Community and Economic Development in North Carolina and Beyond Blog: Local government support for small business recovery and reopening

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It is never too soon to start thinking about recovery, even in the midst of the pandemic. As communities look toward recovery, leaders are wrestling with how to establish a legally permissible aid program to assist small businesses with reopening. Many local governments established small business loan programs with long "no payment" periods to ensure businesses had access to capital to handle cash flow issues during the pandemic, and those programs, coupled with federal loan and grant programs, stabilized many businesses. However, some small businesses will still find it challenging to reopen due to unpaid bills and an unmanageable debt burden. With unemployment at record levels in the midst of a formally declared pandemic disaster, there is a compelling government reason to help stabilize viable businesses that are able and willing to hire back and retain the unemployed. This post will refer to such an effort as a "Reopen and Rehire" program. A prior post**,** Using Federal Coronavirus Relief Funds for Small Business Support, analyzed the legality of small business loan and grant programs. This post applies similar analysis to a "Reopen and Rehire" program and reviews the implications for program design.

Legal Background for a "Reopen and Rehire" Program

Funds may be appropriated from state and local government treasuries only by operation of properly enacted law, regardless of the source of those funds (federal, state, or local revenues). N.C. Constitution, Art. V, Sec. 7. This means that any loan or grant program must have statutory authority and must comply with the state constitution. Federal guidance for utilizing federal funds does not, by itself, provide authority for activities that otherwise are not allowed under state law. Accordingly, this section of the post explores North Carolina constitutional and statutory authority for a Reopen and Rehire program.

North Carolina Constitution

The North Carolina Constitution states that it is "one of the first duties of a civilized and a Christian state" to aid "the poor, the unfortunate, and the orphan." In other words, it is consistent with the state constitution to provide direct aid to individuals in need. For example, the North Carolina Supreme Court has authorized loans for education for those "of slender means," *State Education Assistance Authority v. Bank of Statesville*, 276 N.C. 576 (1970); loans for veterans to purchase homes, *Hinton v. Lacy*, 193 N.C. 496 (1927); provision of residential housing for sale or rental to persons and families of lower income, *Martin v. N.C. Hous. Corp.*, 277 N.C. 29 (1970); and loans for persons of low and moderate income to acquire housing, *In Re Denial of Approval of Bonds,* 307 N.C. 52 (1982). Along these same lines, many local governments in this state and across the nation have established foreclosure and eviction prevention programs for households in need during the pandemic. The legal basis for such grant programs is discussed in a prior post, and the aid can be provided to all needy individuals who lack the means to pay their rent.

It's a different story for businesses. The North Carolina Constitution, along with most other state constitutions across the nation, have long prohibited government aid to private enterprise. Following widespread government bankruptcies in the late 1800s, which resulted from government investments in quasi-public railroads, state constitutions were amended to include "public purpose" and "gift" clauses to avoid future entanglements with private enterprise. Those clauses reflect the national rule to this day. Osborne M. Reynolds, Jr., Local Government Law 515 (4th ed. 2015) ("*Gifts* of property by local governments—at least to private individuals—are generally banned by statute or as a matter of common law; any transfer of municipal property must be supported by some reasonable compensation or benefit in return."); John Martinez, 3 Local Government Law § 21:7, at 21-25 (2d ed. 2017) ("Local government property cannot be conveyed to a private party without adequate consideration, for to do so would constitute an improper gift of public property or the granting of a subsidy contrary to state constitutional constraints.").

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As stated by the North Carolina Supreme Court in multiple decisions, “direct state aid to a private enterprise, with only limited benefit accruing to the public, contravenes fundamental constitutional precepts.” *Maready v. City of Winston-Salem* , 342 N.C. 708 (1996). It is a foundational principle of North Carolina constitutional law that a government must receive valid consideration (performance of a public service) in exchange for any payment to a private entity. Local governments are not even permitted to make donations to charitable entities, as explained by my faculty colleague Frayda Bluestein in a blog post here.

This ban on gifts to private parties even applies in the context of economic development incentives to induce a business to locate in North Carolina. Business location incentives may only be provided to a business that promises to locate significant job creation and taxable private investment in North Carolina that, in the words of the North Carolina Supreme Court, “might otherwise be lost to other states.” *Maready*; *Haugh v. County of Durham*, 208 N.C.App. 304 (2010). Businesses struggling in a challenging economy simply do not meet the threshold requirements for receiving an economic development incentive grant. Attempting to rely on economic development powers for small business recovery efforts is therefore misguided.

