Whenever an owner and contractor enter into a construction contract, cost will likely be the most important issue for both parties. Two common pricing methods are fixed-price contracts and cost-plus contracts. A fixed-price contract is inappropriate when there are too many uncertainties over the work to be performed, whether from unforeseen conditions, design changes, or volatile material prices. For such projects, a cost-plus contract is more appropriate. In a cost-plus contract, the contract price is the costs incurred by the contractor plus a fee for the contractor's services and profit. 1

A cost-plus contract may eliminate some price uncertainties involving the price, but it can raise unforeseen problems. With a cost-plus contract, the owner benefits by paying for the work free from contingencies, but assumes the risk that such costs may be higher than anticipated.2 Cost-plus contracts provide little incentive for the contractor to control or minimize costs. A cost-plus contract with a fee based on a percentage of the costs creates an incentive for the contractor to increase costs, thereby increasing the contractor’s profits. Calling cost-plus contracts “very dangerous,” one court noted that the case presented “another example of a contract where the contractor’s chief aim seems to be to make the price as high as possible” to increase the contractor’s profits.3 Unless the parties draft their agreement carefully, a cost-plus contract can be either a fair deal or license to steal.4

Cost-plus contracts have been the subject of few reported opinions in Virginia. But some cases in Virginia, as well as from other jurisdictions and authorities, provide an overview of issues in a cost-plus contract.

Cost-Plus Contracts in Virginia

*Hitt v. Smallwood* 5 considers cost-plus contracts in Virginia. In *Hitt*, the homeowner hired a contractor under a fixed-price contract to build a stone garage and, under a cost-plus contract to perform extra work. The owner fired the contractor and disputed the accuracy of his final bill. The contractor filed an action to collect. In a separate suit against the contractor, the owner claimed that the contractor’s account was erroneous, grossly excessive or fraudulent. The matter was referred to a commissioner for an accounting. The commissioner’s report was confirmed, and judgment was entered in the contractor’s favor.

On appeal, the owner argued that the cost of the extra work performed under the cost-plus contract was so excessive and unreasonable as to amount to fraud, deliberate overcharging or padding of the accounts, and that the contractor was only entitled to receive the reasonable cost of the work.6 The contractor’s bill was approximately twelve thousand dollars. To prove the reasonable cost of the work, the owner had two contractors testify before the commissioner. One expert testified the cost should have been a little over four thousand dollars. The other expert claimed the cost should have been less than four thousand dollars.7

The court rejected the owner’s argument that the contractor was only entitled to its reasonable costs. Instead, if the costs appear excessive, the contractor would be bound to prove the “bona fides” of its work. The court declined to create a standard for the cost of construction work by which to measure a contractor’s performance. The court reasoned that contractors are so different in their experience, judgment and methods of doing the work, and the conditions under which they work vary to such extent that the law does not and cannot standardize the cost of work.8
Although the contractor did not have to show the reasonableness of its costs, the contractor did have a duty, when performing work on a cost-plus basis, to “keep accurate and correct accounts of all material used and labor performed, with the names of the materialmen and laborers, so that the owner may check up the same.” The Hitt court found no fraudulent purpose on the part of the contractor and that the contractor had used the same skill and ability for both the fixed-price and cost-plus work. Instead, the court concluded that, at most, the contractor lacked experience and efficiency to perform the work economically, and, although the owner was disappointed in the cost, that was a risk the owner assumed in having the contractor do the work on a cost-plus basis.

**Significant Cost-Plus Contract Terms**

No technical language is required to create a cost-plus contract. The agreement stipulates that the contractor will be paid its costs for performing the work plus a fee. The devil, of course, is in the details. If the parties fail to sufficiently articulate the details of their agreement in the cost-plus contract, disputes are likely. For example, the parties may be months into a project when they discover that they disagree on the “cost” and the “plus” the owner agreed to pay. Four standard forms of cost-plus contracts are the American Institute of Architects (AIA) Document A111, the Engineers Joint Contract Documents Committee (EJCDC) Document C-525 (formerly 1910-8-A-2), the Associated General Contractors of America (AGC) Document 230, and the Design-Build Institute of America Document 530. The benefit of these or similar form agreements is that they address types of costs that may be incurred, whether costs are chargeable to the owner, the contractor’s fee and the contractor’s duties regarding the costs.

