Managing Risk in the Face of a Slowing Economy[1]

By[2]
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I. The Problem.

When the economy is good and everyone can make money, the emphasis on risk management tends to lessen. But the time to manage risk for the bad days in business is when the economy is good, the money is flowing and the risks have not manifested themselves into real life problems.

To manage risk, one needs to appreciate what liability a person has, how long the liability exists and what assets may be at risk. Once these are identified, then a person can focus on managing risk.

This paper will focus on managing risk in commercial real estate transactions with an emphasis on the risks created by indemnities and guaranties.

II. The Commercial Real Estate Transaction---What Liability Do You Have?

A. What is Used to Create Liability?[3]

Regardless of whether the transaction is a purchase and sale transaction, a lease, a loan transaction or a declaration creating restrictions or easements related to a real estate project, contractual liability in a commercial real estate transaction arises from the agreements[4] entered into by the landowner. There are seven different

[1] Neither the author nor the firm of Carruthers & Roth, P.A. intends to provide any legal advice in this paper or to establish an attorney client relationship through this paper. Each fact situation is different and the law and how it applies to particular facts changes daily. If you have an issue, then you should consult a licensed attorney in the appropriate jurisdiction to seek legal advice.
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[3] This paper focuses on contractual liability, not on all liability, in a commercial real estate transaction. For example, this paper does not address non-contractual liability including, without limitation, liability arising from negligence, fraud or criminal acts.
[4] I use agreement here not exclusively to denote a separate contract, but rather an agreement in the context of either a separate provision in a contract or a separate stand-alone agreement.

categories of agreements that we want to identify for this discussion--the representation, the covenant, the warranty, the event of default, the guaranty, the third party indemnity and the condition.

1. The first category is representations. A representation is a statement about the existence or non-existence of a fact at a given point in time. For example, in a representation, the borrower may represent that the borrower is a Wendy’s franchisee on the date the representation is made.

2. The second category is covenants. A covenant is an agreement to do something or not to do something at some point in the future. For example, a tenant in a lease may agree only to use the leased premises to operate a convenience dining restaurant selling primarily hamburgers.

3. The third category is warranties. A warranty is an agreement to achieve some status or state of existence over a period of time. For example, a borrower may warrant that it will continue to be a franchisee of Wendy’s during the course of a loan or, a person who has represented that it is in existence in good standing as a North Carolina limited liability company, may warrant that it will continue to exist during the loan term as a North Carolina limited liability company in existence and in good standing during the term of the loan. A warranty could be described as a continuing representation. Some might even say it looks like a covenant to maintain a representation over time.

4. The fourth category is events of default. An event of default is an event set forth in an agreement the occurrence of which results in a party to the agreement being in default and entitling the non-defaulting party to exercise its remedies. Events of default may include the making of a representation that is not correct, the breach of a warranty, and the failure to perform a covenant. Sometimes the list of defaults itself includes representations, warranties or even covenants.

5. The fifth category is guaranties. A guaranty is an agreement to do something if someone else does not do it. A great example is a guaranty of payment found in most commercial loans. Someone who is not the borrower agrees to pay a particular debt of an obligor if the obligor does not first pay.

6. The sixth category is indemnities. There are 2 general types of indemnity provisions. The first is an agreement by one person to reimburse a second person for loss incurred by that second person due to liability of the second person aka the indemnified person to a third party. I will refer to this as a third party indemnity provision. An example of this type of indemnity is an environmental indemnity found in most loan documents in which the borrower agrees to indemnify the lender for

liability to third parties such as the government if the real estate collateral is found to be in violation of applicable environmental laws. The second type of indemnity provision is used to define and clarify the scope of remedies of the non-defaulting party and liabilities of the defaulting party who are in a contractual agreement with one another and to address the scope of remedies and damages between the two contracting parties. This second class of indemnity provisions is just a glorified remedies and damages provision, not an indemnity in the context of our discussion, but many of the same observations that are made in this paper about third party indemnity provisions likewise apply to these glorified damages provisions.

7. The seventh category is conditions. Conditions are typically events that are not in the control of the two contracting parties, the occurrence of which are a condition to another event. For example, in a purchase and sale transaction, obtaining an estoppel from a tenant may be a condition to closing and the failure to obtain that estoppel is likely not to be a default resulting in damages, rather it is likely to be defined as an event for which the contracting parties can terminate their agreement without liability to one another and go their separate ways.