Thus, state and local governments cannot issue grants merely to aid businesses with weathering an economic downturn. This remains true even when the government has arguably contributed to the challenging economic conditions, such as by issuing stay-at-home orders during a pandemic. The inability to compensate businesses lawfully in this situation ought to make intuitive sense; for example, North Carolina governments are not legally authorized to compensate an owner whose business suffers as a result of government actions such as local zoning changes, state environmental regulations, federal tariffs, or international trade agreements. When businesses are dealing with fallout from economic downturns, loan programs (with flexible terms as described in a prior post) are more legally appropriate and simpler to deploy, and they are wiser from a business perspective because they allow business owners to make independent decisions about their capital needs and the long-term prospects of their businesses.

Even when aid to a business is provided in the form of a loan, the loan must serve a public purpose. Financing for private manufacturing facilities was found unconstitutional by the North Carolina Supreme Court in *Mitchell v. N. Carolina Indus. Dev. Fin. Auth.*, 273 N.C. 137 (1968) (industrial development bonds not a public purpose) and *Stanley v. Dep’t of Conservation & Dev.*, 284 N.C. 15 (1973) (financing for pollution control not a public purpose). A narrowly tailored amendment was eventually added to the N.C. Constitution in order to allow bond financing only in those specific situations. N.C. Const., Art V, Sec. 9. The North Carolina Constitution now allows contracting with private enterprises (arguably including loans), but no gifts are allowed and the government must receive valid consideration (public services) in exchange for any contract payment.

Directly relevant to the current pandemic, the North Carolina Attorney General considered the precedent described above and provided a formal opinion stating that low interest loans to businesses *adversely affected by a disaster* are constitutional because the public benefit outweighs the private benefit. The Attorney General determined that a loan program would likely be upheld, *so long as it was tailored to address the emergency situation*. The opinion offered an example, saying that the General Assembly should limit loans only to businesses (1) that “suffered substantial damage” due to the disaster and (2) that were “not otherwise fully compensated” for that damage. One concern in the current crisis is that businesses have not suffered physical “damage” as a result of COVID-19, and many businesses have been “compensated” through federal or state aid (or insurance), creating underwriting and verification challenges that are more easily handled by a loan program. (An excellent review of the AG opinion appears in the General Assembly’s bill draft summary for the state’s loan program to aid small businesses during the pandemic.)

North Carolina Statutes

Statutory authority arguably already exists for a Reopen and Rehire program focused on rehiring the unemployed. G.S. 160D-1311(a)(2) authorizes North Carolina cities and counties to establish “community development programs” concerned with “employment … and welfare needs of persons of low and moderate income.” There are several important points to note about this statutory authority.

- First, it is clear from the language that beneficiaries of programs established pursuant to this statute must qualify under a means or “income” test. This income test ensures the statute remains consistent with the state constitution’s provision allowing aid to the “poor” and “unfortunate” who are of “slender means.” Most unemployed

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persons will qualify under a standard income test depending on their household income. See G.S. 157-3 for more detail on the definition of persons of low and moderate income.
- Second, the term "community development programs" is not further defined in the statute, but it is clear from the context and legislative history that the term refers to federal programs that provide funding for activities that benefit low income persons. The leading federal community development program is the Community Development Block Grant (CDBG) program administered by the federal Department of Housing and Urban Development (HUD). HUD has promulgated regulations related to community development programs, and a local government can be confident that it is acting within the intended scope of the statute when it complies with HUD's regulations. HUD requires documentation to verify that low income persons are benefited by its community development programs. In addition, when a for profit business receives aid through CDBG for the benefit of low income persons, administrators must perform underwriting to ensure the benefit for low income persons will be achieved and that the recipient business has properly structured debt and equity, that profits are not excessive, and that the business will remain financially viable in order to deliver the promised benefit to low income persons.
- Every county in the state received some amount of federal Coronavirus Relief Funds (CRF). Although CRF technically is not a "community development program," it is possible to use CRF for a program to aid unemployed (low income) persons. A program to help rehire the unemployed arguably falls within the parameters of a community development program under G.S. 160D-1311.

The existence of a statute is necessary but not sufficient to determine the validity of a government program. The state constitution preempts statutes; any law enacted by the General Assembly must be implemented in a way that is consistent with the North Carolina Constitution.

Other law

Many local governments work with charitable nonprofit partners such as economic development organizations. Working with a charitable nonprofit does not change the analysis above for two reasons. First, a government cannot pay a nonprofit partner to do something the government could not do itself. Second, charitable entities are subject to their own special set of legal restrictions. A brief review of that law is warranted, not only because it regulates the activities of nonprofit partners, but also because that law could be instructive (though not binding) for a court trying to determine the limits of government authority in this area.

As a starting point, charitable partners such as downtown development groups and economic development organizations are not permitted to provide grants to businesses. The IRS says it quite succinctly: "A business is not an appropriate charitable object." The IRS follows the same distinction that was discussed above under North Carolina law: aiding needy individuals is permissible, whereas aiding businesses generally is not.

