



PLUSES AND MINUSES: COST-PLUS

Exploration of the differences between fixed-price and cost-plus contracts, their different pricing approaches, and different levels of risk.

VERSUS FIXED-PRICE CONTRACTS

JUANITA FERGUSON

It's no secret that construction contracts can and do range from a simple handshake to multipage documents that are replete with technical and legalistic provisions. Regardless of the simplicity or the sophistication of the contract, it is important for the parties to consider, prior to the handshake or the written commitment, the type of contract that will govern the relationship.

There are basically two types of contracts used for construction projects: fixed-price and cost-plus. Each type of contract presents different pricing approaches and differing levels of risk. For each party to the contract, there are advantages as well as disadvantages. Having a basic understanding of the pros and the cons of each type of contract prior to entering into an agreement sets the stage for a positive and productive

working relationship between the contractor and the customer.

A fixed-price, or a lump-sum contract, is one where the contractor furnishes all of the labor and provides all of the materials for a certain amount of dollars. In the event that the contractor's estimates are incorrect or unforeseen costs cause the contractor to spend more to complete the project, those costs are absorbed by the contractor and not passed on to the customer. A fixed-price contract requires the contractor to be meticulous while bidding for the job due to the potential exposure that may result from an inaccurate bid. Alternatively, if the contractor is able to complete the project for significantly less than the stated sum of the contract, then the contractor receives the benefit and the profit associated with the cost savings.

The more complex a construction project, the more difficult it can be for a contractor to estimate labor or costs associated with subcontracts that may be vital to completing that project. A customer experienced at entering into more complex or riskier contracts will be less likely to opt for a contract with

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a fixed price because of the difficulty of projecting all of the actual costs to complete the project. In this type of situation, a fixed-price contract can create tension in the relationship between the contractor and the customer.

Even if the contractor is effective at minimizing the risk of cost overruns or other unexpected costs, a fixed-price contract can still present risks for a contractor. While unforeseen circumstances can be problematic for the contractor working under a fixed-price contract, an indecisive customer can also make it difficult for a contractor to manage such a contract. Excessive change orders may require the approval of a lender, if the customer borrows funds to complete the construction project. If funds are inadequate to accommodate the changes that the customer seeks to make to the project, the lender could require that the customer borrow additional funds against the equity in the project. Time spent securing the additional funds could easily result in lost time in completing the project, thereby frustrating the contractor's ability to complete the project in a timely manner.

The alternative to a fixed-price contract is a cost-plus contract. Under this type of agreement, the contractor agrees to furnish the labor and provide the materials for a certain amount of dollars, or a stated fee . . . plus any *extra or additional* charges that may be incurred during the course of the contract. This type of contract provides the contractor with the flexibility to increase the amount of the contract depending on the varying circumstances that may surface after the parties agree to the terms of an agreement. For example, a demolition company may quote \$30,000.00 to demolish a lot. During the course of demolition, the contractor discovers that some of the fixtures on the lot extend beneath the surface of the lot such that additional equipment is required to fully remove the fixtures or address the quality of previous construction. The \$30,000.00 quote will escalate by the additional cost to secure the equipment as well as the cost of any additional labor that may be required to address the unforeseen issues associated with a

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complete removal of the fixtures. A cost-plus contract requires less accuracy during the bidding process, given that the contractor knows that any unforeseen expenses will be passed through to the customer.

There are different permutations of cost-plus contracts. With a "cost-plus a fee" contract, the contractor is paid the actual costs to complete the construction plus a management fee agreed to by the parties in advance of the start of the project. Another type of a cost-plus contract is a guaranteed maximum price ("GMP") contract. With this type of agreement, the customer still pays the contractor all of the costs of construction in addition to a stated fee. However, the contractor agrees that the customer will pay no more than a GMP, unless the parties agree to additional compensation for change orders or other allowable claims. The third type of cost-plus contract is an estimated maximum price ("EMP") contract. In this type of contract, the customer still pays the actual costs of construction plus a management fee. The distinguishing feature of this type of contract is that the parties agree to split all of the costs that exceed the EMP. Likewise, if the project is completed for less than the EMP, the parties share in the savings.

