# Community and Economic Development in North Carolina and Beyond Blog: Local Government as Lender: Emergency Loans for Small Businesses

**By Tyler Mulligan**

**Article: https://ced.sog.unc.edu/local-government-as-lender-emergency-loans-for-small-businesses/**

**This entry was posted on March 20, 2020 and is filed under Development Finance Initiative, Downtown & Main Street, Economic Development**

Economic activity can be disrupted by any number of unanticipated emergencies, ranging from natural disasters to virus outbreaks like COVID-19. When these events threaten the survival of small businesses, the owners may turn to government for assistance. One legal and effective way for a government to assist a small business with weathering a crisis is by providing an emergency loan. The loan allows the business to maintain operations when cash flow is severely constrained due to disruptions in demand. Loans are a common tool in these situations. For example, the federal Small Business Administration (SBA) offers disaster assistance loans to businesses that are impacted by natural disasters. SBA loans offer interest rates between 4% to 8% depending on a borrower's ability to access other credit (see SBA disaster loan web page here). North Carolina is designated as eligible for SBA loans in response to the coronavirus outbreak.

Local governments may have the means and desire to offer their own local loan programs for small businesses during a crisis. Such loans could provide financing for businesses that cannot qualify for SBA loans or may provide bridge financing until an SBA loan is obtained. This post provides legal and practical guidance for local governments who wish to design and offer such loans.

## Legal Authority

When state constitutions across the nation were written decades ago, they included "gift clauses" to ensure that state and local governments did not make gifts to private entities (see this law review article). In North Carolina, a local government isn't even allowed to make a donation to a charitable nonprofit entity. See my faculty colleague Frayda Bluestein's blog post on the topic here. A local government can enter into a contract with a private entity and pay the entity a reasonable price for a valuable public service (such as paying a business to repair the roof of a public building), but the government cannot make a gift to a private entity.

A loan is not an unconstitutional gift so long as the loan is reasonably secured with collateral and carries an appropriate risk-adjusted interest rate based on the terms and collateral provided. An artificially low interest rate on a government loan would essentially amount to an impermissible gift to the business (equivalent to paying the interest on behalf of the business). In addition, low-interest government loans would cause businesses to obtain capital from the government rather than seeking conventional commercial bank loans—placing the local government in direct competition with private banks, in violation of long-standing law. *See* Mitchell v. North Carolina Ind. Dev. Fin. Auth., 273 N.C. 137, 156 (1968) (stating that "it is not the function of government to engage in private business"); Nash v. Town of Tarboro, 227 N.C. 283 (1947) (holding it is not a public purpose for a town to own and operate a hotel).

The North Carolina Attorney General, in a 1999 opinion, advised the General Assembly about a proposed disaster relief program that would include low-interest loans for businesses. To conform with the state constitution, the Attorney General advised the General Assembly to limit aid to persons "(1) who reside within the disaster zone (2) whose home, farm or business suffered *substantial damage* as a consequence of the disaster and (3) who *have not otherwise been fully compensated for that damage*" (emphasis added). This evaluation would need to occur after considering other forms of relief received by a business, so providing low-interest loans at the outset of a crisis is not consistent with the opinion.

Authority for offering small business loans is found in several North Carolina statutes. For example:

- G.S. 158-7.1(a) provides broad authority to make appropriations for "economic development purposes." Economic development is undefined in the statute but is generally understood to mean public activities to support private creation of jobs and tax base in the local jurisdiction. The "appropriations must be determined by the governing

Copyright © 2009 to present School of Government at the University of North Carolina. All rights reserved.

body of the city or county to increase the population, taxable property, agricultural industries, employment, industrial output, or business prospects of the city or county." It shouldn't be difficult to meet that standard in an emergency. Public hearings are required as described in this blog post: Notice and Hearing Requirements for Economic Development Appropriations.
- Within a municipal service district for "downtown revitalization projects" (G.S. 160A-536), the broad scope of the statute appears to authorize making loans "intended to further the well-being of the central city or downtown area." Statutory requirements related to municipal service districts are described in a blog post here.
- Within a designated urban redevelopment area, G.S. 160A-503(19) authorizes "programs of assistance and financing, *including the making of loans*, for rehabilitation, repair, construction, acquisition, or reconditioning of residential units and commercial and industrial facilities in a redevelopment area." The focus on construction and rehabilitation is not necessarily helpful in an emergency but could form the basis for making loans for other purposes. The statutory requirements related to urban redevelopment law are described in a blog post here.

