*Instructional Case Study*

# No Exit? Trying to Salvage D&H Management LLC[1]: Parts A and B

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*In this two-part case, Richard Davis and Stephen Hodgetts, co-owners of D&H Management LLC, are trying to come to terms with changes in the real estate market—changes that have made their rental homes worth less than their mortgages and at best yielding at most a break-even cash flow. In Part A Davis and Hodgetts are weighing the following options: (1) sell all of the properties, assume a loss (walk away with nothing), and avoid the negative cash flow; (2) walk away from all of the properties, assume a loss (walk away with nothing), and avoid the negative cash flow; (3) delay paying the mortgage on some of the homes, allow these properties, if necessary, to go into foreclosure, and in the interim use the positive cash flow to shore up some of the more positive cash flow homes; (4) contact all of the lenders and try to renegotiate the mortgages so as to have lower monthly rates.*

*In Part B Davis proposes that he and Hodgetts go their separate ways. Davis walks away with the two properties that have mortgages in his name, while Hodgetts obtains the four properties that have mortgages in his. From Hodgetts' perspective this is a losing proposition since (1) he would have to take over the management of four "loser" properties rather than Davis's two, an 'unfair' split of the liabilities; (2) he had no interest in managing properties; and (3) he and Davis would be splitting up a long-standing team*

## Part A

Richard Davis and Stephen Hodgetts, best of friends, academic colleagues, and coauthors, had finally reached the end of their proverbial ropes. Sitting in a small, secluded diner late Sunday night drinking cheap cups of coffee and munching on "the blue plate special," Hodgetts and Davis could not believe that in summer of 2009 they were living a "riches to rags" story, but that was the gist of the situation. Gone were the Merlots, Pinot Noirs, and Cabernets, the gourmet meals, and the long affable chats by the fireplace (in fact, gone was the fireplace!). Gone were the dreams of wealth, early retirement, and perhaps even some local fame. All of their hopes and wishes had been trampled in what seemed like a worldwide calamity, the greatest "recession" since the Great Depression. They were in the eye of the hurricane, the epicenter of this man-made earthquake called the collapse of the U.S. real estate market.

As they huddled together, broken both financially and in spirit, they could not help but wonder what more was in store for them. They went from reminiscing about their past successes and their accumulated wealth (both had financially benefitted from the fast growth in the real estate market in the earlier part of the decade), to wondering how the stock market ever got to be over 9000 under the current economic conditions, to musing as to where all their money had gone when they were caught in the real estate collapse of 2008. The discussion kept moving in this vicious circle, with no resolution in sight.

The crumpling of their local real estate market had not only forced the dissolution of their construction company (DHR Patio Homes LLC), but also pushed Davis into insolvency and left Hodgetts financially bankrupt. The firms' lenders had chased Davis into bankruptcy protection while simultaneously taking Hodgetts' collateral (a rather large CD) for the outstanding balances due on purchased vacant properties. Furthermore the lenders were also suing Hodgetts for repayment of construction mortgage loans (two speculation homes[2]) that he had personally guaranteed but had no way of repaying. Both had lost their homes and their nest eggs and could emotionally and economically ill afford more bad news.

In the quiet of the deserted diner, Hodgetts and Davis 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) thought that 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 (see box story). 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



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seemed like there was little that Hodgetts and Davis could do; there was no exit. On the other hand they felt that they had to do something since doing nothing would unmistakably mean the eventual loss of their other rental properties and literally everything they owned.

They looked sorrowfully at each other, shook their heads in despair and mumbled a few friendly platitudes of optimism. Action was needed, vital decisions needed to be made that meant the survival of their firm and their remaining assets . . . but really what could they possibly do?

**Reports**

**The Housing and Rental Market in 2009**

http://blog.hometownrent.com/2009/05/28/the-u-s-residential-rental-property-market/ July 27, 2009

The global credit crisis, rise in foreclosures and a glut of new houses on the market with no buyers translates into more renters and more rental property. Owners turned landlords are desperate to fill their vacancies, property managers hunt for as many ways as possible to reach renters online and tenants face more economic pressure to make **smart rental choices.**

**. . . With over 36 million rental households,** and between 5–10 million units for rent each year, property managers spend hundreds of dollars and dozens of hours a year advertising each property.

On March 25, 2008, the Associated Press reported that "Home prices slumped 10.7 percent from a year ago in major US cities," based on a Standard & Poor's/Case-Shiller index. Goldman Sachs predicted prices will fall 20-30% from 2006 levels before reaching a bottom.

