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Case Study

DHR Construction, LLC¹: Parts A and B

Herbert Sherman
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Stephen Hodgetts read the e-mail over and over again and still could hardly believe what he had read. He had just come back from his vacation, well rested and refreshed, and this e-mail had dampened his high enthusiasm. It took time to absorb such bad news and for Hodgetts to get over his incredulity. Yet in the end Hodgetts accepted the truth—a deep, dark terrible truth that would not go away. Robert Davis, his business partner's son, had confirmed in an e-mail his worst fears about their newest business partner, David Russ. Many thoughts were running through his mind simultaneously yet each screamed to be heard. "How could he and his partner Richard Davis have been so blind, so trusting?" "How could Russ not have heeded the advice of his business partner, Richard Davis, Russ's former English professor?" And most important, "What was now going to happen to their new business?" Yet the one thought that continued to echo among them all was surprisingly a quote from Sir Arthur Conan Doyle's beloved character, Sherlock Holmes: "But there are always some lunatics about. It would be a dull world without them."

In the Beginning...(Part A)

In August 2002, when the Dow Jones Industrial Average dipped under 8000, Davis and Hodgetts, friends, coauthors, and fellow English professors, lamented their desiccated retirement funds. Neither was getting any richer on a faculty member's salary nor expected any windfalls from relatives, their book sales, or lottery tickets. After a long discussion, they decided that they needed to become masters of their own economic fate. Richard Davis had done enough preliminary research on the real estate market in their area to convince Hodgetts (who had a bad experience renting his house several summers ago) that there was money to be made becoming what Hodgetts half jokingly called "slum lords." In September 2002, they formed D&H LLC, each investing \$50,000, with the idea of buying a total of 10 homes by the following year.

Davis and Hodgetts, with the assistance of Davis's real estate agent, found renters in three months and worked with these families to find them homes in the \$175,000 price range that the families would be happy to lease with the option to buy. The rentals were so attractive that Davis and Hodgetts even had a waiting list for new tenants. Davis and

Hodgetts easily qualified for mortgages but found that the interest rates were higher than they expected as the homes were purchased as rental properties and not primary residences. They decided to put 10 percent down on each property and to use a three-year adjustable rate mortgage to drop the interest rate and their monthly expenses to about \$900 a month. They also found that they needed to invest another \$10,000 into each home for real estate brokerage fees, appliances, interior design, and landscaping. The six homes they had purchased gobbled up their initial investment of \$100,000 and required an additional \$80,000 (which Hodgetts loaned the company). Their net profit was \$1,500 a month, certainly not enough funds to purchase the planned additional four homes, but enough funds in their minds to merit continuation of the business. Property values of these homes were rising at about 10 per year. Hence, the real economic benefit derived from the business would be realized at the end of the three-year lease, when the renters either bought their homes or when the homes would be resold.

Davis and Hodgetts purchased only newly constructed homes for their rental business. This reduced their time spent managing the properties and attracted the interested renters who would be willing to purchase their house at the end of the three-year lease. Davis and Hodgetts believed that these new homes would have minimal repair problems over the three-year time span of the lease and that they would therefore have little, if any, interface with any subcontractors (i.e., carpenters, plumbers, electricians, gardeners) in the future.³ For Davis and Hodgetts the rental business was supposed to be a sideline to their academic careers and certainly was not going to cut into their quality time as academics.

Any problems with the six properties (and there were very few) when Richard Davis was not at home to answer renters' calls, Adrienne Davis, Richard's wife, resolved. She would contact the home's building contractor. Work that was performed on the newly purchased homes (one home had a flooding problem) was covered by the builder's warranty, therefore, there were no out-of-pocket expenses. Any phone traffic or other day-to-day activities related to the business, what little there was, was usually handled by Mrs. Davis since Drs. Davis and Hodgetts spent much of their time at the university. This included collecting rent checks, paying the properties' mortgages, and making bank deposits.

A Short-Term Solution and a New Game Plan

Their solution to raising cash for down payments on new rental properties was to finish off the basements of their renters' apartments, and then remortgage their properties. They could finish the basements off for approximately \$20,000 per home and increase the appraised value of the property by nearly \$30,000. If they did this for all six homes, they could raise \$60,000. While talking with their renters about the possibility of finishing off their basements, they discovered that one couple, Alan and Wilma, were not only willing to finish off their own basement but would be willing to finish the basements of the other houses for \$5,000 less per home.

The work was well underway to finishing off the basements of their six rental units in April 2003. Alan and Wilma formed their own LLC and completed three basements (including their own) while Davis and Hodgetts refinanced those three homes and were able to clear about \$45,000. With these funds, they purchased an additional two homes bringing their total number of rental units to eight.

It was late April when Davis was approached by one of his most recent graduates, Russ, who was designing their basements including drawing the blueprints, about cutting out the middleperson in terms of the rental business by building their own homes. Russ, a young man who had just recently graduated from Davis and Hodgetts' university with a degree in business administration (specialization in management), worked in the home construction industry for several years part-time as both a general construction worker, and then as an assistant designer. During the past year Russ had formed his own LLC (DRArchitectural Designs), with the intention of going into the business full-time once he graduated from college. Working for Davis and Hodgetts designing basements was quite fortuitous for Russ who saw real opportunity in this new venture of home construction.

Russ acted as the contractor. Although he never served as a contractor before, he felt quite confident that his industry experience and his educational background in business provided him with the skills necessary for managing a home construction project. More importantly, given his prior work experience, he knew all of the subcontractors in the area who were needed to construct new homes. He felt confident in his ability to work well with people whom he considered his friends and to manage the process. Russ had taken numerous courses on motivation, leadership, and business operations and knew that his college education would serve him well on his first major managerial position.

