

The Minuses of Cost Plus

by Quenda Behler Story

My observation has been that customers like cost-plus contracts. Even though a cost-plus job and a fixed-price one cost the same — in theory, anyway — many homeowners are happier with a payment term that says they'll pay the direct job costs plus either a certain percentage or a fixed fee for the contractor's overhead expenses and profit. They seem to feel they're getting a better deal that way — regardless of whether they actually are.

Before I go any further, let me point out what a bad idea I think it is to agree to work for cost plus a fixed fee. It's just asking for trouble. Suppose — and this is just one of the many things that can go wrong with a fixed fee — the job takes twice as long as scheduled. The fixed fee, which includes your profit, could turn out to be one reason you are in the red at the end of the year.

Basic Math

So let's concentrate on cost plus a percentage. We'll start with an important lesson in math. Your customer agrees

to pay all the direct costs plus 15 percent of those costs as overhead and profit. If your direct costs are \$1,000, you will collect \$150 on top of that as overhead and profit. If that \$1,000 in direct costs goes up to \$1,500, you will collect an additional \$75 of overhead and profit. That means there's a real motivation to keep your books in such a way that every cost that could legitimately be a direct job cost is accounted for as one.

Put another way, the more items you move from overhead to direct job costs, the more profit you will make on cost-plus jobs. Sounds pretty simple, right? But it has been my sense that small construction companies err in the opposite direction: They count things as overhead that could or should be attributed directly to the job.

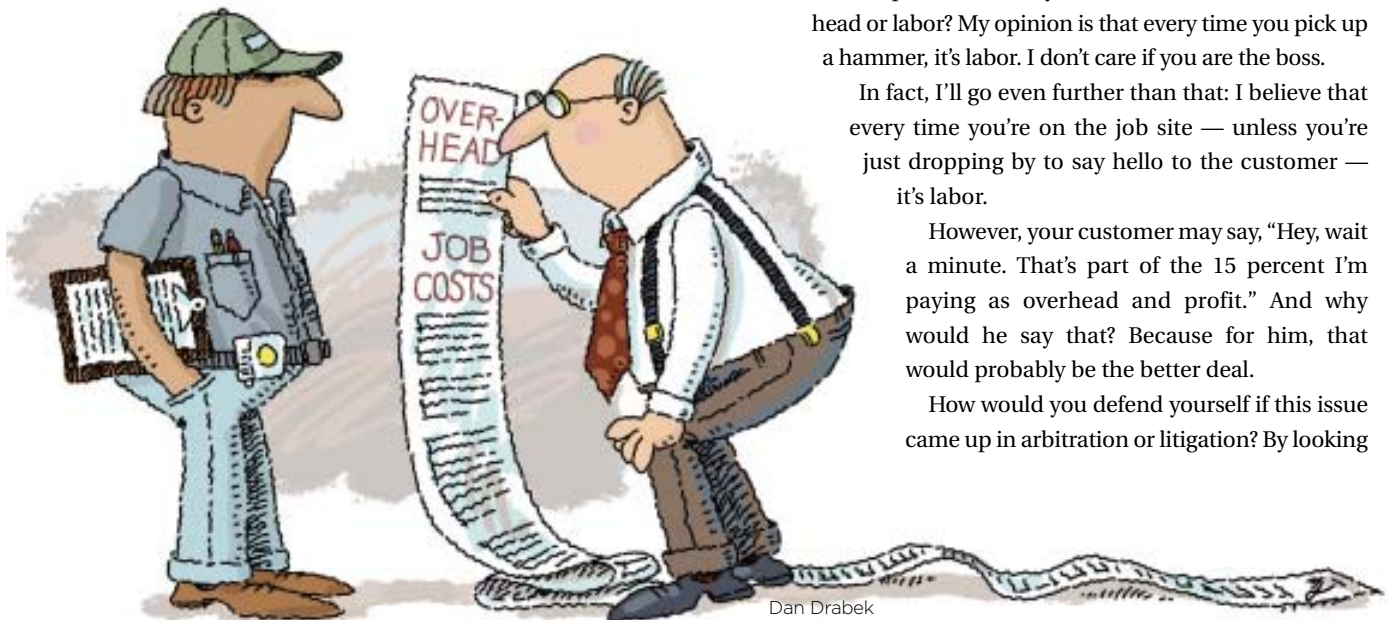
Direct Expense or Overhead?

Here's an example of the kind of decision you can face. Suppose the company consists of you and another carpenter, and you're present on the job as a lead carpenter. Yet it's your company. So when you're functioning as the lead carpenter, should your time be attributed to overhead or labor? My opinion is that every time you pick up a hammer, it's labor. I don't care if you are the boss.

In fact, I'll go even further than that: I believe that every time you're on the job site — unless you're just dropping by to say hello to the customer — it's labor.

However, your customer may say, "Hey, wait a minute. That's part of the 15 percent I'm paying as overhead and profit." And why would he say that? Because for him, that would probably be the better deal.

How would you defend yourself if this issue came up in arbitration or litigation? By looking



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at the same kinds of things you should have looked at back when you initially decided what qualified as direct costs and what qualified as overhead.

What's in the Contract?

You would begin by examining what the contract actually says. Is there a definition of “direct costs” in the contract? If the payment term is clear and detailed, the argument ends right there. (So when you write the contract, be sure to mention issues like lead carpenters.)

But what if the contract isn't clear enough or detailed enough? Suppose the contract just says “direct costs,” without defining the term? Or what if the contract includes the correct language, but you and the client disagree on what exactly that language means? Suppose the client says, “Hey, ‘lead carpenter’ doesn't mean you, it just refers to when you have to bring in somebody else to run the job.”

To address such issues, the court or the arbitrator will — once again — look at the contract. If the contract clearly provides an answer, great. If it doesn't, the next step is to try to figure out what was in the parties' minds when they made the deal. What did you and your customer think those words meant when you signed the contract?

Evidence in Your Favor

How do we figure out what was in people's minds? A moment of quick brain surgery performed with a circular saw may be tempting, but it won't work. We want to know what was in their minds then, not now.

A better place to start is to look at what the parties have done in the past (assuming such information is available). If you've done business with this customer before, and you've always billed your time on the job site as labor,

you're in good shape. If the customer says, “You never itemized before, so I didn't know you were including that as a direct cost,” you're still in decent shape, but on slightly less firm ground.

Beyond past practices, what other evidence might exist to clarify what you and your customer were thinking when you put the contract together?

One possibility is notes that you made at the time about what you explained to the customer. (The lesson here being that you should spend some time explaining to your customer up front what direct costs include — and then make a brief note about the conversation in your daybook or calendar, or even on the contract itself.)

Another resource is what's customary in the industry. You can bring in expert witnesses or published material from the construction industry, or even get someone who's running a business like yours to testify. Remember that “expert” doesn't necessarily mean someone with a degree after his name — it means someone in a position to know. Other people in the industry who negotiate construction contracts can testify about what they understand those contract terms to mean.

Above All, Be Clear

With all of these dire examples and warnings, do I think you should just avoid cost-plus payment terms altogether?

No. It's simply a reality of the marketplace that many customers prefer this approach. But I do urge you to attribute as many expenditures and activities as possible to direct job costs, and to explain the concept clearly and thoroughly in your contract.

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