MEMORANDUM

State of Alaska
Department of Law

TO: Keith Laufer
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AIDEA

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FILE NO: 661-97-0624

TEL. NO: (907) 269-5136

SUBJECT: Religious Organizations Participating in AIDEA Programs

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I. INTRODUCTION

The Alaska Industrial Development and Export Authority (AIDEA) occasionally receives inquiries regarding whether AIDEA may participate in a loan or otherwise extend credit when the borrower is a religious organization. Banks have recently requested that AIDEA participate in proposed bank loans for several purposes. One loan would finance the acquisition and remodel of a building to expand an existing private school and to create a new daycare center in the Fairview area of Anchorage. A second loan would finance the construction of a multiple-use recreational/community facility. While these bank inquiries appear to focus solely upon AIDEA's loan participation program, at your request we also discuss whether AIDEA's other financial programs may be available for these or similar projects.

II. SUMMARY OF CONCLUSION

We believe that AIDEA's participation in these types of loans or credits would rarely, if ever, be constitutional under the Establishment Clauses in article I, section 4 of the Alaska Constitution and in the First Amendment to the United States Constitution. Government actions must pass a three-pronged test to survive Establishment Clause scrutiny. Under the second prong of this test, AIDEA would impermissibly "advance

religion" by funding the construction, acquisition, or expansion of a facility that would be directly used for religious purposes. AIDEA would also impermissibly "advance religion" if its approval of a project created an appearance of endorsing religious aspects of the project or borrower. Under the third prong of this test, AIDEA would impermissibly "entangle itself with religion" under any program where AIDEA could continue to exert oversight or control over the project or the borrower's business activities after the loan or credit is closed. In addition, under the first prong, AIDEA may not alter its usual program requirements to avoid problems that might arise under the second and third prongs of the test.

Thus, we believe that the only loan or credit to a religious organization in which AIDEA might constitutionally participate would be strictly limited to: (1) projects that would not be directly used for religious purposes, (2) projects where AIDEA's approval would not create an appearance of endorsing a religious organization, and (3) programs and circumstances under which AIDEA, following normally applicable credit policies, would retain no ability to exert oversight or control over the project or the borrower's activities. Because we doubt that these conditions will ever arise, we conclude that AIDEA's participation in a loan or credit to a religious organization would be found unconstitutional.

AIDEA's participation in loans to support religious schools would also be barred by article VII, section 1 of the Alaska Constitution which prohibits the use of public funds to directly benefit private schools. We believe that a private school may be a borrower, participant, or object of loan proceeds under an AIDEA program only if there is no financial recourse against AIDEA, contingent or otherwise. Generally, this would limit private schools to AIDEA's conduit financing program.[1]

III. ANALYSIS

A. Establishment Clause

The federal and state Establishment Clauses use substantially identical language. The First Amendment to the United States Constitution states in pertinent part, "Congress

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[1] A loan or credit to a religious private school must also survive constitutional analysis under the Establishment Clause.

shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof; . . . ." Article I, Section 4 of the Alaska Constitution provides, "No law shall be made respecting an establishment of religion, or prohibiting the free exercise thereof."

The United States Supreme Court has developed three criteria with which to evaluate legislation that is challenged under the Establishment Clause. The court should determine whether the legislation (1) has a secular legislative purpose, (2) has a principal or primary effect that neither advances nor inhibits religion, and (3) furthers an excessive governmental entanglement with religion. *Lemon v. Kurtzman*, 403 U.S. 602, 91 S.Ct. 2105 (1971); and *Agostini v. Felton*, __ U.S. __, 117 S.Ct. 1997, 2010 (1997). The Alaska Supreme Court applied this same test in determining whether a statute offended the federal or state constitution. *Bonjour v. Bonjour*, 592 P.2d 1233 (Alaska 1979).

1. First Prong – Secular Purpose

The first prong of this test appears to pose no problem to a religious organization participating in any existing AIDEA program. Whether the legislation has a secular purpose is determined by analyzing the statute as a whole. *Hunt v. McNair*, 413 U.S. 734, 742, 93 S.Ct. 2868, 2874 (1973).[2] AIDEA operates to promote secular legislative purposes of furthering economic development and developing jobs in Alaska and for Alaskans. *E.g.*, AS 44.88.010. The secular purposes of economic development and creating jobs are advanced under AIDEA's programs regardless of whether the participating organization has any religious affiliation.

