

## **No Exit, No Way! Trying to Close D & H Management LLC<sup>1</sup>: Part A & B**

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### **Part A – The Road Less Traveled**

Grey skies lined the backdrop as Stephen Hodgetts, now managing partner of D & H Management LLC, stared out his window at an urban jungle. Stephen sat alone in his apartment wondering how things had gone so terribly wrong ... and if things could get any worse. The real estate crash of 2008 had not only sent his burgeoning construction and management holding company into a spiraling decline but the loss of his longtime friend and business partner in 2011, Richard Davis, the original managing partner and creative genius of the firm, left him emotionally devastated and administratively challenged. Now all Hodgetts wanted to do was to close the one remaining business, D&H Management LLC, and go back to what he knew best, college teaching. Yet his thoughts quickly went back to the famous movie quote from *Godfather Part 3* "Every time I try to get out, they pull me back in."

### **The Way Things Were**

It had begun so well given such bad times. It was August 2002, and the Dow Jones Industrial Average had dipped under 8000. Richard Davis had decided that he needed to take control of his own economic fate. Davis had done enough preliminary research on the real estate market in his area to convince Hodgetts that there was money to be made in becoming landlords against Hodgetts' preliminary objections; more specifically renting to individuals with questionable credit and working with them to fix their credit record so they could eventually buy their rental homes. D & H Management, LLC, was formed and immediately acquired six homes. Davis and Hodgetts realized that they needed to raise additional funds for investment 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. In an attempt to "double profit" and make their homes more desirable for their tenants to acquire, they formed a construction company, DHR Construction, LLC. In January 2003 they hired one of their renters to finish off all of the basements without raising the rents of their tenants.

The individual who was designing their basements thought that Davis and Hodgetts could cut out the middle man if they built their own homes. At first it sounded crazy but then Davis and Hodgetts became convinced that backward integrating their operation by building homes to be purchased by D & H Management as rentals, as well as for public consumption, was a good idea. They could sell their homes to themselves "at cost" making

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<sup>1</sup> The names and location have been changed as per the request of the owners.

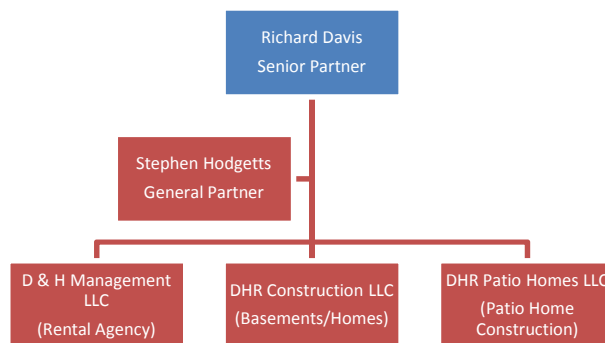
it easier to lower rents to their future tenants. Given the strength of the local housing market in May 2003, they formed DHR Construction LLC and broke ground on their first construction site in the St. Andrews development.

### Unknowingly Sowing the Seeds of Self Destruction

By January 2004, they had completed three homes at St. Andrews. By April of 2004 Davis and Hodgetts had built three homes in another development (Florence), with plans to build five more in that area. Unfortunately the Florence developer did not pay his landscapers and each of the properties that were owned by Davis and Hodgetts received mechanic's liens<sup>2</sup> of \$450,000 per property. This made building homes on these properties economically unfeasible. Davis and Hodgetts then sold the constructed homes in the area to another real estate management firm while being stuck with several unsellable vacant properties. Concurrently Davis and Hodgetts formed a third firm 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 1 below, Organizational Chart.)

**Figure 1**

### Davis and Hodgetts' Businesses (2005)



This was a large and challenging project for Davis and Hodgetts in that it involved building nearly forty custom homes in an upscale community. They built a number of speculative custom homes in the summer of 2005; however the real estate slowdown that started in the summer of 2006 found Davis and Hodgetts still sitting on several homes. They were cash poor and experiencing negative cash flows from having to pay off construction loans, land purchases, and home mortgages. In the interim, the Florence properties which they could not sell were forced into foreclosure (mortgages were swapped for the properties by the lender) and DHR Construction LLC was unincorporated.

