HOUSE COMMITTEE ON BUSINESS & INDUSTRY
TEXAS HOUSE OF REPRESENTATIVES
INTERIM REPORT 2000

A REPORT TO THE
HOUSE OF REPRESENTATIVES
77TH TEXAS LEGISLATURE

REPRESENTATIVE KENNETH "KIM" BRIMER
CHAIRMAN

COMMITTEE CLERK
BONNIE BRUCE

Committee On
Business & Industry

October 13, 2000

Representative Kenneth "Kim" Brimer
Chairman

P.O. Box 2910
Austin, Texas 78768-2910

The Honorable James E. "Pete" Laney
Speaker, Texas House of Representatives
Members of the Texas House of Representatives
Texas State Capitol, Rm. 2W.13
Austin, Texas 78701

Dear Mr. Speaker and Fellow Members:

The Committee on Business & Industry of the Seventy-Sixth Legislature hereby submits its interim report including recommendations for consideration by the Seventy-Seventh Legislature.

Respectfully submitted,

Representative Kenneth "Kim" Brimer, Chairman

Rep. Frank Corte

Rep. Dawnna Dukes

Rep. Kenn George

Rep. Helen Giddings

Rep. Allan Ritter

Rep. Bill Siebert

Rep. Burt Solomons

Rep. Beverly Woolley

Dawnna Dukes
Vice-Chair

Members: Frank Corte, Kenn George, Helen Giddings, Allan Ritter, Bill Siebert, Burt Solomons, Beverly Woolley

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INTRODUCTION

At the beginning of the 76th Legislature, the Honorable James E. "Pete" Laney, Speaker of the Texas House of Representatives, appointed nine members to the House Committee on Business & Industry. The committee membership included: Representatives Kenneth "Kim" Brimer, Chair; Dawnna Dukes, Vice-Chair; Frank Corte; Kenn George; Helen Giddings; Allan Ritter; Bill Siebert; Burt Solomons; and Beverly Woolley.

During the interim, Speaker Laney assigned the Committee on Business & Industry the following five charges:

1. Examine the ways to deter and punish consumer fraud directed at senior citizens, including telemarketing fraud.

2. Assess the public's view of telemarketing generally, the desire and need for simpler ways to prevent nuisance calls, and whether views depend on the business of the vendor or solicitor.

3. Consider the legal status and policies appropriate to any surplus funds held by the Texas Workers' Compensation Insurance Fund. The committee's consideration should be directed at assuring that sufficient funds are available to deal with all possible market conditions.

4. Consider the benefits and problems associated with contingency clauses in construction contracts.

5. Study the emergence of the healthcare technology industry in Texas. Identify factors promoting and inhibiting development of the industry and consider state or private actions potentially affecting its growth.

In addition, the committee was charged with conducting active oversight of the agencies under the committee's jurisdiction (i.e. the Texas State Office of Risk Management, the Risk Management Board, the Texas Workers' Compensation Insurance Fund Board, the Texas Workers' Compensation Commission, and the Research and Oversight Council on Workers' Compensation).

In order to effectively undertake these charges, Chairman Brimer created five separate subcommittees; one subcommittee for each charge. Chairman Brimer wishes to express his appreciation to the subcommittee

chairs and their respective staff members for the time and effort they extended to this project. Each subcommittee held public hearings and accepted considerable amounts of testimony. This report represents the final conclusions and recommendations of each subcommittee and their supporting documentation. The members of the Committee on Business & Industry as a whole have approved all sections of this report.

As well, committee staff wishes to thank Attorney General John Cornyn and his staff including Ester Chavez, Thomas Glenn, and Sally Hanners; the staff of the Texas Workers' Compensation Insurance Fund, especially Jeremiah Bentley, Jaelene Fayhee, Terry Frakes, and Russ Oliver; the entire staff of the Research and Oversight Council on Workers' Compensation including Ron Alves, D.C. Campbell, Jerry Hagins, Chris Hyatt, Amy Lee, and Scott McAnally; the staff of the Texas Department of Insurance; and the staff at the Public Utility Commission including Ron Hinkle, Saralee Tiede, and Trish Dolese. Committee staff would also like to thank computer guru Ambrose Gonzales of the Texas Legislative Council Computer Center.

Further, the committee staff wishes to express their gratitude and appreciation for the efforts of organizations who hosted various subcommittees including Baylor Healthcare Center, U.T. M.D. Anderson, San Antonio City Council, and the University of Texas San Antonio. Specifically, the staff would like to express their gratitude to the individuals whose efforts allowed the subcommittee on healthcare technology to view their facilities thereby contributing to the subcommittee's overall understanding of the healthcare technology industry, including Beta Gene, Baylor Research Institute, Introgen, and the Texas Research Park.

In addition, the committee wishes to extend a very sincere thanks to the citizens of Texas who attended any of the public hearings. Your time and efforts are greatly appreciated.

Lastly, a word of thanks to the Chairman's staff members that assisted in the preparation of this report--Brandon Aghamalian, Ben Modisett, and Jill Crocker.

HOUSE COMMITTEE ON BUSINESS & INDUSTRY

INTERIM STUDY CHARGES AND SUBCOMMITTEE ASSIGNMENTS

SUBCOMMITTEE ON CONSUMER FRAUD DIRECTED AT SENIOR CITIZENS

CHARGE Examine ways to deter and punish consumer fraud directed at senior citizens, including telemarketing.

Bill Siebert, Chair
Frank Corte
Helen Giddings
Burt Solomons
Beverly Woolley

SUBCOMMITTEE ON CONTINGENCY CLAUSES IN CONSTRUCTION CONTRACTS

CHARGE Consider the benefits and problems associated with contingency clauses in construction contracts.

Allan Ritter, Chair
Frank Corte
Helen Giddings
Bill Siebert
Burt Solomons

SUBCOMMITTEE ON THE HEALTHCARE TECHNOLOGY INDUSTRY

CHARGE Study the emergence of the healthcare technology industry in Texas. Identify the factors promoting and inhibiting development of the industry and consider state or private actions affecting its growth.

Kenn George, Chair
Frank Corte
Dawnna Dukes
Allan Ritter
Beverly Woolley

SUBCOMMITTEE ON TELEMARKETING

CHARGE Assess the public's view of telemarketing generally, the desire and need for simpler ways to prevent nuisance calls, and whether views depend on the business of the vendor or solicitor.

Burt Solomons, Chair
Dawnna Dukes
Kenn George
Helen Giddings
Bill Siebert

SUBCOMMITTEE ON THE TEXAS WORKERS' COMPENSATION INSURANCE FUND'S SURPLUS

CHARGE Consider the legal status and policies appropriate to any surplus funds held by the Texas Workers' Compensation Insurance Fund. The committee's consideration should be directed at assuring that sufficient funds are available to deal with all possible market conditions.

Dawnna Dukes, Chair
Kenn George
Helen Giddings
Allan Ritter
Bill Siebert

INTERIM REPORT
ON
CONSUMER FRAUD
DIRECTED AT THE ELDERLY

Committee on Business & Industry
Representative Kenneth "Kim" Brimer, Chair

Subcommittee on Consumer Fraud Directed at the Elderly
Representative Bill Siebert, Chair

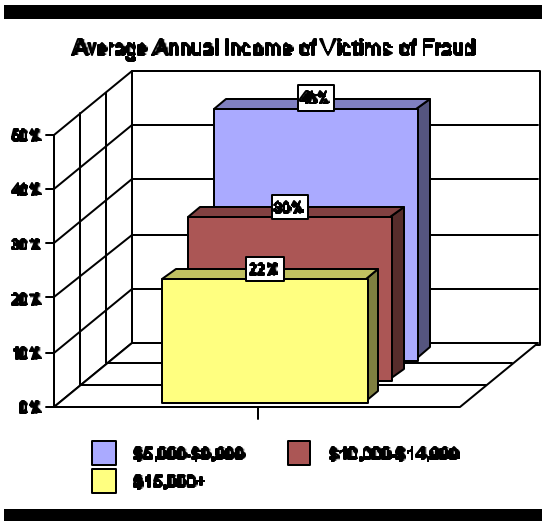
Report to the 77th Legislature

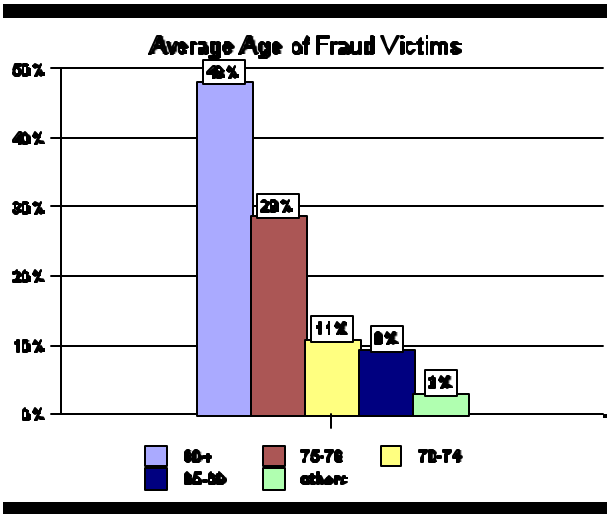
THE ISSUE

During the past decade, fraud perpetrated against senior citizens has become an increasingly significant dilemma. It is a problem which plagues the individual victim, their families, law enforcement agencies, and policymakers alike. However, "fraud" is a difficult term to clearly define and an even more difficult act to deter. Nonetheless, Texas lawmakers continue to grapple with it in an attempt to protect the citizens of this state.

Almost one in five Americans have been victims of consumer fraud at some point, and three in four report having a "bad buying" experience in the past year, according to a recent American Association of Retired Persons' (AARP) survey. The national consumer survey, conducted in November and December of 1998, found that 17 percent of American adults identified themselves as victims when asked if they had been the subject of fraud or a major consumer swindle. Respondents expressed concern about the practices of specific industries, including car dealers, telemarketers, and home repair contractors.

Statistically, seniors prove more likely to become the target of fraud. While older people only make up 12 to 13 percent of the U.S. population, they comprise 30 percent of all fraud victims and 60 percent of all health fraud victims. Nationwide, crimes against the elderly have doubled in the past five years.





According to a 1998 study conducted by the National Center on Elder Abuse, nearly one-third of the reports of abuse documented in the study were incidents of financial exploitation (21,427 of 70,942). Most victims were older than 70 years of age and female. Nearly one-half (48 percent) were 80 years of age and older, while another 28.7 percent were between 75-79 years of age. Victims between 70 and 74 years of age and those between 65 and 69 accounted for 10.8 percent and 9.4 percent, respectively. Female elders were victims of financial exploitation somewhat more than their proportion of the elder population (63 percent versus 57.6 percent), while male elders were victims 37 percent

of the time. Nearly one-half (46 percent) had incomes between $5,000 and $9,999, while almost one-third (29.8 percent) had incomes between $10,000 and $14,999. Slightly more than one-fifth (22.4 percent) had incomes of $15,000 or more.

This report will focus specifically on three major types of fraud that seems to plague Texans the most: telemarketing fraud, sweepstakes fraud, and home repair fraud.

TELEMARKETING FRAUD

While there are many legitimate companies that use the telephone for marketing, consumers lose an estimated $40 billion each year due to telemarketing fraud, according to the National Fraud Information Center (NFIC), a project of the National Consumers League. The Federal Bureau of Investigation estimates that there are 14,000 illegal telephone sales establishments currently operating in the United States.

> *"If I put a gun to your head and rob you of a thousand dollars, I would get 15-20 years. If I conned you out of a thousand dollars, I'd get a slap on a wrist."*
>
> **--Tom deChant**
> **Texas Citizen**

Senior citizens are often the target of telemarketing fraud. Fraudulent telemarketers often compile "mooch lists" of consumers who are potentially vulnerable to telemarketing fraud. According to AARP, 56 percent of the names on such lists are individuals age 50 or older.

According to the NFIC, many senior citizens who have lost money in telemarketing schemes report that they cannot always discern an honest telemarketer's sales pitch from that of a dishonest one. Additionally, many feel uncomfortable hanging up on callers, or are bullied into buying merchandise.

SWEEPSTAKES FRAUD

The most common forms of sweepstakes fraud which effect the elderly involve fraudulent offers made by telephone or mail. A common fraudulent tactic involves leading an entrant to believe that his chance of winning will increase if he makes a purchase. Another practice that misleads many elderly consumers is large lettering on envelopes informing them that they have won a prize when, in reality, the fine print inside the envelopes indicates they *may* have won.

Currently, 20 states have laws addressing sweepstakes fraud. In Kansas, South Dakota, Utah, Wisconsin, and Wyoming, an envelope containing a prize notification may not contain any representation that the addressee may be eligible to receive a prize or a gift. However, this prohibition applies only where receipt of a prize is conditioned upon a payment, purchase or other obligation (such as attendance at a sales presentation or the requirement that a consumer contact the sponsor to learn how to receive the prize).

Many states also require companies which utilize sweepstakes to maintain lists of winners. West Virginia's statutes require that prizes be delivered within 10 days after the contact with the consumer. Statutes in Georgia, Ohio, and West Virginia prohibit prizes or contests as sales promotions unless the dealer offering the

prize discloses the market value of the prize and whether the consumer must listen to a sales pitch.

At the federal level, Congress has passed the Deceptive Mail Prevention and Enforcement Act in 1999. It is important to note that this act does not preempt state laws addressing sweepstakes. It requires, among other stipulations, that a disclosure be posted on sweepstakes letters and order forms that a purchase does not increase the chances of winning.

HOME REPAIR FRAUD

Most home improvement contractors complete projects in a timely and professional manner. However, there are also fraudulent actors who insist on advance payment, but never do the work or do minimal work and never return. They strike a few victims, then quickly leave town. Sometimes they use intimidation to encourage homeowners to refinance their mortgages to pay for the improvements.

Home repair fraud is on the rise and difficult to combat, due largely in part to the fact that most parties fail to execute a written contract and thus have no record of the individuals involved. Many states rely on consumer protection statutes to combat home repair fraud. Where force or abusive tactics are involved, state trespassing or battery laws may be applicable as well.

Another factor contributing to the issue of home repair fraud is that Texas does not regulate the home repair profession and, thus there is not a registration process. Only a few states have specific licensing or registration requirements for home repair improvement contractors. They include Alabama, California, Connecticut, Florida, Illinois, Indiana, Maine, Maryland, Massachusetts, New York, New Jersey, Oklahoma, Pennsylvania, Tennessee, Virginia, and Washington.

California, for example, requires that anyone who contracts to do property improvement projects valued at $300 or more must be licensed by the Contractors State Licensing Board (CSLB) which, in turn, enforces selective qualifications related to a person's experience. In addition the CSLB requires licensed contractors to post a bond in order to protect consumers from losses in the event of a default.

OTHER TYPES OF FRAUD

In addition to the types of abuse found within the telemarketing, sweepstakes, and home repair professions, the AARP indicates counterfeit charities, "where's the check?" scams, and phony business opportunity scams are also burdening senior citizens.

According to Jane King, AARP's Director of Consumer Affairs, ***Charity fraud*** represents a serious threat to seniors. Phoney charities (or dishonest fund-raisers using legitimate organizations) take advantage of seniors' altruism and community spirit by convincing them to contribute large amounts of money to a fictional organization. Some unscrupulous individuals cut deals with legitimate charities, but only pay them a small amount for permission to use their names, and then pocket most of the proceeds.

Another insidious tactic, reports the Better Business Bureau, is the ***"Where's the Check" scam***. It preys on those afflicted with memory loss. The criminal makes an initial call to get as much information as possible

about the potential victim. The next day, the victim receives another call where a number of the same questions are asked in order to determine how well the senior remembers the details of the previous call. If the senior cannot remember many of the details of the previous day's call, the con artist launches into a variety of pitches.

For example, the caller might claim that the senior had paid too much for a previously purchased item. To rectify the error, the caller will suggest, the senior should send another check for the "smaller" amount, and the larger amount will be refunded. Or, the caller might insist that the senior had agreed to send a check by overnight courier for a purchase agreed to in the previous day's conversation. To avoid guilt or embarrassment, the senior sends the money that the caller has asked for.

Another popular scam involves offering individuals ***non-existent job and investment opportunities*** which promise unbelievable earnings for a small investment. A recent bulletin from the Federal Trade Commission lists many of these "opportunities" as illegal pyramid schemes. Work-at-home schemes promise large returns for a simple task like envelope stuffing. After paying a fee, victims usually receive instructions on how to send the same ad to which they had responded. In short, the offer provides no work.

STATE LAWS

STATE TELEMARKETING LAWS

Please see the Subcommittee on Telemarketing report for an in-depth discussion of state telemarketing laws.

STATE HOME IMPROVEMENT LAWS

When a consumer signs a contract for home improvements on their homestead, the contractor can legally fix a lien on the homestead. Section 41.007 of the Texas Property Code requires that any contract a consumer signs for work on their homestead must contain the following warning:

> **"Important Notice: You and your contractor are responsible for meeting the terms and conditions of this contract. If you sign this contract and you fail to meet the terms and conditions of this contract, you may lose your legal ownership rights in your home. Know your rights and duties under the law."**

If a contract is signed containing the required statutory language and the consumer fails to make the payments, the company can file a lien against the consumer's home. Conversely, if a contractor presents a contract without this clause, it is a violation of the Deceptive Trade Practices Act (discussed below).

Under Texas law, if a subcontractor or supplier is not paid, the consumer can be liable and the property may be subject to a lien for the unpaid amount. It is important to note that a consumer can still be liable to a subcontractor even if he has not contracted directly with the subcontractor.

If the homestead improvement exceeds $5,000 in cost, the contractor is required by law to deposit the consumer's payments in a construction account at a financial institution.

STATE DOOR-TO-DOOR SOLICITATION LAWS

Under Texas law [Texas Business & Commerce Code, Section 39.001 et seq.], the door-to-door seller must:

- Advise the consumer orally and in writing of their 3 day right to cancel (before midnight of the third business day after the sale); and
- Give a contract or receipt stating the date of the sale, the name and address of the merchant, and a statement of the consumer's right to cancel the contract which includes the address where the cancellation notice is sent.

If the salesperson complies with the statutory requirements, a consumer may simply sign a "notice of cancellation," form, date it, and mail it back to the seller. Obviously, if the salesperson fails to comply with the statutory requirements, a contract may still be voided in its entirety if the consumer desires.

After a consumer requests cancellation, the seller has ten business days to refund money, return any note signed concerning the sale, and return any trade-in items. The seller of the goods must notify the consumer within ten days whether he or she intends to retrieve the goods or abandon them. He or she may not require the consumer to mail or ship the goods back. If the seller fails to notify the consumer of his or her intention to repossess the goods within twenty days after cancellation, the consumer may not be forced to return the goods at a later date. The consumer is also not obligated to return goods to the seller until they have recovered either their money or their note. Any violation of these provisions is considered a violation of the Deceptive Trade Practices Act.

"These actions are civil, they are not criminal. There's a lot of confusion out there because people want us to put the bad guy behind bars and we can't do that. Second, although we are authorized to seek restitution for folks we do not represent them individually and we can't give them legal advice. We struggle with that dilemma frequently. And finally because of limited resources we really have to be most judicious in our selection of cases. It is very tough sometimes to hear about a problem and know that...there are other cases in which the egregiousness of the practice was so much more profound or the total number of consumers impacted is so much greater that we have to choose to do this case rather than another one."

--Esther Chavez
Director of Consumer Fraud Division for the

THE DECEPTIVE TRADE PRACTICES ACT

The Deceptive Trade Practices Act (DTPA, Texas Business & Commerce Code, Chapter 17) is enforced by the Office of the Attorney General and District and County Attorneys. As well, it provides for private rights of action as well. However, generally speaking, the DTPA does not provide for any criminal penalties.

The Office of the Attorney General and District or County Attorneys may ask for penalties including temporary restraining orders, permanent injunctions (violation of which can be penalized up to $50,000)

and civil penalties of not more than $2,000 per violation, not to exceed a total of $10,000. However, those numbers increase to $10,000 per violation and a total not to exceed $100,000 if the consumer was 65 years of age or older. A court may also compensate consumers for actual damages or to restore money or property, real or personal, but only for knowing violations.

It should be noted that the DTPA does not cover a claim arising out of a written contract if the contract relates to a transaction of more than $100,000 or if the consumer is represented by legal counsel, or if the contract does not involve the consumer's residence.

FEDERAL TELEMARKETING LAWS

Please see the Subcommittee on Telemarketing report for an in-depth discussion of federal telemarketing laws.

FEDERAL DOOR-TO-DOOR SOLICITATION LAWS

Products frequently misrepresented by door-to-door salespeople include home improvement items (such as siding and storm windows), funeral service contracts, living trusts, books, and magazines. Under federal law, a door-to-door sale (which is legally referred to as a "home solicitation transaction") takes place whenever a consumer purchases goods or services for more than $25 at a place other than the merchant's place of business.

The Federal Trade Commission (FTC) adopted an administrative rule (formally cited as the "Rule Concerning Cooling-Off Period for Sales Made at Homes or at Certain Other Locations; 16 CFR Part 429 which is hereinafter simply referred to as the "Cooling-Off Rule") which allows consumers three days (defined as midnight of the third business day after the sale) to cancel purchases of $25 or more.

The "Cooling-Off Rule" applies to sales at the buyer's home, workplace or dormitory, or at facilities rented by the seller on a temporary or short-term basis, such as hotel or motel rooms, convention centers, fairgrounds and restaurants. The "Cooling-Off Rule" applies even when a consumer invites the salesperson to make a presentation in their own home.

Under this rule, the salesperson must inform the consumer about their right to cancellation at the time of the sale. The salesperson also must provide two copies of a cancellation form and a copy of the contract or receipt. The contract or receipt should be dated, show the name and address of the seller, and explain the right to cancel.

Some types of sales cannot be canceled even if they do occur in locations normally covered by the "Cooling-Off Rule". Specifically, the "Cooling-Off Rule" does not cover sales that are:

- Under $25;
- For goods or services not primarily intended for personal, family or household purposes (the rule applies to courses of instruction or training);
- Made entirely by mail or telephone;
- The result of prior negotiations at the seller's permanent business location where goods are sold regularly;
- Needed to meet an emergency; or
- Made as part of a request for the seller to do repairs or maintenance on personal property (purchases made beyond the maintenance or repair request are covered).

Also exempt from the "Cooling-Off Rule" are sales that involve:

- Real estate, insurance, or securities;
- Automobiles, vans, trucks, or other motor vehicles sold at temporary locations, provided the seller has at least one permanent place of business; or
- Arts or crafts sold at fairs or locations such as shopping malls, civic centers, and schools.

COMMITTEE FINDINGS

(Note: the subcommittee deferred all telemarketing recommendations to the Subcommittee on Telemarketing, but does wish to state that telemarketing fraud remains a major issue for seniors and represented a major portion of the testimony submitted to the subcommittee.)

In general, the subcommittee determined that Texas has a strong statutory and regulatory foundation for attacking and preventing consumer fraud. Only minor adjustments are recommended to enhance the overall protection of seniors living in Texas. Nonetheless, the subcommittee has three specific recommendations to help certain curb abuses.

First, policy makers should consider prohibiting the use of the word "winner" in correspondence and telephone conversations unless the consumer has truly won something of value. The word "winner" is used in a number of scams that either indicate to an individual that they have already won a prize, but must pay a fee for it (shipping & handling or international border fees) or to indicate to an individual that they are on a limited list of semi-finalists for a prize. These tactics often entice individuals to invest in a scheme when they otherwise would not have done so.

Likewise, the subcommittee recommends that the Legislature should consider prohibiting the practice of offering a free month's subscription, membership, etc. if doing so automatically enrolls the individual in a program for a sustained period of time at the end of the free offering. The consumer should be allowed to opt in rather being forced to opt out of a promotion. For example, a consumer is often notified they have been selected to receive a free months subscription to a magazine. What they are not told is that accepting this free month's subscription will automatically opt them in to a year long, full-priced subscription at the end of the month. Later, the solicitor insists they are owed money for a full year's subscription even though the consumer never agreed to those terms.

Lastly, the subcommittee felt that while the State has many effective protections for consumers, the enforcement provisions are generally reserved for the Office of the Attorney General for all civil remedies. Although the subcommittee recognizes the Attorney General's earnest pursuit of enforcement, they must choose to prosecute only the most egregious cases due to a lack of resources. Citizens need more direct access to civil remedies.

