



Interim Report

to the 84th Legislature

House Committee on
Business and Industry



January 2015

**HOUSE COMMITTEE ON BUSINESS & INDUSTRY
TEXAS HOUSE OF REPRESENTATIVES
INTERIM REPORT 2014**

**A REPORT TO THE
HOUSE OF REPRESENTATIVES
84TH TEXAS LEGISLATURE**

**RENE O. OLIVEIRA
CHAIRMAN**

**COMMITTEE CLERK
ANGELINA LOPEZ**



Committee On
BUSINESS & INDUSTRY

January 9, 2015

René O. Oliveira
Chairman

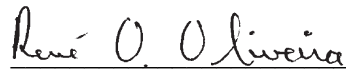
P.O. Box 2910
Austin, Texas 78768-2910

The Honorable Joe Straus
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 of the Eighty-third Legislature hereby submits its interim report including recommendations and drafted legislation for consideration by the Eighty-fourth Legislature.

Respectfully submitted,



RENE O. OLIVEIRA



DWAYNE BOHAC

ROB ORR



EDDIE RODRIGUEZ



ARMANDO WALLE



PAUL WORKMAN



JASON VILLALBA



PAUL D. WORKMAN
STATE REPRESENTATIVE
District 47

December 22, 2014

Rep. René O. Oliveira, Chairman
House Committee on Business & Industry
P.O. Box 2910 Austin, TX 78768

Re: Committee Interim Report to the 84th Texas Legislature, Committee Member Letter Dear Chairman Oliveira:
Thank you for your excellent chairmanship of the House Committee on Business & Industry and guiding the committee through the interim.

I am attaching my signature to the interim report, but the report contains a substantive item that concerns me. Related to the property tax lien proposal, the 10-day notification requirement might generate additional litigation without resolving the stated purpose of the notification.

I respectfully request that this letter be attached to the final committee report. Thank you, again, Chairman Oliveira.
Sincerely,

Paul D. Workman

A handwritten signature in blue ink, appearing to read "Paul D. Workman", with a long horizontal flourish extending to the right.

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INTRODUCTION

At the beginning of the 83rd Legislature, the Honorable Joe Straus, Speaker of the Texas House of Representatives, appointed seven members to the House Committee on Business & Industry. The Committee membership included the following appointees: René O. Oliveira, Chairman; Dwayne Bohac, Vice Chair; Eddie Rodriguez; Rob Orr; Armando Walle; Paul Workman and Jason Villalba.

The Committee was given jurisdiction over all matters pertaining to:

- 1) Industry and manufacturing;
- 2) Industrial safety and adequate and safe working conditions, and the regulation and control of those conditions;
- 3) hours, wages, collective bargaining, and the relationship between employers and employees;
- 4) the regulation of business transactions and transactions involving property interests;
- 5) the organization, incorporation, management, and regulation of private corporations and professional associations and the Uniform Commercial Code and the Texas Revised Limited Partnership Act;
- 6) the protection of consumers, governmental regulations incident thereto, the agencies of government authorized to regulate such activities, and the role of the government in consumer protection;
- 7) privacy and identity theft;
- 8) homeowners' associations;
- 9) oversight and regulation of the construction industry; and
- 10) the following state agencies: the State Office of Risk Management, the Risk Management Board, the Division of Workers' Compensation of the Texas Department of Insurance, the workers' compensation research and evaluation group in the Texas Department of Insurance, the Office of Injured Employee Counsel, including the ombudsman program of that office, and the Texas Mutual Insurance Company Board of Directors.

During the interim, on January 31, 2014, Speaker Joe Straus issued six interim charges to the Committee on Business & Industry to study and report back with facts, findings, and recommendations. The House Committee held three public hearings on, March 27, 2014, April 22, 2014 and May 27, 2014 to study these charges.

The Committee also accepted written testimony and research from the public in the course of compiling this report. And our appreciation is extended to those who testified before the Committee and gave their time and efforts to assist in this process

BUSINESS & INDUSTRY INTERIM STUDY CHARGES

- 1) Study the voluntary nature of workers' compensation in Texas and how it meets the needs of employers and employees.
- 2) Review existing lien laws in Texas. Specifically:
 - a) Examine laws concerning the enforcement of contract liens affecting real property. Identify improvements, if any, that will enhance the certainty of title following sale, enhance ability to ensure that sales are conducted by qualified trustees, prevent unnecessary litigation, facilitate loss mitigation between borrowers and sellers, and protect the interests of homeowners, lenders and trustees.
 - b) Study the imposition of mechanics' liens on automobiles and its impact on mechanics, car owners and purchasers, and lenders.
 - c) Review ad valorem tax lien lending after the implementation of SB 247 (83R) and the impact on homeowners, taxing authorities, mortgage lenders, and tax lien lenders. Review the procedures and powers of the Office of Consumer Credit Commissioner to ensure compliance with SB 247.
- 3) Study the impact of SB 1024 (82R) on wage theft and law enforcement's and regulatory agencies' responses to wage theft claims.
- 4) Examine the issue of misclassifying employees as independent contractors on workers, employers, income tax withholding, and the unemployment insurance system. Review current statutory deterrents, including those required by HB 2015 (83R).
- 5) Study the impact of credit card data theft and other credit or privacy information theft on Texas consumers and businesses.
- 6) Monitor the agencies and programs under the committee's jurisdiction and the implementation of relevant legislation passed by the 83rd Legislature.

VOLUNTARY NATURE OF WORKERS' COMPENSATION

Study the voluntary nature of workers' compensation in Texas
and how it meets the needs of employers and employees.

Background

Texas is the only state in the country that does not require employers to carry workers' compensation insurance. Employers who chose to carry coverage under the state system are known as "subscribers," while those who do not are known as "non-subscribers." Non-subscribers are not protected by the liability limits under the state system, and can be sued for negligence by their injured employees.

The Workers' Compensation Division (DWC) of the Texas Department of Insurance, which oversees the state system, recently published its Biennial Report to the 84th Legislature. Some of the information is derived from surveys, which contain margins of error, and some information is drawn from DWC records. Highlights of the report include:

- Reductions in reports of non-fatal injuries, and overall claims. Injuries vary by industry, however. Industries with the highest rates include: retail trade; transportation and warehousing; agriculture, forestry, fishing and hunting; trade/transportation/utilities; and health care and social assistance.
- Significant "increases in workplace fatalities in 2012 due to increases in both the construction and mining sectors, including oil and gas extraction activities." Fatalities declined to 493 in 2013, a drop of 8%.
- "Half of fatalities in 2013 involved White, non-Hispanic employees; 38 percent involved Hispanic or Latino employees; 9 percent involved Black or African-American employees, and 3 percent were Asian or Native Hawaiian/Pacific Islander."
- DWC received reports on more than 91,000 injury claims in 2013.
- Premiums have declined about 50 percent since 2003, and in 2012 the average premium was \$1.02 per \$100 of payroll. How much employers actually pay varies.
- Loss ratios and combined ratios indicate "that the last seven years have been very profitable for workers' compensation insurance companies."
- About 470,000 workers do not have any coverage - their employers do not carry workers' compensation insurance, nor offer a benefit plan. The benefits offered by employers with benefit plans vary widely, so many more employees could be missing certain benefits under these plans.
- 43 percent of business with 1 to 4 employees are non-subscribers, and 27 percent of businesses with 5 to 9 employees are non-subscribers.¹

The report is only a partial picture of worker injury and medical costs in Texas because it covers mostly those injuries reported by subscribing employers and their insurance companies. About 1.9 million Texas workers fall outside of the worker's compensation insurance system. DWC has no jurisdiction over the types of benefits, amount of benefits, or administration, of alternative benefit plans. Non-subscribers are only required to file two reports. The first reports that the employer has provided notice to employees that the employer does not carry workers' compensation insurance. The second is a report on a work-related injury, but is required only if an employer is not exempt and has more than five employees. One report can report injuries to multiple employees. The report does not include any information on medical costs, wage loss or compensation, or physical impairment.

The Biennial Report acknowledges that “identifying potential non-complying employers has proven to be challenging for the agency....”² So, when attempting to assess injury rates, medical costs, appropriateness of treatment, return-to-work rates, wage replacement, and other benefits, we have less knowledge about the significant number of companies that are non-subscribers and their employees. The DWC does have some information through its survey about the types of benefits offered, but little information on the actual amounts paid.

Here is some of the information DWC has derived from its survey of non-subscribing employers that offer benefit plans:

- 86 percent say they cover the medical costs of injured employees.
- 72 percent say they pay wage replacement benefits.
- 30 percent offer income benefits for permanent physical impairments.
- 25 percent pay accidental death, dismemberment, or other benefits for serious injuries.
- 45 percent offer death benefits for a work-related fatality, and 37 percent offer burial benefits if death benefits are paid.
- 14 percent ask employees to sign arbitration agreements, and 66 percent of large non-subscribers ask employees to sign arbitration agreements.
- 82 percent of employers who use arbitration specify the arbitration is binding.

While this information provides some broad information regarding non-subscriber’s alternative plans, it cannot determine how many employees are affected by these policies because the number of employees per employer varies so widely. Obviously, gauging employee satisfaction with the plans is impossible from the information DWC has.

About 67 percent of private employers are subscribers, covering about 80 percent of the Texas workforce. The other 33 percent, about 119,000 employers, are non-subscribers, but less than 40,000 of them offer an alternative occupational benefit plan. About 80,000 employers, 22.3 percent, do not carry workers’ compensation insurance or have an alternative plan, which leaves almost one half million working Texans uncovered.³ On average, there are 6 uncovered employees for every employer not carrying insurance or offering an alternative plan.

If there is less known about non-subscribing employers with plans than about subscribing employers, almost nothing is known about the employers and employees who are not covered under any option. We have no information on the rate of injury for these employees, severity of this group’s injuries, the costs and who covered them, whether employees were able to return to work, whether injuries were permanent, whether the employee had to turn to public assistance, whether the employee had to pay for the expenses himself, or even what industries they might in concentrated in. Assessing how well employers are taking care of their injured workers and at what cost is not possible when so much information is unknown.

As noted earlier, certain industries have higher injury rates than others. DWC measures injuries per 100 full-time employees. For the entire workforce, employees suffer injuries at a rate of about 2.7 injuries per 100 employees. The industries with the highest injury rates, also have larger percentages of non-subscribing employers.

Industries with Injury Rates and Non-Subscriber Rates		
Industry	Injury Rate / 100 Full-Time Employees	Non-Subscriber Rate
Retail Trade	4.1	34%
Transportation and Warehousing	3.9	34%
Agriculture, Forestry, Fishing and Hunting	3.9	26%
Trade/Transportation/Utilities	3.7	34%
Health Care and Social Assistance	3.4	41%

While injury rates for companies with certain industries are known, injury rates for non-subscribers are unknown. It is possible that a substantial portion of the workforce in an industry falls outside the workers' compensation insurance system, and have higher injury rates. It is also possible that the high number of non-subscribing employers may employ a small percentage of an industry's workforce, and that injury rates are lower. Whether there is a correlation between injury rates for covered businesses and high percentages of non-subscribers in an industry is unknown.

Texas leads the country in total fatalities in 2013, with 493. In 2012, 536 Texans lost their lives on the job. The next highest state in 2013 was with California at 385. California's labor force, however, is almost 50 percent greater than Texas.⁴ Transportation accidents are the leading cause of job-related deaths. "Contact with objects," falls/slips/trips, and violence also contribute heavily to the death toll.⁵

Workers' Compensation and the Construction Industry

A study conducted by the Workers Defense Project, with help from faculty and The University of Texas at Austin and the University of Illinois at Chicago, provides some insight into worker injuries in the construction industry. The researchers interviewed more than 1,100 workers in Texas' largest cities to supplement their research.

They found that between 2007 and 2011, 585 construction workers died on the job in Texas, while 299 died in California in the same time period. They also found that a construction worker was "4.5 times more likely to be killed on the job than the average Texas worker." Seven out of ten injured workers miss some days of work, and often miss more days than average because their injuries are more severe. One in five construction workers has suffered an on-the-job injury requiring medical attention.

According to their survey of workers, only 40 percent worked for an employer who carried workers' compensation insurance, and only 2 percent worked for an employer with an alternative plan. While employers are supposed to inform employees when they do not carry workers' compensation insurance, 94 percent of those surveyed said their employers had not notified them. The survey also reported that many workers did not report hazards or injuries for fear of being fired or harassed.

Beyond the impact on workers, the report also found that employers who carry workers'

compensation often find themselves at a competitive disadvantage to those that do not. Responsible employers often lose business to employers who are willing to cut corners and jeopardize the safety of their employees.

The cost cutting may work well for an individual employer, but he or she essentially transfers his responsibility onto others. Uninsured workers contribute to the high uncompensated care costs of Texas' hospitals. To attempt to make up for these losses, the charges are often indirectly passed onto other, paying hospital patients through higher bills. Higher hospital bills in turn raise health insurance premium.

According to the study, at one hospital injured construction workers made up 20% of work-related uncompensated emergency room costs.⁶ A San Antonio hospital, however, reported that work-related injuries only made up \$11 million out of a total of \$244 million in uncompensated care.⁷

Undoubtedly, some uninsured injured workers or their families end up on public assistance in an effort to survive. When that happens, the employer's responsibility is transferred onto the taxpayers of the state and country.⁸

Representatives of some in the construction industry say they have taken steps to improve worker safety. Injury prevention is extremely important in an industry working with heavy equipment, machinery, and heavy products, often at a considerable height. Construction industry representatives also point out that they are not the only industry with high injury rates, and feel it would be unfair to single the industry out when others face similar problems.⁹ Still, employees are being hurt, and how the medical and rehabilitation costs are being handled is unknown for a significant portion of workers.

