

Morgan Lewis

VENTURE CAPITAL & PRIVATE EQUITY FUNDS DESKBOOK SERIES

The California Finance Lender Law: Venture Capital Bridge Loan Exemption and General Licensing Requirements

The California Finance Lender Law has long since required that a person “engaged in the business of a finance lender or broker” in California be licensed as a Finance Lender unless otherwise exempt. Venture capital funds historically concluded that periodically making bridge loans to portfolio companies to “bridge” them for a relatively short period of time until the next round of equity financing did not require a lender license because (1) persons making no more than one loan in any twelve-month period were specifically exempt or (2) bridge loans generally were made in contemplation of the conversion of principal and interest into equity and not repayment and therefore did not constitute engaging “in the business of a finance lender or broker.”

But after the Internet bubble burst, when raising follow-on equity rounds became increasingly difficult for companies, venture capital funds became concerned about the licensing requirement as bridge loans became increasingly necessary and began to contain terms, such as longer maturity periods and security interests, that were necessary to address the current market situation and to protect their additional investment, but that more closely resembled the terms of more traditional commercial loans. In response to the concerns of venture capital funds, the California legislature enacted a safe harbor from the licensing requirement for certain types of bridge loans made by venture capital funds to their portfolio companies, which are more fully described below. The exemption is useful for traditional venture capital bridge loans, but, given the ever-changing investment landscape, venture capital funds often find that they are interested in making loans that do not satisfy all of the requirements of the venture capital commercial bridge loan exemption and must consider licensing as a lender. The following describes both the exemption and the licensing requirements if the exemption will not be available given a fund’s particular investment strategy.

Commercial Bridge Loan Exemption

A venture capital fund is exempt from the licensing requirements of the California Finance Lender Law if it qualifies as a “Venture Capital Company” and makes only “Commercial Bridge Loans” to “Operating Companies” (as defined below).

To qualify as a Venture Capital Company a fund must do the following:

- (1) Engage primarily in the business of promoting economic, business, or industrial development through “Venture Capital Investments,” defined as the provision of financial or management assistance to operating companies.
- (2) At all times maintain at least 50% of its assets in Venture Capital Investments or commitments to make Venture Capital Investments and, assuming consummation of the equity investment to which the Commercial Bridge Loan relates, maintain an equity interest in the Operating Company.

- (3) Approve each loan made to an Operating Company through the Venture Capital Company's board of directors, executive committee, or similar policy body, based on a reasonable belief that the loan is appropriate for the Operating Company after reasonable inquiry concerning the Operating Company's financing objectives and financial situation.
- (4) Comply, when making the loan, with all applicable federal and state laws and rules or orders governing securities transactions.

For purposes of the exemption, a "Venture Capital Investment" is defined as the acquisition of securities in Operating Companies in which a person, an investment advisor of the person, or an affiliated person of either has or obtains "Management Rights." While Management Rights is not specifically defined in the exemption, it is generally understood to mean the right, obtained contractually or through ownership of securities, to substantially participate in, to substantially influence the conduct of, or to provide or offer to provide significant guidance and counsel concerning the management, operations, or business objectives of an Operating Company in which a Venture Capital Investment is made.¹

A Commercial Bridge Loan is defined as any loan that (1) has a principal amount of \$5,000 or more; (2) the proceeds of which are intended to be used by the borrower other than for personal, family, or household purposes; (3) matures in one year or less; (4) is made in connection with, or in contemplation of, an equity investment in the borrower; (5) is secured, if at all, solely by the borrower's business assets (but not by real property); and (6) is subject to the implied covenant of good faith and fair dealing arising under Section 1655 of the California Civil Code.

A borrower constitutes an "Operating Company" for purposes of the safe harbor if it does all of the following:

- (1) Engages (directly or through subsidiaries) in the production or sale, or the research or development, of a product or service other than the management or investment of capital.
- (2) Uses all of the bridge loan proceeds for the operations of its business.
- (3) Approves the bridge loan through its board of directors, executive committee, or similar policy board, based on a reasonable belief that the loan is appropriate for the borrower after reasonable inquiry concerning the borrower's financing objectives and financial situation.

Given that some technical requirements of the safe harbor are beyond the fund's control, appropriate due diligence should be conducted by the lender or fund manager and care should be taken to obtain specific representations or provisions to ensure or to evidence compliance. For example, the bridge loan should include representations of the borrower (1) with respect to its intent to use the proceeds for the operations of its business and (2) that the borrower's board of directors has approved the bridge loan agreements upon a reasonable belief that the loan is appropriate for the borrower after reasonable inquiry concerning the borrower's financial objectives and financial situation. Similarly, the bridge loan agreements should be explicitly subject to the California "good faith and fair dealing" statute.