The second and third prongs of the test, however, appear to pose substantial difficulty. AIDEA may not alter its existing credit policies attempting to avoid these problems. Under the first prong of the constitutional test, a governmental program may not be established for religious purposes. *Lemon v. Kurtzman*, 403 U.S. at 612-13, 91

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[2] Observations from *Hunt v. McNair* are particularly instructive as that case involved a South Carolina lending program that has many similarities to AIDEA's Tax-Exempt Revenue Bond Program. The South Carolina Education Authority ("South Carolina Authority") issued tax-exempt revenue bonds that would finance site preparation and the construction of facilities at colleges, including colleges affiliated with religious denominations. 413 U.S. at 736-38, 93 S.Ct. at 2871. The South Carolina Authority would own and lease to the college any facility constructed with bond proceeds. 413 U.S. at 739-40, 93 S.Ct. at 2872-73. AIDEA may extend similar credit, and may own and lease a project. See, e.g., AS 44.88.172, and 3 AAC 99.100 - 3 AAC 99.160 (AIDEA's Tax-Exempt Revenue Bond Program).

S.Ct. at 2111; *Bonjour v. Bonjour*, 592 P.2d at 1242. AIDEA would arguably create a new program solely for religious organizations if it altered credit policies for religious organizations.

2. Second Prong - Advance or Inhibit Religion

Whether the primary effect of any AIDEA program advances or inhibits religion must be determined by focusing upon the proposed transaction, rather than upon the statute as a whole. *Hunt v. McNair*, 413 U.S. at 742, 93 S.Ct. at 2874. State action may advance or inhibit religion in many ways, including by providing aid that directly supports religious purposes, or by creating a symbolic union between church and state. Each of these concerns appears applicable to AIDEA programs.

a. Direct support of religious purposes

Whether religion is advanced depends upon whether loan funds or the credit will be used directly for religious purposes. *Hunt v. McNair*, 413 U.S. at 743, 93 S.Ct. at 2874. Indirect or incidental support of religious purposes is permitted. For example, government aid of purely secular activities does not advance religion merely because it permits the religious institution to spend its other resources on religious ends. *Id.*

The "primary effect" of governmental aid normally is considered to improperly advance or inhibit religion when it flows to an institution in which religion is so pervasive that a substantial portion of its functions are subsumed in the religious mission, or when it funds a specifically religious activity in an otherwise substantially secular setting. *Hunt v. McNair*, 413 U.S. at 743, 93 S.Ct. at 2874.[3] Religion is improperly advanced when loan funds will be used directly for religious purposes, or when secular uses are not isolated from religious uses. *Id.* Whether secular uses are isolated from religious depends upon both the type of religious institution involved and the specific uses of the loan proceeds.

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[3] As a preliminary matter, we believe that AIDEA's programs offer aid to participants and therefore may "advance or inhibit religion." First, state aid is provided, directly or indirectly, whenever state funds finance the project or the state's credit is placed at risk. Second, as the Court found in *Hunt v. McNair*, borrowers benefit when they obtain a lower interest rate than the religious organization could obtain with conventional private financing. 413 U.S. at 739-40, 93 S.Ct. at 2872-73. Similar to *Hunt*, AIDEA's various programs offer lowered interest rates that benefit borrowers. *See, e.g.*, AS 44.88.159.

The Court in *Hunt*, for example, observed that benefits from the South Carolina lending program would be isolated to secular purposes. An express statutory condition prohibits a South Carolina college from using any facility constructed with bond proceeds for sectarian instruction or worship. 413 U.S. at 736-38, 93 S.Ct. at 2871. The South Carolina Authority also monitors the use of facilities after the credit closes to ensure compliance with the "non-sectarian" use restrictions. 413 U.S. at 739-40, 93 S.Ct. at 2872-73.