Davis and Hodgetts were forced to offset losses from their construction firms with gains from their rental units. This was an extremely worrisome situation for Davis and Hodgetts since they had both personally signed for property loans of over \$ 2,000,000. In order to secure these loans they had pledged their personal assets. If the loans could not be repaid, then either the payments would have to come out of their own pockets or their remaining assets (including their personal residences) would have to be liquidated. Both had also lent these businesses a combined total of over 1 million dollars. Davis was in particular personal financial trouble, having

<sup>2</sup> "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.

built two additional speculation homes on his own in a market that became heavily saturated with existing home sales. Neither of his homes received much foot traffic and neither home had been bid upon. These homes were later repossessed in a deed for mortgage swap.<sup>3</sup>

### **The Beginning of the End**

Things went from bad to worse in the next four years. By the summer of 2009 the crumbling 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 personal financial bankruptcy.<sup>4</sup> The firms' lenders had chased Davis into bankruptcy protection while simultaneously taking Hodgetts' collateral (a rather large CD) for the outstanding balances due on the purchased vacant properties. Furthermore the lenders were also suing Hodgetts for repayment of construction mortgage loans (two speculation homes<sup>5</sup>) that he had personally guaranteed but had no way of repaying. Both Davis and Hodgetts had lost their homes and their nest eggs and could emotionally and economically ill afford more bad news.

Hodgetts and Davis finally realized that they had falsely placed their slim hopes on the fact that they had vacant property and with possible new construction (and therein a new construction company) they could build their way out of this financial hole. Yet all of their leads had dried up as home construction in the vicinity and nationally came to a near standstill. To make matters worse, their real estate management firm (D & H Management LLC) was starting to hemorrhage cash as renters fell behind in their monthly payments and vacancy rates climbed. One of their properties 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 (they had very low credit scores) there seemed like there was little that Hodgetts and Davis could do; they were trapped and there was no exit.

Stephen Hodgetts and Richard Davis had discussed the dire straits that their real estate management firm was in and Hodgetts saw no real solution that didn't involve losing all of the rental properties in foreclosure proceedings.<sup>6</sup> Upon his wife's urgency, Davis proposed that they split up the firm and that each partner take over management of the six remaining properties that had mortgages in their own name. Davis' proposal, however, seemed quite inequitable to Hodgetts for several reasons:

1. *Hodgetts would have to take over the management of 4 properties* – he had neither the skill nor the inclination to do so and felt that his trying to learn “on the job” when these properties could not even break-even (including the maintenance fees) was a formula for disaster.
2. *Hodgetts would manage 4 “losers” versus Davis’ 2 losers* – since Davis and Hodgetts were 50/50 owners, shouldn't they also share 50% of the risk (as well as the possible reward)?
3. *They would be splitting up the team* – although there may be positive tax implications for dissolving D & H for himself as well as Davis, Hodgetts was taken aback by the proposal to change their working relationship. They were old friends and Hodgetts felt as if Davis was abandoning him like an old shoe.

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<sup>3</sup> The lender accepts ownership of the property as the sole asset that pays off the mortgage.

<sup>4</sup> 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 [Personal Bankruptcy, <http://www.bankruptcyinformation.com/personal-bankruptcy.htm>; retrieved 8/31/09.

<sup>5</sup> Homes built without a guaranteed buyer.

<sup>6</sup> 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 Foreclosure: definition, <http://www.investorwords.com/2039/foreclosure.html>, 1/20/10.

In the end no action was taken and the firm continued to operate as was, albeit losing money every month.

### **The Bad News**

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 had to leave the management of the firm to Hodgetts in December of 2010 when Davis required constant personal care and attention.

When Hodgetts took over 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; notices that had been put on the doors of each property by the lender making the tenants quite nervous about their situation – 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.

