

# Contracts BULLETIN

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## **Bulletin #75, Cost-Plus Contracts – Negotiating the Road Blocks (May 4, 2004)**

The form of construction contracts are limited only by one's imagination. The construction industry has developed a cost-plus contract to address situations where a fixed bid is improper or impractical. (See AIA documents A111 and A131/CMc, and AGC 410.)

A simple definition of a cost-plus contract is where the owner agrees to pay all the costs incurred by a contractor/builder in the performance of its contractual duties, plus a fixed fee over and above such reimbursable services. So, for example, with a cost-plus 10% contract, an owner would be charged \$1.10 for every dollar the contractor/builder spends.

The advantage of using cost-plus contracts is a high degree of flexibility, but owners are often hesitant to enter into cost-plus contracts due to perceived "dangers." In any negotiation, it is crucial to understand the other side's concerns to avoid the "road blocks," which can prevent the parties from reaching an agreement. Therefore, builders/contractors must understand owners' fears, and be aware of how certain provisions in cost-plus contracts can affect the project and profitability.

### **Construction Costs Are Not Fixed in Advance**

Cost-plus contracts are often used when the actual cost of the project is difficult to predict or bid. Cost-plus contracts are favored by many contractors because they allow the contractor/builder to transfer this risk to the owner. A pure cost-plus contract has no limit or cap. The absence of a precise budget in a cost-plus contract makes it difficult to know exactly the project's financial status at any specific time; and, therefore, it is also difficult to anticipate the exact cost of a project prior to completion. This inherent uncertainty precludes many owners from proceeding with cost-plus projects.

In order to proceed on a "cost-plus" basis, owners need substantial trust and confidence in the contractor and a familiarity with the project costs. Contractors, in turn, want owners who have the resources to bear the uncertainty of "cost-plus" contracts. Contractors/builders often must provide owners the reassurance that they will efficiently and fairly monitor the progress of the cost-plus contract to avoid substantial cost overruns.

Contractors/builders can address an owner's uncertainty by providing for caps on costs or a guaranteed maximum price (GMP). (See AIA document A111 and AGC 410.) This is a cost-plus contract with a cap or limit. With a cap in place, any costs incurred in excess of the cap are absorbed by the contractor/builder. This helps to offer certainty to the owner with his finances and budgeting. However, it also shifts risk to the builder. Builders must be especially careful to make sure that they have examined all budgetary issues and will be able to engage in "cost-savings" to enhance their profits throughout the project in order to avoid

exceeding the GMP.

GMPs should not be viewed as a “panacea” to avoid the problems of cost-plus contracts. That is, the parties enter into cost-plus contracts because the total costs are unknown. The builder, by agreeing to enter into a cost-plus contract with a GMP, is now assuming risk in a project. Disputes often occur defining what costs will be included in calculating the GMP. These issues should be carefully discussed and negotiated **before** a contract is signed. Otherwise, litigation between owners and contractors can occur if the project exceeds the GMP limit.

### **Cost Savings’ Provisions**

Owners also think that because the builders get a percentage of every dollar spent on a project, the builders have less incentive to be cost effective or to save money. Owners can address this fear by including provisions that give builders incentives to keep costs down. A “cost savings” provision is a clause that allows the builder and the owner to share in any cost savings after the work is completed.

These provisions can be worthwhile provisions for contractors, especially if the contractors have long-established relationships with their subcontractors. The contractor can negotiate and adjust prices with its subcontractors during construction and realize “savings” with little or no effort or change in work. Thus, because the “savings” are merely discounts normally exchanged between the subcontractor and contractor in the ordinary course of business, they present little difficulty to the contractor/builder, but provide the “worried” owner with peace of mind.

It is crucial that builders be aware that due to the nature of cost-plus contracts (i.e., that the final financial outcome cannot be definitely calculated until the end of a project) and the owner’s reliance on contractors to provide an appropriate accounting, the law expects each party to a cost-plus contract to exercise good faith and fair dealing. Courts regularly rule that contractors may not arbitrarily charge prices in cost-plus contracts and that amounts charged must reflect the reasonable and proper cost incurred. Contractors/builders must use the same or greater skill and ability in pricing and accounting in cost-plus contracts as they will use in contract work for a fixed price.