Davis was highly impressed with Russ's hard work and dedication as a student in his class and felt that these traits would carry over well to the work environment. Davis had

known Russ to be an affable and capable student and vouched for his character to Hodgetts. Alan and Wilma would do the interior work, and/or Alan could hire some part-time workers to help him. In any event, Davis and Hodgetts would build the rest of their homes under a different company name, sell it to themselves for a profit, and then make a profit renting the homes. Davis estimated that on a \$150,000 home they could net a 20 percent profit; \$30,000 over the two- to three-month time period it would take to build one home.

A New Entrepreneurial Venture—The Birth of DHR Construction, LLC

In talking with Davis about this project, Russ noticed that the team of Davis and Hodgetts, academics by training, had many of the same characteristics that his course on entrepreneurship taught him were critical in becoming successful start-up business owners. These traits included: high drive and energy level, self-confidence, setting challenging but realistic goals, using money as a measure of performance, persistent problem-solvers, moderate risk takers, taking initiative and taking personal responsibility, and making good use of resources.⁴ Russ was further impressed with the operation of Davis and Hodgetts' current enterprise since it was clear to him that this was more than just a hobby business—Davis and Hodgetts were depending on the rental business for their future retirement income.

Hodgetts met Russ for the first time at the signing of the LLC agreement and they seemed to hit it off quite well. Their lengthy discussions about the business confirmed Russ's observation about Davis and Hodgetts' entrepreneurial bent. Yet looking back upon this conversation an objective observer might note that certain issues were surprisingly absent from this discussion as well as any previous discussions about the new venture; specifically the marketing and promoting of the business, networking techniques, and initial preparation for the new venture.⁵

According to the agreement, Davis and Hodgetts would have controlling interest in the firm (37.5% each) while Russ would be a minority shareholder at 25 percent. No one consulted a lawyer about the contract, which they all had been given a copy of ahead time. Davis assured both Hodgetts and Russ that this was a standard LLC agreement—one in fact he took off of the Internet and was written given their particular state's LLC's requirements. After much hemming and hawing by Hodgetts, who tended to object to any new venture proposed by Davis, Hodgetts and Davis formed a construction company with Russ, DHR Construction, LLC.

DHR developed a simple business model. Homes would be priced at 20 percent above cost. Russ would act as the architectural designer and contractor. His job was to work with the subcontractors to ensure that their work met sched-

ule and building code requirements, and to make sure that subcontractors' bills coincided with the work provided. Russ was to bill DHR Construction, LLC for his services under his own LLC, leaving DHR with no salaried employees. Davis handled the back office functions of the business (hiring an accountant, pricing out homes, bidding out work to subcontractors, working with real estate agents, and mortgage companies) while Hodgetts played creditor and bankrolled the company's upfront expenses. Hodgetts also took a more active role in Davis's and Hodgetts' academic career by becoming first author on several books and journal articles that he and Davis were jointly working on.

The business was progressing quite nicely—in the opinion of Hodgetts, Davis, and Russ. Davis had located a bank that offered them construction loans at 75 percent of the estimated retail value of the homes to be built for a competitive lending rate,⁶ thus requiring at most a 5 percent loan from Hodgetts to cover minor expenses (assuming a 20% profit margin per home). Norma, their home rental agent, had found them vacant property in the same general vicinity of their rental properties, with each parcel running between \$40,000 to \$45,000. Their mortgage company for their rental units offered them extremely favorable mortgage rates if Hodgetts and Davis decided to buy their own homes for rental purposes. In the interim, Hodgetts lined up a publisher for a fictional piece of work that he and Davis had always wanted to write—*The Bard Meets Sherlock Holmes*. Hodgetts drafted an outline of the text which received very favorable reviews from the publisher.

Russ, their new business partner, was also quite busy. He lined up all of the subcontractors needed to build their homes (including Alan and Wilma who would handle framing and walling) and developed several designs for homes in the 1250 to 1400 square foot range that would sell for \$165,000 to \$185,000. Russ's homes included some added features that differentiated them from other houses in a similar price range, (i.e., more windows, including a garage window, nicer lighting fixtures, upgraded appliances, nicer counters, cabinets, and flooring) including a distinctive California design, featuring an oversized master bathroom, archways, high ceilings, and unique fireplaces. The three partners agreed with their real estate agent that many of these upgrades added minimal cost to the overall price of the home and accentuated customer value.

Of Mice and Men

The strategy was to immediately construct two homes based on the plans developed by Russ. Each property was to be purchased by each of the majority shareholders (Hodgetts and Davis) who would then quick title the land to their property management company, D&H Management. These contributions represented each owner's equity investment in DHR

Construction. Russ's contribution came in the form of sweat equity—much of the startup work on these homes was performed for free although his firm was paid for the architectural drawings.

Construction loans were then obtained based on Russ's architectural drawings, Davis's cost analyses, and the real estate agent's assessment of a competitive selling price for the property. Hodgetts was on a sabbatical feverishly working on *The Bard Meets Sherlock Holmes* and contributed the least to the day-to-day operations, although, he attended all of the company's meetings. The ground was broken quickly, pictures were snapped of the event, company t-shirts and hats were distributed to owners and subcontractors alike, and construction was well underway. Adrienne Davis, who had recently received her MBA, even got into the DHR operation (for no compensation) by organizing meetings and coordinating communications between the office (Davis's home) and the construction site.

While on the surface everything seemed to be going fine, an undercurrent of discontent was running through the ranks of DHR's subcontractors, especially Alan and Wilma. They complained bitterly to Adrienne that Russ was both crude and rude in his dealings with them, and the other subcontractors, and that Russ had threatened to fire them if they protested his actions to Davis and Hodgetts. Other subcontractors were complaining to both Davis and Adrienne that they had been called into a project by Russ either too early, when the work was incomplete (and therefore they could not do their own work), or too late (they'd have to work around someone else's work). Property was also disappearing from the work sites, especially with wrong orders where goods would have to be picked up for return by the deliverer. Both homes were running over budget and the quality of the work being performed was inconsistent and not always up to building codes.

