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Dissecting a Lender Finance Transaction

By Valerie L. Gerard, George Lehnertz, and Patricia Voorhees

In the aftermath of the Great Recession, new entrants — alternative, or nonbank, lenders in such areas as financial-technology, venture capital, private equity, and even insurance — are providing more funding options for equipment lessors. Independent lessors stand to gain because of their nimble yet disciplined approach to origination and portfolio management.

Problems and Issues for Brokers, Lenders and Referral Sources Under the California Finance Lenders Law

By Andrew K. Alper

The California Finance Lenders Law governs what brokers and referral sources may or may not do when brokering or referring commercial loans. The most recent revision, however, is causing confusion for various parties including lenders. Equipment leasing and finance organizations are seeking guidance from the state's Department of Business Oversight. Most likely, these groups also will be working to amend this law.

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The California Finance Lenders Law governs what brokers and referral sources may or may not do when brokering or referring commercial loans. The most recent revision, however, is causing confusion for various parties including lenders. Equipment leasing and finance organizations are seeking guidance from the state's Department of Business Oversight. Most likely, these groups also will be working to amend this law.

The California Finance Lenders Law (CFLL)[1] exists in the state of California for the purpose of ensuring an adequate supply of credit to borrowers; to simplify, clarify and modernize the law governing loans in California; to foster competition among finance lenders in California; to protect borrowers against unfair practices by lenders; to permit and encourage the development of fair and economically sound lending practices; and to encourage and foster a sound economic climate in California.[2]

Although generally the law regarding the CFLL is in the California Financial Code, the Department of Business Oversight (DBO), which administers and enforces the CFLL, also has regulations known as the California Code of Regulations (CCR) which must be followed.[3] When a lender makes a loan or enters into a forbearance of a loan in California, lenders must be aware of the fact that for any written business loan, the rate of interest may not exceed the higher of (a) 10% or (b) 5% plus the rate prevailing on the 25th day of the month preceding the earlier of (1) the date of execution of the contract to make the loan or forbearance, or (2) the date of making the loan or forbearance established by the Federal Reserve Bank of San Francisco on advances to member banks under sections 13 and 13a of the Federal Reserve Act as now in effect or hereafter from time to time amended.[4] Loans or forbearances in excess of that rate are usurious.

With the foregoing as background, this article will focus on new developments in the CFLL that govern what brokers and referral sources are faced with in brokering or referring commercial loans in California. The article will not discuss loans made in California that primarily are secured by real property, because there are different laws when it comes to such loans.

Any person engaged in the business of making consumer or commercial loans must be licensed in California.[5] Generally, a consumer loan is a loan in which the proceeds are intended by the borrower for use primarily for personal, family, or household purposes. For purposes of determining whether the loan is a consumer loan, the lender may rely on any written statement of intended purposes signed by the borrower, and the lender is not required to ascertain if the proceeds of the loan are used in accordance with the statement of intended purposes.

However, any commercial loan of less than $5,000 is also defined to be a consumer loan.[6] Although obtaining a California Finance Lender's License (lender's license) exempts a lender from California's usury law,[7] the fact that a loan is exempt from usury does not eliminate the requirement of a lender to have a lender's license. Each branch office must have a separate lender's license.[8]

Certain lenders are exempt from having a lender's license. For example, any person making five or fewer commercial loans in a 12-month period, as long as the loans are incidental to the business of the person relying on the exemption, is an exempt lender.

Unfortunately, the legislative history of the California Financial Code does not discuss in any detail what "incidental" means. Therefore, what is or is not incidental at this point

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is open to interpretation. Banks and savings and loans are exempt from both California usury law and the requirements of the CFLL law. Bank subsidiaries are also exempt if the subsidiary is making commercial loans.[9] Loans made by a franchisor to a franchisee would not apply to wholesale lending arms of franchisors and are exempt.

Conditional sales contracts are also exempt from the CFLL.[10] If a loan when originally made does not violate the provisions of the CFLL, CCRs or California's usury law, a successor or assignee of the lender is also protected either because of the exemption, because the transaction is not subject to the CFLL, or because it is not usurious. However, the assignment cannot be a sham transaction in an attempt to evade the California usury law.[11] Of course, true leases are not subject to the requirements of the CFLL because they are neither a loan nor a forbearance of money, nor are true leases subject to California usury law.[12]

In the event that a lender is not licensed under the CFLL, the consequences include injunctions and civil penalties as well as the surrender of a lender's license (which is interesting because if the broker or lender never had a lender's license, how could it be surrendered?). If the violation is willful, punishment would be in the form of a fine of not more than $10,000, or by imprisonment in a county jail for not more than one year, or by both the fine and imprisonment.[13] There are also special penalties in connection with consumer loans. Unlike commercial contracts, which cannot be declared void in the event of a violation, if the loan is a consumer loan a contract can be declared void.[14]