### **A Plan, and a Prayer Unanswered**

It was early 2011 when Hodgetts realized that he could not deal with the stress and uncertainty of managing a losing business. He was going to set up an absentee owner operation while dumping the properties. He contacted a real estate broker who specialized in distress and short sales<sup>7</sup> and put all of the rental properties up for sale with a first option to buy going to the existing tenants. 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 given the firm's monthly revenues.

Several of the tenants in the properties showed interest in purchasing their homes. Their rents ranged from \$1100 to \$1300 a month and the assessed market value of these homes ranged around \$125,000 (although the outstanding mortgages were around \$175,000). With as low as ten percent down payment (\$12,500), their monthly mortgage payment on a 30 year fixed 3.5% mortgage would be around \$635.00 a month. This was clearly a good deal for the renters but could they qualify for a mortgage and scrap up the down payment?

His broker warned Hodgetts that the process could take anywhere from 3-6 months assuming that the buyers could qualify for a mortgage. Why so long? Beside the buyer demonstrating to the lender that they could pay off a lower mortgage, Hodgetts was required to 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 last two years income tax forms, declarations indicating his inability to pay off the mortgages, water rights, that he and/or the firm were not receiving any remuneration from the sale, and that he was not related to the buyer in any way.

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<sup>7</sup> “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\\_\(real\\_estate\)](http://en.wikipedia.org/wiki/Short_sale_(real_estate)), August 30, 2012.

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 now in Davis's estate. Hodgetts felt abandoned but understood that Davis's wife wanted nothing more to do with the business – it was a black mark on her husband's otherwise lifelong achievements.

### **Bumps and Bruises but Some Sales**

By January 2012 his broker had actually lined up buyers for each and every property managed by D&H. Most of the buyers were the current tenants, some were small investment businesses. Each sale had its unique problems and required additional time and effort from Hodgetts; time he really did not have to give. For example, several lenders wanted the properties owned by D&H to be quit claimed<sup>8</sup> to the party who actually held the mortgage. This meant signing several documents, getting them notarized, and then e-mailing them (as well as sending hard copies) back to the broker, and then filing these changes with the state. Seemed like busy work to Hodgetts since in some cases he was signing for both himself as an individual and D&H, as the managing partner of the firm. Why was his signature for the firm (which held the deed) less needed than his signature for the borrower of the mortgage?

In one case the second lender on a property wanted Hodgetts to pay a very small sum (about three times the monthly mortgage payment; about a tenth of the outstanding loan) up front in order to settle the mortgage before the house could go to closing. This meant that Hodgetts would have to pay this amount out of company funds or out of his own pocket with no legal way of recouping those funds. The broker finally offered to "help" Hodgetts by "lending him" the amount yet Hodgetts declined because he felt that the broker was actually offering him a bribe in order to make the deal (the broker's fee would have been at least 3 times as large as the lender's settlement fee). Hodgetts had signed a no remuneration form and was not going to break his word (and the law) in order to make this deal for the broker and the buyer.

In two situations Davis's wife's cooperation was needed in order to deal with properties that had mortgages in Davis's name yet she wanted absolutely nothing to do with the business (and the properties) and as far as she was concerned the lenders could foreclose. She would not have any to do with the properties quitclaimed to Davis's estate, leaving the broker, Hodgetts, and the potential buyer wondering if the lender would be flexible in this matter; they were not. Hodgetts was informed by the broker that he could take legal action against Davis' wife in order to force the issue but Hodgetts felt that she had suffered enough and did not want to add to her distress.

