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Best Practices for Bridge Financing Lenders in California

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Financing sources providing debt commitments (which we will refer to in this article as "bridge financing lenders") are advised to consider important precautions when providing any bridge financing to California companies in which they hold equity or intend to hold equity. Identified in this client alert are best practices that bridge financing lenders should implement prior to issuing any debt to such companies. In addition, bridge financing lenders should take note of equitable principles in bankruptcy that may significantly impact the status of claims during the borrower's bankruptcy distribution process. Lastly, we discuss key aspects of the California Finance Lenders Law and the licensing rules that may apply to bridge financing lenders engaging in the business of making loans to California companies. The presented issues are especially relevant for bridge financing lenders that share each of the following characteristics:

- Have already invested in equity of a California company;
- Have board representation in the company and/or can control or significantly influence a shareholder vote; and
- Provide bridge financing to the company that has a priority security interest over the company's assets.

Best Practices Prior to Issuing Secured Debt

Bridge financing lenders are advised to follow four best practice principles when issuing debt to California companies. First, they should adhere to the requirements of the California Corporations Code (the "Code") in obtaining required approvals prior to issuing any debt. Pursuant to the Code, bridge financing lenders who also have one or more appointees on the board of directors of the borrower would be engaging in an interested party transaction when issuing debt to the company. Under these circumstances, bridge financing lenders and the borrowing company must comply with certain provisions of the Code in order to mitigate challenges against the validity of the transaction. The Code provides that an interested director transaction will not be void or voidable if any of the following are present:

- Approval by the disinterested directors
- Approval by the disinterested shareholders
- Satisfaction of the entire fairness standard

The entire fairness standard subjects the challenged party to judicial review with the burden of proving that the transaction was just and reasonable. This is a fact-intensive inquiry, in which it may be difficult to establish in court that the challenged party has satisfied the applicable standards of conduct.

Second, in addition to obtaining the necessary approvals by the disinterested parties, the Code requires that bridge financing lenders ensure full disclosure to the board or board committee and/or shareholders approving the issuance of debt. Full disclosure requires that all the facts and circumstances surrounding the issuance of debt must be available prior to the grant of any approval and is essential to preserve the transparency and legality of the pending transaction.

Third, bridge financing lenders must ensure that the terms of the loan are negotiated at arm's length with the borrower, meaning that both parties to the loan transaction negotiate independently without any influence of judgment from the other side. The purpose of an arm's length transaction is to maintain that both parties negotiate terms in their own self-interest and eliminate any external pressures that may unfairly influence the outcome of the negotiation.

Finally, bridge financing lenders are advised to properly document all loans with comprehensive terms to reflect the parties' intent at the time of the transaction. Bridge financing lenders have faced problems in instances where the loan documents were ambiguous and did not include terms such as fixed maturity dates, clear standards for conversion of debt into equity, if applicable, repayment schedules, and clearly identified collateral. Adherence to these best practices will better position bridge financing lenders to avoid missteps associated with providing bridge financing to companies.

Equitable Principles in Bankruptcy

Equitable principles in bankruptcy may also impact bridge financing lenders. In particular, bridge financing lenders should be aware of the doctrines of equitable subordination and debt recharacterization that may adversely alter the status of a lender's claim during a bankruptcy distribution.

Equitable Subordination

Bridge financing lenders issuing secured debt while exhibiting inequitable conduct in connection with the transaction may find their claims subordinated to more junior claims during a bankruptcy distribution. Equitable subordination is codified under section 510(c) of the U.S. Bankruptcy Code and provides that a bankruptcy court may, on a fact-intensive case-by-case basis, subordinate for purposes of distribution all or part of a claim or interest to all or part of another claim or interest, based upon equitable considerations of fairness. Under equitable subordination rules and principles, creditor claims may only be subordinated to other creditor claims and equity interests may only be subordinated to other equity interests. This means that on a finding of inequitable conduct, a bridge financing lender with a senior secured claim may find their claim subordinated to a junior secured claim. In the presence of grossly inequitable conduct, a senior secured claim may even be subordinated to a junior unsecured claim. Ultimately, a bankruptcy court would apply section 510(c) against a claimant (i.e., the bridge financing lender proposing a right to payment in the bankruptcy proceeding) to remedy an inequity or unfairness against other creditors in the bankruptcy proceeding by postponing payment to the subordinated creditor until the other economically injured creditors have been paid in full.