Therefore, the subcommittee feels education efforts to alert consumers of their authority to seek civil

remedies under Texas statute should be more aggressive. Access to the court system for remedies not only allows consumers an avenue for direct relief, but avoids the intimidating and, often in fraud cases, embarrassing process of involving the State's Attorney General. Further, an individual can be more diligent in prosecution than a State office, which is saddled with every fraudulent solicitation in Texas, both large and small.

The subcommittee was stymied in its efforts to examine this issue on a Texas specific basis. The State relies on both the Attorney General's Office (AG) and the Public Utility Commission (PUC) to combat most form of consumer fraud. The Public Utility Commission is involved in investigating utility consumer protection issues while the Office of the Attorney General has a Consumer Fraud Division and an Elder Law and Public Health Division which combine forces to investigate and prosecute fraud.

However, it was impossible for the subcommittee to specifically assess the status of consumer fraud directed at senior citizens in Texas because these agencies do not require complainants to submit their age. Therefore the subcommittee, while convinced that consumer fraud is specifically targeted at seniors residing in this state, was unable to determine the extent of consumer fraud directed at the elderly, the types of fraud most often used in Texas against the elderly, nor the cost to Texas consumers.

In response to this lack of specific statistics and quantifiable data available to the subcommittee, staff recommends an improvement in the Attorney General's and PUC's reporting requirements. Data collection is a relatively simple process and represents a very necessary element to clearly identifying the problem. First, the subcommittee recommends that the AG and the PUC obtain demographic data (such as the age range and geographic location of a complainant) from all consumers who file complaints with their agency.

Additionally, due to the fact that the DTPA represents the primary tool used to fight fraud in Texas, the subcommittee believes a reporting requirement should be added to Chapter 17 of the Business and Commerce Code which would require the Attorney General's office to submit a report every two years to the Legislature which recommends statutory changes to the DTPA which will better combat consumer fraud. In addition, the AG should report how many civil cases involving fraud it has pursued during the proceeding two years.

In summary the subcommittee recognizes the most effective tool to combat fraud is an educated and diligent consumer. The subcommittee encourages industries to do more to educate consumers, especially seniors, about their rights and the remedies available to them. In addition, the subcommittee commends the state agencies and the Texas chapter of the AARP for their diligent, and often underfunded, attempts to educate consumers in the fight to prevent fraud.

INTERIM REPORT
ON
CONTINGENCY CLAUSES
IN CONSTRUCTION CONTRACTS

Committee on Business & Industry
Representative Kenneth "Kim" Brimer, Chair

Subcommittee on Contingency Clauses in Construction Contracts
Representative Allan Ritter, Chair

Report to the 77th Legislature

THE ISSUE

Construction of real property is a complex process involving many different entities such as property owners, contractors, subcontractors, and suppliers, all of whom have their own fiscal, labor and supply issues. Regardless, it is safe to say that **credit is the life-blood of construction.**

> *"The issue of not being paid for someone's work is not only a serious business issue it is also an emotional one. I hate it when people don't pay me. If we were going to pass laws, I think debtor's prison would be too good a treatment for people who don't pay me what they owe me. But I have to take that emotion and look at it in the context of the industry in which I work; and the construction business in the United States is and has always been more a credit transaction than in any other country in the world. We simply don't get paid until after we've done the work."*
>
> **-- Steve Nelson**

All work, throughout the construction chain (from general contractors down through suppliers) is done in advance of payment, primarily so no one entity can hold an entire project hostage by stopping work. General contractors and subcontractors have contracts that ensure payment of work done or materials provided while suppliers provide materials to contractors on a credit basis that typically requires payment within 60 days of the transaction. In short, regardless of the type of agreement, all parties provide work or materials in advance of payment.

Each entity is afforded protection by constitutional and statutory provisions, as well as recourse through the judicial system to enforce agreements between the parties. Texas law protects general contractors and subcontractors from non-payment through "Prompt Pay" laws, lien laws, and bond requirements [1]. These statutes were designed to prevent an owner from receiving added value to his property without paying for it.

> *"As far as risk is concerned, we are the are the First National Bank of Commerce, as far as where the money comes from. We are financing the owner, the surety and we are financing the general contractor until we receive our first paycheck. So it's only fair to understand that we don't want the contingency clause in our contracts."*
>
> **--Larry Werner**

Traditionally, a general contractor has assumed the risk in this expected payment environment. The general contractor acts as the person responsible for payment to the subcontractors, yet he is dependent upon payment from the property owner. In contractual law, one can only sue for the enforcement of a contract, and thus the payment of that contract, with the person or entity with whom one has *directly* contracted. Therefore, a person within the construction chain only concerns himself about the financial ability of

[1] Prompt Pay laws for private works are located at Texas Property Code, Chpt. 28. Public work laws are located at Texas Government Code, Chpt. 2251. Lien and bonding laws for private works are located at Texas Property Code, Chpt. 53. Bond statutes for public works are found at Texas Government Code, Chpt. 2253.

the person or entity they have directly contracted with to meet the monetary requirements of the contract. Consequently, a general contractor assumes the total risk of the project if the owner defaults.

However, as the economy has grown and construction development has expanded over time, so has the cost and risk of construction contracts. General contractors are no longer able to assume the total risk for multi-million dollar construction projects. The average cost for a twenty-story office building is approximately $20-45 million. Still other projects can be in the hundreds of millions, like Austin Bergstrom International ($100 million) or Enron Field ($340 million).

> *"I'm not saying that there are a bunch of bad generals out there. There are a lot of great generals out there that I do business with, but this has become an accepted clause in their contracts and there's no room for negotiation on these clauses basically. With that becoming the general use of their contracts it has removed a right from me to collect money for work performed. I'm not trying to cast a bad light on general contractors per say, because I do work for a bunch of them, but every night when I lay down I think what if owner "A" does go broke."*
>
> **--Mackie Bounds**
> **American Subcontractors' Association**

In today's environment, it is common to find a general contractor only providing a small percentage of the work done on a large project and distributing the remaining work to subcontractors. For example, a general contractor may elect to only pour the foundation for a high-rise office building, and contract out the framing, electrical, plumbing, roofing and finishing of the building to subcontractors, who may in turn contract with other subcontractors or suppliers. Therefore, on a $100 million dollar job, a general contractor may have contributed 1% of the labor and materials, stimulated 3-4% in profit, and "passed-through" the remaining 95% of the contract price straight to his subcontractors. Yet he is assuming the risk for 100% of the work, labor and materials.

If general contractors still assumed the risk on multi-million dollar projects, they would not be willing or even able to assume the risk of that much debt. This is especially true of public work projects. If a public entity, such as the Stateor a public university, defaults on a project, a general contractor has no recourse (unless sovereign immunity is waived). As a result, general contractors sought a way to assign risk to the subcontractors who would provide the majority of materials, labor and work to the endeavor. Ergo, the contingency payment clause became common practice among construction contracts.

Contingency payment clauses are provisions within a contract which stipulate that the general contractor's obligation to pay the subcontractor is contingent upon the receipt of payment from the property owner. There are two types of contingency clauses: paid-*when*-paid, and paid-*if*-paid.

A **paid-when-paid clause** states that a general contractor will pay a subcontractor when they are paid by the owner. It implies, according to some, a debt obligation on the part of the general contractor to the subcontractor that will be paid in the future. Most subcontractors accept paid-when-paid clauses as a common business practice and understand the principle and wisdom behind it.

However, opinions change when presented with a **paid-if-paid clause**. The clause states that a general contractor will pay a subcontractor *only if* they are paid by the owner. Although it has not been specifically determined in a court, some in the construction industry believe it only creates an obligation of debt on behalf

of the general contractor *if and when* he is paid by the owner.

> *"A paid-if-paid clause is like ordering a Big Mac at McDonald's yet only being responsible for the payment of it when one receives their pay check."*
>
> **-Raymond Risk**
> **Texas Construction Association**

The important thing to note is that these contingency clauses are applied only when an owner withholds payments and thus Prompt Pay Laws are not applicable.

Most professionals believe contingent payment clauses are construed to relate to time of payment only. That is to say, a contingent payment clause will not normally be interpreted as a condition precedent to final payment (or progress payments) to the subcontractor, but will be used only to measure the time period in which that payment must be made. When no time period for payment is specified, a reasonable time is implied. However, the definition of "reasonable time" is not exact and can be years or never.

By contrast, there are some in the construction industry, and indeed some states, that believe these clauses relieve the contractor of debt obligation to the subcontractor. Thus, a contingency payment clause would prohibit a subcontractor from suing a general contractor (because he has not breached contract through nonpayment if the debt does not exist). In turn, this prevents them from filing a lien on the property and from placing a lien on any statutory retainage or payment bonds because a general contractor has fulfilled his obligation to pay. Consequently, regardless of the amount specified in the subcontract, the subcontractor's fee for a job is directly linked to how much a general contractor can get from the owner, and no more.

> *"None of us in this room today could go to HEB grocery this afternoon and get a basket full of groceries and go to the clerk at the checkout counter and say, 'I'll tell you what, here's my name, here's my address, here's my phone number, here's my account numbers at my bank, and I will pay you when I get my paycheck tomorrow'. None of us would leave that grocery store with those groceries."*
>
> **--Mackie Bounds**
> **American Subcontractors' Association**
>
> *"I can't go to HEB and get them to give me a loaf of bread without paying for it. I've also not been very successful going to the state of Texas and saying, 'Ya'll give me that 20 million dollars and I'll build you that state office building'. It's a credit transaction."*
>
> **--Steve Nelson**
> **Associated General Contractors**

Because it increases competition, drives construction costs down, and provides a clear title to property, contingency payment clauses are viewed as beneficial to the construction industry as a whole (including lenders, owners, general contractors, sureties and title companies). As a result, they are becoming more common and are becoming a tool for abuse of the bottom tier of the construction chain: the subcontractor.

STATE LAWS

PROMPT PAY LAWS

Citations: Texas Property Code, Chapter 28
Texas Government Code, Chapter 2251

Who is Protected: The "Prompt Pay" laws provide protections for all members of the construction chain, from the owner down to the sub-subcontractor. The laws apply to parties involved in contracts to improve real property or to perform construction services for an owner on or after September 1, 1993. They do not apply to property or work done for a governmental entity nor to work performed in oil fields, gas fields, mines, and the transportation of oil, gas, or related industries.

Payment Provisions

- An owner is not obligated to pay the general contractor until 5 days after receiving proceeds from a lender;
- The general contractor must make payments to subcontractors within 7 days after receiving payment from the owner. However, generals are only required to make payment to the extent that the property owner's payment is attributable to that subcontractor's work or materials supplied; and
- Subcontractors must make payments to other subcontractors or suppliers within 7 days after receiving payment.

Dispute Provisions

- In the case of a good-faith dispute on workmanship or materials provided, each person within the construction chain has the right to withhold up to 100% (110% for residential contracts) of the difference between each party's claim to the payment;
- Parties to a contract may sue for enforcement of contractual provisions;
- If payment is withheld, interest is accrued from the date on which payment was due at 1.5% per month on unpaid amounts; and
- If payment is withheld, a worker has the right, after notifying the owner and the lender, to suspend work until payment is received. If notice is given properly, the contractor is insulated from damages due from the suspension of work. After a notice is filed an owner has 35 days to either make the payment or give notice of a

good-faith cause to withhold the funds.

Contingency Clause Interference:

Because the "Prompt Pay Laws" are geared toward situations where the property owner has already paid the general, continency clauses usually are not applicable. For example, a subcontractor can not force a general contractor to pay him until 7 days *after* the general receives the payment from the owner. Therefore, if an owner withholds payments, no one below him on the construction chain can evoke the Prompt Pay Laws to force payment. Additionally, if a paid-if-paid clause is used in the contract between the general contractor and the subcontractor, the subcontractor can not force the general contractor to fulfill payment.

LIEN LAWS

Citations: Texas Property Code, Chapter 53
Texas Constitution, Article 16, sec. 37

Who is Protected: Currently, there exists four different types of liens - constitutional, statutory, fund trapping and liens on statutory retainage. In all four, there exists laws which protect all members of the construction chain that engage in *private works*. However, each type of lien does not provide equal protection for every tier of the construction chain.

Constitutional Lien Provisions

- Constitutional liens are available to all mechanics, artisans, and materialmen of every class (that is, contractors and suppliers) who contract *directly* with the owner (i.e. - subcontractors are not included);
- A constitutional lien is enforceable on the improvements (building and fixtures) and the real property on which the improvements are located;
- A subcontractor can only claim a constitutional lien *if* the owner and the contractor have common ownership and one effectively controls the other;
- A constitutional lien is not effective against any person who acquires an interest in the property without actual or constructive notice of the lien.

Statutory Lien Provisions

- A statutory lien may be filed for the value of the improvements placed on the property under the original contract;
- Both the general contractor and the subcontractor can perfect a statutory lien by filing a lien affidavit and mailing notice to the owner (sub-subcontractor must give notice to the general contractor).

Fund Trapping Provisions

- A subcontractor or a sub-subcontractor can obtain a lien on the property and subject

the owner to personal liability to the extent that the owner continues to withhold funds after he has received a claim notice. These funds are considered "trapped."

- If funds have already been paid to the general contractor, the claimant has no valid lien on the property (but prompt payment laws can then be enforced).

Lien on Statutory Retainage Provisions

- Owners are required to retain 10% of the contract amount (or value of the work then completed) during the course of the contract and for 30 days following final completion. This creates a fund for benefits of claimants who have filed lien affidavits within 30 days of completion and who have sent notice.
- A subcontractor and a sub-subcontractor can perfect a lien on statutory retainage by filing a lien affidavit and giving notice to the owner. In addition, the sub-subcontractor must notify the general contractor.

Contingency Clause Interference

Opinions are split as to how contingency payment clauses effect lien laws. If one assumes that a contingency clause does not eradicate a general contractor's debt to a subcontractor, but merely delays it to a specific time of payment, a subcontractor's right to a lien or statutory retainage is no more or less than those described in the statutes. However, if one assumes that a paid-if-paid clause relieves a general contractor of any debt they have not been paid for themselves, then all lien and statutory retainage rights would be affected.

Lien laws and retainage laws are there to protect a person for a debt that has not been paid. If no debt exists, then neither does a claim to a lien on the property or the retainage being held by either the owner or the general contractor. Further, a subcontractor has no claim against a general contractor because the general contractor has met his obligation to pay the subcontractor if he is paid by the owner.

BOND LAWS

Citations: Texas Government Code, Chapter 2253
Texas Property Code, Chapter 53

Who is Protected: Bond laws provide owners protection against liens by allowing them to require general contractor to secure a payment bond for all subcontractors and sub-subcontractors. This allows an owner to virtually guarantee that the subcontractors will be paid and will not be put in the position to file a lien claim against his property in the future. Subcontractors generally prefer bond claims over lien options because they don't have to worry about fund-trapping or statutory retainage.

Private Works Provisions

- For a private works contract, a bond may be issued, but is not required; and

- The statutes do not specify when a surety must pay an obligation.

Public Works Provisions:

- If a project is over $25,000, the state requires general contractor to secure a payment bond (for projects under $25,000 the state does not require a payment bond);
- Public works laws are limited to claims on the payment bond or on any contract funds held by the a public authority. However, the laws do not allow for a lien to be established on the property;
- A subcontractor must send notice to the governmental entity, the general contractor and the surety;
- The statutes do not specify when a surety must pay an obligation;
- If no payment bond, the general contractor's only recourse is to seek permission from the Legislature to sue governmental entity; and
- If there is no payment bond, the subcontractor's only recourse is to try to perfect a lien on any contract funds that the governmental entity still has not paid the general contractor. However, once a the public entity pays the general contractor, there may be no funds left and the subcontractor has no recourse but to sue the general contractor under prompt pay statutes.

Contingency Clause Interference

In a public works project, if the owner has not paid the general contractor and the surety argues there exists no obligation to pay, then the subcontractor is left with no recourse. This is primarily because contingency clauses can be interpreted as stating that the general contractor does not have a debt unless the owner has paid.

Additionally, if there is no contingency clause, and a public owner defaults, a general contractor is liable for the entire risk of the project, yet generally has no recourse against the state.

TEXAS CASE LAW

Texas courts appear to be a split as to whether a contingent payment clause is enforceable as a condition precedent to payment. In *Wisznia v Wilcox* [2], the Court of Civil Appeals construed the following clause:

> "The engineer shall be paid in the same proportion and manner as the architect is being paid by the Overlook Development Corporation."

The court found that such a clause presented a question of contractual interpretation and held as follows:

> "If the parties intend that the debt shall be absolute, and fix upon a future event merely as a convenient time for payment, the debt will not be contingent, and if the future event does

[2] 438 SW2d 874 (Tex Civ App--Corpus Christi 1969, writ refd nre).

> not happen as contemplated, the law will require payment to be made within a reasonable time." [3]

In reaching its decision, the court cited *Thomas J. Dyer Co. v Bishop International Engineering Co.*:

> **"**It is, of course, basic in the construction business for the general contractor on a construction project of any magnitude to expect to be paid in full by the owner for the labor and material he puts into the project....The solvency of the owner is a credit risk necessarily incurred by the general contractor....This expectation and intention of being paid is even more pronounced in the case of a subcontractor whose contract is with the general contractor, not the owner....He is primarily interested in the solvency of the general contractor with whom he has contracted. He looks to him for payment. Normally and legally, the insolvency of the owner will not defeat the claim of the subcontractor against the general contractor. Accordingly, in order to transfer this normal credit risk incurred by the general contractor from the general contractor to the subcontractor, the contract between the general contractor and the subcontractor should contain an express condition clearly showing that to be the intention of the parties...." [4]

In another Texas case regarding a contingent payment clause similar to the one in *Wisznia* [5], the Court of Civil Appeals held that the parties intended that payment of retainage should be made only after full payment to the contractor. The court construed the following clause as creating a condition precedent to a subcontractor's right to payment.

> "Contractor may, at its option on each payment, retain...the percentage specified in the contract documents, of each estimate until final payment (which final payment shall be made after completion of the work covered by this contract and written acceptance thereof by the architect, and full payment therefore by the owner)...."

However, the court did state the fact that the subcontractor did not choose to obtain its retainage by virtue of a release to the owner was some evidence that the subcontractor intended a reasonable time for payment would include adjudication of the dispute between the owner and the general contractor.

Another notable Texas case, *Prickett v Lendell Builders Inc*. [6], examined the following clause:

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[3] *Id* 876

[4] *Id* 660

[5] *North Harris County Junior College Dist v Fleetwood Constr Co.*, 604 SW2d 247 (Tex Civ App--Houston [14 Dist] 1980, writ refd nre).

[6] 572 SWd 57 (Tex Civ App--Eastland 1978)

> "Payment shall be made monthly, within five (5) days after contractor (Villa Constructors) is paid for the same work by Continental Mortgage Investors..."

The court, after examining the four corners of the contract, held that such a clause was not a condition precedent, and held that it applied only to *when* payment would be made, not to the issue of *whether* payment would be made.

A case favorable to the subcontractors point-of-view was decided by the U.S. Fifth Circuit in *Nicholas Acoustics & Specialty Co. v H&M Construction Co.* [7] In that case, H&M was the prime contractor for construction of a Mississippi food processing factory. The contract stated that the owner would make final payment after H&M received its final payment from the owner. After a dispute developed, H&M raised the contingent payment defense and the court noted:

> "This creates a classic Catch-22 situation--the owner will not pay until the subcontractors have been paid and the subcontractors cannot be paid until the owner has been paid." [8]

The court ruled that the clause in the prime contract was the dominant of the two clauses and opined that the prime contractor could delay payment only for a reasonable time after each subcontractor completed its work.

In *Gulf Construction Co. v Self* [9], the court of appeals construed a subcontract provision stating:

> "Under no circumstances shall the general contractor be obligated or required to advance or make payments to the subcontractor until the funds have been advanced or paid by the owner or his representative to the general contractor."

The court held that this clause was a modification of the time provision and did not establish a condition precedent to payment. The court was particularly concerned with the precise language used in the clause sought by the general contractor to establish a condition to establish a condition precedent to payment of the subcontractor. The court specifically stated:

> "There being no privity of contract between the owner and the subcontractor, the risk of nonpayment should not be shifted to the subcontractor....unless there is a clear, unequivocal and expressed agreement between parties to do so." [10]

The court held that the contract in question did not state that the general contractor would not be obligated

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[7] 695 F2d 839 (5th Cir 1983)

[8] *Id* 843

[9] 676 SW2d 624 (Tex App--Corpus Christi 1984, writ refd nre).

[10] *Id* 629

if the money was not received from the owner, nor that the payment would be made out of funds received by the general contractor, but that the general contractor would not be obligated or required to make payments until the money had been received from the owner.

While a Texas court has yet to rule on the general issue of contingency clauses, these cases show a reluctance on the part of the courts in Texas to allow a general contractor to escape the obligation of debt to a subcontractor.

FEDERAL LAWS

THE MILLER ACT

Citations: 40 U.S.C. 270a

Who is Protected: In the United States, the law requiring contract surety bonds on federal construction projects is known as the Miller Act of 1935. This law requires a contractor on a federal project to post two bonds: a performance bond and a labor and material payment bond. The surety company issuing these bonds must be listed as a qualified surety on the Treasury List, which the U.S. Department of the Treasury issues each year.

The Miller Act payment bond covers subcontractors and suppliers of material who have direct contracts with the prime contractor. These are called first-tier claimants. Subcontractors and material suppliers who have contracts with a subcontractor but not those who have contracts with a supplier are also covered under the act and are referred to as second-tier claimants. Anyone further down the contract is considered too remote and cannot assert a claim against a Miller Act payment bond posted by the contractor.

Public Works Provisions:

The Miller Act provides that before a contract which exceeds $100,000 for any building or public work of the United States is awarded to any person, that person shall furnish the United States with the following:

- A performance bond in an amount that the contracting officer regards as adequate for the protection of the United States (bond amount is normally 100 percent of the contract price);
- A separate payment bond for the protection of suppliers of labor and materials. The sum of the payment bond is equal to 50 percent of the contract price when the contract is less than $l million and 40 percent when the contract is from $1 million to $5 million. Contracts in excess of $5 million require a payment bond in the amount of $2.5 million.

Contingency Clause Interference:

Case law illustrates that contingency clauses are invalid in a contract that involves construction on federal works.

"'We don't have to get passed this amount from the owner because once we get there the rest of that's sub. money and we don't owe it unless we go get it.' As a lawyer I can only admire the audacity of it because it's not now illegal. It's not illegal to do that. And as the Texas Supreme Court has said many times we don't have an implied duty of good faith to do that. We don't have this California-like requirement for everyone to be nice all the time in their contracts."

--Kevin Wharburton
construction law attorney

COMMITTEE FINDINGS

The subcommittee realizes that, as in every industry, good working relationships are the insurance of a healthy business future. This is especially true in the construction business. In fact, the subcommittee found that a construction company's need for good working relationships with others often outweighs their need or desire to engage in a dispute about a contract or to file a legal claim.

For example, a general contractor is reliant upon his working relationship with a property owner for future jobs and recommendations. For this reason, a general contractor is frequently unwilling to confront an owner about funds owed to a subcontractor unless he too has money being withheld.

Further, if the general contractor is already in a precarious position with the owner, he is often unwilling to exacerbate the situation by threatening to sue over funds that will simply be passed through to the subcontractor. If a general refuses to collect and/or an owner refuses to pay, and a contingency clause exists in the subcontract, then the general contractor is not obligated to pay the subcontractor. Therefore, it is actually in a general contractor's best interest to never ask the owner for the additional funds. As a result, a subcontractor must either file a lien on the property, the retainage, or hope a payment bond exists.

The subcommittee found that despite these circumstances, subcontractors will, nonetheless, sign contracts containing contingency clauses. This appears to be due to the ubiquitousness of contingent payment clauses and the lack of a unified movement within the subcontractors' industry to refuse to sign contracts with contingency clauses.

Taken altogether, the subcommittee found that general contractors possess the great majority of negotiating power. Furthermore, the subcommittee realizes that contingent payment clauses have existed for many decades. Neither paid-when-paid nor paid-if-paid clauses are a new phenomena. As the construction industry in Texas has metamorphosed through the state's

"Until you all stop doing this, you all will have to do this."

--Kevin Wharburton
construction law attorney
speaking to subcontractors about contingency clauses

plunging economy of the eighties and the ever increasing strength of the nineties, contingent payment clauses have proliferated. Failures of banks and developers in the eighties as well as the changing status of the general contractors has made the construction industry reflect upon the risk inherent in its operations.