Isolating secular uses also depends upon the type of religious organization. It may be impossible to separate secular and religious activities in an organization "in which religion is so pervasive that a substantial portion of its functions are subsumed in the religious mission." *Hunt v. McNair*, 413 U.S. at 743, 93 S.Ct. at 2874. The Court in *Hunt v. McNair* observed that religious primary and secondary schools have religious indoctrination as a substantial purpose or activity, while religious colleges do not. 413 U.S. at 746, 93 S.Ct. at 2875-76. Any activity undertaken as part of the educational purpose of a religious primary or secondary school will therefore necessarily tend to advance religion, and it will be more difficult to isolate secular and religious purposes.

The recent requests for AIDEA participation in loans or credits do not appear to be isolated to secular purposes. The religious organizations appear to operate primarily to advance their religious missions. As the Court in *Hunt v. McNair* observed, a religious secondary or primary school apparently operates to advance religious purposes and activities (including religious indoctrination). Also, while not disclosed, there presumably is no organizational separation of the religious and secular missions of the church interested in the recreational/community facility. Further, that church would be organized primarily to pursue its religious mission. Thus, it appears that religion subsumes the functions of both religious organizations identified in the proposed AIDEA loan participations.

It also is apparent that one can not meaningfully separate the secular and religious purposes and activities to be supported under the proposed loans. AIDEA has no express statutory provision that restricts use of loan proceeds to secular purposes. AIDEA apparently could not meaningfully impose such non-religious use restrictions in any event. One proposed loan would fund the acquisition and remodel of a building for use to expand the school and establish a daycare facility. The second would fund the construction of a multiple-use recreational/community facility. We presume that each facility will be used, at least in part, to further religious purposes. Benefits from each loan would necessarily flow to all uses of each facility (religious and secular) in an

inseparable manner, regardless of any term or condition AIDEA might impose in approving its participation in the loan.

Because it appears that each proposed loan would directly support religious uses or purposes, each would be found to advance religion in violation of the second prong of the Establishment Clause test.

b. Symbolic union between church and state

Government programs also improperly advance religion where a "symbolic union" between church and state would "convey a message of government endorsement . . . of religion." *Agostini v. Felton*, ___ U.S. __, 117 S.Ct. 1997, 2009 (1997) *quoting School Dist. of Grand Rapids v. Ball*, 473 U.S. 373, 389, 105 S.Ct. 3216, 3225 (1985).

A lack of symbolic union has been found where the government aid is provided in a neutral fashion based upon objective criteria. The objective criteria effectively remove state discretion from the selection process. The state would not appear to endorse any participant in such programs, including religious organizations. For example, an agency that makes its facilities generally available to the public based upon objective criteria (*e.g.*, first come, first served), should not exclude religious organizations. *Lamb's Chapel v. Center Moriches Union Free School Dist.*, 508 U.S., __,__, 113 S.Ct. 2141, 2146 (1993) (school district made its facilities available for a wide variety of social, civic, and recreational purposes), *see, also, Rosenberger v. Rector & Visitors of Univ. of Virginia*, __ U.S. __, 115 S.Ct. 2510 (1995) (University student organization published student group publications on a wide variety of topics).

Moreover, a state can more effectively disclaim any endorsement of participants in programs that are generally available to the public. When the state disclaims endorsement of every participant, the public is not likely to become confused that the state actually endorses the religious purposes of religious organizations. *See, e.g., Rosenberger v. Rector & Visitors of Univ. of Virginia*, __ U.S. __, 115 S.Ct. 2510 (1995) (every student publication must include a disclaimer that the University does not endorse the viewpoints expressed).

In contrast, AIDEA programs are not generally available based upon objective criteria. AIDEA conducts its own due diligence, subjective review of proposed development finance projects to determine both the economic development value of the project to Alaska and the credit worthiness of the project and borrower. AIDEA's credit policies also require scrutiny of applications made under other programs.

