|  |  |
| --- | --- |
|  | **UC-hashayne-black** |

9B17M047

LAS VEGAS Construction: ethical contracting

Won-Yong Oh and Young Kyun Chang wrote this case solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

*This publication may not be transmitted, photocopied, digitized, or otherwise reproduced in any form or by any means without the permission of the copyright holder. Reproduction of this material is not covered under authorization by any reproduction rights organization. To order copies or request permission to reproduce materials, contact Ivey Publishing, Ivey Business School, Western University, London, Ontario, Canada, N6G 0N1; (t) 519.661.3208; (e)* [*cases@ivey.ca*](mailto:cases@ivey.ca)*;* [*www.iveycases.com*](http://www.iveycases.com)*.*

Copyright © 2017, Richard Ivey School of Business Foundation Version: 2017-03-21

On December 27, 2010, Cary Holmes, manager of the Supply Chain Management (SCM) group at Las Vegas Construction Inc. (LVC), was in his office in Las Vegas, Nevada, trying to organize the thoughts running through his head as a result of a recent bidding to save operating costs at LVC. There was no problem in terms of the final outcome; in fact, the bid was going to result in cost savings of 25 per cent, which was exactly what LVC’s founder and chief executive officer (CEO), Michael Wells, had asked for. The problem was that the cost savings represented only part of the story: He wondered whether the process to achieve the savings was unethical. As he gazed out of his office window, Holmes reflected on the series of events that had occurred over the previous few weeks.

INDUSTRY OVERVIEW

The construction industry’s main activities came from the construction of buildings, houses, and other engineering projects (e.g., utility systems and highways). The sector also involved the maintenance of infrastructure. Much of the work in the industry was done through contracts with the owners of construction projects, or through subcontracts with other smaller construction companies.

In 2008, construction projects put in place within the United States peaked at US$1.32 trillion.[[1]](#footnote-1) The industry employed workers in a wide variety of positions, including labourers, carpenters, and electricians. During times of economic growth, both the private and the public (e.g., federal, state, and municipal government projects) portions of the construction industry flourished.

**The Global Financial Crisis and Industry Downturn**

Like many industries worldwide, the U.S. construction industry experienced a drastic and unprecedented decline following the financial crisis and recession in the late 2000s. Economists agreed that the economic downturn that began in 2008 was the most severe since the Great Depression of the 1930s, and the effects of the crisis were felt across the world.[[2]](#footnote-2) The financial crisis was triggered primarily by the subprime home mortgage industry, which saw high default rates due to misdirected regulation and aggressive lending practices; these events resulted in the near-collapse of many banks and other financial institutions, government bailouts across multiple industries, plummeting stock markets, unemployment, declines in consumer wealth, and the widespread collapse of businesses.[[3]](#footnote-3) The construction industry was far from immune to the fallout of the crisis. In fact, in the United States, construction was the industry that suffered the most during this period: the 568,000 job losses in this sector comprised one-third of all U.S. jobs lost in 2008.

Before the crisis, the state of Nevada had been a hotbed of construction activity, powered by the constant building and maintenance of the hotels, casinos, and infrastructure of its largest city, Las Vegas. With the economic downturn, Las Vegas developers shifted their focus from the expansion of projects to cost cutting. Jobs were shed, contracts delayed, and projects downsized. Keeping operations as lean as possible became the new priority for the few ongoing projects and operations in the surrounding desert.[[4]](#footnote-4)

From October 2008 to October 2009, construction in Las Vegas dropped 92 per cent, and the city saw its unemployment rate increase from 0.4 per cent to 8.0 per cent by November 2009.[[5]](#footnote-5) With the sharp downturn of the construction industry, the rest of Las Vegas’s economy sagged, sinking to levels last observed in the 1980s. Despite this dramatic decline, the more optimistic of the city’s builders and hoteliers pressed forward with their existing plans, with a renewed emphasis on efficiency and lean operations. In the new economic environment, cost cutting was the key to survival.

LAS VEGAS CONSTRUCTION INC.

Founded in 2000 and headquartered in Las Vegas, LVC was a medium-sized construction firm that employed approximately 1,000 people. The company focused primarily on construction work as main contractors for multiple projects on “the Las Vegas Strip” (a central stretch of road known for its concentration of hotels and casinos) and surrounding areas. Only six years after it was founded, LVC went public and began trading on the New York Stock Exchange. The firm showed strong growth after completing a number of acquisitions of smaller construction companies in Nevada, California, and Arizona.

In spite of the industry-level downturn, LVC actually found itself in better shape than many other Nevada-based construction firms. As of December 2009, due to its outstanding balance sheet and effective hedging strategy, LVC’s stock price dropped by only 11 per cent compared to the previous year, while comparable firms’ stocks had dropped over 45 per cent. With a number of long-term construction contracts on the horizon, LVC was in a good position to survive the economic downturn.