The subcommittee realizes more and more fields in the construction industry are becoming specialized. This trend decreases the role of a general contractor as a tradesman and increases the need for subcontractors who represent specialized trades. Therefore, the role of general contractor has evolved into more of a broker, coordinator, and supervisor. As general contractors furnished fewer supplies and labor, their capital investment in projects lessen. Over time, general contractors sought to transfer the risk of construction projects to those that actually had the capital investment (i.e. - the most risk). This was by no means an effort to evade risk, but rather a dissolution of the risk proportionate to the investment of each individual involved in the construction chain.

The subcommittee found that contingent payment clauses allow smaller general contractors to compete for larger construction jobs, which, in turn, provides increased competition and lower prices for consumers. This increased competition in the market also provides subcontractors and sub-subcontractors with more opportunities. In fact, many individuals who testified had themselves moved up the construction chain during the course of their career (i.e. - employees or suppliers who became subcontractors, or the subcontractor who later became a general contractor).

Despite these benefits, the subcommittee realizes that contingent payment clauses also have grave potential to a subcontractor or sub-subcontractor.

> *"...one of the persons testified that if they didn't have the contingent payment clauses, then they could give more competitive prices. Now whatever it is that they're going to take out of their prices because they no longer have that risk, I'm just going to have to add to mine. So, if you want to go tell the Texas Department of Transportation that the cost of highways just went up...that's what we're looking at."*
>
> **--Steve Nelson**
> **Associated General Contractors**

The subcommittee believes that contingent payment clauses prevent a subcontractor from filing a rightful bond claim and prevent them from filing a mechanic's lien. Prevailing legal opinion states that contingency clauses eradicate a general contractor or surety's obligation of debt to a subcontractor. Texas courts have demonstrated their refusal to decide on such a controversial issue. The few cases brought to trial in Texas have focused on the individual contract before the court rather than the overall legitimacy of contingency clauses in general. Nor should they, according to the subcommittee.

Courts in two other states (New York and California) have weighed in on the issue and found contingent payment clauses void. However, those decisions were based on a legal premise that a person's lien rights can not be waived. Texas has no such statutory provision.

Because of the lack of statutory clarification in Texas, any judicial ruling on contingency clauses would require the courts to develop law rather than interpret it, a clear violation of their authority. It is the responsibility and the duty of the Legislature to make a judgement on whether contingency clauses violate the public policy of Texas.

If they do not violate public policy, then the Legislature could elect to either leave contingency clauses as a private matter between contractual parties, or they could attempt to orchestrate a legislative compromise to even the leverage in negotiations for parties.

If the Legislature decided that contingent payment clauses do violate public policy, then they should be outlawed as such. Three other states have done just that (Maryland, North and South Carolina), while two states (Wisconsin and Montana) have passed laws which entitles the performer to an eventual payment.

The subcommittee feels that it is the best public policy of the state to limit contractual authority between parties only to protect one from misleading, fraudulent and unscrupulous practices. None of the testimony submitted showed contingent payment clauses to be misleading. In fact, most subcontractors who testified fully understood the intent of these clauses and frequently tried to negotiate them out of their contracts. None of the testimony showed contingency payment clauses to be used in a fraudulent manner. No testimony was ever been submitted that illustrated collusion between a general contractor and an owner attempting to defraud a subcontractor. The final matter of unscrupulous use is a muddy issue because the subcommittee does feel that contingent payment clauses have been used to delay payment to and manipulate extra performance from subcontractors above and beyond existing contractual agreements.

> *"I mean what's unfair about these is the sub doesn't have anyone to sue, well they could file a lien, yeah, but if it's a bonded job, it's against the bond claim, they have no one to go against ...public works is the same way, you don't have anyone to go against. You don't even have a lien there. Other than just saying you can't have the clauses, address what's unfair about them, and what's unfair about them is they have no recourse."*
>
> **--Mr. Robert Bass**
> **construction law attorney**

However, this must be balanced with the potential benefits and protections that contingent payment clauses offer general contractors. The subcommittee feels strongly that compromises could be explored that would eliminate the potential for abuse while maintaining the beneficial nature of the clause to the industry while limiting governmental interference with a party's rights to contract.

The subcommittee believes that issues of timely pay and withholding entire payments will be alleviated by the Prompt Pay Laws. As more members of the construction industry become aware of and enforce the provisions of the statute, the general environment will improve. The Prompt Pay Laws were designed specifically to address many of the concerns presented to the subcommittee during public testimony. Furthermore, the subcommittee encourages the industry to utilize the recourse provisions provided by the Prompt Pay Laws and become more self-policing. In fact, if the subcontractors do not use these laws to their advantage, then it is as if the laws do not exist. The law can not help those that do not help themselves.

Further, the subcommittee feels strongly that the Legislature should immediately address the lack of recourse available to a subcontractor involved in a contract containing a contingent payment clause. While this issue should be approached gingerly and with industry input, the subcommittee is alarmed by the denial of such a basic judicial tenant. No State law, or lack thereof, should deny a citizen of due process. The subcommittee hopes the industry will work with the Legislature to explore the compromises mentioned throughout the hearing, such as:

- Assigning the rights of privity to subcontractors;
- Denying sureties a defense to comply with payment bond provision because of contingent payment clauses;
- Requiring general contractors to act in good faith to obtain a payment from the owner; and
- Requiring prompt pay from owners.

The subcommittee feels that contingent payment clauses and the distribution of risk has a positive effect on the construction industry and has no desire to become involved in businesses' right to contract. However, if a business is placed in a position where they have no option but to sign a contract that denies them of a basic, unwaiverable right such as due process, then the Legislature has a duty to regulate the use of contingency clauses to that extent.

> *"I think we ought to try and sit down and ...get a compromise."*
>
> **--Representative Solomons**

INTERIM REPORT
ON
HEALTHCARE TECHNOLOGY INDUSTRY
IN TEXAS

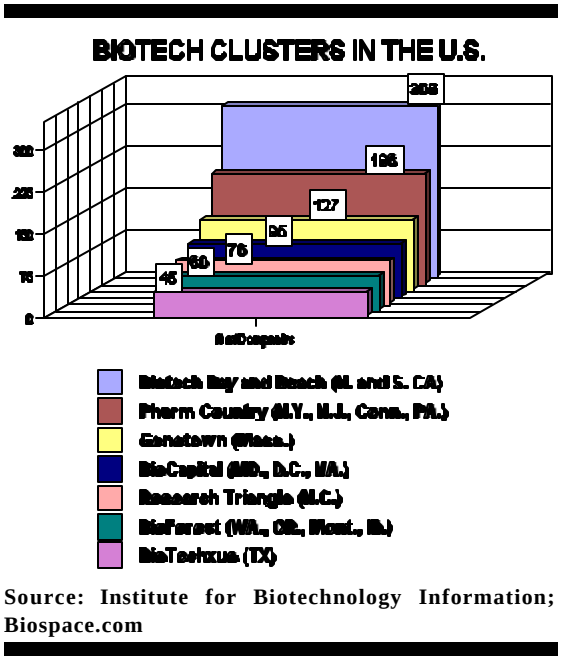
Committee on Business & Industry
Representative Kenneth "Kim" Brimer

Subcommittee on Healthcare Technology Industry in Texas
Representative Kenn George, Chair

Report to the 77th Legislature

THE ISSUE

The healthcare technology industry consists of biotechnology, pharmaceutical and medical device firms, academic research institutions, as well as private research laboratories. Because it incorporates all other factions of healthcare technology, the subcommittee focused its efforts on studying biotechnology, which is defined as the process through which living organisms are modified to create products with commercial applications. Biotechnology can include everything from using recombinant cells to fight cancer to devices that will improve the lives of patients with asthma to diabetes and organ failure to modified foods that are more drought resistant.



Source: Institute for Biotechnology Information; Biospace.com

Advances in medical devices, biomedicine, pharmaceuticals and agriculture seem to be in the news everyday and the world watches as scientists inch closer to unlocking the mystery of the human genome. The question of where new developments in biotechnology will lead us is on the minds of patients, scientists, economists and governmental leaders everywhere.

The healthcare technology industry is better characterized not as individual companies, but rather as synergistic industry clusters. The term cluster more accurately depicts the co-dependent nature of the multiple industries, which are inner-woven together, dependent upon each other for research, technical support and workforce. A critical mass of all the industries involved is necessary for a robust healthcare technology cluster. As Silicon Valley has proven in the computer industry, the strongest clusters become self reinforcing, creating their own internal dynamics of growth and will be the epicenters of new product development, usually based on intellectual property created at an academic institution.

A strong technology-based cluster requires a strong intellectual infrastructure (such as universities and public or private research laboratories); efficient mechanisms through which technology is commercialized; an excellent physical infrastructure (including high-quality telecommunication systems and affordable, high-speed internet connections); a highly skilled workforce; and sound sources of capital.

A recent study by the Milken Institute Review concluded there are twelve key factors that determine the success of a city or region becoming a leading biotechnology cluster. The twelve factors can be organized around two major categories: resource infrastructure and operation sustainability. The importance of the two categories differ dramatically, being almost bipolar in nature, depending on the age and maturity of an individual company.

Much of the difference between the needs of a fledgling and a mature biotechnology company is explained by the development process. Mature companies, while specialized in nature, resemble a basic manufacturing model. However, early stage companies are based on knowledge creation, capture, and development. The resources needed in the early stages are very different and much more capital intensive.

BIOTECH LOCATION FACTORS

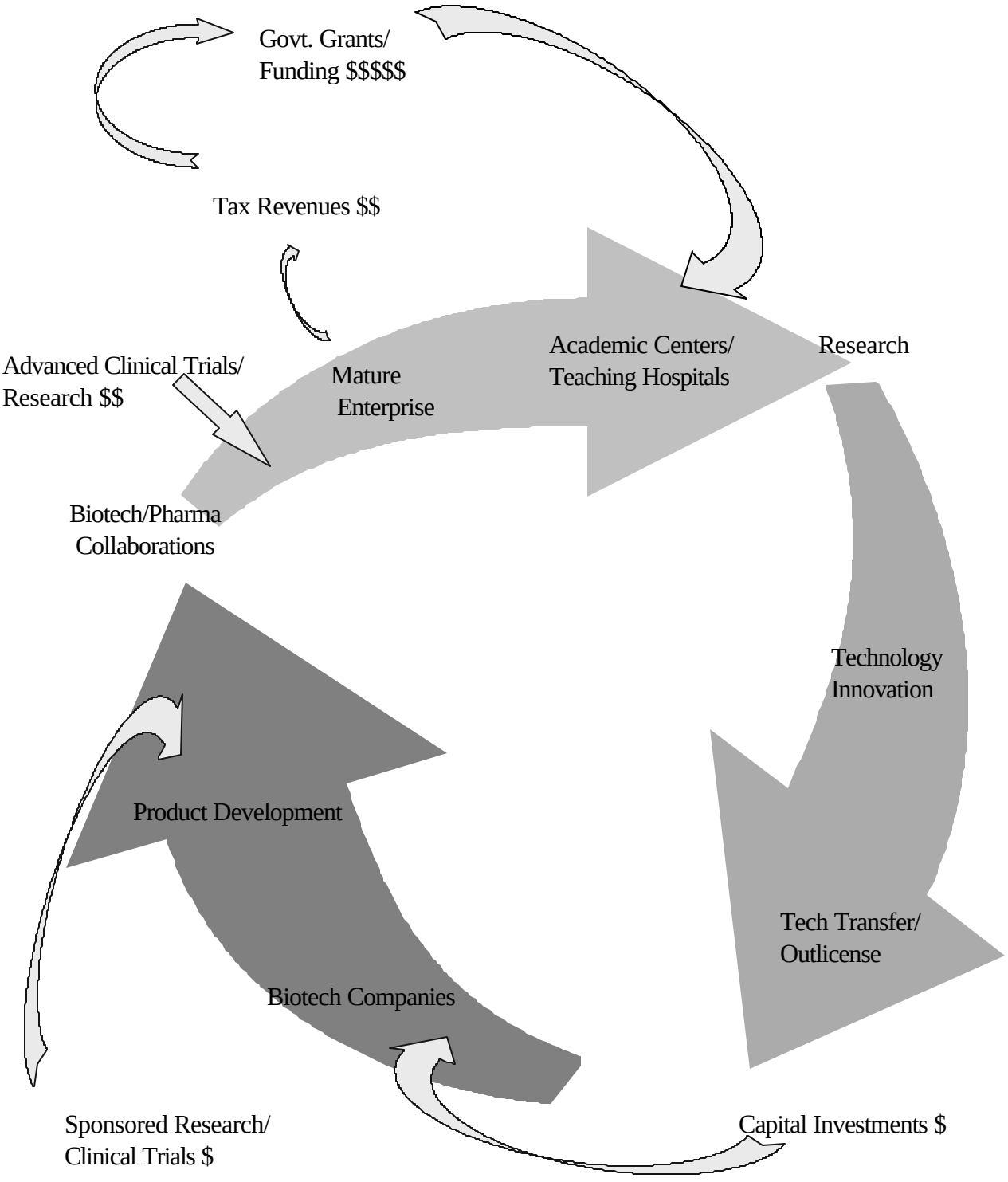
Resource Infrastructure	**Operational Sustainability**
• Quality of Local Research	• Availability of Land for Manufacturing
• Accessibility to Financing	• Tax Incentives
• Quality of Labor Pool	• Operating Costs
• Quality of Life	• Permitting Process
• Quality of Infrastructure	• Health and Environmental Regulations
	• Animal Testing

Taking an innovation all the way from discovery to market is slow and expensive. As reported in the September 2000 issue of *Business Week* it currently takes twelve to fifteen years and half a billion dollars to get a drug from the laboratory bench to the marketplace. The U.S. system of new drug approval is perhaps the most rigorous in the world and this is just the beginning of the cycle of innovation [1] an intellectual property must travel in the healthcare technology industry. Although the cycle of innovation is one that reinvests in itself, it requires intense capital input at various stages to perpetuate the inertia of the process. This need for capital investment can be particularly devastating for early stage companies if not realized.

The majority of early stage companies' assets are in their equipment and the potential worth of their product. Many of the tax credits and incentives that worked for Texas' manufacturing and resource-dependant economy in the sixties and seventies are futile in assisting these technology and knowledge driven companies. Texas has begun an effort to attract high tech companies by adapting its concepts of business incentives to fit this emerging economy.

[1] Please see graphic on page 38 of this report.

CYCLE OF INNOVATION



STATE LAWS

ACCESS TO QUALITY RESEARCH

Technology Transfer

The only Texas statute which specifically addresses the transfer of technology for commercialization is a provision for the University of Texas at Austin found at Section 65.45 of the Texas Education Code. It outlines provisions for a Center for Technology Development and Transfer on the University of Texas at Austin campus only.

RESEARCH AND DEVELOPMENT FUNDING

Linked Deposit Program
Administered by: Texas Department of Economic Development

The Linked Deposit Program (LDP) was established to encourage lending to qualified businesses, or those that are historically underutilized businesses, child care providers, non-profit corporations and small businesses located in an Enterprise Zone, by providing lenders and borrowers a lower cost of capital.

ARP/ATP Program
Administered by: Texas Higher Education Coordinating Board

The Advanced Research Program (ARP) and Advanced Technology Program (ATP) are merit-based, competitive peer-reviewed programs designed to support college/university-based basic and applied research in the state of Texas. Awards are generally for a two-year period, with a new grant cycle started every second year. Established in 1987 by the Texas Legislature at a biennial appropriation of $60 million, it has remained approximately the same funding level since.

The Advanced Technology Program includes the Technology Transfer Program which requires a university to have an industry partner who will provide matching funds for the research (there are no guidelines on where the industry partner must be headquartered or operated).

Overhead Cost Recovery
Administered by: Office of the Comptroller of Public Accounts

Also known as indirect cost recovery, overhead cost recovery occurs when a public university receives a grant from a non-state related funding source for research which will occur on university property and/or with university staff. Part of the grant will be for indirect or overhead costs of conducting the research (i.e. rental of facilities, payment of staff, research assistants, equipment, etc.). Because the state has already paid for these items via the normal appropriations made to all public universities, the State, in essence, "recoups" that amount in accordance to the Texas Education Code, Chapter 145.

ENTREPRENEURIAL SUPPORT

"We're here in Austin because I live here, I want to be here. We got no incentives from the State of Texas to locate that company here or to keep it here. I could barely get a call back..."

--Rick Hawkins
biotech entrepreneur, speaking about Pharmaco located in Austin, TX

"We do feel like we're connected to the communities and we do feel like we're sensitive to their needs by recruiting different companies."

--Gene Richards
Director CER, Texas Department of Economic Development

Corporate Expansion & Recruitment (CER)
Administered by: Texas Department of Economic Development

The department serves businesses that want to expand existing Texas operations as well as out-of-state businesses interested in relocating or expanding in Texas. CER serves as a focal point for disseminating those business leads to Texas communities. Additional services include increasing statewide awareness of the Texas Department of Economic Development as the lead economic development agency in the state and serving as the conduit for all inquiries for presentations regarding agency services and programs.

Office of International Business
Administered by: Texas Department of Economic Development

The office helps Texas companies expand their business worldwide. Through international trade missions, trade shows, seminars and inbound buyer missions, the Office of International Business gives Texas companies the opportunity to promote their products and services to international buyers and partners. The State of Texas' office in Mexico City is a valuable resource for facilitating business between Texas and Mexico.

Office of Small Business Assistance (OSBA)
Administered by: Texas Department of Economic Development

The office is the focal point for ensuring that public and private resources are delivered to support job growth and wealth creation for Texas' small and historically underutilized businesses.

Office of Border Initiatives
Administered by: Texas Department of Economic Development

To strengthen alliances between federal, state, regional, and local leaders along with public, private, and non-profit organizations to attract capital investment to the Texas-Mexico border, to develop a competitive workforce ready for the challenges of a global market, and to encourage the growth and retention of small- to medium-sized businesses.

Texas Enterprise Zone Program
Administered by: Texas Department of Economic Development

The Texas Enterprise Zone Program is an economic development tool communities can use to offer state and local incentives to new or expanding businesses. The program is designed to help cities and counties develop and revitalize economically distressed areas within their jurisdiction by encouraging job creation and capital investment in these areas.

Capital Access Fund
Administered by: Texas Department of Economic Development

The Capital Access Fund (CAF) was established by the 75th Texas Legislature. It is designed as a public/private partnership between the State of Texas and lending institutions to assist "near bankable" businesses in accessing the capital they need. A business or non-profit organization must have fewer than 500 total employees and have at least 51% of them located in Texas. Small businesses are priorities of the program, yet there is an emphasis placed on child care providers and businesses located in Enterprise Zones.

Research and Development Tax Credit
Administered by: Office of the Comptroller of Public Accounts

A corporation may claim a credit for certain incremental qualified research expenses incurred and basic research payments made for research conducted in Texas during the period upon which the tax is based. The law defines "basic research payment" and "qualified research expense" by cross-referencing Section 41,Federal Internal Revenue Code. Under that provision, "qualified research expenses" include expenses for research performed by the corporation, including wages for employees involved in the research activity, costs of supplies used in research, and payments to others for computer time used in qualified research. In addition, qualified research expenses include a portion of the expenses for research performed by other parties on the corporation's behalf. "Basic research payments" include payments to qualified university or scientific organizations for research to advance scientific knowledge not yet identified with a specific commercial objective.

Jobs-Creation Tax Credit
Administered by: Texas Department of Economic Development

To be eligible for a jobs-creation credit, a corporation must be a "qualified business" (generally meaning the business is located in an economically depressed area) and must create at least 10 qualifying jobs. In addition, the corporation must pay an average weekly wage for each year in which credits are claimed of at least 110 percent of the county-average weekly wage for the counties where the jobs are located.

Capital Investment Tax Credit
Administered by: Office of the Comptroller of Public Accounts

A corporation may use a capital investment credit to reduce its franchise tax liability. To take advantage of this credit a corporation must be a qualified business (using the same definition of "qualified business" as the

jobs-creation credit); pay an average-weekly wage that is at least 110 percent of the county-average weekly wage in the county where the job is located; offer a specified group health benefit plan to all full-time employees for which the corporation pays at least 80 percent of the costs; and make a minimum $500,000 qualified capital investment.

WORKFORCE EDUCATION

Technology Education Curriculum in Public Education
Administered by: Texas Education Agency

House Bill 1304, as passed by the 69th Texas Legislature, required the State Board of Education to develop a long-range plan for technology. This long-range plan directs the Texas Education Agency and provides recommendations for districts and campuses to help communities meet these technological goals.

The Health Science Technology Education is a secondary career education program. The program uses industry partnerships to provide students with valuable hands-on experiences. It involves 48,946 students in 516 districts through magnet schools, academies, comprehensive high schools, rural consortiums, industry site-based programs and distance learning. Certification options are available in some districts for: Certified Nurse Aide, Licensed Vocational Nurse, EMT, Phlebotomy Technician, Certified Medical Assistant, EKG Technician, Dental Assistant, Radiography, Pharmacy Technician and Massage Therapy.

Advanced Placement Programs in High Schools
Administered by: Texas Education Agency

Advanced Placement (AP) consists of voluntary, college-level courses taught in high school. The College Board in New York, which administers AP, offers teacher training and curriculum guides for 31 AP courses, ranging from history and languages to math and the arts. While the AP curriculum is local, the AP exam is national, pegged to high academic standards with measurable results. Students scoring at least a 3 out of a possible 5 on national AP exams receive credit at more than 2,900 universities in the United States. Texas currently has a modest, though very successful, AP Incentive Program in place.

Skills Development Fund
Administered by: Texas Workforce Commission

This program is designed to help Texas community and technical colleges and higher education extension agencies finance customized job training for their local businesses. The Fund will provide training for specific skills for workers who will be hired by the businesses.

Smart Jobs Fund
Administered by: Texas Department of Economic Development

The Smart Jobs Fund is a workforce development incentive program created to enhance employment opportunities for residents of this state and to increase the job skills of the existing workforce. Smart Jobs provides job training assistance in the form of a reimbursable grants to eligible businesses operating in, or relocating to, this state.

Self-Sufficiency Fund
Administered by: Texas Workforce Commission

The program teams the business community with local educational institutions to fund job training for individuals that receive Temporary Assistance for Needy Families (TANF). The goal of the Fund is to help TANF recipients obtain jobs and become independent of government financial assistance.

FEDERAL LAWS

BAYH-DOLE ACT

This law states that all intellectual property resulting from federal funding is not owned by the government. As a result of this law, many Texas universities are willing to engage in technology transfer even though it is not specifically allowed by state law. The Act further states that:

- The institution may elect to own an invention made under federal funding;
- The government retains a non-exclusive, non-transferable, paid up license to practice the invention on a world wide basis on behalf of the United States;
- The institution may license the invention for commercialization; and
- The institution may not re-assign without permission from the funding agency.

REGULATION

The biotechnology industry is regulated by the Food and Drug Administration (FDA), the Environmental Protection Agency (EPA) and the Department of Agriculture (USDA).

COMMITTEE FINDINGS

The subcommittee determined that the healthcare technology industry in Texas is an emerging and growing industry with one out of every twenty healthcare technology jobs in the nation found in Texas. It is important to note that the Milken Institute Review showed Austin, Texas (the only Texas site considered for the study) as having all the resource infrastructure factors (discussed earlier in the report) that start-up companies consider important.

The subcommittee found that over the past twelve years, healthcare technology companies have either been drawn to Texas because of its established infrastructure or have evolved as a product of the research developed in Texas universities. Texas now has budding healthcare technology clusters in the four major metropolitan areas (Dallas, Fort Worth, San Antonio and Houston) as well as a few satellite clusters in small communities (Amarillo, San Angelo, and Tyler). Understanding the size and structure of industry activity in each region provides a sketch of each region's contribution to cluster activity statewide.

The subcommittee believes Texas is poised to become a leader in the healthcare technology industry and now is the time to decide if the State intends to become a major player in this revolution, or if it will be an interested observer. The subcommittee found that Texas already lags behind other states.

