

Update to NVCA Members on California Financial Lenders Law:

In a significant victory for our industry, California Governor Gray Davis signed legislation that creates a safe harbor for venture capital firms making bridge loans in California. Attached is a memo from the law firm of Wilson Sonsini Goodrich & Rosati detailing the exact nature of the safe harbor. For further information please contact Katie Merrill or Jennifer Dowling at NVCA (703-524-2549).

To: Venture Capital and Other Private Equity Fund Clients

From: Fund Services Group
Debt Finance Group

Date: August 7, 2003

Re: **California Finance Lenders Law:
Amendment Creates Safe Harbor for Venture Capital Bridge Loans**

This memorandum updates and replaces our memorandum of April 25, 2003, titled "Venture Capital Bridge Loans and the California Finance Lenders Law" (the "Prior Memorandum").

As described in the Prior Memorandum, some members of the venture capital community have expressed concerns that venture capital funds which make bridge loans to current or prospective portfolio companies may be required to obtain a license under the California Finance Lenders Law (the "CFLL"). On August 2, 2003, Governor Gray Davis signed into law Assembly Bill 169 ("AB 169"), which creates a "safe harbor" from the licensing requirements of the CFLL for qualified bridge loans ("QBLs") made on or after January 1, 2004.

We anticipate that many, if not most, of the bridge loans made by venture capital funds operating in California will be QBLs. This memorandum briefly describes the relevant provisions of the CFLL, the safe harbor rules of AB 169, and their potential application to venture capital funds operating in California.

Background

Under the CFLL, a person engaged "in the business of a finance lender or broker" within California generally must obtain a license from the California Department of Corporations. The law provides a number of exemptions from this requirement, including exemptions available for small business investment companies and persons that limit their lending activities to no more than one loan in any 12-month period.

Within the venture capital industry, "bridge loans" traditionally have been used as tools to facilitate equity investments. The typical bridge loan is intended to remain outstanding for only a short period of time (e.g., a few weeks or months) before it is converted into equity as part of a larger equity investment round.

Historically, many attorneys who advise venture capital funds concluded that such funds generally should not be required to obtain a license under the CFLL solely in consequence of making bridge loans. Arguments in support of this conclusion include the following:

1. Because they generally are intended to be converted into equity rather than repaid, bridge loans

appear substantively different from the lending transactions that constitute the "business" of a "finance lender or broker."

2. Many bridge loans are made without a realistic expectation of repayment due to the borrower's lack of revenue or for other reasons. Consequently, many bridge loans have been treated as equity (rather than as loans) for financial accounting purposes.

3. Venture capital funds typically use bridge loans merely as a device to facilitate equity investment, and do not seek to make bridge loans as free-standing investments.

4. Historically, even those venture capital funds that made more than one bridge loan within a 12-month period typically made an average (over their entire term) of less than one bridge loan per year.

5. Despite being aware that many venture capital funds have made more than one bridge loan within a 12-month period, the California Department of Corporations has not undertaken enforcement actions against such funds.

Recent Events

In the post-bubble period, a number of factors have given rise to new concerns that venture capital funds may be required to obtain licenses under the CFLL. These factors include the following:

1. The volume of bridge loan activity by venture capital funds has increased, with many funds averaging more than one bridge loan per year.

2. Due to increased difficulty in closing equity rounds, many bridge loans have been allowed to remain outstanding for extended periods of time.

3. In some cases, bridge loans are being made with the expectation that they will remain outstanding for an extended period of time.

4. In connection with making some bridge loans, venture capital funds are obtaining a security interest in portfolio company assets.

Taken together, these factors may indicate that the bridge loan activities of some venture capital funds qualify as the "business" of a "finance lender or broker."

Assembly Bill 169

Under AB 169, the licensing requirements of the CFLL are not triggered by a QBL, which is defined as a "commercial bridge loan" made by a "venture capital company" to an "operating company." This rule is effectively a safe harbor. Thus, a venture capital fund that made only QBLs would not be required to obtain a license under the CFLL. However, a fund that makes other types of loans should be subject to licensing requirements only if those loans cause the fund to be engaged in the business of a finance lender or broker.

Commercial Bridge Loan. In general, a "commercial bridge loan" is 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;^[1]
3. Matures in one year or less;
4. Is made in connection with, or in contemplation of, an equity investment in the borrower;^[2]
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 (the "Implied Covenant").^[3]

Venture Capital Company. A venture capital fund generally will be a "venture capital company" if it:

1. 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;
2. At all times maintains at least 50 percent of its assets in venture capital investments or commitments to make venture capital investments;^[4]
3. Maintains or, assuming consummation of the equity investment to which a commercial bridge loan relates, will maintain a material equity interest in the borrower;^[5]
4. Approves each loan made to an operating company through the fund'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;^[6] and
5. Complies, when making the loan, with all applicable federal and state securities laws.

AB 169 defines "venture capital investment" as "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." The statute provides no definition of the term "management rights," but the term is well defined in two highly relevant bodies of law. The first is the definition of "venture capital operating company" promulgated by the U.S. Department of Labor under the Employee Retirement Income Security Act of 1974 ("ERISA"). The second is Rule 260.204.9 of the California Code of Regulations, which deals with the regulation of investment advisors.

