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Regulatory Update

The California Financing Law — Commercial and Consumer Lenders Beware

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Lenders or loan brokers[1] based in California or lending to either commercial or consumer borrowers based in California are subject to the California Financing Law (CFL), which imposes licensing requirements on both lenders or loan brokers that meet certain criteria. Though many traditional lenders, including banks and trust companies, are exempt from the CFL, alternative lenders may not engage in lending activities without obtaining a finance lenders license from the California Department of Financial Protection and Innovation (DFPI).

An entity licensed as a finance lender is subject to a regulatory regime that is less onerous than the complex requirements applicable to banks and other highly regulated institutions. As such, obtaining a CFL license provides nontraditional lenders, including foreign lenders, a path of entry into the California lending market. However, as the DFPI continues to be active in its enforcement of the CFL, including with respect to commercial lenders, any entity engaging in any kind of lending in California should closely analyze the parameters of the CFL to determine whether the entity is exempt from the CFL or whether it is properly licensed and in compliance with the CFL's requirements.

History of the CFL

Since July 1, 1995, the CFL has governed those engaged in the business of a finance lender or a finance broker, with several exceptions. Prior to the emergence of the CFL, these lending and brokerage activities were regulated in California under multiple predecessor regulatory regimes — namely, the Consumer Finance Lenders Law, the Commercial Finance Lenders Law and the Personal Property Brokers Law. The CFL effectively brought consumer lending, commercial lending and brokerage activities in California under a single legal framework. Notably, however, regulators have incorporated many provisions of these former laws into the structure of the CFL, and courts have widely referenced regulatory guidance and legal precedent arising under these former regimes when approaching questions under the CFL. (See, e.g., Op. Comm'r Cal. Dept. Corp., 1996 WL 616658 (Oct. 22, 1996); Op. Comm'r Cal. Dept. Corp., 1997 WL 116891 (Mar. 11, 1997).)

Who Must Be Licensed Under the CFL?

The CFL generally prohibits individuals and entities from engaging in the "business of a finance lender or broker" without becoming a licensed finance lender (Cal. Fin. Code § 22100(a)). The statute defines "finance lender" broadly to include "lending money" and "taking ... as security for a loan ... any contract or obligation involving the forfeiture of rights in or to personal property" as long as possession of the property is not retained by the lender, as well as taking a lien on wages (Cal. Fin. Code § 22009).

Several exemptions from the CFL requirements are available, particularly for entities that are regulated under a different regulatory regime or by a different California regulator. For example, exemptions are available for the following types of entities when certain requirements are met:

- U.S. banks, savings and loan associations, industrial banks and credit unions doing business under applicable state or federal banking law (Cal. Fin. Code § 22050(a));
- Trust companies (Cal. Fin. Code § 22050(a));
- Broker-dealers (Cal. Fin. Code § 22050(d))[2];
- Licensed residential mortgage lenders (Cal. Fin. Code § 22060)[3];
- Public corporations (Cal. Fin. Code § 22050(f));
- Franchisors when making loans to their franchisees (Cal. Fin. Code § 22063);
- California-licensed real estate brokers, when making or arranging a loan secured by a lien on real property (Cal. Fin. Code § 22057);
- Credit card issuers (Cal. Fin. Code § 22052);
- Venture capital companies, under limited circumstances (Cal. Fin. Code § 22062); and
- Insurance companies (Cal. Ins. Code § 1100.1).[4]

Two exemptions are also available for certain *de minimis* lending activities. First, any lender making one commercial loan in a 12-month period is not required to be licensed (Cal Fin. Code § 22050.5). Second, the CFL contains a general exemption available for entities making fewer than five California loans in a 12-month period, provided that these loans are commercial loans that are "incidental to the business of the person relying on the exemption" (Cal. Fin. Code § 22050(e)). The legislative history of the bill adding the "incidental" requirement did not provide guidance detailing under what circumstances lending activities would be determined to be "incidental to the business of the person relying on the exemption" (2013 Cal. Stat., ch. 243 (AB 1091)); however, legislative history indicates that the exemption is intended to eliminate "an unnecessary burden on business that may not be engaged in the business of lending but just may make a few loans in a context unrelated to the business of lending" (California Committee Report, 2013 California Assembly Bill No. 1091, California 2013-2014 Regular Session). The legislative history specifically identifies "bridge loans" as a type of lending activity that, when performed by a business that is not typically engaged in lending, would fall within this *de minimis* exemption, although commercial bridge loans made by a venture capital company to an operating company are formally exempt (AB 1091 Assembly Floor Analysis (Aug. 21, 2013); see Cal. Fin. Code § 22062(a)).