When AIDEA approves a project application, it effectively endorses that project (or, at a minimum, creates the appearance of endorsing the project). If the applicant is a religious organization, a substantial risk arises that the public would view AIDEA as endorsing religious aspects of the project or borrower. AIDEA approval of either proposed project would be found to advance religion in violation of the second prong of the Establishment Clause test.

c. Recent interpretations under second prong

Our conclusions above recognize that the United States Supreme Court has recently indicated an increasing willingness to uphold under the second prong of the Establishment Clause test, state support of secular aspects of religious schools. For example, in *Agostini v. Felton*, __ U.S. __, 117 S.Ct. 1997, the United States Supreme Court found that significant changes in Establishment Clause law entitled defendants to relief from a permanent injunction that the Supreme Court had upheld 10 years earlier.[4] The Court therefore permitted public employees to provide secular educational programs within parochial schools, rather than requiring students to be transported to another location. *Id*. 117 S.Ct. at 2012-13.

The United States Supreme Court has also held, under circumstances we believe are inapplicable to AIDEA, that government programs may not discriminate against religion. *See Rosenberger v. Rector*, __ U.S. __, 115 S.Ct. 2510, 2521 (1995). In *Rosenberger*, the Court in a 5-4 decision addressed a University of Virginia program under which student fees would help fund publications of numerous student organizations. *Id.* at 2513-16. The program furthered the "University purpose in maintaining a free and robust marketplace of ideas." *Id.* at 2527. The question posed was whether religious views could be excluded from the student publications funded with student fees.

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[4] Changes found in Establishment Clause law include that the Supreme Court has abandoned presumptions previously held that (1) the placement of public employees on parochial school grounds inevitably creates a symbolic union between government and religion, (2) all government aid that directly aids the educational function of religious schools is invalid (*i.e.*, aid is not improper merely because it relieves a financial burden that frees resources for religious purposes). *Id*. 117 S.Ct. at 2012-13. None of these apparent changes in interpreting the Establishment Clause, however, permit states to support religious aspects of sectarian schools.

The Court described *Rosenberger* as raising a conflict between two First Amendment provisions - Freedom of Speech and the Establishment Clause's prohibition on funding the advancement of religion. *Id.* at 2520-21. Justice O'Connor in a concurring opinion further described the case as a conflict between the Establishment Clause and governmental neutrality towards religion. *Id.* at 2526-27. Justice O'Connor concluded that these conflicts between competing constitutional provisions may only be resolved by drawing a fine line based on the particular facts of each case. *Id.*

Justice Kennedy for the majority drew this fine line in *Rosenberger* focusing upon the free speech aspects of the case. *Id.* at 2520-25. Student funds to help fund student publications were basically made available to all student organizations that met objective criteria. Critical in this analysis was that no public funds were paid to the student organization, but rather all funds were paid directly to the publisher. *Id.* at 2523. The majority therefore found the program to be analogous to government institutions making their facilities (*e.g.*, meeting rooms) available to all organizations in a non-discriminatory fashion. *Id.* at 2523-25. Just as the Court had stricken discrimination against religious views in the use of government facilities, it struck discrimination against religious views in the funding of student publications. *Id. citing Lamb's Chapel v. Center Moriches School Dist.*, 508 U.S.__, 113 S.Ct. 2141 (1993).[5]

While one might suggest discrimination, we believe the Establishment Clause continues to prohibit AIDEA's participation in the proposed loans. Unlike *Rosenberger*, AIDEA's non-participation in the proposed loans implicates no conflict with other constitutional provisions (such as freedom of speech).

Further, it is unclear whether the Alaska Supreme Court would follow the trend of the United States Supreme Court in interpreting the Establishment Clause. Even if the

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[5] Justice O'Connor drew the fine line focusing upon how the program was not likely to give the appearance of government support of the religious views expressed. She found that (1) student organizations are required to include in their published written materials an express disclaimer of the organization's independence from the public institution, (2) funding was paid to the publisher for printing ensuring the program furthered the "University purpose in maintaining a free and robust marketplace of ideas," and (3) the context of assisting publications of 15 widely divergent student organizations would not create a perception of government support of religion. *Id.* at 2526-27. She further found that because students might "opt out" of paying fees for publications, the funding may not constitute public funding. *Id.*

proposed loan passed what appears to be the now more relaxed federal constitutional scrutiny, it still may not pass scrutiny under the Alaska Constitution.

