



UNC  
SCHOOL OF LAW

NORTH CAROLINA LAW REVIEW

---

Volume 40 | Number 4

Article 7

---

6-1-1962

# Contracts -- Cost-Plus Building and Construction Contracts -- Interpretation of "Cost"

Joseph Stevens Ferrell

Follow this and additional works at: <http://scholarship.law.unc.edu/nclr>



Part of the [Law Commons](#)

---

## Recommended Citation

Joseph S. Ferrell, *Contracts -- Cost-Plus Building and Construction Contracts -- Interpretation of "Cost"*, 40 N.C. L. REV. 799 (1962).  
Available at: <http://scholarship.law.unc.edu/nclr/vol40/iss4/7>

This Note is brought to you for free and open access by Carolina Law Scholarship Repository. It has been accepted for inclusion in North Carolina Law Review by an authorized editor of Carolina Law Scholarship Repository. For more information, please contact [law\\_repository@unc.edu](mailto:law_repository@unc.edu).

to all. But, it seems clear that privacy of the individual is one factor that the Court will take into consideration in the determination of cases which arise in these areas.

CHARLES M. HENSEY

### Contracts—Cost-Plus Building and Construction Contracts— Interpretation of “Cost”

Perhaps the most frequently litigated issue arising from construction contracts on a cost-plus basis<sup>1</sup> is the proper interpretation of the word “cost.” In *Lytle, Campbell & Co. v. Somers, Fidler & Todd Co.*,<sup>2</sup> the leading case in this area, the Pennsylvania Supreme Court formulated the general rule<sup>3</sup> that, unless a definition is expressly written into the contract, “cost” must be interpreted to mean only those expenses which can be said to be “operative” or of a productive nature in actually completing the construction, as distinguished from non-productive, indirect and general expenses or “overhead.”<sup>4</sup> The latter are presumed to have been provided for in the agreed percentage of profit.<sup>5</sup>

<sup>1</sup> A “cost-plus contract” is one in which the contractor agrees to do certain work at cost plus a stated percentage of the cost as profit. It is different from a “cost-plus-a-fixed-fee contract” where the agreement is to do work at cost plus a fixed amount of compensation, but for the purposes of this note no distinction will be made between them since the problems attendant to the interpretation of the word “cost” are the same in each. See, e.g., *Continental Copper & Steel Indus. v. Bloom*, 139 Conn. 700, 96 A.2d 758 (1953). See generally 17 C.J.S. *Contracts* § 367(b) (1939); Annot. 27 A.L.R. 48 (1923).

<sup>2</sup> 276 Pa. 409, 120 Atl. 409 (1923).

<sup>3</sup> Since the *Lytle, Campbell* case purported to lay down a general rule for the interpretation of all cost-plus contracts no attempt has been made to reconcile the cases on the basis of the precise wording of the contract before the court. Those courts citing and relying on the *Lytle, Campbell* case have tended to look to the class of contract involved, rather than the particular words employed. See, e.g., *Vinson & Pringle v. Lanteen Medical Lab.*, 63 Ariz. 115, 159 P.2d 612 (1945); *Jensen v. Manthe*, 168 Neb. 361, 95 N.W.2d 699 (1959); *Washington Const. Co. v. Spinella*, 8 N.J. 212, 84 A.2d 617 (1951); *Nolop v. Spettel*, 267 Wis. 245, 64 N.W.2d 859 (1954). Cf. *Dunn v. Hammon Drug Co.*, 79 Ariz. 101, 284 P.2d 468 (1955).

<sup>4</sup> The rule of *Lytle, Campbell* has been cited with approval in many cases, none of which have questioned its validity. See, e.g., *Advance Auto Body Works, Inc. v. Asbury Transp. Co.*, 10 Cal. App. 2d 619, 52 P.2d 958 (Dist. Ct. App. 1935); *Michelson v. House*, 54 N.M. 197, 218 P.2d 861 (1950).

