



## Can California Lenders Pay Referral Fees to Unlicensed Brokers?

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A new California law is drawing attention to a much-misunderstood issue – whether California Finance Lenders can pay referral fees to unlicensed ISOs. Effective January 1, 2016, the answer is yes, but only for commercial loans with an annual percentage rate of less than 36% where the lender reviews documents to verify the borrower’s ability to repay. These restrictions benefit non-profit lenders making business development loans, and shut out their higher-cost commercial lender competitors from paying referral fees to unlicensed ISOs.

Existing regulations under California’s Finance Lender’s Law (“CFL”) prohibit paying any compensation to unlicensed persons or companies for “soliciting or accepting applications for loans.” 10 CCR 1451(c). This prohibition does not apply to referrals for merchant cash advances or referrals to banks, which are not subject to the CFL. A number of not-for-profit CFL lenders offering business development loans complained that it was unfair that they could not pay referral fees to an unlicensed ISO while their higher-cost competitors, the merchant cash advance companies, could.

California SB 197, supported by Opportunity Fund, California’s largest not-for-profit commercial lender, and the California Association of Micro-Enterprise Organizations, a group of more than 170 organizations, agencies, and individuals dedicated to furthering micro-business development in

California, aimed to remedy this perceived problem. According to an information sheet on SB 197 available on the Opportunity Fund's web site:

Often, merchant advance companies offer less favorable terms to small businesses than commercial lenders; however, small businesses never learn about the commercial lenders that offer more favorable terms, because those lenders cannot compensate entities to refer business to them.

[http://www.opportunityfund.org/media/blog/introducing-sb-197-\(block\)!/](http://www.opportunityfund.org/media/blog/introducing-sb-197-(block)!/) (last accessed on December 9, 2015)

The legislature approved SB 197 and Gov. Jerry Brown signed it last October. Starting on January 1, 2016, a CFLL lender can pay a fee to an unlicensed person in connection with a referral of a prospective borrower if:

- The referral by the unlicensed person leads to the consummation of a commercial loan (defined as a loan with a principal amount of \$5,000 or more the proceeds of which are intended by the borrower for use primarily for other than personal, family or household purposes);
- The loan contract provides for an annual percentage rate that does not exceed 36%; and
- Before approving the loan, the lender:
  1. Obtains documentation from the prospective borrower documenting the borrower's commercial status. Examples of acceptable forms of documentation include, but are not limited to, a seller's permit, business license, articles of incorporation, income tax returns showing business income, or bank account statements showing business income; and
  2. Performs underwriting and obtains documentation to ensure that the prospective borrower will have sufficient monthly gross revenue with which to repay the loan pursuant to the loan terms. The lender cannot make a loan if it determines through its underwriting that the prospective borrower's total monthly expenses, including debt service payments on the loan for which the prospective borrower is being considered, will exceed the prospective borrower's monthly gross revenue. Examples of acceptable forms of documentation for verifying current and projected gross monthly revenue and monthly expenses include, but are not limited to, tax returns, bank statements, merchant financial statements, business plans, business history, and industry-specific knowledge and experience. If the prospective borrower is a sole proprietor or a corporation and the loan will be secured by a personal guarantee provided by the owner, the lender must consider a credit report from at least one consumer credit reporting agency that compiles and maintains files on consumers on a nationwide basis.

The licensee must also maintain records of all compensation paid to unlicensed persons in connection with the referral of borrowers for a period of at least 4 years.

SB 197 also provides that a lender that pays compensation for a referral to an unlicensed person is liable for "any misrepresentation made to that borrower in connection with that loan." It is not

clear whether the lender is liable only for misrepresentations made by the unlicensed person who receives compensation for the referral, or if the regulator will interpret this provision more broadly. Further, lenders must provide such prospective borrowers this specific written statement in 10-point font or larger at the time the licensee receives an application for the loan:

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 (1-866-275-2677), or file your complaint online at [www.dbo.ca.gov](http://www.dbo.ca.gov).

Lenders must require prospective borrowers to acknowledge receipt of the statement in writing.

SB 197 defines “referral” to mean either the introduction of the borrower and the lender or the delivery to the lender of the borrower’s contact information. The following activities by an unlicensed person are not authorized:

- Participating in any loan negotiation;
- Counseling or advising the borrower about a loan;
- Participating in the preparation of any loan documents, including credit applications;
- Contacting the lender on behalf of the borrower other than to refer the borrower;
- Gathering loan documentation from the borrower or delivering the documentation to the lender;
- Communicating lending decisions or inquiries to the borrower;
- Participating in establishing any sales literature or marketing materials; and
- Obtaining the borrower’s signature on documents.

Many for-profit CFLL licensees may find the narrow exemption that permits CFLL licensees making commercial loans to accept referrals from non-licensed entities impractical. The industry may instead choose to focus on the existing prohibition against paying non-licensees for “soliciting or accepting applications for loans” to avoid the limitations on the loan terms.