22062, subdivision (a).
business of the lender must be in the business of 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 or commitments to make venture capital investments, and maintain a
material equity interest in the operating company, the venture capital company’s board of
directors, executive committee or similar policy body is required 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, and the lender
must comply, when making the loan with all applicable federal and state securities laws. Therefore, the venture capital company should carefully document in writing, perhaps in the recitals
to its own board or committee resolutions, a description of (i) the lender’s own primary business of
promoting economic, business or industrial development by making venture capital investments and
providing financial or management assistance to operating companies, (ii) the lender’s existing
equity interest in the operating company or the equity interest to be obtained by the lender in
connection with the commercial bridge loan, (iii) the lender’s analysis of the operating company and
the proposed loan and why the board believes the loan is appropriate for the operating company,
(iv) the due diligence performed by the venture capital company concerning the operating company’s
financing objectives and financial situation, and (v) the applicability of the Federal and applicable
state securities laws to the loan and either what exemptions are applicable or what steps have been
taken to comply with such laws.

Assuming the lender qualifies as a venture capital company, the lender must also make sure
that the loan will be made to an “operating company” as such term is defined in the new law. The

venture capital company should perform reasonable due diligence concerning the borrower to make the determination that the borrower meets the qualifications of an operating company. To be an operating company, the borrower must be primarily engaged, 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. 42 An operating company cannot be an individual or a sole proprietorship 43 and it must have a specific business plan that does not involve a merger or acquisition with an unidentified company or companies or another entity or person. 44 These requirements can be confirmed by the venture capital company's due diligence investigation of the borrower. The proceeds of the bridge loan must be used for the operations of the operating company's business 45 so the loan agreement or promissory note should contain a provision restricting the use of the loan proceeds to that permissible purpose. The borrower's board of directors, executive committee or similar policy body, in the exercise of its fiduciary duty, must approve the loan based on its reasonable belief that the loan is appropriate for the operating company after reasonable inquiry concerning the borrower's financing objectives and financial situation. 46 As a condition to making the loan, the lender should require the borrower to provide to the lender a certified board resolution from the borrower's board of directors, executive committee or similar policy board, stating that such board or committee has determined in the exercise of its fiduciary duty and based upon reasonable belief that the loan is appropriate for the borrower after reasonable inquiry concerning the borrower's financing objectives and financial situation.

Even if the loan is to be made by a venture capital company to an operating company, the exemption contained in Cal. Fin. Code § 22062 will only apply to the loan if the venture capital

company makes a “commercial bridge loan” to the operating company. To qualify as a “commercial bridge loan,” a loan must be in a principal amount over $5,000, must not be any loan under an open-end credit program, 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 can be secured by personal property or unsecured and if it is secured, it can only be secured by the borrower’s business assets, exclusive of any real property. Therefore, the lender should make sure that only business assets and no real property are taken as collateral for the loan. The loan must not have a maturity date exceeding one year and must be made in connection with or in bona fide contemplation of an equity investment in the operating company. It is recommended that the board resolutions for the borrower 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.

Commercial Bridge Loans Still Subject to Other California Laws Designed to Protect Borrowers

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. 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.

Venture Capital Company May Still Need a California Finance Lenders License 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 Finance Lenders Law. If a venture capital company only makes commercial bridge loans to operating companies as described in Cal. Fin. Code § 22062 and makes no other loans, the venture capital company should not need to obtain a license under the Finance Lenders Law. However, it is important to remember that the commercial bridge loans have been exempted from the coverage of the Finance Lenders Law - not the venture capital company itself for any other loans it makes in California. Therefore, if a venture capital company makes some loans that qualify as commercial bridge loans to operating companies that would be exempt from the Finance Lenders Law under Cal. Fin. Code § 22062 and also makes more than one loan in California that would not qualify for the new exemption or any other exemption, the venture capital company 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. 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.52 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 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. 53

Therefore, while the Finance Lenders Law is not applicable to a commercial bridge loan made by a venture capital company to an operating company, such loan will still be subject to California’s usury law unless the venture capital company obtains a license under the Finance Lenders Law or another exemption to California’s usury law is applicable. Therefore, a venture capital company will still need to make sure that its commercial bridge loans and any other loans it makes comply with California’s usury law.

**Implied Covenant of Good Faith and Fair Dealing**

Commercial bridge loans are subject to the implied covenant of good faith and fair dealing under California Civil Code § 1655. 54 In every contract there is implied covenant that neither party shall do anything that will have effect of destroying or injuring other party’s right to receive fruits of contract, that is, implied covenant of good faith and fair dealing. 55 Therefore, even though a venture capital company is not required to obtain a license under the Finance Lenders law if it only makes commercial bridge loans to operating companies, a venture capital company 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 commercial bridge loans.

**Conclusion**

The new Cal. Fin. Code § 22062 exempts commercial bridge loans made by a venture capital company to an operating company on or after January 1, 2004 from the requirements of the Finance Lenders Law. This new exemption will allow a venture capital company to make a commercial bridge loan to an operating company 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

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53 California Constitution, art. XV, § 1.
a license. However, it is important for the venture capital company to make sure that (i) it qualifies as a venture capital company,\textsuperscript{56} (ii) the proposed loan qualifies as a commercial bridge loan,\textsuperscript{57} and (iii) the proposed borrower qualifies as an operating company.\textsuperscript{58} It is also important for a venture capital company making loans in California to review other applicable California law designed to protect borrowers to make sure that the venture capital company and all of its loans are in full compliance with California law.

\textsuperscript{56} Cal. Fin. Code § 22062, subdivision (b)(1).
\textsuperscript{57} Cal. Fin. Code § 22062, subdivision (b)(3).
\textsuperscript{58} Cal. Fin. Code § 22062, subdivision (b)(2).