In 2016, California regulators took action to shrink the number of entities exempt from the CFL, as demonstrated by revised regulations that narrow the licensing exemption for nonbank affiliates and subsidiaries of banks and bank holding companies within the context of consumer lending (10 CCR § 1422.3). In a 1988 opinion under the CFL's predecessor statute, the Commercial Finance Lenders Law,

the commissioner of corporations held that a wholly-owned subsidiary of a national bank would be exempt from licensing requirements under the exemption applicable to "any person doing business under any law ... of the United States ... relating to banks" (Op. Comm'r, Cal. Dept. Corp., OP 5792CM (Dec. 1, 1988)). The commissioner reasoned that, as the operating subsidiary of a national bank would be regulated by the Office of the Comptroller of the Currency, such a subsidiary constituted an entity that "does business under the laws of the United States relating to banks" and therefore could take advantage of the exception from the Commercial Finance Lenders Law. The commissioner similarly extended the broad interpretation of this exemption to cover subsidiaries of federal savings banks, federally chartered savings associations and operating subsidiaries of bank holding companies. (See Op. Comm'r Cal. Dept. Corp., OP 95/1, 1995 Cal. Sec. LEXIS 3 (Oct. 11, 1995) (exempting the subsidiaries of a federal savings bank); Op. Comm'r Cal. Dept. Corp., OP 6595 CFL, 1996 Cal. Sec. LEXIS 9 (Nov. 5, 1996) (exempting the subsidiary of a federally-chartered savings association); Op. Comm'r Cal. Dept. Corp., OP 6738 CFL, 1999 Cal. Sec. LEXIS 1 (Aug. 5, 1999) (exempting the subsidiary of a federally-chartered savings association); Op. Comm'r Cal. Dept. Corp., OP 5792 CM, 1988 Cal. Sec. LEXIS 11 (Dec. 1, 1988)(exempting the subsidiary of a bank holding company); Op. Comm'r Cal. Dept. Corp., OP 5862, 1989 Cal. Sec. LEXIS 3 (Feb. 24, 1988) (exempting the subsidiary of a bank holding company).)

Consistent with Section 1045 of the Dodd-Frank Act,[5] however, the 2016 regulations reverse the DFPI's prior stance with respect to consumer lenders, narrowing the scope of this exemption by adding a regulation clarifying that the provision exempting an entity engaging in consumer lending activity "relating to banks" only applies to a "bank, trust company, savings and loan association, insurance premium finance agency, credit union, small business investment company, community advantage lender, California business and industrial development corporation when acting under federal law or other state authority, or a licensed pawnbroker when acting under the authority of that license" (10 CCR § 1422.3(a)). As such, nonbank operating subsidiaries and affiliates of banks engaging in any consumer lending or brokering activity are required to obtain a CFL license unless otherwise exempt.

What Ties With California Would Bring a Lender Within the Scope of the CFL?

The CFL does not provide guidance on the extent to which a loan transaction must be connected to California in order to trigger the applicability of the CFL and subject a lender to its licensing and ongoing compliance requirements. While the broad language of the CFL provides no geographic limitation to its applicability, California courts have indicated that a loan transaction must involve sufficient contacts with California to support application of the CFL. In several such cases, the CFL or its predecessor statute was found not to apply, even where some connection to California was present, when the lender's ties to California were minimal. Courts generally conduct a fact-based analysis to determine whether minimum contacts are present, taking into consideration, among other factors: (1) the location of the lender; (2) the location of the borrower; (3) where the loan is negotiated; (4) where any collateral for the loan is located; and (5) where payments related to the loan are remitted.[6]

How to Become a California Licensed Finance Lender

Entities that seek to or, based on their current activities in California, must obtain a California finance lenders license are required to submit an application to the DFPI via the National Multistate Licensing System (NMLS) as well as fulfill other requirements. The application requires information about the applicant and its proposed activities, as well as about the persons who will manage the business and all persons and entities owning or controlling, directly or indirectly, 10% or more of the applicant. A surety bond of $25,000 is required (See Cal. Fin. Code § 22101 *et seq*.), and the applicant must submit financial statements as well as a business plan outlining how the applicant will conduct its business consistent with the requirements of the CFL. In addition, a licensed finance lender must obtain a license for each branch office through which it conducts business (Cal. Fin. Code § 22102). The requirements for the CFL application are outlined in the Financing Law License New Application Checklist on NMLS.[7] Entities must apply for a CFL license through the Nationwide Mortgage Licensing System.

