CED in NC Blog: Legal and Business Reasons Why Downtown Development Programs Should Involve Secured Loans—Not Grants

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Article: https://ced.sog.unc.edu/legal-and-business-reasons-why-downtown-development-programs-should-involve-secured-loans-not-grants/

This entry was posted on September 19, 2017 and is filed under Built Assets & Housing, Downtown & Main Street, Economic Development, Featured Articles, Financing Development

Dr. Blaine Beeper is a retired hospital administrator who was recently elected to council in the Town of Bushwood. Dr. Beeper thinks he has figured out how to jumpstart revitalization of Bushwood's historic downtown. He proposes for the Town to offer annual cash grants to any owner who redevelops a commercial property within the downtown. Dr. Beeper reasons that redeveloped properties will carry a higher tax assessed value, and the additional tax revenue can be "granted back" to the owners in the form of cash grants for five years, calculated as some percentage of the additional property taxes received by the Town. When Dr. Beeper floats this idea, he runs into resistance from the Town Attorney and the Economic Development Director, each for different reasons. The Town Attorney raises serious concerns about the legality of such a program, while the Economic Development Director says it doesn't make good business sense and a loan program would better address owners' financing needs. This post explains the legal and business reasons why Dr. Beeper's proposed grant program should be scrapped in favor of a loan program.

The Legal Reasons

When state constitutions across the nation were written, 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 and pay a reasonable price for a valuable public service (such as a contract to manage a homeless shelter), but the government cannot make a donation.

Dr. Beeper, however, believes his proposed grant program for private owners is legally authorized because he thinks certain statutes allow it. For example, the Town long ago established a municipal service district (MSD) for downtown revitalization, and the statutory powers granted to the Town within that MSD include "promoting business investment in the downtown area." In addition, he points to the economic development statute, G.S. 158-7.1, which seems to offer boundless authority to local governments to encourage development.

The Town Attorney explains to Dr. Beeper that those statutes are limited by the state constitution. For example, the economic development statute has existed in essentially the same form since 1925, but for decades after it was enacted, it was unconstitutional to offer economic development grants. The constitution always constrained the statute's scope. Then, in the 1996 case *Maready v. City of Winston-Salem*, the North Carolina Supreme Court decided for the first time that incentive grants were allowable—but only in very limited circumstances in order to compete with "neighboring states." The court reasoned that incentive grants serve a constitutional public purpose (and therefore are not unconstitutional gifts) so long as they are "necessary" to obtain significant jobs and tax base that "might otherwise be lost to other states." (For more details, see a law review article on the topic, with the major points summarized in this blog post: When May NC Local Governments Pay an Economic Development Incentive?

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In addition, multiple development statutes express the rule that local governments must receive "fair market value" when conveying property, reflecting the same prohibition on making gifts to developers. For example, the economic development statute mandates that the price received for property "may not be less than" the fair market value (G.S. 158-7.1(d)). In blighted redevelopment areas, competitive bidding processes must be used, and even conveyances to charitable nonprofit entities "shall not be less than the fair market value" (G.S. 160A-514). For conveyance of property for redevelopment, the price received for negotiated sale "shall not be less than the appraised value." (G.S. 160A-457) The mere authorization to convey property by private negotiated sale does not mean that the price can be reduced below fair market value. See blog posts about conveyances for economic development, historic rehabilitation, downtown development projects, and affordable housing.

Dr. Beeper protests, saying he's pretty sure that the City of Nearby has enacted a program similar to the one he is proposing. The Town Attorney is aware of the program in Nearby City and says he believes that Nearby's program violates the state constitution. The Town Attorney recalls that Nearby implemented its program before a recent set of NC Court of Appeals cases clarified the state's incentives law. Initially, some local governments interpreted the case law broadly and enacted their downtown development programs based on that understanding. In subsequent cases (e.g., *Bl inson*, *Haugh*), courts have maintained that incentive grants will be upheld so long as they are "parallel" to the incentives approved in the *Maready* case. Downtown redevelopment projects—which typically cannot promise new high-paying jobs, fail to diversify the economy, and aren't competitive with "other states"—don't even come close.