While we will discuss all of these categories of agreements, this paper will focus more on the implications of guaranties and indemnities for purposes of risk management.

B. <u>**How Long is a Person Liable for their Agreements**</u>?

Managing risk requires not only understanding what a person has agreed to, but for how long that person has to stand behind their agreements. To know how long, one must look to the statutes of limitations and the statutes of repose for each issue. A statute of limitation tells us how long a person can bring a lawsuit to enforce the person's rights once a cause of action arises. Sometimes a statute of limitation does not start to run until the discovery of some event or the incurrence of a loss, so we have statutes of repose that set an outside date on when a person can enforce their rights even if the cause of action has not yet been discovered as a precondition to the running of the statute of limitations.

In North Carolina, the general rule is that a breach of contract claim carries a three (3) year statute of limitation that runs from the date of the breach. N.C. Gen. Stat. 1-52(1). However, a document executed under seal has a ten (10) year statute of limitation. N.C. Gen. Stat. 1-47(2). Normally, to be under "seal" a document has to include an expression of an intent to sign the document under seal which may include the word "seal" being printed beside the signer's name. <u>Davis v. Woodlake Partners, LLC</u>, 230 N.C. App. 88 (2013). An exception to this is for instruments for the conveyance of an interest in real property, which is deemed to be a document under seal with a ten (10) year statute of limitations regardless of whether a document includes a statement of intent to be executed under seal.

Deeds, deeds of trust and easements are conveyances of an interest in real estate which should have a 10 year statute of limitations whether or not executed under seal.[4] A lease is not treated as an interest in real property for purposes of the statute of limitations and should not have a 10 year statute of limitations absent actually being signed under seal.[5] Similarly, a purchase and sale agreement is not a conveyance of an interest in real estate and also should not have a 10 year statute of limitations absent actually being singed under seal.[6]

Regardless of conveyances of an interest in real estate being deemed to be documents under seal, most deeds, deeds of trust, easements, leases and purchase and sale agreements will be expressly stated to be under seal.

Knowing the applicable statute of limitations is the first step. Knowing when the statute of limitations starts to runs is the second important step which depends on the particular facts and circumstances of each matter. Generally speaking, the statute of limitations for a breach of contract, like a breach under a purchase and sale agreement, begins running on the date of the breach. Miller v. Randolph, 124 N.C. App. 779 (1996). This would seem simple enough to apply; however, like many things in the law, it is not that simple.

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[4] See Nationstar Mortgage, LLC v. Dean, 850 S.E.2d 854 (N.C. Ct. App. 2018) [holding that a deed of trust "is indisputably an instrument of conveyance of an interest in real property" and applying 1-47(2)] and Duke Energy Progress, Inc. v. Kane, 827 S.E.2d 312 (N.C. Ct. App. 2019) [recognizing that "[a]n easement, while considered to be an incorporeal hereditament, is also *real property* because it implies an interest in land" and that "an encroachment on an easement is considered an injury to that interest in real property."]

[5] Fleet Nat'l Bank v. Raleigh Oaks Joint Venture, 117 N.C. App. 387 (1994) [affirming the "well settled principle" that "a leasehold interest in real property is a chattel real and subject to the rules of law applying to personal property", and refusing to apply the NC anti-deficiency statute to a deed of trust secured by a leasehold interest].

[6] N.C. General Statutes Section 1-47(2) applies to "instrument[s] of conveyance of an interest in real property." In North Carolina, since "[a] conveyance of land can only be by deed," New Home Building Supply Co. v. Nations, 259 N.C. 681 (1963), and since a deed "ordinarily denotes an instrument in writing, signed, sealed, and delivered by the grantor, whereby an interest in realty is transferred from the grantor to the grantee," Gifford v. Linnell, 157 N.C. App. 530 (2003), a typical purchase and sale contract which contemplates the delivery of a deed at closing does not convey an interest in real property. Rather, such purchase and sale agreements only evidence a *promise* to convey real property at a later date by the delivery of a deed. Therefore, causes of action arising under a purchase and sale contract will be subject to the three (3) year statute of limitations contained in N.C. General Statutes 1-52(1) (unless the contract is actually executed with the formality and expressed intent of being under seal).