In May 2003, less than two weeks into construction, Adrienne decided to intervene and have a chat with Russ. She gave him a chance to reflect on the feedback that she was getting. She told Hodgetts in an e-mail that "my lunch with Russ went well. We brainstormed bringing his wife into the business as a PR representative. Meaning, she would schedule the subs, bake cookies for them, and visit the job site to listen to concerns. That would take pressure off Russ and make him a better manager. There are still rough edges on him, but he enjoyed our time together. I'll do it again." Hodgetts replied, "Russ is young, inexperienced, and probably a bit over his head—a normal reaction would be to give orders and criticize others but I'm sure that you can break him of this habit!" Davis seemed less concerned than his wife about Russ's behavior—no one had complained to Davis about Russ and when Russ and Richard (Davis) were together on the site, everything seemed fine and everyone seemed happy.

The Plot Thickens

According to Adrienne, however the situation was getting worse. "My anger toward David Russ continues to grow," she confided in Hodgetts a week after the meeting. "Now I have learned that he may be undermining our relationship with various subs. He rushed the roofers to finish. Now the heating people have to drill holes and repair them to finish their part. He is unrealistic about deadlines. We may lose business over his behavior. That is unacceptable to me."

"Alan is the one who smoothes things over for us once Russ has left the job site. Thank God for Alan! Russ needs to know it's not just me, Adrienne, who is upset about his behavior. He writes me off because I'm a woman, and he believes that I don't understand the nature of the construction business. I don't buy that one! These are people issues that pertain to any business." Adrienne then took a long pause in which to catch her breath.

"I have counseled Russ to speak more softly and to give Alan permission to question him and ask for clarifications. I have also counseled Alan to speak up and not take Russ's behaviors to heart. Alan is such a gentle spirit. Russ is such a bull. We'll see how time plays out with these discussions. Russ wonders why he doesn't get more respect. There's a topic to explore with him. Respect doesn't come from yelling orders at people. He has no sense of how to express gratitude to our subcontractors. It's all about him.

Richard is tired of talking about it. He just wants things to go away. I know they won't without some action. I asked Richard to consider using Russ in another role, or dissolving the corporation. This is a small college town and word gets around. I don't want his attitude to bring us down. We have such a wonderful team otherwise." She took another long breath before she continued.

"Stephen, would you be willing to address this issue with Russ? I think he is in over his head and doesn't really know how to function with people on the job site. His ego is huge. If he brings relatives around to show off the place, he is worse, giving everyone orders as if he runs the place. He creates an unhealthy workplace environment. Perhaps some words from you about being humble and caring would have an impact. Hearing the message from several places might help it sink in. Thanks for listening."

Hodgetts was placed in a real bind. He respected Adrienne's opinions and thought very highly of her ability to read people. He also valued his long-time writing partner and could not believe that Richard would overlook such a glaring problem. Russ might be Davis's former student but Hodgetts could not imagine Davis coddling Russ. He hoped that his reply to Adrienne would be both thoughtful and diplomatic. "You have posed a real conundrum for me since I am not involved with the day-to-day operations and I have no real

contact with the subcontractors. I am therefore even more removed, at least in Russ's eyes, than you are from the business. Advice from me at this point, if you pardon the expression, would be like pissing into the wind."

Adrienne looked a bit perturbed but seemed to accept Hodgetts' comments with grace. Hodgetts continued, "I think that you and Richard need to sit down with Russ and his wife and have a good clearing of the air. Richard needs to set the ground rules, explain that he is the principal owner and therefore the boss, and discuss with Russ our way of working with people. I'm sure that Richard and Russ can work these things out once everyone puts their cards on the table."

The Meeting

Hodgetts had a nice chat with Davis who concurred that a meeting would put this issue to bed once and for all. The meeting went well according to Davis. "I had a very good chat with Russ, who brought his wife, yesterday afternoon. His wife was far more upset and angry than Russ, well at least that's the way it appeared, but we talked through all of the issues. Adrienne is not convinced that Russ is changing that much, but I don't particularly agree. Alan and Wilma have to be more assertive and speak up for themselves rather than tell Adrienne about their problems. This will keep Adrienne from then getting angry on their behalf. Anyway, at the moment, I think things will settle down."

Adrienne had a slightly different perspective but agreed with the outcome. "Richard asked me to stay for the meeting with Russ. Russ brought his wife, as she was upset as well. It was good. They needed to be angry and express their frustrations. Amazingly, none of this upsets me. I embrace the challenge of understanding. No tears! We left with everyone feeling better. I can't say the discussion is over, as Russ doesn't express any ownership of the problems." In a mocking, sarcastic tone she continued, "There needs to be bosses. He is doing alright. He's done it all. He has lots of expertise. On and on. He talks fast and loud. I just listened. Richard spoke out of his frustrations with the issues. Mostly to have this resolved, as he is tired of this nonsense! Russ's wife does hear and hopefully will help Russ to see what needs to happen."

From Hodgetts' standpoint the meeting actually turned out better than expected. He was sure that Richard would put in his two cents in terms of who calls the shots and that Richard would reiterate the need for Russ to be a team player. He was also certain that Russ would see this problem as an issue of competence (not compassion) and that Russ unfortunately would not understand that it isn't always the smartest person who makes a good manager, it is the one who possesses excellent interpersonal skills.

