

SUBJECT: Amending the definition of qualified commercial loan

COMMITTEE: Financial Institutions — favorable, without amendment

VOTE: 8 ayes — Averitt, Solomons, Denny, Ehrhardt, Elkins, Grusendorf, Pitts, Juan Solis

0 nays

1 absent — Marchant

WITNESSES: (*On original bill:*)
For — Arthur Val Perkins, Texas Business Law Foundation

Against — 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, in and of itself, does not trigger the state’s 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: HB 2781 would amend the definition of qualified commercial loan in the revised civil statutes and in the Finance Code 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.

This bill would take effect on September 1, 1999.

SUPPORTERS SAY: HB 2781 would make it easier for smaller businesses to acquire startup capital and necessary financing to expand their operations in Texas.

Qualified commercial loans allow the lender to receive additional compensation from the borrower in the form of equity participation. This feature gives lenders enough incentive to finance small and startup businesses in emerging fields such as high technology. Without this provision, these businesses may not be able to borrow sufficient capital, as the risk involved in these loans cannot be covered by the lender with traditional interest, as governed by the state's usury laws.

The current statutory definition of a qualified commercial loan now is limited to a single loan with a principal of \$3 million or more. Often, a borrower will work with several different lenders to put together a bundle of loans. HB 2781 would allow equity participation for this group of borrowers if the aggregate loan principals exceeded \$3 million.

The \$3 million threshold protects smaller business owners from undue pressure to give away equity in their business to a potential lender. If the threshold were lowered, lenders would be in a stronger position to require that a borrower give equity participation while paying the maximum interest rate. There is a delicate balance between protecting small businesses and increasing the maximum rates of interest or charges that borrowers can assess to stimulate capital flow to small businesses. The \$3 million level was recommended by the Texas Credit Code Revision Task Force in 1996 and enacted by the Legislature in 1997.

**OPPONENTS
SAY:**

The bill should lower the threshold to \$250,000 for a loan to be considered a qualified commercial loan. Many small businesses need a far smaller amount of capital, and expanding the use of equity participation would make capital more readily available to these businesses. This reduction in the threshold should apply only to loans that are not secured by real property, as the real property is sufficient collateral to cover the risk of these loans. There is enough competition among lenders to protect the borrowers' interests and to provide a fair interest rate and equity participation plan.

**OTHER
OPPONENTS
SAY:**

Equity participation is a complex financial agreement with legal obligations that are equally difficult to understand clearly. No qualified commercial loan should be entered into without at least the opportunity to consult with an accountant or attorney. Any lender entering into a qualified commercial loan should have to obtain a statement from the borrower acknowledging that the

borrower has been advised to seek the advice of an accountant or attorney and has had an opportunity to do so.

NOTES:

The proposed amendments to the Finance Code would be effective only if SB 1368 by Harris, which would make nonsubstantive changes in enacted codes, is signed into law by the governor. Should SB 1368 not take effect, HB 2781 instead would amend the revised civil statutes.

A Senate bill related to commercial loans, CSSB 172 by Harris, passed the Senate on March 25 and was reported favorably as substituted by the House Financial Institutions Committee on May 6. CSSB 172 would define a qualified commercial loan as 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 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.