Courts have adopted the three-prong test set forth in *In re Mobil Steel Co., 563 F. 2d 692 (5th Cir. 1977)* as a method to determine when to invoke the doctrine of equitable subordination. The party seeking equitable subordination has the burden of proving the following three criteria: (1) that the claimant engaged in some type of "inequitable conduct," (2) that the misconduct injured the debtor's creditors or shareholders and resulted in an unfair advantage on the claimant, and (3) that subordination would not be inconsistent with the Bankruptcy Code:

A. Proof that the claimant engaged in some type of "inequitable conduct"

For purposes of identifying the level of inequitable conduct, courts have refined this first requirement for equitable subordination by creating a distinction between insiders and non-insiders. The standard for insiders and fiduciaries includes a fact-intensive scrutiny of the alleged inequitable conduct. Bridge financing lenders should be aware that the possible triggers of inequitable conduct are especially sensitive for lenders who also serve as insiders or fiduciaries of the borrower. For insiders or fiduciaries, inequitable conduct is likely to be found by evidence of any of the following actions in a loan transaction:

- A breach of fiduciary duty or the abuse of a fiduciary position to the disadvantage of other creditors
- The use of the debtor as a mere instrumentality or "alter ego" to benefit the creditor or a third party and disadvantage other creditors, and
- Lending to a known undercapitalized borrower.

Capitalization of a borrower is considered inadequate if, in the opinion of a skilled financial analyst, it would be insufficient to support a business of the size and nature of the debtor and if, at the time of the advances, the debtor could not have borrowed a similar amount of money from an informed outside source. With this in mind, bridge financing lenders that are also insiders or fiduciaries of a company must not engage in any inequitable conduct that disadvantages other creditors in order to preserve the senior status of their claim during the bankruptcy proceeding.

Alternatively, identifying the level of inequitable conduct for non-insiders requires a finding of "gross or egregious misconduct" on the part of the claimant that is severely unfair to the other creditors. This standard is often difficult to meet, but courts have found the following actions by non-insiders as sufficient to establish "gross or egregious misconduct":

- Predatory lending practices (including by encouraging the borrower to assume unnecessary debt)
- Substantial misconduct tantamount to fraud
- Misrepresentation clearly present in a transaction

B. Proof that the inequitable conduct injured the debtor's creditors or shareholders and resulted in an unfair advantage on the claimant

Once the applicable level of inequitable conduct has been established, the proponent must demonstrate sufficient legal injury – meaning that the inequitable conduct injured debtor's creditors or shareholders and resulted in an unfair advantage to the claimant. The injured creditors or shareholders must prove that the misconduct may result in harm to the entire creditor body, a particular class of creditors, or to a few creditors or only one creditor. When the misconduct results in harm to the entire creditor body, it is sufficient to show that the general creditors are less likely to collect their debts. For this reason, the offending creditor's claim should be subordinated below the general creditors to ensure payment. If the misconduct results in harm to specific creditors, the offending claim should only be offset to the extent necessary to remedy the harm to the debtor and creditors. In all, the bankruptcy court is only concerned with offsetting the offending claim to the extent necessary to remedy the unfair advantage.

C. The subordination would not be inconsistent with the Bankruptcy Code

In light of section 510, which codifies equitable subordination, this third element requiring that the subordination not be inconsistent with the U.S. Bankruptcy Code is considered moot. However, it is important to note that bankruptcy courts cannot use equitable subordination to adjust the bankruptcy distribution with respect to a legally valid claim merely because it perceives that the results of the distribution are inequitable.

