Community and Economic Development in North Carolina and Beyond Blog: Using Federal Coronavirus Relief Funds for Small Business Support

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On May 6, 2020, the North Carolina Office of State Budget and Management delivered a letter to counties with the amount of federal funds that will be distributed to each county from the “Coronavirus Relief Fund” (CRF) pursuant to the federal CARES Act. Guidance from the U.S. Department of Treasury Department says that CRF can be used for local government expenditures related to COVID-19, and the list of examples includes grants and loans for businesses. The federal guidance merely offers examples and provides no separate authority for activities, and importantly it does not override state law.

The CRF is welcome news for local governments that have enacted loan programs in compliance with state law (as described in prior posts here and here). This means that local governments may receive reimbursements for capital outlays for loans. In addition, programs to aid individuals in need, which are also permitted under state law, can utilize CRF. Grants for businesses, however, remain legally and practically problematic for multiple reasons. This post explores state law surrounding these possible uses of CRF allocations.

What is the Coronavirus Relief Fund (CRF)?

The federal CARES Act (full text here) established the “Coronavirus Relief Fund” (CRF) and sets forth permitted uses of CRF in Section 5001 of the Act:

> (d) Use of funds.—A State, Tribal government, and unit of local government shall use the funds provided under a payment made under this section to cover only those costs of the State, Tribal government, or unit of local government that—
>
> > (1) are necessary expenditures incurred due to the public health emergency with respect to the Coronavirus Disease 2019 (COVID–19);
> >
> > (2) were not accounted for in the budget most recently approved as of the date of enactment of this section for the State or government; and
> >
> > (3) were incurred during the period that begins on March 1, 2020, and ends on December 30, 2020.

This is sparse language. The CARES Act contains a few other regulatory requirements such as reporting, but it doesn’t offer any other explanation of the allowable uses of funds. In other words, *CRF is an incredibly flexible pool of funds that can offset any number of unforeseen COVID-related expenses of a local government, ranging from the purchase of protective equipment to upgrading space for improved social distancing.*

The U.S. Treasury Department provided their interpretation of allowable uses in written guidance. The examples seem to cover just about every imaginable local government expense related to COVID-19, including economic support to businesses. The fact that one use or another appears in the federal guidance is not relevant to North Carolina local governments, which derive all of their powers from the state.

In North Carolina, a local government cannot engage in any activity unless a statute permits it. There are statutes on the books authorizing local governments to aid needy individuals, and even for engaging in public activities to support businesses. However, the primary concern is compliance with the state constitution.

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North Carolina Legal Authority to Provide Financial Aid to Individuals

The North Carolina Constitution, the law of the land in this state, tells us that it is a "first duty" of the State to aid "the poor, the unfortunate, and the orphan." In other words, it is *always* constitutionally permissible 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).

A local government cannot engage in any activity unless it has statutory authority to do so. Fortunately, there is ample authority for aiding individuals in need. Existing statutes authorize cities and counties to establish "community development programs" to provide for the "welfare needs of persons of low and moderate income." G.S. 160A-456(a)(2) (cities), G.S. 153A-376(a)(2), and G.S. 160D-1311(a)(2) [effective in August 1, 2021]. There are two important points to note: (1) recipients of welfare aid must be limited by income, and (2) the reference to "community development programs" refers to federal programs, such as Community Development Block Grants (CDBG), which provide funding for activities that benefit low income persons. These statutes provide authority for activities such as providing safe and decent housing for persons of low income; construction of community facilities for the benefit of low-income persons; and training programs for the unemployed.

Finally, the North Carolina Attorney General in a 1999 opinion examined whether the General Assembly could provide disaster aid to individuals and opined that it was permissible. The Attorney General noted that it is a "first duty" to aid the "poor" and the "unfortunate," and concluded that aid to individuals in need can serve a public purpose under the North Carolina Constitution, provided the program is properly tailored to address the immediate emergency.

Using CRF for aid to individuals in need

The federal CRF allocation can help pay for new COVID-related programs designed to aid individuals in need. Examples in the federal guidance include the following:

- Expenses for food delivery to residents, including, for example, senior citizens and other vulnerable populations
- COVID-19-related expenses of maintaining state prisons and county jails, including as relates to sanitation and improvement of social distancing measures
- Expenses for care for homeless populations provided to mitigate COVID-19 effects

North Carolina Legal Authority to Provide Financial Aid to Businesses

Providing aid to a for-profit business is an entirely different matter from aiding "poor" and "unfortunate" individuals. For one thing, state constitutions across the country were intentionally designed to prevent aid to private enterprises after widespread government bankruptcies occurred in the late 1800s following the collapse of quasi-public railroads in which governments had invested. 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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Specifically in North Carolina, the state constitution requires all expenditures of public funds to be "for public purposes only." In addition, no private entity may receive "emoluments or privileges" (gifts) unless a public service is provided in return. Under North Carolina's "exclusive emoluments and privileges" clause, 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.

