No Good Deed Goes Unpunished: Trying to Pull a Fast One on D & H Management LLC

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Stephen Hodgetts, the managing partner of D & H Management LLC (D & H), was talking with his property management agent about the deal he had thought he had made with his last remaining tenant. "He now wants what? A month's free rent on top of his prior request to have his water bills paid for! What does this guy think he is a rock star? He has got to be kidding. I might believe in social entrepreneurship but when did I become the welfare department?"

The Way We Were

D & H was started back in 2002 by himself and his recently deceased partner, Richard Davis. Davis had done enough preliminary research on the real estate market in his area to convince Hodgetts that there was money to be made by becoming landlords and by renting to individuals with questionable credit while working with them to fix their credit record so they could eventually buy their rental homes. Davis and Hodgetts strongly believed in helping others help themselves while making a profit. D & H Management LLC was formed and immediately acquired six homes. Davis and Hodgetts needed to raise additional monies for growth purposes and decided that if they finished off the basements of their rental properties they could re-mortgage those properties and pull out an additional $10,000 - $20,000 per home. They thought this would increase their cash flow and make their homes more desirable for their tenants to acquire. In January 2003 they hired one of their renters to finish off all of the basements.

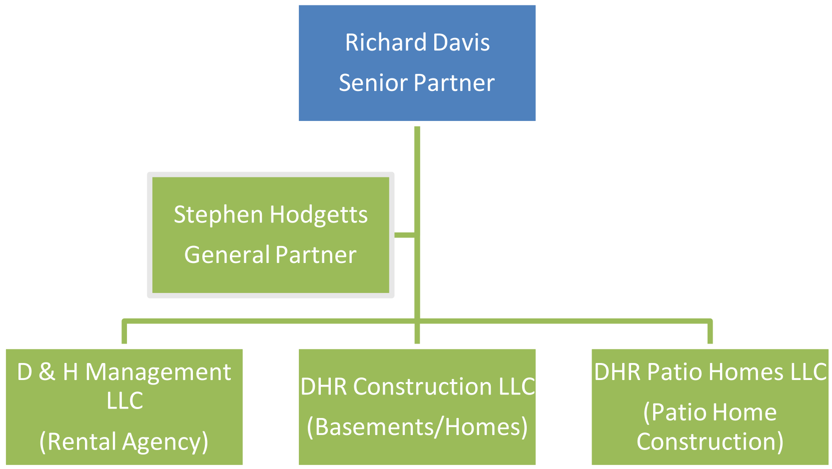
As the finishing work progressed the individual who was designing their basements thought that Davis and Hodgetts could cut out the middle man if they built their own homes. They could sell their homes to themselves "at cost" making it easier to lower rents to their occupants. Given the strength of the local housing market in May 2003, Davis and Hodgetts formed DHR Construction LLC and broke ground on their first construction site in the St. Andrews development. By January 2004 they had completed three homes at St. Andrews and by April of 2004 Davis and Hodgetts built three more homes in another development (Florence). It was unfortunate that the Florence developer did not pay his landscapers and the vacant properties that were owned by Davis and Hodgetts received mechanic's liens[1] making building new homes on the unworkable. Davis and Hodgetts then sold the built homes to another real estate firm while being stuck with several unsellable and unbuildable properties.

Davis and Hodgetts formed a third business in the summer of 2004, DHR Patio Homes LLC, which was created in order to work on their latest construction project, Mountain Trails. (See Figure 1below, Organizational Chart.) This was a difficult project for Davis and Hodgetts in that it involved building nearly forty custom homes in an upscale community, something completely different from their prior projects. They built a number of spec homes[2] in the summer of 2005; however the market slowdown that started in the summer of 2006 found Davis and Hodgetts having several unsold homes.

[1] "The right of a craftsman, laborer, supplier, architect or other person who has worked upon improvements or delivered materials to a particular parcel of real estate (either as an employee of the owner or as a sub-contractor to a general contractor) to place a lien on that real property for the value of the services and/or materials if not paid." Retrieved from http://legal-dictionary.thefreedictionary.com/Mechanic's+Lien, 9/13/12.

[2] "A home builder term used to describe a "speculative" or "inventory" home built without a buyer. Builders build spec homes to satisfy demand from buyers who do not have time to build a home." Retrieved from http://www.realestatewebmasters.com/glossary/spec-home/, 2/12/13.