House prices over the past 10 years went much higher than fundamentals would support, far beyond any historically known relationship to rents or salaries. The current housing crisis reflects a contraction in the housing market—both in terms of new construction, sales and prices—that will likely last for two or more years. On average, **yearly rents are 3% of the purchase prices of similar homes.** If mortgage rates are 6%, then it costs more than twice as much to borrow money to buy a house than it does to rent it. Total owner costs including taxes, maintenance, and insurance can reach up to 9%, which is three times the revenue from renting! Many people's salaries cannot cover mortgages. A safe purchase price is a maximum of three times the buyer's yearly income, but most purchases from 2005 to 2007 went well beyond that. Many people who bought recently suffered losses immediately and will for the next several years, as prices keep falling.

***The Impact of the Real Estate Crisis:***

The National Association of House Builders estimated that 25% of houses bought in the last few years were pure speculation, not houses to live in, and that speculators are going into foreclosure in large numbers now. JP Morgan foresees nearly 40% of all foreclosures in 2008–2009 coming out of investment and speculative property.

A record number of homeowners who cannot sell condominiums and houses are competing for tenants with the biggest apartment owners. Houses that end up in foreclosure probably will be bought by people who will rent them until demand improves, adding to supply on the market.

***Impacts on the Rental Market:***

- Buyers are unable to find credit, constricted by salary limits and skittish about entering the market while prices are still likely to fall further.
- Creditors are constricted by default rates and unable to extend credit to many buyers.
- Sellers are forced to rent unsold property if they need to move.
- Real estate investors and speculators are pressured to find renters for unsold properties.
- Vacancy rates are driven higher because builders have a huge excess of inventory they cannot sell.
- It will take years before demand, driven by population increase and young people earning enough to buy their first home, increases.

This glut of rental property on the market means more choices for renters, downward pressure on rent and an expanded number of landlords and property managers forced to advertise more aggressively to make sure their rentals do not end up on the vacancy list.

. . . While homeownership rates have risen slightly in the past 20 years—from 64% in 1987 to 68.1% in 2007—younger Americans (under 25) have seen a slight but important drop in their homeownership rates from the highs of 25.7% in 2005 to 24.8% in 2007. Younger buyers and first-time homeowners are hard hit by the housing crisis, and a further transition from buyer to renter is expected in coming years. Only when prices have hit a bottom and the U.S. economy pulls out of the upcoming recessionary period do ownership rates stabilize and rise again.

**Apartment Rental Vacancies Rise Across the Nation**

July 10, 2009 Matt DiChiara (http://www.mynewplace.com/blog/2009/07/10/apartment-rental-vacancies-rise-across-the-nation/, July 27, 2009)

Fueled by the climbing unemployment rate, vacancy rates in the nation's apartment buildings have risen to their highest rate since 1987. The national vacancy rate reached 7.5 percent in the second quarter, up .2 percent from the previous quarter and 1.4 percent higher than Q2 2008.

The speed that the vacancy rate is approaching the all time high (7.8 percent in 1987) is especially worrisome; it was only 2006 when the only 5.5 percent (that cycle's trough) of apartments for rent were vacant.

As a result, Q2 asking rents fell .7 percent from a year ago to $1,040 a month, the bulk (.6 percent) of that drop occurring in the second quarter. Effective rents fell even further, down 1.9 percent to $975, that decline spurred on by apartment management companies offering concessions to renters. Effective rents dropped almost 1 percent from the first quarter to the second in 2009.

Reis, Inc, who conducted the study, expects more than 100,000 units from new construction to add to the rental inventory by the end of the year, which, along with unemployment rates softening demand, will keep vacancies high and rents low.

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***Regional and Demographic Trends***

Earlier this week we mentioned housing statistics from the Census Bureau (which include both the rental and for sale markets) showed a higher growth rate for urban areas than in suburban areas. While the national rental market figures are useful as macroeconomic indicators of the economy as a whole, they don't exactly provide insightful information for apartment management companies in terms of their respective markets.

According to the LA Times, the effect of the high vacancy rate is visible to anyone walking down the street, even in traditionally popular areas. Landlords are dropping rents and making concessions for Westwood apartments and apartments in Redondo Beach, trying to keep their units occupied.

The only apartments in Los Angeles where rents haven't gone down are those apartments near UCLA, where demand is buttressed by college students. Also, UCLA, with a high percentage of graduate students will probably have more students than during years when the job market was stronger, as young professionals take the opportunity to go back to school.