**Guaranteed Maximum Price**

One of the most important terms, from the owner’s perspective, a cost-plus contract can include is a guaranteed maximum price (GMP). A GMP limits or caps the amount the owner will pay for the work—it is a “not to exceed” cost of the work project.
costs are deemed to have been included in
the contractor's fee.25 If the contractor
intends to include indirect overhead costs
as a reimbursable cost, then the contractor
must expressly provide for that in the con-
tract.26 The argument that it is customary
in the trade to charge the owner for indi-
rect overhead as part of the costs is gen-
erally unsuccessful, based on the rule that
trade customs are not binding on those
who are not in the trade.27

Contractor's Duty to Control Costs
—Is the Contractor a Fiduciary?
Under a cost-plus contract—particularly if
there is no GMP—the owner may have
given the contractor a blank check, and
the sky is the limit. Not surprisingly, by the
end of the project the owner may question
the contractor's costs, efficiency, skills and
ability, as in Hitt. The owner may justifi-
ably believe that the contractor had a duty
to the owner to control the costs of the
work. The extent of such duty may depend
on the parties' contract and the
facts of the case.

Even in the absence of a written agree-
ment, a contractor under a cost-plus con-
tract has some duty to reasonably control
his costs.28 In Hitt, the contractor's duty
to control costs was to use the same skill
and ability in performing the cost-plus work as
it used in performing fixed-price work, for
which a contractor must work efficiently
and cost effectively to secure a profit.29
Provided the contractor satisfies its duty
to use the same skill and ability, and that the
contractor can prove its costs, the reason-
ableness of the contractor's costs under a
cost-plus contract may not be subject to
challenge unless the owner shows the
“work was done in such ruthless disregard
of the contractor's obligations as to be tan-
tamount to fraud or gross negligence.”30

The AIA A111 addresses the contractor's
duty to control costs by defining the
owner-contractor relationship as follows:

The Contractor accepts the relation-
ship of trust and confidence established by this Agreement and
covenants with the Owner to cooper-
ate with the Architect and exercise the
Contractor's skill and judgment in furthering the interests of the Owner;
to furnish efficient business adminis-
tration and supervision; to furnish
at all times an adequate supply of
workers and materials; and to per-
form the Work in an expeditious and
economical manner consistent with
the Owner's interests. The Owner
agrees to furnish and approve, in a
timely manner, information required
by the Contractor and to make pay-
ments to the Contractor in accordance
with the requirements of the Contract
Documents.31

This definition has been interpreted to
give rise to a fiduciary duty on the part of the
contractor to the owner.32 In Jones v.
J.H. Hiser Const. Co, Inc.33 (a Maryland case), the contractor agreed to build a
house for the owners under a cost-plus
contract. There, the contract provided that
the contractor accepted a “relationship of
trust and confidence” with the owners
and agreed to further owners' interests by per-
forming work in an economical manner
and keep full and detailed accounts.34
These terms of the contract imposed a
fiduciary duty on the contractor, and the
owners were entitled to rely on his exper-
tise, good faith and fair dealing to protect
their pocketbook.35

Absent contractual provisions to create a
relationship of trust and confidence, an
owner may be unsuccessful in claiming the
contractor breached a fiduciary duty
to control costs. In Munn v. Thornton36
(an Alaska case), the court rejected the
owners' argument that a cost-plus contract
alone, without a contract provision such
as the one in Jones, creates a fiduciary
duty on the part of the contractor to the
owners, and declined to create such a
relationship.37

What Is the “Plus” in Cost-Plus?
Under a cost-plus contract, the contractor's
compensation is the “plus” added to the
costs, which is either a percentage of the
costs or a fixed fee.38 A fixed fee is
intended to eliminate any incentive to
increase costs to increase fees. The AIA
A111 contract provides blanks to fill in the
fee percentage or state a fixed fee.39 The
EJCDC C-525 offers a fixed fee or a fee
based on percentages of certain enumer-
ated types of costs, rather than a single
percentage on all costs.40 The EJCDC form
also offers a guaranteed maximum con-
tractor's fee provision for fees based on
percentage of costs, which caps the
amount of fees the owner must pay.41