Figure 1: Davis and Hodgetts' Businesses (2005)



They quickly became credit poor while experiencing negative cash flows from having to pay off construction loans, land purchases, and rental home mortgages. In the interim, the Florence properties which they could not sell were forced into foreclosure[3] and DHR Construction LLC was unincorporated.

The Beginning of the End

Things went from bad to worse in the next four years. By the summer of 2009 the crumpling of their local real estate market had not only forced the dissolution of their remaining construction company (DHR Patio Homes LLC) but also pushed Davis and Hodgetts into Chapter 7 personal financial bankruptcy.[4] Both Davis and Hodgetts had lost their homes and their nest eggs and could ill afford more bad news. To make matters worse, their real estate management firm was hemorrhaging cash as renters fell behind in their monthly payments and vacancy rates climbed. Of the eight properties still in rental their inventory, one was already in foreclosure while the values of the rest of their rental homes were lower than the associated property mortgages. With negative cash flows, negative equity, and no access to capital there seemed like there was little that Hodgetts and Davis could do.

Hodgetts thought matters could not get any worse but of course he was wrong. Davis developed a terminal medical condition in 2010 which necessitated his leaving the management of the business to his wife. She managed as best as she could but eventually left the management of the firm to Hodgetts in December of 2010. When Hodgetts took over as managing partner he could not believe that the firm had survived as long as it had. The firm was at least 4 months behind on every mortgage payment and the mortgages of each property far exceeded the current market value of the property. The firm also had received several notices that foreclosures would be forthcoming on all of the properties; notices that had been put on the doors of each property by the lender creating very nervous tenants– would they have to move given a 30 day notice? Luckily no action was taken by the lenders as long as Hodgetts kept paying the monthly mortgages as behind as he was.

Trying to Exit

It was early 2011 with another property foreclosed upon when Hodgetts recognized that he could not deal with the stress and uncertainty of managing a no win business. He was going to set up an absentee owner operation while getting rid of the remaining six properties.

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[3] "The legal process by which an owner's right to a property is terminated, usually due to default. Typically involves a forced sale of the property at public auction, with the proceeds being applied to the mortgage debt." Retrieved from http://www.investorwords.com/2039/foreclosure.html, 2/12/2013.

[4] "Chapter 7 is a liquidation of all assets while Chapter 13 is reorganization where the debtor creates a three to five year payment plan."Retrieved from http://www.bankruptcyinformation.com/personal-bankruptcy.htm, 8/31/09.

He contacted a real estate broker who specialized in distress and short sales[5] and put all of the rental properties up for sale with a first option to buy going to the existing tenants, as per their rental agreement. This broker put him in touch with a professional real estate management firm whose expertise was managing distressed rental properties and they took over all of the day-to-day operations of the business for a 14% fee. Hodgetts was left to just dealing with the firm's cash flow which meant determining which lending institutions could get paid and which would not given the firm's monthly revenues.

All of the tenants in the properties showed interest in purchasing their homes which made Hodgetts quite elated since that was his and Davis' original mission for starting the firm. His broker warned Hodgetts and the tenants that the process could take anywhere from 3-6 months assuming that the residents could qualify for a mortgage. Why so long? Beside the purchasers demonstrating to the lender that they could pay off a lower mortgage, Hodgetts had to demonstrate that D & H could not continue to financially support these properties. Due diligence[6] required that he file several forms for each property including a declaration of his personal assets, his chapter 7 bankruptcy, monthly personal and corporate bank statements, monthly income statements and balance sheets of the firm, his and the businesses' prior two years tax forms, declarations indicating his inability to pay off the mortgages, water rights, that he and/or the firm were not receiving any benefit from the sale, and that he was not related to the buyers in any way.

By October 2011 Davis finally succumbed to his illness. Davis's wife quickly departed the business leaving Hodgetts with all the properties, the business itself, as well as the responsibility of continuing to pay all of the mortgages of properties now part of Davis's estate. Hodgetts felt abandoned but understood that Davis's wife wanted nothing more to do with the business – it was a large black mark on her husband's otherwise lifelong accomplishments.

The Hitch

By January 2012 his broker had lined up buyers for each and every property managed by D & H. Most of the buyers were the current tenants, yet not all of the tenants qualified for mortgages. In those cases investors were found to take over the properties and to continually rent them out. Each sale had its unique problems and required additional time and effort from Hodgetts; time he really did not have or want to give. Three of the properties required Davis's wife's cooperation in order to make the deal yet she wanted absolutely nothing to do with the business (and the related properties). She could have quitclaimed[7] the properties to D & H or Hodgetts so as to facilitate the sales but as far as she was concerned the lenders could foreclose. This left the broker, Hodgetts, and the potential buyers wondering if the lenders would be flexible in this matter and allow the sale through proxy[8] – the lenders said no.