When the Mice Are Away

It was only a few weeks later, in early July, that Richard Davis and his wife planned a two-week trip to Europe, after Davis's summer term was over. Davis was scheduled to present a paper (co-authored by Hodgetts) at a conference in Spain and hoped to take a break from the business by traveling a bit in Europe. Hodgetts had plans of his own that also took him away from the area and therefore Davis's son Robert was left to represent both Davis and Hodgetts' interests while they were away. Both signed proxies giving Robert the formal authority to act on their behalf. Robert was slightly older than Russ, had worked as a paralegal, and was currently the administrative assistant to the chief financial officer of the local hospital. Robert had originally planned to tour Europe with

his parents but opted to use his vacation from work to stay home and mind the business. Robert scheduled a luncheon appointment with each of the subcontractors during the time his parents were away to give him a chance to connect with all of the subcontractors and catch up on events.

The two weeks in Europe were quite blissful for Davis and his wife—they received no emergency calls, kept in touch with Robert via e-mail, and enjoyed the scenery and wines of Spain, Portugal, and France. Hodgetts was also well rested, having spent time away from work gathering background information for future writings and enjoying some time off from his intensive writing schedule. When they came back from their respective breaks they found the following e-mail from Robert:

From: Robert Davis
To: Stephen Hodgetts
Cc: Dad, Ma
Subject: Updates

Just thought you should be aware of some things that are going on and issues that will be addressed today.

After spending a week at the helm of the business while my parents were out of the country, I became very aware of some issues that were going on within the company.

I know for a fact that the situation with Russ is getting worse by the day. I had lunch with Wilma on Thursday, during which she reluctantly provided some rather distressing information about his behavior on the site (in front of her children in a few cases). After our lunch, I phoned Russ's wife and left a message asking to have lunch with her the next day to get her perception on how things were going with scheduling and the progress on the houses. (I mentioned nothing of my meeting with Wilma). Somehow, however, this all got back to Russ. The fact that I was speaking to others outside of him caused him to become quite agitated. He proceeded to threaten Alan and Wilma (in front of his own wife) saying that no one was to speak to anyone but him and that he would report any information necessary to either myself or my parents.

I was not aware of this particular incident as it was happening, but I did quickly become aware that something had happened because Wilma called me a few hours after our lunch (post-threat) and in a very shaky, scared, and (like a witness to a mob hit) begged for me to forget everything she had told me. She rapidly denied what she had said and told me not to breathe a word. Instinctually, I knew Russ had gotten to her somehow (I didn't hear about the threat until Saturday—two days after the fact when everything was calmer). I've had enough experience in life to tell me when someone has been threatened. At the time I didn't know what had happened, but I knew without a doubt something had taken place.

I bit my tongue, however, and fought off all my immediate impulses to find Russ and bluntly tell him that I will speak to whomever I damn well please, that I will talk to everyone to get the whole story on everything that goes on with this project, and that he had no right to address one of our dearest subs in that fashion. But as he seems to feed off of confrontation, I stayed calm and quiet.

Meanwhile, I have heard things from some of our subs (our carpenter, particularly irritated by our horrible scheduling that caused him to wait four hours to complete his tasks on our first home). They are not happy—no matter what they tell Russ to his face, and what I hear behind the scenes is not pleasant.

I received calls from Russ almost daily telling me things were ok, but when I checked in with other people, that's not what I'm told.

I have to say that I am beginning to feel uncomfortable around Russ. The way he keeps his wife silent. The speed at which he responds when I talk in confidence with other persons within the group to keep them from contacting me again.

The instinctual discomfort I felt when I was standing by him and he was holding a hammer like a talking stick (though I knew he wouldn't hit me, I still felt like I should stand out of arm's reach). All of this is disquieting to me.

I have tried to remain as neutral a presence as possible. I have always tried to keep a polite, professional attitude around them. I have invited his wife to lunches, to celebrations, and to chat. And the thing that really gets to me is that she will only engage if she has his permission.

This is not a healthy arrangement. I now liken him to a cancer within the group, slowly eating away at the strength, integrity, and unity that were first present in our team...except that now we're not a team at all. We are a series of single units coexisting to bring this project to an end.

This saddens me as I felt (and still feel) this project, this company, this idea is a wonderful brain child that should not be coerced to continue. The joy and prosperity it has the potential to bring is extraordinary. But, sadly, there is one piece that is acting as the broken link in this dream and it needs to be taken care of immediately. I don't know how; I just know that it must be soon...for everyone's sake.

Please understand, I do not enjoy making these statements. I wish to see everything work out for the best. But, try as I did over this past week to make everything better, I fear that I did not do enough to keep it from getting worse.

The houses are wonderful, but the company is strained. I quietly wish that there was something I could do to make it right. But this is beyond me. My suggestions have been: (1) move Russ to a subcontractor role where he does not have the possibility of asserting false authority; (2) Richard (dad) must be on the site more frequently to observe the progress and interactions first hand (everyone has said that things are better when he's around, so therefore it only makes sense that he make his presence a more common sight); and (3) we need to assert again and again the rules, job descriptions, and ideals of this company. There must be no doubt who we are and what we are here for.

Thank you for allowing me to rant in my report in such a lengthy fashion. I do feel these issues must be brought to light and acted upon. I'm sad there is nothing more I can do to make this better.

Sincerely

RD

Dissolving Partnerships (Part B)

The die had been cast and the sisters of fate, with scissors poised for action, awaited the time of the cutting of the thread. It was July 2003 and Hodgetts and Davis reluctantly agreed that they needed to rid themselves of their co-owner, Russ, given the negative reports they had received from their subcontractors and business associates. Russ's arrogance, coupled with his threatening approach when dealing with subcontractors, made him an immediate liability that would quickly blow up in their faces. Both Davis's wife and son found Russ's behavior intolerable; evidently these behaviors were not going to be corrected in the near term. Davis was forced to choose between his family and his business partner and his business partner drew the short straw.