Hodgetts assumed that it would have been easy to sell the six remaining properties held by D&H yet nearly a year after his business partner's death Hodgetts was still stuck with four properties with no exit strategy and no

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<sup>8</sup> "A quitclaim deed is a release by the grantor, or conveyor of the deed, of any interest the grantor may have in the property described in the deed. Generally a quitclaim deed relieves the grantor of liability regarding the ownership of the property. Thus, the grantor of a quitclaim deed will not be liable to the grantee, or recipient of the deed, if a competing claim to the property is later discovered. A quitclaim deed is not a guarantee that the grantor has clear title to the property; rather it is a relinquishment of the grantor's rights, if any, in the property. . . . The holder of a quitclaim deed receives only the interest owned by the person conveying the deed. If the grantee of a quitclaim deed learns after accepting the deed that the grantor did not own the property, the grantee may lose the property to the true owner. If it turns out that the grantor had only a partial interest in the property, the quitclaim deed holder holds only that partial interest." Retrieved from <http://legal-dictionary.thefreedictionary.com/Quitclaim+Deed>, 9/13/12.

end in sight. Cash flows from the rental properties were barely enough to pay for the mortgages with recent vacancies and major repairs causing him to be on the average three months behind on his monthly payments.

### **Two Paths and the Road not Taken**

Hodgetts could have easily walked away from these properties (two were in his name, two in Davis's) with no economic repercussions for himself or Davis's wife since all of the properties in question were part of both of their Chapter 7 settlements.<sup>9</sup> Yet he felt obligated to help his tenants by continuing to pay the mortgages while assisting them acquire the homes they lived in as well as aiding the broker who would only get paid (regardless of the time and effort spent on each sale) if a house went through closing.

Hodgetts really wanted to do the "right thing" but felt that the right thing was just not right thing for him since he had not made even one penny since these businesses' inceptions. Why should he expend anymore effort in a fruitless venture guaranteed to yield him no profit? Yet how could he abandon Davis's original vision of helping renters acquire their homes and realize a part of the American dream? As his mind pondered the problem Robert Frost's "The Road not Taken" kept replaying in his head.

*Two roads diverged in a yellow wood,  
And sorry I could not travel both.  
And be one traveler, long I stood  
And looked down one as far as I could  
To where it bent in the undergrowth;*

*Then took the other, as just as fair,  
And having perhaps the better claim  
Because it was grassy and wanted wear,  
Though as for that the passing there  
Had worn them really about the same,*

*And both that morning equally lay  
In leaves no step had trodden black.  
Oh, I marked the first for another day!  
Yet knowing how way leads on to way  
I doubted if I should ever come back.*

*I shall be telling this with a sigh  
Somewhere ages and ages hence:  
Two roads diverged in a wood, and I,  
I took the one less traveled by,  
And that has made all the difference.<sup>10</sup>*

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<sup>9</sup> Chapter 7 bankruptcy alleviates the debtor's obligation to pay back the loan on any debt included in the filing. [Retrieved from <http://www.sandberglawfirm.com/blog/stop-foreclosure-with-chapter-7-chapter-13-bankruptcy-filing/>, 9/13/12.]

<sup>10</sup> Retrieved from <http://www.poemhunter.com/poem/the-road-not-taken/>, 9/13/12.

**Appendix A****D & H Balance Sheet – 12/31/11**

<b>ASSETS</b>	
<b>Current Assets</b>	
<b>Checking/Savings</b>	
1140 · Checking - Chase	1,609.62
1150 · Savings - Chase	45.29
<b>Total Checking/Savings</b>	<b>1,654.91</b>
<b>Other Current Assets</b>	
1220 · A/R - Key Property Mgmt	1,730.40
1350 · Mortgage Escrow	4,394.03
1355 · Mortgage Suspense	2,285.79
1360 · Security Deposit	13,300.00
<b>Total Other Current Assets</b>	<b>21,710.22</b>
<b>Total Current Assets</b>	<b>23,365.13</b>
<b>Fixed Assets</b>	
<b>1500 · Leased Properties</b>	
1501 · 2703 Property A	195,446.12
1503 · 2712 Property B	201,775.94
1505 · 2704 Property C	198,274.91
1506 · 2700 Property D	196,141.66
1507 · 2512 Property E	215,265.96
1510 · 2416 Property F	199,709.78
<b>Total 1500 · Leased Properties</b>	<b>1,206,614.37</b>
1600 · Accumulated Depreciation	-373,031.00
<b>Total Fixed Assets</b>	<b>833,583.37</b>
<b>TOTAL ASSETS</b>	<b>856,948.50</b>
<b>LIABILITIES &amp; EQUITY</b>	
<b>Liabilities</b>	
<b>Current Liabilities</b>	
<b>Other Current Liabilities</b>	
2300 · Security Deposits	13,300.00
<b>Total Other Current Liabilities</b>	<b>13,300.00</b>
<b>Total Current Liabilities</b>	<b>13,300.00</b>
<b>Long Term Liabilities</b>	
<b>2400 · N/P - Mortgages</b>	
2401 · N/P –Property A	171,751.23
2401.1 · N/P - Property A(2nd)	19,645.85
2403 · N/P –Property B	142,388.26
2403.1 · N/P - Property B(2nd)	24,598.78

