

SUBJECT: Amending the definition of a qualified commercial loan

COMMITTEE: Financial Institutions — committee substitute recommended

VOTE: 7 ayes — Averitt, Solomons, Denny, Ehrhardt, Elkins, Grusendorf, Marchant
0 nays
2 absent — Pitts, Juan Solis

SENATE VOTE: On final passage, March 25 — 31-0

WITNESSES: For — John F. Cassidy; Paul Johnson, KBK Financial; David Pinkus, Small Business United of Texas
Against — None
On — Bill Stinson, Texas Association of Realtors

BACKGROUND: In 1997, the 75th Legislature created a new class of commercial loans called “qualified commercial loans,” the principal of which must be \$3 million or more. Lenders may receive additional compensation on a qualified commercial loan in the form of equity participation, profit participation, or revenue participation. Because none of this compensation is considered interest, acceptance of this compensation does not trigger state usury laws. No loan, including the renewal or extension of a loan for which the original principal is less than \$3 million, can be considered a qualified commercial loan.

DIGEST: CSSB 172 would redefine qualified commercial loans in the Finance Code to allow businesses to borrow smaller amounts of money. Under the revised definition, a qualified commercial loan would be a single loan or bundle of loans with an aggregate value of:

- ! \$3 million or more if secured by real property;
- ! \$500,000 or more if not secured by real property;

- ! between \$250,000 and \$500,000 if not secured by real property and the borrower had been advised to seek the advice of an attorney and an accountant; and
- ! above \$250,000 if it was a renewal or extension of a qualified commercial loan.

CSSB 172 would exclude commercial loans made for the purpose of financing a business licensed by the Motor Vehicle Board of the Texas Department of Transportation.

The bill would take immediate effect if finally passed by a two-thirds record vote of the membership of each house.

**SUPPORTERS
SAY:**

CSSB 172 would make it easier for smaller businesses to acquire startup capital and financing to expand operations by allowing smaller loans to be qualified commercial loans. The bill would lower from \$3 million to \$250,000 the threshold for a single loan or bundle of loans.

Qualified commercial loans allow the lender to receive additional compensation from the borrower in the form of equity participation. This gives lenders the incentive to finance small and startup businesses in emerging fields, such as high technology. Without such incentives, businesses would not be able to borrow sufficient capital, because the risk involved in these types of loans cannot be covered by the lender with traditional interest, as limited by state usury laws. CSSB 172 would provide substantially more flexibility for equity participation.

Many small businesses need far smaller amount of capital than \$3 million. Expanding the use of equity participation would make capital more readily available to these businesses. The threshold reduction would apply only to loans that are not secured by real property. Equity participation is not needed for loans below \$3 million secured by real property because that property is sufficient collateral to cover risk. There would be enough competition among lenders to protect the interests of borrowers and to provide a fair interest rate and equity participation plan.

The bill would require any lender entering into a qualified commercial loan below \$500,000 to obtain a statement from the borrower acknowledging that the borrower had been advised to seek the advice of an accountant or attorney

and had had an opportunity to do so. Equity participation is a complex financial agreement with legal obligations that are difficult to understand. It is important for a borrower to have the opportunity to consult with an accountant and an attorney.

**OPPONENTS
SAY:**

The \$3 million threshold for a qualified commercial loan should be retained. There is a delicate balance between protecting small businesses and increasing the maximum charges that borrowers can assess in exchange for providing capital to small businesses.

Lower thresholds of CSSB 172 would expose smaller business owners to undue pressure to give away equity in their business to potential lenders. The \$3 million level was recommended by the Texas Credit Code Revision Task Force in 1996 and enacted by the Legislature in 1997. This higher threshold in current law prevents lenders from requiring that a borrower give equity participation, while, at the same time, paying the maximum interest rate.

NOTES:

The substitute added the requirement that lenders of the smallest qualified commercial loans obtain a statement regarding the borrowers' opportunity to seek counsel and would exclude loans used to finance automobile dealerships from the definition of qualified commercial loan.

On May 11, the House passed HB 2781 by Pitts, which would amend the definition of qualified commercial loan to include a bundle of loans for which the aggregate principal was \$3 million or more, so long as all the loans were part of the same transaction. The definition also would apply to the renewal or extension of such a loan. The Senate Finance Committee reported HB 2781 favorably, without amendment, on May 14 and recommended it for the Senate Local and Uncontested Calendar.