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HOUSE OF REPRESENTATIVES

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RQ 724

August 1, 1994

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Mr. Dan Morales
Texas Attorney General
Attn: Sarah Shirley, Chair of Opinions Committee,
1500 Congress
P.O. Box 12548
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SJS
FILE # ML-28016-94
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Dear Mr. Morales:

As Chairman of the House Investments and Banking Committee, I request your official opinion on the construction and application of a provision of the Texas Pawnshop Act (Article 5069-51.01 et seq. V.T.C.S.).

Article 51.03A (a) (2) requires an applicant for a pawnshop license to "have net assets of \$150,000 readily available for use in conducting the business of each licensed pawnshop." Article 51.06 (d) mandates that "each licensee shall maintain net assets either used or readily available for use in the conduct of the business of each licensed pawnshop in the amount of \$150,000 as determined by using the definition of net assets prescribed by the Act."

Article 51.02 (g) provides the applicable definition for the net asset requirement as follows:

"Net Assets" – means the book value of the current assets of a person or pawnbroker less its applicable liabilities as stated in this subsection. Current assets include the investment made in cash, bank deposits, merchandise inventory, and loans from customers excluding the pawn service charge. Current assets do not include the investments made in fixed assets of real estate, furniture, fixtures, or equipment; investments made in stocks, bonds, or other securities; or investments made in prepaid expenses or other general intangibles. Applicable liabilities include trade or other accounts payable; accrued sales, income or other taxes; accrued expenses; and notes or other payables that are unsecured or secured in whole or part by current assets. Applicable liabilities do not include liabilities secured by assets other than current assets. Net assets must be represented by a

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capital investment unencumbered by any liens or other encumbrances to be subject to the claims of general creditors. If the pawnshop is a corporation, the capital investment consists of common or preferred shares and capital or earned surplus as those terms are defined by the Texas Business Corporation Act, as amended; if it is any other form of business entity, the capital investment consists of a substantial equivalent of that of a corporation and is determined by generally accepted accounting principles.

The standard of net assets is further defined and described in the Consumer Credit Commissioner's Rules. 7 TAC S85.2 (a) (2) (A) provides in pertinent part:

Determination of net assets. Pursuant to Texas Civil Statutes, Article 5069-51.02 (g) an applicant or licensee's net assets is the sum of cash on hand, bank deposits, the value of merchandise inventory held for sale in the pawnshop or to be held for sale in the pawnshop, and the amount of money loaned on open pawn loans receivable less any and all unsecured debts, and debts secured in whole or in part by the previously listed assets. Assets must be available for use in the pawnshop business to be acceptable.

Other provisions relate to the method for valuation of merchandise inventory.

The Texas Pawnshop Act and the Commissioner's Rules indicate that some pawnshops have grandfathered rights for a lower net asset requirement. However, I do not believe that to be relevant to my inquiry. My question to you relates to what diminishes or reduces net assets rather than to the specific dollar requirement.

The statutory definition is clear and straightforward. Net assets are the book value of current assets that remain after subtracting or deducting the current or applicable liabilities. Applicable liabilities of the pawnshop appear to be all liabilities other than liabilities specifically secured by assets other than current assets. The key statutory requirement is:

Net assets must be represented by a capital investment unencumbered by any liens or other encumbrances to be subject to the claims of general creditors.

I seek your opinion as to whether a pawnshop meets this requirement if it has a general financing debt that is subordinated by the lender in an effort to permit the pawnshop to meet the net asset requirement. Let me recite what I understand to be a growing practice. To illustrate, I will use a hypothetical set of facts.

Pawnshop A has current assets under the definition of \$160,000. Except for the subordinated debt to which I will refer, it has no applicable liabilities. However, Pawnshop A has borrowed from and owes to Bank X \$100,000. Pawnshop A has executed a security agreement and financing statement to Bank X covering all of the assets of the business.

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However, both Pawnshop A and Bank X have recognized the requirement for Pawnshop A to meet the net asset requirement. So Pawnshop A and Bank X simultaneously entered into a subordination agreement at the time of the execution of the security agreement and financing statement.

The subordination agreement states that Bank X subordinates any lien or claim it might have to permit Pawnshop A to meet the net asset requirement. The subordination agreement provides that any lien or claim of Bank X to the assets of Pawnshop A will always be subordinate to the \$150,000 net asset requirement and subordinate to the right of general creditors to have first claim to the first \$150,000 of net assets of Pawnshop A.

I am advised that the subordination agreements come in various forms with various requirements. However, the basic thrust is that a lender who would otherwise be a secured (by current assets) or general creditor has agreed to subordinate its debt and any claim it might have against the current assets of the pawnshop to permit the pawnshop to meet the net asset requirement.

Under the scenario I described, the pawnshop would not meet the net asset requirement if the subordinated debt is required to be subtracted from current assets to arrive at the total net assets. On the other hand, if the subordinated debt of the pawnshop is not considered to be an "applicable liability" and therefore need not be subtracted from current assets, the pawnshop would have the requisite amount of net assets.

My question to you is whether general indebtedness of a pawnshop and/or debt secured by current assets can be eliminated or removed from the definition of "applicable liabilities" by a subordination agreement or subordination arrangement? If the pawnshop creditor contractually commits that the first \$150,000 for each licensed pawnshop will be first available for general creditors and it will subordinate any and all claims to that first \$150,000 of net assets for each pawnshop in every way to permit the pawnshop to meet the net asset requirement, does that action remove the pawnshop's liability or debt or payable to the creditor from the definition of "applicable liabilities?" Because the pawnshop still has a debt and liability even though subordinated, is that debt or liability "notes or other payables that are unsecured or secured in whole or part by current assets" within the definition of "applicable liabilities"? Because the debt is subordinated, can it be concluded that the net assets are represented by a "a capital investment unencumbered by any liens or other encumbrances" as required by the statute?

I understand that the legal documents in use or proposed to be used to subordinate debts or notes of a pawnshop take many different forms. Without regard to the form, my question to you is whether a debt of a pawnshop which has been subordinated to claims of general creditors and/or subordinated to the legal net asset requirement of the pawnshop falls within the definition or coverage of "applicable liabilities" under Article 5069-51.02 (g)? Should the indebtedness be

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subtracted from current assets in the determination of the dollar amount of net assets the pawnshop has?

I would appreciate receiving your official opinion on the inquiry at your earliest convenience.

Sincerely,

A handwritten signature in black ink, appearing to read "K Marchant". The signature is fluid and cursive, with a large initial "K" and a long horizontal stroke at the end.

Kenny Marchant
Chairman
Investments and Banking Committee