

Liening on DHR Construction, LLC¹

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This case describes the attempts of a small residential construction company to close on a home that they have built. The problem for the characters in question is how to proceed in this situation given the fact that a third party lien has been put against their properties because the developer they bought the properties from had not paid his landscaper. The case has a difficulty level appropriate for a freshmen and/or sophomore level course. The case is designed to be taught in one to two class periods based upon the authors' prior experiences in teaching this case. Instructional time may vary from 50 to 100 minutes depending upon the instructional approach employed while it is expected that between three to six hours of outside preparation by students will be required (depending upon the instructor's choice of class preparation and debriefing methods).

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“What do you mean we can't close on the Smith residence right now?” shouted Richard Davis. Richard Davis, the general contractor, David Smith, the buyer, and Mr. Marsh, the representative of the mortgage company, were all sitting around Mr. Marsh's conference room; Mr. Davis opposite Mr. Smith, with Mr. Marsh at the head of the table. What started out as a very friendly meeting had taken a sudden turn for the worse.

“All of the arrangements have been made weeks ago to do this closing on exactly this date and this time” continued Davis. “All the paper work has been done and everyone is in agreement with the terms of the contract. The Smith family is ready, I'm ready, the house is ready, and you told me that the mortgage company is ready. What could possibly be the holdup?” “That's right” chimed in David Smith. “I'd like to finally close on this house as well. First it was the mortgage company not getting my paperwork right, then I was sent out of town for two weeks by my company, and then the town made a mistake in issuing an erroneous certificate of occupancy; when will I finally own my home?”

Company Background and History

DHR Construction, LLC² was formed in April, 2003, by two college professors (Stephen Hodgetts, 50% owner; and Richard Davis, 50% owner) as an offshoot of their real estate management firm, D & H Management, LLC. The construction company was started as a money saving venture for finishing off the basements of their rental homes. The value of each rental home would go up approximately \$30,000 while the finishing cost would only be about

\$15,000. By refinancing each rental unit at its new value, they pulled this additional \$15K from each home. Having 12 units, this little venture yielded them \$ 180,000. Additional income could also be derived from the accelerated appreciation of each home (the higher valued homes would be worth proportionately more given the prevailing real estate price increases and yield a higher amount when sold) as well as the increased rental fees that could be charged to new tenants if the old tenants were to leave the premises.

The success of the construction company led Davis and Hodgetts to backward integrate their operation; they were going to build homes not only to be purchased by D & H as possible rental units but also for public consumption. DHR developed a simple business model. Homes would be priced at 20% above cost with Richard Davis acting as the architect and head of operations of construction. His job was to work with the subcontractors to ensure that their work met schedule and building code requirements and to make sure that subcontractors' bills coincided with the work provided.

The designs for DHR's new homes included some added features that differentiated these homes 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 (i.e. oversized master bathroom with archways, high ceilings, and unique fireplaces). Davis and Hodgetts agreed with their real estate agent that many of these upgrades added minimal cost to the overall price of the homes and accentuated customer value.

Davis also became the principal owner/manager of the firm and handled the back office functions of the business with his wife Adrienne (hiring an accountant, pricing out homes, bidding out work to subcontractors, and 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 careers by becoming first author on several books and journal articles that he and Davis were jointly working on. Davis's wife, Adrienne (who recently received her MBA) also organized meetings and coordinated communications between the firm's office (Davis's home) and the construction site.

In May 2003, DHR broke ground on their first construction site in the St. Andrews development and by January 2004 had completed three homes. They then shifted their building site to another location, the Florence Development, which they felt had a more up-scaled look and would allow them to build nicer and more expensive homes. By April of 2004 they had built three homes in Florence, had plans to build five more in that area, and were looking at other developments for future growth and expansion.

To Close or Not to Close, That is the Question!