**An Example of a Flexible Emergency Loan**

An emergency loan is designed to provide cash quickly to a business for a short period of time. The goal is to get a business through the "emergency" period with enough cash to pay its employees and bills, without having to worry about repayment until demand is stable again. Stability may not be achieved for many months, so an emergency loan should take that into account.

Flexible loan terms designed to help a business through an emergency period could, for example, include the following:

- *Initial deferral period: no payments due initially.* For the first few months, defer all interest and principal payments by rolling the interest payments back into the loan, so no payments are required for the first 6-12 months. Note that the principal owed on the loan would increase each month because interest payments, rather than being paid by the business during this period, would instead be rolled up into the loan.
- *Interest only period.* Following the initial deferral period, switch the loan to "interest only" payments for 6-12 months. The "interest only" period will involve relatively low payments for the borrower because no payments will go toward reducing the principal. Loan principal will not grow during this period, but neither will it be paid down.
- *Lengthy amortization period*. Following the "interest only" period, convert the loan into a conventional amortization schedule, with interest and principal being repaid over a long period of time, such as ten years. Some SBA loans are amortized over 30 years. The longer the amortization period, the more manageable the payments will be for the borrower.
- *Appropriate "risk-adjusted" interest rate applied at all times.* Interest rates are based on the loan terms and collateral. More risky, unconventional loans carry a higher interest rate. As already noted in the legal analysis section, offering low-interest loans would essentially place local governments in direct competition with banks, which generally violates the law. A typical commercial bank loan, secured by a lien on real estate or other repayment guarantee, carries an interest rate above 5%. An emergency loan with unconventional terms and weaker collateral would carry an interest rate at least 200 basis points (or 2%) higher than a conventional bank loan. A higher interest rate serves an important business purpose as well: the local government's ultimate goal is for the borrower to refinance using a conventional bank loan at a lower interest rate and repay the emergency government loan. If the interest rate on the emergency loan is artificially low, the borrower will have no incentive to refinance the loan. Another business purpose is to encourage a business to take out a loan for only as much as it needs. A low interest rate, aside from the legal concerns, would cause businesses to seek more loan than they need from the government instead of seeking private sources of capital. In an emergency, local governments may not have time to evaluate business financials carefully to determine the precise need, so a properly structured interest rate would encourage a borrower to make that determination on its own.
- *No loan forgiveness*. Loan forgiveness is not permitted. Forgiveness would amount to an unconstitutional gift to the business, as explained in the legal section above. Further legal analysis is provided in blog posts here and here.

What would the flexible loan described above look like? Amelie Bailey, Analyst with the School of Government Development Finance Initiative (UNC DFI), crunched the numbers on a $10,000 emergency loan at an interest rate of 7% with the following payment structure: 12 month deferral, then 12 month "interest only," then the remaining principal amortized over ten years starting in month 25.

Copyright © 2009 to present School of Government at the University of North Carolina. All rights reserved.

**Initial loan principal: $10,000 Interest rate: 7%**

| Loan period | Monthly payment | Principal owed at end of perio |
|---|---|---|
| Deferral period (**months 1-12**) | $0 | $10,723 |
| "Interest only" period (**months 13-24**) | $62.55 | $10,723 |
| Fully amortized **over 10 years starting in month 25** | $124.50 | $0 |

**To view different loan structures, download a dynamic business loan model here (MS Excel file).** The model allows the user to enter different principal amounts and interest rates, and to modify the lengths of the deferral period, "interest only" period, and amortization period. Contact UNC DFI if your local government needs assistance with establishing or managing a loan program.

**Practice Tips for a Loan Program**

A local government loan program should address the following elements as a minimum:

