**Construction and Design Law: Managing the Network of Interdependent Relationships**

Carl J. Circo

**Lesson 3: Pricing Alternatives**

Pricing arrangements for construction and design work and services operate to allocate some of the most significant financial risks that industry participants face. While most pricing alternatives are straightforward, as the reading assignments for this lesson show, complications and disputes sometimes arise over pricing terms. Moreover, even a fixed-price (or stipulated-sum) contract requires the parties to anticipate changes in the plans and specifications, delaying events, unforeseen developments, and other special circumstances.

Conventional pricing schemes

For a thorough, and an admirably concise, introduction to pricing alternatives, read Sections 6:96-6:117 in volume 2A of *Bruner & O’Connor on Construction Law* (Westlaw Aug. 2023), by Phillip L. Bruner & Patrick J. O’Connor, Jr. These sections cover each compensation method conventionally used in the industry for work and services. Note that the main distinction is between systems that compensate based on a stated fixed amount and those that directly or indirectly use a cost basis. Contracts specifying fixed sums allocate substantial financial risk to those providing work and services, while cost-based arrangements allocate financial risks, at least in the first instance, to the other contracting party, most often the project owner.

Note also that, except in the simplest situations, pricing terms in contracts for both design and construction must be flexible enough to anticipate many possible developments that logically support adjusting compensation. This is especially true with fixed-price contracts because an agreement to provide work or services for a definitive price inevitably results from assumptions and projections about many relevant considerations that are difficult to predict and control, such as future costs of labor and materials, the amount of time activities will require, costs of complying with governmental requirements, and the impact of contract breaches on the non-defaulting party. Of course, freedom of contract principles dictate that a builder or design professional should expect to be held to an unambiguous agreement to accept a fixed price for defined work and services. See 1A Phillip L. Bruner & Patrick J. O’Connor, Jr., 1 *Bruner & O’Connor on Construction Law*, § 3:1 (Westlaw Aug. 2023). Even limited experience with the design and construction processes, however, assures that parties to industry contracts will commonly negotiate standards and procedures allowing for economically rational adjustments to fixed-price commitments. Theoretically, cost-based pricing can largely avoid pricing adjustments because the cost approach itself should accommodate most circumstances that might arise over a contract’s duration. In practice, however, the parties negotiating cost-based compensation may sometimes decide to allow for fixed pricing for some of those circumstances, such as proposals for changes to plans and specifications. Moreover, cost-based pricing often includes guaranteed maximum price terms, thereby reintroducing the need for flexibility when circumstances change.

As reflected repeatedly in the excerpts from the Bruner and O’Connor treatise, no matter what pricing arrangement the contract employs, the parties will sometimes have disputes over contract interpretation or the correct method for applying the contract’s compensation formulas or standards. As discussed in Sections 6:99-106, unit pricing presents special challenges due to the risks of unbalanced bidding techniques, potential inaccuracies in estimated quantities, measurement problems, and the use of special provisions applicable to unit pricing, such as a variation in estimated quantity clause.

As Sections 6:108-109 explain, basing compensation on the costs of the work to be performed requires the parties to include in the contract detailed definitions of the components of reimbursable costs. This may lead to tedious negotiations and to provisions for auditing cost records. In most situations, a cost reimbursable provision will also provide for additional compensation as a profit and overhead allowance, thus giving rise to the “cost-plus” label. Finally, cost-based contracts frequently include a guaranteed maximum price provision that caps compensation, thereby reallocating some pricing risk to the party performing the work.

Stipulated-sum and cost-based pricing examples

For a detailed example of stipulated-sum pricing, read the selected portions of the American Institute of Architects (AIA) contract forms discussed here. First, consider Article 4 of the AIA’s A101 (2017), “Standard Form of Agreement Between Owner and Contractor where the basis of payment is a Stipulated Sum.” Note that Section 4.1 specifies that the fixed amount the Owner agrees to pay the Contractor for the work is “subject to additions and deductions as provided in the Contract Documents.” The other sections and subsections of Article 4 reflect some of the special considerations that may account for changes to that fixed amount. In arriving at the stated contract sum, the owner and the contractor may have chosen certain alternative details over others that were under consideration as the fixed price was being established (Subsection 4.2.1), and they may have agreed to defer decisions about other alternatives that could ultimately change the contract sum (Subsection 4.2.2). The contract sum might also increase if decisions the owner ultimately makes concerning identified details cost more than the maximum amounts allotted for those details in the fixed sum (Section 4.3). Furthermore, the stated contract sum may also be subject to adjustment based on unit pricing of certain items (Section 4.4), due to the assessment of agreed liquidated damages (Section 4.5), or as the result of other special agreements between the owner and the contractor (Section 4.6). Thus, this AIA standard form for stipulated-sum pricing highlights the potentially variable character of what initially appears as a definitive amount.