What began as a very affable closing on April 12, 2004 between contractor, client, and loan officer was turning into a near barroom brawl. Richard Davis, the contractor and managing owner of DHR Construction, LLC had tried to close on this home several times. In each instance a problem had arisen that delayed the closing, no one's fault per se, yet certainly more than a mere annoyance since Davis's firm was paying interest on the construction costs and the Smith family needed a place to live (having sold their house based upon an earlier closing date). When the last

closing couldn't be arranged, Davis allowed the Smith family to move into their future home while the paperwork problems were being cleared up. David Smith agreed to pay the interest on the construction loan plus electrical, sewer, garbage removal, and water expenses. This may have reduced Davis's costs from the property not being sold, but his capital and his credit were still tied up in this project; capital and credit he desperately needed for his other building projects.

"Well you see Mr. Davis" stated Mr. Marsh, the representative for the mortgage company, "the title company has done a very thorough search of the property in question and has noted that a mechanic's lien³ has just been placed on the property by a local firm, Eddie O's Landscaping, LLC. You know that we cannot go to closing with an outstanding lien on the property."

Mr. Davis was livid but tried to calmly explain the situation. "But I know absolutely nothing about this lien and I have never heard of the company in question. In fact, I have purposely not landscaped the property so that the Smith family could work with my landscaper directly and decide how he wants to allocate the landscaping budget I have set aside for the house. Mr. Smith mentioned that he might go over budget, which is fine with me as long as he pays for the over charges. Secondly, if you knew that there was a lien on the property, why didn't you contact me and Mr. Smith and let us know that there was a problem prior to this meeting? Perhaps we could have solved the problem before we met?"

"That was not possible" replied Mr. Marsh "I just received the updated title search just 30 minutes before the meeting. Since I knew that the two of you would be here shortly, I thought that the simplest thing would be to just tell you both when you got here. I apologize for not contacting you sooner although I do not know how successful I would have been in trying to reach each of you." The air in the conference room turned heavy as Davis and Smith sat uncomfortably in their chairs. Neither Davis nor Smith said a word and allowed the silence to permeate the room.

"Be that as it may" Marsh said to finally fill the void "a lien is a lien, and I cannot grant a mortgage today on this property unless, of course, either you Mr. Davis, or you Mr. Smith, were to put an amount equivalent to the lien in an escrow account. We have lawyers right here at the company who could quickly establish this account." "Not a problem" responded Davis to Mr. Marsh's suggestion. "I'll take care of the lien. How much could it be? A few thousand dollars? I've got the corporate check book right here." A light seemed to appear at the end of a long tunnel and relief spread on the faces of both Smith and Davis.

"Let's see" said Mr. Marsh "There it is – the lien amount is \$450,000." A deadly silence followed as if Marsh's statement was the equivalent of a death sentence. Both Davis's and Smith's jaws dropped simultaneously, their openings quite pronounced, as if both had seen a ghost. The stillness was short-lived as Davis found both his voice and his anger. "The sales price of the house is \$250,000, how in God's name could the lien be for \$450,000? There's got to be an error somewhere!" "There is no error, Mr. Davis, and I apologize for the inconvenience that this will cause both you and Mr. Smith. The lien amount is what it is and only \$450,000 placed in an escrow account will allow us to move forward today."

From the Frying Pan into the Fire

Davis and Smith both left the closing empty handed, with Davis first apologizing to Mr. Smith for the inconvenience, and then vowing to get to the bottom of the situation. Davis filled in his business partner Hodgetts and Davis's wife right after the meeting. Mrs. Davis then called the landscaping company on April 13, 2004 and found out what was behind the lien.

"The land development firm we had purchased the property from, Florence Development, hasn't paid their landscaping company" commented Mrs. Davis. "The developer was served papers just this last Saturday. The landscaping firm put a lien on all of the lots in the development, including our own, with each lien equal to the total amount of the outstanding bill. We should be receiving these third party lien papers shortly. The owner's comment to me was "well, you can just pay the lien and go to closing!" After talking with the landscape firm, I called Milton James, the president of Florence Development. He said he'd have this settled in a week to ten days and not to worry. I also spoke with James' lawyer and he told me that everything should be settled in two weeks, the latest."