With almost 2,000 units in the construction or planning phase this year and rampant job losses, Greenville apartments' vacancy rates have risen high above the national average at 12.5 percent.

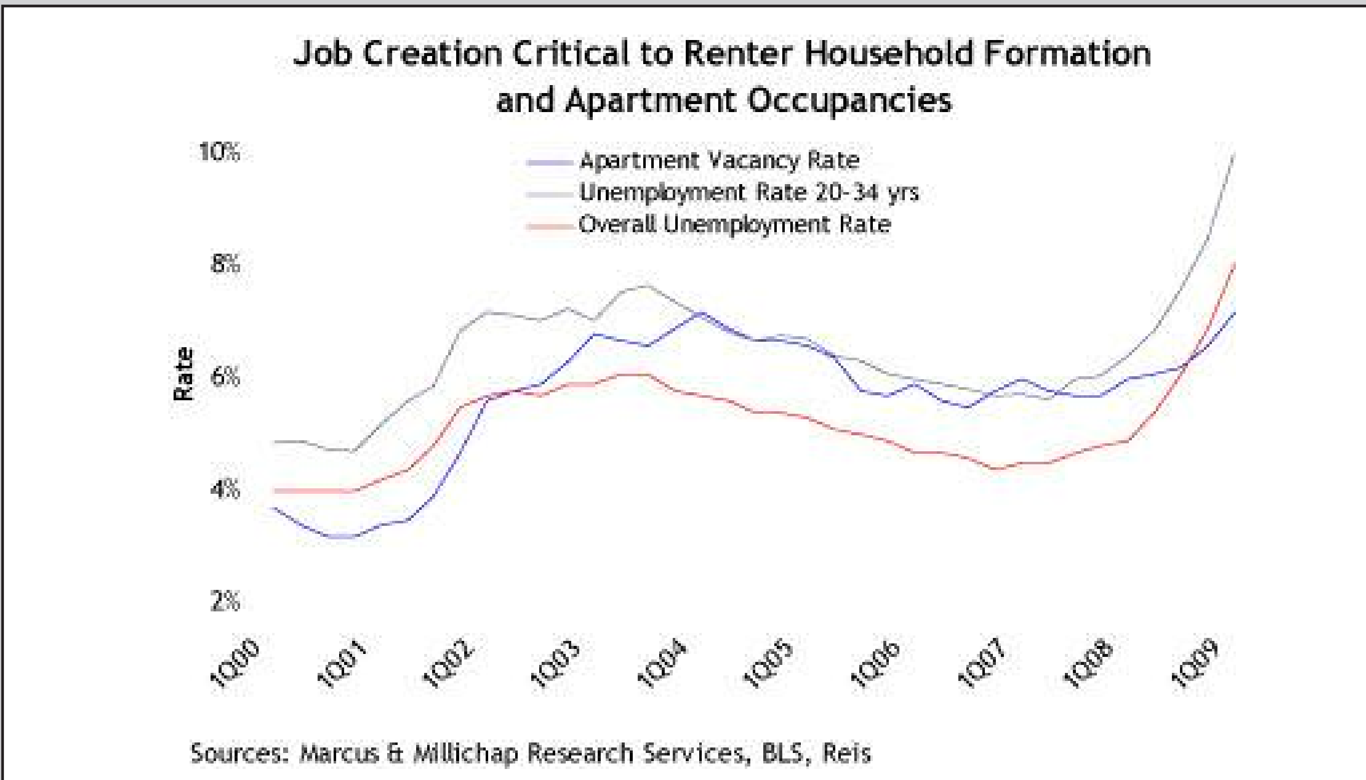
There are a few bright spots, however. Apartments in Columbus, Ohio, are currently enjoying their lowest vacancy rates in years, investors are beginning to buy up Orlando apartments again, and renters moved into Atlanta apartments in volumes that far exceeded previous quarters.

**Apartment Vacancy Rising as Steep Job Losses Stall Renter Household Formation**

http://www.jackmangroup.com/Outlook_2009June.asp, July 27, 2009

***Apartment Demand Weakening***

Vacancy increased to 7.2 percent in early 2009, matching the peak level recorded during the last cyclical downturn. At the end of the first quarter, vacancy was up 60 basis points from year-end 2008 and 120 basis points from one year earlier, as net absorption posted its largest decrease since early 2002, excluding conversion-related declines in 2006. Extreme job losses and rapidly rising unemployment are hampering household formation, forcing many renters to double up or even move back with family. In addition, deeply discounted home prices due to foreclosure sales and an $8,000 tax credit for first-time homebuyers are encouraging some current renters to purchase houses.