Davis was especially disturbed, since Russ was a former student of his, and hoped that he could have mentored Russ over the long term of the business and groom him to take over both businesses (D&H Management, DHR Construction) when he and Hodgetts retired (within the next five to ten years). Such was just not to be the case. Davis currently did not have the time necessary (given his teaching and office responsibilities) to provide Russ the day-to-day supervision

he apparently needed to properly run the business and it was evident that Adrienne could not serve in that capacity. Without coaching and counseling from Davis, a business meltdown seemed imminent if Russ were to continue to stay involved in the business.

The Dagger Is Drawn

It was during one of Hodgetts and Davis's friendly weekly gatherings, a custom that now included family members and subcontractors from the business, that they both decided to adjourn to a separate room in Davis's house to discuss the matter discretely. Hodgetts had just finished describing a possible twist ending to their co-authored book *The Bard Meets Sherlock Holmes* and was intently listening to Davis's reaction, which of course was delivered in the tradition of the great detective. "I never get your limits, Hodgetts. There are unexplored possibilities about you.⁷ At present I am, as you know, fairly busy, but I propose to devote my declining years to the composition of a textbook which shall focus the whole art of detection into one volume.⁸ You, my dear Hodgetts, have captured the essence of that art in the last chapter and are to be congratulated for a marvelous piece of work."

“Thank you, thank you,” replied Hodgetts. He was smiling from ear to ear and Davis could tell that Hodgetts was very pleased with himself and with Davis’s response to Hodgetts’ work. Hodgetts had never taken on such a heavy portion of the work load before in their co-authorship and hoped to satisfy Davis’s high standards. “I wish that we could deal with Russ as easily as Mr. Holmes dealt with the Bard imposter in Chapter 7. For now is the winter of our discontent.⁹ We have seen better days¹⁰ and what is done is done.¹¹ For to mourn a mischief that is past and gone is the next way to draw new mischief on.¹² So, brave Richard, how might we draw this dagger from our chests?”

Richard Davis had switched his mindset into business mode and dropped his Holmes persona. “This is quite difficult for me as you well know, Stephen. Russ was a student of mine and I encouraged him to become involved in our business. I thought I knew him and clearly I have misread his character. I know that I’m not to blame but I can’t help feeling somewhat responsible for Russ—maybe he just wasn’t ready to take on such an important position. We must understand that we are in essence not only losing a fellow owner but also firing our building contractor. In any event, I think that we should make him a very nice offer, one that is beyond our ownership agreement.”

Davis continued, “Between the two of us we have the majority of shares and therefore Russ has no choice but to leave the company if we so vote. If we were to dissolve the corporation or buy him out, the contract reads that we’d split the company’s equity based upon our ownership. That being said, Russ would receive 25 percent of \$30,000 (\$7,500) minus the salary he drew on this upcoming home building project.”

“I have no problem offering him a little more money than he is due,” concurred Hodgetts. “What did you have in mind in terms of a buyout settlement?”

Heart of Gold

“First” responded Davis, “I would like us to buy his architectural designs for the homes we’ve built. We have four separate designs, at \$1,000 apiece that’s \$4,000. I would also like him to have the special plotter which DHR bought which prints the architectural plans, that’s worth another \$3,000.” “That sounds quite generous,” quipped Hodgetts. Hodgetts was about to continue about the virtues of generosity when Davis interrupted him.

“I’m not done. I also think that we need to help Russ start his own construction company. We owe him that much. He is

the one who introduced us to all of the subcontractors and he certainly was instrumental in getting this business started. I suggest that we help him finance his business, more specifically, I would like us to countersign any loans that Russ would have to take out to build his first three homes. This would include real estate and construction loans. There is no way that Russ could swing these types of loans given his current credit situation. Remember that one of the homes that we are building is his and his money will be heavily tied up in that home.”

Hodgetts was silent and Davis knew that this was not a good sign. Hodgetts had been playing banker for the company, his major role in the building projects, and was very cautious as to how the firm’s money was spent. Davis expected a very snide remark, undoubtedly a quote from the Bard about being neither a borrower nor a lender, and was prepared for the worst. Hodgetts, who was normally as predictable as the tides, threw Davis for a loop. “An excellent settlement package” Hodgetts said with the greatest sincerity. “What did you have in mind in terms of lending rates? I would like us to make one percent over our own borrowing rate plus 2 percent of the profit from each house. Considering that we usually plan a 20 percent profit margin, I don’t think 2 percent is being too greedy.”

Davis was impressed with Hodgetts’ easy concurrence and thought that the old boy might actually have a kind streak in him after all. “It’s settled then,” Davis remarked. “I’ll set up a meeting with Russ so that we can go through the entire settlement proposal. I know that we’re being overly benevolent but I think that we’re making him an offer that he really cannot refuse.”

“Perhaps,” Hodgetts interjected, “You might meet with him alone, one on one so to speak. This is a very delicate situation and I think that you should break the news to him gently, teacher to student, where Russ won’t feel overwhelmed by both of us putting pressure on him. He needs to understand that we have voted him out of the business but that we are offering him far more than his fair share. He also needs to understand that we are not only doing this for the good of the business but for his own good as well.” Davis and Hodgetts agreed on this tactic and then rejoined the get together of subcontractors and family members.

Davis’s Meeting with Russ

It was a busy week for Hodgetts and Davis so Hodgetts was not surprised when he received the following e-mail from Davis:

Sorry I did not get back to you sooner on the events of Monday and today. On top of everything else, my allergies are kicking in like gang-busters and I just want to hibernate! Anyway, yesterday's lunch with Russ went well. I did not share with him any written proposal or agreement, because I wanted to go through the issues first, gain agreement, and then go to more official documents. I approached this from the point of view that he and the two of us are going in different directions, both in terms of the short term (management style) and longer term (he wants to become a developer, and at least I don't). I suggested we begin to break up the company with him using his own LLC as a vehicle to construct three homes, with our financial backing. At the end of lunch (1 1/2 hours) we were on very good terms. He admitted that he thought I was going to fire him, and I tried to reassure him that wasn't the way I work. I'm a problem solver, not a problem maker. He seemed more relieved than anything.