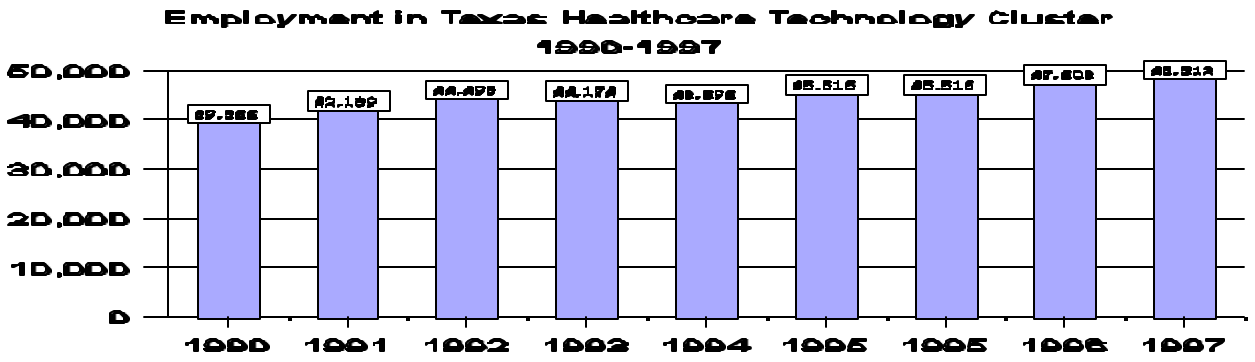
For example, Georgia has instituted the Georgia Research Alliance which is a partnership of the state's research universities, the business community and state government. Its mission is to foster economic development within Georgia

Employment Statistics for Texas Regions

North		
Central		
Gulf Coast		
West		
South		

Source: Texas Healthcare and Bioscience Institute; 1998 Index of the Texas Healthcare Technology Industry

by developing and leveraging the research capabilities of the research universities within the state and to assist and develop scientific and technology-based industry, commerce and business. This commitment to Georgia's future is made possible by a public-private partnership in which private donations are matched by state funding. Through fiscal year 1999, the state of Georgia has invested $242 million through The Alliance in research and development programs at its six member universities, matched by $65 million in private funds.



Source: Regional Financial Associates

This Alliance has assisted in establishing twenty-one start-up companies.

Another creative model of a collaborative effort can be found at the North Carolina Biotechnology Center, which is a non-profit corporation. This Center's mission is to provide long term economic benefit to North Carolina through support of biotechnology research, development and commercialization. A technology development center, rather than a scientific center, it has invested $60 million in grants and loans to North Carolina universities and companies. The center helps arrange collaborations with local universities, provides access to venture capitalists and government officials, and provides training for biotechnology employees. The Center encourages industry-university collaborations, technology transfer, business development, venture capital formation, networking, and workforce training.

The subcommittee found other states like Pennsylvania with their Governor's Action Team, and Arizona's Science and Technology Authority, are ahead of Texas in almost all areas of industry development, public education, research funding and support, intellectual property development, financial and technical assistance for start-up companies, and in tax-incentives. These other states have already made commercialization of research a priority and are positioning themselves for the revolution by committing major additional investments in biomedical research.

The subcommittee feels strongly that supporting the healthcare technology industry will create a tremendous opportunity for Texas to make a major leap forward. Healthcare technology is, and will be, the growth area of the future. But Texas will only benefit if it capitalizes on the potential of the industry by taking strategic steps necessary to create a favorable economic environment in which new technologies can flourish. If the State waits, it will lose the opportunity, and an opportunity of this scope and impact will not occur again. With that in mind, the subcommittee makes a number of recommendations, categorized by the two major categories the Milken Institute Review study identified: resource infrastructure and operational sustainability.

RESOURCE INFRASTRUCTURE

For Texas to enhance its position as a leading center for healthcare technology universities, corporations, and government must work together to translate research and development into patents, licenses and commercial products and services. To do this, specific unaddressed needs in the areas of access to quality research, research and development funding, and workforce education must be resolved.

Texas is fortunate to have some outstanding medical research facilities and researchers that include Nobel laureates and members of the National Academy of Sciences, who serve as magnets to attract top quality colleagues and collaborators. From these leaders, the healthcare technology industry demands constant intellectual property developments to have a healthy and maturing cluster. However, recent studies show that although Texas is in the top five of universities that generate intellectual property, they are not even in the top fifty who commercialize it. The subcommittee has found that research that culminates in commercialized intellectual property is not valued in our system. Professors are not recognized, either symbolically or professionally, for their contributions to society or to the university. This could be attributed to many things, starting with a lack of an entrepreneurial culture in our universities and health science institutions.

> *"The first Jaguar parked in a faculty parking lot from a faculty member who has commercialized technology is the best incentive to make the next one happen."*
>
> **--Roger Elliott**
> **Assistant Commissioner of the Texas Higher Education Coordinating Board**

The intangibility of entrepreneurial culture makes it difficult to define. However, in an entrepreneurial culture, faculty seems to view starting a company as routine rather than an unusual occurrence, entrepreneurs are celebrated, individuals know many others who have started their own company, and people view company failure as a possible outcome of doing business rather than a cause for social disgrace. Further, in a university which doesn't encourage an entrepreneurial culture, a scientist's research can be deemed as "tainted" by peers and department heads because of the involvement of industry. It is not "science for science sake," rather a research project with pointed commercial goals.

- Therefore, the subcommittee feels that incentives should be created to encourage intellectual property development. This would include allowing more release time to professors from academic universities *and* health science centers involved in technology transfer or creation of a start-up company that has evolved from an intellectual property. This time would allow them to either take a sabbatical or to dedicate more time to business obligations from start-up companies.

- Additionally, the subcommittee believes that professors should be encouraged, both symbolically and by tenure track incentives, for commercialization involvement, just as professors are encouraged by these means for publication of scholarly work.

The few universities which have engaged in equity agreements have allocated the profits of equity to the creator, not the equity itself. This means that the university holds all stock options, not the creator, who only has rights to the profits gained by the sale of or dividends from said equity.

- The subcommittee suggests a statutory allocation of 50% to the creator, 25% to the university, and 25% to the originating department. This would give everyone involved a stake and a reward for technology transfer of intellectual property.

- Further, the subcommittee recognizes that the Legislature should outline provisions for equity agreements that allow the creator rights to hold actual equity garnered from an equity/patent agreement, rather than just the profits from said equity.

- The subcommittee feels that a panel that represents both the administration, professors and industry should be convened to examine the possibilities of allowing universities to create policies which would delay professors from presenting published articles or presentations at professional conferences or journals until a patent has been secured for the intellectual property. However, if this is done, it is imperative to give tenure incentives to professors for technology transfer.

Additionally, the subcommittee understands that all but one university in Texas may have good cause for not encouraging commercialization -- they do not have statutory authority to do so (the one exception being the University of Texas at Austin). Many universities engaging in technology transfer are doing so on the trepidatious advise of the system's general counsel based on the Bayh-Dole Act, not by any state statutory authority or mandate.

> *"Technology transfer happens in many ways, that is in essence what Universities are all about - -transferring knowledge to the public through the teaching, through the service, through the research."*
>
> **--Terry Young**
> **Assistant Vice Chancellor for Technology Transfer at the Texas A&M University System**

- Therefore, the Legislature should expand the law to encourage, permit and mandate technology transfer of intellectual property at all universities and health science centers. The subcommittee recommends strongly that the provision should:

    - Allow universities to explicitly enter into joint ventures or limited partnerships with a private company for the purpose of development and revenue sharing from products derived from intellectual property as an option to selling the patent or licensing rights outright;
    - Allow universities to exchange patent or licensing rights to intellectual property in exchange for equity in private companies;
    - Allow and encourage universities to provide incubation services from science and business departments, including services, equipment and space (for a cost);
    - Allow royalty participation;
    - Allow universities to accept sponsorship of research from a company that a professor on the project has holding in if approved by the System Board;
    - Clarify that not all ventures will be successful for the protection of the universities and the technology transfer offices; and
    - Allow universities to include a set-aside percentage of space for technology transfer activities (to be at least partially directed and managed by outside consultants, private sector or other professionals) in future construction plans.

The subcommittee continually heard complaints that technology transfer was a difficult process for a variety of reasons. First, the actual technology transfer process is fragmented and not unified from university system to university system. Secondly, it is not even consistently applied to the component institutions within those university systems. Lastly, funding and release-time incentives for professors differ from academic universities to health science centers and teaching hospitals. The arduous process sometimes retards development and venture capital investment.

> *"At the state level you have legislation that allow us to form companies, and in fact encourages the formation of companies. And yet, when you look at some of the policies within universities you have policies which do not allow that or prohibit that because of conflict of interest regulations and other sorts of regulations, and it makes it difficult when you are trying to negotiate with companies to adequately represent the ability to transfer technology."*
>
> **--Dr. Marianne Woods**
> **U.T. Dallas**

Moreover, universities face additional disadvantages when participating in technology transfer, for example, recovery of overhead costs (also known as indirect cost recovery). As discussed earlier, overhead cost recovery occurs when a public university receives a grant from a non-state related funding source for research which will occur on university property and/or with university staff. Part of the grant will be for indirect or overhead costs that the state has, in essence, already paid for via the regular state appropriation process.

The Texas Education Code states that a university, medical or dental unit's planned state appropriation from general revenue will be decreased by 50 percent of the overhead costs covered in any and all grants they receive. The other 50 percent is retained by the university and mandated by code to be used for six specific purposes, including:

- Preparing competitive proposals for sponsored programs;
- Providing carryover funding for research teams to provide continuity between externally funded projects;
- Supporting new researchers pending external funding;
- Engaging in research programs of critical interest to the general welfare of the citizens of this state;
- Purchasing capital equipment directly related to expanding the research capability of the institution; and
- Research or project administrative costs.

It is important to note that health science centers are not mentioned in the Education Code as being able to "retain" their overhead costs, yet the Texas Government Code requires all state agencies to deposit their reimbursable indirect costs into general revenue. Therefore, all overhead costs in federal grants received by health science centers are "recouped" by the state without being reallocated back to the center.

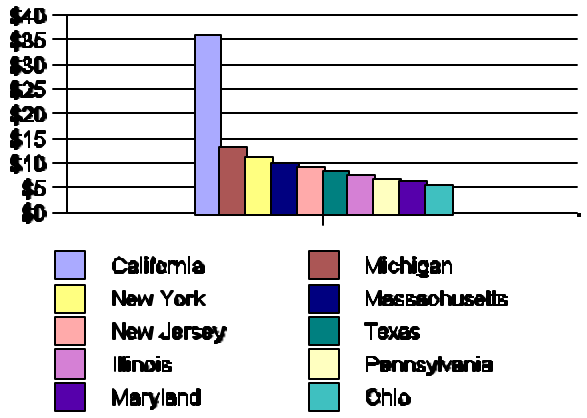
Another funding issue involving grants involves one of the most successful research grants in Texas. Funding for the ATP/ARP programs have remained constant since its inception, which means that its funding power has decreased each year. Outcomes from the ATP/ARP programs have proven the programs to be outstanding and well administered. Indeed, the low overhead cost (approximately two percent) needed to administer the program is remarkable considering the number of grants issued. However, the grants can no longer match the ever increasing cost of research.

- Therefore, the subcommittee concurs with the Governor's Science and Technology Council's recommendation for an increase in the funding of the ATP/ARP program by at least $32 million dollars, however questions the direction of 2/3 of the increase to the TD&T (the program that requires industry partners, which is a subset of the ATP program). In 1999, the total amount of dollars requested by grant applicants to the TD&T program equaled only $15.9 million. In addition to funding from the regular appropriation, this seems extreme and denies funding that could be directed to other grant proposals.

The subcommittee also discovered that TD&T requirements for an industry partner are not specific enough,

especially when applied to the pharmaceutical industry. The current requirement has little impact on the growth and support of the Texas healthcare technology industry.

- Therefore, the subcommittee believes that industry partners should either be required to be based in Texas or plan on doing the majority of manufacturing in Texas. The subcommittee felt this would stimulate the search for a Texas based industry partner. Penalties would apply for any company who withdrew manufacturing from Texas within a certain deadline (i.e. 5 years).

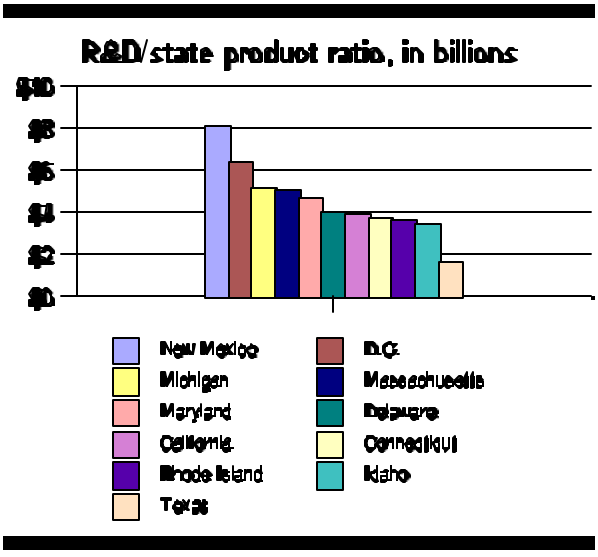


Source: Ft. Worth Star Telegram, 3-11-99 "Incentives for Science", Max B. Baker

With Texas' growing base of patentable discoveries, dependency on academia can cause difficulties for industry and slow the process of development. Even if all conditions are favorable for a collaboration between a university and an industry partner, the issue of whether a university can secure exclusive rights to the commercialization of that intellectual property is questionable.

Currently there is no funding for patent protections from state allocated money because all appropriated funds are Educational and General Support Funds (commonly referred to as E&G funds). The specific uses of E&G funds are outlined in the house appropriations bill. To this date, while research is an acceptable expenditure for E&G funds, the protection of intellectual property which spawns from that research is not.

Therefore, universities must find funding resources to run technology transfer offices and to secure patents for intellectual property. As a result, universities are forced to choose only the property with the most income generating potential to patent. Without a patent, the university nor the creator has any legal claim of possession, regardless of the investment they, and ultimately the state, have invested. The procurement of these patents are essential to future development for all technology industries, but especially for the healthcare technology industry.



- The subcommittee suggests that ATP/ARP grants and/or permitting E&G funds be used for patent protection.

One study [2] stated that one-third of the Texas companies surveyed have relationships with Texas universities. Many of these relationships result not only in technology transfer, but in the actual creation of a company. As previously discussed, many researchers in healthcare technology nation-wide now expect the ability to commercialize their technology. Unfortunately, many times a professor does not have the ability or knowledge to create and implement a successful business plan.

The subcommittee discovered that many states offer incubation services. However, in Texas, there is virtually no incubation support from the state. Further, the appropriations bill typically states that "No educational and general funds appropriated to any institution or agency named in this article may be expended on auxiliary enterprises [3]." In addition to a specific lack of authorization for technology transfer, this prohibition limits any incubation or venture capital support that a university may supply. Taken altogether, this create an atmosphere which is challenging at best for researchers who are unfamiliar with business practices and the entrepreneurs who are unfamiliar with university regulations to work together.

A few Texas universities, following the example set by their colleagues in other states have created technology transfer offices with private funds. These offices not only act as a liaison between industry and university researchers, but provide valuable incubator services for the fledgling spin offs, including lab space, business planning, capital investment and even solicitations for venture capital. In exchange, many of these offices either take a portion of the equity, or own the spin off company out right.

> *"Venture capitalists invest in companies, NOT technology. Where Texas has a gap, in this stream of spinning out companies, is at that first initial step in company formation. We are not taking that first step of starting a company that can then be built around and invested in."*
>
> **--Terry Young**
> **Assistant Vice Chancellor for Technology Transfer**
> **at the Texas A&M University System**

The subcommittee found that the University of Baylor Medical School has a private, for-profit subsidiary, the BCM Technologies, Inc., whose purpose is the promotion and commercialization of Baylor College of Medicine faculty inventions through the formation of new companies. They assist in incubation, business plan formation, capital raising and venture investment in exchange for equity agreements. This highly successful model operates with only 6 full time employees and 2 interns, and has founded 23 companies, 7 of which are currently traded on the NASDAQ. Since 1990, first round investors have earned returns greater than 30% and in FY 1997, BCMT reported a total of $4.7 million in licensing income and $7.8 million in portfolio income.

- The subcommittee is convinced that allowing public universities to operate similar models of BCMT, Inc. could unify and expedite the technology transfer process, as well as create a vehicle for generating venture and capital investments.

A single unified clearinghouse for technology transfer seems not only to be a national trend in healthcare technology, but the answer to many of the problems stemming from the lack of consistent communication between state agencies, universities and industry members. The subcommittee found that the New Jersey Small Business Development Center has created the New Jersey Commission on Science and Technology

[2] *A Profile in Progress,* A collaborative effort between Texas Healthcare and Bioscience Institute, and Texas A&M's Center for Business and Economic Analysis and the Lowry Mays College & Graduate School of Business.

[3] CSHB1, the General Appropriations Bill, Article III-230, Sec 6.8(b)

which acts as a single point of contact for information services. Massachusetts has also implemented a similar model with their Biotechnology Industry Specialist. Ombudsmen serve as a guide for biotechnology by providing guidance and assistance in negotiating the regulatory process. The ombudsman is the industry's advocate inside the system who will prompt quick responses from government agencies.

Legislation (SCR 9) was passed during the 76th Legislative Session that endorsed the creation of the privately-funded Texas Institute of Science and Technology as a vehicle for promotion of sciences and technology. If established, the Council will be a nonprofit corporation with strong ties to industry, government, and the education community. To this date, a Texas Institute of Science & Technology has yet to find funding and a champion for its creation.

Successful research and commercialization has become not only the most important factor for the growth of healthcare technology, but it has become the heart of the issue of maintaining the quality of researchers in this field at our universities. Texas is losing ground on the ability to attract and retain researchers in this field, due not only to the lack of state and institutional support, but also the lack of critical mass of the industry. To date, there is only one manufacturing biotech company in the Dallas/Ft. Worth Metroplex and it only employs 12 individuals. If the company scales back, those employees will be forced to change careers to stay in the area, move to another part of Texas, or more likely, another state entirely.

> *"I personally know 16 professionals who were recruited to come to Texas from New Jersey and for one reason or another, mostly mergers, these people were left unemployed."*
>
> **--Connie Stout**
> **Aronex Pharmaceuticals**

A study conducted by the George Bush School of Government and Public Service at Texas A&M showed that Texas companies believe that workforce issues are the state's most significant barrier to future growth. The study found that:

- Texas faces a growing workforce shortage: over 60 percent of the companies surveyed had unfilled technology jobs; and
- Texas' workforce has skills deficiencies: over 90 percent of companies identified some skill gap in their current high-tech workforce.

> *"The quickest limiting factor as far as a workforce is the master degree level managers. We don't have in Texas a large pool of people that know how to start-up a company and make it profitable as a startup. So we are constantly having to recruit in from California, North Carolina, and Massachusetts, people to be the CEO of these new companies. Our experience is that the scientists themselves a) don't want to be the CEOs of these companies, and b) don't make a very good CEO in some places. But they do need someone who knows science and knows how to do start-ups ...we don't have a pool of those people in Texas."*
>
> **--Dr. Kern Wildenthal**
> **President UT Southwestern Medical School**

Much of the testimony the subcommittee heard from biotechnology industry leaders in Texas reiterated the need for mid-management employees with experience with biotechnology firms. There is no critical mass of biotech companies in Texas from which to recruit, and new graduates from business schools do not have the science back ground that is necessary in this field. Additionally, the number of life science degrees awarded in Texas increased 56% overall between 1989 and 1995. However, many of these

graduates appear to be leaving Texas for states in which there is critical mass in their field which will provide a career ladder and a competitive pay scale.

The subcommittee also learned that, in addition to the business managers and researchers, biotechnology firms can also employ individuals with specific skills needing only an associates degree or equivalent experience. While many of today's jobs are concentrated in the laboratory, significant job opportunities exist for plant process and assembly line workers as well. This employment diversity increases the cluster's importance to the state's economy.

The subcommittee learned that Texas' healthcare technology industry average growth rate and average salary is rapidly outpacing the state average, yet still lags behind the national industry average wage. While this presents an excellent opportunity for employers in Texas, this disparity in wages allows other regions to attract workers from Texas.

To combat the problem of a lack of specialized labor force, Austin Community College has started a very successful two-year degree program for biotech technicians. It cost the college very little to start because the Director, Dr. Linnea Fletcher, has collaborated with local industry to donate lab space and equipment for classrooms and employees to teach the classes with curriculum that was jointly designed by local industry and Dr. Fletcher.

Whether it is high-tech, healthcare technology, e-business or the medical field, the world is becoming increasingly more advanced in its evolution, utilization and dependency on technology. The State needs to take steps to not only supply an immediate source of workers but to create initiatives to maintain a future workforce.

The subcommittee believes that a base in science and math must be the cornerstone of our education from kindergarten through 12th grade in order to meet the demand of a growing healthcare technology market. Texas schools are not producing sufficient numbers of high school graduates with adequate science and math skills.

In the current biennium, Texas appropriated $172 million to pay for remedial courses for students in community colleges and four-year universities. Up to 50 percent of first-time freshmen cannot pass the entrance exam which tests for English and math skills necessary to do college-level work. The Governor's Council concluded that a statewide AP Incentive Program offers the best solution to this problem. It prepares students to do college-level work and saves the state money by reducing the need to fund expensive remedial courses.

- The subcommittee concurs with these findings and supports the implementation of a state-wide AP program.

In the 69th Legislative Session, the legislature directed the State Board of Education to develop a Long Range Plan for Technology for 1996-2010 which recognized several changes in society, including developments in technology and increased expectations by business and industry on even its entry-level employees. The Long-range Plan for Technology is an excellent plan for the integration of high-tech in Texas schools as a needed skill and as a learning and teaching tool. However, it is important to understand that its definition of technology is solely focused on high-tech.

- The subcommittee feels that it would beneficial to students and to the healthcare technology industry if life sciences were included into the Long-Range Plan for Technology.

Basic public school instruction does not integrate healthcare technology to any greater degree. Required curriculum consists of foundation and enrichment subjects. The foundation subjects include English, Language Arts, Reading, Mathematics, Science, and Social Studies. The enrichment courses are anything else outside of these basics. Although a wide variety of Health Science Technology classes are available to school districts, these enrichment classes are not required to be taught and are usually only provided in the wealthiest of districts who can afford to concentrate on non-required curriculum.

The subcommittee heard testimony from the Texas Education Agency that the competition to get into the smaller, more advanced magnate public schools is fierce, with only about 25% of applicants receiving admittance. Details on the cause for denial of applications, whether they were based on a lack of academic skills requirements or if they were based on a lack of resources from the magnate school to accommodate all qualified applicants, were not submitted to the subcommittee.

- The subcommittee feels that if the later is the case, investigation into more dedicated resources to magnate schools may be worthy and a goal of 50% admittance of qualified applicants is not unreasonable.

OPERATIONAL SUSTAINABILITY

The subcommittee found that many of the previous economic development initiatives that Texas has created are not synergistic with the biotechnology industry and hamper attraction and retainment of healthcare industries in Texas. Of the initiatives and tax credits available, either they lack the support of a fully functioning agency or they are targeted to development in strategic investment areas which do not have the educational or manufacturing structure that fosters robust healthcare technology clusters. Most programs are designed for heavy manufacturing industries or mature companies with a positive earnings base, not start-up science and technology companies.

The subcommittee understands that several technical assistance programs administered by the Texas Department of Economic Development (Office of International Business and Border Initiatives) are targeted at businesses in Texas looking to expand their markets. While these incentives could be used to recruit manufacturers and companies wishing to commercialize a product, it does not create an incentive for start-up manufacturers or laboratories whose stability could not handle national expansion.

The subcommittee learned that before the creation of the Texas Department of Economic Development, there were several state offices who were extremely successful in recruiting and encouraging the growth of technology-based industries in the 1990s. For example, the Office of Advanced Technology (OAT), a division of the Texas Department of Commerce (TDOC) was established in 1989 and served as the lead technology business development organization in the state. Its mission was to establish Texas as a global economic leader by creating an environment that encourages and supports the development and adoption of technology. OAT's four staff members served as catalysts and facilitators for developing programs that created a stronger technology support structure in the state. This was a very active office that was eliminated with the creation of Texas Department of Economic Development.