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***New Supply Contributing to Weakness***

At an annualized rate, first-quarter apartment completions were 45 percent below the long-term average, but new supply was down only modestly when compared to last year. In addition, a flood of shadow-rental stock continues to plague many markets. Fortunately, apartment starts have dropped 50 percent from peak levels, while the number of units in the final planning stages has declined more than 60 percent since the first quarter of 2008, and multi-family permits have retreated 50 percent over the past 12 months, all trends that suggest a drop-off in construction starting next year. Furthermore, many development projects are likely to stall as softer fundamentals make it difficult to justify construction.

***Apartment Property Sales Continue to Slide***

During the first quarter of 2009, sales dollar volume was down 55 percent from the previous quarter and 90 percent from a peak in the fourth quarter of 2006. The number of transactions declined to a lesser degree over the same period, as smaller deals accounted for a greater share of overall activity. Financing properties over $15 million has become a considerable challenge, as most lenders are wary of originating large loans and increasing their single-asset risk exposure. A handful of large property sales have closed recently, though prices for many of these assets reflect significant discounts when compared to the market's peak. In early May, for example, the first multi-family REIT acquisition of the year was completed by AvalonBay. The property, located in Bellevue, Wash., traded for slightly more than $33 million, which is 45 percent below the estimated replacement cost.

***Lending Still Tight, but Apartments Faring Better than Other Core Property Sectors***

Year over year, total commercial mortgage originations were down 70 percent as of first quarter; however, the apartment sector recorded a less severe decline due to lending by Fannie Mae and Freddie Mac. Like other lenders, the two government sponsored-enterprises (GSEs) have reduced originations of new multi-family loans over the past year, but by only 26 percent.

***Risk Premiums More Pronounced Based on Quality and Location***

Apartment cap rates continue to rise, with the current average at 6.7 percent, up from a record low of 5.6 percent in 2006. The degree of change in prices and cap rates vary widely by property quality and location. Cap rates for properties in primary markets have increased by an average of 80 basis points from their most recent low point, while cap rates among assets in tertiary markets are up approximately 150 basis points. Further upward correction is anticipated as fundamentals continue to weaken and distress rises amid a wave of maturing debt. From 2009 to 2012, more than $300 billion of multi-family loans are expected to mature, including $36 billion in CMBS mortgages. Based on current estimates, more than 70 percent of the multi-family CMBS loans reaching maturity during this time may not qualify for refinancing. This will likely result in strong acquisition opportunities for well-capitalized investors who are ready to move quickly as properties are brought to market.

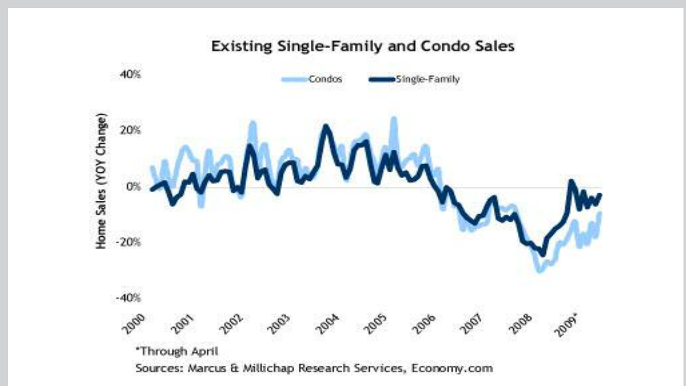
***Forecast***

**Further Weakening in Fundamentals Expected.** Apartment vacancy is forecast to approach 8 percent this year, the highest level on record since at least 1980. Effective rents are expected to lose 4.5 percent to 5.0 percent in 2009, with rents in some markets forecast to fall at double-digit rates. Apartment owners are finding it necessary to compete aggressively to retain and attract renters, resulting in concessions rising to more than 7 percent of asking rents by year end, compared to approximately 5 percent at year-end 2008. Market rents began to slip in late 2008 and are forecast to decrease by 1.2 percent in 2009, the largest decline on record.

**Benefits of Development Pullback, Economic Recovery to Emerge in 2011.** New supply is forecast at 80,000 units this year, down from 107,300 units in 2008. Based on the diminishing development pipeline, completions are expected to slow in the second half of 2009 and drop dramatically in 2010, setting the stage for a relatively swift recovery once housing finds its bottom and the economy turns the corner.