Even in a disaster, the rules for charitable organizations are strict. IRS Publication 3833, *Disaster Relief: Providing Assistance through Charitable Organizations*, covers the topic. It draws on guidance that was provided to 501(c)(3) organizations following the September 11 attacks, when New York City was shut down and businesses were struggling.

Charitable organizations are clearly permitted to provide aid to *individuals* affected by a disaster, including "basic necessities, such as food, clothing…." The publication makes clear that the appropriate aid "depends on the individual's needs and resources." Once a victim's immediate needs are met, further aid depends on "individual financial needs assessments." Thus, even when individuals are bonified victims of a disaster, charities can address immediate needs but thereafter must assess financial need prior to disbursing aid.

The IRS publication directly addresses when it is appropriate to aid businesses in disaster areas. Basically, the focus of charitable assistance should remain on needy individuals. It might be permissible to aid a business in order to aid an individual (such as a sole proprietor who could lose their livelihood), but the focus remains on the individual and any benefit to the private business must be "incidental." All of the following considerations were important in determining that aiding a business was acceptable:

- Businesses selected for aid were ones which "would hire unemployed or underemployed residents" (Rev. Rul. 74-587);
- Aided businesses would not likely locate or remain in the area without the charity's assistance; and
- The aided businesses did not have adequate resources from their own assets, conventional financing, or

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insurance.

A charity that aids a business must make an assessment of financial need before disbursing aid to the business, and then once a business has been "restored to *viability* … further assistance from a charity is no longer appropriate." The charitable organization is required to have "criteria and procedures in place to determine when aid should be offered and discontinued." An assessment of financial need is critically important.

Putting the legal principles together

Combining the legal principles articulated above, a small business Reopen and Rehire grant program should contain the following elements:

- Primary focus is "poor" or "unfortunate" individuals, not businesses.
    - The Constitution calls it a "first duty" to aid "poor" or "unfortunate" individuals. A program that encourages hiring of individuals of "slender means" who have filed for unemployment meets this standard.
    - The statutory authority refers to community development programs for the benefit of persons of low and moderate income. Typical community development regulations require documentation of household income to verify income eligibility.
    - Private enterprises can be a conduit for benefiting "poor" or "unfortunate" individuals. However, any benefit to private enterprise should be merely incidental to accomplishing the primary focus of aiding needy individuals.
- Businesses that agree to reopen and rehire qualifying unemployed individuals can be stabilized—with loans first and then perhaps an argument can be made for grants in rare cases—to ensure a business can survive to deliver the desired benefit to those individuals. In community development and disaster assistance programs, stabilization involves financial underwriting of the aided business and consists of verifying the following:
    - The aided business would not be able to reopen without the assistance, which is determined by evaluating its financials;
    - The aided business does not have adequate resources from its own assets, conventional financing, or insurance;
    - The aided business has properly structured debt and equity (e.g., if a business has additional debt capacity, where 1.15 is the debt service coverage ratio used by the federal Small Business Administration (SBA), then debt should be fully utilized prior to resorting to a grant); and
    - The business financials indicate that the business will remain viable in order to deliver the promised benefit to low income persons, but anticipated profits will not be excessive. Low-margin businesses (meaning, businesses without much net operating income) will not be able to handle much debt, so the grant amount required to stabilize a business could be quite substantial. Policy makers should consider the maximum grant that they are willing to offer each business (after determining appropriate debt) in order to stabilize the business so it can reopen and rehire.
- For a disaster relief program, the Attorney General has stated the program should be tailored to address the emergency situation.
    - Businesses eligible for stabilization are those that "suffered substantial damage" due to the disaster. In the current pandemic, businesses have not suffered physical damage, but perhaps an argument can be made that *actual losses* resulting directly from ordered closures can be counted as "damage." Note that *actual losses* are not the same as mere revenue reductions. Businesses manage reduced revenue by reducing expenses, such as limiting operations or laying off employees. However, when revenue reduction is so steep that a business cannot reduce expenses by the same amount, then the business will take *actual losses*. Although it is a stretch, an argument can be made that those *actual losses* are a form of damage when they can be traced directly to the pandemic.
    - Eligible businesses are those that were "not otherwise fully compensated" for the damage. This means that other federal and state aid offered during the pandemic, such as the federal Paycheck Protection Program, Emergency Injury Disaster Loans, and Main Street Lending Program, tax credits, and other benefits such as insurance, must be evaluated to determine whether they already offset the *actual losses*.

Example Reopen and Rehire program

A "Reopen and Rehire" program that contained the following elements would be more likely to satisfy the legal

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requirements described above—especially the requirement for the primary focus to be "poor" and "unfortunate" individuals—than would a program that simply provided grants to any local business that claimed it suffered during the pandemic.