The Regulatory Regime Governing Licensed Finance Lenders

Once an entity has obtained a license under the CFL, the entity may make loans in line with the type of business activities selected on the application (e.g., consumer, commercial or both). Additionally, unlike more restrictive regimes such as the California Real Estate Law (see Cal. Bus. & Prof. Code § 10000 *et seq*.), the CFL permits the employees of a CFL-licensed entity to work under such an entity held license without the requirement to obtain additional licenses at the employee level. In addition, loans by licensed finance lenders are exempt from the usury provisions of the California Constitution (Cal. Fin. Code § 22002; see also Cal. Const. art. XV, § 1).

However, a licensed finance lender must also satisfy certain ongoing obligations, including the requirements to submit an annual report (due March 15 of each year) and fee to the DFPI (due each October), maintain books and records, and notify DFPI of any changes in its directors and officer (Cal. Fin. Code §§ 22156; 22157, 22158, 22159). Moreover, the failure to update a change of address via NMLS without 10 days prior notice will result in a $500 fine.

Subject to certain protections to licensees, the DFPI has discretion to issue penalties against licensees who do not submit required reports (Cal. Fin. Code § 22715(b)(1)). A licensed finance lender is also subject to requirements related to advertising, including limitations on advertising rates of interest and the requirement to make advertising materials available for the DFPI's review upon request (see, e.g., Cal. Fin. Code §§ 22162; 22164; 22165; 22166). To facilitate this requirement, licensees must keep all copies of advertising on file for a period of two years from when it was used (Cal. Fin. Code § 22166). If the DFPI disapproves of advertising materials used by a licensee, it can require submission of new advertising materials for prior approval (Cal. Fin. Code § 22165).

Aside from these ongoing reporting and administrative requirements, licensed finance lenders are also subject to limitations on the types of activities these lenders and brokers may conduct, as described below.

Limitations Applicable Only to Consumer Loans

Consistent with its stated goal of protecting borrowers (Cal. Fin. Code § 22001), the CFL imposes more restrictive limitations on the activities of consumer lenders and brokers than on those engaging only in commercial lending. Licensed finance lenders engaging in consumer lending activities[8] must comply with interest rate and fee restrictions (see generally Cal. Fin. Code ch. 2), and the CFL contains several provisions emphasizing the right of the DFPI to enforce such consumer loan restrictions with respect to out-of-state consumer lenders (Cal. Fin. Code §§ 22322; 22323, 22324). In addition, as summarized below, *licensed* finance lenders making consumer loans are not authorized to pay referral fees to *unlicensed* entities.

Limitations and Requirements Applicable Only to Commercial Loans

The provisions specifically applicable to commercial loans, on the other hand, are largely permissive, and do not impose significant restrictions on commercial lending activities. For example, the commercial lending provisions of the CFL authorize a licensed finance lender to sell promissory notes to certain "institutional investors," including banks, trustees of funds and corporations, with respect to both real-estate-secured loans and loans not secured by real estate without obtaining a real estate broker's license (Cal. Fin. Code §§ 22600; 22600.1). Notably, a 2014 California District Court decision, *LFG Nat. Capital LLC v. Alioto*, emphasized the permissive nature of these provisions. In *Alioto*, the court rejected an argument that, because the CFL expressly authorizes commercial lenders to sell promissory notes to institutional investors and does not address assignments of lines of credit, the assignment of a line of credit is invalid. Accordingly, *Alioto* emphasizes that these provisions act to authorize the listed activities and do not restrict activities on which the statute is silent. This interpretation has been reinforced in other cases addressing the interpretation of particular CFL provisions as well.[9] For purposes of the commercial loan provisions, a "commercial loan" means a loan with a principal of $5,000 or more for use other than

for "personal, family, or household purposes" (Cal. Fin. Code §§ 22502; 22204); all loans under $5,000 are subject to the CFL's consumer loan provisions.