2405 · N/P - Property C	172,828.77
2405.1 · N/P - Property C (2nd)	18,918.29
2406 · N/P - Property D	155,910.99
2406.1 · N/P - Property D (2nd)	41,000.00
2407 · N/P - Property E	166,980.22
2407.1 · N/P - Property E (2nd)	25,800.00
2410 · N/P -Property F	168,597.13
<b>Total 2400 · N/P - Mortgages</b>	<b>1,108,419.52</b>
<b>Total Long Term Liabilities</b>	<b>1,108,419.52</b>
<b>Total Liabilities</b>	<b>1,121,719.52</b>
<b>Equity</b>	
3100 · Davis Capital	-295,260.33
3200 · HodgettsCapital	16,177.65
Net Income	14,311.66
<b>Total Equity</b>	<b>-264,771.02</b>
<b>TOTAL LIABILITIES &amp; EQUITY</b>	<b>856,948.50</b>

#### D & H P&L Statement 2011

<b>Ordinary Income/Expense</b>	
<b>Income</b>	
4100 · Rental Income	95,424.07
<b>Total Income</b>	<b>95,424.07</b>
<b>Gross Profit</b>	<b>95,424.07</b>
<b>Expense</b>	
<b>6600 · Rental Expenses</b>	
6630 · Cleaning/Janitorial	510.27
6640 · Depreciation Expense	45,021.00
6650 · Insurance	4,224.00
6660 · Interest Expense	44,205.99
6670 · Legal Fees	275.00
6700 · Management Fee	9,702.00
6750 · Repairs & Maintenance	4,563.96
6820 · Property Taxes	5,900.75
6970 · Utilities	1,083.19
<b>Total 6600 · Rental Expenses</b>	<b>115,486.16</b>
6060 · Bank Service Charges	17.50
6310 · Professional Fees	800.00
<b>Total Expense</b>	<b>116,303.66</b>



<b>Net Ordinary Income</b>	-20,879.59
<b>Other Income/Expense</b>	
<b>Other Income</b>	
<b>7100 · Gain/Loss on Sales</b>	35,191.25
<b>Total Other Income</b>	35,191.25
<b>Net Other Income</b>	35,191.25
<b>Net Income</b>	<b>14,311.66</b>

### Part B - No Good Deed Goes Unpunished

Ten months had passed (October 2012) and Hodgetts' broker had managed to close on one more property while the bank had foreclosed on another. Hodgetts was down to two properties in D & H's possession and it seemed that the last two properties would eventually be sold to their existing tenants. In the interim, Hodgetts had managed to save up about \$10,000 from rental payments in an ironic manner – several of the lending institutions where D&H was running 3-4 months behind in payments refused to take “partial payments” (their usual monthly mortgage fee) and returned D&H's checks. Hodgetts thought that this was a rather strange way to make money but did not look a gift horse in the mouth. Hodgetts actually thought that if he could hold onto these properties a little longer he might just be able to walk away with something in his pocket for all of his trouble and heartache.

### Denials – It's over! Or is it?

The last two properties seemed to be impossible to sell as noted in the below e-mail from Hodgetts' real estate broker in late October of 2012:

Finally I was able to get thru to a person of authority with the lending institution for the two remaining properties. I will try to explain what has happened.