1. Breach of Representation. Take a breach of a representation for example. Both fraud and negligent misrepresentation, which are torts not contract claims, have a three (3) year statute of limitation that runs from the date of discovery and suffering harm (it is a little more complicated than that, but we don't need to get into that for the purposes of this discussion). N.C. Gen. Stat. 1-52(9) [fraud]; N.C. Gen. Stat. 1-52(2) [negligent misrepresentation]. However, a breach of a representation under a contract carries a three (3) year statute of limitation that begins when the contract is signed and thus the misrepresentation is made, not when the misrepresentation is discovered. N.C. Gen. Stat. 1-52(1).

A misrepresentation in a contract is analyzed under contract law rather than as a negligent misrepresentation under tort law because of the economic loss rule. The economic loss rule provides that a party cannot maintain an action in tort for purely economic loss where the parties have a contractual agreement that addresses the issue at hand. Bradley Woodcraft, Inc. v. Bodden, 795 S.E.2d 253 (NC Ct. App. 2016).

For example, a borrower makes a representation in the loan agreement that the financial statements delivered in connection with closing by the borrower to the bank are true, correct and complete not realizing that there is a mathematical error in the financial statements that overstates the borrower's income. This is discovered four (4) years after closing. The contract claim should be barred by the statute of limitations which began to run on the date the misrepresentation was made in the loan agreement on the date of closing. While the statute of limitations would not start to run until after discovery for a negligent misrepresentation claim, a claim for negligent misrepresentation should be barred by the economic loss rule because the parties have a written agreement that governs the loan.

This does not mean that a borrower (or any other party to a contract) is entitled to deliver false financial statements or other information with impunity. A claim for fraud is an extra-contractual claim that is not barred by the economic loss rule. Bradley Woodcraft, 795 S.E.2d 253. If the borrower made the misrepresentation knowing it was false, or made it recklessly without knowledge of its truth, intending to deceive the bank, the bank reasonably relied on the representation and suffered injury, then a fraud claim could be brought within three (3) years after discovery, provided that the discovery was made within ten (10) years after the date of the occurrence of the last act of the fraud. N.C. Gen. Stat. Section 1-52(16) [the statute of repose for fraud claims].

2. Breach of Indemnity. Unlike a contractual misrepresentation claim discussed above, the cause of action for a claim for indemnity does not arise on the date the promise to indemnify is made. Rather, "North Carolina follows the general rule that a cause of action on an obligation to indemnify normally accrues when the indemnitee suffers actual loss." Schenkel & Shultz, Inc. v. Hermon F. Fox & Assocs., P.C., 180 N.C. App 257 (2008). In other words, for third party claims, "The right to sue for indemnity for damages resulting from the negligence,

misfeasance or malfeasance of another does not accrue until legal payment has been made." Hager v. Brewer Equipment Co., 17 N.C. App. 489 (1973).

Claims on indemnities are likewise subject to the ten (10) year statute of repose with the exception of claims for groundwater contamination under N.C. General Statutes 130A-26.3.

Several examples may be worthwhile here. Let's use an environmental indemnity in a lease which typically is a mixed bag of a provision that defines the scope of remedies and damages between the parties and also includes an indemnity by the tenant in favor of the owner for injuries to third parties. A lease environmental provision might read as follows, "Tenant agrees not to use, store or otherwise allow to exist on the leased premises any hazardous substances. Tenant agrees to indemnify Landlord for all loss, liability and expense related to any hazardous substance brought onto and/or stored at the leased premises after the date of this Lease including, without limitation, any damage to the leased premises and any injury to third parties."

Assume that Tenant brings a hazardous substance onto the leased premises and that hazardous substance causes damage to the land and improvements. Let's also assume that a third party customer of the Tenant also comes into contact with the hazardous substance, suffers severe injury and sues both the Tenant and Landlord. As to the liability for the damage to the property, this is really a breach of lease claim for which the indemnity provides an explanation of what damages the Landlord is entitled to. Arguably, the statute of limitations for the breach of the tenant's covenant not to bring hazardous substances onto the leased premises would carry a 3 year statute of limitations arising at the time that the damage occurred to the leased premises. (Our example language above which requires the Tenant not to allow hazardous substances to exist on the leased premises could extend the date of accrual). The indemnity obligations for the liability to the third party is a different story. That indemnity obligation would arise on the date the indemnitee, the Landlord in this case, suffers harm which would be the date the injured third party prevails in a lawsuit against the Landlord and the Landlord has to pay the injured third party.