However, under statutory amendments to CFL enacted on October 1, 2018, California became the first state to mandate specific disclosures for a broad array of commercial financings (the California Disclosure Law) (Cal. Fin. Code § 22780.1). As described in our client alert "Finance Providers Need to Be Aware of New Commercial Finance Disclosure Laws," these disclosure requirements apply to a greater subset of financial services providers than those subject to the CFL's licensing requirements and broadly apply to providers of commercial financing in amounts equal to or less than $500,000. Put differently, these disclosures may be required in California even in connection with types of financing that is not formally considered to be lending (e.g., factoring) and not subject to a formal license. For instance, merchant cash advances are explicitly considered in the commercial financial disclosure regulations (Cal. Code Regs. Tit. 10, § 901), but are not a form of loan requiring a license under the CFL.

Referral Fees and Restrictions

The CFL limits the compensation a licensed finance lender may pay to entities providing referral services. These recent amendments permit licensed finance lenders to pay referral fees to an entity that does not hold a CFL license only if certain requirements are met.

Specifically, a licensed finance lender may pay referral fees to an unlicensed person if:

- The referral leads to consummation of a commercial loan (Cal. Fin. Code § 22602(a)(1));
- The loan contract provides for an annual percentage rate that does not exceed 36 percent (Cal. Fin. Code § 22602(a)(2));
- Before approving the loan, the licensed finance lender obtains documentation confirming the borrower's commercial status (Cal. Fin. Code § 22602(a)(3)(A));
- Before approving the loan, the licensee conducts underwriting and obtains documentation related to ability to repay (Cal. Fin. Code § 22602(a)(3)(B));
- The licensed finance lender "maintains records of all compensation paid to unlicensed persons in connection with the referral of borrowers for a period of at least four years" (Cal. Fin. Code § 22602(a)(4));
- The licensed finance lender "annually submits information requested by the commissioner regarding the payment of compensation in the report required pursuant to Section 22159" (Cal. Fin. Code § 22602(a)(5)); and
- The licensed finance lender provides the prospective borrower with a disclosure statement (the language of which is set forth in the CFL) at the time the licensee receives an application for a commercial loan, and shall require the prospective borrower to acknowledge receipt of the statement in writing (Cal. Fin. Code § 22603).

Importantly, the CFL clarifies that these provisions do not authorize unlicensed entities to engage in activities that exceed the scope of the "introduction of the borrower and the finance lender or the delivery to the finance lender of the borrower's contact information" (Cal. Fin. Code § 22602(g)); any other participation of the unlicensed referring entity in the relationship between the borrower and the finance lender is impermissible under the CFL unless the unlicensed entity is exempt from this prohibition (Cal. Fin. Code §§ 22602(c)-(d)).[10] The unlicensed entity is not authorized to, among other activities, prepare any loan documents, communicate lending decisions or inquiries to the borrower, or obtain the borrower's signature on loan documents (Cal. Fin. Code § 22602(c)). The licensee is also responsible for any misrepresentation made to borrowers by the person making the referral (Cal. Fin. Code § 22604).

The CFL also grants the DFPI the power to enforce requirements with respect to referrals directly against the unlicensed person receiving referral compensation. The DFPI can, and does, act against such persons if it finds they are making false or misleading statements or representations regarding the loan, engaging in fraudulent or dishonest dealings, or failing to protect the personal identifiable information of prospective borrowers (Cal. Fin. Code § 22602(b); see also *In re Celsius Lending LLC* (Feb. 2025)).

Penalties for Noncompliance With CFL

The CFL imposes both civil and criminal penalties for failure to comply with its requirements. For consumer loans, if a lender willfully violates the CFL when making or collecting a loan, the loan contract is "void" and "no person has any right to collect or receive any principal, charges, or recompense in connection with the transaction" (Cal. Fin. Code § 22750(b)). For both consumer and commercial loans, a "willful" violation results in a penalty of up to $10,000 and up to a year's imprisonment; however, no person may be imprisoned without knowledge of the applicable rule or order set forth by the DFPI (Cal. Fin. Code §§ 22753; 22780).

Action Plan

Because of the CFL's broad reach — covering commercial as well as consumer lenders and foreign as well as in-state entities — all entities currently engaged in lending activities in California and all entities who seek to participate in the California lending market should closely review the statute's requirements and restrictions. While the CFL regulatory regime is less onerous than the requirements applicable to traditional financial institutions, the CFL requires licensure as well as ongoing compliance activities for those lending in California.