Others believe that the easy availability of cheap labor, especially from undocumented immigrants, plus competitive pressures, entice employers to cut corners. They say it is simply too easy for an employer to dump injured workers on hospitals and taxpayers. Many of the employers, especially small employers with few assets, believe they are "judgment proof"- even if they were to lose a lawsuit there would be little or no money for the injured worker to collect from the business. Some would simply declare bankruptcy and open under a different name.¹⁰

Why Employers Don't Carry Workers' Compensation Insurance

Employers do not choose to carry workers' compensation insurance for a variety of reasons. The DWC's Survey of Employer Participation in the Texas Workers' Compensation System lists the primary reasons employers choose to subscribe:

- Employer thought having workers' compensation was required by law,
- Employer was able to provide injured employees with medical care through a workers' compensation health care network,
- Employer was concerned about lawsuits,
- Employer needed workers' compensation coverage in order to obtain government contracts; and Workers' compensation insurance rates were lower.

The survey also points out the primary reasons non-subscribers choose not to carry insurance:

- Workers' compensation insurance premiums were too high.
- Employer had too few employees.
- Employers are not required to have workers' compensation insurance by law.
- Medical costs in the workers' compensation system were too high.
- Employer had few on-the-job injuries.¹¹

Some employers are making a risk assessment regarding injured employees, and others simply say they cannot afford insurance. It is difficult to imagine that an employer who cannot afford workers' compensation insurance can afford to pay the medical bills of an injured worker. If they do not, then the cost of the injury will be transferred to the employee, the local hospital, or taxpayer-funded public assistance programs.

One of the legal trade-offs employers make when they decide not to provide workers' compensation insurance is that they may be sued by injured workers. In practice, injured employees rarely can find an attorney who will take their case. Uninsured injured workers often do not have the money to hire a lawyer. Even if a lawyer would be willing to take the case, filing a suit, taking depositions, preparing and arguing a case, are expensive endeavors. The lawyer would have to risk those costs, hoping to be awarded attorneys' fees if the injured worker prevails. Most attorneys find the risk unacceptable. Because a suit might only involve a few hundred, perhaps a few thousand, dollars, the cost of bringing the suit is prohibitive.

The Affordable Care Act may impact health care for some injured workers when the employer mandate takes effect. Because the mandate for some small businesses has been delayed, it is hard to say how businesses will react and whether the Act will have an indirect effect on workers' compensation cover or utilization rates.

Conclusion

The Speaker of the Texas House of Representatives charged the House Committee on Business and Industry to “[s]tudy the voluntary nature of workers' compensation in Texas and how it meets the needs of employers and employees.” Unfortunately, with little or no information from 2 key groups—non-subscribers who offer alternative plans, and non-subscribers who do not—regarding injury rates, medical costs, wage replacement, return-to-work rates, permanent disability, and many other factors, the committee feels the information available is insufficient to determine how the voluntary nature of workers' compensation meets the needs of employers and employees.

The data do reveal that almost 80,000 employers, or about 22 percent of employers, do not carry insurance or offer an alternative plan, which, unless they are capable of paying potentially large medical bills, exposes employers, hospitals, and taxpayers, to costs that should be covered by employers. Almost 500,000 Texas workers work for these employers.

Recommendation

The Texas Legislature should direct the Division of Workers' Compensation of the Department

of Insurance to study the employers who are not insured or offering an alternative plan to determine the industries these employers may be concentrated in and why they elect to be unprotected. The Division should also study uncovered injured employees to determine the extent to which those workers rely on public benefits for treatment and rehabilitation of their injuries and income while they cannot work.

REVIEW EXISTING LIEN LAWS

Review existing lien laws in Texas. Specifically:

- a. Examine laws concerning the enforcement of contract liens affecting real property. Identify improvements, if any, that will enhance the certainty of title following sale, enhance ability to ensure that sales are conducted by qualified trustees, prevent unnecessary litigation, facilitate loss mitigation between borrowers and sellers, and protect the interests of homeowners, lenders and trustees.
- b. Study the imposition of mechanics' liens on automobiles and its impact on mechanics, car owners and purchasers, and lenders.
- c. Review ad valorem tax lien lending after the implementation of SB 247 (83R) and the impact on homeowners, taxing authorities, mortgage lenders, and tax lien lenders. Review the procedures and powers of the Office of Consumer Credit Commissioner to ensure compliance with SB 247.

Enforcement of Contract Liens Affecting Real Property

As part of the committee's charge to review existing lien law in Texas, the committee was directed to:

Examine laws concerning the enforcement of contract liens affecting real property. Identify improvements, if any, that will enhance the certainty of title following sale, enhance ability to ensure that sales are conducted by qualified trustees, prevent unnecessary litigation, facilitate loss mitigation between borrowers and sellers, and protect the interests of homeowners, lenders and trustees.

The committee received testimony from Mr. Brian Engel of the law firm Barrett Daffin Frappier Turner & Engel, LLP. His written testimony, which includes proposed legislation, can be found here: <http://www.legis.state.tx.us/tlodocs/83R/handouts/C0402014052710001/8a48ce5a-a4d0-4959-92e4-ca80f2a5a955.PDF>

The committee is deeply appreciative of Mr. Engel's expertise, work, and the time he generously gave in helping the committee members and staff understand the intricacies of the foreclosure process. To develop meaningful recommendations, the committee would have like to have heard from more entities that are part of the foreclosure process. Unfortunately, no one else came forward with input on the issue.

The committee recommends that in the 84th Regular Session the Texas Legislature consider legislation along the lines of Mr. Engel's proposals to improve the certainty and efficiency of the foreclosure process.

Auto Mechanics' Liens

Background

A mechanic who repairs an automobile should be paid for the work he performs. To help ensure payment, Texas law permits a mechanic to keep a vehicle until he or she is paid the amount due under the repairs contract. If there is no repair contract, the mechanic can keep the vehicle until he or she is paid the reasonable and usual amount.

With today's financial instruments, a mechanic can be deceived into relinquishing possession of a motor vehicle through fraud. To protect the mechanic, the law permits a mechanic to repossess a vehicle in limited circumstances - the check, money order, or credit card transaction he or she accepted as payment is stopped, bounces, or was made on a nonexistent or closed account. If any of the limited circumstances occurs, the lien continues, entitling the mechanic to possession of the vehicle. If, at the time the mechanic attempts to repossess the automobile, it is in the possession of a "bona fide purchaser" who bought the car after a stop payment order was made, the lien is not continued.

To protect consumers, a possessory lien can only be enforced if the customer signs a notice stating that the vehicle may be subject to repossession under Section 70.001, Property Code. The notice must be separate from the written repair contract or printed on the written repair contract "in type that is boldfaced, capitalized, underlined, or otherwise set out from surrounding written material so as to be conspicuous with a separate signature line."¹²

PROPERTY CODE
TITLE 5. EXEMPT PROPERTY AND LIENS
SUBTITLE B. LIENS
CHAPTER 70. MISCELLANEOUS LIENS
SUBCHAPTER A. POSSESSORY LIENS

Sec. 70.001. WORKER'S LIEN. (a) A worker in this state who by labor repairs an article, including a vehicle, motorboat, vessel, or outboard motor, may retain possession of the article until:

(1) the amount due under the contract for the repairs is paid; or

(2) if no amount is specified by contract, the reasonable and usual compensation is paid.

(b) If a worker relinquishes possession of a motor vehicle, motorboat, vessel, or outboard motor in return for a check, money order, or a credit card transaction on which payment is stopped, has been dishonored because of insufficient funds, no funds or because the drawer or maker of the order or the credit card holder has no account or the account upon which it was drawn or the credit card account has been closed, the lien provided by this section continues to exist and the worker is entitled to possession of the vehicle, motorboat, vessel, or outboard motor until the amount due is paid, unless the vehicle, motorboat, vessel, or outboard motor is possessed by a person who became a bona fide purchaser of the vehicle after a stop payment order was made. A person entitled to possession of property under this subsection is entitled to take possession thereof in accordance with the provisions of Section 9.609, Business & Commerce Code.

(Other provision omitted.)

If the mechanic wants to sell the automobile at a public sale to recoup his costs, he must provide a foreclosure notice, by certified mail, return receipt requested, to the owner and any lienholders

of record within 30 days of the accrual of charges. The mechanic must also file the lien with the local County Tax Assessor-Collectors Office within 10 days a \$25 administration fee, a copy of the notification, and a signed copy of the work order. Within 15 days, the County Tax Assessor-Collector must send copies of the notice and work order to the owner and lienholders. This ensures that the owner of the car and any lenders who may have financed the purchase of the car and still have debt outstanding are aware of the pending sale.

If the charges are still unpaid after or on the 31st day after the County Tax Assessor-Collector has mailed notice, the mechanic may sell the vehicle at public sale without obtaining a release of lien. The proceeds from the sale pay the mechanic's charges, and any excess proceeds are paid to the person entitled to it.¹³

The requirements to file the notice and work order with the tax assessor, and for the assessor to the owner and each lienholder, were added by Senate Bill 543, 81st Legislature. The primary purpose of the bill was to reduce fraudulently acquired titles.

Criminal actors have exploited a loophole in the notice requirement to acquire fraudulently title to a motor vehicle. The fraud involves a person or organization that falsely claims to hold a mechanic's lien and files a fraudulent "notice" containing false information (or no information at all) to the owner and lienholders of record, who often sign the return receipt without first checking to see if the notice is valid. After the expiration of the 30-day period following the mailing of the notice, the person committing the fraud will request an application for title to the motor vehicle from a tax assessor and present the fraudulently acquired return receipt as "proof" that notice was given. Upon acquiring title, the criminal actor usually will sell the vehicle at a public auction and pocket the proceedings.¹⁴

In Calendar Year 2009, the year the legislation was passed, there were about 17,500 mechanics liens claimed. The number dropped to about 10,000 by 2010. Over the last three years, an average of 3,600 liens have been filed.¹⁵

Assignment of Liens

One company in particular, Banatex L.L.C (Banatex), a debt purchasing company doing business as FIT Finance, has argued that mechanics liens are transferrable to a third party. The company signed up about 600 mechanics in the Dallas area, through which Banatex could offer loans with interest rates of 250 to 260 percent to customers who could not pay their repair bills. Banatex claims that their loans enabled mechanic's to get paid, and customers to finance repairs to their cars, they might not otherwise be able to afford. Banatex also says that for most of its customers the alternative would be high interest rate payday loans or car title loans.¹⁶

When some customers would not or could not pay off the loans to Banatex, the company would repossess the vehicle claiming to hold a mechanics lien. Banatex believed that Texas court cases made mechanics' liens assignable. Banatex also believed that, because the loan agreement stated that repossession was a possibility if the loans were not paid, it could repossess and sell the cars of nonpaying borrowers. Banatex also believed that, as a Utah headquartered company, Utah

law applied to its loans - permitting interest rates in excess of 250%, where Texas law would limit the interest rate to 10%.

In the 83rd Legislature, Banatex testified in favor of House Bill 3071. The bill would have expanded the conditions under which a mechanics' lien is continued. It also would have granted mechanics the ability to assign the lien “a lien to a third party that does not perform repossession service.”

Banatex began operation well before the start of 83rd Legislature and stated that it wanted to “clarify” the law through the passage of HB 3071. Banatex believed that changes to the statute made in the 74th Legislature had the “unintended consequence” of narrowing the circumstances of repossession.¹⁷ When the bill failed to pass, Banatex continued to operate.

Court Action

Santander Consumer USA, Inc. v Fix It Today, LLC (Banatex), et al

In January of 2014, a district court in Tarrant County held a trial Banatex and Santander Consumer USA, Inc. (SCUSA), which holds and services “motor vehicle retail installment sale contracts and promissory notes secured by motor vehicles....” SCUSA, as the plaintiff, argued that Banatex had deprived SCUSA of its security interest in vehicles by claiming Banatex held a mechanics lien on certain automobiles and improperly taking possession of those automobiles.

In March of 2014, the court issued its Finding Of Facts And Conclusions of Law stating among other things that:

The Court finds that as a matter of law, after having received payment of those charges (repairs) and have voluntarily relinquished possession of the Vehicles, any statutory possessory worker’s lien against any Vehicle was discharged and extinguished, and therefore, any sale, transfer, assignment or convenience of that worker’s lien is void ab initio, and a violation of Texas Law.

The Court finds that because the workers did not relinquish possession of the Vehicles in return for a check, money order, or credit card transaction on which payment was stopped, dishonored, or the account was closed, any subsequent repossession by FIT Finance (Banatex) was unlawful under the provisions of Chapter 70 of the Texas Property Code.

The Court finds that the dishonored ACH (Automated Clearing House)¹⁸ transaction with FIT Finance related to a default as to payment of the Borrower’s debt with FIT Finance which occurs after the worker voluntarily released possession of the (Vehicle) does not fall into the statutory condition precedent to repossession by a worker who relinquished a vehicle in exchange for a check that was subsequently dishonored. (sic) (Parentheticals added.)¹⁹

Thus, the court essentially found that Banatex’s claim that mechanics' liens are transferrable is incorrect and a violation of the law.

Section 342.051(a), Texas Finance Code, requires that any person in the business of lending money for personal, family, or household use, that charges interest rates in excess of 10 percent which is not secured by a lien on real property must obtain a license from the Texas Office of the Consumer Credit Commissioner. Section 302.001(b), Texas Finance Code, says that the maximum interest rate that can be charged on a loan is 10 percent unless otherwise provided by law.

When the court determined that Banatex had no liens, the foundation of Banatex's claim that it could charge interest rates of 250 to 260 percent was undermined. So, the court further concluded that Banatex had made loans without a license and at interest rates that were "unconscionable, clearly usurious and in violation of Texas laws."²⁰

In its final judgment, the court ordered Banatex to pay damages and legal fees, and that SCUSA was entitled to immediate possession of the vehicles.²¹ Banatex officials testified they intend to appeal the decision, and so on November 13, 2014.