Today I met with Russ out on the site for another hour. He had had time to think and talk it over with his wife and had some more questions. He is concerned about three things: (1) the salary issue, which I said I hadn't had time to process yet, but since salary would be coming out of his equity position, we could buy him out and give him the cash up front (he seemed interested); (2) how he could move forward on three homes, build and sell them in a short period of time; and (3) he really does not want to cut ties with you or me—and he is offering to teach me everything he knows about the management side for some sort of management fee.

Initially, he said we could pay him an 8 percent management fee, but I said that was half our profits and that would never fly, so he backed way off. I know Adrienne will go ballistic if we entered into any sort of management agreement for one or two years, so I said to Russ that I'd need to think about it and chat with you. But overall, he is in full agreement with our decision. I've made it crystal clear to him that he is not to give Alan or Wilma or anyone else any direction, criticism, or his wisdom—all of that is to go through me now, and he has fully agreed.

I think he is basically a good kid. He's still a bit immature and has an anger problem, but I don't doubt his sincerity or honesty. This is the right decision—for him to move on and for us to go our own way, but I don't think it has to be based on rancor or pettiness. I'm trying my best to keep personalities out of the discussion and focus on future directions. I've got several hurdles to overcome with Russ and with Adrienne before we get to a final agreement, but I think a full separation is at hand. I just want to do it gently—this will take more time, but I think everyone will benefit in the end.

Hodgett's e-mail reply was succinct and to the point:

You handled this very well and you made him a generous offer—more than I would have to begin the discussion. Your initial offer puts cash in his pocket, about \$15K from what I remember, and that should be equal to three months of living expenses. Since we will be helping him on the financing side of his first three homes then what does he need more cash for? I want to help the guy but we have to be very careful about our own cash flow and our own needs—like paying ourselves back our initial investments and paying me back on my short-term loans!

In terms of him working for us, in all candor, I do not know if we want any of his wisdom since it comes with a heavy price—I would rather pay for you to take a course on home construction or hire someone else. We need to distance ourselves from him ASAP if we are to keep your wife and the subcontractors on friendly terms.

The End Is Near—Or Is It?

Davis, Hodgetts, and Russ met for breakfast in August 2003 to finally iron out the buyout agreement. The meeting went very well, with the agreement including all of the extras that Davis and Hodgetts had discussed and excluding any side agreement with Russ for consulting services. Russ was to continue supervision of the building of the three homes that were near completion, and that he was drawing a salary from, but was excluded from all other building sites of DHR Construction. Everyone left with a signed copy of the agreement, hand shakes, and a feeling that all had been settled. But had it?

In Hodgetts and Davis's next weekly meeting, it became plain that events were not transpiring as planned. "Russ still pokes his nose in where it doesn't belong, but I tell people to ignore him," Davis commented. "The latest, he told Bob the painter he couldn't paint the Wexford, one of our new

homes, this weekend because the door wasn't in yet. I told Bob to ignore Russ and work on our schedule. I don't know what's wrong with this kid. He just doesn't get it."

"He doesn't get it, does he?" replied Hodgetts. "Perhaps we need to remind him that it is a breach of contract to visit our sites, especially those he is not involved with, and that we would be more than happy to go back to the original agreement of merely splitting the assets from the three sales. Has he started to work on developing his own projects? If not, it may be a good idea to have a quick wake-up call with him. He needs to be reminded that he needs to concentrate in getting his own business off the ground. The clock is ticking since in our agreement, we gave him six months in which to use our financial support."

Several weeks went by and the situation was worsening. Davis was livid and did not mince words with Hodgetts. "Regarding Russ—I'm going to be buying a gun this after-

noon. The delightful boy is hot on the rumor mill, and is trying to sabotage us. He told Keith at West Point Interiors (that's our carpet, tile guy) that we're bankrupt and going out of business and that I'm firing our employees before the end of the week. He's told our other subs pretty much the same things and they're all upset. My wife is making cookies and I will meet with all the subs this afternoon and dispel this one. I think he's psychotic.

I am also meeting with the other David, our mortgage specialist, at 1p.m. today to specifically discuss Russ. It turns out that Russ's credit scores have plummeted, and he no longer qualifies for a mortgage. I know Russ wants us to buy the place we are building for himself and then lease it to him with the option to buy, and we probably will, since that house is going to be hard to sell to someone else. I was supposed to meet with David Russ this morning, but was so depressed that I couldn't get out of bed, so I'm meeting with him on Friday for a real come-to-Jesus meeting. Threats will be involved.

You and I have *not* signed any guarantees for Russ on his new ventures, and I'm thinking of withholding them based on all this going on. Getting stuck with his house is bad enough, but getting stuck with three more would be beyond my tolerance.

In the interim, Russ has hired a lawyer to try to renegotiate the deal that had already been signed and agreed on, most specifically dealing with the issue of how Russ was now not able to obtain financing for the home that DHR Construction was building for him."

Hodgetts was shocked, not only at the turn of events but how his colleague had become so incensed about Russ. He

responded in a like, harsh tone. "I have no qualms breaking our agreement with Russ if we can document that he has interfered with our business (i.e., spreading these rumors, showing up at our work sites). There is a law against slander and I think he needs to be reminded that he is responsible for his actions.