As the CFL casts a wider net than the lending regimes in other states, entities conducting lending activities in California should be sure to consider whether their business activities trigger obligations under its provisions. If an entity is already engaging in activities under the scope of the CFL without a license, a sound strategy is needed for approaching the application process in a way that limits any potential consequences imposed by regulators for conducting unlicensed activities in the past. Entities already engaging in lending activities in California without a CFL license or those seeking to commence lending activities in California should seek legal counsel in developing an action plan to assess the applicability of the CFL provisions and, if needed, develop an action plan for approaching the licensing process and ongoing compliance with the CFL, including:

- An analysis of whether your current and/or proposed activities fall within the scope of lending activities covered by the CFL;
- Consideration of whether an exemption from the CFL licensing provisions may be available;
- If a license is required, a strategy for approaching the application process and engaging with the DFPI;
- Development of internal policies and procedures to ensure ongoing compliance with the CFL; and
- An assessment of any requirements under other regulatory regimes (e.g., commercial financing disclosure laws, including California's (Cal. Fin. Code §§ 22800 *et seq*.).

In addition to requirements under state law, a foreign lender seeking to engage in commercial lending activity in the United States under the CFL also must consider whether its proposed activities would trigger obligations under the federal laws. These requirements may include, but not be limited to, the commercial lending company rules under the Federal Reserve Board's Regulation K (12 C.F.R. § 211.21(g)) and will be of particular concern where a foreign lender seeks to locate an office or personnel within U.S. borders.

Paul Hastings attorneys are actively working with clients seeking to obtain licenses under the California Financing Law and otherwise comply with its provisions.

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[1] A person is a "broker" under the CFL if the person "is engaged in the business of negotiating or performing any act as broker in connection with loans made by a finance lender" (Cal. Fin. Code § 22004).

[2] Broker-dealers acting under a valid certificate issued under Section 25211 of the Corporations Code are exempt from the licensing requirements of the CFL.

[3] The CFL does not apply to a loan made or arranged by a licensed residential mortgage lender or servicer when acting under the authority of that license.

[4] Insurance companies operating under a certificate of authority issued under the provisions of Article 3 of the Insurance Code are exempt from CFL licensing requirements.

[5] See Notice of Proposed Rulemaking Action, TITLE 10. CALIFORNIA DEPARTMENT OF BUSINESS OVERSIGHT (Oct. 16, 2014). The initial PRO was subsequently modified to clarify that this change would apply only to consumer lenders. See California Department of Business Oversight, Notice of Modifications to Proposed Regulations under the California Finance Lenders Law and the California Residential Mortgage Lending Act (July 23, 2015).

[6] For example, the California attorney general determined that an out-of-state lender would not be required to obtain a CFL license in order to make loans to government agencies, even where some of these agencies were located within California, because no California residents would be impacted under the program, the lender had no offices in California, the lender negotiated the agreement outside of California, all payments would be remitted outside of California and no California residents would be parties to the loan agreement. Op. Comm'r, Cal. Dept. Corp. (Apr. 2, 1997) (noting that "[a]ssuming arguendo that [a lender's] activities meet the definition of a finance lender under the CFL," the lender should not be subject to regulation under the CFL because "[the lender's] contacts with California are minimal").

[7] NMLS Checklist Compiler (follow "New Application" hyperlink, then scroll down to "California," then "Company," then "Financing Law License").

[8] Under the CFL, the definition of "consumer loan" also includes any loan under $5,000, even if such loan is not intended for personal, family or household purposes (Cal. Fin. Code § 22204).

[9] See *Skinner v*. *Mountain Lion Acquisitions*, *Inc*., 2014 U.S. Dist. LEXIS 10425 (N.D. Cal. Jan. 28, 2014) (holding that Cal. Fin. Code § 22340, stating that licensees may sell promissory notes evidencing the obligation to repay consumer loans to institutional investors, does not prohibit the licensee from selling such promissory notes to entities that do not meet the definition of "institutional investor").

[10] The prohibition on activities of an unlicensed entity do not apply if the unlicensed entity is exempt from licensing under the CFL, is a tax-exempt 501(c)(3) organization under the Internal Revenue Code, is a business assistance organization recognized by the United States Small Business Administration or its activities fall below the *de minimis* threshold (Cal. Fin. Code § 22602(d)).