We received a letter of denial for both short sales for several reasons.

1. It turns out D&H LLC and you as an individual are not authorized to sell the property since the County Assessor's Office has DHR Construction listed as the owner of record. This entity has been dissolved and would need to be reincorporated with the State. In order to do this you would need to obtain permission from Davis's wife as she is the executrix of his will.
2. The loans with bank are in Davis' name and you cannot negotiate a short sale on his behalf, the only one who could potentially do that is his wife. She would have to open probate and agree to sign the necessary papers. If she does not agree the only course the bank can take is foreclosure.
2. The Tenants cannot buy subject properties, as the bank will not consider that as an arm's length transaction.

“Well” Hodgetts thought “I gave it my all but the matter seems to be out of my hands. The tenants will be informed by the broker that the deals are off and that they will have to make alternative living arrangements. I am very sorry that I could not help them out.”

On 10/30/12 Hodgetts received the following e-mail from one of the tenants:

This letter is written from the tenants of Property A. We are trying to make light of this situation we are in with you. Please take the time to read this letter and hopefully you can place yourself in our position and understand what we are trying to accomplish in our lives at our age. According to our records, as well as the ones on file, we had paid the required deposit of \$2750.00 when we first moved in our home that we currently are living in. According to the signed agreement our rent of \$1125.00 we paid on time every month, \$100.00 was to be placed in a secured account to be used towards any and all of the down payment and closing costs that would be needed if and when we decided to purchase our home. The amount of \$7900.00 according to our records as well as the ones on file should be in such account. After learning with all the confusion involved that we would not be able to purchase our home as per the agreement. There were at the time a lot of incidents that occurred without our knowledge happening that we probably should have been made aware of. Some of the things we found out were sad and our condolences go with prayers to everybody involved. We have now learned that because of these changes that occurred that we are now losing our financial investments made to our home. We are aware of the situation and now know that you have the power to help us. We are considered low middle class income and work very hard for our paychecks. We are at that age where we need to purchase a home within the next year or our chances of doing so after will be slim. We have always felt we are in God's eyes and have been hard working and honest people that would not even consider doing anybody wrong.

What we are asking is we would like to have our deposit of \$2750.00 refunded to us in the next three days (November 2, 2012). We have kept our home immaculate and have done many improvements to this home with the thought in mind that we will own this home one day. Instead of having the \$100.00 per month that was supposed to go towards the down payment and closing costs, this total amount is now \$7900.00 and we would like to offer an arrangement that instead of paying the rent for 6 months which will be a total of \$6810 be deferred so you may use the amount that we paid so far for the closing costs. That will not happen now so we may save up and accrue down payment and closing costs on another home. We feel that this arrangement is fair and we very much hope that you will consider this arrangement after placing yourself in our situation as to what has happened since learning of the complications that have occurred. Please take the time to consider and agree to this agreement and we can say that in God's eyes, we have done the right thing.

Hodgetts was clearly moved by the letter but felt that their request for their deposit money back in three days was out of the question. Perhaps if he had more time to think this through he could come up with a viable alternative. He fired off the following e-mail on the same day:

I understand and appreciate your desire to put a deposit on a home by November 2. We have both been placed in a difficult position by a mortgage and title company that will not cooperate with the sale (they will not let me sell the house under D&H) as well as other personal circumstances. (The operating manager's passage and my "inheritance" of the management of this firm while being provided limited information from his wife and having minimal experience).

You are asking me to release a deposit on this property and then allow you to stay in the property rent free for 6 months based upon a contract that allots you \$100/month towards the purchase of this property. I cannot consider that request without a copy of this contract (which I do not have a record of ... my apologies) and a verification that the rent has always been paid according to the contract requirements in order to accrue the funds in question. I also need some financial assurance that the property will be in good shape when you leave.

