

Reminder: Bridge Loans and the California Finance Lenders Law (AB 169)

As a reminder, please note that recent amendments to the California Finance Lenders Law (“CFLL”) could impact the manner in which venture capital or private equity funds make bridge loans to portfolio companies in the future.¹ Effective January 1, 2004, if a fund makes multiple short-term commercial bridge loans to portfolio companies during a 12-month period, the fund will not be required to obtain a lender’s license from the California Department of Corporations as long as the fund qualifies as a **venture capital company** and makes **commercial bridge loans** solely to **operating companies**.

To qualify as a **venture capital company** under the new legislation, a fund must:

- ▶ make **venture capital investments** (i.e., investments in which operating companies grant **management rights** to a fund) or provide assistance to operating companies;
- ▶ maintain at least **50 percent** of its assets in venture capital investments at all times;
- ▶ maintain a **material equity interest** in the operating company before, or after, the consummation of the equity investment to which the loan relates;
- ▶ reasonably approve, and comply with all securities laws when making, each such loan.

Each **commercial bridge loan** must be:

- ▶ **greater than \$5,000**, with a maturity date of **less than 1-year**;
- ▶ made in contemplation of an equity investment in the operating company, and intended for **business purposes** other than personal, family or household purposes;

- ▶ **unsecured** (or secured solely by business assets other than real property); and
- ▶ subject to the **implied covenant** of good faith and fair dealing under California law.

Each **operating company** receiving a commercial bridge loan must:

- ▶ primarily engage, directly or indirectly, in the production, sale, research, or development of a **product or service** (other than management or investment of capital);
- ▶ use the loan proceeds for **business purposes**; and
- ▶ obtain **board approval** of the loan based on the reasonable belief that the loan is appropriate for the operating company.

While many key terms under the legislation have not been defined, we anticipate that each fund will qualify as a **venture capital company** with sufficient **management rights** if:

- (i) the fund qualifies as a venture capital operating company (or “VCOC”) under ERISA;² or
- (ii) the fund invests at least 50 percent of its assets (other than short-term investments), valued at cost, in the securities of operating companies in which the fund or its general partner has obtained the right to substantially participate in, influence, or guide management or operations.³

If a fund qualifies as a venture capital company and will make multiple commercial bridge loans within a 12-month period, the legislation suggests that it may be appropriate for an operating company to make written representations that proceeds of the loan

are “intended for use primarily for other than personal, family or household purposes.” In certain circumstances, it may also be appropriate for an operating company to represent that the loan (i) is subject to the implied covenant of good faith and fair dealing under Civil Code Section 1655, and (ii) has been approved by the company’s board of directors “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.”

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This information is a general description of the law and is not intended to provide specific legal advice.

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We anticipate that updates will be distributed once additional information regarding the new legislation is available. If you have any questions, please contact your Venture Capital attorney at Cooley Godward LLP. ■

Notes

¹ A copy of relevant CFLL provisions (including the recent legislation) are included in the Appendix.

² Employee Retirement Income Security Act of 1974, as amended; see, 29 C.F.R. §§ 2510.3-101(c), 2510.3-101(d).

³ See, 10 C.C.R. § 260.204.9.

Appendix: Excerpts

California Finance Lenders Law

§ 22000. This division is known and may be cited as the “California Finance Lenders Law.”

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§ 22002. To accomplish its underlying purposes and policies, this division creates a class of exempt persons pursuant to Section 1 of Article XV of the California Constitution...

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§ 22050. (a) This division does not apply to any person doing business under any law of this state or of the United States relating to banks, trust companies, savings and loan associations, insurance premium finance agencies, credit unions, small business investment companies, California business and industrial development corporations, or licensed pawnbrokers.

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(e) This division does not apply to 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 Section 22502.

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Chapter 163, A.B. No. 169

Financial Institutions Commercial Bridge Loans Venture Capital Companies

AN ACT to add Section 22062 to the Financial Code, relating to finance lending. [Filed with Secretary of State August 2, 2003.] The people of the State of California do enact as

follows: SECTION 1. Section 22062 is added to the Financial Code, to read:

§ 22062. (a) This division does not apply to a commercial bridge loan made by a venture capital company to an operating company.

(b) For purposes of this section:

(1) “Venture capital company” means a person other than an individual or sole proprietorship that meets all of the following:

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

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

(C) Approves each loan made to an operating company through the venture capital company’s board of directors, executive committee, or similar policy body, based on a reasonable belief that the loan is appropriate for the 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.

(2) “Operating company” means a person that meets all of the following:

(A) Primarily engages, wholly or substantially, directly or indirectly through a majority owned subsidiary or subsidiaries, in the production or sale, or the research or development, of a product or service other than the management or investment of capital. This shall not include any of the following:

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

(ii) A person that has no specific business plan or purpose or has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or companies or other entity or person.

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

(C) Approves each commercial bridge loan through its board of directors, executive committee, or similar policy board, in the exercise of its fiduciary duty, based on a reasonable belief that the loan is appropriate for the operating company after reasonable inquiry concerning the operating company’s financing objectives and financial situation.

(3) “Commercial bridge loan” means a loan that meets all of the following criteria:

(A) 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 personal property or unsecured, the proceeds of which are intended by the operating company for use primarily for other than personal, family, or household purposes.

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

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

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

(4) For purposes of paragraph (1), “venture capital investment” is an acquisition of securities in an operating company that a person, an investment adviser of the person, or an affiliated person of either, has or obtains management rights to.

(c) For purposes of paragraph (3) of subdivision (b), for the purposes of determining whether a loan is a commercial bridge loan, a venture capital company may rely on any

written statement of intended purposes signed by the operating company. The statement may be a separate statement signed by the operating company or may be contained in another document signed by the operating company, but in each case it shall be approved by its board of directors, executive committee, or similar policy body. The venture capital company may not be required to ascertain that the proceeds of the loan are used in accordance with the statement of intended purposes.

(d) For purposes of subparagraph (A) of paragraph (3) of subdivision (b), the principles set forth in Section 22551 shall be used to determine whether the specified amount of a commercial bridge loan is a bona fide principal amount.

(e) This section shall apply only to a commercial bridge loan made by a venture capital company to an operating company on or after January 1, 2004.

(f) Nothing in this section 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.

SEC. 2. The Legislature finds and declares it is not necessary or appropriate in the public interest or for the protection of borrowers to regulate commercial bridge loans made by venture capital companies to operating companies under the limited circumstances described in Section 1 of this act.