> *"Rather than rely on purely financial incentives, North Carolina works to create a distinctive business environment favorable to biotechnology."*
>
> **--Tom Ridge, Governor of Pennsylvania**

The Texas Innovation Network System was a non-profit, 501 (c)(3) organization chartered by the Texas Legislature as a clearinghouse for science

and technology information. TINS built and managed a user-friendly, Internet-based online system featuring databases that described: the activities of key technology areas, more than 4,000 faculty members at public and private Texas universities, the activities of more than 400 private research centers across the state, and more than 150 business and technical assistance programs. TINS worked closely with the Office of Advanced Technology and the Texas Higher Education Coordinating Board to assist with technology development and transfer. Lack of funding forced TINS to close in 1994.

- Resurrection of The Office of Advanced Technology and the Texas Innovation Network System or similar offices would be as significant an assistance to the healthcare technology industry today as it was to the high-tech industry in the 1990's.

The subcommittee learned that other state-supported organizations such as the Small Business Development Centers (SBDCs) take a more active role in supporting technology, often on their own initiative and many times in partnership with other entities. The Dallas SBDC created the Technology Assistance Center (TAC) to assist small businesses in the commercialization of new and innovative technologies linking inventors, manufacturers, and marketers with solutions to problems, and with opportunities on which to capitalize in commercializing their products. The Texas Product Development Center (TPDC), housed at the University of Houston SBDC, offers a Product Evaluation Program in which experts assist with market feasibility and provide financial leads to individuals with an idea for a new product.

- The subcommittee recommends examination of these programs as to how they could be expanded.

With Texas in direct competition with states like New Jersey, Maryland, and California, the lack of eagerness from Texas state agencies and the deficiency of targeted incentives place Texas in an uncompetitive position for this capital intensive industry. An attempt was made last session to create a venue for small start-up companies to have access to venture capital by allowing insurance companies a tax credit on their premium tax for investments in small business venture capital funds. S.B. 899 would have allowed insurance companies to fund certified capital investment companies in exchange for receiving certain premium tax credits. The capital investment company could be created for a specific investment strategy to help generate venture capital for a targeted industry. The insurance company would have received a dollar for dollar tax credit to be divide over ten years with no more than $20 million in credits allowed in one year. The bill passed the House and the Senate, but a conference committee was never assigned to compromise differences in the two versions passed.

- The subcommittee feels that because the State is limited in how it can encourage capital investment, this type of tax credit represents a creative and viable method to stimulate investment in start-ups. For this reason the subcommittee feels that legislation of this vein is worthy of consideration and support.

> *"If you want to raise money to drill a hole in the ground to look for something called oil, you can find it all over River Oaks. And if you want to gather together the people it takes to drill that hole, you can get on the phone and set up a team to go and drill that hole. In Houston, if you want to find money to start a biotech company, good luck!"*
>
> **--Dr. John Mendleson**
> **UT M.D. Anderson on Venture Capital**

Another proposal that the subcommittee feels warrants close attention by the Legislature is the sale of tax credits as a method to create an influx of cash flow for young companies in Texas. Legislation recently passed by the New Jersey Legislature allows a company to transfer unused franchise tax credits to other qualified companies in exchange for cash. California has passed a similar law that allows a company to sell the unused franchise tax credits back to the

State for a rebate. This program is especially useful for companies that can not claim a franchise tax credit, even though they've earned it, because they do not have any profits against which to take the credit. However, for a nascent company, especially in the healthcare technology industry, influx of cash resulting from the sale of unused tax credits can be utilized to expand in-state research or manufacturing facilities or to fund research and development activities.

- The subcommittee firmly believes that any measures which enhance the ability of a biotech company to generate cash flow should be seriously considered by the Legislature and given a very high priority.

The subcommittee also learned that in 1989, Texas voters passed a constitutional amendment to permit the State to issue up to $25 million in general obligation bonds to capitalize a Product Development Fund. The intent of the Product Development Fund was to increase the amount of risk capital for new technology development projects. The Texas Department of Commerce was designated to establish the rules and guidelines to manage this fund. Although advisory boards were formed and public hearings conducted, general obligation bonds were never issued to support these programs. Strong concern of investing State of Texas funds in high risk ventures as well as the appropriate department to manage the funds ultimately sidetracked these funding programs and enabling legislation was repealed in 1997. These funds are still dedicated.

- The subcommittee believes that this type of program represents the assistance needed by the industry and efforts should be made to revive the Product Development Fund (or a similar initiative).

At the same time the Product Development Fund was passed, Texas voters passed a another constitutional amendment permitting the state to issue up to $20 million in general obligation bonds to capitalize a Small Business Incubator Fund. This fund was authorized to create and expand incubators that would provide support to entrepreneurs with new technology products during the critical early business development stage. Unfortunately, this fund fell to the same fate as the Product Development Fund.

- Again, the subcommittee believes that this type of program represents the assistance needed by the industry and efforts should be made to revive the Product Development Fund (or a similar initiative).

These same types of programs have been very successful in other states that have strongholds in the healthcare technology industry. As companies develop, they need targeted assistance by the state.

For many small start-up biotech companies, the majority of their investment is in equipment, not employees or real estate.

- Therefore, the subcommittee believes a sales tax exemption on research and development expenses (with a maximum exemption annually) should be created for companies under a certain size instead of the franchise tax exemption.

Additionally, in other states, notably California, other industries have offered incentives to recruit and retain healthcare technology companies. An excellent example of this effort is with utility companies. Many biotechnology companies have clean rooms in which to do research. These clean rooms not only house large research equipment that require a constant cool temperature, but the purity of the environment must be controlled. Thus, where normal facilities recycle the air 3-4 times, in a clean room air is used only once. In warm-climate states, like California and Texas, a biotech company's utility bills can be astronomical depending on the size of their clean rooms. Because utility companies see biotech and high-tech companies as excellent customers, arrangements have been made between utilities and biotech companies in a number of other states

where the utility company has offered incentives to the biotech company to locate in their area. Incentives range from utility cost breaks to guaranteeing the lease of a biotech company for 10 years. Although Texas is currently still operating under a regulated utility system in the retail market which prohibits these types of incentives, the market will be deregulated by January 1, 2002 and pilot programs will begin as soon as June 1, 2001.

- The subcommittee feels that the Legislature should encourage the utility industry to offer incentive packages to the bio and high-tech industry.

Once a healthcare technology industry has commercialized a product, it reaches a manufacturing stage like any other industry. However, like every other aspect of their development, healthcare technology has specialized manufacturing needs. Pharmaceutical and medical device products have been described as fairly easy to produce, but they require a specially trained workforce and highly specialized equipment.

- Thus, the subcommittee believes a tax credit or sales tax exemption on the purchase of equipment for research as well as manufacturing should be established.

Once produced, the product needs transportation to its distribution facilities. Texas has developed an extraordinary infrastructure for transportation. However, further development and maintenance is crucial for all industries in Texas.

> *"Obviously, one of the things that we're here to learn is how and what is the proper role of state government in supporting the economic development, commercialization and creation of jobs in what we believe will be the driving science of the 21st century--healthcare technology."*
>
> **--Representative Kenn George**

It is the proven and proper role of government to create an environment that encourages economic development and increases the standards of living for all its citizens. The State of Texas has strongly supported its traditional industries of agriculture, oil and manufacturing. When the high tech industry began to be the economic driver of the late 20th Century and Texas was caught behind, State government stepped forward and planted our flag for all to see by helping facilitate the creation of MCC and Semetech. Those two collaborations between government, academic institutions and private industry supported and publicly encouraged the increased development of our currently vibrant high tech industrial base. One of its most important accomplishments was to attract the best minds in the industry to live and work in Texas. It also made a statement that we were "open for business" to the high tech start-up entrepreneurs. Jobs and economic development were the result.

As the 21st Century begins, it is obvious that where chemistry and physics were the science of the 20th Century, biology will reign supreme in the 21st. The subcommittee has found that, like before with our natural resource base, we are exporting our resources for others to develop. Texas institutions do billions of dollars in research while other states and communities enjoy the job creation that results from commercialization of that research.

> *"I'm a Texan, I wanna stay here. The next company I start, I want it to be here in Austin, I want it to stay here. And I hope that in your infinite wisdom, you understand that there are ways to make that happen."*
>
> **--Rick Hawkins**
> **biotech entrepreneur**

The subcommittee feels that by supporting and encouraging healthcare technology, the public will receive a return on its investment in research activities through job creation and an increased tax base. Healthcare technology and specifically

biotechnology will be the technology of the 21st Century, creating jobs and tax base, driven by intellectual property. Due to the different nature of intellectual property driven industries, there will be a limited number of communities or "community clusters" which will be concentrated, integrated and synergistic in their growth.

Silicon Valley is the original role model with the North Carolina Research triangle being another. Other states and even individual communities like San Diego and Boston are actively recruiting the best minds and supporting the commercialization of their intellectual property. They have developed sophisticated and integrated approaches to provide research, healthcare institutions, manufacturing capacity and financial support at the crucial start-up phases thereby creating sufficient knowledge resource to have a fluid employment base.

The State of Texas needs to understand the competitive market place for this growing industry and react to the challenge. Without an integrated approach to recruit and retain this industry in Texas, we, may put our tax base and our citizens at a permanent economic disadvantage.

INTERIM REPORT ON TELEMARKETING

Committee on Business & Industry
Representative Kenneth "Kim" Brimer, Chair

Subcommittee on Telemarketing
Representative Burt Solomons, Chair

Report to the 77th Legislature

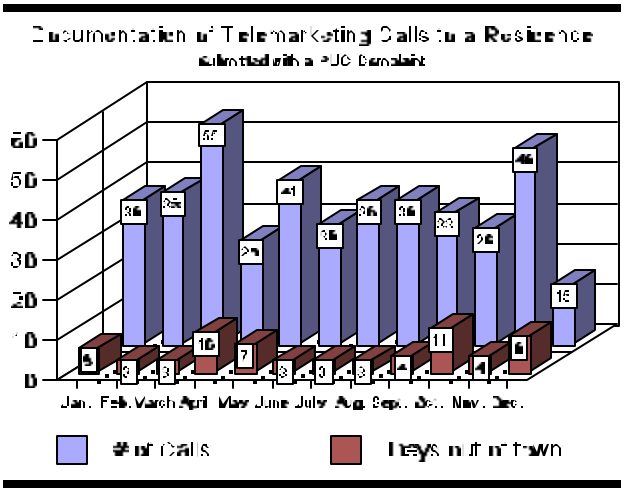
THE ISSUE

Telemarketing is a very important, vital industry in Texas. Telemarketing remains the number one direct marketing medium in America (followed by direct mail). 1998 witnessed $460 billion in nation-wide sales as a result of telemarketing alone. While entities utilize telemarketing for a variety of reasons, the two most striking advantages of telemarketing are the savings one incurs in terms of both time and money. Considering that while the cost of doing business usually increases with time, the relative cost of a phone call has decreased over time. The bottom line, the business of telemarketing is only getting cheaper.

All the testimony received by the subcommittee in conjunction with staff research shows telemarketing to be a valuable asset to both industry and consumers. In addition, the teleservices industry is one that Texas has aggressively recruited, enjoyed a profitable symbiotic relation with, and hopes to foster an on-going mutually beneficial relationship. In Texas, the telemarketing industry represents 275,000 jobs (which is estimated to grow between 3-5% annually over the next five years). According to industry sources, more than $80 billion dollars of goods and services were sold in Texas via telemarketing.

Despite the fact that there are many legitimate companies that use the telephone for marketing, there are also fraudulent actors within the industry. Moreover, the problems associated with the telemarketing industry do not appear to be going away. Telemarketing fraud is an easily accomplished crime due to the anonymity provided the solicitor. Consumers lose an estimated $40 billion across the United States each year through telemarketing fraud. The Federal Bureau of Investigation estimates that there are 14,000 illegal telemarketing establishments currently operating in the United States. Fraud also affects the legitimate industry as well, tarnishing its image and increasing the opposition and disdain for this useful medium.

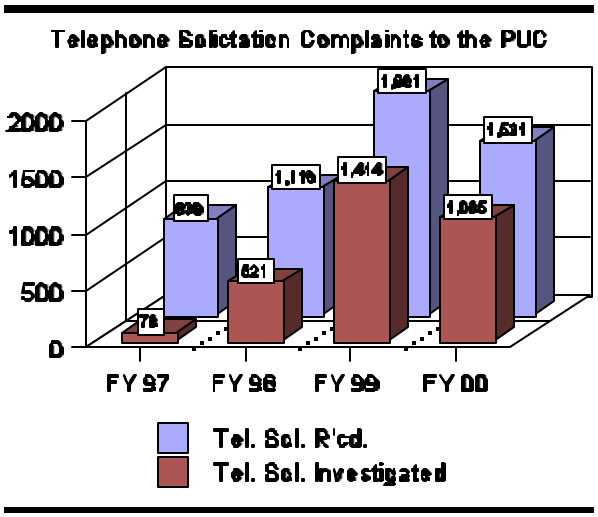
In addition to fraud, the industry suffers from the widespread consumer opinion that all solicitations are nuisances, even solicitations from legitimate businesses. At worst, they are seen as an invasion of privacy. To varying degrees, consumers and industry professionals alike support certain restrictions (some that are already in existence, some that are not).



Most consumer complaints stem from one of four common issues: the sheer number of calls received during the course of a day, the aggressiveness of the solicitor, violations of state and federally mandated, in-house "do not call" lists, or receiving solicitation calls outside of the allowable hours.

The Public Utility Commission (PUC) reports that consumer complaints concerning telephone solicitation have been on the rise over the past few years (although statistics from the first five months of FY 2000 show a decrease). One Texas citizen documented the number of calls he received from

telemarketers during the 1999 calendar year. In his letter, the complainant exclaimed "By any standard, this is harassment and nothing is being done about it in Texas, unlike some other states. Are you going to let this plague continue and grow as it does each year? I cannot eat a meal, take a nap or even go to bed early without being interrupted or wakened. If this were a disease someone would discover a vaccine, but since its of no consequence to politicians, nothing is done."



While he is incorrect about the lack of telemarketing legislation, he aptly describes certain consumers' disdain for any type of telemarketing. The only legislative solution that can address this type of consumer contempt appears to be a statewide "no-call" list. This is almost certainly what he is referring to when he mentions legislative action in other states. While legislation creating a statewide no-call list has failed in the Texas Legislature, telemarketing in general has become an ever increasing focus of the Texas House and Senate. This is evidenced in several significant pieces of legislation which passed during the 76th Legislative Session. They include HB 23, which created time restrictions and no-call provisions for fax solicitation; SB 86 and SB 560 which protects customers from fraudulent, deceptive and anti-competitive practices and prohibits cramming [1], slamming [2] and redlining [3]; and SB 7 which created consumer protections for utilities telemarketing consumers in the future such as a no slamming and cramming provision as well as a statewide no-call list *for utility telemarketing only* to be maintained by the PUC.

While the definition of a nuisance call varied, an overwhelming desire was communicated to the subcommittee for assistance in implementing a simpler, more effective way to prevent nuisance calls.

CURRENT LAWS

The following is a break down of the current laws and agency regulations that pertain to telemarketing in Texas. First is an explanation of the state and federal regulations that cites the relevant statute or regulation, a description of the regulating authority and applicable penalties. After the an explanation of the laws, there is a discussion of the regulations applicable to the areas of registration, telemarketing, no-call lists,

[1] Placing charges on a telephone billing statement for unsolicited services.

[2] Switching a customer's long distance service provider without approval.

[3] Discrimination based on income level, source of income or geographical area.

Automatic Dialing Announcing Devices (ADADs), and fax solicitation. Each lists the prohibited and required actions and the exemptions applied to each area of telemarketing.

State Regulation

The state telemarketing laws are contained in the Texas Business and Commerce Code, Chapter 37 (Telephone Solicitation) and Chapter 38 (Regulation of Telephone Solicitation). In addition, Chapter 17 (the Deceptive Trade and Practices Act) has certain applications, especially in enforcement and penalties. Violation of Chapters 37 and 38 of the Business and Commerce Code is considered a violation of the Deceptive Trade Practices Act. In addition the Public Utility Commission has statutory and regulatory laws regarding telemarketing.

Chapter 37 of the Business and Commerce Code applies only to the solicitation of consumer goods or services via calls made to residential telephone numbers. The only enforcement authority is the Office of the Attorney General (civil action only) or private action by the consumer, either of whom may ask for a civil penalty not to exceed $10,000 per knowing and continuing violation. This is an extremely difficult burden of proof.

Chapter 38, on the other hand, applies to solicitation made to residential or business numbers and includes Automatic Dialing Announcing Devices. Enforcement authority is given only to the Office of the Attorney General (civil action only) and District or County Attorneys (criminal action only). The Office of the Attorney General may ask for civil penalties of up to $5,000 per violation or injunctive relief (maximum $50,000 violation penalty). District and County Attorneys may pursue violations as a Class A misdemeanor.

The Deceptive Trade Practices Act is enforced by the Office of the Attorney General (civil action only), District or County Attorneys (civil action only) or private parties may file private action. The Office of the Attorney General and District or County Attorneys may ask for penalties including temporary restraining orders, assurance of voluntary compliance, permanent injunctions (violation of which can be penalized up to $50,000) and civil penalties of not more than $2,000 per violation, not to exceed a total of $10,000. However, those numbers increase to $10,000 per violation and a total not to exceed $100,000 if the consumer was 65 years of age or older. A court may also award to compensate consumers for actual damages or to restore money or property, real or personal, but only for knowing violations.

The Texas Business & Commerce Code[4] includes regulations for "certain electronic communications made for purpose of sales." It gives both the consumer and a District or County Attorney the ability to file criminal actions against communications which violate the federal Telephone Consumer Protection Act.

[4] Tex. Business & Commerce Ann., Sec. 35.47

A District or County Attorney may prosecute violations as a Class C misdemeanor and a consumer may ask for actual damages or $500 (whichever is greater); maximum of $1,500 if court finds the violations were knowing and intentional.

Title 16 of the Texas Administrative Code gives the Public Utility Commission regulatory power over certain uses of Auto Dial Announcing Devices. The Public Utility Commission is granted administrative authority to order certain service providers to disconnect service to device users.

The Public Utility Commission has several citations in the Public Utility Regulatory Act (PURA)[5] and one statutory citation[6] dealing with telemarketing which applies to utilities and billing providers regulated by the Public Utility Commission. Under these regulations, the Public Utility Commission has administrative authority against telephone solicitors and telecommunications utilities. They can assess in administrative penalties up to $1,000 per day for violations, and can revoke certifications and registrations for repeated violations or may order a disconnect from service by a telecommunications utility. In addition, the Office of the Attorney General (civil action only) and a District or County Attorney (criminal action only) have authority to prosecute. The Attorney General may ask for penalties of $1,000-$5,000 per day for knowing violations, and ask that officers and directors be personally fined $1,000 per knowing violation. District and County Attorneys may prosecute violations as 3rd degree felonies. Under these regulations the Public Utility Commission may require certification or registration as a condition of doing business in Texas.

Federal Regulation

Federal telemarketing laws contained in the Telemarketing Consumer Fraud and Abuse Prevention[7] statutes and the Telemarketing Sales Rule[8] prohibit deceptive and abusive telemarketing acts or practices.

Authority to enforce these laws is afforded to the Federal Trade Commission (both civil and criminal action), state Office of the Attorney General (civil action only), other state officials authorized by the state, and consumers are given a private right of action, but only if damages exceed $50,000. All parties have the ability to request penalties including injunction, damages, and restitution. In addition, the Federal Trade Commission can charge the telemarketer with criminal contempt.

[5] PURA Sections: 15.021-15.033, 17.051-17.053, 55.121-138, 55.151-153.

[6] 16 T.A.C. Section 26.126

[7] 15 U.S.C. Section 6101

[8] 16 C.F.R. Part 310

The Telephone Consumer Protection Act[9] which restricts the use of Automatic Dial Announcing Devices and fax machines when used for soliciting purchase, rental, or investment in property, goods or services without the recipient's prior express permission (there are exemptions for situations where the caller has an established business relationship with the receiving party, and for calls made by tax exempt nonprofit organizations).

Under the Act, The Federal Communications Commission, the State Office of the Attorney General and the consumer may file a civil action for injunctive relief, actual damages or $500 per violation (whichever is greater), treble damages for knowing or intentional violations.

REGISTRATION

Citations: Chapter 38 of the Texas Business & Commerce Code

Provisions: Under these laws a telemarketer is *required* to:

- Register with the Secretary of State and pay a $200 registration fee (registration is effective for one year and must be renewed).
- Update registration information quarterly if it changes.
- submit a $10,000 bond.
- Post registration information at its business.
- Authorize the Secretary of State to be their agent for service of process.
- Disclose prior convictions, sales information,
- Disclose name and the name under which the seller is doing or intends to do business, if different.
- Disclose the name of each parent and affiliated organization of the seller that will engage in telemarketing solicitations or accepts responsibility for statements made by, or acts of, the seller relating to those solicitations.
- Disclose information about the seller's business including its place of organization, a copy of its articles of incorporation and bylaws or a copy of the partnership agreement, any assumed business name and the location where the assumed name has been registered.
- Disclose the complete street address of each location of the seller, designating the principal location from which the seller will be conducting business in this state.
- Disclose a listing of each telephone number to be used by the seller and the address where each telephone using the number is located;
- Disclose the name, title, complete residential address, the date of birth, and the driver's license number of each of the seller's executive and management staff.
- Disclose either the name and residential address of each salesperson or a copy of

[9] 47 U.S.C. Section 227

the "Employer's Quarterly Report" submitted with the Texas Workforce Commission.

- Disclose the name and address of each financial institution with which the seller does business and the identification number of each of the seller's accounts in each institution.

Exemptions: The following are exempt from registration under Chapter 38 of the Texas Business and Commerce Code:

- Sellers who make calls on their own behalf (i.e. - third party businesses are not required to adhere to these provisions.);
- Sales of securities;
- Sales by publicly traded corporations (or their subsidiaries or agents);
- Sales of insurance;
- Sales related to "supervised financial institutions;"
- Sales by entities regulated by the Public Utility Commission of Texas (unless an automated dialing device is used);
- Sales by anyone regulated by the Federal Communications Commission;
- Solicitations for Public Safety Organizations;
- Sales of regulated commodities;
- Sales of newspapers, magazines, and cable television;
- Sales of preordered merchandise and certain catalogue sales;
- Sales by educational institutions and non-profit organizations;
- Sales of food;
- Sales which are the result of follow-up calls from persons selling extended warranties and calls to former or current customers of the business;
- Sales that are not completed on the telephone;
- Sales calls by businesses that have been in existence for at least two years and that sell retail items to the public at the business' establishment location;
- Sales calls from telephone solicitors who meet certain requirements and who work for exempt entities;
- Sales calls for isolated transactions.

Citation: Public Utility Regulatory Act (PURA)[10]

Provisions: Under these regulations *the Public Utility Commission may:*

- Require certification or registration as a condition of doing business in Texas.

TELEMARKETING

[10] PURA Sections: 15.021-15.033, 17.051-17.053, 55.121-138, 55.151-153.

FEDERAL REGULATIONS ON TELEMARKETING

Citations: Telemarketing Consumer Fraud and Abuse Prevention[11] statutes and the Telemarketing Sales Rule[12]

Provisions: Under these laws a telemarketer is *prohibited* from:

- Debiting a consumers' checking accounts without express, verifiable authorization.
- Calling prior to 8:00 a.m. or after 9:00 p.m.
- Collecting payment before providing loan arrangements.
- Offering credit repair services or recovery of money lost in a prior scam.

Under these laws a telemarketer is *required* to:

- Inform the consumers that the purpose if the call is to sell goods or services.
- Describe the goods or services being sold.
- Inform consumers that no purchase is necessary to win a prize promotion.
- Disclose costs and other terms of buying the goods or services.

Exemptions:

- Solicitations in which the sales transaction is completed face-to-face.
- Solicitations subject to requirements of other Federal Trade Commission rules.
- Calls from consumers in response to ads in the general media.
- Calls from consumers regarding catalog sales
- Solicitations from business-to-business, except sales of office or cleaning supplies.

TEXAS REGULATIONS ON TELEMARKETING

Citation: Texas Business and Commerce Code, Chapter 37 (Telephone Solicitation)

Provisions: Under these laws a telemarketer is *prohibited* from:

- Calling before 9:00 a.m. or after 9:00 p.m. Monday-Saturday and before Noon or after 9:00 p.m. on Sunday (which is less time than allotted by federal statutes).

Under these laws a telemarketer is *required* to:

- Identify themselves and the person on whose behalf they are soliciting (i.e. not the telemarketing firm, but the contracting entity that they are telemarketing for).
- Notify consumer of right to refund/cancellation within 7 days of receipt of goods or services for charge cards transactions.
- Process a refund within 30 days of cancellation of services.