If a finance broker licensed under the CFLL obtains its license, a finance broker licensee may only broker loans to, and collect brokerage commissions or referral fees from, other licensed lenders. The finance broker licensed under the CFLL may not broker loans to and collect brokerage commissions from other types of lenders that are not licensed, such as credit unions and banks.[15] Therefore, if an unlicensed broker chooses to broker a loan to a bank, this transaction is determined not to be under the CFLL and the transaction does not violate the CFLL. Essentially, the licensed lender or broker is being penalized because it has a broker's or lender's license, since it cannot obtain referral fees or commissions from a bank or a bank's subsidiary. Notwithstanding this prohibition of doing business with an exempt lender that does not have a license, the DBO has stated that the broker can notify the DBO and it will consider allowing the broker to conduct business with an exempt lender such as a bank.

Prior to January 1, 2016, commercial lenders with lender's licenses were prohibited from paying a fee to any person in exchange for a referral of business.[16] Effective January 1, 2016, the California Legislature enacted new statutes authorizing state licensed commercial lenders to pay referral fees for commercial loans to unlicensed persons including brokers and dealers.[17] The term "referral" means either the introduction of the borrower and the finance lender or the delivery to the finance lenders of the borrower's contact information.

The new law was intended to protect borrowers by ensuring that they are not steered to loans with unfavorable terms by unlicensed persons' referral or based entirely on the compensation they generate, and not on the extent to which the loan makes sense for the borrower being referred. The new law was allegedly designed to eliminate the possibility that referral fees paid to unlicensed individuals would result in predatory lending. Now, unlicensed brokers can be paid referral fees or commissions, but the new law is very restrictive.

Unlicensed persons may not:

- participate in loan negotiations,
- counsel or advise the borrower about a loan,
- participate in the preparation of any loan documents,
- contact the lender on behalf of the borrower beyond the initial referral,
- obtain loan documentation from the borrower or deliver that documentation to the lender,
- communicate lending decisions or inquiries to the borrower,
- participate in creating sales literature or marketing materials,
- obtain the borrower's signature on loan documents,
- make a misleading statement or omit material information in any form, including advertisements for prospective borrowers about the terms of the loan,
- engage in any acts that violate the California Business and Professions Code,
- commit an act that constitutes fraud or dishonest dealings, or
- fail to safeguard a prospective borrower's personally identifiable information.

The new law allows only for the payment of a referral fee once a loan has been approved, and it requires that all loans involving the payment of a referral fee adhere to the best practices for commercial lending, including:

- verification of borrower's commercial status,

- the loan's annual percentage rate not exceeding 36%,
- a minimum loan term of one year,
- vigorous underwriting by the lender to ensure the borrower's financial support for the repayment of the loan, and maintenance of records for at least four years, and
- submission of information requested by the commissioner regarding the compensation.

In addition, the new law requires the lender to provide the borrower with a written statement detailing the referral arrangements (in 10-point font or larger) at the time the licensee receives an application for a commercial loan, and the new law requires the borrower to acknowledge receipt of the following statement in writing:

> You have been referred to us by [Name of Unlicensed Person]. If you are approved for the loan, we may pay a fee to [Name of Unlicensed Person] for the successful referral. [Licensee], and not [Name of Unlicensed Person] is the sole party authorized to offer a loan to you. You should ensure that you understand any loan offer we may extend to you before agreeing to the loan terms. If you wish to report a complaint about this loan transaction, you may contact the Department of Business Oversight at 1-866-ASK-CORP 1-866-ASK CORP FREE (1-866-275-2677 1-866-275-2677 FREE), or file your complaint online at www.dbo.ca.gov.

The above prohibitions do not apply if the unlicensed person meets one or more of the following criteria:

- is exempt from licensure under this provision,
- is exempt from federal income taxes under Section 501(c)(2) of the Internal Revenue Code,
- is a business assistance organization recognized by the U.S. Small Business Administration, or
- in a 12-month period, is engaged in five or fewer commercial loans made by persons licensed under the CFLL. Note that there is a difference on this exemption that the five or fewer commercial loans do not have to be "incidental" to the business of the lender like the exemption discussed above.[18]

In addition, a licensee paying compensation to a person that is not licensed is liable for any misrepresentation made to that borrower in connection with that loan.[19] Presumably, even though most loan documents disclaim any and all warranties and representations of all persons and entities that are not the lender and disclaim any agency relationship between any other party and the lender, it remains to be seen whether an unlicensed broker representation will result in a lender being liable to the borrower, notwithstanding such contractual provisions, which are enforceable.[20]

If the lender and the borrower have a choice of law clause in their loan contract indicating that another state's law applies to the contract and, therefore the prohibitions under the CFLL or California usury law are not applicable, what will a court do with respect to enforcement of the choice of law clause? Will it nevertheless apply California law?