**Freddie Mac's Securitization Model a Step in Right Direction.** Freddie Mac is in the process of securitizing approximately $1 billion of multi-family loans originated in 2008. The sale of the highly rated securities will mark the first full-scale securitization for the GSE and the first CMBS issuance since the market stalled last June. Compared to the original securitization model, whereby all risk was passed through to investors who purchase the CMBS, Freddie Mac will guarantee the senior bond classes. If its inaugural issue is a success, Freddie Mac could move forward with another securitization of multi-family debt this fall. By shifting a significant amount of debt off its balance sheets, Freddie Mac will be able to free up capital for new multi-family lending.

**Apartment Market Vital Signs**

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## 1Q 2007 to 1Q 2009 Change in Apartment Vacancy

### Top 10 Markets by Change in Vacancy

| Metro | 1Q 2009 | YOY Chg (bps) |
|---|---|---|
| West Palm Beach | 7.7% | -30 |
| Louisville | 7.1% | 10 |
| Indianapolis | 8.2% | 10 |
| San Francisco | 4.2% | 10 |
| Cincinnati | 7.3% | 20 |
| Washington DC | 5.8% | 40 |
| Milwaukee | 4.3% | 50 |
| Minneapolis | 4.7% | 50 |
| Boston | 6.4% | 50 |
| San Diego | 4.6% | 70 |
| *US Metro Average* | *7.2%* | *120* |

### Bottom 10 Markets by Change in Vacancy

| Metro | 4Q 2008 | YOY Chg (bps) |
|---|---|---|
| Tampa-St Petersburg | 9.3% | 190 |
| Orlando | 9.9% | 190 |
| Charlotte | 8.5% | 200 |
| San Jose | 5.6% | 210 |
| Austin | 9.2% | 230 |
| Phoenix | 11.3% | 230 |
| Jacksonville | 12.7% | 240 |
| Oakland-East Bay | 6.9% | 250 |
| San Antonio | 9.8% | 250 |
| Tucson | 11.7% | 350 |
| *US Metro Average* | *7.2%* | *120* |

## In the Beginning . . .

It was August 2002, and the Dow Jones Industrial Average had dipped under 8000. Davis had decided that he needed to take control of his own economic fate. He had done enough preliminary research on the real estate market in his own area to convince Hodgetts that there was money to be made in becoming landlords—against Hodgetts' preliminary objections. Davis became the managing partner of the business while Hodgetts focused on their academic writing. Davis would make the money while Hodgetts would crank out research and publish academic articles and books. Both were quite happy with this arrangement.

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 remortgage those properties and pull out an additional $10,000 to $20,000 per home. In an attempt to "double profit" from their venture, they formed a construction company, DHR Construction, LLC. In January 2003 they hired one of their renters to finish off all of the basements.

One of Davis' students, the individual who was designing their basements, thought that Davis and Hodgetts could cut out the middleman if they built their own homes. Davis and Hodgetts were 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. 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.

By January 2004, they had completed three homes at St. Andrews. By April 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 of $450,000 per property. This made building homes on this property 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.

## Growth to Overcome Adversity or Just More Adversity?

Concurrently Davis and Hodgetts formed a third firm in the summer of 2004. DHR Patio Homes, LLC, was created in order to work on their latest construction project, Mountain Trails (see Figure 1). This was a large and challenging project for Davis and Hodgetts; it involved building nearly 40 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 (Hagerty and Corkery, 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 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. 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. Davis was in particular personal financial trouble, having 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.[3]

## Typical Rental Home of D&H Management LLC[4] and the Local Market

Davis and Hodgetts' typical rental home could be categorized as a "starter home," a three-bedroom, two-bath unit sitting on less than a quarter acre plot that had approximately 1,200 to 1,600 square feet of living space, a one- or two-car attached garage, a small outside back porch, a living room with a fireplace, walk-through kitchen, dining room, and a finished basement feet. The basement added another 1,000 square feet with an additional two bedrooms, one bath, and a family room. Homes would rent from $850 to $1,200 a month based