Exemptions:

- Calls from businesses regarding a consumer inquiry.

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[11] 15 U.S.C. Section 6101

[12] 16 C.F.R. Part 310

- Calls on existing debts or contracts.
- Calls to an a customer that already has a established relationship with the seller.
- Solicitation from business-to-business.

Citation: Texas Business and Commerce Code, Chapter 38 (Regulation of Telephone Solicitation)

Provisions: Under these laws a telemarketer is *required* to:

- Seller must make limited disclosures to consumer.

Citation: Public Utility Regulatory Act (PURA)[13]

Provisions: Under these regulations a telemarketer is *prohibited* from:

- Using methods which block caller-id devices.

Under these laws a telemarketer is *required* to:

- Provide certain identifying information to consumers.

Further, *local exchange companies must*:

- Notify customers of their rights under Texas telephone solicitation laws once a year via billing inserts

NO-CALL LISTS

FEDERAL REGULATIONS ON NO-CALL LISTS

Citation: Telemarketing Consumer Fraud and Abuse Prevention[14] statutes and the Telemarketing Sales Rule[15]

Provisions: Under these laws a telemarketer is *prohibited* from:

- Calls to consumers who have asked not to be called.

Under these laws a telemarketer is *required* to:

- Have a written policy and training for telephone solicitors and keep a record of do-not-call requests.

Exemptions:

- Calls in which the sales transaction is completed face-to-face.
- Calls subject to requirements of other Federal Trade Commission rules.
- Calls from consumers in response to ads in the general media.
- Calls from consumers regarding catalog sales

[13] PURA Sections: 15.021-15.033, 17.051-17.053, 55.121-138, 55.151-153.

[14] 15 U.S.C. Section 6101

[15] 16 C.F.R. Part 310

- Solicitations from a business-to-business, except sales of office or cleaning supplies.

Citation: The Telephone Consumer Protection Act[16]

Provisions: Under these laws a telemarketer is *prohibited* from:

- Making calls to a residence using auto-dial devices without the resident's prior consent.
- Sending of unsolicited fax advertisements.
- Calling consumers who have requested not to be called.

Under these laws a telemarketer is *required* to:

- Have a do-not-call policy.

Exemptions:

- Calls for non-commercial purposes.
- Prior business relationship.
- Tax exempt organizations.

TEXAS REGULATIONS ON NO-CALL LISTS

Citation: Public Utility Regulatory Act (PURA)[17]

Provisions: Under these laws a telemarketer is *required* to:

- Design and implement do-not-call lists.

ADADS

FEDERAL REGULATIONS ON ADADS

Citation: The Telephone Consumer Protection Act[18]

Provisions: Under these laws a telemarketer is *prohibited* from:

- Using auto-dialers to call emergency numbers, hospitals, or pagers.
- Making calls prior to 8:00 a.m. or after 9:00 p.m.
- Make calls to a residence using auto-dial devices without the resident's prior consent.
- Calls cannot tie up line after a hang-up for more than 5 seconds.

[16] 47 U.S.C. Section 227

[17] PURA Sections: 15.021-15.033, 17.051-17.053, 55.121-138, 55.151-153.

[18] 47 U.S.C. Section 227

- Calling consumers who have requested not to be called.

Under these laws a telemarketer is *required* to:

- Have a do-not-call policy.
- Disclose certain identifying information.

Exemptions:

- Calls for non-commercial purposes.
- Prior business relationship.
- Tax exempt organizations.

TEXAS REGULATIONS ON ADADS

Citation: Title 16 of the Texas Administrative Code

Provisions: Under these laws a telemarketer is *prohibited* from:

- Using random number dialing.
- Dialing numbers in successively increasing or decreasing integers.
- Using a device that ties up a line after a hang-up for more than 5 seconds.
- Making calls to emergency numbers, hospitals, or pagers.

Under these laws a telemarketer is *required* to:

- Get a permit from the Public Utility Commission.
- Disclose certain identifying information during calls.
- Keep the message to less than 30 seconds.
- Calls in Texas are limited to certain times of the day.

Exemptions:

- Emergency calls.
- Calls related to truant students.

Citation: The Texas Business & Commerce Code[19]

Provisions: Under these laws a telemarketer is *prohibited* from:

- Use of auto-dial devices to call mobile phones.

FAX SOLICITATION

FEDERAL REGULATIONS ON FAX SOLICITATION

Citation: The Telephone Consumer Protection Act[20]

[19] Tex. Business & Commerce Ann., Sec. 35.47

[20] 47 U.S.C. Section 227

Provisions: Under these laws a telemarketer is *prohibited* from:

- Making calls prior to 8:00 a.m. or after 9:00 p.m.
- Calls cannot tie up line after a hang-up for more than 5 seconds.
- Sending of unsolicited fax advertisements.
- Calling consumers who request not to be called.

Under these laws a telemarketer is *required* to:

- Have a do-not-call policy.
- Disclose certain identifying information.

Exemptions:

- Calls for non-commercial purposes.
- Prior business relationship.
- Tax exempt organizations.

TEXAS REGULATIONS ON FAX SOLICITATION

Citation: The Texas Business & Commerce Code[21]

Provisions: Under these laws a telemarketer is *prohibited* from:

- Transmission of faxes without prior consent when recipient would be charged.
- Transmission of fax solicitations between 11:00 p.m. and 7:00 a.m.

Under these laws a telemarketer is *required* to:

- Include a number on the fax that the recipient can call to stop receiving the solicitations.

OTHER STATES' LAWS

Registration, Bonding, Application Requirements

Alabama, Alaska, Arizona, Arkansas, California, Colorado, Florida, Idaho, Kentucky, Louisiana, Mississippi, Montana, Nevada, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, ***Texas***, Utah, Washington, West Virginia. Arizona requires limited registration of exempt sellers. (NOTE: Most states have exemptions for established businesses or businesses otherwise registered to do business and identifiable to consumer fraud officials.)

Do-Not-Call Lists

Alaska, Arkansas, Florida, Georgia, Oregon (Kentucky and Alabama have a do-not-call list that is tied to the registration law; if required to register, then one is also required to use the do-no-call list). Tennessee's do-not-call list will be operational as of July 1, 2000.

[21] Tex. Business & Commerce Ann., Sec. 35.47

Alaska	Maintained by individual telephone companies
Arkansas	Run by the state
Florida	Florida Department of Agriculture & Consumer Services
Georgia	Georgia Public Service Commission
Oregon	OTA Services
Tennessee	Run by the Tennessee Regulatory Authority (TRA)

Restricted Hours or Days

Alabama regulation restricts calls to between 8 AM and 8 PM; no Sundays or holidays. Michigan, Minnesota, and New Mexico restrict calls to between 9 AM and 9 PM. ***Texas restricts calls to between 9 AM and 9 PM; Sundays, 12 noon to 9 PM.***

Request to Continue Solicitation

Illinois, Oregon, South Carolina

No Rebuttal

If the consumer says he or she is not interested in the product or service as offered, the seller must discontinue the call in Arkansas, Illinois, Kansas, Oregon, Pennsylvania, South Carolina, and Utah.

Written Consent For Bank Account Debit

Arkansas, Montana, Vermont

Other Issues

- In an effort to curb the problem, 27 states have passed laws to combat telemarketing fraud and most others have a general telemarketing statute.
- These statutes typically require registration and bonding, submission of sales scripts (known as pitches), and information about prizes (if any) to a designated state enforcement agency which is often the state's attorney general's office.
- Some states, such as Mississippi, restrict the duration of calls or require the salesperson to hang up as soon as the consumer indicates a lack of interest.
- Other states including Alabama, Oklahoma, Utah, and Washington give consumers the right to cancel the sale within a set time period. North Dakota's statute grants consumers at least three days to cancel.
- A few states, such as Virginia, have expanded their door-to-door sales laws, which include a right

to cancel, to cover telephone sales.

- Many telemarketing laws include penalties for abusive language, and some, such as Alabama's, specifically discuss the prevalence of telemarketing fraud directed toward the elderly.
- Additionally, a few statutes contain enhanced penalties for fraudulent telemarketers who target elderly consumers.
- In Georgia, for example, fraudulent telemarketing practices targeted toward the elderly are subject to twice the applicable civil and criminal penalties.
- Some states, such as Indiana, Kentucky, and Florida, include civil and criminal penalties for elder fraud in their elder abuse statutes.
- Other states, such as Oklahoma, include enhanced penalties for elder fraud in their consumer protection statutes.

COMMITTEE FINDINGS

The subcommittee's charge has two specific aspects. The first is to assess the public's view of telemarketing in general. Part of this aspect must include the subcommittee evaluating the reality and the perception of telemarketing fraud. Secondly, the subcommittee is charged with assessing the need and the desire of the public to prevent nuisance calls. It is important for the subcommittee to distinguish between fraudulent actors and legitimate businesses that are operating within the law yet, some citizens find a nuisance. Additionally, the subcommittee is charged with examining which variables determine whether a citizen considers a call a nuisance.

The subcommittee has examined the submitted public testimony and feels that the public's view of telemarketing is a simple one. The issue of a consumer's definition of a nuisance call seems to depend less on the type of business, but rather pivots on the consumer's feelings about invasion of privacy and the particular business practice employed by an individual telemarketer.

> *"I hate that this is going to be on the record that I said this, but there's a lot of good that happens because commercial entities can reach new customers. I mean that provides jobs. It does a lot of wonderful things. But it also has its seamy side, and I think that we have to find a way to endure that. We can create a universal system so that we know who is out there so we can get back to them again."*
>
> **--Reggie James**
> **Consumer Union**

However, the provisions implemented to curb nuisance calls must be balanced between the perception of privacy invasion by a consumer and the governments interference with business practices. This issue of balance was an important one for the subcommittee. It is not the position of the subcommittee to invade the privacy of the business community by micro-managing the teleservices industry with unreasonable regulations.

Additionally, the subcommittee is painfully aware of the limited ability of the state to enact certain provisions that would not violate federal or

constitutional laws. Complete bans on solicitations for contributions would impede upon a person's right to political speech. Certain federal statutes on fax solicitation prevent the passage of more stringent state laws. The state is at all times mindful of the limitations and guidance of the federal statutes.

Nonetheless, the subcommittee has some specific recommendation for the 76th Legislature. When examining current telemarketing laws in Texas, the subcommittee was struck by the fragmented nature of the statutes that govern this industry. They include four chapters in the Business & Commerce Code, four chapters in the Texas Administrative Code, six chapters in the Texas Utilities Code, and one chapter from the Texas Occupations Code, in addition to numerous federal laws.
The subcommittee believes this fragmentation of the governing statutes is a direct contributor to the difficulties incurred by both consumers and telephone solicitors in understanding their statutory rights and responsibilities. The subcommittee feels strongly that telemarketing has become a significant and permanent medium for Texas businesses, and acknowledgment of its importance in our economy would be reflected in a recodification and reorganization effort.

In addition to the need for a recodification, the subcommittee also believes there is a lack of remedies made available to them under current law. While state law contains many effective consumer protection measures, enforcement of these provisions is generally reserved for the Office of the Attorney General. The subcommittee finds that while current law does empower individual consumers with a cause of action, the public needs and deserves more direct access to civil remedies.

Few consumers are aware of their authority to seek civil remedies. Access to the court system for remedies allow consumers an avenue for direct relief without the intimidating and potentially embarrassing process of involving the State's Attorney General. Further, an individual can be more diligent in prosecution than a state office which is saddled with every fraudulent solicitation in Texas, both large and small. The subcommittee feels that educating consumers about their rights to seek these civil remedies and increased penalties would increase the utilization of these rights.

In addition, the subcommittee feels that because of the pressure which often accompanies a telephone solicitation, especially for seniors, the Legislature should consider provisions which would give consumers more rights during a telephone solicitation transaction. First, the subcommittee feels that telemarketing solicitation should be no different from state laws regulating "in-home" solicitations which allow a three day right of recission due to the high pressure nature of door-to door sales. Consumers should have a right to recission and limited liability for transactions conducted over the telephone as well.

Another option the Legislature should consider is a "no rebuttal" provision for solicitors. These laws, as passed in other states, require a telemarketer to end a phone call once a consumer has said they are not interested. The subcommittee feels that a measure like this greatly enhance a consumer's ability to determine which calls are a nuisance which are not.

> *"It's worth it to me--time--my poverty is about time. And so any time somebody invades on my time, they're putting me into a different kind of poverty, and I'm not an exception. There are a whole bunch of people out there that feel that way."*
>
> **Representative Helen Giddings**

Additionally, current law does not treat business consumers and residential consumers the same. Many of the regulations which address when and how a telemarketer may complete a call are only applicable to residential phone numbers. Many businesses find telemarketing just as invasive and time-consuming as an individual consumer. In fact, small businesses in particular which have only one or two phone lines can be extremely burdened by long calls with a telemarketers which prevent legitimate business from taking place. The Legislature should consider extending the same consumer protection provisions which govern residential transactions to business establishments as well.

To further enhance the enforcement, the subcommittee recommends strengthening the state ability to penalize fraudulent actors. Currently, the PUC can revoke a telecommunications companies operating license for repeated violations of the Texas Utilities Code. Similar authority should be extended to the courts and the Secretary of State's Office. For example, the Legislature could allow the courts or the Secretary of State to revoke a telemarketer's's registration for repeated violations of the state's telemarketing laws.

In many aggregated cases, fraudulent telemarketers in Texas will call consumers in other states and defraud them of a few hundred dollars at the most. Yet, Texas statutes require prosecutors to locate those victims, investigate their claims, and produce each victim before the court. In order to secure a first degree felony, a prosecutor must prove $200,000 in damages or obtain 1,000 out-of-state witnesses. It is simply too cost prohibitive for many county and district prosecutors to pursue. Sophisticated fraudulent actors realize this situation and use it to their advantage. The end result is that Texas becomes a home for the criminally mischievous.

Therefore, the subcommittee believes that district and county attorneys should be allowed, in a aggregated prosecution, to build a fraud case based on the testimony of select witnesses. Moreover, direct and/or circumstantial evidence should be allowed so prosecutors are not forced to prove that fraud was committed against each and every victim with direct testimony. Current federal law allows this type of prosecution. The subcommittee believes that the more stringent state law hinders a prosecutor's ability to convict.

Many question whether heightened enforcement will be effective because of the elusive nature of the solicitor in a telephone transaction. Therefore, the subcommittee recommends that the Attorney General be provided with the funds to employ a pilot project in an undisclosed major metropolitan area to aggressively pursue telemarketers over the next biennium. Analysis of the results could direct future legislative efforts.

The subcommittee also found that continued statistical input from the regulatory agencies would be useful information for further legislative efforts within this issue. The subcommittee recommends additional reporting requirements for the Public Utility Commission and the Office of the Attorney General and believes each agency should report specific recommendations for change to the Legislature each biennium.

> *"I've found the only effective way to deal with a fraudulent 'boiler room' is to identify it, locate it, and promptly run a search warrant on it, seizing voluminous records, and identifying all the people working inside the operation, their true names, and their various roles. Each time you take on one of these large telemarketing operations, or any large financial fraud, it's like going to war."*
>
> **--Russel Turbeville**
> **Harris County Assistant District Attorney**

Increased knowledge of who the solicitors are and where they are located will also help enforcement efforts. The subcommittee feels strongly that the registration process for telemarketers in Texas should be strengthened. Registration information should include current business name, physical locations, a list of true identities and residential addresses for all managerial or executive staff and a physical address of all operations in Texas, with a working inbound phone number and a brief description of the goods or services being sold. Further, personnel files and records of all sales transactions should be maintained at every site along with a posted copy of the registration. Personnel files should include original, signed employment applications disclosing identifying information on the employee, as well as hard copies of their social security card and driver's license.

In addition, sales records should include information such as a customer's name, address, telephone number, date of purchase, price of purchase, and the nature of the product or service purchases. Additionally, each sales transaction should identify the sales person who involved in the transaction. Banking records should be kept for all sales transactions. These are all common practices exercised by legitimate businesses. The subcommittee believes none these would place an undue burden on the telemarketing industry and represents the bare minimum necessary to establish a creditable registration process that aids citizens, state agencies and prosecutors.

In addition to strengthening the registration process, the subcommittee found too many exemptions to the registration requirement. Therefore, the subcommittee recommends no exemptions to registration process, period.

However, the implementation of these registration improvements should not be placed on businesses that are already tightly regulated and overseen. It is not the intention of the subcommittee to require highly reputable industries that utilize telemarketing to be subject to duplicative registration and bonding requirements. Many industries that call Texas home operate already under intense regulation. It is not the intention of the subcommittee to require multiple registrations. The subcommittee is confident that the regulating agencies of Texas are capable of amending their current registration process in order to determine whether a registrant intends to telemarketer's. If they do, the business' pertinent registration information could be forwarded to the Secretary of State's Office. A business should receive confirmation of a transfer of registration to assure compliance with statutory requirements.

Implementation of tighter registration, heightened access to civil remedies, pilot enforcement projects and a leveling of the sales transaction will increase the need for funding for offices like the Secretary of State, Public Utility Commission and the Attorney General's Office. Combating fraud and investigating complaints from citizens should be a priority for those agencies and state appropriations should reflect the state's dedication to consumer protection and enforcement. Further, the subcommittee feels that it may be necessary

to consider a grant program from the Attorney General's office for district and county attorney offices to assist in the prosecution of telemarketing cases.

The subcommittee feels that there are certain measures that the industry itself could establish to improve the public's perception of telemarketing calls. These provisions seem to fall into two categories: customer service and full disclosure.

One of the most repeated complaints is that solicitation calls frequently appear as "unknown caller" or "out of area" on an individual's Caller ID service. In fact, HB 2128 as passed by the 75th Legislature requires telephone solicitors to transmit data to all Caller ID units which reflects their companies' name and a telephone number. However, the law has been rendered impotent due to the telephone industry's technical inability to comply with the statute. The industry claims it is not feasible for telephone companies to be responsible for this transfer of information as it is often lost by an intermediary. Thus, they effectively argued that it was too punitive to expect telephone solicitors to abide by standards which were technically impossible and beyond their control. To date, the legislative intent of this statute has not been clarified and penalties are not being assessed.

However, the subcommittee was presented with no credible, empirical evidence that this technology is not possible, even if not immediately. The subcommittee believes this is an issue that should be clarified by the 77th Legislature and enforced within the next biennium.
This recommendation should apply to fax solicitations as well. Additionally, direct fax solicitation companies should be required to disclose on each transmittal the company's telephone number, a true and correct physical address, plus the solicitor's fax number. Without this information, a consumer cannot contact the proper party or property direct redress. Further, the phone numbers provided by the solicitation company should be answered by a live operator during the same hours the company is allowed to transmit faxes.

One idea proposed to the subcommittee involved requiring fax solicitors to identify themselves as a solicitor in the CISD, a station identification location that prints on the incoming fax. However, federal statutes governing fax solicitation prevents any alteration of the tech standards of the CISD (although federal statutes only apply interstate faxes). Nonetheless, the subcommittee is hesitant to make recommendations that would implement different standards for a fax solicitor based on the geographic destination of a fax.

The subcommittee also believe the regulations regrading Automated Dialing Announcement Devices could be clarified. The subcommittee recommends prohibiting the use of automated devices which ask the caller to stay on hold until a human solicitor gets to the phone.

> *"One of the arguments we constantly hear is, we've got all the laws on the books we need. We just need to educate folks. Well, that's fine, but tell us what you're going to do to help us do that. The Legislature cannot do it. The State of Texas can't do it all either. We need your help. We need to know what you're willing to do."*
>
> **--Representative Burt Solomons**

Industry should be responsible for updating the Public Utility Commission on the latest advances in technology in an effort to assist the PUC's recommendations to the Legislature. Moreover, the subcommittee emphatically believes that industry should become more involved with

consumer education efforts. Yearly inserts in a billing statement which are typically thrown away with other advertising inserts are a disappointing effort at consumer education.
Representative Dukes implored the industry leaders at the hearing:

> "We may need to start looking at some measures from within the industry for really doing some true consumer education...The cream of the crop should be the ones really willing to get out there and take the lead on this because you guys end up continuing to be the leaders in the market....The point I'm trying to make is many people, many businesses, don't want us to enhance the penalties, don't want us to tighten up the laws. For the year 2000, we need to look for something different and maybe we need to look for some participation from you guys or just look at increasing penalties."

True financial support and initiation of outreach programs to consumers would improve both the consumers and the Legislature's perception of the industry's dedication to fight fraud and nuisance levels.

Finally, the subcommittee recognizes that a small section of the populace would like to have direct control over the number of solicitations they receive and simply do not wish to receive telemarketing calls at all. For those individuals, Texas lacks an effective way to prevent nuisance calls. Much of this has to do with the individual consumer's control of their own information once they submit it to a solicitor, state agency, or even a private organization to which they may have membership. The subcommittee is aware of the interim charge being studied by the House Committee on State Affairs regarding privacy and feels this issue will be examined in detail in that committee's interim report. However, the subcommittee did believe that some version of an opt-in[22] law should be examined before an organization can distribute or sell a member's information. This would allow consumers some control over who has the ability to contact them.

The ultimate form of control over a solicitor's access to an individual would be a statewide "no-call" list. This option would allow a consumer, with one, simple phone call or form, to request that all solicitors in Texas cease contact with them via telemarketing. This is a contentious issue with varying concerns for both consumers and businesses. Representative Debra Danburg offered a well balanced compromise during the 76th session in HB 537 but the bill died in the Senate Committee on Economic Development.

Many industry advocates who are concerned about technological problems associated with a statewide "no-call" list have suggested requiring Texas telemarketers use the Direct Marketing Association's (DMA) "no-call" list. The DMA, the largest trade association for businesses interested in interactive and database marketing, has nearly 4,600 member companies from the United States and 53 other nations. The DMA's no-call list is updated every 3 months.

The subcommittee found that as of January 2000 there were over 2,988,698 individuals signed up on the no-call list, of which 128,033 are Texans (roughly 4%). Currently, with no statutory requirements to utilize the DMA "no-call" list, 4,500 entities nationwide utilize the list (200 of which are non-profit). Of the total number

[22] "Opt-in" is a term of art used to describe a situation where an individual must expressly grant someone permission to do something (i.e. - distribute or sale of personal information).

of companies utilizing the no-call list, 162 are headquartered in Texas and an additional 111 have operations in Texas for a total of 273 Texas companies that utilize the DMA's no-call list. That translates to 12 percent of the 2,300 telemarketers in Texas.

The subcommittee feels it is the overwhelming desire of the public for the legislature to establish a statewide no-call list. While industry leaders disagree with "no-call" list proposals, they admit it is inefficient to contact consumers who have no desire to speak to them. For these reasons the subcommittee encourages the 77th Legislature to pass a statewide no-call list. Further, subcommittee members felt the method utilized to request to be added to the no-call list should be extremely accessible to the general public. Representative Giddings recommended a form located in the telephone directory, still others testified that downloadable forms located at a state agency's website would be advantageous for consumers.

Consumer's perception of telemarketing in general is affected by fraudulent actors, aggressive sales pitches, an unlevel playing field in sales transactions, nondisclosure by solicitors, and an invasion of time in their most private of locations. The subcommittee hopes that implementation of some or all of the provisions discussed above will continue the growth of this industry in Texas while furthering a more positive image and at the same time provide remedies that the public feel are accessible and potent.

INTERIM REPORT ON THE TEXAS WORKERS' COMPENSATION INSURANCE FUND'S SURPLUS

Committee on Business & Industry
Representative Kenneth "Kim" Brimer

Subcommittee on the Texas Workers' Compensation Insurance Fund's Surplus
Representative Dawnna Dukes, Chair

Report to the 77th Legislature

THE ISSUE

The Texas Workers' Compensation Insurance Fund (known as the "Fund") was created in 1991 by the Texas Legislature as a stabilizing and competitive influence on the workers' compensation market in Texas and is the designated provider of last resort[1]. It currently has assets of $1,320,661,000, of that $686,665,000 is dedicated to current liabilities (operations and claims), which leaves a surplus of over $633 million dollars (as of July 31,2000).

