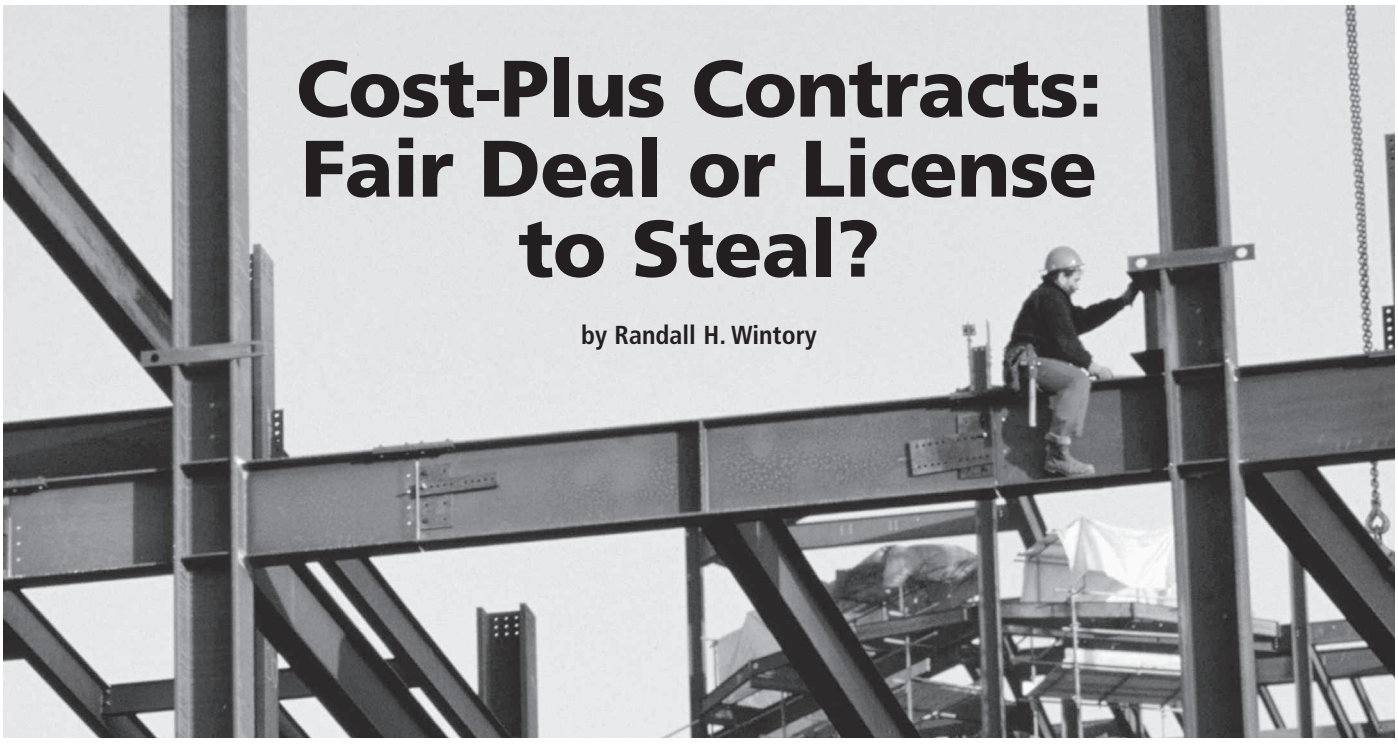

Cost-Plus Contracts: Fair Deal or License to Steal?

by Randall H. Wintory

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."[9] 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.[10]

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.[11] 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.[12]

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 provision.[13] A GMP means that the owner is not at risk of contracting for the proverbial "money pit." With a GMP, the contractor accepts the risk that if the project results in unanticipated costs, the owner will not pay more than the GMP.[14] Thus, a GMP converts the cost-plus contract into a fixed-price contract if the contractor's costs exceed the GMP. Of course, a GMP is subject to modification if changes are made to the scope of work, and the contract should provide a procedure for such a modification.

So there is no confusion, the contract must make clear that the GMP is the total of the cost of the work plus the contractor's fee.[15] Also, the GMP must be clearly stated. Providing an estimate of the ultimate cost of the work or a schedule of values may not establish a GMP.[16]

By including a GMP, the owner creates an incentive for the contractor to minimize the total costs. The incentive is created by including a shared savings provision, pursuant to which the owner and the contractor divide the savings if the cost of the work and contractor's fee total less than the GMP.[17]

What Are the "Costs" in a Cost-Plus Contract?

An owner and a contractor using a cost-plus contract may dispute the costs charged to the owner. When construction costs exceed the owner's expectations, the owner may suspect that the contractor is inflating the cost to increase its profit or charging the owner for labor and materials furnished to other projects.