Hodgetts, the most argumentative and short-tempered of the group, flew into a rage. "We have eight properties at Florence, four of them currently under construction. Are you telling me that we can't close on any of these properties until either the liens are removed or we put \$450,000 per property into an escrow account? We've got over a million dollars already tied up in these projects, how are we going to operate if we can't free up some capital? Secondly, it is quite unfair that the lien was not apportioned as a percent of the properties in question. How can the landscaper recover damages that are larger than the outstanding amount due?"

"I don't know the answer to your second question but I do understand your feelings about the situation and I share them" retorted Richard Davis. "Let me call Milt to verify that this is just a minor glitch that will be quickly settled. If the closing for the Smith's house is delayed for a week or two it won't be a major tragedy."

Richard Davis then called Milton James and verified that there was a dispute between his firm and Eddie O's and that the dispute would be resolved by next week. Mr. James assured Mr. Davis that everything was under control. Richard Davis then called Mr. Smith to inform him of the situation and to assure him that the closing would occur in a week or two. Smith was empathetic with Davis's situation and asked to be kept abreast of the situation.

From Bad to Worse but Then an Epiphany

On April 20, 2004, Stephen Hodgetts received the following e-mail from Richard Davis. "The Florence development situation is in limbo, but I think things will change toward the end of the week. Should close with David, then, early next week." On April 26th, Hodgetts received an e-mail from Mrs. Davis stating "No news from Milt yet. I will be calling you as soon as we know anything."

Hodgetts was never known for his patience and immediately called for a meeting to discuss the situation. When he and the Davis's met he was fuming at the fact that two weeks had transpired and nothing had seemingly been done about the liens.

"Hold that thought for a moment Stephen – let's see if we can, through our powers of deduction, try to piece this puzzle together before we confront the big question." Richard Davis was a great admirer of Sir Arthur Conan Doyle's character, Sherlock Holmes, and in his more contemplative moods would adopt a near Holmesian demeanor and philosophy. Davis walked back and forth for a few moments, hands behind him. Suddenly, he stopped dead in his tracks as if struck by a bolt of lightning.

"I should have known that something like this would have happened" pronounced Davis. "Remember those properties up on the ridge that Milt originally showed us?" "No" Hodgetts replied, "and what does this have to do with our problem?" "You'll see in a minute, just hold on" retorted Davis. "Well, if you recall, when we first were dealing with Milt he kept showing us these properties which he swore on a stack of Bibles would have a wonderful view of the mountains." "Oh yeah, now I remember" snapped Hodgetts. "You're talking about those properties with the restricted fronts imposed by the local zoning board. The garage on those properties had to be set back fifteen feet from the front of the house. Our preliminary architectural drawings on those properties produced a very small first floor, under a thousand square feet, and we concluded that only two story homes could be built on those lots in order to obtain decent sized homes. We also concluded that the market segment we were targeting much preferred ranch (one story) style homes and therefore homes would not sell on these properties."

"Your memory" shot back Davis in his best Sherlock Holmes accent "when not moderated by wine, women, and Shakespeare is remarkable." This jibe evoked several giggles from Richard Davis's wife, Adrienne, and softened Hodgetts' overly foul mood. "Again" Hodgetts grumbled "what does this have to do with the situation at hand?" "You're a smart guy" responded Richard Davis in his normal manner "let's see if you can put two and two together! You don't need to be Sherlock Holmes to solve this mystery."

Hodgetts, who normally waxed eloquently of the Bard, pumped out his chest, and donned a fake hat and pipe, in his best attempt to mimic the great detective. "Indubitably, my dear Davis. It is as clear as the nose on your face that if we, mere beginners at the construction game, have concluded that these properties are of little value then evidently our competitors have reached the same conclusion. That being the case, Milt is the proud owner of over 50 acres of property, normally worth about \$5 million, which he will have a very difficult time divesting himself of."