In the interim, I want to help you with this down payment and have a suggestion that may work. I'm asking our property manager to release the deposit IF you sign a promissory note made out to D&H that would equal the amount of the deposit and pledging your new house (or any other verifiable asset you may own that is greater or equal to the deposit amount) as collateral for the loan. In this way you get the cash you need upfront and D&H gets some assurance that the property will have some protection when you vacate the premises.

I hope that this will help you in the short term while we work out the details.

### **Trouble Ahead, Troubles Behind**

Five days passed and in the interim Hodgetts was able to verify that the tenants of Property A had in fact paid their rent on time, every time. He had not heard back from the tenants so he thought the matter was settled – he thought very wrong. He received the following certified letter from an attorney representing the tenants from Property A.

November 5, 2012

Re: Breach of Lease Rental Agreement with Lease Option

My office has been retained in all matters concerning the Lease Rental Agreement with Lease Option to Purchase. As you know, the renters have been renting the property for many years. Beginning in April 2006, your firm agreed to credit the renters \$100 per month toward their down payment for each month the lease is in effect. In effect, the renters paid an additional \$100 per month in rent based on the promise that your firm would credit them that amount at the time they exercised their option to purchase. You agreed to sell the home to the renters because the bank had approved a short sale. Regardless of the circumstances involved, the tenants entered into a contract to purchase the home, which your firm was unable to fulfill.

I am aware of your difficulty in completing the short sale process and that the short sale has been terminated. The net result is that your firm has failed to honor its agreement to sell the property to the renters. Thus, you have defaulted on your obligation and are now in breach of Lease Agreement with Lease Option to Purchase.

The renters have contacted you seeking the return of their option money due to your inability to close on the purchase of the home. You have re-buffed their reasonable offer and demanded a promissory note and pledge of collateral from them. You have attempted to link the option money to the rental deposit, which is wholly inappropriate and unlawful. Your counter-offer is rejected.

I understand that you blame the mortgage and title company because they will not “cooperate with the sale.” I blame you and your firm. I am confident a court will too. Therefore this is a demand letter for the return of the renter’s \$7900 option money. The deadline for receipt is November 19, 2012. Please be advised this is the final notice prior to initiating litigation, which would include claims of breach of contract, conversion/civil theft, fraud and violation of the Colorado Consumer Protection Act. Some of these claims entitle a plaintiff to treble damages. ....

The letter went on for another three pages detailing all of the events leading up to the alleged breach of contract and accusing Hodgetts of masterminding a plot to defraud the renters of property A.

Hodgetts first reaction was shock, then absolute dismay. The option to buy was not supposed to have created a running bank account (similar to a rental deposit) for the renters but rather a way of discounting the price of the house against a third party assessment of the fair market value of the property. It was assumed that the value of the homes would go up, not down, and that the increased value of the home would more than cover the difference between what the firm paid for the home and the sales price. Hodgetts and Davis never imagined that they would have a situation where the mortgages were actually higher than the value of the homes.

There had never been any monies “put away” from the rents collected for any of the renters and none of the renters had ever asked for these funds including those who had previously bought their homes through short sales. Secondly, Hodgetts was aware of the fact that the renters of Property A had not asked for these funds as part of the negotiated short sale since Hodgetts knew that the firm would never have been able to cover the difference between the short sale price and the option monies.

Hodgetts took a deep breath and then verified that the renters had paid their rent on time, that they did have this option in their contract, and that they had seemed to have met at least most of the requirements of that contract. However there did seem to be some loose ends that might allow him to fight a possible lawsuit.

1. The tenant had to respond within 48 hours of the owner’s notice of intent to sell –did they?
2. The tenant had the right to exercise the option to buy up until April 2012. This included arranging financing within 30 days – again, did they?
3. If the option is not exercised, the funds are treated as part of the rent.
4. There was no clause in the agreement saying that the \$100/month would be placed into a bank account.

Hodgetts did verify with the broker that the tenants had at no time presented a document indicating that they had obtained financing within 30 days of agreeing to purchase the home and it was not clear if they had exercised their option to buy in a timely manner. What was clear was that the short sale contract did not include the placing of option funds into a bank account.