### **Time is of the Essence Clauses**

Another concern often expressed by owners regarding cost-plus contracts is that the project will “go on forever.” This fear can be addressed by including “time is of the essence” clauses and by identifying specific completion dates. Owners may insist on clauses that require a project be completed by a certain date or the contractor will be subjected to penalties. When negotiating these clauses the builder/contractor needs to conservatively estimate project completion (taking into account potential delays due to weather, material availability, etc.) so that he can negotiate a reasonable project deadline. If the cost-plus contract contains a time of essence clause, a contractor should make sure that the contract includes a *force majeure* clause, as well. The contractor should draft the contract to provide that penalties are not imposed for delays due to causes beyond the contractor’s control. (See [\*Contracts Bulletin #65\*](#).)

### **Self Performance of Work**

In order to better control costs, contractors/builders will often perform subcontractor work themselves. This allows contractors to be ultimately responsible for the quality of the work performed. Other advantages are the builder can potentially realize **both** the traditional mark-up associated with performing the work as a subcontractor, as well as the “cost-plus” allowance permitted as a general contractor.

This presents another road block to cost-plus contracts because owners often see this as merely “passing through” costs for a cost-plus contract. Owners will argue that by doing the work themselves, the general contractor is not setting a “market price” for its work, but rather is choosing a rate that may or may not reflect a proper rate for the project. Moreover, because of the “cost-plus” nature of the contract, the contractor could be seen as “double-dipping.” That is, the contractor will be receiving profit both as a

subcontractor, as well as, the general contractor through its fee. Such a situation creates a potential conflict of interest that many owners are unwilling to accept and bar general contractors from performing work in cost-plus contracts.

Ideally, a cost-plus contract should identify whether a general contractor is permitted to perform work of a subcontractor and how percentages will be applied. If a contract does not contain a clear discussion of whether this is permitted, the parties need to be aware this is grounds for uncertainty and potential conflict.

### **Billing for Construction Errors**

Another crucial area in “cost-plus” contracts is deciding who will be responsible for insurance, liability, and errors. In determining the rate of compensation, the parties must assess not only the amount the general contractor will be paid for its services, but who will be responsible for damages and liability resulting from the construction.

As with so many provisions in contracts, this involves a balancing of the parties’ interests. If an owner accepts responsibility for damages, errors, and liability, the price should be substantially lower. However, this also represents substantial risk because it is ultimately the contractor who controls what is done on the site and the potential errors and liability which may flow from faulty construction or management. In any event, responsibility for damages and insurance must clearly be addressed between the parties and be reflected in the bidding of the contract.

### **Builders’ Fiduciary Duty to Owners**

AIA document, A111 – Standard Form of Agreement Between Owner and Contractor, is one of the most widely used standard form construction contracts. Some courts have looked whether a contractor/builder is a fiduciary under these and other cost-plus contracts. A fiduciary duty means that the builder has a duty to act with the highest degree of honesty and loyalty toward the owner and in the best interests of the owner.

Courts generally do not find contractors to be a “fiduciary” of the owner. That is, a contractor has no duty of loyalty beyond the terms of the contract itself. However, at least one court has ruled that a contractor had a duty to be aware of escalating cost overruns in construction and to communicate this information to the owner in a timely fashion. Jones v. J.H. Hiser Construction Co., 484 A.2d 302 (Md. App. 1984). Such a duty arises because the contract places the contractor in a position of trust to efficiently and economically perform the work in a workmanlike manner. If it is found that the contractor delayed the project, increased costs, or otherwise acted in a manner which harmed the owner, a contractor may be found liable for breach of the cost-plus contract.

### **Careful Accounting**

One of the best ways to avoid problems in cost-plus contracts is for the contractor to provide continuous and accurate information concerning the cost of a project, future anticipated costs, and date of completion. Regular updates on such information, as well as active monitoring by a construction manager or job supervisor, can further limit some of the road blocks discussed above. Where there is a positive trust relationship and/or continuous and careful monitoring by an owner, a cost-plus contract can be appropriate for building projects. However, a central prerequisite is that a contractor provides detailed and frequent updates to the owner on the physical and financial condition of the project.

### **Conclusion**

Cost-plus contracts present a superb example of the importance of carefully reading contracts prior to execution. As discussed above, contractors and owners should clearly establish what the mutual obligations and costs are between the parties. For example, what is the completion date, how often must reports be given to the owner, what “costs” will be reimbursable, and who will bear the risk of any loss (including

obtaining of insurance)? A discussion of such provisions **prior** to signing a contract can prevent confusion and heartache later on. Cost-plus contracts present substantial risks, but are a vehicle that is appropriate for some projects. As always, you must be especially careful in drafting these contracts to make sure they reflect your intent.

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