3. Third Prong - Excessive Entanglement with Religion

Under the third prong of the Establishment Clause test, a substantial danger also exists that AIDEA would become excessively entangled with religion. Whether AIDEA will become improperly entangled in religion must be determined by focusing upon the proposed transaction, rather than upon the statute as a whole. *Hunt v. McNair*, 413 U.S. at 742, 93 S.Ct. at 2874. In *Lemon v. Kurtzman*, the U.S. Supreme Court explained:

> In order to determine whether the government entanglement with religion is excessive, we must examine the character and purposes of the institutions that are benefited, the nature of the aid that the State provides, and the resulting relationship between the government and the religious authority.

403 U.S. at 615, 91 S.Ct. at 2112. This question is one of the degree of involvement by the state. In *Walz v. Tax Commission*, the United States Supreme Court commented:

> Obviously a direct money subsidy would be a relationship pregnant with involvement and, as with most governmental grant programs, could encompass sustained and detailed administrative relationships for enforcement of statutory or administrative standards . . . .

Walz v. Tax Commission of City of New York, 397 U.S. 664, at 675, 90 S.Ct. 1409, at 1414 (1970).

Whether AIDEA would become improperly entangled in religion is somewhat speculative at this time. AIDEA may impose terms and conditions as a condition of approving its participation in a loan. *See, e.g.*, AS 44.88.080(13) (AIDEA has the power to enter into loan agreements upon terms and conditions AIDEA considers advisable). The current proposals are therefore similar to what the Court analyzed in *Hunt v. McNair*. Because no revenue bond had yet been approved, the Court could only speculate about what terms and conditions the South Carolina Authority might impose. 413 U.S. at 747-49, 93 S.Ct. at 2876-77.

The Court in *Hunt v. McNair* accepted the interpretation of the South Carolina Supreme Court that while the South Carolina Authority possessed broad powers to become deeply involved in financial and policy decisions of the college, that it did not do so in practice. *Id.* The basic function of the South Carolina Authority was merely to ensure that the college paid sufficient fees to meet bond payments on the non-recourse debt. *Id.*

The Court observed that the South Carolina Authority would only take action if the college defaulted on a payment obligation. 413 U.S. at 747-49, 93 S.Ct. at 2876-77. Upon such default, that Authority could either foreclose upon the facility or interject itself into the financial and policy aspects of the college, including how rules, charges, and fees would be established. *Id.* The United States Supreme Court suggested in *dicta* that the Establishment Clause might allow only foreclosure of a mortgage to enforce a payment obligation, and might not permit state involvement in the business operations of the religious institution. 413 U.S. at 748-49, 93 S.Ct. at 2877.

In contrast, AIDEA has a greater likelihood of becoming entangled (or potentially entangled) with the ongoing business operations of the borrowers under the proposed loan participations. Unlike the non-recourse obligation addressed in *Hunt v. McNair*, AIDEA would have a greater incentive to protect its financial interest by monitoring the ongoing business operations of the borrower or participant and by maintaining the right to influence actions related to those operations. Further, the degree of actual entanglement would tend to become more pronounced if the credit became distressed.

In order to avoid unconstitutional entanglements, we believe that religious organizations may not participate in AIDEA programs where AIDEA may potentially become entangled in the ongoing operations of the religious organization. We believe that the observations and *dicta* in *Hunt v. McNair* offer the most useful guidance. Credit may be extended if AIDEA will not significantly influence the business operations prior to default, and if AIDEA's activities after default will be limited to foreclosure of the collateral and debt collection.

However, AIDEA may not agree to a special waiver of rights to monitor the loan or credit that would not be extended to similarly situated, non-religious borrowers. Under the first two prongs of the constitutional test, a governmental program may not be established for non-secular purposes or to advance religion. *Lemon v. Kurtzman*, 403 U.S. at 612-13, 91 S.Ct. at 2111; *Bonjour v. Bonjour*, 592 P.2d at 1242. AIDEA's agreement to waive its rights to monitor a loan or credit solely for religious organizations

would arguably create a new program solely for religious organizations that would violate the first two prongs of the test.

