

SUBJECT: Rewriting the Texas Credit Code; creating qualified commercial loans

COMMITTEE: Financial Institutions — committee substitute recommended

VOTE: 8 ayes — Marchant, Ehrhardt, Elkins, Giddings, Grusendorf, Patterson, Smith, Solomons

0 nays

1 absent — Gutierrez

WITNESSES: For — Kenneth Brensen; Sam Kelly, Texas Automobile Dealers Association; James Ronay, Small Business United Texas; Bill Stinson; Robert Howden, National Federation of Independent Business; Karen Neeley, Independent Bankers Association of Texas; Author Val Perkins, Texas Business Law Foundation; David Pinkus, Small Business United Texas; Kelly Rogers, Texas Bankers Association; Scott J. Sheehan

Against — Gerald Boudreau; Jeannette Peten; William Broussard

On — Leslie Pettijohn, Office of Consumer Credit Commissioner; Catherine Ghiglieri, Texas Department of Banking

BACKGROUND
:

The Texas Credit Code protects persons from usurious interest on commercial and consumer loans. The code is intended to protect Texans from “abusive and deceptive practices being perpetrated by unscrupulous operators, lenders and vendors.” Usury is committed if a lender contracts for, charges, or receives more than the maximum amount of interest allowed by law. The amount of interest allowed varies with the type of loan but is generally set at an annual rate of 18 to 21 percent.

The usury penalty for a lender who contracts for, charges, or receives more than the maximum amount of interest allowed by law is the greater of (1) three times the usurious interest collected or (2) \$2,000 or 20 percent of the principal, whichever is less. A lender who contracts for, charges, or receives more than twice the maximum amount of interest allowed by law is liable for an additional penalty of forfeiture of principal, as well as all interest and other charges.

A lender who discovers a violation may give notice to the borrower and correct it, whether by contract amendment or refund. A lender determining that a bona-fide error caused an overcharge could use this error as a defense to an action for usury brought by a borrower.

A consumer loan is a loan for personal, family or household use. Any other transaction is considered commercial.

During the interim, the Texas Credit Code Revision Task Force reviewed the statute, originally passed in 1967, to identify areas that might need revision.

DIGEST: CSHB 1971 would reorganize and revise certain chapters of the Texas Credit Code regulating consumer and commercial credit and insert them into the recodified financial services statutes.

CSHB 1971 would create a new consumer loan chapter consolidating existing chapters dealing with regulated loans, installment loans and secondary mortgage loans and allow a minimum interest charge of \$25 on single payment loans that were prepaid.

The bill would make two changes relating to commercial loans — creating qualified commercial loans and amending the penalties in certain cases.

A “qualified commercial loan” would be a loan or a renewal or extension of a loan of \$3 million or more. The bill would permit a lender to receive compensation on a qualified commercial loan in the form of equity participation, profit participation, or revenue participation, and would stipulate that compensation would not include interest. The compensation could be in addition to interest charged on the loan.

CSHB 1971 also would change the law on usury penalties to allow a lender who contracted for or charged usurious interest to be given an opportunity to cure the violation before the borrower filed suit seeking usury penalties.

The bill would stipulate that the additional penalty of forfeiture of principal could be levied against a lender only if the lender actually received interest greater than twice the maximum authorized, rather than just contacted for or

charged the excess interest.

CSHB 1971 would take effect September 1, 1997, and would apply to transactions on or after that date.

**SUPPORTERS
SAY:**

CSHB 1971 would consolidate consumer credit laws and propose changes only to commercial credit laws for the benefit of businesses.

Allowing commercial transactions of \$3 million or more to use a combination of interest and equity would expand small business access to capital in Texas. The parties involved in \$3 million transactions are sophisticated and would be represented by counsel, assuring that they were well protected.

The \$3 million threshold would protect smaller business owners from undue pressure to give away equity in their company to a potential lender. It would be unwise to eliminate the floor on qualified commercial loans, since small businesses could be put in the position of having to give up a share of their equity to the lender just to get a loan. Lenders would have the upper hand in all cases; they could both require that a borrower give equity investment in the businesses and charge the maximum interest allowed on the loan. This problem could not be prevented by a requirement that the borrower be represented by counsel, which would not keep lenders from stipulating that loans would be made only on the condition that they received equity in the small company.

There is a delicate balance between protecting consumers and businesses and lifting maximum rates of interest and charges to business in the hope of creating more access to capital and stimulating economic development. The \$3 million threshold for qualified commercial loans is the product of thorough research and examination. The Texas Credit Code Revision Task Force concluded that \$3 million would allow commercial borrowers greater access to capital by giving lenders an opportunity for better return on their investment and protecting smaller business consumers.

Under current law, merely contracting for or charging interest in excess of twice the maximum will trigger the forfeiture penalty. This is too onerous a burden on lenders and allows borrowers to sue for a simple mistake. The

penalty should only be allowed if excessive interest was actually paid. The change proposed would allow forfeiture of principal only when lenders actually gained from their wrongdoing. If a mistake has been made, the bill would give the lender the opportunity to correct the mistake, rather than be sued for loss of principal.

Combining the various consumer loan provisions into a single chapter would be more efficient and make the Credit Code easier to use.

OPPONENTS
SAY:

All commercial lenders and borrowers should have the opportunity to enter into qualified commercial loans, so long as the borrower is represented by counsel. This privilege should not be limited to just those making loans of \$3 million or more. There should be no threshold amount for commercial loans to combine interest and equity as payment for a loan.

Small speculative business ventures have few avenues for raising adequate capital. Eliminating the floor on qualified commercial loans and requiring the borrower to be represented by an attorney would expand capital sources for these small enterprising companies. Requiring all borrowers to have counsel would ensure that the rights of borrowers were protected.

OTHER
OPPONENTS
SAY:

The \$3 million threshold for qualified commercial loans is too high and should be reduced to \$1 million. The \$1 million level was recommended by the Texas Finance Commission and the Texas Bankers Association. The high threshold precludes small businesses from being able to benefit from these types of transactions. Transactions over \$3 million are already being made in Texas, but are being closed out of state in order to circumvent the Texas Credit Code. Out-of-state closure is not an option for smaller transactions.

NOTES:

The companion bill, SB 1649 by Cain, has been referred to the Senate Economic Development Committee.