"Exactly" chimed in Richard Davis. "I'm sure that his inability to sell off these properties is putting a real crimp in his cash flow. It is not hard to imagine that Milt would be very slow in paying some of his bills related to the Florence development given the fact that about a quarter of the development may remain 'au natural' (as is) for a long while." "So what you're saying" concluded Hodgetts "is that Milt stiffed his landscaper because he can't sell off a good portion of his development." Richard Davis allowed a small smile to emerge as he turned to his wife and said "by George Adrienne, I think he's got it."

Coda

“Oh I got it alright, right in the neck” barked Hodgetts. “His problems have become our problems. Milt’s been stalling us for the past two weeks because he’s not man enough or honest enough to just tell us straight out that he has a problem that he can’t handle. Pride goeth before the fall but my fear is that we’ll all be taking a fall with Milt.”

“That’s right” indicated Adrienne Davis. “We can’t go to closing because of the third party liens on our properties, the liens won’t be removed until Milt pays his bills, or we handle the liens ourselves. Probably Milt can’t afford to pay his bills and I know we can’t afford to cover the exorbitant liens on our properties. What do we do now, pray for a miracle or make a deal with the devil?”

NOTES

¹ The name has been changed at the request of the owners.

² This case is US-centric in nature. Those requiring an overview to the U.S. Construction Industry and a brief industry report should read Appendix A. For an overview to real estate transactions in the U.S. go to *Real Estate Transactions: An Overview*. (n.d.) Retrieved July 5, 2005, from http://www.law.cornell.edu/topics/real_estate.html. FAQ’s on U.S. Real Estate Law may be found at *Real Estate Law Questions* (n.d.). Retrieved July 5, 2005, from <http://real-estate-law.freeadvice.com/>

³ See Appendix B for definition. Further information about mechanic’s liens see *Mechanics Lien Law* (n.d.) Retrieved July 5, 2005, from <http://www.nationallienlaw.com/GeneralLienLaw.asp>; Fullerton, J.D. (1997). *Mechanic’s Lien Rights and General Principles*. Retrieved July 5, 2005, from <http://www.fullertonlaw.com/genml.htm#II.%20What>.

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APPENDIX A

The U.S. Residential Home Construction Industry

This industry comprises establishments primarily responsible for the entire construction (i.e., new work, additions, alterations, and repairs) of single family residential housing units (e.g., single family detached houses, town houses, or row houses where each housing unit is separated by a ground-to-roof wall and where no housing units are constructed above or below). This industry includes establishments responsible for additions and alterations to mobile homes and on-site assembly of modular and prefabricated houses. Establishments identified as single family construction management firms are also included in this industry. Establishments in this industry may perform work for others or on their own account for sale as speculative or operative builders. Kinds of establishments include single family housing custom builders, general contractors, design builders, engineer-constructors, joint-venture contractors, and turnkey contractors (IBIS-World, 2005).

The Construction Contracting sector of this market consists of general contractors, who undertake the construction of entire structures, and trade contractors, who perform specialized services such as site preparation, structural work (steel or concrete), mechanical and electrical systems installations, and other interior and exterior work. The latter normally operate as subcontractor to the general contractor (Industry Canada).

Report on the U.S. Construction Industry

“If you build it, they will come.” Not necessarily. But if you combine historically low interest rates with a booming U.S. housing market and strong overseas demand for construction materials, the construction industry will build; investors will come; and bank accounts will swell.

Alan Greenspan and the Federal Reserve pushed the prime lending rate, and thus mortgage rates and all borrowing rates, to historical lows in the early 2000s. After mortgage interest rates peaked at about 8.8% in 2000, Greenspan cut the Fed funds rate 13 times between 2001 and mid-2003 to encourage borrowing and construction. In mid- to late-2003, the average 30-year mortgage rate bottomed out at about 5.3% and the Fed funds rate was a mere 1%. That’s a low not seen since Ed Sullivan was in his prime (late ‘50s-early ‘60s). The Fed started boosting rates again in June 2004, but lending and mortgage rates remain low.