For an expenditure to serve a public purpose and not amount to an unconstitutional gift, the expenditure must meet a two-part test. First, the activity must be reasonably connected to a legitimate aim of government. Second, the ultimate gain must be the public's, not that of an individual or private entity. Under this test, even *loans* to businesses have been denied. *Mitchell v. N. Carolina Indus. Dev. Fin. Auth.*, 273 N.C. 137 (1968) (industrial development bonds not a public purpose); *Stanley v. Dep't of Conservation & Dev.*, 284 N.C. 15 (1973) (financing for pollution control not a public purpose). In 1996, the North Carolina Supreme Court created an exception to the general rule when it determined that business location incentives serve a public purpose when a business promises to create substantial "jobs and tax base" that "might otherwise be lost to other states." *Maready v. City of Winston-Salem*, 342 N.C. 708 (1996).

Most disaster relief programs don't involve creation of substantial jobs and tax base that "might otherwise be lost to other states," and North Carolina courts haven't created an exception for disaster relief in the same way that they created an exception for business location incentives. However, there is reason to believe that a disaster *loan* program for businesses would meet the two-part legal test for public purpose.

Disaster relief for those in need is, in general, a legitimate aim of government and therefore a tailored program would meet the first part of the test. The second part, ensuring that public benefits predominate over private interests, is probably achieved by a *loan* program for businesses damaged by a disaster. The public benefit is achieved because a loan with flexible collateral and payment terms will keep the business afloat in the short-term, allowing the business to repair damage, hire back its employees, and spread any losses over future years. A requirement for a business to hire unemployed workers would place the program on even more solid footing, because the focus of the program would be aiding needy individuals, rather than focusing on businesses. The public benefit predominates because, ultimately, a business owner takes only so much of a (properly structured) loan as the owner *needs*, and then the private interests are minimal because the loan gets *paid back*.

The North Carolina Attorney General was asked for a formal opinion regarding whether the state could legally offer *loans* to businesses adversely affected by a disaster. The Attorney General performed the two-part public purpose test, and in particular examined the second part regarding whether the public benefit predominated over private interests. 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 the loans only to businesses (1) that "suffered substantial damage" due to the disaster and (2) that were "not otherwise fully compensated" for that damage. (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.)

One concern in the current crisis is that businesses have not suffered physical "damage" as a result of COVID-19, and many have received assistance from the federal government and can now benefit from the state's loan program, too. There are multiple sources from which a business may have been compensated. An advantage of a loan program in this situation is that a loan can be structured to ensure that federal and state loans remain more advantageous for a business, thereby encouraging borrowing businesses to utilize the federal and state loan programs before resorting to a local government program (or pay back a local government loan with proceeds from a federal or state loan). Advice on structuring a loan program to achieve this result, in addition to avoiding competition with commercial banks, is described in blog posts here and here.

Using CRF for a local government loan program for small businesses

One of the challenges faced by local governments in offering COVID loan programs is a lack of capital; that is, many local governments don't have the financial means to create a loan program. CRF can be used for the capital outlays and related costs of a local government loan program. We know that loan programs are eligible for CRF because one of the examples

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of allowable programs in the Treasury guidance is a “payroll support program,” which is a type of loan program offered by Treasury for air carriers and other companies (see CARES Act §§ 4112-4117). [UPDATE: U.S. Treasury issued updated guidance here that confirms loan programs are permissible.] The North Carolina Pandemic Recovery Office, which is responsible for overseeing CRF in the state, confirmed in its guidance here that CRF can be used to fund small business loan programs.

Using CRF for a loan program may allow a local government to accept more risk in the loan program and offer loans with very business-friendly payment structures. An example of a business-friendly loan might be something like the following:

- A two-year “no payment” period (during which interest accrues but is not paid). For comparison, the General Assembly recently enacted a loan program with a six month no payment period (Section 4.2. of Session Law 2020-4).
- At the end of the no payment period, the loan converts into a very long amortization period, such as 10 or more years. To view the sizable impact of the amortization period, see the loan model available through a link in this blog post.
- Unsecured/no collateral required. For comparison, the General Assembly’s loan program requires borrowers to provide collateral in the form of a UCC Financing Statement, but some cities are offering unsecured loans (with a higher interest rate to account for the higher risk of the loan).
- Minimal underwriting.

In my experience with small businesses, a loan with this structure would make an enormous difference, allowing the business to pay bills and keep moving, with plenty of runway (two years) before a single payment was required. The School’s Development Finance Initiative (UNC DFI) is offering free consults for local governments who would like assistance structuring a legal and effective loan program.