So that the owner can verify the contractor's costs, the contractor must keep accurate, detailed records, whether required by the contract or not.

Generally, the contractor may charge only for the actual direct costs of work performed in furtherance of the project, absent explicit provisions in the contract that provide otherwise.[18] "Costs" means actual costs—not average costs, approximate costs, estimates or costs from a catalogue.[19] The costs that may be charged include materials and supplies furnished to the project, the wages of workers, the salaries of superintendents, and the premiums for accident and indemnity insurance.[20]

So that the owner can verify the contractor's costs, the contractor must keep accurate, detailed records, whether required by the contract or not.[21] "Presentation of invoices and statements of account, accompanied by proof of payment, is the proper method of proving expenses or costs; the presentation of an invoice *in globo* will not meet that requirement."[22]

Even if not required, keeping good records, segregating costs for the particular project and providing detailed, frequent itemized statements and copies of invoices and bills constitute good contracting practices. Good records protect the owner from concerns over vague or duplicative charges by verifying the costs, and records protect the contractor from unfounded claims of overcharging or false billing.

Is Indirect Overhead Included in Costs?

Overhead is the contractor's indirect cost of to the management, supervision, and conduct of its business, which include general and administrative costs not attributable to a specific job, as opposed to the contractor's operating costs.[23] The contractor is not entitled to include as "costs" the contractor's indirect overhead expenses, such as salaries, telephone service and office supplies; for time overseeing the work; or for cost of tools not used in the job.[24] These general or indirect overhead

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 contract.[26] The argument that it is customary in the trade to charge the owner for indirect overhead as part of the costs is generally 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 justifiably 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 agreement, a contractor under a cost-plus contract 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 reasonableness 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 tantamount 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 relationship of trust and confidence established by this Agreement and covenants with the Owner to cooperate with the Architect and exercise the Contractor's skill and judgment in furthering the interests of the Owner; to furnish efficient business administration and supervision; to furnish at all times an adequate supply of workers and materials; and to perform 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 payments to the Contractor in accordance with the requirements of the Contract Documents.[31]

Absent contractual provisions to createa relationship of trust and confidence, an owner may be unsuccessful in claiming the contractor breached a fiduciary duty to control costs.

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 performing 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 expertise, 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. Thornton*[36] (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 enumerated types of costs, rather than a single percentage on all costs.[40] The EJCDC form also offers a guaranteed maximum contractor's fee provision for fees based on percentage of costs, which caps the amount of fees the owner must pay.[41]

Jessee v. Smith[42] 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 percent 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, concluding 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 contractor's evidence. The parties were free to contract as they chose and courts cannot

relieve a party of its contractual obligations merely because that party subsequently rues the bargain or considers it unwise.[44]

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.[45] This is not always true, however. The AIA and EJCDC contracts permit the contractor to charge the owner for costs of repairing or correcting defective work caused by the contractor's negligence.[46] 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.[47]

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.[48]

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. ⚖

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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. Znidarsic*, 267, 599 N.E.2d 360, 361 (1991); *Lenslite Co. v. Zocher*, 388 P.2d 421 (1964) ("labor and materials plus 10 percent is distinguishable from cost-plus 10 percent in that former term limits contract to wages and actual costs of material, without overhead expenses"); *Kubela v. Schuessler Lumber Co.*, 492 S.W.2d 92, 95 (Tex.Civ.App.-San Antonio 1973); *Dougherty v. Iredale*, 108 N.E.2d 754, 755 (Ohio App. 1952).

2 *See Hitt v. Smallwood*, 147 Va. 778, 133 S.E. 503 (1926). See also Medina v. Sunstate Realty, Inc., 889 P.2d 171, 173 (N.M. 1995); 2 Steven G.M. Stein, Construction Law, § 11.06[B].

3 *Lytle, Campbell & Co. v. Somers, Fitler & Todd Co.*, 276 Pa. 409, 417-18, 120 A. 409, 417-18 (Pa. 1923).

4 Robert M. Wright, *Cost-plus Contracts: The Construction Contractor—Is He a Fiduciary?*, 7-JAN, Construction Lawyer, 3 (Jan. 1987).

5 *Id.*, 147 Va. 778, 133 S.E. 503.

6 *Id.*, 147 Va. at 786-87, 133 S.E. at 506.

7 *Id.*, 147 Va. at 787, 133 S.E. at 506.

8 *Id.*

9 *Id.*, 147 Va. at 788-89, 133 S.E. at 506.

10 *Id.*, 147 Va. at 789-91, 133 S.E. at 507.