Accordingly, although business was not exactly thriving at LVC, there were some reasons to be optimistic. As a lean, dynamic company that had focused on technological advancements, acquisitions of smaller firms, and an aggressive approach to acquiring new clients, LVC looked as though it might even be able to profit from the losses of rival companies who found themselves in worse situations. Rumours began to surface about LVC making another acquisition.

However, this mood of optimism did not last. By December 2009, the few multibillion-dollar projects that had promised to provide employment for the construction firms in Las Vegas had either been cancelled, put on hold, or scaled down. The financial crisis showed no signs of being relieved in the United States, and the outlook for the survival of Nevada’s construction firms was grim. It was at this point that Wells (LVC’s CEO) called an emergency meeting with LVC’s SCM group.

THE MEETING

Although he was not quick to anger, Wells was angry now. Sitting at the head of a long, wooden conference room table, he clenched his fists and pounded the table, emphasizing the gravity of the situation that his company was facing. Sitting around the table and witnessing this display of anger were the five members of LVC’s small SCM team; most of them were both young and relatively inexperienced. The team included the SCM manager, Holmes; two specialists, Matt Daniels and Tory Falk; and two analysts, Michelle Grover and Sean Nichols.

Holmes had been with LVC for four years. He was chosen to lead the SCM group when it was created because of his 15 years of experience in managing supply chains and logistics—including managing the contracts and relationships with subcontractors—at various other construction firms in Las Vegas. In contrast, the other team members had considerably less experience. The two specialists, Daniels and Falk, had only recently graduated from business programs at prestigious universities in the United States, and the analysts, Grover and Nichols, had had little experience in supply chain management before being transferred to the SCM group from other business units within LVC.

Nevertheless, although their tenures with LVC had been relatively brief, the members of the SCM team had made small but consistent progress throughout the economic downturn in lowering costs among the company’s various internal business groups. Unfortunately, this progress did not meet Wells’ expectations. “It’s not good enough!” the CEO exclaimed. “We’re looking at a large-scale economic downturn here! The current market is not sustainable for us. If we are to meet our targets with the current budget, we need to see at least 25 per cent reductions in our capital and operating costs. Basically, we need to be in survival mode!”

Holmes, who was never one to shy away from a challenge, understood his boss’s request completely. He looked around the table at the different members of his team. His gaze was met with looks of shock and awe. He then turned to lock eyes with the CEO, stating, “You can count on us, Wells. We will find a way and you will get the result. I know it will not be easy, but we will try our best. Please, give us some time.”

THE BIDDING

Since the meeting with Wells, Holmes and his team had been working as hard as they could, and they were producing very impressive results for LVC. They were seeing compliance with a mass letter that they had sent out asking for cost concessions from their vendors. In addition, the team members were executing bids and requests for proposals that resulted in reduced rates, increased discounts, and greater efficiencies.

The young team was operating at a level that Holmes had not thought possible given the limited number of employees he had at his disposal. Yet the daunting target that the team members had to meet always seemed to overshadow the progress they made. A 25 per cent reduction in all costs contributing to capital and operating expenditures was almost unheard of; they still needed to cut more.

Holmes thought that there was one particular expense category that had been left untouched by the SCM group: costs of subcontracting. The construction industry relied heavily on subcontractors, especially when the project required additional labour that exceeded a company’s capacity. Project companies like LVC acted as the main contractor, and these firms then subcontracted plumbers, carpenters, electricians, landscapers, drywallers, painters, roofers, and flooring specialists. Holmes had long been looking for an opportunity to scrutinize this category, because he felt that LVC was not fully attentive to the potential cost savings of re-evaluating its subcontractors.

A single manager who coordinated with three of the company’s subcontractors was in charge of organizing the acquisition of outside labour that LVC used for its large projects. This manager, Bernie Gilmore, was essentially responsible for sourcing the subcontracting services that LVC used. Gilmore had been with LVC for seven years and was a fast riser within the company ranks. He felt that his management was contributing to the company’s overall efficiencies and success on the projects it had completed in Las Vegas. Gilmore knew the CEOs of the three subcontracting companies that LVC used on a first-name basis. He played golf with them in a company tournament every year, and received bottles of wine from them as Christmas gifts.

Therefore, when Holmes called him about helping with cost reductions for his department, Gilmore politely reassured him by saying, “No, I can handle it. Just give me some time.” Gilmore hung up the phone, and subsequently called his friend, who happened to be the head of the largest labour service company in Nevada. The conversation initially consisted of a few friendly jokes and updates about each other’s families. Finally, Gilmore brought up the topic of cost reductions. The call concluded with Gilmore’s counterpart throwing out a number: “I understand your concerns . . . . How does 10 per cent off the all-inclusive rate sound to you?” Gilmore felt that the discount was more than sufficient, and agreed immediately. He then more or less repeated the same phone call with his friends at the two other labour service companies.