Beyond the potential that the stated contract sum might change due to the special circumstances recognized in Article 4 of A101, significant variations may result from provisions of the “general conditions,” which Subsection 9.1.3 of A101 incorporates by reference into the parties’ agreement. Of special significance on this point are Articles 7 and 8 of the AIA’s A201 (2017), “General Conditions of the Contract for Construction.” Article 7 governs how changes in the work may affect the stated contract sum, and Article 8 addresses pricing impacts that may result from certain time-related events resulting in delays. Later lessons cover changes and delays in detail.

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Now, to compare the far more complex terms of a cost-based contract that establishes a guaranteed maximum price (GMP), read the selected provisions discussed here from ConsensusDOCs 410 (2017). Subsection 3.1.3 obligates the design-builder to prepare a preliminary estimate once “sufficient Project information has been identified,” and it provides for periodic updates to that estimate. Section 3.2 then sets out the process for establishing the guaranteed maximum price (GMP), which begins with the design-builder’s GMP Proposal (Subsection 3.2.1). and which calls for a detailed statement of the basis for that proposal (Subsection 3.2.2) and specifies the steps necessary to finalize the GMP (Subsections 3.2.4 and 3.2.5). Note also that Article 3 provides that the GMP proposal will include the design-builder’s contingency (Subsection 3.2.7) and a requirement for the design-builder to maintain cost accounting documentation (Subsection 3.2.8).

As one would expect, the GMP is subject to increases for such matters as delays beyond the design-builder’s control (Section 6.3). Liquidated damages, however, may be assessed against the design-builder as the result of inexcusable delays (Section 6.4).

Article 7 governs payments, with Section 7.1 providing for the design phase payments and Section 7.2 covering construction phase payments. Under Subsection 7.2, the design-builder’s compensation for construction work includes reimbursement for the costs of the work, plus the design-builder’s fee as agreed by the parties, but the total compensation is limited by the GMP. Section 7.3 specifies the design-builder’s fee, Section 7.4 provides for adjustments in the fee for such matters as changes in the work, and Section 7.5 contemplates that the parties may agree that the design-builder will receive a bonus payment if the total of the cost of the work and the design-builder’s fee is ultimately less than the GMP.

Article 8 defines the phrase “Cost of the Work.” This is one of the most important topics in any cost-based compensation arrangement, whether the agreement includes a GMP or does not. Seventeen separate subsections itemize the costs to be included in the calculation of reimbursable costs. Articles 9 and 10, respectively, cover the important topics of changes in the work and the payment process for construction phase services. These topics, however, are beyond the scope of this lesson because later lessons will discuss them in detail.

Keep in mind that these two examples are just that—examples. To be sure, the provisions of these two industry form contracts derive from decades of experience in negotiating and administering stipulated-sum and cost-based pricing arrangements, and they reflect lessons from countless claims, disputes, settlements, judicial decisions, and other dispute resolution processes. Accordingly, the AIA and ConsensDOCs approaches merit considerable respect as standards or guidelines for effectively addressing compensation for fixed-price and cost-based pricing. Contracting parties, however, remain largely free to craft pricing arrangements in accordance with their own objectives and bargaining positions, subject to limited exceptions based on legislative or judicial policy determinations.

Later lessons, in addition to delving into contractual provisions concerning changes in the work and payment processes only briefly mentioned in this lesson, will also address enforceability limits affecting such provisions as conditional payment clauses, liquidated damages, and will also consider other policy-based principles and controls that legislatures and courts have imposed concerning compensation for design and construction.

For Review and Discussion

1. What factors should a project owner consider when deciding whether to retain a builder on a fixed-price basis versus a cost-plus basis?
2. When a construction contract provides for unit prices, how can a crafty or dishonest bidder use an unbalanced bid to its advantage?
3. Can a variations-in-estimated quantities (VEQ) clause protect an owner against unbalanced bidding? If so, how and to what extent? If not, why not?
4. Review Section 8.3 of ConsensusDOCs 410 (2017), which is reproduced below. Is this provision balanced and fair to both parties, or might either the owner or the design-builder logically consider proposing changes to it?

8.3. DISCOUNTS All discounts for prompt payment shall accrue to Owner to the extent such payments are made directly by Owner. To the extent payments are made with funds of Design-Builder, all cash discounts shall accrue to Design-Builder. All trade discounts, rebates, and refunds, and all returns from sale of surplus materials and equipment, shall be credited to the Cost of the Work.