11 *See, e.g.*, AIA A111, Article 5; EJCDC C-525, Article 5. Obviously, the other necessary elements 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 fired 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 Lanier, Inc. v. Pagan*, 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, ¶ 6.01, 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).

13 *See, e.g.*, AIA A111, § 5.2; EJCDC C-525, Article 8. *See also, D.A. Davis Const. Co., Inc. v. Palmetto Properties Inc.*, 315 S.E.2d 370 (S.C. 1984); *TRW Inc. v. Fox Development Corp.*, 604 N.E.2d 626, 630 (Ind.App. 4 Dist., 1992).

14 *Bohman 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. Rohrer*, 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).

16 *Jones v. Rose,* 1990 WL 751135 (Loudoun County, April 26, 1990) (holding that draw schedule with estimates did not set a ceiling on the total contract price); *T.W. Morton Builders v. Buendingen*, 450 S.E.2d 87 (S.C. Ct. App. 1994) (contractor's estimate did not establish GMP in cost-plus contract).

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

18 *See, e.g.*, AIA A111, § 7.1 (defining "Cost of the Work" as costs necessarily incurred in the proper performance of the Work); 13 Am. Jur. 2d *Building & Construction Contracts*, § 19; 17A Am. Jur. 2d Contracts § 495.

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. Esslinger-Lefler Inc.*, 591 P.2d 989, 991-92 (Az.Ct.App. 1979) ("costs" means actual costs, not average costs or costs from a catalogue and approximations and averages are insufficient).

20 *See, e.g.*, AIA A111, § 7.1; 13 Am. Jur. 2d *Building & Construction Contracts*, § 19; 17A Am. Jur. 2d *Contracts* § 495; *House v. Fissell*, 51 A.2d 669, 671-72 (Md. 1947).

21 *See Hitt*, 147 Va. at 787-88, 133 S.E. at 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).

22 17A Am. Jur. 2d *Contracts* § 495; *Burdette v. Drushell*, 837 So.2d 54, 59-62 (La.App. 1 Cir., 2002).

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*

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Contracts, § 19; 17A Am. Jur. 2d *Contracts* § 495; Freeman, 968 P.2d at 253; Lytle, 120 A. at 413-16.; *Nolop v. Spettel*, 64 N.W.2d 859, 863-64 (Wis. 1954); *Wymard v. McCloskey & Co.*, 342 F.2d 495 (3rd Cir. (Pa.) 1965) (subcontractor was not entitled to add charge for overhead based on custom of the trade, because such custom did not trump rule of law that such overhead charges, unless specified in the agreement, are not recoverable under cost-plus contract); *Keever & Associates Inc. v. Randall*, 119 P.3d 926, 929 (Wash. App. 2005); *Conditioned Air Corp.*, 114 N.W.2d at 309.

25 *Id.*

26 *Freeman*, 968 P.2d at 253; *Lytle*, 276 Pa. at 413, 120 A. at 413. *See also Nolop*, 64 N.W.2d at 863-64 (overhead expense must be expressly provided in the contract, and the overhead must be defined.); *Foster v. Soule*, 310 So.2d 170, 172 (La.Ct.App. 1975); *Peru Associates Inc. v. State of New York*, 70 Misc.2d 775, 334 N.Y.S.2d 772, 780 (N.Y.Ct.Cl. 1971).

27 *Freeman*, 968 P.2d at 252-53.

28 *J.E.T. Development v. Dorsey Const. Co. Inc.*, 642 P.2d 954 (Idaho App. 1982).

29 *Hitt*, 147 Va. at 787, 133 S.E. at 506.

30 *John W. Danial & Co. v. Janaf Inc.*, 169 F.Supp. 219, 225 (E.D. Va. 1958) (citing Hitt).

31 AIA A111, Article 3.

32 For articles discussing a contractor's potential fiduciary duty to owners, *see* Robert M. Wright, *Cost-plus Constrs: The Construction Contractor—Is He a Fiduciary?*, 7-Jan CONSTRUCTION LAWYER, 3 (Jan. 1987); Paul J. Walstad, Sr. & Camille Williams, *Contracting on a Cost-Plus Basis: The Owner's Relationship of Trust with the Contractor*, Construction Briefings No. 2000-12 (Dec. 2000).

33 484 A.2d 302 (Md.App.1984).

34 *Id.*, at 304.

35 *Id.*, at 305.

36 956 P.2d 1213, 1219-20 (Alaska, 1998).

37 *Id. See also, Eastover Ridge LLC v. Metric Construction Inc.*, 553 S.E.2d 827 (N.C. App. 2000) (no fiduciary duty).

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.

42 222 Va. 15, 278 S.E.2d 793 (1981).

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.