During the 76th Legislative Session H.B. 3697 was filed, which would have required the Fund to serve as a stabilizing, rather than as a competitive, force in the marketplace. In addition, this bill, as introduced, deleted the prohibition against the use or appropriation of unassigned funds for any other purpose than to cover claims against the Fund and to provide that unassigned surplus funds are subject to legislative appropriations on the approval of the Commissioner of Insurance. Under this bill, unassigned surplus funds from the Fund would have been appropriated to the general revenue fund, contingent on the approval of the Commissioner of Insurance that such appropriations not adversely affect the financial ability of the Fund to perform its duties and responsibilities.

Concerns about the viability, legality and consequences of this action led to a substitute which , in addition to some premium structure changes, authorized the Fund to make payments from the surplus to insurers and certified self-insurers who paid the maintenance tax surcharges for calendar years 1991-1996.

The maintenance tax surcharge had provided monies to pay debt service on the $300 million in revenue bonds that were sold in 1991 to provide the Fund's initial capital. Because of voluntary payments by the Fund in 1994,1998 and 1999 to help pay off the bonds, the maintenance tax surcharge was no longer necessary after 1997. The Fund's voluntary payment for this purpose totaled $246.1 million. The Fund was required to issue separate checks to each insurer and certified self-insurer for each year in which the maintenance tax surcharge was paid. Each insurer, in return, had to issue a refund check to their policyholders for a proportional amount of the refund.

In this way, the Fund reduced the debt and repaid all insurance companies and self-insurers in Texas who contributed to the repayment of the bonds. The Fund is self-supporting and receives no state funds and has no authority to assess other insurers. Its employees do not receive state benefits. Operating revenues and surplus are generated from premium income and net income on investments. Original and current statutory language specifies "Money in the fund shall be paid from the fund, without legislative appropriation, on vouchers approved by the board. That money shall be held exclusively for the purposes stated in this article and may not be used or appropriated for any other purpose."[2] The Fund pays the same state taxes and fees as other workers' compensation insurance companies.

[1] providing insurance for those that are denied coverage by private insurance companies.

[2] Insurance Code, Art. 5.76-3, Section 13(c)

The issue of the legal status of the Fund's surplus and the options for its use were never directly answered during the 76th Legislative Session.

Thus, during the 76th Interim the Speaker assigned the House Committee on Business & Industry to consider the legal status and policies appropriate to any surplus funds held by the Texas Workers' Compensation Insurance Fund. The committee's consideration was directed at assuring that sufficient funds are available to deal with all possible market conditions. The following report is the result of that investigation.

FUND FINANCIAL HIGHLIGHTS

FOR THE YEAR 2000	Gross Premiums written	$ 184,208,000	
AS OF JULY 31, 2000	Net Premiums earned	$ 151,232,000	
	Total revenue		$ 151,255,000
	Benefits (claims) paid & incurred		$ 119,274,000
	Dividends to Policyholders		$ 0
	Underwriting expense		$ 46,754,000
	Net investment income	$ 47,666,000	
	Net income		$ 32,893,000
AT JULY 31, 2000	Assets		$1,320,661,000
	Liabilities		$ 686,665,000
	Capitalization		$ 633,996,000
	Number of policies in force		32,084
	Number of employees covered on policies		426,676
KEY INDICATORS,	Incurred loss ratio		78.0%
JULY 31, 2000	Combined ratio	105%	
	Premium to surplus ratio	0.29:1	

STATE LAWS

APPROPRIATION OF UNOBLIGATED FUND BALANCES TO GENERAL REVENUE FUND

Citations: TX Government Code, Chapter 316.031-033

Provisions: This sub-chapter provides that all state agencies' unobligated fund balances

at the end of a fiscal year "in excess of that amount necessary to fulfill an agency's statutory duties" shall be appropriated to the general revenue fund. It further goes on to state that any dedication of such unobligated funds is suspended for the purpose of this sub-chapter. Lastly, it enumerates an exemption for a fund derived from constitutionally dedicated revenues and six other situations which include monies "held in trust or escrow for the benefit of any person or entity other than a state agency."

Implications:

This is the statute cited when trying to justify the reallocation of monies from the Fund back to the State's coffers. However, the language in two provisions make it questionable as whether it is applicable to the Fund.

First, the sub-chapter specifically states that it applies to state agencies. The question of the Fund's status as a state agency versus a state-chartered entity is the foundation of the argument against Sub-chapter 16 being applicable and the inappropriateness of reallocation monies to the state's General Revenue Fund.

Further, since the surplus' purpose is to cover future claims of the Fund's policyholders (both current and future), it can be argued that the money is being held in trust for the benefit of any person or entity other than a state agency. The legislative intent of this provision and the definition of "held in trust" is ambiguous. Do the monies have to be in an actual trust fund, or are being held for the benefit of a person or entity via an agreement with The Fund sufficient?

Although it is not addressed in the statutes, the monies held by the Fund are generated by policy premiums and investment revenue only. They receive no appropriations or tax generated revenues. There are questions of appropriating money to the state which are privately generated funds that have never originated with a state appropriation.

R.O.C. STUDIES

Citations:

Insurance Code Article 5.76

Provisions:

This Section authorizes and compels the Texas Workers' Compensation Insurance Fund to participate in and fund interim studies conducted by the Research and Oversight Council on Workers' Compensation (R.O.C.). Study topics were specifically enumerated that related only to the Texas workers' compensation system. While the section gives the R.O.C. the ability to contract out services related to the studies, a ceiling for the Fund's

contribution is not quantified[3], although the section does stipulate that the monies will be from The Fund's surplus. This section is effective until March 1, 2001.

Implications:

This section is an example of the Legislature's ability to force the Fund to dedicate a portion of its surplus to purposes other than those outlined in the original statutory authority of the Fund. Additionally, although less than $1 million was spent on the interim studies, and therefore the expenditure does not jeopardize the federal tax exempt status[4] of the Fund, the lack of a ceiling for the financial support leads to the questions:

- Should the Legislature be mandating the use of privately generated monies to support system-wide benefits and what sort of precedent does that set for other state-chartered entities.
- If they do dedicate monies, how much can the Legislature dedicate without jeopardizing the confidence of the insurance industry in the Texas market by endangering the solvency or the structure of the Fund.

FEDERAL LAWS

FEDERAL TAX-EXEMPT STATUS

Citations:

United States Code; 501(c)(27)(B)

Provisions:

Provides tax exempt status to any organization created by State law, organized and operated under State law exclusively to provide workmen's compensation insurance and incidental coverage. Such an organization must provide workmen's compensation insurance to any employer in the State which seeks coverage and meets reasonable requirements. The State must make a financial commitment to the organization either by extending the full faith and credit of the State to the initial debt of the organization or by providing the initial operating capital. Additional requirements are that all funds must revert back to the State, after payment of its obligations, if

[3] Total financial support was $982,000

[4] Please see federal law section

the organization is dissolved or State law must not permit dissolution of the organization, and a majority of the board of directors or oversight body must be appointed by the chief officer of the State, by the State Legislature or by both.

Implications:

The Fund qualifies for this exemption and benefits greatly from the flexibility this allows their investment strategy. Any change to their structure or their operations must be reported to the Internal Revenue Service for evaluation of compliance with their exemption.

When discussing the reappropriation of monies from the Fund the question of exclusivity of operation becomes an issue. Can money be redirected to a purpose which is not exclusively for workers' compensation? Can money be redirected if its purpose is of benefit to the workers' compensation system or must it be beneficial exclusively for the Fund's policyholders? If monies are appropriated for either purpose, how much can be removed from the Funds' surplus or operating budget before it becomes a significant enough amount to place the Fund's tax-exempt status in jeopardy?

COMMITTEE FINDINGS

In order to address the issue of who owns or controls the Fund's surplus, the Fund hired Vinson and Elkins to research the issue and offer their conclusions. Vinson and Elkins found that:

"TWCIF is a separate body corporate, and, as a result, is not subject to legislative appropriation. The Legislature may, however, amend TWCIF's statute to require TWCIF to transfer its surplus to the General Revenue Fund where it would be subject to legislative appropriation.

Under existing law, TWCIF monies may be used only for TWCIF purposes and may not be appropriated for any other purpose. There may be an argument that an unreasonable surplus may be subject to transfer to the General Revenue Fund where it would be subject to legislative appropriation. However, such an argument is ultimately not persuasive because relevant case law concludes that a special fund such as TWCIF is a de facto trust fund and not subject to legislative diversion for general purposes.

The Legislature, through its inherent powers, could seek to change the TWCIF statute to require the surplus to be transferred to the General Revenue Fund of the State. Any such statute would be subject to several constitutional questions that would probably invalidate any such amendment."

In addition, the Fund asked Fulbright and Jaworski to respond to questions regarding the Fund's federal tax exemption.

Question: What activities may the Fund undertake which will be consistent with and will not jeopardize the Fund's tax-exempt status under section 501(c)(27)(B) of the Internal Revenue Code of 1986, as amended (the "Code")?

Response: The Fund may undertake only those activities which are exclusively the provision of workmen's compensation insurance and related coverage incidental to workmen's compensation insurance. The Fund may not undertake activities other than the provision of workmen's compensation coverage and related coverage incidental thereto, except to an insubstantial degree.

Question: What activities might the Legislature of the State of Texas require that the Fund undertake either directly (including by amendment of its governing statute) or through appropriation of the Fund's assets which activities or appropriation will be consistent with and will not jeopardize the Fund's tax-exempt status under section 501(c)(27)(B) of the Code?

Response: The Legislature may require that the Fund undertake either directly (including amendment of its governing statute) or through appropriation of its assets only those activities which are exclusively the provision of workmen's compensation insurance and related coverage incidental to workmen's compensation insurance. The Legislature may not require the Fund to undertake directly or through the appropriation of its assets activities other than the provision of workmen's compensation coverage and related coverage incidental thereto, except to an insubstantial degree."

Committee staff asked the Legislative Council to analyze both the Vinson and Elkins and Fulbright and Jaworski legal memoranda and offer their thoughts. The following is the Legislative Council's conclusion:

"Based on the analyses presented by the Vinson and Elkins and Fulbright and Jaworski memoranda, it appears that the use by the state of the surplus accrued by the Texas Workers' Compensation Insurance Fund for purposes unrelated to the goals and powers set forth in Section 2(a), Articles 5.76-3, Insurance Code, would probably not be upheld if challenged in court and would probably jeopardize that fund's tax exempt status under 26 U.S.C. Section 501(c)(27)(B).

Under Section 18.25(a), Chapter 12, Acts of the 72nd Legislature, Second Called Session, 1991, the fund was granted an initial appropriation of $5 million from the State Board of Insurance operating fund to begin operations. Subsection (b) of that section directed the fund to 'pay to the State Board of Insurance $5 million plus interest calculated at eight percent per year' from the proceeds of bonds issued by the fund under Article 5.76-5, Insurance Code, presumably to reimburse the state for the initial appropriation. It is unclear from the memoranda or the other materials presented to this office whether the fund has so reimbursed the state. To the extent that the state has not been reimbursed by the fund in full for the initial appropriation, it is arguable that the state could recoup the amount outstanding from the fund's surplus."

Complete copies of the Vinson and Elkins, Fulbright and Jaworski and Legislative Council findings are on file in the House Committee on Business & Industry office.

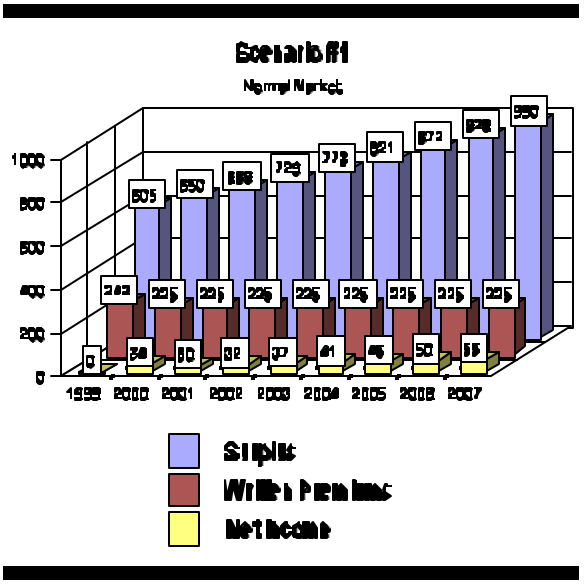
The main influence over the Fund's surplus continues to be the financial markets. If the U.S. economy--and the financial markets--maintain their strong course, the Fund's surplus will continue to grow. Conversely, if the markets falter, the Fund's surplus will lag. Examination of the Fund's dependency on its investment capital income generation is crucial in the decision on whether the Legislature should consider reappropriation of monies, even if it is capable of doing so.

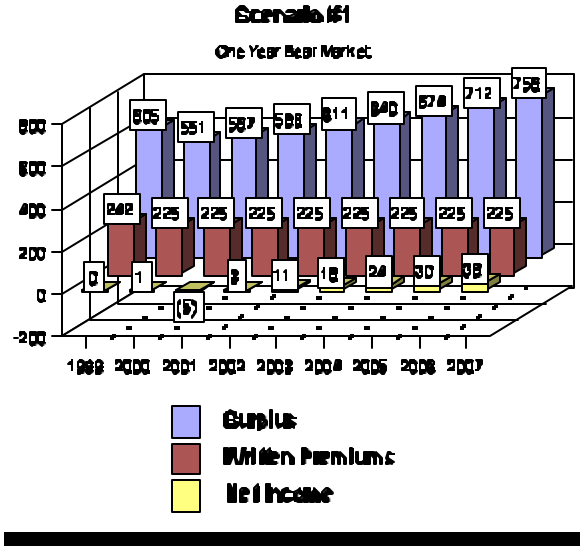
Financial scenarios have been designed[5] to represent the effect on the Fund's financial stability and their ability to cover policyholders in light of changes in the stock market, the workers' compensation market and any possible reappropriation of monies.

In the first scenario, assumption parameters are that the Fund would continue at its current written premium level ($225 million) in a stable workers' compensation market during 2000- 2007[6], with no action taken by the Legislature or the Fund Board to affect the current surplus level.

Under normal financial market conditions (market returns annually of 7.1%), the Fund's surplus would increase from $605 million at the beginning of 2000 to $990 million in 2007.

In a one year bear market[7] projections for scenario one

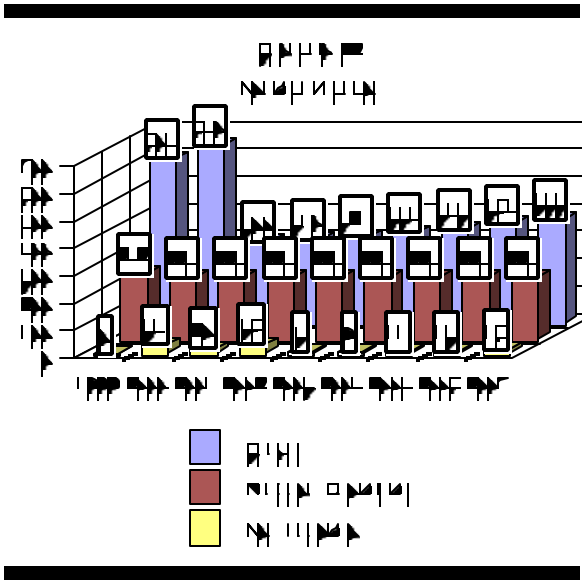


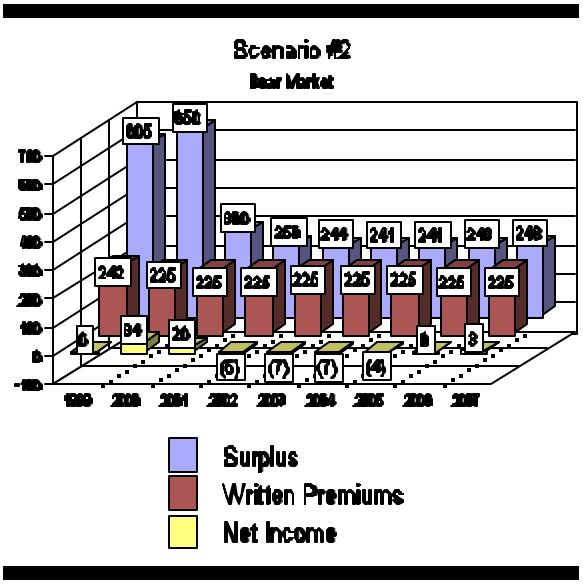


[5] Commissioned by the Fund from Asset Strategy Consulting out of Los Angles, CA., which has merged to become Investor Forces.

[6] 2007 is when the Fund is up for Sunset review.

[7] A severe case of an abrupt decline in the market, which for the purpose of these financial scenarios were characterized as an increase in interest rates of 1.75%. Prices of bonds falls about 6%, equity prices fall by about 25%. Bear market in the model is assumed





are much less positive. Assuming the Fund would continue at its current written premium level ($225 million) in a stable workers' compensation market during 2000-2007, with no action taken by the Legislature or the Fund Board to affect the current surplus level, under a one year bear market (FY 2000 market returns of 5.1%), then returning to normal financial market conditions (market returns annually of 7.1%), the Fund's surplus would decline by $54 million in that bear year, and then rise by modest increments to $756 million by 2007.

In the second scenario, assumption parameters are the same as the first scenario [the Fund would continue at its current written premium level ($225 million) in a stable workers' compensation market during 2000-2007], with the exception that the Fund's surplus in fiscal year 2001 is $300 million (rather than $605 million), which is the amount of surplus held by the Fund when it began operations in 1992. This is an arbitrary reduction of the surplus that represents a Legislative reappropriation of surplus funds above and beyond its original amount[8].

Under normal financial market conditions with a market return of 7.1% for fiscal years 2000-2001, then 6.7% in fiscal years 2002-2007. The Fund's surplus would decrease from $650 million at the end of 2000 to $383 million in 2007.

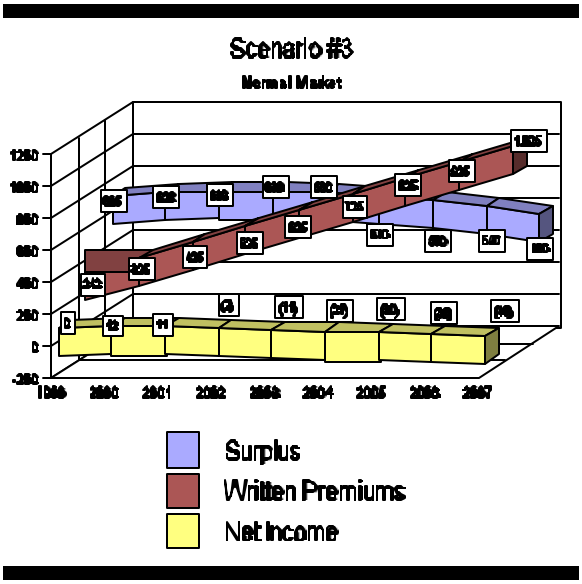
In a one year bear market[9] estimates become bleaker.

to last one year.

[8] This was an arbitrary variable chosen by the financial consulting firm and does not represent a past or current proposal from any legislator or committee. It's inclusion is not meant to be taken as a recommendation by the subcommittee.

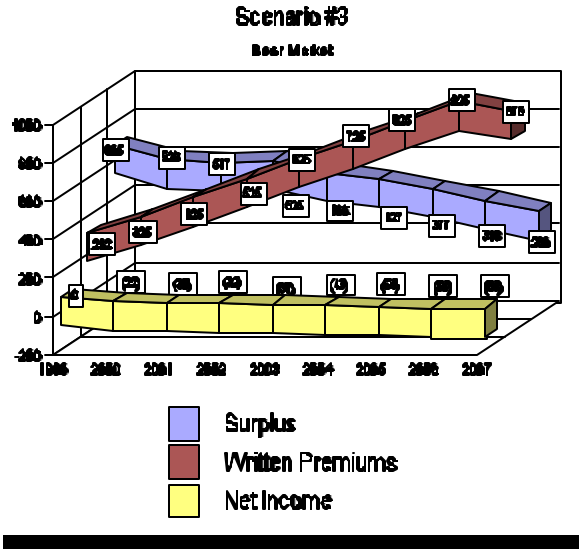
[9] A severe case of an abrupt decline in the market, which for the purpose of these financial scenarios were characterized as an increase in interest rates of 1.75%. Prices of bonds falls about 6%, equity prices fall by about 25%. Bear market in the model is assumed

Assuming the Fund would continue at its current written premium level ($225 million) in a stable workers' compensation market during 2000-2007, with no action taken by the Legislature or the Fund Board to affect the current surplus level, under a one year bear market (FY 2002 market returns of -4.2%% then 6.6% thereafter annually), the Fund's surplus would decline by $350 million in that bear year, drop another $56 million over next two years and then slowly rise to $248 million in 2007.



Considering the surplus represents the Fund's ability to cover future claims of current and potential policyholders, the smaller the difference between the surplus and the written premiums, the greater the risk to current and potential policyholders that the Fund will be unable to cover their claims. Since they are the provider of last resort, the slightest potential to not be able to cover claims is unacceptable. This is emphasized even greater in Scenarios 3 and 4.

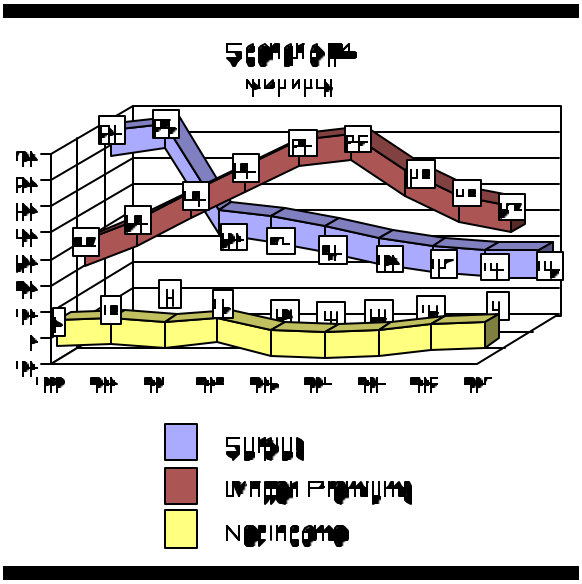
Scenario #3 shows the Fund surplus projections under negative workers' compensation market conditions. It assumes that the Texas workers' compensation market deteriorates in 2000, meaning that fewer insurance companies are offering workers compensation policies. The companies whose coverage had been provided by an insurance company that has left the market would then be shifted to one of the remaining companies, including the Fund. This scenario assumes that the Fund's written premiums increase by $100 million per year (to pick up the slack); and consequently the Fund's net income declines during 2000-2007.



Under *normal* financial market conditions (7.1% returns for 2000 and decreasing each year starting in 2001 to 6.4% in 2007), the Fund's surplus under scenario #3 would follow a downward glide from $605 million at the beginning of 2000 to $490 million in 2007, even though the Fund's premium income has quadrupled during the same time.

Under *bear* market conditions (representing a -5.1% return in 2000 and in returns in 2001 of 6.9% decreasing

to last one year.



to 6.2% in 2007), the Fund's surplus would decline more rapidly, from $605 million in 2000 to $206 million in 2007 despite enormous growth in the Fund's premium income. This would impair the Fund's ability to write any additional premiums because of a statutory 3:1 premium to surplus limit, which requires the Fund to limit the number of premium dollars written to an overall ratio of one dollar of surplus for every three dollars in premiums. This provision is to help protect the solvency of the Fund and the current policyholders. It does not limit the Fund from having more than three dollars in surplus for every one dollar of premiums, however it does prevent them from writing more premiums than the ratio. As one can tell from the chart[10], the number of premiums the Fund can write are directly linked to the health of the surplus. Once the statutory ratio is reached, the Fund can no longer continue to cover additional policies.

As provider of last resort, the Fund must be able to cover those that the voluntary market[11] is unwilling to cover. Which means that if the Fund had to restrict its coverage, they would be unable to write any new policies, either in the voluntary market or as the insurer of last resort. Additionally, as policies were up for renewal, the Fund may find itself unable to renew these accounts and maintain a 3:1 premium to surplus ratio. The absolute worst possible circumstances are depicted in Scenario #4.

Scenario #4 shows the Fund surplus projections under the worst possible conditions, a negative workers' compensation market, a reduction of the surplus (by Legislative or Board action) to $300 million under both normal and bear market conditions. As in Scenario #2 it assumes that the Texas workers' compensation market deteriorates in 2000, increasing the Fund's written premiums by $100 million per year; and consequently the Fund's net income declines during 2000-2007.