Jessee v. Smith42 illustrates the importance
of clearly stating the “plus” to be added to the
costs. In Jessee, a carpenter agreed to
do finishing work in the owner's store for
“cost-plus 25 percent.” When the work
was completed, the carpenter submitted a
bill for the cost of materials, plus 125 per-
cent of that cost for his labor based on his
interpretation of their agreement. The
owner refused to pay and the carpenter
sued for breach of contract. The trial court
struck the contractor's evidence, conclud-
ing that there was no meeting of the minds
on the contractor's markup for labor, and
that the added costs were exorbitant and
against public policy.

On appeal, the Supreme Court of Virginia
held that the trial court erred by striking
the contractor's evidence. The jury had to
determine if there was a meeting of the
minds related to the contractor's labor
charge.43 Also, public policy was not a
proper basis on which to strike the con-
tactor's evidence. The parties were free to
contract as they chose and courts cannot
Who Pays to Fix the Defective Work?

The contract should state which party pays for correcting defects. Under a fixed-price contract, the contractor unquestionably bears the cost of correcting defects in its work. With cost-plus contracts, the contractor must also be responsible for bearing the costs of correction. This is not always true, however. The AIA and EJDC contracts permit the contractor to charge the owner for costs of repairing or correcting defective work caused by the contractor’s negligence. The AIA-A111 goes even further by allowing the contractor to charge the owner for corrective work during the warranty period, provided the cost does not exceed the GMP.

Change Orders

Like other contracts, changes in the work impact the work performed under a cost-plus contract, and can be a source of dispute between the owner and contractor. Changes in the work that add to or deduct from the contractor’s scope of work will affect the GMP and the contractor’s fee. A change order will likely address the change in the cost and contract time associated with the change. To avoid disputes at the end of the project, the parties must also include in the change order terms addressing changes to the GMP and the contractor’s fee.

Conclusion

In the proper circumstances, cost-plus contracts can be the best agreement for both the contractor and the owner if they understand the benefits and risks. The dangers of such contracts can be easily avoided if the parties ensure that their agreement reflects their expectations and intentions on key terms.

Endnotes:

1 See 13 Am. Jur. 2d Building & Construction Contracts § 19; 17A Am. Jur. 2d Contracts § 495. In some cases, parties seem to use “cost-plus” and “time and materials” interchangeably. A time- and-materials contract, however, is generally distinguished as not including overhead or a percentage for profit. See, e.g., Petersen Painting & Home Improvement Inc. v. Znadiani, 267, 599

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5 Id., 147 Va. 778, 33 S.E. 503.

6 Id., 147 Va. at 786-87, 33 S.E. at 506.

7 Id., 147 Va. at 787, 33 S.E. at 506.

8 Id.

9 Id., 147 Va. at 789-89, 33 S.E. at 506.

10 Id., 147 Va. at 789-91, 33 S.E. at 507.

11 See, e.g., AIA A111, Article 5; EJCDC-C-525, Article 5. Obviously, the other necessary element of a binding contract must be stated, e.g., the precise work to be performed. A contractor, believing he had a cost-plus contract to remodel a farmhouse, spent approximately eighteen thousand for labor and materials. When the owners’ financing came through, they freed the contractor and hired his employees to do the work instead. The contractor sued the owners for breach of contract, but the court dismissed the claim on demurrer, concluding that the contractor’s proposal was “incomplete” because it did not describe the work to be done, so there was no binding contract. See Lateri, Inc. v. Paquin, 45 Va. Cir. 258, 259-261 (Spotsylvania County, March 30, 1998).

12 See AIA A111, Article 7 (“Costs to Be Reimbursed”) and Article 8 (“Costs Not to Be Reimbursed”). EJCDC-C-525, ¶ 6.0, which incorporates the provisions for determining the reimbursable and non-reimbursable costs set forth in the Standard General Conditions of the Construction Contract, EJCDC-C-700 (formerly 1910-8).


