



Working for Costs Plus a Fixed Fee

by John Sylvestre

Every contract divides the risks and benefits of a transaction between the two parties. The trick to a fair contract is finding a way to divide both risks and benefits evenly. Some building and remodeling contracts come closer to this ideal than others.

The lump sum contract, for instance, in which the contractor agrees to do the job for a given price, places all of the risk on the contractor. It is the contractor who takes the hit if costs or schedules get out of whack, even if factors are beyond his or her control.

The most common alternative to the lump sum contract is the time-and-materials contract, also called the cost-plus contract, since it includes charges for time and materials, plus a percentage markup for overhead and profit. As costs increase, so do the contractor's profits. Seen from the client's point of view, this shifts the risk too far the other way: If the job takes longer or requires more materials than expected, for whatever reason, the client reaches deeper, while the contractor profits the more.

A Sane Alternative

It's for these reasons that many builders and remodelers prefer a third type of contract, the cost-plus-fixed-fee. This approach divides the risks more evenly between contractor and client. Basically, it works like this:

The owner is charged for all direct costs — material, the contractor's hourly labor costs, and subcontractor and other fees — at actual invoice cost. The contractor's profit comes from a fixed fee, which is negotiated as part of the contract.

This fee represents the contractor's sole source of profit. It is therefore in the contractor's best interest to finish the project as soon as possible at the least direct cost. A speedy finish produces the

maximum profit for the time spent, and allows the contractor to get on to the next job and its opportunity for profit. At the same time, the owner bears less risk, paying only for what is actually used, with a contractor's fee that does not go up if material or labor costs increase.

Eliminating fudge factors.

Perhaps the nicest thing about these contracts is that they let both parties benefit from eliminating some of the protective fudge factors that most contractors include in bids (or omit at their peril). For starters, you can safely negotiate a fee that is smaller than you would ordinarily accept for a given job, because your fee is guaranteed and can't be eroded by cost overruns.

In addition, you can omit from the bid many of the markups you include to protect yourself. For instance, for ordinary lump sum bids, I usually include a 10% to 15% labor contingency, as well as a similar lumber contingency, to guard against price fluctuations or overruns.

I also generally include a percentage, again varying with job complexity, to cover subcontractor fee overruns. This pays for the little tasks that subcontractors might have overlooked when making up their bids, and for which they may want additional payment at invoice time — things such as the drywall crack in the back bedroom that needs to be patched, mudded, and painted, or the extra three-way switch in the hallway. I don't want to go back to the owner for these things near the end of the job, so I'll build them into a lump-sum bid. Most contractors who plan to stick around have some similar way to cover such contingencies.

In lump-sum bids, I need these markups to protect me from unexpected increases in labor or material costs. But in a cost-plus-fixed-fee bid, I don't need or

include any of these percentages, since I know that such increases will be covered by the owner. My motivation for preventing overruns, on the other hand, is customer satisfaction and my own interest in seeing the job completed on schedule and within budget.

Trust me. These contracts work best when you are able to establish a trusting relationship with the client — that is, when the client is one who can see that you have nothing to gain from time and cost overruns, and therefore trusts you to keep them in check. Other independent business people, for instance, tend to understand that you are honestly trying to fairly balance the risks and make a reasonable profit without adding to your bid at their expense.

Some clients, on the other hand, simply aren't ready to share the risks. Scared by horror stories about shady contractors, they feel safe only if the contractor carries all the risks, even if they have to pay a little more to not carry any themselves. With these folks, I usually end up giving a lump sum bid.

Change Orders

The cost-plus-fixed-fee contract also creates a fair and orderly way to deal with change orders. We include a 110% change order allowance in our contracts — that is, the owners can change or add orders that add up to 10% of the original estimated cost of the project before we assess further fees. (The owner, of course, picks up the actual increase in costs.) Once costs exceed 110% of the original estimate, we collect a 25% markup on the excess.

This gives the owners reasonable leeway to change their laminate to Corian or choose a nicer baseboard, but compensates us if their change orders keep us on the job much longer than expected. It's important, of course, to remind the

owners that every change order does bring a cost increase, and to let them know if they are nearing their 110% mark.

Contract Essentials

In general, cost-plus-fixed-fee contracts must carry all the safeguards that ordinary lump sum contracts do. These include:

- a detailed list of the scope of work contracted
- detailed material and design specifications
- a detailed list of any materials the owner has agreed to supply — appliances, for instance, or wallpaper, or that great sink they saw in Kankakee.

In addition, there are some essentials, peculiar to the cost-plus-fixed-fee contract, that we always include:

- We provide the owner with a detailed list of the expected costs, both materials and labor.
- We establish an exact fee for our services, to be charged on top of the reimbursement for our labor, material, subcontractor, and other costs.

As a courtesy, we update the cost estimate with each payment, letting the owner know exactly how the costs are progressing. Sharing the risks means sharing the facts.

Cost-plus-fixed-fee contracts address the interests of both parties: The client gets the best job at the best price, and the contractor makes a safe and reasonable profit for doing a good job. This sense of mutual benefit can actually help create that rare sense of teamwork between contractor and client — when both feel they are working not as adversaries, but together toward a common goal. ■

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