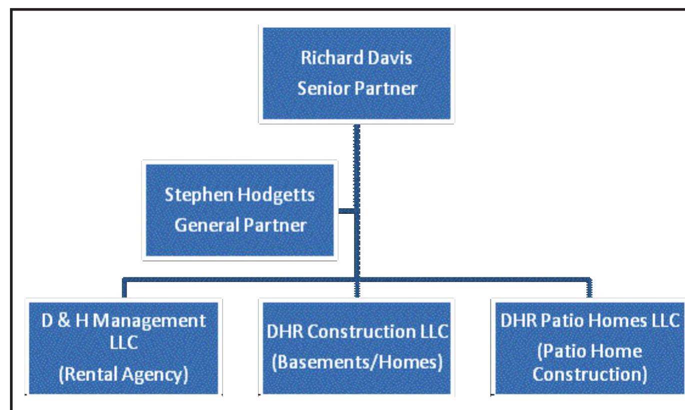


**Figure 1. Davis and Hodgetts' Businesses**

on square footage, demand, and additional amenities (i.e. upgraded appliances). See Figure 2.

Before their meeting, with a little on-line research, Davis and Hodgetts found that the town where they owned their rental properties was also having economic troubles. In 2009, the town had nearly 100,000 people with an annualized growth rate of about 2 percent for the past 20 years although the growth rate in 2008 was flat. Unemployment was rising and was 5.5 percent in January 2008 jumping to 9.9 percent in 2009 (U.S. avg. was 9.50%). Job growth in 2009 was negative with jobs having decreased by 3.9 percent; spending on public schools per student was $5,681 per student (U.S. was $6,058). In 2006 approximately 83 percent of the population was white, nearly 70 percent over the age of 18, 40 percent of the residential units were renter occupied (vacancy rate in 2008 was around 9%), with a median family income of nearly $55,000. The CPI rose from 1.8 in the 2nd half of 2007 to 4.0 in the 2nd half of 2008 yet the town's cost of living was 13.82 percent lower than the U.S. average. (Bureau of Labor Statistics, 2010)

Davis and Hodgetts noted that the median home cost was $162,950 with home appreciation in 2008 at -11.30 percent. Existing starter homes with similar square footage to their own rental homes cost around $135,000 to $150,000. With a 25 percent down payment, the mortgages on these homes would be somewhat over $100,000; this would translate into a monthly mortgage payment (30-year fixed mortgage, 5.25% rate)[5] of about $600 with associated real estate taxes of approximately $100 a month. Table 1 shows quarterly rental surveys conducted by the town.

**Figure 2. Typical Rental Home of D&H Management LLC**

**Table 1. Town Rental Survey**

| Survey | Average Rent | Median Rent | Vacancy Rate |
|---|---|---|---|
| 2009Q1 | $655.57 | $622.90 | 8.4 |
| 2008Q4 | $628.77 | $631.16 | 8.1 |
| 2008Q3 | $655.11 | $637.31 | 5.5 |
| 2008Q2 | $630.30 | $636.05 | 6.1 |

## An Overview of the Properties in D&H Management LLC's Real Estate Portfolio

The firm owned eight properties within one specific development that was on the outskirts of town. The eight homes were within a four-block radius of one another with several homes on the same block. One of the homes was already in foreclosure, yet no action had yet been taken by the lending institution and therefore the home was still renter occupied. Summary financials for the properties are shown in Table 2; property details are provided in Table 3.

Cash flow was the critical issue for the firm. First, the firm was only solvent when all of the renters paid their rent. This was not a problem in the beginning of the business when the economy was in good shape, but as the economy worsened and unemployment increased at least one renter was either late with a payment or missed a payment or two. On several occasions renters had to be evicted due to lack of payment. Worse, several had left the property in ill repair, and the expense of the repair work far exceeded the monthly security deposit. There was little chance for legal redress for making up the difference and therefore Davis and Hodgetts had to use their own personal funds to pay for the repairs.

**Table 2. Summary Financials of D&H Management LLC Portfolio—Property Cash Flow**

| | |
|---|---|
| *Scheduled Rent Amount* | 8,675.00 |
| *Property Maintenance (10%)* | (782.50) |
| *1st Mortgage* | 1,185,016.00 |
| *2nd Mortgage* | 115,700.00 |
| *1st Mortgage Payment* | 6,029.64 |
| *2nd Mortgage Payment* | 904.22 |
| *Total Mortgage Payments* | 6,933.86 |
| ***Difference:*** | **958.64** |

**Other Related Expenses**

| | |
|---|---|
| *22,997.69* | *Outstanding Lines of Credit* |
| 420.00 | Monthly Expense |
| 150.00 | Monthly Legal Expenses |
| 62.50 | Monthly Accounting Expenses |
| **632.50** | **Total Related Expenses** |

Secondly, property repair and maintenance were increasing in cost. The properties were aging and starting to show some real wear and tear from multiple renters. Hodgetts and Davis' 10 percent property maintenance reserve was not large enough to cover the costs. They tried to raise the rent, but found that the availability of rental homes put a very low ceiling on home rentals prices.