Such low rates caused a flurry of construction sector activity in the U.S., particularly in the housing market. Almost every participant in the construction and real estate industry – appraisers, home inspectors, real estate agents, mortgage brokers and refinancers, construction materials companies, general contractors, subcontractors, home improvement stores, etc. – benefited. *Everyone* refinanced (many people multiple times), the real estate agent ranks nearly doubled, and homebuilders such as DR Horton, Lennar, Pulte, and Centex have been toasting record-breaking increases in sales and profits and growing stock prices.

Despite the low rates and booming housing market, the overall economy has been shaky. The country was in the midst of a slight recession when the tragedy of September 11, 2001, occurred, and the unrest and uncertainty that followed did little to bolster economic optimism and business spending. Even with low rates, businesses aren’t as likely to spend on capital improvements and expansion when business is slow. That fact, combined with fallout from the dot.com era, has meant less sunny times for the commercial construction business.

But whether you’re working on a new house, constructing an office building, or remodeling your own home, you need construction materials. This simple fact means that companies that supply building materials such as lumber, wallboard, cement, concrete, plywood, roofing, aggregates, insulation, and steel have had more business than they can handle. Beneficiaries include timber giants International Paper, Weyerhaeuser, and Louisiana-Pacific; cement companies such as Lafarge, Holcim, and CEMEX; and aggregate companies such as Vulcan Materials. The primary demand driver, besides the U.S. home market, has been overseas demand from places like China. Not surprisingly—considering all the moving, building, and refinancing going on—home improvement stores like Lowe's and The Home Depot have been raking it in.

If it’s been good news and bad news for the commercial construction industry, it’s been pretty much all bad news for the manufactured housing industry, which has been suffering through its toughest time since it emerged from the RV industry in the 1960s. After a decade of unprecedented growth during the 1990s, the largest manufactured homebuilders—Champion Enterprises, Clayton Homes, Fleetwood Enterprises, and Oakwood Homes—have been thrashed like a trailer park in tornado alley. A record number of units (more than 370,000) were shipped in 1998, but it’s been all downhill ever since; fewer than 350,000 were shipped in 1999; about

250,000 were shipped in 2000; less than 170,000 were shipped in 2002; and about 131,000 were shipped in 2003. The collapse of the market has led to dozens of factory closings and thousands of lost jobs and retail outlet closures. Explanations for the hit-a-brick-wall downturn include over-aggressive lending practices and resultant record repossession rates, intense competition, and regulatory strangleholds in key states such as Texas (Simonetta).

Construction Loan A short-term loan usually made during the construction phase of a building project.

APPENDIX B Definition of Key Terms

Construction Loan	A short-term loan usually made during the construction phase of a building project.
Escrow Account	A trust account held in the borrower's name to pay obligations such as property taxes and insurance premiums. A lawyer or escrow agent deposits money or documents that do not belong to him/her or his/her firm into this account.
Lien	An encumbrance on a property title/deed that must be paid or resolved prior to a sale. The lien acts like a mortgage or deed of trust since it is a recorded and/or filed claim against the property itself. It acts like a cloud or "hook" on the property. For this reason, it is a very powerful device. It has the effect of preventing the owner from selling, financing, or refinancing the property.
LLC (Limited Liability Corporation)	A business structure that is a hybrid of a partnership and a corporation. Its owners are shielded from personal liability and all profits and losses pass directly to the owners without taxation of the entity itself.
Mechanic's lien	One of the most common types of liens. It is caused by failure to pay a contractor for services rendered on a property. This lien needs to be reconciled before legally taking possession of the property with a lien.
Third party	Someone other than the principals directly involved in a transaction or agreement.

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