<sup>5</sup> The normal definition of the word “profit,” in the absence of circumstances tending to show otherwise, is “net profit,” that is, the remainder after all expenses of whatever nature have been paid. *Buie v. Kennedy*, 164 N.C. 290, 80 S.E. 445 (1913); *Thomas v. Columbia Phonograph Co.*, 144 Wis. 470, 129 N.W. 522 (1911). Yet the word “profit” in a cost-plus agreement is given a different meaning in that certain types of expenses, those

The great weight of authority appears to be that under a cost-plus agreement the contractor is not entitled to recover as part of his "cost" that portion of his general overhead directly attributable to the specific undertaking in question.<sup>6</sup> But the decisions display a striking lack of unanimity as to whether certain *specific* items should be classified as "costs" or "overhead." Among such items are taxes and insurance, supervision fees, sub-contractor's overhead and profits, wages paid to unproductive or non-essential labor, and use, rental and depreciation of equipment.

### *Taxes and Insurance*

There would appear to be little doubt that expenses for public liability and workmen's compensation insurance and various social security taxes<sup>7</sup> do not contribute directly toward the erection of a

---

classified as "overhead," are presumed to be included within the stated percentage of profit. No case has been found in which this anomaly has been noted, but there appears to be no sound reason for creating an inflexible exception to the general rule.

<sup>6</sup>See, *e.g.*, *Denemark v. Ed B. Mooney, Inc.*, 218 Ark. 944, 237 S.W.2d 41 (1951); *House v. Fissell*, 188 Md. 160, 51 A.2d 669 (1947); *Shaw v. G. B. Beaumont Co.*, 88 N.J. Eq. 333, 102 Atl. 151 (Ct. Ch. 1917). *Contra*, *Hoggson Bros. v. Spiekerman*, 175 App. Div. 144, 161 N.Y. Supp. 930 (1916); *cf. Hamilton v. Coogan*, 7 Misc. 677, 28 N.Y. Supp. 21 (C.P. 1894). In *Benes v. Hickox Bldg. Co.*, 89 N.E.2d 315 (Ohio App. 1949), general overhead was treated as part of cost in computing damages for breach of a cost-plus contract where the owner had prevented performance.

The rule denying overhead would appear to be inconsistent with the practice of computing damages for breach of a regular fixed-fee contract. Where performance of a fixed-fee contract has been prevented, the measure of damages is the cost of the work already done plus the profit reasonably expected if completion had been allowed. There overhead is treated as part of cost. See *Sofarelli Bros., Inc. v. Elgin*, 129 F.2d 785 (4th Cir. 1942); *Grand Trunk Western R.R. v. H. W. Nelson Co.*, 116 F.2d 823 (6th Cir. 1941); *Snyder v. Reading Scho. Dist.*, 311 Pa. 326, 166 Atl. 875 (1933); *Dravco Contracting Co. v. James Rees & Sons Co.*, 291 Pa. 387, 140 Atl. 148 (1927). *But cf. Harris & Harris v. Crain & Denbo*, 256 N.C. 110, 123 S.E.2d 590 (1962).

It would also appear that a different rule may be applied where the contract is to *manufacture* an article in the first instance on a cost-plus basis as opposed to the construction of a building. In *Mailander v. Continental State Bank*, 11 S.W.2d 615 (Tex. Civ. App. 1928), the court stated in a dictum that the rule denying recovery of overhead under a cost-plus contract did not apply in this situation, but did not say what the correct rule was. No case has been found squarely on point where the contract in question was on a cost-plus basis. *Cf. Alvey Conveyer Mfg. Co. v. Kansas City Terminal Ry.*, 356 Mo. 770, 203 S.W.2d 606 (1947); *International Contract Co. v. City of Tacoma*, 79 Wash. 311, 140 Pac. 373 (1914).

<sup>7</sup>As employers, contractors are generally required by state and federal law to purchase certain insurance and pay employment taxes if they employ more than a stated number of persons. See, *e.g.*, INT. REV. CODE OF 1954,

building but are part of the general cost of doing business and are, therefore, indirect and non-productive. Arizona and Rhode Island have held that these are not proper charges under a cost-plus contract unless it affirmatively appears the parties intended otherwise.<sup>8</sup> However, the trend appears to be toward treating these items as part of cost.<sup>9</sup>

### *Supervision Fees*

Under the *Lytle, Campbell* rule only the actual manual labor performed on the structure may be recovered as cost. This would appear to preclude wages paid to a foreman or supervisor as an item of cost; yet the trend of the courts is toward allowing supervision fees, at least where the supervisor is an employee and not the contractor himself.<sup>10</sup> Washington has drawn an interesting distinction

---

§§ 3301 (unemployment insurance), 3111 (F.I.C.A.); MD. ANN. CODE art. 95A, § 8 (1957) (unemployment insurance); R.I. GEN. LAWS ANN. § 28-29-6 (1956) (workmen's compensation insurance).