In light of the statutes and constitutional law, the Town Attorney suggests that Dr. Beeper explore alternatives that don't involve gifts to private entities. Creativity is permitted so long as the local government does not attempt to give a gift to a private developer. Some creative and legally permissible approaches include the following:

1. Construct publicly-owned infrastructure to support private development	Examples include lighting, public parking, and street improvements. Public parking spaces can be leased to private businesses, subject to some limitations.
2. Enter into a public-private partnership (P3) with the developer	A P3 involves the developer constructing public infrastructure and the Town buying it for a reasonable price (see blog posts about public-private partnerships here and here and reimbursement agreements here).
3. For historic buildings, pay the owner a fair price for a preservation easement on the building façade.	The local government can pay to acquire an historic preservation easement on the building façade, enabling the Town to repair the historic façade if the owner fails to do so. G.S. 160A-400.8(3)
4. Designate an historic structure as an historic landmark.	Designated landmarks receive favorable tax treatment as described here.
5. Offer loans with appropriate market rate terms (no gifts)	Loans offered by a local government should be secured and carry an appropriate risk-adjusted rate of interest.

None of the alternatives above (also discussed here and here) involves an unconstitutional gift to the owner. The Town Attorney recommends that Dr. Beeper talk with the Economic Development Director about her ideas on the last item in the list: a loan program.

The Business Reasons

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The Economic Development Director is a sophisticated real estate development professional. She wants to implement a loan program because she knows it will be more helpful to a downtown redevelopment project than Dr. Beeper's proposed grant program, and a loan program better preserves the Town's resources—which means more projects can be assisted over time. She outlines her downtown redevelopment loan program and the rationale for Dr. Beeper:

1. **The Town should offer a "mezzanine loan" program for redevelopment of downtown buildings.**

Redeveloping buildings is expensive, and developers typically obtain a commercial bank loan for each project. Private bank financing should continue to be the primary source of financing in her view, but the Town could offer a loan that supplements, rather than replaces, the bank loan. Thus, the Town loan would be the second or "mezzanine" loan. The main advantage of requiring a developer to secure a bank loan first is that the Town will know that a bank has underwritten the redevelopment project. It should give the Town some comfort to know that a business-minded lender is paying attention to the project.

2. **The interest rate on the Town's loan should be several points higher than the interest rate of the primary bank loan on the project. In current conditions, this would put the Town's rate in the range of 8% to 10%, depending on the risk of the loan. The riskier and more unconventional the loan, the higher the interest rate.**

The bank will require the Town's loan to be subordinated to the bank's loan. That is, the bank will hold a lien on the property in *first position*, meaning the bank is first in line at foreclosure should the borrower fail to pay. The Town's loan will be subordinate—in *second position*—so the Town will be second in line, making the Town's loan a bit riskier. Market pricing for loans is based on risk. Since the Town's loan is riskier than the bank loan, it should carry a higher interest rate than the bank loan.

Offering a low-interest loan (lower even than the bank loan rate) would be counter-productive and inconsistent with sound development finance principles. To illustrate the point, say that a borrower eventually earns enough income to pay off some principal on its loans. A rational borrower would choose to pay off the highest interest loan first. If the Town's loan carries a lower interest rate than the bank loan, then a rational borrower would pay off the bank loan first. The Town, however, actually wants to have the opposite effect: that is, for the borrower to maximize the (private) bank loan and take no more (public) Town loan than is absolutely required to make the redevelopment project feasible.