3. Breach of Guaranty. Like a breach of contract claim, a guaranty has a three (3) year statute of limitations. N.C. Gen. Stat. 1-52; Durham Shopping Center Inc. v. ORCO, Inc., 71 N.C. App 628 (1984). With a guaranty, the cause of action accrues when the underlying obligor refuses or fails to pay and is reset for each subsequent failure of payment. Durham Shopping Center, Inc., 71 N.C. App 628.

The takeaway from this discussion of statutes of limitations is that managing risk in the future requires managing what you agree to guaranty today.

C. **What Assets are at Risk and What is the Down Side**?

To manage risks, one must appreciate what assets are at risk because once a judgment is obtained against a liable party, a judgment holder wants to realize on all of the assets of the debtor possible to satisfy the judgment holder's unpaid debt. So to analyze what assets are at risk, one should consider what assets of a debtor are protected by law from a judgment holder.

There are limitations as to how the judgment holder can enforce its judgment. Individual judgment debtors are entitled to various protections contained in the North Carolina Constitution, the North Carolina General Statutes, and the common law. Beyond that there is bankruptcy.

First, in North Carolina, real property owned by a husband and wife is frequently owned as tenants by the entirety. If a married couple owns their property as tenants by the entirety, each spouse "is deemed to be seized of the whole, and not of a moiety or any undivided portion thereof." <u>Carter v. Continental Insurance Co.</u>, 242 N.C. 578, 579, 89 S.E.2d 122, 123 (1955) (*quoting Davis v. Bass*, 188 N.C. at 203, 124 S.E. at 568). Based on that, a spouse cannot convey his or her interest in the estate without the joinder of the other spouse. <u>Combs v. Combs</u>, 273 N.C. 462, 160 S.E. 2d 308 (1968) *See also* <u>Worrells v. North Carolina Farm Bureau Mut. Ins. Co.</u>, 103 N.C. App. 69, 404 S.E.2d 188 (1991). Nor can either spouse encumber the property without the written joinder of the other spouse. N.C. Gen. Stat. § 39–13.6. With the limited exception of liability for income taxes as affirmed by the Supreme Court in <u>U.S. v. Craft</u>, 535 U.S. 274 (2004), since both spouses must consent to conveying an interest in or encumbering entireties property, entireties property in North Carolina is not subject to any creditor's claim if that creditor's claim is only against one spouse. <u>Grabenhofer v. Garrett</u>, 260 N.C. 118, 120, 131 S.E.2d 675, 677 (1963).

Additionally, every individual resident of North Carolina is entitled to retain certain property free of the enforcement of claims of creditors. N.C. Gen. Stat. § 1C-1601(a). "Property allocated by a debtor is exempt from the enforcement of the claims of creditors for indebtedness … for so long as the debtor owns it." N.C. Gen. Stat. § 1C-1604(a). Subject to certain exceptions,[7] an individual resident of North Carolina may designate the following property exempt from enforcement: (a) up to $35,000 in value of real property (or personal property if dealing with a mobile home) that serves as the debtor's personal residence or up to $60,000 000 in value of real property (or personal property if dealing with a mobile home) that serves as the debtor's personal residence if the debtor is 65 years old or older; (b) up to $3,500 for

[7] The exemptions described in § 1C-1604(a) are inapplicable to claims of (1) the United States or its agencies, (2) the State or its subdivisions for taxes, appearance bonds, or fiduciary bonds, (3) contractors' liens, (4) mechanics' liens, (5) payment obligations for the purchase of specific real property, (6) contractual security interests in specific property, (7) statutory liens other than judicial liens, (8) child support or alimony payments, or (9) criminal restitution orders. Additionally, exemptions created through recent purchases of tangible personal property (within the immediately preceding 90 days) are inapplicable.