<sup>8</sup> *Vinson & Pringle v. Lanteen Medical Lab.*, 63 Ariz 115, 159 P.2d 612 (1945); *Brown v. Benn*, 75 R.I. 76, 63 A.2d 781 (1949); *Pelletier Const. Co. v. Trullis*, 70 R.I. 121, 37 A.2d 369 (1944).

<sup>9</sup> *House v. Fissell*, 188 Md. 160, 51 A.2d 669 (1947); *Jensen v. Manthe*, 168 Neb. 361, 95 N.W.2d 699 (1959) (dictum). Cf. *Piehl v. Marino* 254 Wis. 538, 36 N.W.2d. 694 (1949), where these items were not allowed due to failure of the contractor to establish that they were reasonable.

The California decisions are in conflict. These items were not allowed in *Advance Auto Body Works, Inc. v. Asbury Transp. Co.*, 10 Cal. App. 2d 619, 52 P.2d 958 (Dist. Ct. App. 1935), but this decision appears not to have been followed, and there is no ruling as yet by the California Supreme Court. These items were allowed in *Eby v. Bensemon*, 177 Cal. App. 2d 756, 2 Cal. Rptr. 503 (Dist. Ct. App. 1960); *Vowels v. Witt*, 149 Cal. App. 2d 257, 308 P.2d 415 (Dist. Ct. App. 1957) (dictum); *Cunningham v. Weaver*, 130 Cal. App. 2d 787, 279 P.2d 830 (Dist. Ct. App. 1955); cf. *Citizens State Bank v. Gentry*, 20 Cal. App. 2d 415, 67 P.2d 364 (Dist. Ct. App. 1937) (allowed on an estoppel theory); *Boat & Barge Corp. v. Beverly Fin. Co.*, 71 Cal. App. 2d 800, 163 P.2d 913 (Dist. Ct. App. 1945).

Washington has held that sales tax is an item of cost. *Irwin v. Sanders*, 49 Wash. 2d 600, 304 P.2d 697 (1956). It has also been held that the Indiana gross income tax is an item of cost to the contractor as a tax directly chargeable to the work. *Herlihy Mid-Continent Co. v. Northern Ind. Pub. Ser. Co.*, 245 F.2d 440 (7th Cir. 1957).

<sup>10</sup> The decisions in this area are in conflict. In *Timmons v. Nelsen*, 159 Neb. 193, 66 N.W.2d 406 (1954), it was held that the salary of a general supervisor could not be recovered as cost since this was the responsibility of the contractor himself, even though another was hired to do the work. But the expense of work actually performed by the supervisor in construction was allowed. *But see Jensen v. Manthe*, 168 Neb. 361, 95 N.W.2d 699 (1959), where the court stated in a dictum that supervision costs were generally regarded as operative and not overhead.

Supervision costs were allowed in *Churchill v. Anderson*, 128 F. Supp. 425 (W.D. Ky. 1955) (supervisor was partner of contractor); *Crone v. Amado*, 69 Ariz. 389, 214 P.2d 518 (1950); *Ferguson v. A. F. Stewart*

between supervision at the "operative" and at the "administrative" level, including the former as an item of cost but classifying the latter as overhead.<sup>11</sup>

### *Sub-Contractor's Overhead and Profits*

Under a strict application of the *Lytle, Campbell* rule the main contractor may not include as part of his costs any sums paid to sub-contractors for items which he could not have included had he done the work himself. Thus the sub-contractor's overhead and profits must be paid by the main contractor out of his own profits. Only one case so holding has been found.<sup>12</sup> The weight of authority is that the entire amount paid to sub-contractors is part of the main contractor's cost, even though this may include overhead and profits.<sup>13</sup>