Reasons for Obtaining a License

1. This definition is based on California law and is a departure from the meaning of written contract "Management Rights" pursuant to Department of Labor Regulation 29 C.F.R. § 2510.3-101(d) (2009) regarding a fund qualifying as a venture capital operating company under the Employee Retirement Income Security Act of 1974 (ERISA).

As noted above, the exemption relates to specific types of traditional convertible bridge loans and therefore may not always suit a fund's needs. Funds or fund managers may desire to secure loans with the real property of portfolio companies or to make loans directly to their own principals and employees or to the founders of their portfolio companies. They may not want to offer their portfolio companies commercial loans that do not contain a convertible feature or that may contain terms otherwise considered usurious.² For some funds, these desires may outweigh the cost and expense of obtaining and maintaining a California lender license.

Obtaining a License—Process and Structure

Applicant Requirements and Application Process

Each applicant is required to have a minimum net worth of \$25,000 and to have obtained a surety bond in the amount of \$25,000. A licensee is required to maintain the minimum net worth and the surety bond for as long as it is licensed. The lender license application itself is relatively lengthy and requires detailed information about the business and financials of the applicant. Generally, principals in the licensee may not have a criminal record or a history of noncompliance with regulatory requirements.

Personal Information Requirement of Application

The application requires not only information about the entity seeking the lender license and its general partner/manager, but also confidential information about each individual manager of the management company, anyone with direct involvement in the applicant's proposed activities under the lender license (e.g., officers such as the chief financial officer or chief operating officer), any person "in charge" of the applicant's place of business, and any person that owns or controls, directly or indirectly, 10% or more of the applicant. The Statement of Identity and Questionnaire required to be completed by such individuals requires the following personal confidential information:

- Current and former addresses
- Current and former employment information
- Social security number
- Descriptive information (height, weight, hair and eye color)
- Misdemeanor or felony convictions
- Civil litigation other than divorce, condemnation, or personal injury
- Bankruptcy proceedings

This information may be freely shared with other state and federal agencies if relevant and necessary to accomplish a lawful purpose. For example, this information is used to investigate an individual's background and qualifications prior to issuing a lender license; to conduct a background check by state, federal, or local law enforcement; or in response to requests by child support agencies.

The California Public Records Act requires disclosure of public records, such as the Statements of Identity and Questionnaire, if they are not deemed confidential. A California Department of Corporations Release indicates that before disclosing any personal information under the law, the Department determines whether the information should be disclosed or maintained in confidence. While the Release specifically provides that social security numbers will be blacked out prior to any public inspection, no such representation is made with respect to other confidential information. Note, however, that the application specifically states that a request for confidentiality of certain documents may be made. In connection with a previous application and in response to our formal request that Statements of Identity and Questionnaire be maintained under seal, the Department has indicated that the Statement of Identity and Questionnaire is "confidential" and not subject to public inspection.

2. Obtaining a license also exempts the licensee from the usury provision of the California Constitution.

In addition, each individual required to provide such information must also submit fingerprints for the purpose of conducting a criminal background check.

Structure of Licensed Lender

In order to accommodate a fund manager with multiple funds, any one of which may desire to make loans outside the scope of the exemption and determine it needs to obtain a lender's license, we typically suggest that fund managers form a new limited partnership to act as the licensed lender. We believe this can reduce the administrative costs of separately licensing each managed fund. The fund manager acts as the general partner and provides an initially required capitalization of \$25,000. Managed funds will become limited partners in the new vehicle and will subscribe to various "series" of interests in order to fund loans to each fund's own portfolio companies.

Formation and Application Fees and Expenses

The license application fee itself is \$300. Additional expenses will be incurred with respect to forming and structuring the limited partnership, adequately capitalizing the limited partnership initially, obtaining a required surety bond, obtaining a letter of credit in support of the surety bond, and legal fees, which, depending on the extent of comments or additional requests by the Department of Corporations in response to the initial application, can be significant.

Ongoing Information and Audit Requirements

Licensees are subject to statutory books and records requirements and an annual assessment of \$250, and must submit an annual report that requires information similar to that required in the application itself. Most significantly, licensees are subject to periodic regulatory inspections and examinations at the licensee's expense. The scope and potential expense of such an audit is unclear.

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For more information on the issues discussed here, please contact your Morgan Lewis [Private Investment Funds Practice](#) attorney.

About Morgan Lewis's Private Investment Funds Practice

Morgan Lewis has one of the nation's largest private investment fund practices and is ranked as "#1 Most Active Law Firm" in the U.S. based on the number of funds worked on for general and limited partners by *Dow Jones Private Equity Analyst* (2011).

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