Banatex LLC. v Steve Mossman, Denton County Tax Assessor Collector

In a separate court action, Banatex filed for a writ of mandamus after the Denton County Tax Assessor-Collector (TAC) refused to file Banatex's notices and forward them to a car owner and lienholders. The TAC had sent a letter to Banatex saying the Texas Department of Motor Vehicles had determined that "these transactions must be filed through the Court System and have a Court Order issued for ownership of each of the vehicle you have enclosed."²²

The Texas Department of Motor Vehicles in its Motor Vehicle Title Manual had determined, much as the trial court in *Santander Customer USA v Fix It Today*, that financial companies or institutions are not eligible to file a mechanic's lien. Based on this advice, and the opinion of the Denton County County/District Attorney, the TAC chose not file and forward Banatex's notices. Banatex argued that TAC had no authority to determine the validity of its claim to a lien, and that TAC must accept and process its notices.²³

In a summary judgment, the court sided with Banatex, but did not limit its decision to the one automobile Banatex named in its petition. Rather, the court "ordered the TAC to file any and all notices from a person claiming to have a possessory lien...." Banatex then requested, and the court granted, a refusal to suspend of its judgment while Denton County appealed the ruling.

Denton County filed an appeal with the Eighth District Court of Appeals, and request the appeals court reverse the trial court's refusal to suspend its judgment pending appeal. The appeals court did stay the lower court's writ of mandamus until Denton County's appeal is resolved by the appellate court.²⁴

In its order suspending the lower court's writ of mandamus, the appellate court noted that:

It is not entirely clear whether the TAC could simply un-file the notice once it has been filed. Even if the notice could be un-filed, the TAC could not retract the notice which has been sent to the owner and other lienholders. Thus, in the event

the TAC is successful on appeal and the writ of mandamus issued by the trial court is reversed, our judgment cannot undo the TAC's transmission of the notice to the owner and other lienholders.

The court points out that the filing of inappropriate documents can cause problems that cannot be easily undone. The case is still pending in the appellate court.

The case is still pending before the Eighth Court of Appeals, and it could rule on the assignability of mechanics' liens.

The cost of all the litigation is apparently too much for Banatex to withstand. Banatex officials have said they are winding down operations, and will only operate automobile repair shops. They say the cost of litigation is adding too much to their costs, and would force them out of business.

Impact on Mechanics, Car Owners, and Lenders

Many mechanics would like to find an alternative to maintaining possession of motor vehicles when the customer cannot pay repair bills. Mechanics have to store the automobile while they wait for the customer to pay off the bill. Additionally, they have to send notice, pay a \$25 filing fee, have the county tax assessor-collector send notice to car owners and lienholders, then sell the car at public auction before they can recover their costs. Of course it is always possible that the sales price will not cover the actual expenses the mechanic has incurred.

Few mechanics can afford not to get paid, or take the risk of financing repairs. As long as they are storing a vehicle, they may also have some risk for damage that might occur. Mechanics would like to transfer their risk to another party. Even if mechanics are capable of setting up payment plans for repairs, current law seems to exclude using a mechanic's lien to repossess the car if the owner does not make payments. Mechanics would probably have to file a separate lien based on a security interest. If the automobile has an outstanding purchase money lien, that lien would take priority. In a foreclosure sale, the purchase money lien would be paid off first, then the mechanic recovers any excess funds, up to the amount of the repair cost still due.

Mechanics need to be cautious of making repairs which cost more than the value of the vehicle being worked on. They must also be aware that if they are forced to foreclose on the car, the amount they receive may be less than the value of their work.

Car owners who cannot afford to pay automobile repairs have a few options. They may be able to negotiate with the mechanic to take payments, but as noted above that does pose some risks for the mechanic.

If they own the car free and clear, they could attempt to borrow money from their bank or credit union. If the car has an outstanding purchase money lien, whether a bank would lend money would depend largely on the value of the car and the remaining amount to be paid on the original loan. Of course, credit rating and other risk factors will also be considered by a financial institution.

If they hold clear title, they can also try a car title loan. The loans carry extremely high interest

rates, and most customers have to renew the loan, often multiple times, before the loan is paid off. Many people get caught in a cycle of debt that is extremely difficult to get out.

Payday loans are another option, but these carry very high interest rates. Essentially, the lender “advances” money that will be paid on the borrower’s next payday. These loans are generally less than \$500, but can be for higher amounts, which may not be enough to pay for a major repair. These loans do not have extended payments plans, but many people “roll over” the loans as they attempt to get back on their feet financially.

Given the high interest rates, and the number of borrowers who fall into a cycle of debt, car title loans and payday loans may not be good options, but for some they will be the only options.

Car purchasers want to know that the car they are buying is not encumbered in any way. The current mechanic’s lien statute does provide some protection for purchasers. If a person is a bona fide purchaser of a motor vehicle after a stop payment order was made on the repair bills, the mechanic’s lien is not continued.

Lenders also want to know that the cars they are financing have clean titles. Secondary finance plans increase the risk to primary lenders, especially if they do not know a second loan has been made. Increased risks could make lenders much less willing to finance automobiles, making it harder for people to acquire vehicles or pay higher interest rates for those cars.

Under current law, lenders know that if a vehicle they have financed receives high cost repairs the mechanic will generally hold on to the car. When they receive notice that the mechanic intends to foreclose, they have the option to pay off the mechanic’s bill to obtain possession of the vehicle.

When Banatex began lending money to cover repairs, primary lenders found they had to negotiate with Banatex. Some report that in addition to the amount of repairs outstanding, Banatex wanted them to pay its high interest rates, plus as much as \$1,500 in repossession fees. Those combined costs often resulted in a total loss to the lender. Even though many believed that Banatex had improperly claimed a mechanic’s lien, the cost of litigating the issue would be more than the amount of the original loan or the value of the vehicle. Some simply abandoned their right to the vehicle rather than incur further costs.

If a secondary lender financing repairs can claim a mechanic’s lien and supersede the lien position of the original lender, the secondary lender is only concerned about whether the value of the automobile is greater than the amount they are lending. They know that if they are forced to foreclose their position will be covered. The original lender’s position, however is greatly undermined. While the secondary lender might recover all his money, the primary lender could only recover whatever amount might be left over after the secondary lender is paid.

Primary lenders do not believe the law permits a secondary lender to claim a mechanic’s lien. If that were to change, the risks for primary lenders would increase. Lenders say they might tighten credit standards or raise rates in an effort to manage the risk. Fewer sales could mean fewer jobs or less pay in the industry. Car sellers could find it more difficult to sell their vehicles.

Conclusion

The current state of the law has evolved over time in an effort to balance the interests of mechanics, car owners, and lenders. In response to concerns of illegal activity and abuses of liens, the Legislature added requirements to file notices with the county tax office. As a result, the number of mechanic's liens filed have dropped from a high of about 17,500 in 2009 to an average of 3,600 over last three years. One company has interpreted state law and legal precedence to permit a loan company that finances repairs to repossess a car under a mechanics lien if the car owner does not pay the loan. The company has lost one court case, and is appealing. Another case is also on appeal. The company says the cost of litigation is forcing them out of business, but the outcome of the appeals could open the door for future lenders.

Recommendations

While one company contends that the law permits a loan company to repossess automobiles via a mechanic's lien and sell the car at public sale, the committee disagrees. The highly mobile nature of automobiles means that owners or original lenders can quickly face very high costs to attempt to secure their equity in the automobile. While the committee believes the law is clear as written, the Texas Legislature needs to monitor the cases on appeal, and, if necessary, further clarify that entities that lend money to pay for repairs are not eligible to claim a mechanic's lien.

Property Tax Liens

Background

In 2011, almost \$40.5 billion in property taxes were levied by school districts, cities, counties, and other special districts.²⁵ Around the 1st of October of every year, tax assessor-collectors send tax bills to property owners notifying them of the amount of tax due on January 1st of the following year, giving the owner about three months to pay the tax bill. An overwhelming majority of property owners pay their taxes on time, usually by escrowing funds monthly along with the mortgage and insurance payments. Those who are disabled, 65 years old or older, a disabled veteran, or the surviving spouse or child of a disabled veteran, can pay their taxes in four installments. Still, some find they are unable to pay their taxes for a wide variety of reasons.

A property owner who determines that he or she cannot pay the taxes fully before they are due should contact the local tax assessor-collector's office to determine what payment options might be available. These options may include:

- **discounts**, if you pay your taxes early;
- **split payment** of taxes, allowing you to pay half your taxes by Nov. 30 and the remainder by June 30 without a penalty;
- **partial payment** of your taxes;
- **escrow agreements** for a special year-round account; and
- **work contracts**, in lieu of paying taxes, for certain taxpayers doing certain duties.²⁶

If these options cannot resolve the tax debt, the property owner might sell assets, borrow from relatives, or attempt to find private financing. Financing can take many forms including: home equity loans; home equity line of credit, reverse mortgage, consumer loans such as loans secured by personal property or the borrowers signature, personal lines of credit, credit cards, or other options. Generally, lenders consider loans backed by real estate safer than other types of loans, and lenders offer lower interest rates. A property owner's personal financial situation and credit history will have some role in determining the terms of a loan.²⁷

Tax liens are attached to property to secure payment of taxes, penalties, and interest on January 1st of each year.²⁸ Taxes become delinquent February 1st, and penalties are assessed.²⁹ (For a full explanation of due dates, delinquency dates, and penalties, see <http://www.window.state.tx.us/taxinfo/proptax/taxbills/>.) Any time after the taxes become delinquent, any government holding a lien can file a suit to foreclose the lien and attempt to sell the property.³⁰ If the property is a residence homestead, a taxing unit must offer a payment plan of up to 36 months, if the owner request it.

Texas law also permits a property owner to transfer a tax lien to a third party who pays the taxes due. The use of this provision increased after the Financial Crisis, the Subprime Mortgage Crisis, associated the Great Recession 2007 - 2008. While Texas weathered the subprime home loan crisis better than most states due to safeguards on "cash-out" refinancing and home equity loans³¹, many Texans still found themselves unable to pay their mortgages and taxes, and turned

to property tax lenders.

As property tax lending increased, the Texas Legislature began to examine the industry more closely. Some practices have been restrained or prohibited, yet, despite these regulations, the Legislature continues to be concerned about property tax lending impact on property owners and the housing market.

Legislative History of Property Tax Lending

Property tax lending was first authorized in Texas during the Great Depression. During that time Texas was suffering greatly, as was the rest of United States, with high unemployment rates, which prevented people from earning a living, much less pay their taxes. At the time, “taxes delinquent were about twice the amount of taxes actually collected.”³²

In 1933, one of the ways the state attempted to deal with the situation was to permit another person to pay off the tax debt of another, but the property owner was required to first get the consent of a person who holds a superior contract lien on the property.³³ Less than two years later, the provision requiring consent of another lien holder was removed.³⁴

Additionally, the 1933 bill provided that “the person, company or corporation paying said taxes shall thereafter become vested with and hold such tax lien against such property as fully and to all intents and purposes as such State, county or subdivision theretofore held the same.”³⁵ The provision gave the property tax lender the same superior lien as the governments held.

As Texas was trying numerous legal changes to help collect delinquent taxes, the federal government was dramatically changing financing in the housing industry. Prior to the Great Depression, home loans were short term and renewable. Life insurance companies, commercial banks, and thrifts, provided most of the loans. Down payments were often for half the purchase price, and the loan was for 5 to 10 years, with a large balloon payment at the end.

In 1932, the federal government enacted the Federal Home Loan Bank Act, which created the FHLBank System, under the regulation of the the Federal Home Loan Bank Board, as part of the New Deal. The Home Owners’ Loan Corporation, the Federal Housing Administration, and Fannie Mae, were also created. In 1933, about four months before the Texas Legislature permitted property tax lien transfers, the passage of the Home Owners’ Loan Act introduced “long-term, fixed-rate mortgage financing....” In 1934, Congress established federally backed insurance on home mortgages.³⁶

The large, lump sum property tax payments were a problem for many homeowners, and many were delinquent or lost their homes to tax foreclosures. As part of the federal reforms, lenders began to establish escrow accounts - small monthly payments made along with mortgage payments - to pay future tax debts. In 1934, escrow accounts became mandatory on all FHA insured mortgages, and subsequently became a standard practice.³⁷ (In the 1990s, deregulation lessened escrow requirements, and, while still the practice, there was an increase in loans made without escrow requirements.)

These changes may have greatly reduced the need for property tax loans. For more than 60 years

after tax transfers were permitted, most liens were transferred to family members or employees of the property owner.³⁸

In 1995, the Texas Legislature increased the permissible interest rate on property tax lien transfer to from 10 percent to 18 percent,³⁹ the federal maximum interest rate allowed. Testimony from the bill's author noted that in some years property owners were could not find a lender because the 10 percent interest rate was below market rates. He added that no companies were lending and accepting tax transfers because the rate was too low.⁴⁰ The bill also permitted non-judicial foreclosure of transferred tax liens, and contract terms that could lead to foreclosure within one year for non-payment of loans.⁴¹

By 2005, the Texas Legislature began to modify the statutes relating to tax transfers, and restricted when a tax transfer could be used. If a property was owned free and clear, the owner could transfer a lien. If, however, the property was subject to a mortgage lien, then the transfer could not occur until the taxes were delinquent. The legislature also limited closing costs, limited fees for payoff statements, set new requirements for redeeming property after foreclosure, and required other lien holders to notified before a foreclosure.⁴²⁴³

In 2007, the Legislature required property tax lenders to be licensed by the Office of Consumer Credit Commissioner. Additional consumer protections were also enacted through Senate Bill 1520. At the request of Chairman René Oliveira, Texas Legislative Council summarized the bill.

Senate Bill 1520 requires, in a sworn property tax lien transfer document, a statement indicating that notice has been given to the property owner regarding the property owner's eligibility for a tax deferral if the property owner is 65 or disabled. The legislation requires the Finance Commission of Texas to prescribe the form and content of an appropriate disclosure statement to be provided to a property owner before the execution of a tax lien transfer and to adopt rules relating to the reasonableness of closing costs, fees, and other permitted charges.

Under previous law, property tax liens, in addition to being authorized for delinquent taxes, were also authorized for certain future no delinquent taxes. Senate Bill 1520 authorizes tax liens for taxes that are not delinquent at the time of payment if certain conditions are met, including that an authorized tax lien transfer had been executed and recorded for one or more prior years on the same property. This provision was later removed by Chapter 206 (S.B. 247), Acts of the 83rd Legislature, Regular Session, 2013.