Although choice of law clauses are generally enforceable as a matter of law so long as they bear a reasonable relation to the state and also to another state or nation,[21] the choice of law clause is probably not enforceable. The CFLL was enacted primarily to protect the citizens of California from fraudulent and unconscionable conduct of those in the lending business. Therefore, the state's public policy would in all likelihood prevail, and the choice of law clause will not be enforceable as to the use of another state's law.[22]

This article has focused on the new amendments to the California Financial Code, discussing the law in California under which brokers and referral sources can conduct their business and receive a fee. Of course, if there is no referral fee or commission there is no issue. But if brokers or referral sources did not expect to be paid, they would not be in business.

Equipment leasing and finance organizations such as the Equipment Leasing and Finance Association, National Equipment Finance Association, and National Association of Equipment Leasing Brokers have not only asked the DBO for interpretative opinions on the law but, in all likelihood, will be working in the future toward amending this law. Among other reasons is the Hobson's choice that a broker or referral source needs to make. A broker or referral source must choose either (1) to remain unlicensed and to broker or refer loan transactions only to banks and bank subsidiaries or (2) to obtain a license and to broker or refer loan transactions only to licensed lenders, which means never brokering or referring loan transactions to banks or bank subsidiaries.

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The stated goal of the California Finance Lenders Law is to simplify, clarify, and modernize

the law in order to promote lending in California. The effect of the law is quite the opposite: brokers, referral sources, dealers, and lenders are avoiding the state because of the regulation and penalties imposed by the CFLL and the confusion that the law and its most recent revision has created.

Endnotes

1. Financial Code Sec. 22000 et seq.

2. Financial Code Sec. 22001.

3. See California Code of Regulations Title 10.

4. California Constitution Article XV, Sec. 1.

5. California Financial Code Sec. 22009.

6. Financial Code Sec. 22502.

7. See U.S. Constitution, Article XV, Sec. 1.

8. Financial Code Sec. 22102.

9. Financial Code Sec. 22101 and 10 CCR Sec. 1422.3; see also Commissioner's Opinion nos. OP5767 CM (Dec. 1, 1988), OP5792 CM (Dec. 1, 1988), and OP5862 CM (Feb. 24, 1989).

10. Financial Code Sec. 22054.

11. Constitution Code, Article XV, Sec.1.

12. The issue of whether a transaction is a true lease or a disguised loan with a security interest in the equipment, sometimes called a lease intended as security, is beyond the scope of this article. However, a court will look at the economic realities of the transaction and look beyond form to substance. Without discussing this issue in any detail, if the lessee can own the leased personal property at the end of the lease term for nominal or no additional consideration, then the lease is not a true lease but instead a disguised loan or lease intended as security. If the personal property has some meaningful residual value at the end of the lease term, then generally that lease will be a true lease. (See Commercial Code Secs. 1201(35) and 1203; *In re Rebel Rents, Inc.*, 291 B.R. 520 (Bankr. C.D. Cal. 2003) for a further explanation of the law.)

13. Financial Code Secs. 22713, 22716, and 22780.

14. Financial Code Secs. 22750 and *In re Rose,* 266 B.R. 192 (Bankr. N.D. Cal. 2001)

15. See Code of Regulations Sec. 1422.

16. California Code of Regulations Sec.1451.

17. Financial Code Secs. 22602-22604.

18. Financial Code Sec. 22602.

19. Financial Code Sec. 22602.

20. See, e.g., Commercial Code Secs. 1302 and 2316.

21. Commercial Code Sec. 1301(a).

22. *People v. Fairfax Family Fund, Inc.*, 235 Cal.App.2d 881, 884 (1965); Brack v. Omni Loan Co., Ltd., 164 Cal.App.4th 1312 (2008) (where the Court held an out-of-state choice of law provision in a contract to be unenforceable because California had a greater public policy interest in enforcing its laws regarding finance lending, including the CFLL – however this was a consumer loan); *Rochester Capital Leasing Corp. v. K & L Litho Corp.*, 13 Cal.App.3d 697 (1970) (where the Court held that California law preempted a New York choice of law clause because the agreement was executed in California, the site of the personal property which formed the security for all transactions was and remained in the State of California, the act which effectuated the New York agreement was the payment of the money from California for the personal property subsequently leased through an escrow executed and completely performed in California and all acts by the lender to enforce its rights of repossession, disposition and to recover the balance of sums due if obligor's failure to make payments occurred, were exercised in California); but some older cases have held the choice of law clauses would be enforced and applied to the other state's law where the loan would have been usurious under California Law (*Sarlot-Kantarjian Kronovt v. First Pennsylvania Trust,* 599 F.2d 915 (9th Cir. 1979); Ury v. Jewelers Acceptance Corp., 227 Cal.App.2d 11 (1964)).

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