What about grants for businesses, rather than loans?

The federal guidance issued by Treasury also lists the following as an eligible use of CRF: “grants to small businesses to reimburse the costs of business interruption caused by required closures.” The state’s Pandemic Response Office parrots this vague federal guidance. It is difficult to decipher this example in the guidance because there are few “costs” of business interruption due to closure; rather, businesses take *losses* as their bills pile up and revenue is reduced. Do “costs” mean purchase of masks and disinfectant by a business? Can CRF only be used for such costs? Setting aside the fact that the Treasury guidance is unclear on this point, there is a more important issue. Regardless of what is listed as an example in federal or state program guidance, state law controls and grants to businesses are generally not permitted under the state constitution.

Recall that North Carolina courts will evaluate the public purpose of an expenditure by conducting a two-part test. The two-part test is the same described previously for loan programs, except that in a grant program, private interests are far more substantial—a business never pays back a grant, even if the business ultimately recovers and could have paid it back. Thus, grant programs are generally not permissible because they cannot pass the two-part test; private interests dominate.

Demand for a grant program is no indication of public benefit nor financial need. A rational business will always seek a grant, so a grant program or other subsidy program will be over-subscribed even if applicant businesses don’t need it or qualify for it (as seen with COVID-related federal grant and loan programs).

Community development programs (G.S. 160A-456(a)(2), G.S. 153A-376(a)(2), and G.S. 160D-1311(a)(2)) occasionally involve grants to businesses, but only when the grant is necessary to achieve benefit for low-income *individuals*. It bears repeating: the primary focus is benefit for *low income persons*, not the business. Examples might include prison reentry programs and apprenticeship programs for the unemployed, in which a business receives some incidental benefit from a training program designed to assist individuals in need. A grant program for developers of privately-owned housing for low income persons is another common example (as described in an earlier blog post).

The guiding federal program in this area, the Community Development Block Grant (CDBG) program, requires documentation to verify that low income persons are benefited. When a for profit business receives aid through CDBG, administrators must perform underwriting to ensure the benefit for low income persons will be achieved and that the recipient has properly structured debt and equity, that profits are not excessive, and that the business will remain

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financially viable in order to deliver the promised benefit to low income persons.

Thus, local governments implementing a community development program that provides some benefit to businesses would need to determine the following: (1) assisting low and moderate income persons is the focus of the effort; and (2) the level of aid to the business is necessary to achieve the benefit for low and moderate income persons after evaluating the recipient business in terms of debt, equity, and viability of the business, and considering other forms of assistance the business is receiving from federal and state sources (standard underwriting to determine first whether a loan works). This is a business-by-business determination that can be quite burdensome.

[UPDATE: In June 2020, an Assistant Attorney General at the NC Department of Justice provided an informal advisory opinion (not formally approved as an Attorney General opinion) on using federal CRF for grants "of no more than $10,000? to small, non-publicly traded businesses during this singularly unique crisis. The opinion appeared to establish an even more difficult standard for grants than those described above. The opinion states that a court would likely uphold a grant "to the extent that a local government finds that *but for the intervention of their grant program a business would fail or likely relocate* and that grants are necessary to restore the economic vitality of the jurisdiction." That has the effect of ensuring the program is focused on needy individuals. The opinion also assumed that grants would be limited to *actual losses* (not mere loss of revenue), which is a moving target with ever-changing federal loans, grants, and loan forgiveness.]

A properly structured loan program, in contrast, can be simpler and requires less administrative burden up front, because businesses take only as much loan as they need and then pay it back. In a recent webinar about COVID loan programs, a city manager of a small community explained how the city's first-ever loan program, administered by city staff, went from concept to issuing loans in less than two weeks.

Consider "fundamental constitutional precepts"

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 the legal concepts discussed earlier in this post are connected to other areas of law. For example, if grant programs are established, then 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 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 as compared to more legally sound and equally effective loan programs.

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). 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.

Can a local government pay a nonprofit to do what the local government cannot?

Could a local government simply turn funds over to a charitable nonprofit partner and let that partner issue grants to businesses? The answer is no for two reasons.

The first reason should be obvious. A nonprofit cannot use government funds to do something that the appropriating government is not permitted to do. Public funds remain subject to constitutional requirements even when appropriated to another entity. Briggs v. City of Raleigh, 195 N.C. 223 (1928); Dennis v. City of Raleigh, 253 N.C. 400 (1960).

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The second reason is less obvious. *Charitable partners are subject to their own requirements and 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 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.

This highlights an advantage of a properly structured loan program with a risk-adjusted interest rate. Business owners won’t take a loan unnecessarily—interest charges encourage applicant businesses to take only what they need, thereby boosting confidence that they meet the financial need test.

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