Previous law entitled a transferee to foreclose a property tax lien in a manner specified in certain provisions of the Property Code and Tax Code if the property owner and the transferee entered into a contract that was secured by a lien on the property. Senate Bill 1520 entitles a transferee to use this method of foreclosure if the transferee also obtains a court order for foreclosure under Rule 736, Texas Rules of Civil Procedure, and fulfills certain other requirements. This provision was later removed by Chapter 206 (S.B. 247), Acts of the 83rd Legislature, Regular Session, 2013.

Senate Bill 1520 specifies that a right of rescission described by certain federal law applies to a tax lien transfer. The legislation sets out delinquency notice provisions for a loan secured by a transferred tax lien and entitles the

holder or mortgage servicer of a recorded preexisting lien on the property to obtain a release of the transferred tax lien within a certain period based on when the notice was sent, rather than on when the tax lien was recorded. The legislation establishes similar rights and authorizations that apply if an obligation secured by a preexisting first lien on the property is delinquent for at least 90 consecutive days and the obligation has been referred to a collection specialist. The bill specifies that these rights do not affect the right of redemption established under law.

Senate Bill 1520 removes a provision added by Chapter 406 (S.B. 1587), Acts of the 79th Legislature, Regular Session, 2005, requiring the transferee of a property tax lien or any successor in interest to notify the holders of all recorded liens on the property before foreclosure in the same manner and within the same time frame as the transferee must notify an owner of property under provisions of law relating to the sale of real property under a contract lien.

Senate Bill 1520 revises the amount that must be paid to redeem foreclosed property to include the amount reasonably spent by the purchaser of the property on certain costs in connection with the property and the legal judgment rate of return on that amount. The legislation makes numerous procedural changes.⁴⁴

After the 2007 Session, the Office of Consumer Credit Commissioner began receiving reports from lenders, and a clearer picture of the number and value of loans, closing cost, and other fees, developed. The results of those reports will be discussed later.

In 2009, the Legislature required the Finance Commission to develop a standardized form for the tax lien transfer document signed by property owners. Other technical and conforming changes were also made. In 2011, the Legislature enacted further consumer protections, limiting the amounts and types of fees that can be charged after the closing on a tax lien.

In 2013, the Legislature passed more consumer protections because "...there is a growing sense of concern that some in the industry are taking advantage of property owners through the non-judicial foreclosure process and fraudulent advertisements, among other mechanisms. In addition, some fear that property tax lenders are threatening market stability by using property tax liens as a bundled investment mechanism."⁴⁵ Legislative Council also detailed the changes made by Senate Bill 247.

Senate Bill 247 redefines "transferee" as a person who is licensed under the Property Tax Lender License Act (Chapter 351, Finance Code) or who is exempt from the application of the act and is authorized to pay the taxes of another or is a successor in interest to a tax lien that is transferred. The legislation also prohibits a person who is 65 years of age or older from authorizing a transfer of a tax lien on real property on which the person is eligible to claim a residence homestead exemption from school district taxation and removes a related tax deferral notice requirement added by Chapter 1329 (S.B. 1520), Acts of the 80th Legislature, Regular Session, 2007.

Senate Bill 247 removes the property tax lien authorization for taxes due, but not delinquent, for property with prior tax lien transfer authorization. The

legislation limits the foreclosure options of a tax lien transfer to the manner provided by law for foreclosure of tax liens.

Senate Bill 247 requires the Finance Commission of Texas by rule to prescribe the form and content of a request a lender with an existing recorded lien on a property must use to request a payoff statement and the transferee's response to the request and sets out related payoff statement and fee disclosure requirements, including a requirement that a transferee who receives a request for a payoff statement must be given at least seven business days to deliver the statement by finance commission rule. The legislation authorizes the consumer credit commissioner to assess an administrative penalty against a transferee who wilfully [sic] fails to provide a requested payoff statement.

Senate Bill 247 makes void a contract between a transferee and a property owner that purports to authorize payment of taxes that are not delinquent or due at the time of the authorization, or that lacks the proper tax lien authorization. The legislation prohibits a tax lien from being transferred to the person who pays the taxes on behalf of the property owner if the property has been financed, wholly or partly, with a grant or below market rate loan provided by a governmental program or nonprofit organization and is subject to the covenants of the grant or loan or if the property is encumbered by a lien recorded under statutory provisions relating to municipal regulation of dangerous structures. The legislation authorizes the finance commission to adopt rules to implement this prohibition.

Senate Bill 247 prohibits a property owner from waiving or limiting any requirement imposed on a transferee by Section 32.06, Tax Code, except as provided by that section.

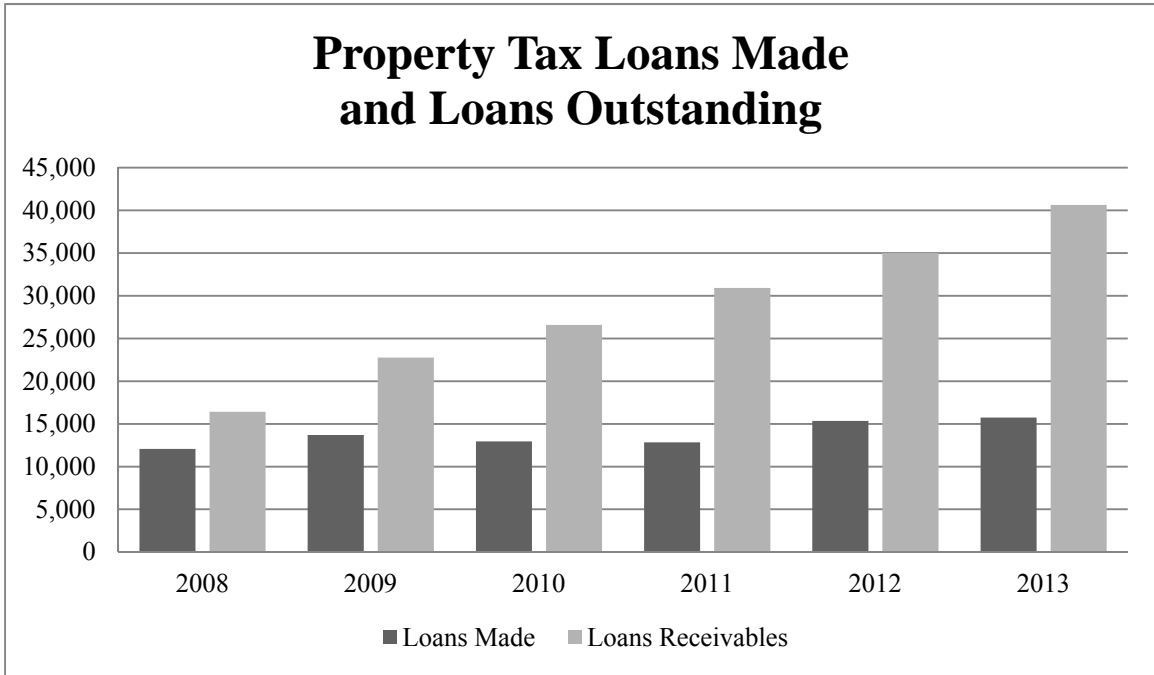
Since 2005, the Texas Legislature has alternatively expanded property tax lender's abilities in some areas, and restricted it in others. The Legislature has even passed some provisions, only to delete them a few years later.

Property Tax Lending Activity

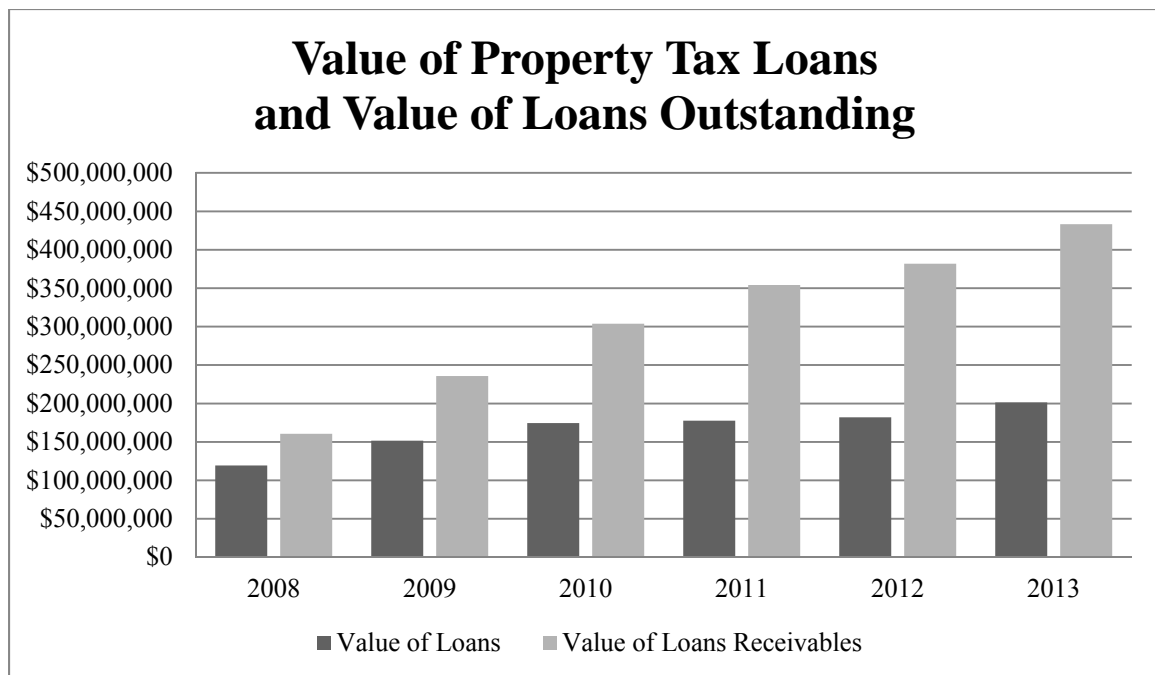
As noted earlier, for most of the time property tax lien transfer have been permitted they were little used, except by family members or employees of property owners. More than a decade after the Legislature increased the allowable interest rate to 18 percent, a legislator estimated that only about 20 companies were writing property tax loans, and those loans were valued at about \$75 million dollars.⁴⁶

In 2008, the first year the Office of Consumer Credit Commissioner began to receive reports from lenders, 44 companies reported just over 12,000 loans valued at \$119.3 million. That same year the companies reported almost 16,500 loans outstanding with a value of \$160.6 million.

The chart below tracks the number of loans made per year since 2008, and the number of loans outstanding. Because some loan terms are for more than one year, a loan made in one year may be outstanding for several more years. Thus, the number of outstanding loans continues to climb.



The next chart shows the value of loans made in a year and the value of outstanding loans. The increase in the value of loans per year is reflective of average amount per loan increasing. As taxable values and/or rates increase over time, it follows that the average loan amount would increase. In addition to multi-year loans contributing to the increases in outstanding loans amounts, some property owners are signing additional loans to pay taxes in subsequent years. The OCCC attempts eliminate double counting of these subsequent loans, so that the number of loans is more closely reflective of the number of properties under tax transfers.⁴⁷



Leslie Pettijohn, the Consumer Credit Commissioner, testified before the House Committee on Business and Industry that the number of loans has been increasing an average of 5 percent per year. The average property tax lien transfer averaged \$7,232 in 2008, and was \$7,924 in 2013. In 2010 and 2011, however, the average loan amounts were \$8,658 and \$8,810, respectively.

The Legislature's efforts to bring down closing costs appears to be working. In 2008, the average closing cost per loan was \$1,259, but \$707 in 2013. Interest rates have declined as well. In 2008 the average rate was 17.41 percent. For 2013 the average rate was 8.92 percent.⁴⁸ These average rates include commercial and residential properties. For residential properties, the average interest rate was 15.92 percent in 2008, and was down to 12.80 percent in 2013. Such declines are undoubtedly due to a variety of reasons, including increased competition.

The number of property tax lending companies jumped from 44 in 2008, to 61 in 2009, and 73 in 2010. In February of 2014, there were 87 companies in the industry, which was down from 100 in December of 2013. Some consolidation among lenders has been taking place.⁴⁹ Additionally, at the height of 2007 - 2008 recession when interest rates were the highest, property owners who lost jobs or had salary reductions had little time to adjust to the downturn, and may not have had the opportunity to explore other financing options. Under those circumstances, they may have been willing to agree to higher interest rates.

While the OCCC is still assimilating the changes required by S.B. 247, the expectation is for the number of loans to level off in the coming years.

Consumer Protections

The Federal Reserve took steps to shore up the housing market in the wake of the Great Recession. Many of the first people unable to pay their mortgages when unemployment rates increased were "subprime" borrowers. The Fed amended Regulation Z (Truth in Lending) to prohibit "unfair, abusive, or deceptive" lending practices and limit other practices associated with "higher-priced mortgage loans, secured by a consumer's primary dwelling."

The four main reforms include:

- Prohibiting a lender from making a loan without considering the borrower's ability to repay the loan with income and assets other than the property's value.
- Mandating verification of income and assets.
- Ban some prepayment penalties.
- Require creditors to establish escrow accounts on first-lien mortgages for property taxes and insurance.

The regulations apply to loans in which the interest rate is 1.5 percentage points higher than the "average prime offer rate" on a first-lien mortgage, and 3.5 percentage points on a subordinate-lien mortgage.⁵⁰ Currently the average prime offer rate is about 4 percent, so the applicable interest rates would be 5.5 percent and 7.5 percent. These rates are lower than rates property tax lenders are currently reporting.

Whether these provisions are applicable is at question in several lawsuits filed in federal court. In one of the cases a judge has ruled that the Truth in Lending Act is not applicable to tax transfers, but the plaintiffs say they will appeal. The other cases have not had any ruling as of this writing.⁵¹ Because the ruling is so recent, the committee has not had an opportunity to review the decision. The Legislature does have the authority to apply regulations similar to those in the Truth in Lending Act, should it deem that necessary.