a motor vehicle; (c) up to $5,000 in value in household furnishings, household goods, books, animals or crops held primarily for personal, family, or household use, plus $1,000 in value per dependent for the same; (d) up to $2,000 in value for professional books or tools of the trade of the debtor or his/her dependents; (e) all life insurance proceeds naming such debtor's spouse, children, or a combination thereof as beneficiary; (f) all professionally prescribed home health aids; (g) compensation derived from a personal injury claim; (h) individual retirement accounts including IRAs and Roth IRAs; (h) funds maintained in a Section 529 college savings account up to $25,000 (but excluding contributions made in the prior twelve months, unless such contributions were made in the ordinary course of the debtor's dealings); (i) retirement benefits under the retirement plans of other states and governmental units of other states, to the extent that such benefits are exempt under the laws of the state or governmental unit under which the benefit plan is established, and (j) alimony, child support, and separate maintenance payments. N.C. Gen. Stat. § 1C-1601(a).

Furthermore, assets owned by certain trusts like spendthrift trusts which name the debtor as a beneficiary but have an independent trustee who has absolute discretion over disbursements to the beneficiary will not be subject to the claims of the debtor's creditors. N.C. Gen. Stat. § 36C-5-501.

While the aforementioned protections address specific items of property that cannot be reached by a judgment creditor, they do not speak to the ongoing personal liability that a judgment debtor faces nor to non-exempt or unprotected assets. Thus, there is ongoing personal liability and the judgment can attach to future non-exempt property. However, a judgment debtor may be able to achieve additional protection by filing a petition for bankruptcy protection.

There are three different types of consumer bankruptcy set forth in Title 11 of the U.S. Code (the "Bankruptcy Code"). If a debtor seeks bankruptcy protection pursuant to Chapter 7 of the Bankruptcy Code, a trustee will be appointed to assist in the orderly liquidation of the debtor's nonexempt assets. 11 U.S.C. § 701 *et seq*. The Bankruptcy Code incorporates the exemptions set forth above by reference. 11 U.S.C. § 522. Upon completion of the orderly liquidation, the debtor receives a discharge of such debtor's personal liability of prepetition obligations, subject to certain exceptions to discharge.[8] 11 U.S.C. § 524. Thus, a judgment debtor does not obtain any novel asset protection from a case under Chapter 7 but does receive a discharge of indebtedness upon completion of the liquidation. The biggest benefit derived herein is that a one-time liquidation discharges the entirety of the debtor's unsecured obligations. If a debtor's unsecured obligations greatly exceed the value of the debtor's non-exempt and unencumbered assets and the debtor is willing to part with such non-exempt assets, Chapter 7 may provide a desirable outcome.

[8] Debts for (a) most unpaid taxes, (b) money, property, or services obtained by fraud, (c) unscheduled debts, (d) domestic support obligations, (e) willful and malicious injury claims, and (f) student loans are examples of debts that cannot be discharged in bankruptcy. 11 U.S.C. § 523(a).

Not all debtors desire to be subjected to an asset liquidation pursuant to Chapter 7, and thus many elect reorganization pursuant to Chapter 11 or Chapter 13. In a case under Chapter 13, a debtor will obtain a discharge after making payments subject to a court-confirmed plan of reorganization for either 36, or more typically, 60 months to a trustee that then distributes those payments to the debtor's creditors. 11 U.S.C. §§ 1326 – 1328. Under such plans, debtors are frequently able to discharge unsecured debts—even business debts for pennies on the dollar. However, to be eligible to reorganize one's debts and obtain a discharge under Chapter 13, a debtor must have (a) regular income, (b) unsecured debts in an amount less than $383,175.00, and (c) secured debts in an amount less than $1,149,525.00. 11 U.S.C. § 109(e). Because many judgment debtors face debt obligations in excess of $383,175, they are ineligible for a Chapter 13 reorganization.