- During an interim period of closure, when the emergency temporarily prevents a business from rehiring its employees back at full time, loans should be offered with long "no payment" periods (that accrue interest during the "no payment" period as described here and here). This will keep the business solvent until it is ready to reopen and rehire the unemployed, at which point the government will have legal authority to offer grants. The debt accrued during this interim period can be restructured with loans and grants once the business reopens and promises to rehire unemployed or underemployed staff.
- To prepare for reopening, reimburse businesses for training the unemployed. Grants may be provided to help pay for training unemployed persons who return to work. A program could establish a reasonable training period (e.g., four weeks) and share or reimburse the costs of training and wages paid during the established training period. In this way, grant payments are focused on "unfortunate" individuals, and any benefit to the business is merely incidental.
- Pay for cleaning and measures related to making the workspace safe *for those unemployed persons returning to work*, including equipment and supplies that make it possible for a business to reopen, rehire, and retain employees over the long-term.
- Offer stabilization loans and grants *only for a business that agrees to reopen and hire a certain number of unemployed persons and retain them for a long period of time* (e.g., one year). Loans should be offered first, up to a reasonable debt service coverage ratio (such as 1.15 used by SBA), before grants are considered. The financial underwriting for such an effort is more challenging than it first appears. Businesses have received many different types of compensation for their losses during the pandemic, such as federal grants and loans, and North Carolina law indicates that compensation should be provided only for losses that were not compensated in any other way. Experts such as Small Business Centers at community colleges, university experts such as SBTDC and the School of Government Development Finance Initiative, or community development financial institutions, may be able to provide back-office support for such programs.
- Impose requirements on businesses that receive assistance:
  - Verify that the business cannot reopen without government aid by evaluating the business plan and pro forma financials.
  - Ensure the program is "tailored for the emergency situation" by requiring a business to certify and provide support for the claim that the disaster is the reason the business closed and is unable to reopen without aid.
  - Require the business to provide access to financial information for underwriting purposes, to ensure that any aid (loans and grants) is structured to restore the business to viability without leading to excessive profits.
  - Require the aided business to provide documentation to prove it hired qualifying unemployed persons and regular reports to verify those new hires were retained, such as quarterly reports submitted to the North Carolina Division of Employment Security (Form NCUI 101).
- Consider adding parameters that help the program address areas of greatest need, such as the following:
  - Size limitations (maximum annual income of business or maximum number of employees) to ensure the program reaches businesses that may have difficulty accessing conventional financing and federal programs.
  - Geographic limitations within government-approved districts such as formally established urban redevelopment areas, municipal service districts for downtown revitalization, or census tracts that are designated as low-income areas.

Consider "fundamental constitutional precepts" and exercise caution when aiding private enterprise

As already mentioned above, North Carolina courts have stated in multiple decisions that "direct state aid to a private enterprise, with only limited benefit accruing to the public, contravenes fundamental constitutional precepts." This quote was approvingly restated by the North Carolina Supreme Court in the *Maready* case. Consider how aid to private enterprise could intersect with other areas of law. For example, if grant programs are established, then longstanding legal requirements governing property conveyance at fair market value can be worked around. Grants could be used to undermine uniformity of taxation as classes of grant recipients could receive the equivalent of tax refunds. Utility law requirements about treating similarly situated customers the same could be easily avoided. Procurement rules and the outcomes of bidding processes could be nudged up or down by offering a grant. State law, rooted in constitutional

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principles, contains a carefully constructed web of requirements and prohibitions designed to minimize direct government aid to private enterprises. These legal implications should be considered when weighing the legal validity of small business grant programs, particularly when a properly designed loan program can accomplish the same goal and is more legally sound.

In addition, local governments should exercise caution when considering grant programs. Consequences for making unconstitutional grants can be severe. Public officials can be criminally prosecuted for knowingly ignoring legal requirements. *See, e.g.*, *State v. James*, 184 N.C.App. 149 (2007). Misappropriation of local government funds can be prosecuted as a federal crime. In addition, any taxpayer may file a lawsuit against their local government for making unlawful appropriations. If the taxpayer succeeds, the transaction will be unwound, disrupting the business, and the local government will be required to pay the plaintiff's litigation costs.

Finally, consider simple programs that will incidentally benefit small businesses without making improper grants. For example, a local government could lease space (for government use) in buildings that are temporarily vacant due to coronavirus closures. The government could temporarily use the space to allow for safer distancing of public employees who otherwise would need to work in higher density spaces in existing government buildings. Expenditures for such leased space would also qualify as a legitimate Coronavirus Relief Fund expenditure in the sense that it would be a previously unplanned expense that is necessary to address the coronavirus emergency. For more on CARES Act and Coronavirus Relief Fund requirements, see this prior post.

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