## Back to the Diner: Making the Impossible Possible?

Hodgetts and Davis were reviewing the Financial Information of D&H Management LLC Portfolio (Table 3) when Hodgetts received the following text message from Davis' wife:

> I have had enough. I want to be out of D&H by the end of the year. Losing our home, etc. has been a big blow emotionally. We have a nice patio home which helps the transition, but not the feelings of loss. You and Richard in the interim can discuss how to cope with these houses.

Hodgetts shared the text message with Davis who softly moaned to himself. He had had this discussion many times before with his wife and explained to her that if they wanted out of the business now that not only would all the properties be repossessed (and therefore they would be left with nothing) but that all of the personal funds they had lent the business would also be lost with no hope of recovery. Furthermore, their new patio home might also be taken by creditors since new property defaults would not be covered by their prior bankruptcy filing.

Davis and Hodgetts put their heads together and decided to list all of the available options that came to mind and their immediate ramifications:

1. *Sell all of the properties, assume a loss* (walk away with nothing), and avoid the negative cash flow. The lending institutions would be paid back part of their loans and perhaps would be willing to settle for that amount. However, there was a good likelihood that these institutions would seek legal redress from both Davis and Hodgetts and sue both of them for the difference between the sale price and the outstanding mortgages of all of the homes.
2. *Walk away from all of the properties, assume a loss (walk away with nothing), and avoid the negative cash flow.* Again, the lending institutions might seek legal redress for the differences between the selling prices of the houses and their mortgages.
3. *Delay paying the mortgage on some of the homes, allow these properties, if necessary, to go into foreclo-*

**Table 3. Financial Information of D&H Management LLC Portfolio—Property Cash Flow**

| *Address:*[1] | *A1* | *A2* | *B1* | *C1* | *D1* | *A3* | *B2*[2] | *E1* |
|---|---|---|---|---|---|---|---|---|
| *Scheduled Rent Amount* | 1,100.00 | 1,125.00 | 850.00 | 1,100.00 | 1,175.00 | 1,175.00 | 1,100.00 | 1,050.00 |
| *10% Maintenance Fee* | (110.00) | (112.50) | | (110.00) | (117.50) | (117.50) | (110.00) | (105.00) |
| *1st Mortgage* | 179,424.68 | 157,941.12 | 174,041.81 | 173,287.40 | 179,274.43 | 142,399.99 | | 178,646.57 |
| *2nd Mortgage* | 20,500.00 | 41,000.00 | | 25,800.00 | | 28,400.00 | | |
| *1st Mortgage Payment* | 890.98 | 730.42 | 860.57 | 1,017.14 | 898.47 | 791.53 | | 840.53 |
| *2nd Mortgage Payment* | 109.48 | 290.65 | | 121.00 | 109.52 | 134.22 | | 139.35 |
| *Total Mortgage Payments* | 1,000.46 | 1,021.07 | 860.57 | 1,138.14 | 1,007.99 | 925.75 | | 979.88 |
| *Difference* | **(10.46)** | **(8.57)** | **(10.57)** | **(148.14)** | **49.51** | **131.75** | **990.00** | **(34.88)** |
| *1st Mortgage Rate* | 5.75% | 6.00% | 5.75% | 5.38% | 4.13% | 6.50% | | 5.38% |
| *2nd Mortgage Rate* | 7.25% | 8.63% | | 5.75% | 6.50% | 6.50% | | |

[1]Letters indicate properties located on the same street (i.e. A1, A2, A3).
[2]Property B2 is in foreclosure but has not been repossessed by the lending institution.

*sure, and in the interim use the positive cash flow to shore up some of the more positive cash flow homes.* This seemed like a short-term "wait and see," culling of the flock strategy (what Hodgetts referred to as a "slow suffocation" versus a "quick hanging"). The better cash flow properties would be saved at the expense of the poorer ones, yet Davis and Hodgetts would still be subject to potential litigation.

4. *Contact all of the lenders and try to renegotiate the mortgages so as to have lower monthly rates.* This strategy had the least obvious short-term negative impact although the institutions could easily say no and Davis and Hodgetts would be back to where they were before.