If a debtor is not eligible for a Chapter 13 reorganization and is either ineligible or uninterested in a Chapter 7 liquidation, they may seek relief under Chapter 11 of the Bankruptcy Code. A Chapter 11 bankruptcy grants a debtor the most discretion in reorganizing his or her debts, as such a debtor may propose a plan of reorganization, and, as long as that plan meets certain requirements set forth in Chapter 11 and is approved by the creditors pursuant to Section 1126, the debtor's plan binds the creditor body to receive only the repayment set forth in the debtor's bankruptcy plan. 11 U.S.C. § 1141. Thus, like in cases under Chapter 7 or Chapter 13, debtors can frequently discharge their personal liability for unsecured claims for pennies on the dollar. Like plans under Chapter 13, Chapter 11 plans may be funded through future earned income. Alternatively, debtors under Chapter 11 frequently sell certain unencumbered or partially unencumbered assets and use the income to fund the plan. Finally, post-petition financing may come into play as well. Thus, Chapter 11 often offers some benefit to debtors with large unsecured debts. However, Chapter 11 bankruptcies are typically administratively demanding and involve considerable legal fees and court costs.

As an example of the forgoing, consider the hypothetical distressed real estate investor Nick Underwater. Nick lives with his wife in a home they own together, he has various assets, but his most valuable assets are his home, his retirement account, his ownership interests in several LLCs, and his brokerage account. In connection with a project of one of his LLCs, Nick signs a personal guaranty. The deal goes bust, and the bank obtains a judgment against Nick. If Nick does not file for bankruptcy, (a) his home is protected because he and his wife own the home as tenants by the entirety and Nick's wife did not execute a guaranty in association with this project, and (b) his retirement account is protected pursuant to N.C. Gen. Stat. § 1C-1601(a)(8). However, his brokerage account and the LLC interests are available to satisfy his judgment creditor. Thus, he'll wind up depleting his brokerage account and enduring charging liens repaying his judgment creditor if he does not seek bankruptcy protection.

If Nick sought protection under Chapter 7, the trustee would liquidate his non-exempt assets (here, the brokerage account and LLC interests) and pay off his unsecured creditors. This may also mean selling Nick's interests in his LLCs, which may make Chapter 7 unappealing.[9] Upon completion of the liquidation, any outstanding balance on the guaranty would be discharged. Alternatively, if Nick's unsecured obligations are less than $383,175 and Nick is otherwise eligible for a Chapter 13 reorganization, the court should approve a plan that allows Nick to make 60 monthly payments in an amount equal to his monthly disposable income (which is equal to a formulaic calculation which considers secured obligations, income, and IRS-determined acceptable monthly expenses). After making such repayments, Nick's remaining unsecured obligations are discharged.

Alternatively, Nick may choose to restructure his obligations under Chapter 11 (particularly if his unsecured claims are too high for Chapter 13). In such an instance he'll have the opportunity to propose a plan of reorganization to the creditor-body which will be subject to court approval. Typically such a plan provides that secured creditors and administrative and priority claimants (like post-petition claims and tax claims) will be paid in full, but unsecured creditors will likely only receive pennies on the dollar for their claims if anything. The plan may be funded through post-petition financing, post-petition earned income, or selling off assets with equity. In Nick's case, he may fund his plan by agreeing to a combination of the foregoing (a) selling his equity in one or more of his LLCs to the other members and contributing the proceeds to fund a portion of the plan, (b) contributing some earned income over the life of the plan, (c) contributing other distributions he receives, and (d) selling off other assets like cars, vacation homes, or securities. Upon confirmation of the plan, the creditors are bound by its terms, and after completion of the plan, the debtor will be discharged of liability to the creditors. Thus, Nick may be able to propose a plan that mixes ways to contribute value to his creditors while also receiving a discharge of liability.

The takeaway here is that the assets of a debtor are available to satisfy claims of creditors unless there is a specific protection for the debtor. Protection after judgment is a much harder, and less rewarding, game than managing risk on the front end.

III. MANAGING RISKS.

A. **Indemnities**.

[9] N.C. Gen. Stat. § 57d-5-03 limits the rights of judgment creditors to the right to receive the distributions that otherwise would be paid to the interest owner with respect to the economic interest. However, the entire interest in such LLC is property of the bankruptcy estate and thus could be liquidated. 11 U.S.C. 541(a)(1). *See also* Sheehan v. Warner *(In re* Warner*)* 480 B.R. 641 (Bankr. N.D. W. Va. 2012) providing a helpful analysis of LLC interests in bankruptcy.