In the absence of authoritative guidance under AB 169, it would appear reasonable to apply the definition set forth in Rule 260.204.9(b)(6), which provides that "management rights" means the right, obtained contractually or through ownership of securities, either through one person alone or in conjunction with one or more persons acting together or through an affiliated person, to substantially participate in, to substantially influence the conduct of, or to provide (or to offer to provide) significant guidance and counsel concerning, the management, operations or business objectives of the operating company in which the venture capital investment

is made. Under this definition, a venture capital fund can hold "management rights" even if it does not have the power to appoint a representative to the borrower's board of directors. Management rights of this type often are obtained through a "management rights agreement" that supplements a loan agreement or stock purchase agreement. [7]

Operating Company. In general, a borrower is an "operating company" if it:

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; and
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. [8]

Conclusion

AB 169 is good news for the venture capital industry because it will help to establish that most typical bridge loan activity on or after January 1, 2004 should not give rise to licensing requirements under the CFL. However, the safe harbor created by AB 169 includes a number of technical conditions that some funds may find difficult to satisfy. Furthermore, many of those technical conditions are not well defined by the statutory language and may be supplemented by regulations or other interpretive guidance in the future. Finally, even a venture capital fund that made bridge loans prior to January 1, 2004, or made non-QBLs on or after that date, would not be required to obtain a license under the CFL unless its overall lending activities caused it to be engaged in the business of a finance lender or broker.

* * * *

This memorandum is intended only as a general discussion of the information presented and should not be regarded as legal advice. For more information, please contact your Fund Services Group or Debt Finance Group attorney.

EXHIBIT A**SAMPLE PROVISIONS FOR BRIDGE LOAN AGREEMENTS****Provision #1**

Borrower hereby represents that borrower intends to use the proceeds of this loan primarily for the operations of its business, and not for any personal, family or household purpose.

Provision #2

Notwithstanding any provision of this loan agreement to the contrary, this loan agreement shall be (to the extent necessary to satisfy the requirements of Section 22062(b)(3)(D) of the California Financial Code) subject to the implied covenant of good faith and fair dealing arising under Section 1655 of the California Civil Code.

Provision #3

Borrower hereby represents that its board of directors, in the exercise of its fiduciary duty, has approved borrower's execution of this loan agreement based upon a reasonable belief that the loan provided for herein is appropriate for the borrower after reasonable inquiry concerning the borrower's financing objectives and financial situation.

[1] Under AB 169, the lender generally is entitled to rely upon a written statement of intent executed by the borrower and is not required to verify that loan proceeds are actually used in the manner specified in such statement of intent. To ensure satisfaction of this technical requirement, venture capital funds should consider including in each bridge loan agreement Sample Provision #1 set forth on Exhibit A.

[2] There is no requirement that the lender's "contemplation" of an equity investment be documented in any specific way. However, it generally would be prudent to reflect such intention in the minutes or similar records of a venture capital fund's general partner (unless such intention is otherwise documented, such as in the applicable bridge loan agreement).

[3] Many loans made within California by California residents will be subject to the Implied Covenant without the need for special effort by the parties. However, the Implied Covenant may not apply if: (i) one or more parties are outside California; (ii) the loan agreement expressly provides that the loan will be governed by the laws of another jurisdiction; or (iii) the loan agreement contains specific provisions that override the Implied Covenant. To ensure satisfaction of this technical requirement, venture capital funds should consider including in each bridge loan agreement Sample Provision #2 set forth on Exhibit A.

[4] Several key questions regarding the meaning of this 50 percent test are unanswered by the strict language of AB 169. For example, the statute provides no guidance as to the meaning of "assets," but it would appear reasonable to disregard unfunded "capital commitments" made by a venture capital fund's general and limited partners. The measurement of assets also is unspecified. Possibly, a venture capital fund could measure assets by reference to either cost basis or fair market value. The meaning of "at all times maintains" is unclear, but it would appear reasonable to assume that the phrase means "at

all times while the relevant commercial bridge loan is outstanding." Finally, the meaning of "commitments" to make venture capital investments is unclear, but it would be prudent to assume that commitments must be legally binding in order to be taken into account for purposes of this test.

[5] The meaning of "maintains" in this context is unclear. Presumably, it cannot mean "at all times maintains," since a fund must at some point be free to sell equity securities acquired pursuant to the conversion of a bridge loan into equity. A reasonable interpretation would be: "holds a material equity interest in the borrower at the time the loan is made, at some time during the term of the loan, or immediately following the conversion of some or all of the loan principal into equity."

[6] Presumably, a fund's general partner would qualify as a "similar policy body" for this purpose. In most cases, records of ordinary and routine due diligence on the borrower by the fund's general partner should provide sufficient documentation that this requirement has been satisfied. For added security, members of the general partner may wish to execute a contemporaneous resolution confirming their approval and the basis thereof.

[7] The definition of "management rights" applied for ERISA purposes is somewhat narrower and more onerous. For a discussion of Rule 260.204.9, see our presentation titled "California Regulation of Investment Advisers: Recent Changes Affecting Venture Capital Firms." For a discussion of ERISA's definition of "management rights," see our memorandum titled "ERISA Rules Applicable to Venture Capital Funds" (the "ERISA Memo"). Both are available at http://www.wsgr.com/FSG/gen_mat/ and the ERISA Memo includes a sample management rights agreement that generally should satisfy the requirements of AB 169.

[8] To establish satisfaction of this technical requirement, venture capital funds should consider including in each bridge loan agreement Sample Provision #3 set forth on Exhibit A. Additional protection could be obtained by securing a certified copy of the borrower's board resolution approving the transaction.