In a normal financial market (7.1% returns for 2000 and decreasing each year after the capital withdrawal to 6.2% in 2007 due to asset reallocation), the Fund's surplus under scenario #4 would dramatically decrease constricting the Fund's ability to write premiums beginning in 2004, forcing lower premium writings in each subsequent year, despite demand.

[10] Scenario #3, Bear Market

[11] Private insurance carriers

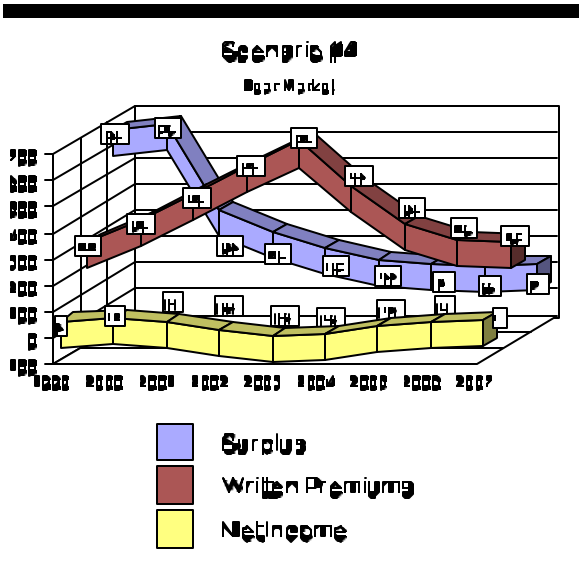
1999 Top 20 W.C. Insurance Carriers In Texas

The percentage of National Direct Premiums

	TX Market Share	TX (% of US)	US Total
Texas Workers' Compensation Fun	$234,189,000	100.00%	$234,189,000
Liberty Mutual Insurance	$157,885,000	5.52%	$2,851,681,000
CNA Insurance Group	$107,549,000	7.95%	$1,729,988,000
Reliance Group reorganized	$100,811,000	9.28%	$1,118,172,000
Kemper Insurance Companies	$83,804,000	7.55%	$1,093,729,000
Travelers PC Group	$82,129,000	6.45%	$1,270,929,000
American International Group	$78,488,000	6.71%	$1,160,519,000
Hartford Insurance Group	$57,885,000	5.41%	$1,068,804,000
Royal & SunAlliance	$57,008,000	5.92%	$980,059,000
Zurich US Group	$50,981,000	6.28%	$809,544,000
St Paul Companies	$32,518,000	7.55%	$424,715,000
CGU Group	$31,999,000	6.70%	$475,259,000
Fremont General Group	$29,850,000	2.50%	$1,195,971,000
Allianz of America	$28,788,000	3.82%	$750,870,000
Fairfax Financial (US) Group	$29,737,000	5.69%	$523,042,000
Farmers Insurance Groups	$28,508,000	8.91%	$319,589,000
Ameristate Insurance Group	$20,742,000	10.78%	$221,245,000
EMPIRE Insurance Companies	$23,702,000	6.47%	$366,488,000
Old Republic General Group	$22,089,000	14.02%	$157,497,000
HDI US Group	$20,451,000	8.00%	$322,822,000
Total for Top 20 Companies	$1,015,571,000	7.91%	$12,825,217,000
Industry Total	$1,740,732,000	5.75%	$30,213,480,000

Under *bear* market conditions (representing a -3.2% return in 2002 and in returns in 2003 of 6.3% decreasing to 6.1% in 2007), the Fund's surplus would decline more rapidly, from $605 million in 2000 to only $91 million in 2007. This dramatically confines the number of premiums possible to less than the current coverage.

One variable that these scenarios do not figure in, is the impact of a possible reallocation of the Fund's federal tax exempt status. If the Fund were to pay federal taxes on all of their investments, it would not only impact their net income (which in return would continue to impact the surplus), but it would possibly affect the Fund's investment strategy.



While all of these scenarios represent static, unfavorable or even down-right disastrous conditions, they are an important tool in underlining the impact that a large deduction from the surplus would have on the fund's net income and additionally, it magnifies the dependency of the Fund on the surplus to meet the claim obligations on current and future policies. An ability to write policies in the future in the face of any market condition, is a complex and daunting task for any insurance company.

The nature of the insurance business is cyclical in nature. It has its highs and lows that repeat in a sine curve pattern intricately linked to the condition of state, national and financial market economies. Unfortunately, underwriters who set premium rates can only look to the

past to predict what amount of premium they will need to cover their losses. Insurance companies in our current economic conditions (low unemployment, good investment returns) will drive premium prices[12] down to compete with each other for policies. Even if they are writing policies for less than their expected losses, they can still make a profit in the investment market as long as good economic conditions continue. For national companies, good profit margins in one state can balance the questionable profits in another.

However, eventually insurance companies drive premiums to a point where their investment revenue will no longer cover the costs not covered by the premiums and their net income plummets. Their ability to cover claim cost is compromised. Consequently, national insurance carriers may choose to limit their liability in a state by restricting the number of policies in a line of insurance[13] they will write in a state. In extreme cases, insurance companies will discontinue writing lines of insurance in a state, if it does not represent a significant amount of its entire national business.

There were 113 groups and 278 companies that had direct written premiums for workers' compensation coverage in Texas in late 1999. Of those, 25 groups total 80.25% of the total coverage. The Fund carried the largest market share at 13.43%. However, of those top 25, only two other insurers' Texas market is a significant amount of their total market in the United States. Therefore, all but three (the Fund, Amerisafe Insurance Group and the Old Republic Group) could severely limit their market share in Texas without dramatically affecting their bottom line. Texas Department of Insurance only has provisions to keep a mass immediate exodus of insurance companies and a single insurance company from withdrawing more than 75% of a single line of insurance at a time.

The decision on whether to stay in a market is based on several market indicators. The solvency and strength of a state's fund can be a significant market indicator for insurance companies. A financially sound Fund in Texas not only is a market stabilizer but a cost containment issue for insurance carriers. In 1999, at Legislative direction, the Fund became a member of the Texas Guaranty Fund. This Fund oversees the financial responsibilities of failed insurance companies in Texas. All insurance carriers in Texas pay into the Guaranty Fund to help pay for claim costs of insurance companies that have become insolvent in Texas. The Fund now helps share that burden. However, if it became insolvent the Guaranty Fund, and thus all insurance carriers in Texas, would be responsible for its costs. If the Legislature takes action to lower the surplus of the Fund and thereby increases the risk for insolvency an insurance carrier in workers' compensation would not only have to judge their own personal loss potential in Texas, but the potential of sharing the costs for the largest market holder. Therefore, the Fund's capabilities to fulfill their statutory mandates are an issue for insurance carriers as well as employers.

The Fund, unlike a national, stock-holder owned insurance company, is unable to supplement their profits with other lines of insurance from in state or out of state. They are unable to withdraw from the market. Therefore, the Fund's only source of revenue to cover claim costs in a competitive market is their investment

[12] The price of a policy is the premium an employer pays. The cost of a policy is the losses incurred by the insurance company on claims processed on that policy.

[13] e.g. Workers' Compensation, Auto, Life, Property

revenue, which is linked directly to their surplus. Further, as the provider of last resort the Fund must be prepared to cover Texas businesses even when other insurance carriers are unwilling to do business in Texas. These two limitations intimately link the Fund's solvency and their ability to fulfill their statutory mandates with Texas' economy and the financial investment markets. As history can teach us, both are susceptible to long-term declines.

Currently two-thirds of the Funds policies are covering "small businesses" paying less than $5,000 in premiums. Ninety-five percent of the policies paid less than $25,000. If monies were appropriated by the Legislature language would need to be very specific to clarify that the expenditure was not to be included as an operating expense. Operating expenses are paid for out of premiums, not from surplus. In other words, premiums rates are based on claim costs and operational costs. Any money that was dedicated as an additional operational cost would increase policyholders' premiums.

In addition, any monies spent on activities that were not statutorily mandated would need to be an insignificant amount or less than five percent of the total operating budget or the Fund could risk losing its federal tax-exemption. Currently the Fund's operational budget is about $110 million, which would allow $5.5 million for "other activities." Items paid for from any account that was not directly for providing workers' compensation coverage to the Fund's policyholders would be included in this amount. For example, the Fund provides around $250,000 in educational programs that the Internal Revenue Service may question as being part of their charge. That would leave no more than $5.25 million to dedicate to any additional services or benefits.

In addition, these services or benefits would need to be involving workers' compensation in some aspect. A total deviation from the original purpose of monies could also jeopardize the Fund's federal tax-exempt status.

When considering whether the Legislature should consider using Fund resources to support programs, they should consider the original dedicated purpose of that capital. The money held in surplus is for the current and future claims against policies that the Fund has or will write. In effect, this money is held in trust for those employers to cover the needs of their injured workers.

Although Chapter 316.031-033 of the Government Code provides that an undedicated surplus of a state agency should be reappropriated back to the General Revenue Fund, it also states that there is an exemption for any funds held in trust for the benefit of individuals or an entity which is not a state agency. Even if the question of whether the Fund is a State agency is ignored, the surplus does seem to be held in trust for the benefit of individuals.

While the Vinson & Elkins report appears to support this position, they rely more heavily on the position that the Fund is completely exempt from this Sub-chapter because it is not a state entity. The Texas Legislative Council reaffirmed the Vinson & Elkins report, but did not specifically address this issue. When contacted by committee staff, staff of the Legislative Council confirmed that in order to qualify for the exemption under Sub-chapter D of the Government Code, an actual trust account was not needed, but rather a trust relationship.

Further, the Legislative Council stated that if the Legislature chose to reappropriate monies from the surplus the Fund policyholders would have legitimate standing for a judicial challenge, and based on outcomes of similar cases in other states they would likely win under the current statutory language. This further strengthens the argument that these monies are first and foremost for the benefit of the policyholders.

Which leads to a discussion of the appearance of a reappropriation of monies by the policyholders themselves. Testimony has been submitted to the subcommittee that a policyholder, not understanding the need for a surplus in the insurance industry, could view a surplus as a cache of over payments in premiums by policyholders. Therefore, a natural reaction by policyholders would be to expect dividends from the company. Any dedication of those funds to a state program or a state benefit could be considered an unconstitutional tax on a select few. While this may not be the case, it is a possible perception of policyholders that could affect whether an employer chose to have insurance with the Fund over another company.

Although the Fund's monies are currently not subject to legislative review and dedication through the appropriation process, the Fund has been active in supporting system-wide benefits both at the direction of their Board of Directors and at the specific direction of Legislative action.

The Fund currently supports the salary and benefits of a Travis County District Attorney whose job description is limited to the prosecution of workers' compensation insurance fraud. They are in discussion with another County for similar support. They provide statewide educational seminars and subsidize a college on risk management in West Texas. They have eliminated the need for a maintenance tax surcharge for all insurance companies and employers in Texas. Further, they have paid dividends to their policy holders (a power they independently hold) and refunds to insurance carriers who paid into the maintenance tax surcharge which resulted in a refund to all policyholders from that time.

While they can invest in programs, the Fund has been very conservative in this arena for several reasons. First, they lack a directive from the Legislature to support other programs and agencies in the system. Secondly, they are concerned about any appearance of a conflict of interest in supporting programs and studies specifically for agencies like the Texas Workers' Compensation Commission (TWCC) and the Texas Department of Insurance. Not only does the TWCC regulate the business of the Fund, in addition to the Department of Insurance, but they resolve any disputes that might arise between the Fund and a claimant.

After reviewing all submitted and public testimony, the subcommittee feels that the legal status of the surplus funds held by the Fund is a delicate and often contradictory one (All testimony and written materials submitted to the subcommittee are on file in the House Committee on Business & Industry Office). There seems to be several State and federal statutes with either direct or questionable jurisdiction over the monies held by the Fund.

The only direct mention of the surplus in the enabling legislation of the Insurance Code states:

- Rates must be set to provide for, among other things, a reasonable surplus[14].
- The fund must maintain a ratio of net written premiums on policies written after reinsurance to

[14] Texas Insurance Code, Art. 5.76-3, Section 9 (b)(3)

surplus of not more than 3:1[15]

- Not more than once in any calendar year, the board may use up to 20 percent of any surplus that exceeds the ratio specified to assist in prepaying or retiring the original capitalization bonds[16]
- The fund shall issue separate checks from the surplus of the fund for repayment of the maintenance tax surcharge to insurance companies who paid into that surcharge within a specified time.[17]
- The Texas Workers' Compensation Insurance Fund shall fund interim studies conducted by the Research and Oversight Council on Workers' Compensation to improve worker safety in this state and reduce the cost and improve the quality of health care delivered to injured workers. Funding shall come from the surplus of the Texas Workers' Compensation Insurance Fund.[18]

The enabling statute lacks a clear and decisive policy on management of a surplus, but rather leaves discretionary powers to the Fund. The only limitation seems to be that the surplus is to be reasonable (whether this is meant to be a minimum or a maximum is unclear). It is the subcommittee's opinion that additional provisions for grants to the Texas Workers' Compensation Commission, cash dividends and investments can and do apply to the surplus.

There have been three provisions for a one time allocation, specifically from the surplus for the repayment of the original capitalization bonds, but monies have already been dedicated to sufficiently provide for those debts, funding for 1999-2000 Interim studies conducted by the Research and Oversight Council on Workers' Compensation and refunds for insurance carriers who paid the maintenance tax surcharge .

Therefore, despite the fact that the statute states that the surplus is not subject to Legislative appropriation and that the funds can only be used for the purposes in the enabling legislation, it does appear that the Legislature may direct funds for uses, outside the original statutory mandates, by amending the statutes governing the Fund's operations. However, it appears that this has only been utilized for very specific purposes related directly to workers' compensation; each provision lasting for limited time frames. This directly answers the question, the subcommittee feels, of whether the Legislature has directive authority over the monies in the surplus; Yes, the Legislature may direct monies from the Fund's surplus but only for specific purposes, related to workers' compensation, through Legislative action. This in no way is to mean that the Fund is subject to the Legislative appropriations process and the monies are able to be "reappropriated back[18]" to the State's General Revenue Fund.

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[15] Texas Insurance Code, Art. 5.76-3, Section 13

[16] Texas Insurance Code. Art. 5.76-3, Sec. 20. (a)

[17] Texas Insurance Code, Art. 5.76-3, Sec. 10A. (b)

[18] Texas Insurance Code, Art. 5.76-6, (a)

[18] The monies in the surplus are not appropriated to the Fund. All monies are privately generated, so this is misnomer, but useful in the contexts of the discussion.

The issue of whether the surplus is subject to the provision in Government Code 316, Sub-Chapter D, which states that all state agencies' unobligated fund balances at the end of a fiscal year "in excess of that amount necessary to fulfill an agency's statutory duties" shall be appropriated to the State's General Revenue Fund, hinges on four questions:

- Is the Fund a state agency;
- Are the monies necessary to fulfill their statutory duties;
- Are the funds unobligated; and
- Does the surplus fit the exemption for monies held in trust for the benefit of individuals or entity other than a state agency.

The subcommittee feels that based on the testimony submitted, statutory language and Texas case law, this issue is unresolved. The enabling legislation for the Fund specifically states[19] that the Fund is an insurance company capable of issuing workers' compensation insurance and that it is not a state agency, unless specifically defined as a state agency in a specific statute. This language is open for interpretation, especially if any language was added to the statutes in the future that labeled the Fund a state agency. While, Vinson & Elkins purports (and the Texas Legislative Council affirms this finding) that this exact same language is definitive support for their position that the Fund is not a state agency, the subcommittee questions this argument noting conflicting case law.

The Austin Court of Appeals decided in 1995 that the Fund was a state agency for the purpose of determining whether the maintenance tax surcharge is unconstitutional as a public fund used for private purposes[20]. However in 1998[21] and again in 1999[22], the same court ruled that the Fund was a "governmental corporation." As neither statutory nor case law is very concrete on this issue, the subcommittee understands this issue to be undecided and is unsure that any further clarification with statutory language would be helpful.

After weighing evidence, the subcommittee has determined that the surplus is necessary to fulfill its statutory duties. However, they are uncertain that the entirety of the current surplus balance is necessary to fulfill those responsibilities. Obviously, recent large deductions have been made with little effect on the overall investment returns[23]. However, we are currently enjoying remarkably favorable conditions which makes such

[19] Texas Insurance Code, Art. 5.76-3, Sec. 21

[20] *American Home Insurance v. Texas Department of Insurance*, 907 S.W. 2d 90

[21] Del Industrial, Inc. v. Texas Workers' Compensation Insurance Fund, 973 S.W. 2d 743, 744

[22] *Weldments Corp. v. Liberty Mutual Insurance Co.*, 3 S.W. 3d 654,656 n.2

[23] Deductions made for repayment of the maintenance tax surcharge, a policyholder dividend, financial support of R.O.C. studies.

large deductions possible. The same deductions made in a less favorable market could have negative impact on the Fund's investment returns and thus, their ability to maintain a reasonable surplus that would cover any and all claims. Which leads us directly to the question of whether the funds are unobligated.

> *"If we wanted to answer the question 'How much surplus does an insurance company need so that we can be absolutely certain that under any possible condition there's no way the company can become insolvent?' Well, unfortunately the answer to that question is that the company would need to have an infinite amount of surplus and that's neither possible nor the best use of funds."*
>
> **--Robert Conger**
> **Towers Perrin**

Certainly, statutory language shows that the original intent was that all monies only be used for the Fund's statutory duties. However, the Legislature has expanded these duties and the purposes for which the money has been used. The subcommittee has heard that a surplus is a necessary and prudent component for responsible insurance companies to be able to fill all of their obligations to their policyholders, especially as the market hits a decline. This need is more dramatic for the Fund who has an inability to diversify their lines and states of coverage. However, the subcommittee is unpersuaded that an ever growing supply of money is necessary for a functional surplus. Certainly, the Fund's Board of Directors should be able to determine a point where the surplus is larger than needed for the Fund to comfortably cover their policies. The enabling legislation allows for dividends as a measure of control of the surplus.

> *"If I'm a Fund customer is this a tax that I'm paying that nobody else in the state is paying because I paid too much in premium at the time."*
>
> **--Bill Henry**
> **Insurance Agent**

This one ability for control of the surplus through dividends (versus the one time appropriations which have been amended into the enabling statutes), indicates that the original intent of the enabling legislation was for the funds to be used solely for the purpose and benefit of the policyholders. This raises the question of whether the funds are held in trust for the policyholders and thus exempt from Government Code Chapter 316. The Vinson & Elkins report cites many judicial cases, both from Texas and other states, that support State Workers' compensation funds and similar state agencies that hold money for the benefit of individuals (e.g. State Employee Retirement Funds) are in effect trust funds setting up a trust relationship between the agency and the individuals, in this case the Fund and the employers. This is to apply to money that is held separate for the benefit of individuals and grants immunity from legislative diversion of funds. The Texas Legislative Council upholds Vinson & Elkins reasoning and asserts that this may constitute a ground for judicial challenge for any legislative commitment of funds.

The Fund's Board of Directors have complete financial control and fiducial responsibility. They have the ability to utilize surplus control measures through dividends, and support of programs, including but not limited to: educational efforts, loss prevention, investigation of fraud, and safety programs that benefits their policyholders and the system. The subcommittee feels strongly that additional statutory language could clarify the Board of Director's discretion in this area.

However, if the Legislature feels that the surplus is unreasonable they may legislate surplus containment measures through one-time allocations of monies from the surplus, not exceeding the "insignificant" standard for the Fund's federal tax-exemption, to support workers' compensation initiatives that would support system-wide benefits.

Therefore, the subcommittee has determined that the funds in the surplus are exempt from regular reappropriation back to the General Revenue Fund because such a permanent reallocation without regard to market conditions could severely impair the Fund's ability to fulfill its statutory duties. Again, clarifying statutory language that specifically exempts the Fund from the Texas Government Code Chapter 316, Sub-chapter D would be useful.

However, control of an unreasonable surplus is given to both the Board of Directors through authority to issue dividends, as well as to the Legislature through limited direction of surplus spending for workers' compensation purposes through amendments to the enabling action. These actions should be taken not only with great consideration to market conditions, but to the Fund's federal tax-exempt status as well.

The subcommittee agrees with the appraisal of the Fulbright & Jaworski report (also upheld by the Texas Legislative Council) that states that only very limited use of the Fund's monies could be used for non-statutory directives within a tax year. Uses should be limited to purposes that are within the workers' compensation arena and should be limited to less than five percent of the total operating budget of the Fund, which currently equates $5.5 million dollars, to meet the "insubstantial" amount requirements of the Internal Revenue Service. A deviation from these parameters could cost the Fund their federal tax exempt status, which could cost them up to thirty-five percent of their income on an on-going basis, a devastating loss to their investment abilities and a drastic impairment to their ability to fulfill their statutory duties.

Already the Fund utilizes part of this "insubstantial" amount to conduct educational seminars and support the Howard College Risk Management Program. Additionally, statutory direction has been given for limited uses of funds for support of studies in 1999-2000 to identify medical cost drivers in an attempt to help improve medical cost containment in the Texas market. Likewise, additional statutory language was added to give the Fund the ability to issue grants not to exceed $2.2 million through September 1, 2003 to implement specific steps to control and lower medical costs in the workers' compensation system and to ensure the delivery of quality medical care.[24]

The subcommittee feels strongly that the Fund's Board of Directors has the fiducial responsibility for all assets of the Fund, and as part of that responsibility, should monitor the surplus levels in conjunction with market conditions and determine when an unreasonable surplus could be used for the benefit of their policyholders and the workers' compensation system. The subcommittee feels that it is important for the Board to consider the insurance market, economic and financial market conditions when considering whether a reduction in the surplus is appropriate. Extreme caution should be used before requiring an on-going mandate because a large, on-going dedication could be extremely difficult for the Fund to maintain during difficult market conditions and still fulfill its statutory duties, which should always be their primary concern.

[24] To date, these funds have not been requested by the Texas Workers' Compensation Commission.

The subcommittee urges the Legislature to exercise extreme caution as well when considering possible reductions of the surplus. They should be well advised as to market conditions and trends before assessing the nature of the surplus and determining whether it has reached an unreasonable level. It is extremely important that the status of the Fund as the provider of last resort be considered in any future reductions to the surplus. The subcommittee feels strongly that the surplus is there not only as safety net for current policy holders, but for future policy holders as well. The Fund must be positioned to accept the responsibility for all Texas employers that would choose to have workers' compensation coverage. The subcommittee feels that legislative action to reduce the surplus has been limited to times of excessive resources available in the surplus during extremely favorable market conditions to support very worthy programs that will help identify and address some of our current problems with the medical cost containment and outcomes in the Texas workers' compensation system. Particularly, on this note, the subcommittee would like to encourage the Texas Workers' Compensation Commission to avail themselves to the grants available to them through the Fund to help address the issue of medical costs. Additionally, the subcommittee feels that all efforts should be made to encourage the Board of Directors to use their discretionary authority to control the surplus level by support of dividends to policyholders as well as support of programs previously mentioned.

> *"I am concerned about where we're going to be in the next five to ten years because it is important for Texas to have a strong competitive industry. It's the main key in that ball in that whole big bearing in my opinion and to go rob it to do something else with it at the probability of hurting the industry and businesses like mine and my friends in the future, I don't think that's the right thing to do. I want to use good wisdom and make sure we're doing what we can planning for the future and keeping a strong Fund."*
>
> **--Representative Allan Ritter**

While there are current provisions for expenditures of the surplus there is a lack of policies that direct when these measures are appropriate. The subcommittee urges further development of written policies from the Board of Directors on when the surplus has become unreasonable and when action should be taken to reduce that balance.

The subcommittee is in no way faulting the Board of Directors or the Fund staff for its financial direction. Quite the contrary, because of their adept management the question of an unreasonable surplus has become an issue. The subcommittee applauds the Board of Directors, the President and their staff for an excellent performance in directing such an important public trust.

However, it is the subcommittee's opinion that direction and encouragement from the Legislature for exercise of these surplus management control options has been minimal, and thus, appropriately the Board of Directors have acted in an extremely cautious manner. The subcommittee feels strongly that it is the intent of the Legislature for the Fund to be a market model through example both financially and through service. The Fund should lead the industry in responsible and cautious use of any funds they feel are part of an unreasonable surplus, during good market conditions only, for the maximum benefit of their policyholders, including dividends, safety, educational, and loss prevention programs and support of studies and programs that would improve the overall system and therefore benefit their policyholders. Such dedication of funds should be taken with extreme caution, weighing the benefits of money that could be used for a limited state-wide benefit versus the potential instability in the Texas market created from such action.