Debt Recharacterization

Debt recharacterization refers to the bankruptcy court's power to examine the economic reality of a transaction and reclassify a creditor claim to that of an equity interest. In jurisdictions that recognize debt recharacterization, claims made by creditors may be subordinated to claims made by equity holders during the bankruptcy distribution. The purpose of debt recharacterization is to prevent an equity holder from shifting the risk of equity ownership to the debtor's other creditors by examining the substance of a transaction and reclassifying equity contributions that have been merely disguised as debt. Unlike equitable subordination that is concerned with whether a legitimate creditor engaged in misconduct, the analysis for debt recharacterization centers on whether a debt actually exists. It is important to note that a claim for debt recharacterization is often joined with a claim for equitable subordination under section 510(c).

Although courts have adopted conflicting judicial views on the doctrine of debt recharacterization, the Ninth Circuit, which notably includes federal courts in California, takes the view that bankruptcy courts cannot use the general equitable powers of section 105(a) of the Bankruptcy Code to subordinate a creditor claim to that of an equity interest. *In re Pacific Express, 69 BR 112 (B.A.P. 9th Cir. 1986).* Moreover, the Ninth Circuit has found that the bankruptcy court's ability to recharacterize a debt as equity is inconsistent with section 510(c) of the Bankruptcy Code, which already governs the determination of equitable subordination. The Ninth Circuit has reasoned that because Congress authorizes equitable subordination and is silent on debt recharacterization, Congress intended to deprive bankruptcy courts of the power to recharacterize a claim as equity rather than to subordinate it to other claims. Accordingly, absent inequitable conduct, federal courts in California will not subordinate any claim or interest in the bankruptcy proceeding.

Other Considerations – California Finance Lenders Law

Bridge financing lenders that provide secured debt to California companies may be subject to the California Finance Lenders Law (the "CFLL"). This would include both companies organized under California law as well as companies doing business in California. The CFLL requires any person engaged in the business of making loans to be licensed with the California Department of Corporations (the "DOC"). Even out-of-state lenders may be subject to the CFLL if the negotiation, credit investigation, or repayment of the loan takes place in California or if the loan is issued to a California borrower. Certain exemptions apply for several entities, including banks and savings and loan associations, credit unions, mortgage lenders, licensed check cashers, licensed pawn brokers, or those licensed under the deferred deposit transaction law. However, bridge loans made by bridge financing lenders are not included in the exemption. Even so, a bridge financing lender may avoid licensing requirements under the safe harbor of the CFLL if it makes only one loan in the State of California or to a California borrower in any 12-month period.

If more than one loan is made in a 12-month period and no exemption applies, a bridge financing lender will likely need to apply for a California Finance Lenders License. The rigorous licensing process requires lenders to prepare and submit an application form, provide financial statements, obtain a surety bond for $25,000, and have net worth of at least $25,000. In addition, the executive officers, board members, 10 percent shareholders, and any other person responsible for the applicant's lending must also provide fingerprints and complete a questionnaire.

Under the CFLL, licensed lenders are obligated to maintain books and records on any loan for three years after the last payment of the loan has been made. In addition, a licensed lender must file an annual report to the DOC, pay an annual fee, and maintain the $25,000 surety bond as well as a net worth of at least $25,000. The CFLL requires the lender's license to be posted in a conspicuous location and the lender must notify the DOC with all relevant information relating to any changes on the license application.

Bridge financing lenders should be aware that a violation of the CFLL can result in penalties of $2,500 for each violation or imprisonment for not more than one year, or both. Furthermore, any *willful* violation can result in a fine of $10,000 in addition to imprisonment for not more than one year, or both. For this reason, bridge financing lenders are strongly advised to ensure compliance with the CFLL requirements anytime an exemption does not exist or if more than one loan is made in any 12-month period.

Conclusion

Bridge financing lenders seeking to act prudently are advised to incorporate the discussed key steps and rules as routine practice prior to the issuance of secured debt to California companies. By doing so, bridge financing lenders will overcome some of the legal challenges associated with providing bridge financing to California companies and avoid potential grave risks that may materialize in a bankruptcy distribution.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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