The regulations may have an indirect impact on property tax lending. If a substantial portion of tax transfers are for properties under “higher-priced mortgage loans,” then as new loans are written those properties would be escrowing the taxes, rather than having to come up with the full amount of the payment when the taxes are due. It is conceivable that as these loans are made, the demand for tax transfer could decline.

The Texas Legislature, and the voters of Texas, impose strict consumer protections on home equity loans. Home equity loans are similar to property tax loans in that property is being pledged to pay off the note, if the borrower defaults. The notes are different, however, in that a tax lien is imposed on the owner and the amount of taxes owed is determined by local governments. A home equity borrower can use the proceeds of the loan as he wishes, while the proceeds from a property tax note are used solely to pay off the taxes and the costs of originating the transfer.

“Because a house is such a valuable asset, Texas law also establishes limits on the use of home equity to protect homeowners from the risk of losing their homes.”⁵² The most important protection may be that a homeowner cannot borrow more than 80 percent of the equity he or she has in the property. Texans imposed this limit to keep homeowners from getting overextended, and to “protect our economy during times of economic slowdown.”⁵³ The provision is credited with lessening Texas’ losses during the housing crisis.

Other consumer protections include caps on closing costs and prepaid interest, a 12-day waiting period, a 3-day period to cancel the loan after closing, and only one home equity loan is issued at a time.

The amount of tax owed is not determined by a homeowner’s equity, but rather by local government taxation rates and property value. Thus, it is possible that the amount of taxes due can exceed a homeowner’s equity. Texas law mandating a 3-day cancellation period applies, but longer waiting periods could force homeowners into higher interest and penalties, if certain dates are passed.

Cost of Tax Lien Transfers and Government Penalties

In its August 2012 Property Tax Lending Study, the Office of Consumer Credit Commissioner compared the cost of tax lien transfers with remaining delinquencies, a 36-month installment plan, and using a credit card. The comparison found that over a five-year period, a tax transfer in February on an \$8,000 tax bill, at 14.37 percent interest with regular penalties, interest, collection penalties, and other fees, would cost more than 30 percent more than a 36-month installment plan. (The installment plan is only available on a residence homestead.) A tax

transfer in June under the same terms would cost 35 percent more than the installment plan.⁵⁴

As noted earlier, the average residential interest rate on a tax transfer is now 12.6 percent, so the cost difference has closed. Because of the great variability in interest rates, length of loans, collection fees, and lengths of payment plans, the results should be viewed as instructive, but not definitive. For example, the highest permitted interest rate on a property tax loan is 18 percent, and in 2008 when the average interest rate reported to OCCG was 17.41 percent, most borrowers were paying near that. The average residential rate in 2013 was 12.80, and that many mean homeowners using tax liens are paying less. However, if loans are being written for longer periods of time, then homeowners may be paying more overall. As another example, the maximum rate governmental units can contract with tax collection law firms is 20 percent of a delinquent tax bill. Many governmental units negotiate rates below the maximum, so certain homeowners face lower costs. These variables make general comparisons - especially comparisons of legal maximum of some options to averages of other options - inconclusive when attempting to determine the suitability of one option over another.

A property owner should research all the variables of all the options available to determine which is his or her best option.

Property Tax Loans When a Mortgage Exists

Most of the testimony the committee received centered around the relationship between property tax loans where a mortgage currently exists. Over 60 percent of property tax loans are made on property where a mortgage is outstanding. For about 70 years property tax liens were generally taken out by relatives or employees of property owners who could not pay their property tax bills. The volume of tax liens was low, and mortgage companies could deal with them on an individual basis, with people close to the property owner.

Events other than laws regarding property tax lending kept the industry from expanding and set up the growth the industry has seen in recent years. As noted earlier, as the original legislation was being passed in the Great Depression, the federal government created and backed long-term mortgages that required property taxes and insurance be escrowed in monthly payments. Once the mortgages became common, the vast property taxes were paid, unless the owner stopped making his monthly payments. There did not appear to be much need for tax transfers. Banks and other mortgage lenders knew almost immediately when a person was in danger of having governments apply a tax lien.

Over time, escrowing became less common, usually to try to lessen mortgage costs. While still the routine in the prime mortgage market, “[s]ubprime lenders dispense with mandatory escrows to keep monthly payments low. That’s an important lure because the interest rates they charge often are 3 percentage points or more above prime market rates, and many clients already have high debt and modest incomes.”⁵⁵ When the downturn in the economy hit, many of these homeowners found they were making less money, and could not make their lump sum property tax payments. Many noted that the higher risk borrowers who most need escrow accounts were not required to have them. As noted earlier, escrow requirements have been implemented for “higher-priced mortgage loans” secured by a consumer’s dwelling.

The computerization of tax records, enabling the data mining of public tax records, also made it easier to search for, and market to, delinquent taxpayers. Before the computer age, property tax lenders would have had to go to the county courthouse and search through records, a labor intensive process. Now, records can be “dumped” and sent electronically enabling lenders to search the records for delinquent properties very quickly from nearly anywhere.

The Financial Crisis, Housing Bubble, and the high unemployment of the Great Recession, jeopardized homeowners abilities to pay lump sum tax payments. In 1995, the Legislature increased the maximum allowable interest rate on a property tax loan from 10 percent to 18 percent, but that did not trigger dramatic growth in the industry. Twelve years later, just before the Great Recession, it was estimated that the industry consisted of about 20 companies writing \$75 million worth of loans per year.⁵⁶ A year later, 44 companies wrote more than \$119 million in loans.

The jump from about 20 companies in 2007 to 80 in 2013 means that as much as three-quarters of property tax lending companies might have been created in just six years. The changes and growth have made it difficult for mortgage lenders to adjust.

The OCCC’s 2012 study examined over one thousand loans, and one subset was loans that had been paid off. In this subset of 302 loans, mortgage companies paid off 130 loans, or 43 percent of the loans. For 113 of the loans that were paid off, there were 113 where the tax lender did not keep track of who paid off the loan. Fifty-nine loans were paid off by the borrower. For the 189 loans where it is possible to determine who paid off the loan, mortgage companies paid off 130 loans, or 69 percent.

Earlier it was noted that more than 60 percent of property tax loans are made on properties where a mortgage currently exists. Of the loans sampled by the OCCC, 216 of the loans that were paid off had a pre-existing mortgage. A mortgage company paid off 117 of those loans, or 54 percent. The borrower is only shown paying off 16 percent of those loans, but in 30 percent of the loans the records did not show who paid off the loans. From the loans surveyed by the OCCC, in 152 loans with a pre-existing mortgage it can be determined who paid off the loan. Mortgage companies paid off 117 of the 152 loans, or 77 percent.

The Texas Property Tax Lienholders Association reports that “roughly 12% of all principal payments are made by mortgage companies.”⁵⁷ The association is comprised of about 20 property tax loan companies, and estimates these companies make about 75 percent of lending activity.⁵⁸ They argue that the sample from the OCCC report is not representative of the industry’s portfolio.⁵⁹

Mortgage companies are not a party in a property tax loan, and they do not negotiate the terms. Yet, they may find themselves in the position of having to pay off a loan in order to protect their interests. Mortgage companies would be in a similar position for a tax default, but the governments’ terms are in statute and well known. Because those conditions were democratically adopted, the mortgage companies and banks had, and still have, some opportunity to influence those terms and penalties. The terms and conditions of a property tax loan are negotiated between a homeowner and property tax lender, without the primary lender on the property even knowing about the negotiations.

Of course, banks and mortgage companies have the same access to governmental tax delinquency information as do property tax lenders. Mortgage companies have begun to notify customers, especially those without escrow accounts and those who are delinquent on their mortgage payments, to contact their loan officer if they may have trouble paying their taxes. If mortgage companies feel compelled to mine tax records as property tax lenders do, then it is likely those costs will be passed on to consumers.

Mortgage companies and property tax lenders are essentially in a race to locate properties with delinquent tax bills with mortgages. If the property tax lender finds and signs them up first, then they stand to not only profit from the loan, but reduce their risk because another entity has been found the perhaps pay off the loan. If the mortgage company reaches the property owner first, then it may lessen its reduction in collateral, or reduce its losses, which would be the difference between what it might of paid the governments and what it will have to pay property tax lenders to clear the lien.

A borrower becoming delinquent on his taxes or using a property tax lenders may be violating his mortgage contract, and putting his mortgage in jeopardy. Most mortgages contain provisions stating that “allowing a priority lien to be imposed on the property (such as a tax lien) violates one of the promises in the deed of trust, and is an event of default.”⁶⁰ The borrower’s failure to comply with the provision puts the lender’s collateral at risk.⁶¹

The imposition of the lien, whether by government or property tax lender, reduces the owner’s equity, if there is any, and reduces the value of the collateral the mortgage was based on. This is especially a concern with “higher-priced mortgage loans” when the owner has little to no equity in the property for the first few years. The imposition of a tax lien can put a property “underwater,” meaning the debt secured by the property is greater than the value of the property.

If, for example, a homeowner had just \$5,000 in equity on his home, but owed \$8,000 in taxes, then \$3,000 of the collateral the bank based the loan on is lost. If this happens often enough, confidence in these loans and the banks that made them erodes.

When a borrower violates a provision of his or her mortgage for nonpayment of taxes, resulting in a tax lien, the mortgage company has a few options. First, the mortgage company could pay the taxes that are owed, and the owner’s cost would depend language in the mortgage. The lender could restructure the loan, adding in the additional costs and changing the payment schedule. The lender could also “call the loan,” demanding that it be paid off right away.

It is not unreasonable to assume that many borrowers are unaware that allowing a priority lien could jeopardize their mortgage. If lenders began calling loans due to these violations, assuming the terms of the mortgage lets them, homeowners could be much worse off than simply having a tax lien.

In fact, one law firm practicing in banking and financial institution law lays out as one way to mitigate the risk of tax lender liens that mortgage companies:

Consider whether to accelerate the loan balance to expedite foreclosure

proceedings by the lender in the event a tax lien is discovered when there is high likelihood the borrower will not be able to bring the loan current. Leaving the tax lender lien in place is never a good option as the fees and interest will adversely impact the economics of any loan from the lender's perspective if left in place. Often the tax lender is content to let it go for years without foreclosure since they are almost always over secured.⁶²

Homeowners with mortgages should consult with their lender about the terms of their mortgage regarding priority liens, and the possible and likely consequences of incurring a tax lien, before engaging in a practice that could seriously jeopardize their ability to stay in a home.

Conclusion

While property tax transfers have been permissible for decades, only recently did an industry develop. Over the last 20 years, the Texas Legislature has made statutory changes that have encouraged the industry and protect homeowners from unscrupulous practices. The industry has seen growth over the past decade attributable to many circumstances, but consumer protections at the federal level and the Legislature through the enactment of Senate Bill 247 are anticipated to slow the growth rate.

Senate Bill 247 has only been in effect for one tax payment cycle, and more time is needed to assimilate and judge the changes mandated by the bill.

Taxpayers are given about three months' notice of the amount and date taxes are due. The vast majority pay their tax bills on time, but, due to a variety of circumstances, some of those who own their house free and clear or do not escrow their property taxes can have trouble paying the lump sum tax payment due January 1st of each year. There are a few governmental options to help certain property owners, especially homeowners, work out payment of delinquent taxes.

Depending on an individual property owner's financial situation, there may be options available from commercial lenders, including property tax lenders. Over time interest rates on property tax loans have come down, but are still well above other loans secured by real estate. Legislative action has also brought down closing costs and other fees.

It is not uncommon, perhaps it is even likely, that a mortgage company will pay off a property tax loan, even though the mortgage company was not a party to the loan. Mortgage companies will do so to protect their collateral, and avoid the increasing fees and interest charges that erode their security under expensive property tax loans. A tax lien results in some diminution of collateral unless the owner cures the delinquency quickly. The penalties and interest imposed by governments is known to bankers and predictable, while the terms of property tax loans agreed to by a property owner and a property tax lender are not.

Recommendations

Incurring a tax lien on a property with an existing mortgage almost certainly violates the terms of that mortgage. Such violations can have serious consequences, including accelerating the loan

balance to expedite foreclosure. Many homeowners are unaware that incurring a tax lien violates the provisions of their mortgage, and if they do not consult with their mortgage loan officer to determine the mortgage company's policy for dealing with tax liens, they could end up losing their property. Because a borrower has an existing contract with a mortgage lender, and because incurring a tax lien probably violates the terms of that contract, the Texas Legislature should require delinquent property owners with an existing mortgage to notify their mortgage company that they anticipate incurring or have incurred a tax lien 10 days before signing a property tax loan.

Statistical evidence regarding how often mortgage companies pay off property tax loans, even though they are not a party to those loans, is disputed. The Texas Legislature should direct the Office of Consumer Credit Commissioner to collect information regarding how often mortgage companies pay off the loans, and whether they do so because the borrower has defaulted and the company is trying to protect its collateral.

WAGE THEFT

Study the impact of SB 1024 (82R) on wage theft and law enforcement's and regulatory agencies' responses to wage theft claims.

Background

Wage theft appears to be a common problem in the United States. While there is little statistical evidence regarding wage theft in Texas, there is no reason to believe that the issue would be less pervasive in the state. A recent study, extrapolating from previous city studies, estimates that wage theft could cost employees across the country some \$50 billion per year. By contrast, “all of the robberies, burglaries, larcenies, and motor vehicle thefts in the nation cost their victims less than \$14 billion in 2012.”⁶³

Wage theft takes many forms, any of which deny an employee wages or benefits they have rightfully earned. These include:

- Not paying workers;
- Minimum wage violations;
- Overtime violations;
- Off-the-clock violations;
- Misclassifying workers to avoid payment of benefits;
- Denial of work breaks;
- Not dispersing tips;
- Paychecks that bounce; and
- Denying last paychecks.

