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Construction Contract Keystones, Part I: Payment Mechanisms

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Construction at Much

We are launching a series of articles discussing some of the most important terms in a construction contract. Up first: payment mechanisms. This article will review the three most commonly used payment mechanisms in construction contracts and the benefits and drawbacks of each.

Fixed Price, or Lump Sum

Perhaps the simplest and most commonly used payment mechanism is the fixed-price, or lump-sum, contract. Under this method, the contractor proposes the price to the party seeking the work (likely an owner or tenant) after estimating its costs and adding a profit margin. If the party seeking the work accepts the proposed amount, it becomes part of the contract as the price for the work.

Benefits:

- Certainty and simplicity. Both sides know precisely how much will be paid and for what work. This is especially favorable to an owner able to limit its exposure on a project and not worry about cost overruns (barring, of course, unforeseen conditions or additional work).

- A lump-sum contract encourages a contractor to beat its own estimate, being faster and more efficient than it anticipated it would be. This means potentially higher profit margins for the contractor as well as the possibility of a speedier completion for the owner.

- Although a lump-sum contract requires a contractor to be as accurate as possible in estimating its costs up front, the contractor is not required to maintain precise accounting of its expenses on the project, leading to less project overhead.

Drawbacks:

- Although a contractor has every reason to beat its estimate in order to increase its profit, contractors do not always realize this potential. And the flip side can be disastrous for a contractor. Because sophisticated owners will almost always seek bids from multiple contractors, bidding contractors have every reason to come in as the low bidder in order to garner the work. The risks are self-evident: if the contractor is too aggressive in its pricing, it can go over budget, minimizing or even losing its profits; if the contractor sees a project as a lost cause, it might cut back on its workforce or even pull out of the job, delaying completion for the owner.

- Contractors that are risk adverse will build contingency plans into their bids to protect themselves from cost overruns. This could unnecessarily increase the cost to the owner.

- A contractor that is seeking to increase its profit margins or minimize losses has the opportunity to cut corners by hiring inferior subcontractors. If the contractor cuts corners, the owner will certainly see diminished quality in its overall project.

Which projects are most suitable for a lump-sum contract? Projects that include comprehensive construction documents, plans and specifications lend themselves to lump-sum contracts because they allow the contractor the best opportunity to accurately bid the project. Lump-sum contracts are also appropriate for projects where the owner has little capacity or interest in monitoring the work.

Cost Plus

In cost-plus contracts (also called "cost plus a fee"), the owner agrees to pay the contractor for its actual costs incurred in performing the work, plus a predetermined fee. The predetermined fee may be a stipulated amount or a percentage of the construction costs.

Benefits:

- Transparency. The owner knows precisely what the work will cost to perform.

- Potential savings for the owner. Where, in a lump-sum contract, the contractor may benefit from beating its estimate, in a cost-plus contract such savings are realized by the owner.

- Latitude in making changes to the work. Because a contractor is being paid based upon the work it actually performs and has not necessarily estimated its cost relative to each aspect of the project, the owner can more easily alter the work to be performed without being forced to renegotiate the contract price. The contractor merely performs the revised work and bills for the cost incurred in doing so.

Drawbacks:

- Cost-plus contracts can be complicated and require precise project accounting by both sides. The contractor is required to report all of its costs to the owner in order to get paid. Similarly, the owner has to scrutinize bills to ensure accuracy and truthfulness. As such, both sides should have familiarity and experience with construction costs. If the owner needs to use professionals to audit the project, that will increase its project cost.

- Project costs are not capped. This means that the owner's exposure is unknown and open-ended. Similarly, the contractor has no motivation to reduce its cost or work efficiently because it is being reimbursed for all of its costs. In fact, the contractor may even be motivated to increase the cost of the project and be inefficient where it will receive a percentage fee based on the overall project cost. Using a fixed fee rather than a percentage-based fee would resolve the latter issue.

Which projects are most suitable for a cost-plus contract? Projects where there are not yet comprehensive construction documents or the project may change but the owner wants to proceed promptly are appropriate for cost-plus contracts because the owner need not obtain bids under the cost-plus method. Projects with more sophisticated or experienced owners are also more suitable to the cost-plus method because they are more likely able to negotiate an appropriate fee and scrutinize bills.

Guaranteed Maximum Price

A popular alternative to the cost-plus contract is the guaranteed maximum price (GMP) contract. Under this arrangement, the owner is responsible for paying the contractor's costs up to a certain cap. It is essentially a cost-plus contract with a cap. If the contractor exceeds the cap, it is liable for the cost overruns. GMP contracts are appealing to owners because they have the cost-saving benefit of the cost-plus contract and the overrun protection of a lump-sum contract. Oftentimes, in order to persuade the contractor to take on the risk of the overruns and to work efficiently, the owner will agree to share the savings if the costs are less than the guaranteed maximum price.

Benefits:

- As with the lump sum contract, the contractor is encouraged to work efficiently and come in under the guaranteed maximum price because it will share in the savings. This is similarly attractive to the owner that realizes the benefits of coming in under cost.

- The owner is protected from cost overruns.

- Like the cost-plus contract, the owner knows precisely what the work cost to perform.

Drawbacks:

- From the contractor's perspective, it has more risk than a cost-plus contract. Similar to the lump-sum contract, the contractor bears the risk of cost overruns and has every incentive to increase the guaranteed maximum price to protect itself.

- GMP contracts are more complicated and require thorough negotiation. This means paying attorneys more to get the contract right.

Which projects are most suitable for a cost-plus contract? Larger projects and projects with more sophisticated and experienced owners may find a cost-plus contract to be an attractive option. However, owners must be prepared to negotiate the contract and monitor the work thoroughly. Also, similar to the lump-sum contract, projects should have comprehensive construction documents in order to ensure an appropriate guaranteed maximum price.

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