Ten months had passed (October 2012) and Hodgetts' broker had managed to close three properties while the bank had foreclosed on another. Hodgetts was down to two properties in D & H's possession yet the last two properties seemed to be impossible to sell because of Davis' wife's lack of cooperation as the Executrix of Davis's estate.

[5] "A short sale is a sale of real estate in which the proceeds from selling the property will fall short of the balance of debts secured by liens against the property and the property owner cannot afford to repay the liens' full amounts, whereby the lien holders agree to release their lien on the real estate and accept less than the amount owed on the debt." Retrieved from http://en.wikipedia.org/wiki/Short_sale_ (real_estate), August 30, 2012.

[6] "Due diligence is a concept that is inherent in most types of transactions. The goal of due diligence is to provide parties to a transaction all possible information such that the person can make an informed determination and essentially enter into a transaction with open eyes." Retrieved from http://www.ehow.com/facts_5142206_meaning-due-diligence.html, 2/12/13.

[7] "Quitclaim deeds transfer or "quit" any interest in real property. The grantor may not be in title at all, so the grantee cannot assume that the grantor has any real interest to convey. However, if the grantor were, say, married to the owner of the property, signing and recording a quitclaim deed in favor of the spouse would transfer any interest the grantor may have in the property to the spouse." Retrieved from http://homebuying.about.com/od/glossaryqr/g/quitclaimdeed.htm, 2/14/13.

[8] "1. A person authorized to act for another; an agent or substitute. 2. The authority to act for another. 3. The written authorization to act in place of another." Retrieved from http://www.thefreedictionary.com/proxy, 2/20/13.

I Can See the Light at the End of the Tunnel – Heh, Who Turned out the Lights?

By February of 2013 Stephen Hodgetts seemed to have finally accomplished what he dearly wanted to happen, to exit the business and get rid of its final two properties. The lender had foreclosed on one of the properties and was in the process of foreclosing on the other.A few days ago he had talked with his last renter who knew that he had to move out of the foreclosed property within 30 days – the renter had called Hodgetts and made a deal to move into the remaining property on a month to month basis for a highly reduced rental rate. Hodgetts was busily surfing the internet when he received the following e-mail from his property management agent:

> I did get a message from the last tenant that he wanted to move into our last property and that he had come to an agreement with you. So I will get a month to month lease put together for him. I don't have a date on when the last property will be auctioned off but I will keep looking to see if they have posted that information yet. Thanks.

His property manager kept contacting him over the next few days, each time with a request from the tenant wanting more concessions. Hodgetts got so fed up with what he called “these shenanigans” that he finally called his property manager to explain why he originally agreed to a very low rent and perhaps why his tenant was now trying to take full advantage of him.

> Maybe this is my entire fault. I should not have given in so quickly to a reduced rent. I felt bad for the guy because the house he was renting just went into foreclosure sale and he was outbid by the mortgage company. They gave him 8 days to move out, not a lot of time. He called me and told me his tale of woe and offered to move into our other property next door, our last remaining rental. I knew that the rugs were in bad shape but he went on and on about how poorly the house had been kept, and how he had taken money out of his own pocket to do minor repair work on his own rental. I explained to him that the new rental property was also going to be foreclosed on within the next month or two and therefore I had no intention of sinking any money into the property. He mentioned that he’d then have to put some work into the new rental to make it habitable and that these repairs would come out of his own pocket. So feeling sorry for the guy I offered to cut the rent by over 60%.
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> We agreed on a rent of $500/month, no deposit, and a month by month lease with the renter picking up all related upkeep expenses. I even gave him permission to swap the appliances in his current residence with this other property because he felt that his appliances were better. I have to admit that his incessant requests really anger me because I feel like he is trying to pull a fast one. Pay his water bills? Give him a month’s free rent? Next he’ll be asking me to pay his moving expenses! If he doesn’t like this deal let him move elsewhere. I have half a mind to tell him the deal is off and to let him fend for himself.

Hodgetts was troubled by the incident, perhaps the final incident he would ever have to address with this firm. He ruminated on his partner’s original vision for D & H, reminisced over the history of the firm including its rise and fall. He knew that in a month or two it all would be over and the firm would be gone for good. What would Davis have done in his place? What would be the final legacy for D & H?