In addition to the wage theft, employees can often face illegal retaliation from the offending employer. Retaliation can take the form of threatening or actually firing or suspending an employee, reducing hours or pay, harassing or abusing employees, or giving the worker harder, more dangerous, or worse assignments.⁶⁴

While studies indicate wage theft occurs throughout the workforce, it appears that workers in low-wage job markets are more likely to be victims. For these workers, the impact can be greatest because losing even a small amount of wages can be a significant portion of their income. For example, shaving one half hour a day would reduce a minimum wage workers annual income by \$1,400, almost 10 percent of the employee’s annual income.⁶⁵

A survey of low-wage workers in New York, Chicago, and Los Angeles estimated that “these workers lost an average of \$2,634 annually due to work place violations, out of earnings of \$17,616,” or 15 percent of earnings.”⁶⁶

Unfortunately, studies show that almost all classes of workers can be victims of wage theft in some form, varying greatly in degree by industry and pay scale. But, it seems that those at the lower end of the economic scale are more likely to be victims. These are the major findings of a three-city study determining the most vulnerable victims:

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- Women were significantly more likely than men to experience minimum wage violations, and foreign-born workers were nearly twice as likely as their U.S.-born counterparts to have a minimum wage violation.
 - The higher minimum wage violation rate for foreign-born respondents was concentrated among women—especially women who are unauthorized immigrants.
 - Foreign-born Latino workers had the highest minimum wage violation rates of any racial/ethnic group. But among U.S.-born workers, there were significant race differences: African-American workers had a violation rate triple that of their white counterparts (who had by far the lowest violation rates in the sample).
 - Higher levels of education, longer job tenure, and English proficiency (for immigrants) each offered some protection from minimum wage violations. But even college-educated workers and those who had been with their employers for five or more years were still at significant risk.
 - Overtime, off-the-clock and meal break violations generally varied little by worker characteristics. On the whole, job and employer economical characteristics were more powerful predictors of the workplace violations considered in this study.⁶⁷

Attempting to Recover Wages

Victims of wage theft have four formal processes for attempting to recover wages. They can file claims with the Texas Workforce Commission, file claims with the Wage and Hour Division of the Department of Labor, file a criminal complaint under Section 31.04, Penal Code, or file a lawsuit.

Texas Workforce Commission

According to testimony from the Texas Workforce Commission (TWC), about 15,000 claims are submitted and investigated each year. For Fiscal Years 2011 through 2013, wages were awarded in an average of 6,479 claims per year. Through state statute, the TWC provides an administrative alternative to litigation.

Under Chapter 61 of the Labor Code, employees file claims with the commission. The commission can only investigate claims filed with 180 days of the date the wages became due for payment. Older claims fall outside the jurisdiction of Chapter 61, Labor Code. TWC then, by letter, notifies the employer that a wage claim has been filed and explains the process. The letter includes a form for the employer to respond to the claim. Once a response has been received, the claim is assigned to an investigator who makes a preliminary determination as to whether wages are owed. The determination may also conclude whether a violation of statute has occurred, and whether additional penalties should be assessed. If the order determines that an employer owes wages, the employer has 21 days to appeal the decision or pay the commission the owed wages.

Both parties have 21 days to appeal the decision to a TWC tribunal. Usually, a telephone hearing is conducted among the parties, and a written decision is mailed to the parties. Either party can appeal the decision to TWC commissioners, who will review the case and make a ruling. Either party can then take the matter to court as a further appeal.

The TWC has several options if an employer does not voluntarily pay wages after a decision. It can file to freeze bank accounts and levy the accounts for wages that are owed. The commission can also file property tax liens, and, if desired by the employee, TWC can assign the lien to the employee to take further legal action. Or, if the employer is owed money for services to the state, garnish that money to satisfy the wage debt.

Resolving claims under Chapter 61, Labor Code, can be a drawn out process. Employers often do not respond voluntarily with information, forcing TWC investigators to acquire the information on their own. Additionally, the appeals process can add weeks to the process. After the preliminary determination, up to three weeks can pass before an employer has to decide whether he wants to appeal. While that may be reasonable amount of time for the employer to assess his or her case and determine whether to appeal, the employee remains uncompensated during that time.⁶⁸

According to the Texas Workforce Commission's website, "It may take six to eight weeks" to receive the information regarding the appellate hearing, and that information will come "ten to twenty days before" the hearing. The Appeal Tribunal will mail the parties with its decision usually within five to ten business days. Thus, if an employee is granted wages through a preliminary decision, an appeal can add 11 to 14 weeks to the process.

Should either party disagree with the tribunal's decision, he or she may appeal to the TWC commissioners. The appellant has 14 days to decide whether to appeal. A TWC attorney will review the case, and make a recommendation to the commissioners. The commissioners will separately review the recommendation, vote on the case, and issue a written decision, which is then mailed to the participants.⁶⁹

Either party may appeal the commission's decision for judicial review. The commission and any other participating party must be made defendants in the suit. The appeal "is by trial de novo with the substantial evidence rule being the standard of review...."⁷⁰ If an employer who is determined to owe wages does not appeal, he or she must pay the commission within 30 days of the final adjudication. The commission then pays the employee.

While the process is an alternative to litigation, it is complicated and time consuming. Still, whether a case of wages denied or wages wrongfully claimed, due process is required. The commission may impose "bad faith" penalties against either party if it feels an employer has acted in bad faith in not paying wages or an employee has acted in bad faith in bringing a wage claim.⁷¹ The bad faith penalties are paid to the commission, rather than to the offended party. So if, for example, an employer delays paying through bad faith maneuvers, he may face a civil penalty, but the person who suffers most from the bad faith moves, the employee, is not compensated. Instead, the commission, which was only inconvenienced by the moves, receives the benefit of the penalty.

Federal Wage Claim

Another option for pursuing unpaid wages is for an employee to file with the Wage and Hour Division (WHD) of the United States Department of Labor. The division investigates violations of the Fair Labor Standards Act, the Family and Medical Leave Act, the Migrant and Seasonal

Agricultural Worker Protection Act, and other relevant federal statutes and rules. Unlike state investigations, the WHD can recover wages going back two years (three years for willful violations) from the time it files a federal court lawsuit.

The two-year statute of limitations on wages is not from the filing of the complaint, but rather from the date of the filing of a lawsuit. Because investigations take time, the filing of the lawsuit may be weeks for months after the filing of the claim. Wages going back more than two years from the filing of the lawsuit are not collectable.

While many investigations are initiated through complaints, the division can begin an investigation for a variety of reasons. For example, the WHD website says the following:

In addition to complaints, WHD selects certain types of businesses or industries for investigation. The WHD targets low-wage industries, for example, because of high rates of violations or egregious violations, the employment of vulnerable workers, or rapid changes in an industry such as growth or decline. Occasionally, a number of businesses in a specific geographic area will be examined. The objective of targeted investigations is to improve compliance with the laws in those businesses, industries, or localities.

Often, cases are resolved simply by phone calls. These cases, known as conciliations are usually single violations, such as a missed paycheck, or involve only one worker. WHD contacts the employer, explains the law and the nature of the complaint. If WHD finds a violation has occurred it can assess back wages, and impose further penalties for repeated or willful violations.⁷²

While many claims are handled at the administrative level, the WHD has a variety of enforcement techniques available, depending on statute. Under the Fair Labor Standards Act, for example:

- An employee may file suit to recover back wages, and an equal amount in liquidated damages, plus attorney's fees and court costs.
- The Secretary of Labor may file suit on behalf of employees for back wages and an equal amount in liquidated damages.
- The Secretary may obtain a court injunction to restrain any person from violating the law, including unlawfully withholding proper minimum wage and overtime pay.
- Civil money penalties may be assessed for child labor violations and for repeat and/or willful violations of FLSA's minimum wage or overtime requirements.
- Employers who have willfully violated the law may face criminal penalties, including fines and imprisonment.
- Employees who have filed complaints or provided information during an investigation are protected under the law. They may not be discriminated against or discharged for having done so. If they are, they may file a suit or the Secretary of Labor may file a suit on their behalf for relief, including reinstatement to their jobs and payment of wages lost plus monetary damages.

Many of these provisions are repeated in other statutes enforced by the WHD.⁷³

According to its 2013 budget request, “WHD utilized over 1,000 investigators during FY 2011. WHD also completed 33,295 compliance actions and collected more than \$224 million in back wages for more than 275,000 workers during FY 2011.”⁷⁴ It is an average of about \$815 per worker.

Criminal Complaints

An employee may file a criminal complaint under Section 31.04, Theft of Service, Penal Code. In 2011, with the passage of S.B. 1024, the Texas Legislature strengthened law enforcement’s ability to prosecute cases by removing a partial payment loophole.

Under the law prior to 2011, employers often would make a partial payment of wages owed to avoid prosecution. The 2011 law stated that partial payment was not sufficient to negate the actor’s intent to steal the service.

As noted by the average recovery statistics per worker cited above, cases involve a few hundred to perhaps a few thousand dollars. Under the Texas penal code, these cases would generally be Class A misdemeanors or state jail felonies.

The applicable parts of the statute, theft of service occurs in an actor “with intent to avoid payment for service that the actor knows is provided only for compensation...the actor failed to make payment under a service agreement within 10 days after receiving notice demanding payment...” Thus, an employee must send a demand notice in compliance with the statute to the employer, and, if the employer does not make full payment, the employee can file a theft of service report with police.

The matter is then up to police to investigate and determine the proper course of action. Some departments have established a protocol for investigating cases, while other departments handle the cases on an individual basis. Those who have used the system say that it is not suitable for all cases, but can be very effective when suitable.

For example, the Workers Defense Project in Austin referred to law enforcement 58 cases in 2012, and 60 in 2013. The WDP reports that 85 percent of cases are resolved in the demand letter or negotiation phase, with the police investigator making on a call to the employer. Of the 60 cases filed in 2013, only 5 resulted in the arrest of the employer.

The WDP reports that some employers feel they are “judgement proof” in the administrative processes under TWC and WHD because they are small in size or lack sufficient cash flow. These employers often pay owed wages when police inform them that they may face arrest, trial, fees, and court costs if the matter remains unresolved.⁷⁵ While it might be rare that police would set out to arrest an employer, once a warrant is in police computer systems, a traffic violation or some other minor violation could result in an arrest - similar to the way police handle failure to appear warrants and other lesser charges.

Civil Lawsuit

While employees who are owed wages have the option to file a civil lawsuit against the employer, the option is rarely used. Because most cases involve a few hundred to a few thousand dollars, the vast majority would fall under small claims court. Certainly, the cost of hiring an attorney is often considerably more than amount of wages sought.

Small claims court is a less formal procedure for resolving money disputes, but the plaintiff (employee) will have to pay a filing fee and a citation fee when the suit is filed. Employees who have been denied or shortchanged on their wages often cannot afford these up-front fees. Filing often must be done in person, which is less convenient than the administrative procedures or the criminal complaint.

Rather than having an agency or police investigator gathering evidence, the employee must gather the evidence and argue the case. The process can be intimidating and costly, thus it is rarely used.

Wage theft is commonplace across the United States, and while there are no broad studies specifically on Texas, there is no reason to believe that it is less common here. Considering that minority and low-wage employees may be most vulnerable, it is possible that Texas, with its high minority population, may have a higher rate of occurrence. A University of Texas study found that one out of every five construction workers in Texas has experienced wage theft.⁷⁶

Wage theft steals from workers who often cannot afford the loss. Studies show that wage theft occurs throughout the workforce, but that women, minorities, and low-wage workers may be most vulnerable. Certainly those populations are least able to absorb the losses.

Wage theft also places law-abiding businesses at a competitive disadvantage. If an employer rightfully obeys minimum wage and overtime laws, while a competitor does not, the employer will find it much harder to compete in the marketplace. Essentially, wage theft compromises the operation of free markets. An unlawful competitive advantage rewards thieves at the expense of working families and responsible businesses.

Conclusion

Senate Bill 1024 has improved workers' ability to collect wages. As police departments work through the changes and exchange information on best practices, criminal complaints will become more common, and handling those claims will become more efficient. It is important to note that criminal complaints are not suitable for most cases, and victims, advocates, and police will need to make determinations on the best ways to pursue wage theft claims.

Recommendations

The Texas Legislature needs more information on wage theft in Texas to determine the scope and impact of the problem. The Texas Legislature should direct the Texas Comptroller of Public Accounts to study and report back to the Legislature the economic impact of wage theft in Texas, specifically examining which demographic groups are most vulnerable, the economic loss suffered by employees, and negative impact on law-abiding businesses. Additionally, the Legislature should direct the Texas Workforce Commission to study and report back to the

Legislature the substantive and procedural differences between state wage theft recovery efforts and federal efforts, and recommend ways to reconcile the differences.

EMPLOYEE MISCLASSIFICATION

Examine the issues of misclassifying employees as independent contractors on workers, employers, income tax withholding, and the unemployment insurance system. Review current statutory deterrents, including those required by HB 2015 (83R).

Background

The United States' economy has experienced some reorganization during and following the "Great Recession." Businesses use more part time workers and more frequently contract out some services.

The reasons for these changes are myriad, but include reducing costs, handling seasonal business activity, systems upgrades to aid permanent employees, improve response times to changing economic conditions and contracting of routine administrative functions. Some workers may prefer to work as independent contractors to have more control over their work schedules or better control their tax payments.⁷⁷

"Employee misclassification not only deprives workers of their rightful wages and benefits, it also undercuts honest employers by placing them at a competitive disadvantage for obeying the law."

Cynthia Watson,
regional administrator for the Wage and Hour
Division in the Southwest, U.S. Department
of Labor

As a consequence of these changes, many traditional employees have been replaced with "independent contractors." These independent contractors are compensated differently than employees, and their rights, benefits, responsibilities, and duties, are different as well. While many businesses have made the shift, a good many of them do not realize the complicated legal issues involved.⁷⁸ A wide variety of conditions impact whether a business can treat someone as an independent contractor, or must treat them as an employee.