### **To Fight or not to Fight – Is That Really the Question?**

A quick call to a lawyer friend, followed up by a tense meeting, verified Hodgetts' worst fears. First, the plaintiffs seem to have some merit to their case given the fact that Hodgetts, acting as the managing partner of D & H, attempted to sell a property which neither he personally nor D & H had ownership of. The fact that a defunct sister firm with the same owners was the owner of record (and the fact that Hodgetts did not know that D & H did not own the property) did not mitigate the fact that Hodgetts did not have the authority to enter into sale of property contract. The lawyer did point out that the broker's title company should have been aware of this difficulty and should have not allowed the house to go into short sale contract. Although there may be some culpability on their part (which Hodgetts could pursue if he so chose to), since they were acting as Hodgetts' agents,<sup>11</sup> he was culpable for their actions.

Secondly, it would cost Hodgetts at least \$2000 upfront to retain the services of a lawyer and, at \$250/hour, it was estimated at least another \$5000 (20 hours of labor) would be needed to cover lawyer costs assuming that the case would not have a protracted time in court. If Hodgetts were to win the case in court, most of the costs could be recovered from the other side, however not all of them.<sup>12</sup> Losing this case could, on the other hand cost him a small fortune that he did not have – treble damages (\$23,700) plus lawyers' fees (at least another \$7000).

Third, Hodgetts did not want to devote the time and energy that a case of this nature would require. This business was draining him of every ounce of energy he had and was disrupting both his academic career and his family life. He saw this business as a money pit and that it had drained him of all of his financial wherewithal and now his psychological well-being. Did he really want to go through the time and energy needed to fight what could be a protracted and painful court case? What was the actual upside for him and the business?

However, as Hodgetts pondered the situation more and more he got angry; very angry. Angry at his partner Davis for getting him into this mess in the first place and yes, even angrier at Davis (and his wife) for leaving him with this mess to clean up - Davis' mess! He was fuming at his broker who should have done her proper due diligence, irate at his property manager for not alerting him to this option in the contract which was renewed every year (since the manager was not retaining funds for this possibility), and of course enraged at the renters of Property A for not at least giving him the courtesy of talking about the situation before they "lawyered up." He was livid at the world that had bankrupted him and demoralized him and yes, kicked him hard when he was down and out. He was tired of being a victim, tired of being walked on. "So the tenants want to fight this out in court do they, they asked for it ...". And then, a sudden calmness enveloped Hodgetts.

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<sup>11</sup> "The law of agency allows one person to employ another to do her or his work, sell her or his goods, and acquire property on her or his behalf as if the employer were present and acting in person. The principal may authorize the agent to perform a variety of tasks or may restrict the agent to specific functions, but regardless of the amount, or scope, of authority given to the agent, the agent represents the principal and is subject to the principal's control. More important, the principal is liable for the consequences of acts that the agent has been directed to perform." Retrieved from <http://legal-dictionary.thefreedictionary.com/agency>, 1/22/13.

<sup>12</sup> Only reasonable and proportionate costs will be awarded. This will be determined by the overall value of the case and what the judge deems as a reasonable amount to pay. Incurred costs which the judge does not believe are proportionate will be disqualified and will only order contributions towards the ones that are. Retrieved from <http://EzineArticles.com/5934233>, 1/22/13.

A small yet discernible voice popped into his head and reminded him that the reason he and Davis went into this venture in the first place was to help those people who could not buy homes on their own because of lack of cash or poor credit history. The tenants of Property A had been perfect tenants (even made some upgrades to the property that Hodgetts just became aware of from the property manager), never missing a payment, and they had been denied the opportunity to buy the home they had lived in for over five years. Didn't they deserve something for their disappointment and loss of home?

Regardless of what they deserved or didn't deserve Hodgetts knew he didn't deserve this letter from their lawyer nor a potential lawsuit. Yet he also knew that he had to make a decision in two weeks as to how he was going to handle this situation. The question was what to do now?