When it comes to indemnities, the easiest way to manage risk is not to agree to them. This however is not practical. Some people, like lenders, will require them as a matter of course and in other instances, like in leases, you may have to offer an indemnity to get a reciprocal indemnity or just to get the deal done. With respect to indemnities, the most important question in any deal is why am I giving this indemnity?

If you have to agree to an indemnity, consider the following:

1. Who am I indemnifying? Often times, the "Indemnified Party" will include a long list of people, including the purchaser and its tenants, its officers, its members, its employees, its affiliates, its customers, its guests, and its invitees. Are all of these people necessary?

2. What am I indemnifying them for? Make the obligation as narrow as possible. If you are a tenant indemnifying a landlord for liability under a lease arising from environmental contamination occurring after the date of the lease, should you, the tenant, be liable in all cases for environmental damage if there are multiple tenants at the site or if there is the risk of off-site contamination migrating onto the leased premises?

3. How long does the indemnity last? Using the tenant example again, does the indemnity apply to environmental contamination on the leased premises from the beginning of time until judgment day? Does the indemnity only cover the period of the tenant's lease term? Does it only cover the period of the tenant's occupancy in case of a loss of possession arising from the exercise of the landlord's remedies?

4. Who is giving the indemnity? Is the person making the indemnity a special purpose entity who is the borrower under a loan? Or is the indemnitor an individual signing a standalone environmental indemnity agreement?

B. **<u>Guaranties</u>**.

Guaranties can be used in many different contexts including leases and loans. Like with indemnities, the most important question in any deal is why am I giving this guaranty?

Also like indemnities, work to limit your exposure. Ask these questions: (1) To whom am I making the guaranty? (2) What obligations am I guarantying? (3) How long does the guaranty last? (4) Who is giving the guaranty?

1. To whom am I making the guaranty? Unlike an indemnity, guaranties usually run to only one person and that is the holder of the obligation being

guarantied. If it is anyone else, then the guarantor should look closely at what the guarantor is being asked to guaranty.

2. What obligations am I guarantying? Sounds simple, but ask the question, is this a guaranty of a single loan or a guaranty of a credit facility which contemplates multiple credit obligations?

3. How long does the guaranty last? Again sounds simple, but a guarantor should look closely at the term of the underlying obligation. Is this a 3 year loan, a 10 year loan, a 30 year lease?

4. Who is giving the guaranty? This is an important question. As noted above, in North Carolina if an individual makes a guaranty, then assets held as tenants by the entireties are not subject to the claims of the creditor of the individual guarantor as long as the spouse of that guarantor does not also sign the guaranty.

There are, however, additional questions that should be asked about a guaranty including: (a) Do the obligations being guaranteed include any cross defaults to other transactions? (b) Does the guaranty include any cross defaults? And if so to what? (c) Is there more than one guarantor? And if so, how are the guarantors related? (d) What is the nature of the obligations being guaranteed?

(a) Do the obligations being guaranteed include any cross defaults to other transactions? This may have less importance with a mom and pop loan; however, if the ownership structure is more complicated, then this becomes more important especially if the cross default extends to defaults by affiliates.

(b) Does the guaranty include any cross defaults? Cross defaults in guaranties are double edged swords. Not only does it run the risk of tying multiple projects which may be very different together, it also may tie the underlying project to unrelated projects of the guarantor. Consider whether a guarantor should want a payment and performance guaranty in a construction loan and a limited recourse guaranty on a limited recourse loan tied together.

(c) Is there more than one guarantor? If you have multiple guarantors, there are many issues. How do the amounts of the underlying obligations guarantied relate to the interest of the guarantor in the project? If there are guarantor cross defaults, what other projects are the guarantors involved in?

(d) What is the nature of the obligations being secured? Is this a construction loan, a limited recourse loan, a short term lease, a long term lease or something else?

IV. PREPARATIONS BEYOND MANAGING RISKS.

One cannot eliminate risk and, even if one does their best to manage risk, unexpected problems arise. There are several things that are beneficial to have on your side when the economy starts to slide. The first is the ability to bring more cash into your deal, and the second is the ability to allocate losses in a manner that recognizes the parties intent and the business structure of the particular investment.