The economic incentives to classify a worker as an independent contractors are great, and studies show that a significant percentage of independent contractors are misclassified, and are actually employees. The impact of the misclassification can undermine free markets, damage law abiding businesses, deprive employees of wages and other legal rights, and lessen governmental revenues, thus shifting the burden on to other taxpayers.

Determining Correct Classification

Generally, a person is an employee if he or she "is subject to another's right to control the manner and means of performing the work." Independent contractors usually provide services to customers who do not control the manner in which the services are provided. Different laws establish different standards as to whether a worker is an employee or independent contractor, which makes it complicated how to classify a worker.⁷⁹ There are numerous comprehensive tests that take into account numerous factors which courts have created to define independent contractors and employee status.

The Internal Revenue Service (IRS) for instance, has what is known collectively as the 20-factor test, also known as the common law control test. All factors to be considered generally fall within three categories: behavioral, financial, and type of relationship. Any decision based on an incomplete set of facts may be wrong, however. Each factor's degree of importance varies

depending on the occupation and the facts involved in each particular case.

Behavioral control refers to facts that show the types of instruction given, such as when and where to work, what tools or equipment to use, etc. This also includes the degree of instruction, which means that the more detailed the instructions, the more control the business exercises over the worker, which usually indicates that the worker is an employee. Behavioral control also takes into account evaluation system measures and training. If the business provides training on how to do the job, this shows that the business wants the job done in a particular way. This then gives strong evidence that the worker is in fact an employee.

Financial control refers to facts that show whether or not the business has the right to control the economic aspects of the workers job. This includes looking at significant investments, such as equipment, which true independent contractors usually have a substantial financial investment in with their independent business. Unreimbursed expenses, which independent contractors are more likely to have also give a good indication of one's title. Another important factor, including whether the workers' services are freely available to the market and the method of payment. Generally, a worker paid by the employer in regular amounts at stated intervals - such as every week or every two weeks - will be considered an employee.

The last common law method in trying to determine whether a worker is an employee or independent contractor is to look into their type of relationship. This refers to facts that show how the worker and business perceive their relationship to each other. This can include written contracts, employee benefits, permanency of the relationship and services provided as key activity of the business. An employee often continues to work for the same employer month after month or year after year, whereas, an independent contractor is usually hired to do one job of limited or indefinite duration and has no expectation of returning.

If after reviewing the three categories of evidence, it is still undetermined whether a worker is an employee or an independent contractor, there is a more extensive "20 factor" comparative test developed by the IRS and currently used by the Texas Workforce Commission.⁸⁰

Unfair Advantages of Misclassifying

While determining proper classification can be difficult, and undoubtedly many businesses simply make an incorrect determination because of that complexity, misclassifying employees can result in cutting labor costs by up to 30 percent.⁸¹ By classifying employees as independent contractors, whether by mistake or intent, employers avoid financial obligations that properly classifying employers will face.

The list of undeserved advantages gained by misclassifying employees include:

- Evading labor laws that apply employer-employee relationship, such as paying the minimum wage, paying overtime, and prohibitions against child labor.
- Avoiding the cost of litigation involving civil rights violations for employment discrimination based on age, race, gender, color, religion, or national origin. Avoiding the cost of litigation for sexual harassment violations.
- Depriving some workers of health and pension benefits available to other employees.

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- Eluding liability for worker's injuries suffered on the job, perhaps forcing hospitals and public health programs to pay the cost. Reducing costs for workers compensation insurance.
 - Cut costs by not withholding federal income taxes.
 - Cut costs by not matching Social Security and Medicare tax payments. Transferring employer costs to employees who must make full Social Security and Medicare payments out of their wages, instead of combining with employer match. Transferring future living and health costs of workers to other taxpayers.
 - Avoiding payments for unemployment insurance. Denying employees rightfully earned unemployment insurance, perhaps forcing them into taxpayer-funded welfare programs.
 - Denying the various protections for employees who need time off for medical problems or the birth or adoption of a child.
 - Avoiding costs associated with administration of payroll.
 - Bypassing verification that employees are U.S. citizens or covered by work visas.
 - Enabling noncustodial parents to avoid child support payments by not garnishing wages, thus denying children a better quality of life and perhaps forcing them into taxpayer funded welfare programs.

Many of the times on this list directly benefit the employer at the expense of the employee, but by no means are the negative effects limited to employees and their families. A misclassifying employer compromises free markets through unfair competition and promulgates lawlessness.

Several studies on the economic impact of misclassification have attempted to quantify the cost advantage of misclassifying employees. These studies have generally found that payroll costs can be reduced by 15 to 30 percent, but can be even higher in some industries.⁸² Honest businesses often cannot compete against a competitor with such a huge, but ill-gotten advantage. The free market is compromised when some competitors gain an illegal advantage over those who rightfully obey the law.

These studies conclude that a business that profits from knowingly misclassifying its workers may ignore other laws as well. As honest businesses lose work to misclassifying businesses, they may feel the pressure to break the law in order to stay competitive. Such a response would amplify the disrespect for the laws and regulations that are meant to apply to all market participants.⁸³

Misclassifying employees can also have a negative impact on government revenues. If an employer does not deduct income tax withholdings, Social Security taxes, and Medicare taxes, the federal government suffers losses in those programs. Injured workers can cost hospitals substantial sums when the misclassifying employer avoids his responsibility for that injured worker's medical costs and lost wages. It is certainly conceivable that an injured employee or his or her family may be forced onto public assistance in order to survive. Because the misclassifying employer has not withheld taxes or paid his match, the burden for his employee is transferred onto responsible taxpayers.

Misclassification in Texas

In Texas, the extent and cost of the misclassification problem is largely unknown. Unlike some

other states, Texas has not taken on a comprehensive study to attempt to determine how pervasive misclassification is and how it impacts the state's markets and social programs. It is not unreasonable to assume that Texas' problem is about the same as other states.

The Texas Workforce Commission (TWC) is the state agency charged with determining whether an employee is misclassified. The United States Department of Labor (DOL) and the Internal Revenue Service (IRS) investigate and enforce misclassification at the federal level. By DOL rule, the TWC must audit one percent of employers to ensure compliance with unemployment insurance laws. About half of these audits are targeted at certain industries with high incidences of violations, but the businesses selected in those industries are selected randomly. The other half of the audits are generated by complaints and claims against specific employers.⁸⁴

"Those of us...who have chosen to run honorable companies are facing a situation where we don't know if we can stay in business."

Don Dyer
CEO
Professional Janitorial Services

In calendar year 2013, TWC conducted 6,158 audits. Of those, 1,776 audits, or 28.8 percent, found at least one employee who was misclassified as an independent contractor. TWC reports that 19,960 employees were misclassified in those 1,776 audits. Without knowing how many employees the audits covered, it cannot be determined what percentage of employees were misclassified. On average, however, more than 11 employees were misclassified for each audit where violations were found.

TWC reports that the wages for the wrongly classified employees totaled more than \$174 million, and, as a result, about \$2.3 million were owed in uncollected unemployment insurance taxes.⁸⁵ The employer must pay the past due taxes, plus interest of 1.5% per month, up to a maximum of 37.5%.⁸⁶

Audits are not the only way TWC finds violations. Laid off workers who were classified as independent contractors often file unemployment claims after they are fired. TWC investigated 9,480 businesses for this type of claim in 2013, and found that 2,454 businesses, or 25.9%, misclassified at least one worker. The total number of employees found to be misclassified by these businesses was 16,608. With wages for these workers totaling \$122.1 million, more than \$1.5 million was owed in unemployment insurance taxes.

The result of all types of investigations that lead to finding misclassified employees in 2013 found 60,680 employees who had been misclassified, and more than \$8.6 million owed in unpaid taxes.⁸⁷ The Texas labor force in 2013 was about 12.7 million people.⁸⁸

The DOL and IRS also conducted investigations. The DOL has made the results of a few investigations public through press releases, but the committee was unable to obtain total figures for the State of Texas. Investigations by the IRS are kept confidential by federal law. The TWC reported the audit results by industry. Of the 6,158 audits conducted, 752 were for businesses in the construction industry. Of those, 283, or 37.6% were found to have misclassified at least one employee. Those businesses misclassified 3,638 employees, or an average of almost 13 employees per business.

The TWC conducted 906 audits in the Accommodation and Food Service industry. Of those, 177 businesses, or 19.5% were found to have misclassified at least one employee. A total of 1,687 employees were found to have been misclassified.⁸⁹ (The full spreadsheet for all industries is reproduced in the appendix of this report.)

It should be noted that while the businesses audited are selected randomly, the number of audits may or may not be sufficient to develop statistically valid information about the rates at which employers misclassify, and the rate at which employees are misclassified. The purpose of the audits is to ensure compliance. The number of businesses to audit was not determined for a statistical analysis of misclassification of employees in Texas.

The data seems to confirm that Texas is like many other states in regard to general misclassification: misclassification occurs throughout the economy, but certain industries have higher rates of misclassification than others.

HB 2015

In the 83rd Regular Session of the Texas Legislature, House Bill 2015 passed to “establish that an employer (general contractors and subcontractors or person) awarded a contract for public works must ensure that any individual performing services under such contract (including individuals working for subcontractors) are properly classified as an employee or independent contractor.”⁹⁰ Violations of the law can result in fines of up to \$200 per misclassified employee payable to the Texas Workforce Commission. The law prohibits the TWC from collecting fines “after the third anniversary of the date on which the violation occurred.” The law took effect on January 1, 2014, and applies to violations that occur on or after that date.

The TWC reported that, until the conclusion of the 2014 calendar year and additional time to review any cases that were finally adjudicated, it is too soon to determine the effectiveness of the law. This committee looks forward to a report from the TWC in the 84th Regular Session.

Conclusion

Misclassifying employees provides some employers with an illegal competitive advantage over employers who classify employees correctly. Misclassifying employers save money on income tax withholding, Social Security taxes, Medicare taxes, child support garnishment, unemployment insurance taxes, and avoid workers compensation insurance premiums and liability. Employees who are misclassified lose rights and privileges, such as guaranteed minimum wage and overtime, and protection from discrimination and harassment.

Recommendation

The misclassification of employees occurs throughout the Texas economy. The 84th Texas Legislature should direct the Comptroller of Public Accounts, with the help of the Texas Workforce Commission, to thoroughly study the economic impact of misclassifying employees on markets, industries, and individuals, and report the findings with recommendations to the Legislature.

CREDIT CARD DATA THEFT

Study the impact of credit card data theft and other credit or privacy information theft on Texas consumers and businesses.

Background

The theft of credit card information and personal information regarding customers stored by retailers has become a common occurrence. Routinely, the media break news of major corporations and banks data systems being breached by hackers and other cybercriminals, stealing credit card numbers and other information from, hundreds of thousands of customers.

While data breaches had occurred before, the breach of Target's system captured the public's attention because of its size. Between November 27 and December 18 of 2013, cybercriminals stole information on as many as 110 million customers. These criminals gained access to Target's system through security flaws in the software used by vendors worked for Target. (See graph on page __ to how the Target breach occurred.)

Similar data breaches at Home Depot, Neiman Marcus, Michael's, White Lodging, Sony PlayStation Network and Sony Online Entertainment, JPMorgan Chase, the Office of the Texas Comptroller of Public Accounts, Dairy Queen, Staples, and other business have captured the public's attention, and cost vast amounts of money. Some cybersecurity experts believe that regional retailers, who have lesser security measures, will be next in line, if they are not under attack.⁹¹

While most thieves are after financial information, such as credit and debit card numbers, others have targeted information regarding purchasing patterns and medical records, too.

While the credit card system was originally designed as a secure and convenient way to make transactions, businesses have "piggybacked" onto the system to track customer activity. So, at many businesses a credit card transaction yields both payment information and personal information. The financial transaction is payment information. By using unique identifiers in the credit card system, businesses develop personal information by keeping track of what individual customers have purchased. That personal information is then used to target marketing efforts at individual customers.

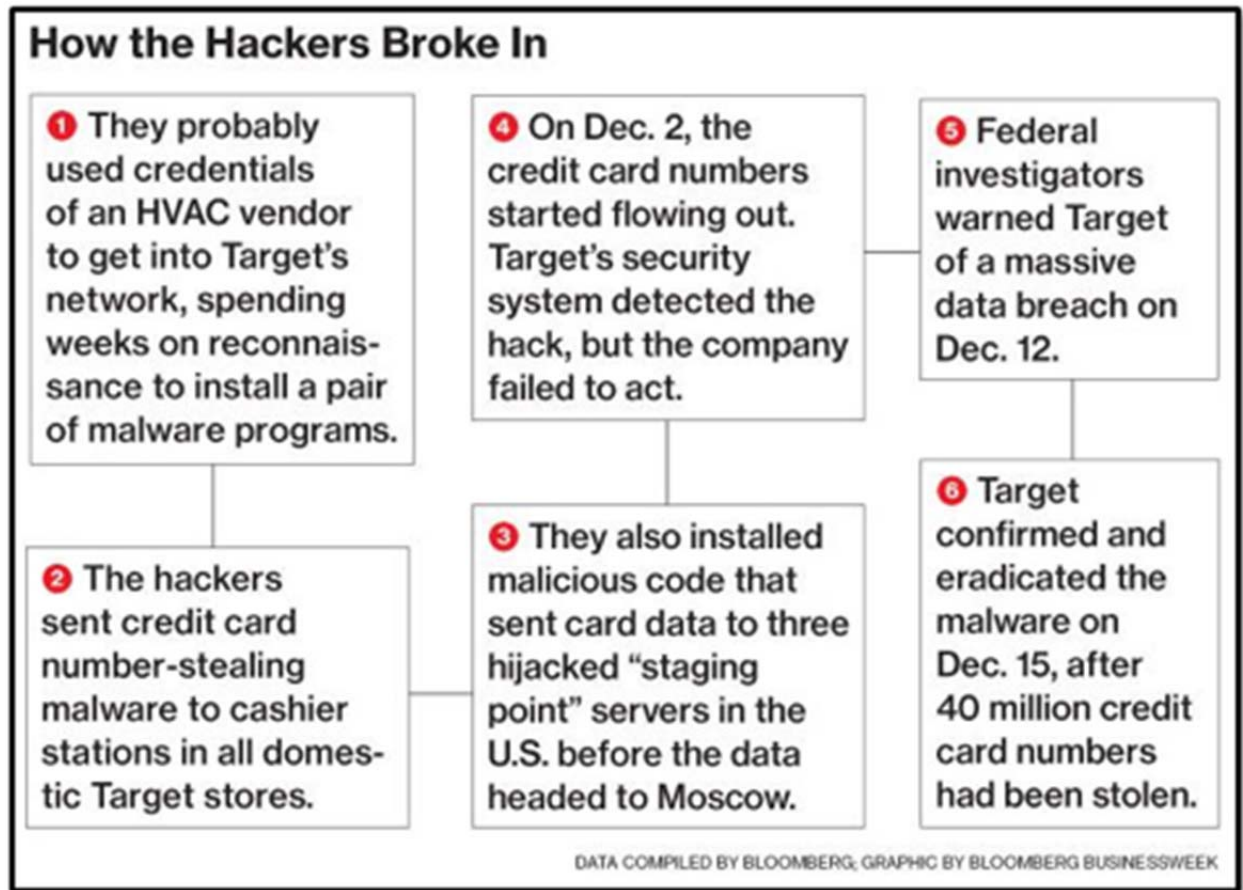
In the Target case, both types of information was stolen. Some 40 million customers had their payment information compromised, and 70 million customers had their personal information stolen. How many individuals or families are in both categories is unknown, but assuming no overlap, Target says that as many as 110 million individuals could be affected.⁹²

Mega-breaches (involving more than 100,000 compromised records) continue to garner headlines. The JPMorgan Chase breach affected 76 million customers holding 83 million accounts.⁹³ The Home Depot breach hit 53 million customers⁹⁴.