- *Eligibility.* Establish which businesses in the community are eligible to receive the loan. For example, a loan program could be restricted to those businesses located within a designated municipal service district for downtown revitalization (in other states, an area known as a business improvement district). Eligibility could also be limited to businesses with revenues below some threshold. The SBA limits access to their programs based on business size as determined here. Finally, the local government may not impose unconstitutional eligibility restrictions (such as race or religion) and must have a rational basis for any eligibility restrictions it establishes.
- *Loan Structure.*
  - *Maximum loan amount.* Determine the maximum loan amount available to each business/borrower. Banks often set the maximum loan amount based on the value of the borrower's collateral. Local government lenders typically set relatively low maximums in order to conserve limited resources and assist more businesses.
  - *Payment structure.* Will the loan have a period of deferral (no interest or principal payments due, with interest rolled into the principal each month)? Will it have a period of "interest only" payments before the outstanding principal is converted into a fully amortizing loan?
  - *Amortization period.* An amortizing loan is familiar to most individuals who have a home mortgage. An amortizing loan involves the borrower making a set scheduled payment over a period of years that will pay interest and eventually reduce the principal amount to zero. Many commercial loans amortize over a ten year period. SBA disaster loans are amortized over a 30 year period (similar to home mortgages). Longer amortization periods make the regular payments more manageable.
  - *Maturity date.* The borrower must pay back the loan in full on the maturity date. Regardless of the payment structure and amortization period, a loan could still have a short-term maturity date, such as one or two years. If the borrower doesn't have adequate cash to pay back the loan by the maturity date, then the borrower would be expected to find new financing in order to satisfy or "take out" the emergency loan.
- *Security or collateral.* Commercial loans are typically secured with some form of collateral provided by a borrower, such as a lien on real estate or a personal guaranty. Upon default by the borrower, the lender can sell the collateral and use the proceeds to offset any amount still owing on the loan. Sometimes collateral will have multiple liens for multiple loans, and each lien has a specific priority. The first lien has highest priority—if the collateral must be taken and sold to satisfy a loan in default, the first lien gets paid first when the collateral is sold. A second lien has second priority—meaning, it gets paid with anything remaining after the first lien is satisfied. A loan with a second lien thereby carries higher risk than a loan with a first lien and should carry a higher interest rate (approximately 100-300 basis points higher) than the loan with a first lien. Unsecured loans have no collateral requirements and the lender holds no lien; therefore the lender has no recourse in the event of default. These are the riskiest loans and should carry the highest interest rates (at least 300-400 basis points higher than the interest rate on a loan secured by a first lien). While a local government could offer an unsecured loan in an emergency, the government must be mindful of the significant risk of loss.
- *Loan servicing considerations.* Determine which local government department will be responsible for tracking loans, collecting payments, sending default notices, and following up on collections. Check whether the local government already possesses this capacity in-house or whether the local government needs to contract with a loan servicer (as described in a subsequent post here).

Copyright © 2009 to present School of Government at the University of North Carolina. All rights reserved.

- *Loan committee*. A loan committee, made up of skilled officials and supported by professional expertise, should be charged with reviewing loan applications and business plans to ensure that every loan makes business sense. Some local governments contract with community-minded financial institutions to manage their loan programs (as described in a subsequent post here). The expectation is that every local government loan will be repaid (no gifts to borrowers allowed), and a business ought to present a logical plan for repayment before receiving a loan.
- *Legal documentation.* Every loan should be evidenced by a fully executed promissory note. An example of a promissory note utilized by the North Carolina Housing Finance Agency can be found here. In addition, it is highly advisable for every loan issued by a local government to be secured. A conventional form of security or collateral for a loan involves execution of a lien on the borrower's property, such as a deed of trust (Fannie Mae form here) or a UCC Financing Statement.
- *Public records*. Loan documents in the hands of the government (or nonprofits they control) are public records.

A number of North Carolina local governments manage small business loan programs continuously (not solely for emergency situations). The loan funds are "revolving," so when the loans are paid back, new loans can be issued. Examples are here and here. Contact UNC DFI if your jurisdiction would like assistance with establishing a revolving loan fund.

UPDATE on related resources for emergency loans for small businesses:

Blog posts:

Using Federal Coronavirus Relief Funds for Small Business Support

Local Government as Lender: Emergency Loans for Small Businesses

Local Government Emergency Loans for Small Businesses: Contracting with Financial Institutions for Loan Administration

Zoom Call:

Local Government Emergency Loans for Small Businesses

Advising support:

Advising support on local governments and emergency loan funds for small businesses, Development Finance Initiative (DFI)

This blog post is published and posted online by the School of Government to address issues of interest to government officials. This blog post is for educational and informational use and may be used for those purposes without permission by providing acknowledgment of its source. Use of this blog post for commercial purposes is prohibited.

To browse a complete catalog of School of Government publications, please visit the School's website at www.sog.unc.edu or contact the Bookstore, School of Government, CB# 3330 Knapp-Sanders Building, UNC Chapel Hill, Chapel Hill, NC 27599-3330; e-mail sales@sog.unc.edu; telephone 919.966.4119; or fax 919.962.2707.