### *Wages Paid to Unproductive or Non-Essential Labor*

Often an employer cannot obtain labor at any price without complying with various union regulations concerning the minimum number of laborers to be hired, rest periods, and so forth. Such regulations may substantially increase labor costs without resulting in a correspondingly greater work out-put. Under the *Lytle, Campbell* rule that portion of labor costs which might be said to be unproductive or non-essential would be excluded from costs.<sup>14</sup> Yet in *Willett v. Davis*,<sup>15</sup> the one case in which the problem has been squarely raised, the Washington Supreme Court had little difficulty in including as cost all wages required to be paid in order to get the work done,

---

Const. Co., 115 Okla. 31, 241 Pac. 121 (1925). Cf. *Carrico v. City & County of San Francisco*, 177 Cal. App. 2d 97, 2 Cal. Rptr. 87 (Dist. Ct. App. 1960) (general contractor allowed to recover for compensation paid by sub-contractor to superintendent).

<sup>11</sup> *Whitney v. McKay*, 54 Wash. 2d 672, 344 P.2d 497 (1959).

<sup>12</sup> *Grafton Hotel Co. v. Walsh*, 228 Fed. 5 (4th Cir. 1915).

<sup>13</sup> *Churchill v. Anderson*, 128 F. Supp. 425 (W.D. Ky. 1955); *Carrico v. City & County of San Francisco*, 177 Cal. App. 2d 97, 2 Cal. Rptr. 87 (Dist. Ct. App. 1960); *Eby v. Bensemon*, 177 Cal. App. 2d 756, 2 Cal. Rptr. 503 (Dist. Ct. App. 1960); *Ford & Butterleld v. St. Louis, K. & N.W. Ry.*, 54 Iowa 723, 7 N.W. 126 (1880); *Baker v. Stamps*, 82 So. 2d 858 (La. App. 1955); *Jensen v. Manthe*, 168 Neb. 361, 95 N.W.2d 699 (1959); *Hamilton v. Coogan*, 7 Misc. 677, 28 N.Y. Supp. 21 (C.P. 1894). Kentucky and Wisconsin have held that whether these items were intended to be included as cost is a jury question. *Thoroughbred Motor Court, Inc. v. Allen Co.*, 296 S.W.2d 690 (Ky. 1956); *Piehl v. Marino*, 254 Wis. 538, 36 N.W.2d 694 (1949).

<sup>14</sup> *Nolop v. Spettel*, 267 Wis. 245, 64 N.W.2d 859 (1954).

<sup>15</sup> 30 Wash. 2d 622, 193 P.2d 321 (1948).

regardless of whether the wage-earners actually contributed directly to the construction.

### *Use, Rental and Depreciation of Equipment*

It has been held, in the absence of agreement to the contrary, that one who agrees to perform work impliedly agrees to supply the necessary tools at his own expense.<sup>16</sup> Thus, a contractor under a cost-plus agreement may not charge for the use of equipment owned by him.<sup>17</sup> On this point, at least, there is general agreement.<sup>18</sup> However, Oklahoma has allowed a contractor to charge for *repairs* to his equipment which was damaged in performance.<sup>19</sup>

The contract before the court in *Lytle, Campbell* was on a "time and materials" basis. Whether the operative expense test is of much value in construing a cost-plus agreement with a different wording would seem to be at least doubtful. If the case be taken as establishing a general rule for the classification of expenses under cost-plus contracts *as a class*, without regard to the particular wording of the contract under consideration,<sup>20</sup> it would appear to be unsound in that it displaces the normal canons of interpretation and precludes extrinsic evidence tending to show the intention of the parties.

The preferable view would seem to be that the terms "cost" and "overhead" have no legal definition but must be interpreted in the light of the surrounding circumstances.<sup>21</sup> This leaves the court free to determine the intent of the parties from such factors as the customs of the trade, the nature of the undertaking, and the tenor of the agreement as a whole. A controlling element in one case was the

<sup>16</sup> *Shaw v. G. B. Beaumont Co.*, 88 N.J. Eq. 333, 102 Atl. 151 (Ct. Ch. 1917); *Lytle, Campbell & Co. v. Somers, Fidler & Todd Co.*, 276 Pa. 409, 120 Atl. 409 (1923), referred to with approval in *Pioneer Constructors v. Symes*, 77 Ariz. 107, 267 P.2d 740 (1954); *Michelson v. House*, 54 N.M. 197, 218 P.2d 861 (1950).

