

THE CONSTRUCTION CONTRACT: LUMP SUM VS. COST PLUS

By David J. Pfeffer



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Before ground is broken on a construction project, an owner is faced with many difficult decisions. Most importantly the owner must decide what kind of construction contract to enter into with the contractor. The most common options available to an owner are the lump sum contract and the cost-plus-fee contract.

Both of these contracts have advantages and disadvantages from an owner's perspective. The owner must keep his financial interest in mind, while at the same time, allowing the contractor to make a reasonable profit and build a quality project efficiently.

The Lump Sum Contract

For an owner who has very tight budget constraints or lacks experience in the construction industry, the lump sum contract is often ideal. The lump sum contract is the most basic form of an agreement between an owner and contractor and is fairly easy to manage. For this kind of contract to be effective, the owner must have sufficiently detailed and complete drawings and specifications. The construction documents must be well defined at the time of the bid to allow the bidders to properly estimate the cost of labor and materials.

Under a lump sum agreement, the contractor is responsible for completing the project within the agreed-upon fixed cost set forth in the contract. If the contractor completes the project under the fixed total cost, then the contractor keeps the difference and makes a profit from the work. The owner is not entitled to any savings if the project is completed below the fixed total cost. A lump sum contract is generally a closed-book arrangement,

so the contractor does not have to report the cost of labor and materials to the owner.

Advantages. There are several advantages for an owner to enter into a lump sum contract. It is a huge benefit to an owner that the contract is easy to manage. Payments to the contractor are based on the percentage of completed work. Generally, the payment schedule is created by the contractor and reviewed by the owner and architect during the course of construction.

Disadvantages. There are disadvantages an owner must consider under a lump sum agreement. Perhaps the biggest concerns are cost overruns and lack of flexibility.

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In the event that the contractor exceeds the fixed total cost of the project, the theory goes that the contractor is responsible for any cost within the scope of the work that exceeds the agreed-upon total. In practice, however, the contractor may stop working on the project and blame the owner and others for cost overruns.

If the owner wants to make changes to the project during the course of construction, the owner may find that the lump sum contract does not provide for much flexibility. Making changes while construction is in progress can be fraught with difficulty because the contractor bid on the project according to completed plans, not ever-changing plans; the changes may be costly and difficult for the owner to obtain. Since the project is closed book, the owner must specify the materials that the contractor is required to use during construction; otherwise the contractor is likely to use the lowest suitable grade materials to save money.

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In order for an owner to protect himself, he must work closely with the design team during the planning stages of the project to ensure that everything he wants is documented in the final plans.

The Cost-Plus Fee Contract

For an owner who has experience in the construction industry, or for an owner who cannot initially define or sufficiently detail the scope of the work, the cost-plus-fee contract (known in the industry simply as the “cost-plus” method) is best. In a cost-plus agreement, the contractor is reimbursed by the owner for the actual cost of performing the work. The contractor is not supposed to make a profit on any phase of the construction and the project is open book.

Before the project begins, the owner and contractor agree on a fee (often a set monthly fee or a fee based on a percentage of the cost of the work) that the contractor will retain for profit and overhead. The idea of the cost-plus arrangement is for the owner to pay the cost of the actual work without markups, plus a set fee for the contractor’s profit. To avoid disputes, the owner and contractor should specify early on in the process what is a reimbursable expense to the contractor (for his general conditions such as employees on the project, insurance, etc.) and what is considered a cost to the owner.

Advantages. The cost-plus agreement is ideal for fast-tracked projects or for situations where the contractor becomes involved before the construction documents are substantially completed. The cost-plus contract allows an owner to have more flexibility to change designs and materials as the project proceeds.

Furthermore, this agreement usually requires the contractor to obtain several competitive bids for each trade, allowing the owner to review the bids and secure the lowest cost. And, since the project is open book, the owner is entitled to know the cost of materials and labor at each phase of the construction

process. If the owner and contractor have a good working relationship, the cost-plus contract allows for a flexible and efficient building experience.

Disadvantages. The biggest disadvantage of the cost-plus contract is that the costs can rise quickly. Under the cost-plus contract the owner must verify hundreds and often thousands of claimed costs; such an arrangement is ripe for a dishonest contractor to defraud the owner.

The GMP Add-On

While the traditional cost-plus agreement does not have a fixed budget, an owner and contractor often agree to cap the price once the project’s design is substantially complete. This is known as a Guaranteed Maximum Price (or GMP) provision. Under a GMP agreement, a contractor who exceeds the capped amount is responsible for the difference, and if the total cost of the project is below the capped cost, the owner and contractor often agree to a “shared savings” benefit.

Even with a GMP contract, the owner must remain alert and ensure that the contractor does not set the GMP too high or use loopholes in the agreement to get around the GMP cap. Alternatively, some contractors set the GMP higher than need be so that the total cost of the project comes in below the capped cost. In so doing, the contractor can try to receive “extra profit” through the shared savings clause.

If owners are well informed and take an active role in the development of the project, they can avoid the pitfalls of both the lump sum and cost-plus contracts, and enjoy the fruits of a well-constructed, final project that was completed within budget.

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