They looked over the options, looked at each other, and then looked over the options again. They decided that they needed time to think through each option, or better yet, find new options. Yet the clock was ticking and they knew that they could not "do nothing" forever.

## Part B

Two days after Hodgetts and Davis had discussed the dire straits that their real estate management firm was in Hodgetts was feeling quite depressed. He saw no real solutions that didn't involve both of them going into personal bankruptcy[6] as well losing all of the rental properties in foreclosure proceedings.[7] Hodgetts' biggest fear was that the foreclosed properties would sell for lower than their mortgages and that the lending institutions would file lawsuits against him and Davis for the dollar value differences; and those differences could be substantial.

What sustained Hodgetts through all of this chaos was that at least he and Davis had stuck together through the good times and the bad. They faced this problem, like all of the other problems they had in their life: together. And together Hodgetts thought they had a good chance of weathering the storm. They had known each other for more than 20 years and Hodgetts felt that their friendship was an unbreakable bond. Given his faith in Davis' comradeship, he was shaken to the core when he received the following e-mail:

> This month we had to pay a second mortgage on one of the properties mortgaged in your name out of my salary because there was no money in our contin-



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gency fund and I know you have no funds to fall back on. This is doing nothing to improve my relationship with my wife … Adrianne and I will continue to do whatever we can to make this business work, but neither of us wants to be the person (people) who have to make the decisions about individual properties.

I propose that we quit claim the properties with your mortgages to you, and have the proceeds from rents collected on these 4 properties sent directly to you so that you can deal with the bills and rent as you see fit. Adrianne and I would do the same with our 2 properties. When all properties are rented and there are no problems, hopefully there will be enough cash to pay all mortgages. However, when there are extraordinary expenses (like we dealt with this month with basement flooding) or vacancies, property owners can make the decision as to how to proceed. This will take a great burden off of Adrianne, and if things work out over time, everyone can recover their investments and (hopefully) make some money. But I think it is time to recognize that is it not fair to depend on me to come up with shortages, when I no longer have our construction company to provide for deficits (all shortages are coming out of my personal income).

Let me know what you think, and whether or not this will work. I don't want to close down D&H this year, as was true last year, because Adrianne and I have lent D&H several thousand dollars, this money would be converted to income for you. If we transfer properties next year, the depreciation and other losses should overcome our loans.

Hodgetts didn’t know what to think or what to say. Davis had made all of the critical decisions about the businesses and Hodgetts never blamed Davis for the series of unfortunate events that had lead to the downfall of both businesses. Rather than pointing fingers of blame and filing lawsuits, Hodgetts had remained steadfast and loyal and continued to do his part on the academic side of the house. However, he also understood that it was not fair to Davis to shoulder the burden of the economic losses alone. Davis’ proposal, however, seemed quite inequitable 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). He felt this 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 percent 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 may not have been successful as a team in business, but at least they were successful in the academic arena given Hodgetts’ research and publishing efforts (although Hodgetts freely admits that Davis had mentored him in the early years). More importantly, they were old friends and Hodgetts felt as if Davis was abandoning him like an old shoe.

Hodgetts knew that reacting immediately to Davis’ proposal was the worst possible solution. He did not want his emotions to get in the way of making a tough business decision. He gave himself a week to think through Davis’ proposal and to develop a counter solution that would not only save the businesses but save his friendship as well. What that solution was, however, seemed well beyond his talent and experience, but he would develop one nonetheless.

Notes

1. The names and location have been changed as per the request of the owners.
2. Homes built without a guaranteed buyer.
3. These homes were later repossessed in a deed for mortgage swap.
4. References deleted as needed to protect anonymity of the owners.
5. Washington Post (August 1, 2009). “30-Year Rates Rise for 2nd Straight Week.” Retrieved from http://www.washingtonpost.com/wp-dyn/content/story/2009/07/31/ST2009073102656.html, August 3, 2009.
6. See Chapter 7 on liquidation of all assets and Chapter 13 on reorganization in which the debtor creates a three- to five-year payment plan in Personal Bankruptcy. (http://www.bankruptcy information.com/personal-bankruptcy.htm; retrieved August 31, 2009).
7. The legal process in which an owner's right to a property is terminated, usually due to default. Typically the process involves a forced sale of the property at public auction in which the proceeds are applied to the mortgage debt (Foreclosure: definition, http://www.investorwords.com/2039/foreclosure.html; retrieved January 20, 2010).

## References

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