<sup>17</sup> *Lytle, Campbell & Co. v. Somers, Fidler & Todd Co.*, *supra* note 16.

<sup>18</sup> *Charles Elmer & Sons v. Kelly*, 263 Fed. 687 (5th Cir. 1920); *Savannah A. & N. Ry. v. Oliver*, 174 Fed. 140 (5th Cir. 1909); *Pioneer Constructors v. Symes*, 77 Ariz. 107, 267 P.2d 740 (1954); *Jensen v. Manthe*, 168 Neb. 361, 95 N.W.2d 699 (1959) (dictum); *Michelson v. House*, 54 N.M. 197, 218 P.2d 861 (1950).

<sup>19</sup> *Ferguson v. A. F. Stewart Const. Co.*, 115 Okl. 31, 241 Pac. 121 (1925).

<sup>20</sup> See note 3 *supra*.

<sup>21</sup> *Cost*: *Navco Hardwood Co. v. Mobile & Gulf Nav. Co.*, 214 Ala. 176, 106 So. 862 (1925) (on rehearing); *Singer Metals, Inc. v. Industrial Management Corp.*, 116 Cal. App. 2d 85, 253 P.2d 515 (Dist. Ct. App. 1953); *Boston Molasses Co. v. Molasses Dist. Corp.*, 274 Mass. 589, 175 N.E. 150 (1931). *Overhead*: *Wynkoop Hallenbeck Crawford v. Western Union*, 268 N.Y. 108, 196 N.E. 760 (1935).

fact that the contract called for the abnormally high profit of two hundred per cent.<sup>22</sup>

Nearly all of the litigation over the proper meaning of the word "cost" in cost-plus contracts could have been prevented by careful draftsmanship. Due to the unsettled state of the law in the area and the relative lack of authority,<sup>23</sup> the attorney faced with the task of drafting such an agreement would be well advised to carefully define the specific items intended to be covered by or excluded from "cost."

JOSEPH STEVENS FERRELL

### Contracts—Indefinite Duration of Exclusive Sales Agreements—Distributor's Right to Prospective Profits for a Reasonable Time

In the recent case of *General Tire & Rubber Co. v. Distributors Inc.*,<sup>1</sup> the North Carolina Supreme Court, by way of dictum, approved the majority view that an exclusive sales and distributors contract, which expresses no time for its duration, will by implication of law be considered to run for a reasonable period of time.<sup>2</sup>

The parties orally agreed that the defendant would be the sole and exclusive distributor of plaintiff-manufacturer's product in North and South Carolina for an indefinite period of time. Shortly thereafter, due to insufficiency of defendant's working capital, the parties executed a written agreement, known as a "Warehouse Agreement," whereby the plaintiff agreed to consign goods to defendant while retaining legal title to them. A year later this agreement was altered by an oral modification which provided that plaintiff would continue his consignment of goods as before for a stated period of three years, during which time the defendant would purchase the goods by monthly installments. Under this purchasing agreement, the defendant, who was in arrears in payments, refused to surrender the goods upon request and plaintiff brought this action to recover their

<sup>22</sup> The court quite properly held that cost was intended to include only actual out-of-pocket expenses. *Loewy v. A. Rosenthal, Inc.*, 104 F. Supp. 496 (E.D. Mich. 1952).

<sup>23</sup> North Carolina has never explicitly ruled on the construction of a cost-plus contract, but in *Harris & Harris v. Crain & Denbo*, 256 N.C. 110, 123 S.E.2d 590 (1962), the court clearly implied they were inclined to the majority view that overhead cannot be considered part of cost.

<sup>1</sup> 253 N.C. 459, 117 S.E.2d 479 (1960).

<sup>2</sup> *E. I. Du Pont Nemours & Co. v. Claiborne-Reno Co.*, 64 F.2d 224 (8th Cir. 1933); *J. C. Millett Co. v. Park Tilford Distillers Corp.*, 123 F. Supp. 484 (N.D. Cal. 1954); *Elson & Co. v. Beselin & Co.*, 116 Neb. 729, 218 N.W. 753 (1928).