When Holmes received an email from Gilmore reporting the 10 per cent reduction in subcontracting costs, he was perplexed and annoyed. He had been asked by his CEO for a 25 per cent reduction; 10 per cent just would not suffice. It had become obvious that Gilmore was not using proper techniques in negotiating with vendors, and this was negatively affecting Holmes’ cost-reduction initiative.

Holmes had been preparing a bid document for the subcontracting expense category, and he had planned to send it to Wells and the other executives with Gilmore’s help. Holmes refused to appear ineffective, so despite Gilmore’s actions, he sent the bid document to a pre-screened group of labour service companies. All the companies included in the bid had the capability to meet LVC’s external labour demands when the company needed them. The deciding factor would be how much each company would be willing to lower the price they charged, which was critical in reducing operating costs.

The bid included the three companies Gilmore currently used, as well as six other companies that operated in Las Vegas and the surrounding areas. It seemed that these six other companies were excited about this new business opportunity. As the deadline for bidding approached, Holmes received nine proposals for the labour subcontracting position, six of which were not only better prepared and more thorough than the three companies LVC already worked with, but also included rates in line with Wells’ request for a 25 per cent cost reduction. Holmes was ecstatic with the results of his bid; not only was he able to finally bring about change in the subcontracting category, but he would also be able to fulfill his promises to LVC’s CEO. He felt this was a huge win for his team, and one that would eventually improve the company’s financial performance during an economic downturn.

Holmes painstakingly compiled the data he had received, analyzed it, and formulated it into a recommendation. It turned out that the three companies that Gilmore insisted on using were asking the highest rates, at only a 10 per cent discount. In his analysis, Holmes stressed the confidential manner in which the data must be treated; the proper legal and ethical procedure was not to disclose any information about the other participants’ submissions. Once he was satisfied with the document, Holmes sent Gilmore the final copy, along with a request to meet to discuss plans to switch from using the three current labour providers to any of the other six firms that had submitted better bids.

**New Proposals**

The following day, Holmes received an email from Gilmore. The email contained new proposals from the three companies that had submitted bids with the highest costs. In the three new proposals, the rates had been drastically reduced to match the lower rates—surprisingly, to the exact dollar amounts—proposed by the other respondents. Yet other than the reduction in rates, the proposals had not changed much.

Holmes was furious. He thought that Gilmore had simply looked at the document Holmes had sent him, and upon discovering that his “buddies” would be losing LVC’s business, had contacted the three executives and warned them to lower their bids. In fact, Holmes suspected that Gilmore had probably told them exactly how much they would need to take off the price in order to continue providing their services to LVC.

WHAT to do next?

Holmes gathered his thoughts and calmed down so that he could think about what to do next. This bidding was important for LVC, especially during this economically challenging time. The bid would result in a 25 per cent reduction, which was exactly what the CEO had asked for; however, Holmes was not entirely comfortable with the process. He thought that the situation was potentially unethical, regardless of the success of the outcome. Several questions raced through Holmes’ mind: What should he do next? What should he do about Gilmore? Should he report his conduct to Wells? Or should he simply accept the 25 per cent reduction and move on?

1. All currency amounts are in US$ unless otherwise specified; FMI Corporation, U.S. Markets Construction Overview 2016, 2015, 2, accessed January 17, 2017, www.smacna.org/docs/default-source/business-management/fmi-s-2016-u-s-markets-construction-overview.pdf. [↑](#footnote-ref-1)
2. Barry Eichengreen and Kevin O’Rourke, “What Do the New Data Tell Us?” VOX CEPR’s Policy Portal, March 8, 2010, accessed January 15, 2017, http://voxeu.org/article/tale-two-depressions-what-do-new-data-tell-us-february-2010-update. [↑](#footnote-ref-2)
3. Kimberly Amadeo, “2008 Financial Crisis: Causes, Costs and Could It Reoccur?” The Balance, September 8, 2016, accessed January 15, 2017, www.thebalance.com/2008-financial-crisis-3305679. [↑](#footnote-ref-3)
4. Alexandra Berzon, “Construction Industry Drying up, and Not Just in the Desert,” *Las Vegas Sun*, December 11, 2008, accessed January 20, 2017, https://lasvegassun.com/news/2008/dec/11/construction-industry-drying-and-not-just-desert/. [↑](#footnote-ref-4)
5. T. R. Witcher, “The Good Times Stop Rolling: Vegas Meets the Recession,” *TIME*, December 29, 2008, accessed January 20, 2017, http://content.time.com/time/business/article/0,8599,1868932,00.html. [↑](#footnote-ref-5)