Determining the aggregate cost of these breaches is incalculable. Cybercriminals wait months, if not years, before using only a small portion of the information they have stolen to obtain money or merchandise. Thus, the significant impact of a data breach may not occur until well after the data was originally stolen.

Additionally, banks handle the theft of credit card information differently. Some replace cards

immediately, others increase the monitoring of accounts. Because they are often participating in law enforcement investigations, banks and businesses are often asked not to delay disclosure or not disclose the losses they suffer. Often; the disclosure of the breach is not publicly revealed until months after the last information is taken and security upgrades are made.



The cost of replacing debit and credit cards varies widely, adding to the difficulty in determining aggregate losses. Information systems that are breached must undertake additional expenses to secure the network, and ongoing expenses in an effort to prevent further attacks.

Further, it can take weeks, if not months, to detect that information is being stolen. There are, undoubtedly, breaches that are ongoing that no one is aware of. Some businesses may never publicly announce a breach, but work with customers individually as fraud is detected.

While the total cost of breaches, records compromised, and individual's affected is incalculable, some have attempted to estimate the costs, but each methodology has its own flaws. For example, the Center for Strategic and International Studies estimates the cost to the U.S. economy was between \$20 billion and \$140 billion dollars in 2012.⁹⁵ Considering that the report was published before the Target and subsequent mega-breaches, the estimates are almost certain to increase in the coming years.

It appears that theft of data is increasing exponentially, and estimates simply cannot keep up. When tens of millions of individuals can be added to the totals on any particular day, estimating

models can be skewed greatly. While the number of exposed individuals is great, only a fraction may feel a negative impact.

It is important to remember that not every one of these victims will have his or her identity stolen or bank account raided. In fact, a low percentage of them will actually suffer that kind of direct loss. But every one of them is at risk of it because once your personal information is outside of your control your options are limited. You can start credit monitoring and get new credit cards, but to a large degree your best hope is that the information becomes stale before someone tries to use it themselves or sell it on the thriving black market.⁹⁶

In August of 2014, the United States Secret Services estimated that more than 1,000 U.S. businesses, with thousands of stores, had been hit by the "Back off" malware, which attempts to break into point-of-sale networks and steal credit card numbers.⁹⁷ Point-of-sale networks are vulnerable to attack at several points. (See chart on next page.)

Banks, retailers, and many other industries spend billions of dollars every year to protect their data and consumer data. Whether the breach occurs at a bank, retailer, other business, or in the transaction process, banks issuing credit cards face costs as a result. Costs vary widely depending on how the bank decides to handle the breach.

A recent study found that the cost of a breach at a financial institution can range between \$66,000 and \$938,000 depending on the size of the company. Another survey of financial institutions found that for the Target breach banks lost \$331 per debit card fraudulently used, and \$530 per credit card fraudulently used. Most of the costs are "charge offs" for losses due to fraud. It should be noted that only a small percentage of the card information stolen has been used.

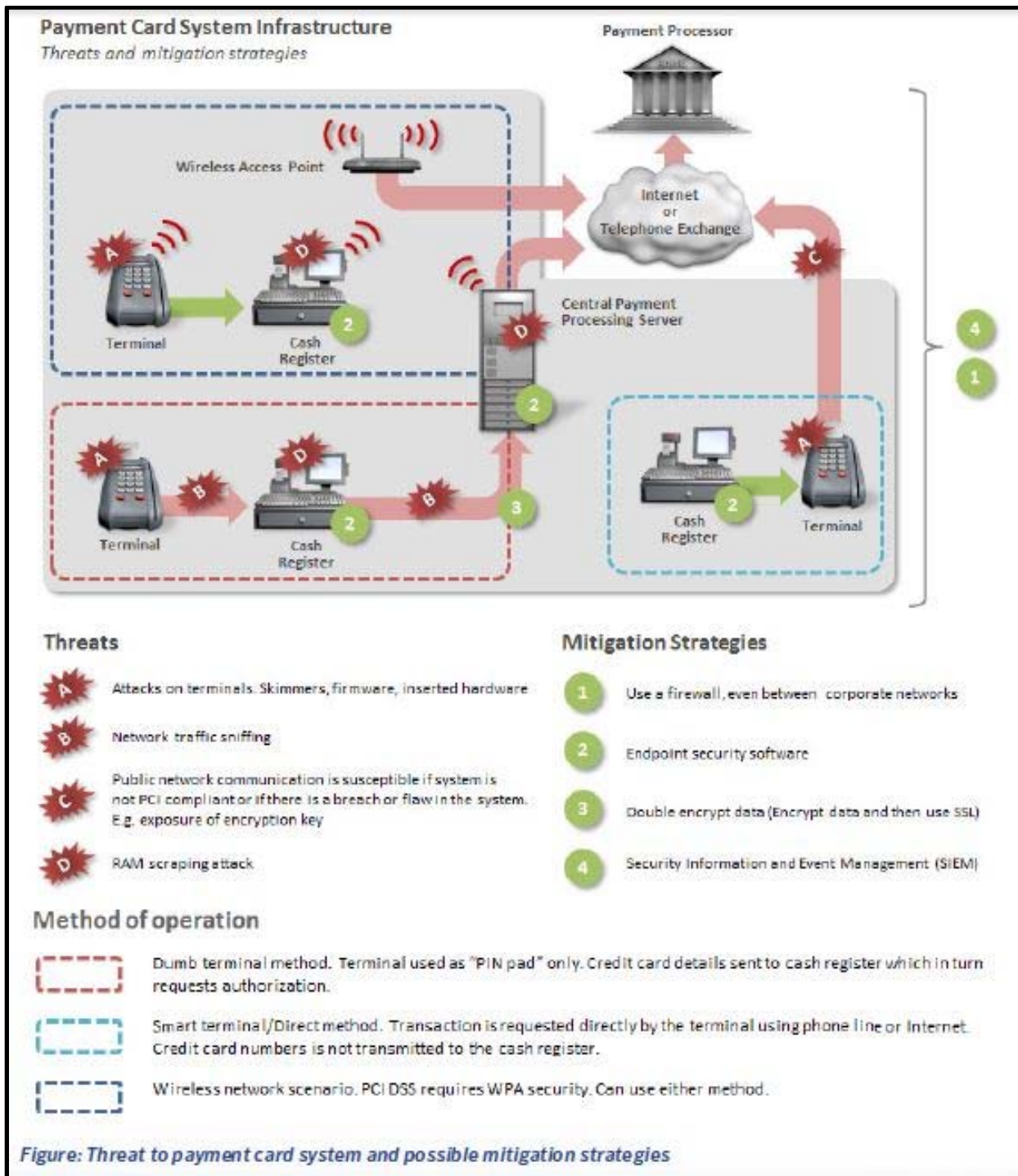
Small banks spend about \$11 per debit card reissued, while large banks, taking advantage of economies of scale, spend about \$2.70 per reissued debit card. The cost for reissuing credit cards ranges from \$2.99 for larger banks to \$12.75 for community banks.

Card reissuing is only part of the cost banks face. Other less tangible costs include damage to reputations, stock value, loss of employee morale, increased customer service calls, technology costs to close the breach, and loss of customers.⁹⁸ Many of these same costs will fall on retailers whose systems are breached.

The Texas Credit Union Association told the committee that its members reissued 393,000 cards to customers due to the Target and Neiman Marcus breaches at a cost of about \$5.83 per card. Financial losses due to those breaches was about \$30 million as of late March 2014.⁹⁹ The Independent Bankers Association of Texas reported its members lost about \$15 million in the 120 days following the mega-breaches that occurred at the end of 2013.¹⁰⁰

The credit card system is a key transaction method worldwide. The card essentially establishes a revolving account and line of credit for the account holder. This enables the consumer to purchase items when needed, rather than waiting until the consumer has the cash to pay for the item. In addition to leveraging the consumer's purchasing power, it offers greater convenience and security than using cash. Any loss in confidence in the credit card system would have an

impact on the overall economy.



Source: A Special Report on Attack of Point of Sales Systems, Symantec, Feb. 3, 2014

Suggestions for Legislative Action

The committee took testimony on the issue of data breaches and received suggestions to make the credit card system more secure. The magnetic strip on credit cards is a particular

vulnerability, and those that testified stated that it needed to be changed. The technology dates back to the 1970s, and is not adequately secure in today's technological environment. Europe has had a more secure system for years, but the United States has been slow to make changes because of the cost and inconvenience of implementing the security measures.

Soon, the credit card companies will start to issue cards with EMV technology, commonly referred to as "chip and pin." EMV cards contain embedded microprocessors that generate a one-time code, known as tokenization, for each transaction, rather than reading the credit card number. So, when data breaches of transaction information occur, the one-time code number is essentially useless because it cannot be used again.

The cards are also much more difficult to clone and use fraudulently¹⁰¹. The EMV cards will greatly reduce fraud and the use of counterfeit cards in face-to-face transactions.¹⁰² The cards do not increase security of online and mobile transactions, however, which have become larger targets in countries using EMV cards.¹⁰³ While tokenization methods are being developed for online and mobile transactions, system-wide implementation is not on the immediate horizon for those transactions.

The EMV cards are commonly called "chip and pin" because the card has a microprocessor and, at least in Europe, the personal identity number, or pin, is also required. The U.S. will use a "chip and signature" method instead, so, rather than entering a pin, card users will sign their names, much as they do today.¹⁰⁴

The U.S. as a whole did not adopt the EMV security measures, which were developed in 1996, earlier for a variety of reasons. U.S. telecommunication structure was much more developed than in Europe, so merchants and banks continued to use systems developed for that network for real-time authentication. Additionally, pin pads don't work in all environments, especially when the total of a purchase is unknown. For example, at a restaurant a diner's credit card is run less the tip, which is added later. If pin technology is required, restaurants would have to find a way for diners to enter their pins tableside.

Retailers have also been concerned that the use of pins slows down the transaction process, thus lengthening checkout lines and inconveniencing customers.¹⁰⁵

By October of 2015, the credit card companies intend to make changes that may force retailers to upgrade systems. Visa and MasterCard will shift the liability for unauthorized transactions, which has traditionally fallen on the banks, to the party that employs the less secure technology. So, if a retailer does not upgrade his registers to handle EMV cards, the retailer would face exposure that does not fall on retailers today. If banks do not issue EMV cards, liability could fall on them.

Merchants and card issuers will have to pay costs up front to protect themselves from the liability shift. Many believe that the upgrade costs will be far less than the potential direct losses, plus the losses that come from publicized data breaches. The cost to merchants is expected to be \$200 to \$600 per card reader.

The liability shift will not take place until October of 2015, and undoubtedly some merchants

and banks will delay adopting the new technology. Even if all met the deadline, there is still a good amount of time before October 2015 when vulnerabilities continue to exist. Still, any legislative mandate would not take effect until approximately September of 2015, just before the liability shift.

Additionally, the time-consuming process of developing, adopting, and implementing legislation could result in standards that are out of date by the time they are implemented, considering how rapidly cybercriminals adopt new methods steal information. A patchwork of state regulations might also make it harder for companies doing business in several states to comply with regulations. State regulations might also be limited because many of the transactions will be interstate commerce, which is specifically regulated by Congress.

A collection of organizations representing a variety of financial institutions, while asking for a national standard data protection and consumer notice to replace the current patchwork of state laws, specifically requested that lawmakers not endorse one solution.

Threats to data security are ever changing and unpredictable. Therefore, policymakers should not mandate or embrace any one solution or technology, such as EMV, as the answers to all concerns. As the threat evolves, so too must coordinated efforts to combat fraud and data theft that harm customers.¹⁰⁶

Recommendations

The Legislature should continue to closely monitor developments regarding data breaches and cybersecurity. Because the deadline to transition to new EMV technology almost coincides with the implementation date of legislation passed in the 84th Regular Session, the committee recommends the Legislature closely monitor the implementation of EMV technology.

The Legislature should examine the cost to state agencies to adopt the new technology, assess the risks of maintaining current technology, and determine whether to direct agencies to make the transition and how to pay for any upgrades. To assist the 84th Legislature, the committee has asked the Legislative Budget Board and the Office of the Comptroller of Public Accounts to begin to study the costs and benefits to state agencies of adopting the new EMV technology.

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