3. **Even with a higher interest rate, a mezzanine loan program is still potentially more helpful to a redevelopment project than Dr. Beeper's original grant proposal, for several reasons.**

Redevelopment projects need financing up front to cover the costs of development. When a developer says a project has a financing "gap," it means the project needs up front financing to make the project work. Dr. Beeper's annual grants would be paid only after the redevelopment was complete, so the grants do not address the "gap." Furthermore, because Dr. Beeper's proposed grants would be paid after the project is complete, the grants cannot be "necessary" to make the project feasible (a legally significant point). A mezzanine loan does not suffer from the same deficiencies in part due to its risk-adjusted rate of interest. When a developer takes out a mezzanine loan, the developer accepts added cost and complexity, so the Town can be fairly certain that the loan is necessary to the success of the project. The interest rate also ensures that the developer will maximize the bank loan and borrow no more from the Town than the project requires.

A mezzanine loan—even at 10% interest—is less expensive than equity provided by investors, who often expect high rates of return (sometimes well above 10%). A mezzanine loan provides up front capital to a project in the 8% to 10% interest range. While this rate is more expensive than a conventional bank loan, it is still cheaper than capital provided by an equity investor, who may demand a 12% to 15% return or more, depending on project risk. The Town improves the feasibility of the redevelopment project by replacing high cost equity with a mezzanine loan.

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When a mezzanine loan replaces high-cost equity, this creates "leverage" that increases returns for the equity investor. When a mezzanine loan replaces high cost equity, this means that less up-front cash is required from an investor. Because the investor provides less cash up front, the project's overall returns are larger in comparison to the investor's (now smaller) cash investment. This effect is called "leverage."

4. **A mezzanine loan is intended to be paid back, generating revenue for the local government over time that can be put toward other projects.**

Mezzanine loans are secured loans that, with proper underwriting, are expected to be paid back with interest. This generates revenue for the local government above and beyond property tax revenue—revenue that can be revolved back into other projects. However, it must be acknowledged that mezzanine loans involve risk of loss because they are secured by a lien in "second position" behind the bank loan. That is, in the event of default by a borrower, the bank loan takes precedence. Although a mezzanine loan involves risk of loss, it still compares favorably with Dr. Beeper's annual grant program, which fails to generate any income and results in lower net revenue for the Town.

5. **A mezzanine loan program is flexible and the loan structure can be modified to avoid causing cash flow problems for a redevelopment project with thin margins.**

What if a project's operating income is not sufficient to make the loan payments on a mezzanine loan (because the project is already burdened by the debt service for the primary bank loan)? Mezzanine loans are flexible financial instruments that can be structured to meet the needs of the project.

For example, a mezzanine loan could be amortized over a long period of time, such as 30 years, to make payments manageable. Or a loan could be structured as interest only with a balloon payment upon sale or refinancing. For the most difficult projects, a government could even consider deferring all principal and interest payments until sale or refinancing. If deferral of that sort fails to make a project work, then the viability of the project should be seriously questioned.

When structuring a mezzanine loan, it is important to evaluate the effect of different terms on investor returns. In addition, the relative riskiness of the loan should be reflected in the interest rate charged to the borrower. To see an example of different loan structures and their comparative effect on investor returns (e.g., equity multiple), see a mezzanine loan pro forma illustration from an actual revitalization project in North Carolina here.* (Readers are also challenged to calculate the effect of Dr. Beeper's proposed grant program on developer returns and see for themselves why his grants are less effective.)

Finally, if a developer insists that a project cannot accommodate even the most flexible mezzanine loan, that doesn't mean the Town must make a grant or gift to the developer. The Town could consider making an equity investment (through a limited liability vehicle) that results in ownership on the same terms as any other owner or investor. (The Town Attorney can confirm that local governments possess statutory authority to acquire interests in real property and to hold and lease that property for economic development, provided statutory procedures are followed.)

The mezzanine loans described in this post can help a redevelopment project earn higher returns while potentially preserving a local government's resources—without running afoul of the North Carolina Constitution. This and other related topics are covered in greater detail in a course for public officials held at the School of Government called the Development Finance Toolbox.

Sources

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* Sarah Odio and Andrew Trump, Project Managers with the School's Development Finance Initiative, created the mezzanine loan pro forma illustration.

Links

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