In terms of his house, if he cannot qualify for a mortgage, then he should ask his parents to cosign the loan for him. I really do not want to enter any business deals with Russ and would much rather sue him if he is going to breach our contract about the house. How is he going to make rental payments? In all candor, I can be a very spiteful guy if someone tries to screw with me and my partners. I would be happy to just buy his house outright (at our cost), rent it, sell it, or just own it as a second home. If we get stuck with his house, my feeling is that we have satisfied our agreement with Russ and that he is on his own. Boy, is this kid self-destructive! Looks like he wants to get punished! I wish I could be at the meeting on Friday but as you know I have my two classes to teach."

Yee Gods, What Was That?

The meeting in late August with Russ went as Davis and Hodgetts expected. Russ denied the spreading of rumors to Davis while Davis reminded him that any of these actions violated the noninvolvement clause in the originally signed contract. Davis also reminded Russ that he was responsible for the cost overruns in his own home and that those overruns would come out of his profits from the eventual sale of the home.

A few days later, in early September, Hodgetts received the following e-mail from Russ:

I wanted to first take the opportunity to tell you thank-you for giving my wife and me the opportunity to be part of DHR with you. It is unfortunate that it didn't work out the way we had originally planned. Things here have been pretty good. I don't know if you have heard yet or not. I had to pull out of the house. Due to us being self-employed and my wife not having a job due to student teaching this semester, the mortgage company's rate changed and they were saying that the mortgage would be around \$1,600 per month, which we couldn't afford. So we decided that we would go a different direction in regards to a house. Currently we are living with my parents until January.

On another note I was wondering if you would be interested in investing in my new company privately outside of DHR and Richard Davis. Right now I am looking to raise 20 to 25 percent of the building cost for the bank to give the loans to me in my own name. I have worked up a promissory note, which states that I would return to you in six months the initial sum along with a 10 percent return. The one house I am currently seeking money for would need an investment of \$50,000. This house is a 1,265 square foot house, which will be built in the Westridge Village subdivision, which is where I was initially going to build my house. The community in which the homes will be built in will be a maintenance-free patio home community. They all have rear loaded garages and large front porches. Each house is designed in a 1920s cottage/craftsman style. If you could please e-mail me or call me and let me know if this sounds like an investment you would be interested in, I would appreciate it.

Simultaneously, Richard Davis received a similar e-mail:

I'm sorry that I haven't been able to get a hold of you on the phone the last couple of days. I wanted to talk to you before the letter got to you. However I was unable to reach you. I wanted to take the opportunity to thank you for all that you have done for my wife and me. I am sorry that our original plan never got to where we wanted it to. I also wanted to wish you the best of luck with DHR Construction, LLC. I also wanted to see if you were still interested in guaranteeing and providing the 20 percent for the land as was originally discussed for my first project. If you are, I would like to treat it as a private investment in which I would pay you your original investment plus 2 percent of the total sales price as was previously agreed upon. If you are unable to do so, I understand completely. I am currently working on a contract that will layout the agreement for the investment. I have sent you a hard copy of a similar letter in which I have enclosed the corporate credit card and the keys to the houses DHR is building. I mailed them to your office. If you could please get back to me regarding the properties either via e-mail or by phone, I would greatly appreciate it.

Hodgetts immediately replied to the e-mail, blind copying Davis.

David:

Thanks for keeping me informed as to your plans with your own construction firm and I appreciate your contribution to starting up DHR. I understand that the mortgage on your house is quite high and that you cannot afford to buy this home—any suggestions for the disposition of this house to recoup the costs?

I am honored by your invitation to become involved in your business. What I do not understand is why would you need these start-up funds in the first place? Davis and I signed an agreement with you that said that we would be cosigners on your next three projects provided that they started within the next six months.

Maybe I've been out of the loop and I have missed something—let me know what you think.

Davis also responded to Russ's e-mail and blind copied Hodgetts. He took a very different approach:

David:

You have put me in a very, very awkward position. You gave no indication of problems when you, Stephen, and I met for breakfast, and signed the breakup contracts so I was extremely surprised when I got the letter from your lawyer wanting to renegotiate the deal. I have no idea why you felt you had to go that route to solve problems you had not alerted Stephen and me to, but it was your choice. Simply, what you have now done is put our relationship in the realm of attorneys. All agreements from this point on will have to be done through our attorneys. I have instructed my attorney regarding our official response to the request for renegotiations and the conditions that will best serve DHR Construction, LLC, and will await a response from your attorney. I hope we can come to a final agreement very quickly.

Regarding further investments or guarantees for your new real estate business from me, based on the events of this last week, I am surprised you would even ask. I continue to wish you the best of fortunes and I sincerely hope you will be successful, as I have said all along. Exactly what my help to you could/should be at this point deserves some very careful consideration, which I will do.

O.K. Genius, Now What?

Davis and Hodgetts had tons to talk about at their next weekly meeting. Davis, brandy in hand, immediately launched into a vigorous discussion of the Russ situation. "Just when you thought it was safe to go back into the water...The guy's delusional! Not only does he not share any of his thoughts with me on his problems with the breakup, but then he pulls this stunt! I assume you're playing with him, Hodgetts, you can't be serious about investing in him I'm sure."

Hodgetts allowed a few moments of silence to elapse before he reacted. He could see that Davis was actually tensing up and Hodgetts could barely keep himself from breaking

out into hysterical laughter, no less keep a simple smirk off his face. He had known Davis for a long time and this was the first instance he could actually remember being in a position to play a serious trick on his good friend and colleague. "Well you know that the offer is quite tempting," Hodgetts lightly remarked. "You keep telling me how I need to diversify my investments. Perhaps I should give Russ's proposal earnest consideration—I could even negotiate for partial ownership of this new venture!"