A. Preserve the Ability to Bring Cash into the Deal.

This sounds obvious, but many times a group of investors will enter into agreements that do not contemplate a cash shortfall. Ownership agreements are full of provisions that restrict transfers of membership interests, that limit the ability to obtain additional financing and may even make providing additional equity unattractive. In addition, most loan documents will restrict an ownership entity from transferring membership interests, admitting new members or borrowing money even from members of the ownership entity without the lender's consent. These issues should be considered in the context of the deal and addressed to promote flexibility.

B. Clarify Contribution Rights and Obligations.

Establish how those who have stepped up to sign indemnities and guaranties for the benefit of the ownership entity will be reimbursed by other persons benefitting from those guaranties and indemnities.

The North Carolina Limited Liability Company Act does provide some basic assistance with this issue. Section 57D-3-31(b) of the Act provide that "An LLC shall reimburse a person who is or was a member for any payment made and indemnify the person for any obligation, including any judgment, settlement, penalty, fine or other cost, incurred or borne in the authorized conduct of the LLC's business or preservation of the LLC's business or property, whether acting in the capacity of a manager, member, or other company official…" This right of indemnity is limited to an obligation of the LLC which is helpful if the LLC has assets, but is of much less use in a meltdown of the LLC.

Limiting the right of recovery under Section 57D-3-31(b) to an obligation of the LLC makes sense when we focus on the primary advantage of being a member of a limited liability company is the advantage of limited liability. Section 57D-3-30 of the N.C. General Statutes expressly states that "A person who is an interest owner, manager, or other company official is not liable for the obligations of the LLC solely by reason of being an interest owner, manager or other company official." As a result, other than the benefits of Section 57D-3-31(b) of the Act, a guarantor or indemnitor of the obligations of an LLC will find little help under the Act.

A guarantor or indemnitor may find some relief under the common law based on the equitable principal of contribution. Under the equitable remedy of contribution, "The principle of contribution is equality in bearing a common burden." Nebel v. Nebel, 223 N.C. 676 (1943) [Right of contribution among taxpayers who were liable for a tax owed by them jointly]. "The general rule is that one who is compelled to pay or satisfy the whole or to bear more than his just share of a common burden or obligation, upon which several persons are equally liable or which they are bound to discharge, is entitled to contribution against the others to obtain from them payment of their respective shares." Nebel, 223 N.C. 676.

To be entitled to the remedy of contribution, "A plaintiff seeking contribution-based relief is simply required to prove that the obligation exists, that the parties are both required to pay the obligation, and that one obligor has paid a portion of the obligation for which the other obligor was legally responsible." College Road Animal Hospital, PLLC v. Cottrell, 236 N.C. App. 259 (2014) [Court held that since loan was not in default, right of contribution from guarantors in favor of LLC and its owners did not arise]. The important point of that case is the requirement to prove that "the parties are both required to pay the obligation." So the remedy of contribution works as between two people, whether as guarantors, indemnitors or other obligors of the same obligation. But, remember, Section 57D-3-30 which provides that a member is not liable for the obligations of the LLC. That Section stands in the way of a guarantor or indemnitor recovering through contribution against another member who is not also a guarantor.

In addition to the practical limits of the equitable remedy of contribution, the law is unsettled as to what constitutes an equitable share in contribution. Is it per capita among the guarantors, is it based on ownership interest in the LLC, is it based on the relative ownership in the LLC of the guarantors, or perhaps some other standard?

In a mom and pop business the question of contribution obligations may not be a big deal, but in an LLC with different types of investors and different ownership interests this may be the difference in having someone step up and take additional risk when it is needed to extend the future of a troubled investment or the difference in fairly satisfying the score after the creditors are paid.

Rather than rely on the Act or an equitable principle of contribution, the more prudent course would be to have the members of an LLC as wells as those who guaranty the debt contractually agree on their respective rights of contribution at the outset.

V. CONCLUSION.

Preparing for a down economy involves understanding how liability is created, how long the liability lasts, and what assets are impacted by that liability. That preparation also involves working now to manage risks including limiting indemnities based on who, when and for what the indemnities are being given. That preparation also involves understanding what is being guaranteed. In addition, attention should be devoted to preserving opportunities to inject additional capital in the future as well as addressing key ownership concepts before things get tough. Finally, without casting a cloud of negativity, the question needs to be asked, "If this goes South, how is the economic loss shared especially if less than all of the members are guarantying obligations."