



Outlaw Design Company

Ruth Ellen Outlaw

1186 Old Lynchburg Road
Charlottesville, Virginia 22903
434 971 9914 w/h 434 996 7849 c

reoutlaw@earthlink.net outlawdesigncompany.com

Understanding Your Construction Contract

There are several different types of construction contracts, and this document is designed to help you understand the basic types and decide which is best for your job.

The type of contract that you choose for your project should be the one that you feel the most comfortable with. This is somewhat determined by the level of risk you are willing to take, the trust you feel in your contractor, the project schedule, and the status of the design at the commencement of work. There are pluses and minuses to all of them, but one will likely suit you best. Some attorneys specialize in construction law and can add their expertise to making this decision.

Definitions

Allowance: A flexible line item amount within the total contract price. Allowances are useful in that any materials, appliances, or equipment that haven't been selected before construction begins can still be included in the contract price, albeit in approximate form. Allowances are often used for kitchen cabinets, ceramic tile, and plumbing and light fixtures, among other things. Allowance amounts are based on "best guess" assumptions about the eventual selections; they are also a good guide to use when choosing finishes and other building components that are within budget.

Change Order: An addendum to the contract that describes the scope and cost of any work to be done that's different from, has been deleted from, or has been added to the scope as defined on the Construction Documents. Change orders typically must be reviewed and approved by the owner before being executed.

Construction Documents: The set of drawings showing the design as approved by the client, a written description of the materials and methods to be used in the project, and supplemental details as required.

Scope of Work: The extent of the area to be worked on and the components of the project described in the construction documents and the contract.

Types of Contracts

The “Lump Sum”, or “Fixed Price” Contract

In this contract type the contractor agrees to do the project as described and specified on the construction documents for a fixed price. Deviation from what is on the documents requires a change to the fixed price in the form of a change order.

A Lump Sum or Fixed Price contract is suitable if the scope and schedule of the project are sufficiently defined to allow the contractor to very accurately calculate project costs. The entirety of the design and materials specified in the construction documents are included in the price, as is the contractor’s percentage of overhead and profit. Supervision costs are usually based on the anticipated duration of the work.

This type of contract poses relatively low risk to the owner because a pre-determined fixed price for a clearly defined scope of work means that costs are more likely to be anticipated and therefore controlled than with the “Cost Plus” contract types described below. However, when a contractor prepares a fixed price contract, he/ she adds a percentage, called a “contingency”, so that the company doesn’t lose money on the job due to any omissions and errors in the estimating. For this reason, this contract type can result in a higher cost for the work compared to a Cost Plus contract in which the owner pays only for actual costs, providing that the estimate on which the Cost Plus contract is based is carefully done and costs are well-managed during construction. The higher cost in a Fixed Price contract may be preferred in exchange for the low risk of cost overruns, but the pricing must be scrutinized to anticipate any errors and omissions that could result in change orders and obviate the security of having the price contractually set prior to construction commencing.

The “Cost Plus”, or “Time and Materials” Contract

This is a contract agreement wherein the owner agrees to pay the cost of all labor and materials plus an amount for the contractor’s overhead and profit (usually as a percentage of the total supervision, labor, and material costs of the project). The two most common forms of Cost Plus contracts are:

- Cost + Fixed Percentage
- Cost + Fixed Percentage with Guaranteed Maximum

Other less common forms of the “Cost Plus” contract are

- Cost + Fixed Percentage and Bonus
- Cost + Fixed Percentage with Agreement for Sharing any Cost Savings

Cost Plus formats are favored when the scope of the work is indeterminate or somewhat uncertain, when the types and amounts of labor, materials and equipment needed are uncertain, or when a contract is negotiated rather than bid. Under any of these contract types, complete records of all time spent and materials used by the contractor should be maintained and delivered to the owner in the form of worksheets and receipts to accompany each billing statement.

The “Cost Plus Fixed Percentage” Contract

In this contract format, compensation is based on a percentage of the total cost of time and materials, usually between 15% and 20%, depending on the contractor. This percentage consists of combined profit and overhead percentages. Sometimes an owner can negotiate this number by a few percentage points. Supervision labor and project management labor are sometimes included in the fixed percentage number, but at other times they’re listed in the cost breakdown as separate line items.

This type of contract carries more risk to the homeowner than a fixed price contract because the final project costs are less predictable, and the decision about whether the project is affordable in the first place is based on the contractor’s estimate. Having an accurate estimate and a good cost-tracking system in place reduces the chances that there will be cost overruns.

The contractor’s estimate should be itemized for transparency, and the owner can ask to see the worksheets that the contractor used to arrive at each line item. Each line item should be discussed in detail to be sure that the contractor understands the drawings and is making the correct assumptions about any portions of the project not specifically described in the construction documents.

There can be savings in a Cost Plus contract because the owner gets what he/ she pays for without paying the contingency normally included in a fixed price contract. However, there can be unforeseen cost increases if the estimate is missing items or if the contractor has made inaccurate assumptions about the quality of construction that the owner expects.

The “Cost Plus Fixed Percentage with Guaranteed Maximum Price” Contract

This contract is identical to the above except that there is a cap on the project costs, known as a Guaranteed Maximum Price, or GMP. The owner can be assured that the total project cost will not exceed an agreed-upon upper limit, usually arrived at by adding 10 to 15 percent to the initial estimate. Change orders may or may not increase the guaranteed maximum price, depending on the cost of the change and how the budget has been managed up to that point. Many owners prefer this type of contract because it gives them the best of both worlds: they get what they pay for in addition to having control over costs.

The “Cost Plus Fixed Percentage with Bonus” Contract

Under this contract, a bonus is given if the project finishes below budget or ahead of schedule. For instance, if the owner is having a wedding at the house in September and wants to insure that the project is completed in August, he/ she may want to offer a bonus for staying on schedule. The owner decides the appropriate amount for the bonus. Sometimes the bonus amount is adjustable based on the the degree of compliance with the target budget or date.

The “Cost Plus Fixed Percentage with Agreement for Sharing Any Cost Savings” Contract

If the completed project comes in below budget, any cost savings are shared between the owner and the contractor.