Davis, usually the cool, calm, and collected partner, was turning several lovely shades of red when Hodgetts could no longer contain himself from bursting out laughing. "Of course

I'm playing with him! How could I not follow this to its most illogical conclusion? Our new book which I have just outlined, *The English Professor Turns Capitalist*, states that a moral capitalist allows all irrational behavior to be treated as humanely and kindly as possible—Russ has built his castle in the sky, why shouldn't I let him live in it for awhile? I'm just wondering how far I can carry on this farce until he realizes that I'm not serious.

I must admit that I read his e-mail with real amusement. He must know that any information that he sends me I will share with you and vice versa. Unless, of course, he wants you to know that he's made me an offer. Does he think he can drive a wedge between you and me? Secondly, does he actually think that I would fund a competitive startup venture to DHR Construction?"

Davis poured himself another brandy as he pondered the situation. "Russ must be in serious trouble to ask us both, independently, for assistance. I thought he may have found another investor to shore him up and that's why he decided to renege on our contract. Apparently not. He acted before thinking (as if that's something new) and he's starting to realize the consequences. He's now scrambling for an investor if he's desperate enough to contact you and me in this way. Frankly, if you and I refuse to guarantee his loans, he's probably screwed. He's still sending out rumors that I am a bad manager and that on his own he can build 100 homes a year. The guy needs a very strong dose of reality. I'll be interested in his next contact with you—there will be no contact with me."

Hodgetts was a bit taken aback by Davis's last comment since Russ was a former student and Davis had gone out of his way to bring Russ into DHR Construction. Hodgetts had set his brandy down during the entire discussion and finally took his first sip—he needed to steady himself before he ventured into his next line of commentary. "I think that Russ is waiting to see what you and I will do in terms of his offer and perhaps hopes to play us off against each other. I'm curious if he'll come back to me with a counter offer, or if he'll contact us through his lawyer again.

I must admit, however, that I am tired of these games. We need to take positive actions now that we have permanently and forever severed our ties with Russ." A few more sips of brandy and Hodgetts fell back into his old habit of quoting the great bard, William Shakespeare:

When we mean to build, we first survey the plot, then draw the model; and when we see the figure of the house, then must we rate the cost of the erection.¹³ But O, what men dare do! What men may do! What men daily do, not knowing what they do!¹⁴

What's gone and what's past help should be past grief¹⁵ for to mourn a mischief that is past and gone is the next way to draw new mischief on.¹⁶ Yet a crafty knave does need no broker¹⁷ for time shall unfold what his plaited cunning bides.¹⁸ Come what come may, time and the hour runs through the roughest day.¹⁹ What else seest thou Richard in the dark backward and abysm of time?²⁰

Davis, who would normally respond to Hodgetts' play acting through the persona of the great detective, Sherlock Holmes, decided to quote from Scott Adams' beloved cartoon *Dilbert*. "Stephen, I can please only one person per day. Today is not your day. Tomorrow isn't looking good either.²¹ What I need from you now is a list of specific unknown problems that we will encounter.²² Intelligence, as you might have guessed, has much less practical application to our problem than you'd think."²³

Both Hodgetts and Davis chuckled at Davis's acerbic response. Their pedantic play seemed more like the Bud Abbott and Lou Costello routine "Who's on first?" than a serious conversation. Both knew that they had a real problem on their hands that neither one really wanted to deal with. It wasn't a matter of who was on first but "what do we do now?"

Editors' Note: Anyone wishing to obtain the instructor's manual for the case study should contact Dr. Herbert Sherman at Herbert.Sherman@liu.edu.

Endnotes

¹ The names of the companies and individuals in the case have been changed as per the owners' requests.

² <http://www.bcpl.net/~lmoskowi/HolmesQuotes/q.creed.html>, March 23, 2004.

³ We would like to thank the reviewer for indicating the need to discuss Stephen Hodgetts', Richard and Adrienne Davis's managerial experiences with their rental business as well as David Russ's previous work experience.

⁴ Dingee, A. L. M., B. Haslett, and L. E. Smollen. 2002. Characteristics of a successful entrepreneurial management team. In R. W. Price (ed.) Annual Editions: Entrepreneurship 02/03. Guilford, CT: McGraw-Hill/Duskin, 100–104.

⁵ We are indebted to the reviewers for their observations and comments.

⁶ Most construction loans were based on a percentage of construction costs, not assessed value, and therefore required at least 20 percent out-of-pocket expenses for the builder excluding land costs.

⁷ <http://www.bcpl.net/~lmoskowi/HolmesQuotes/q.Watson.html>, October 13, 2003.

⁸ <http://www.bcpl.net/~lmoskowi/HolmesQuotes/q.detection.html>, October 13, 2003.

⁹ <http://absoluteshakespeare.com/trivia/quotes/quotes.htm>, October 14, 2003.

- ¹⁰ Ibid.
¹¹ Ibid.
¹² Ibid.
¹³ <http://www.bartleby.com/100/138.18.html>, November 19, 2003.
¹⁴ <http://www.allshakespeare.com/quotes.php?id=336>, November 19, 2003.
¹⁵ <http://www.allshakespeare.com/quotes.php?id=344>, November 19, 2003.
¹⁶ <http://absoluteshakespeare.com/trivia/quotes/quotes.htm>, November 19, 2003.
¹⁷ <http://www.fool.com/specials/2000/sp000401.htm>, November 19, 2003.
¹⁸ <http://www.bartleby.com/100/138.33.html>, November 19, 2003.
¹⁹ <http://www.bartleby.com/100/138.31.html>, November 19, 2003.
²⁰ <http://www.bartleby.com/100/138.1.html>, November 19, 2003.
²¹ <http://users2.ev1.net/~fkubat/sayings/b/sayb56.htm>, November 19, 2003.
²² <http://www.qis.net/~jimjr/work86.htm>, November 19, 2003.
²³ <http://users2.ev1.net/~fkubat/sayings/b/sayb56.htm>, November 19, 2003.



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