There are advantages and disadvantages to a customer who is party to a cost-plus agreement. The customer does not have to assume the risk of any cost overruns incurred by the contractor, but the customer does accept the risk that the project may cost more than any budget agreed to by the parties. If the project actually costs less than the proposed budget for the project, then the customer gains the benefit of the cost savings. Other advantages for the customer who is a party to a cost-plus contract are that a contractor has little incentive to cut corners and the final cost of a contract can actually be lower than a lump-sum contract because the contractor has no need to inflate the cost to complete the contract to cover risks such as cost overruns, design deficiencies, or unexpected labor costs.

The obvious disadvantage of a cost-plus agreement for a customer includes

the uncertainty of the final cost of a contract. Prior to the start of construction, the customer must ensure that there are sufficient funds available to complete the project. This will require the customer to analyze cost estimates provided by the contractor to ensure accuracy and an appropriate level of consideration for risks that are expected to be incurred in the contract. Low-cost bidding as a means of projecting the final cost of a project is a risk that could affect the relationship between the parties. Also, a cost-plus agreement requires a heightened level of oversight of the progress of construction. Otherwise, the customer may risk that the contractor exercises inadequate cost controls during construction. Finally, a cost-plus contract does not require the same level of efficiency as a fixed-price contract.

Regardless of whether a construction project is fixed-price or cost-plus, the parties must address the issue of sales tax within the contract. For the contractor, if sales tax is not included in the contract, it may not be possible to seek reimbursement from the customer once the contract is completed. A simple clause within the contract stating that if sales taxes are due or become due, that they shall be the responsibility of a particular party to the contract, is usually sufficient to safeguard against nonaccountability for taxes.

It is beneficial for the contractor to become familiar with the sales tax laws of the location where the project is to be completed. However, other jurisdictions' tax laws may also affect the project. For example, if the contractor is a business based in the state of Illinois, purchases materials in the state of Michigan, fabricates materials in the state of Indiana, and then constructs the project in the state of Indiana, it is important to know the sales rules for each state in order to address the sales tax issues within the context of the construction contract.

Sales taxes may be treated differently depending upon whether the parties are governed by a cost-plus or a fixed-price contract. The more expensive the project, the more the necessity to have a thorough understanding of the impact

of sales taxes on a construction contract prior to agreeing to the type, as well as the terms, of a particular contract.

It is not uncommon for even the most experienced parties to a transaction to be overwhelmed with all of the factors that can and do affect the successful completion of a construction contract. To provide uniformity throughout the construction industry with respect to application for payment, dispute resolution, and even approval by the architect, the American Institute of Architects ("AIA") produced contract forms to accommodate both cost-plus and fixed-price agreements. AIA Document A101 is used for lump-sum agreements and AIA Document A111 is used for cost-plus contracts. While the documents can be characterized as all-encompassing, it is nonetheless important for parties to a construction contract to be careful and to avoid relying on the standardized documents to address all of the particular requirements of their respective agreement.

Regardless of whether the parties agree to a lump-sum or a cost-plus agreement, proper accounting of the costs associated with a contract will increase the likeli-

hood that the parties have a productive working relationship. Keeping accurate records is a necessity, particularly if the contractor is required to justify the costs of the project to resolve any disputes during or at the conclusion of the project. In a cost-plus contract, accounting methods range from the accrual method, to the direct cost recording per job, to the actual percentage-of completion method. The Internal Revenue Service provides resources for contractors and construction accounting professionals to comply with the rules and regulations for reporting costs associated with cost-plus construction contracts. Attention to detail during the construction of the project with a verification of costs is a crucial step in satisfying customer concerns, and in those cases where disputes arise, it is beneficial to proving a claim. Weekly detailed payroll reports, as well as weekly or monthly breakdown of costs itemized by subcontractors or suppliers, are the types of verification that minimize the possibility of customer dissatisfaction, eliminate frustration for the contractor during construction, and protect all parties' interests long after the project is completed. ■