CHAPTER EXCERPT

BUILDING BY THE BOOK: LEGAL ADVICE FOR CONTRACTORS

CHAPTER 2: THE FIXED PRICE CONTRACT: PROS AND CONS

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The majority of remodel projects are performed on a "bid" basis. This means that the contractor reviews the plans and specifications prepared by a designer and determines a fixed price for the work, which includes labor, materials, subcontractors, profit and overhead. This amount is then submitted to the owner who compares it to bids from other contractors and then chooses one of the contractors to work with. A contract is signed and the project proceeds accordingly.

Similar to the lump sum bid is the fixed price per unit contract, which takes into consideration unknown quantities. For example, if an area needs to be excavated, the contractor can quote a fixed price per cubic yard of dirt. The unknown is the amount of dirt that will need to be removed. The quoted price includes cost, profit and overhead. Consider whether your price needs to be adjusted at certain threshold limits, either up or down, and whether you should require a minimum number of units.

Fixed price contracts are subject to many pitfalls. The following are some suggestions for avoiding the pitfalls.

Missing Items: Sometimes contractors attempt to bid on plans that are incomplete. This is a disaster waiting to happen. The best thing to do is to point out to the owner that the plans are insufficient and request that they go back to the designer to obtain more details. This alternative, however, may leave you without a project, because other contractors will bid on it. The next best thing to do is to carefully document in your bid what is missing and indicate to the owner that you intend to submit a revised bid for those items when the plans are completed.

Assumptions: When bidding a project, a contractor makes many assumptions, especially if the specifications are minimal. If the plans call for a hardwood floor, the contractor may assume oak will be used. If the plans call for sheetrock, the contractor may assume textured finishes. The owner, however, does not know the assumptions unless you tell them in the bid. If they agree to use you as their contractor and then decide to use cherry wood for the floors, they are not going to understand why you think you are entitled to more money.

To avoid ambiguity, list all assumptions that you have made as part of the bid. This will also allow the owner to make a more informed comparison of the bids they receive, because they will have greater information.

Allowances: Allowances are used when the owner intends to make decisions about materials to be used at a later date. Typical allowance items include appliances, floor coverings, countertops, cabinets, and light fixtures. The bid should indicate the amount the contractor has allowed for each of these items. It should then explain that if the owner chooses items that are in excess of these amounts, the contract amount will increase. If they choose items that are less, a credit to the contract price will be issued. You also need to indicate whether you will charge/refund a percentage for overhead and profit, although this practice is somewhat unusual.

The biggest problem with allowances comes when the contractor includes his labor charges in the allowance amount without telling the owner. In other words, the contractor provides the owner with a tile allowance of $10,000. The owner then chooses tile that costs a total of $9000. The owner thinks they are going to get a credit of $1000, but instead the contractor tells them that they owe an additional $3000 because the labor to install the tile will cost $4000. The owner assumed that the entire allowance item was for materials, but the contractor included the installation cost in the amount.

When delineating allowance items, indicate whether the cost quoted includes the labor for installation or whether it is only for material. You should also indicate whether you are going to pass any contractor discounts through to the owner as part of the allowance amount.

Break Down Bids: Many contractors break down their bids into categories, i.e. HVAC, framing, demolition, electrical, etc., and give this information to the owner. Then during the course of construction they bill the owner for the percentage of completion of each item at the time of invoicing.

This method works well when dealing with a construction lender that has a contractor review the work and render opinions regarding whether the percentage is truly complete. It is, however, a problem for an owner who does not have a clue about construction. At some point in the project they will have paid a certain amount of money, let's say an amount that corresponds to 60% completion; however, they will not think you are that far along. They will then start asking for invoices from your subcontractors and suppliers to determine whether they have really billed you for that percentage. As you know, your line item does not necessarily match a bid from a subcontractor because you will have your own labor, materials and other items included in that line item. Try to explain that to an owner! And then, when you tell the owner that they are not entitled to receipts, they will think you are trying to hide something.

The best way to avoid this problem is to never give the owner a breakdown of a bid amount. Put a provision in your contract that states: *"This is a fixed price contract. The owner is not entitled to a cost breakdown, nor is the owner entitled to receipts for costs, unless related to allowance items."* The way to handle the billing is to tie lump sum payments to certain milestones, such as completion of demolition, completion of foundation, etc. The owner can see these events (sometimes they will correspond to building department inspections, which give the owner greater comfort) and know exactly the amount they need to pay. Under these conditions there should never be a need to provide underlying invoices.

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