14 Bobman v. Berg, 54 Cal.2d 787, 797, 8 Cal.Rptr. 441, 447 (1960) (work involved conversion of Greyhound bus into “land yacht”—both parties knew this was an unusual, experimental venture and there might be some trial and error, so when the contractor accepted a GMP, he accepted the risk that the nature of the project might result in unanticipated costs and, therefore, contractor was not entitled to payment of more than the GMP).

15 Matos v. Roberer, 661 P.2d 443 (Mont., 1983) (contract was ambiguous regarding whether or not the total cost included the contractor’s fee; Court held fee was included where owners made clear they could afford no more than total cost).


17 Glower W. Jones, ALTERNATIVE CLAUSES TO STANDARD CONSTRUCTION CONTRACTS (2nd ed.), § 17.5, (suggested provision and commentary regarding AIA A111 § 5.2.1)


19 Freeman & Co. v. Bolt, 968 P.2d 247, 254 (Idaho App., 1998) (in the absence of a contractual definition of costs, the court construed the contract against the contractor who prepared it, and interpreted the term to include only those costs directly associated with the performance of the contract, such as materials and supplies actually furnished, and wages, Workman’s Compensation, liability insurance, health insurance, FICA, Medicare, State Employment Insurance, and FUTA, which were costs that comprised a percentage of the wage that the employer was required to pay every time his employee was paid a wage). House, 51 A.2d at 671-72, Nolop v. Spettel, 64 N.W.2d at 863-64, Arc Electric Co. v. Eisingler-Keller Inc., 591 P.2d 989, 991-92 (Ala.Cit.App. 1979)” (Costs” means actual costs, not average costs or costs from a catalogue and approximations and averages are insufficient).


21 See Hitt, 147 Va. at 787-88, 33 S.E. 506, AIA A111 Article 11 (requiring contractor to keep and maintain cost records). § 12.1.4 (requiring submittal of records to support contractor’s costs for progress payments), EJCDC C-525, ¶ 13.01 (requiring contractor to keep and maintain cost records).


23 BLACK’S LAW DICTIONARY (6th ed.). Freeman, 968 P.2d at 251 n. 4; Conditioned Air Corp. v. Rock Island Motor Transit Co., 114 N.W.2d 304, 309-310 (Iowa 1962), Lytle, 120 A. at 412-416.

24 13 Am. Jur. 2d Building & Construction Cost-Plus Contracts continued on page 33
25 Id.
27 *Freeman*, 968 P.2d at 252-53.
29 *Hit* 147 Va. at 787, 133 S.E. at 506.
31 AIA A111, Article 3.
34 *Id.*, at 304.
35 *Id.*, at 305.
38 See 2 *Stein*, Construction Law, ¶ 3A.03[2]; AIA A111, ¶ 5.1.2; EJCDC C-525, ¶ 7.01.
39 AIA A111, ¶ 5.1.2.
40 See EJCDC C-525, ¶ 7.01.
41 See EJCDC C-525, ¶ 7.02.
43 *Id.*, 222 Va. at 17, 278 S.E.2d at 794-95.
44 *Id.*, 222 Va. at 17-18, 278 S.E.2d at 795.
45 13 Am. Jur. 2d Building & Construction Contracts, § 19. But, compare EJCDC 1910-8 (1990) (General Conditions), ¶11.5.5 (this prior version of the General Conditions excluded costs of correction from reimbursable costs) with EJCDC 1910-8 (1996 ed.) (General Conditions), ¶11.01(A)(5)(f) (costs for damage to work reimbursable provided such damage not caused by negligence of contractor or those for whom contractor is responsible).
46 AIA A111, ¶ 7.7.3; EJCDC 1910-8 (1996 ed.) (General Conditions), ¶11.01(A)(5)(f).
47 AIA A111, ¶ 12.2.5.
48 See, e.g., AIA A111, Article 6; and EJCDC C-525, Article 9.