To avoid excessive entanglements with religion under the third prong of the Establishment Clause test, AIDEA should not extend credit to a religious organization under any program if AIDEA retains an expectation that it might desire to influence business operations either before or after default. Only under circumstances where AIDEA would waive its ability to become entangled in the business operations of any borrower (religious or not) may AIDEA programs be extended to a religious organization.

B. Direct Benefit to a Private Educational Institution

The Alaska Constitution also prohibits the use of public funds "for the direct benefit of [a] religious or other private educational institution." Art. VII, sec. 1, Alaska Constitution. The initial inquiry when determining if a state action or program violates this constitutional prohibition is whether "public funds" are expended. While AIDEA funds are not considered money of the state (AS 44.88.190), we believe that its funds would be classified as public funds for purposes of article VII, section 1 because AIDEA is a public corporation of the State (AS 44.88.020). Thus, the provisions of Article VII, Section 1 would be implicated in any transaction in which AIDEA funds may be expended.

The second inquiry focuses on whether the benefit is a "direct" benefit, prohibited by the constitution, or an "indirect" benefit that may be permitted. In *Sheldon Jackson College v. State*, 599 P.2d 127 (Alaska 1979), the Alaska Supreme Court set out a three-part test for whether a benefit is a "direct benefit" in violation of the constitution: (1) Is the benefit applied with neutrality and without regard to status or affiliation? (i.*e.*, a benefit flowing only to private schools, or to those served by them, does not reflect neutrality and non-selectivity) (2) What is the nature of the use of the funds? (3) What is the magnitude of the benefit conferred? *Id.* at 130. These three parts focus on the fundamental character of the transaction to determine whether a direct benefit is provided to the private school.

We believe that AIDEA's participation in the contemplated loan to expand the religious school would be found to “directly benefit” the private school under this three-part test. Under the first two parts, the benefit of the loan participation would flow primarily to the private school. AIDEA would participate in a loan the participating bank would provide directly to the religious school. Loan proceeds would finance the acquisition of real property and a building that would be used for the school's expansion

and the creation of a daycare facility. While a portion of the loan proceeds would benefit the daycare facility, the primary use of funds would appear to benefit the school. The school's expansion would directly enhance the school's ability to function by providing additional space for educational needs.

Under the third part of the test, AIDEA's participation would provide a substantial benefit to the private school. Similar to the benefit described in *Hunt v. McNair*, AIDEA's participation would lower financing costs over the life of the loan. *See Hunt v. McNair*, 413 U.S. at 739-40, 93 S.Ct. at 2872-73, and AS 44.88.159 (interest rates AIDEA charges). Unlike the non-recourse debt described in *Hunt v. McNair*, AIDEA funds would be at risk if any default occurred by the borrower. Contingent upon default and subsequent non-collection, AIDEA would directly fund up to its $600,000 participation in the loan for the benefit of the private school. This contingent use of public funds would also provide substantial benefit to the private school.

Thus, AIDEA's participation in the proposed loan to the religious school would appear to provide a direct benefit of public funds to a private school in violation of art. VII, sec. I of the Alaska Constitution.

Because this constitutional provision only restricts providing public funds, it would appear to apply only where AIDEA funds are used or placed at risk. We therefore believe that private schools may participate in AIDEA programs that do not involve AIDEA funds and which are non-recourse against AIDEA, such as AIDEA’s conduit financing programs.

IV. CONCLUSION

We believe that AIDEA may not constitutionally participate in the proposed loans to the religious institutions. AIDEA's participation would be prohibited under the Establishment Clauses in article I, section 4 of the Alaska Constitution and in the First Amendment to the United States Constitution. We believe that AIDEA's participation in the loan would advance religion, that it may create an appearance of AIDEA endorsing religion, and that AIDEA’s obligation to monitor financial credit creates the potential for AIDEA to become impermissibly entangled with religion.

Further, AIDEA's participation in the proposed loan to the religious school would further be barred by article VII, section 1 of the Alaska Constitution, which prohibits the use of public funds to directly benefit private schools. We believe that a private school

may be a borrower, participant, or object of loan proceeds only under an AIDEA program where there is no financial recourse against AIDEA, contingent or otherwise.

We therefore do not believe that AIDEA may participate in either of the proposed loans.

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