

COMMON SENSE ABOUT HOME OFFICE OVERHEAD —
PART I
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INTRODUCTION: The Continuing Attack on Eichleay

For over 20 years, the case of *Eichleay Corp.*, 60-2 BCA ¶2688 (1961) has been the most commonly accepted guide to allocating home office overhead to construction contracts delayed by the government/owner. In simple terms, the "extended overhead" concept in *Eichleay* allocates home office overhead to the delayed contract in the proportion of billings generated by the delayed contract to total billings for the same period. This figure is then divided by the number of contract performance days to give a daily rate which is multiplied by the number of delay days to give the amount claimed.

This is expressed in the so-called "Eichleay Formula" as follows:

- (a) $(\text{Contract Billings divided by Total Billings for contract period}) \times (\text{Total overhead for contract period}) = \text{Overhead allocable to the contract};$
- (b) $\text{Allocable overhead divided by Days of performance} = \text{Daily contract overhead};$
- (c) $(\text{Daily contract overhead}) \times (\text{No. days delay}) = \text{Amount claimed}.$

If Contract Billings include all change order work, and the contract period includes all delay days and extensions, the overhead allocation should be historically accurate.

Recently, however, two trial-level decisions, *Capital Electric Co.*, 83-2 BCA ¶16,548 (1983) and *Savoy Const. Co., Inc. v. United States*, 1 FPD ¶120 (1983), rejected *Eichleay's* extended home office overhead concept and held that a contractor could not receive an equitable adjustment for home office overhead without showing that the delay effected the rate at which the company's entire contract earnings normally absorb home office overhead expenses. The "underabsorption" theory accepts that each contract must absorb, i.e. pay for, its fair or reasonable share of home office costs in a given accounting period. Underabsorption therefore occurs when the allocating base for overhead is diminished, by, for example, a contract delay, causing the delayed contract's share of overhead to decrease and the share assigned to other contracts to increase. 83-2 BCA at 82,311.

Capital Electric and *Savoy* both suggested that the contractor could demonstrate underabsorption by showing that the delay increased home office expenses, or that the delay reduced other contract earnings by, for example, restricting bonding capacity. Neither contractor, however, successfully met those tests at the trial level.

Contractors are unlikely to meet either test. Bonding capacity is more clearly a function of the contractor's net worth than delay of a single contract. The cause of an increase in largely fixed expenses would also be difficult, if not impossible, to prove.

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SUMMARY:

- A. *Although the U.S. Court of Appeals has reaffirmed the "Eichleay" formula as an acceptable method for allocating home office overhead to a delayed contract, criticism of extended home office overhead continues.*
- B. *Critics of Eichleay generally read the case too closely.*
- C. *The Eichleay formula was not intended to be foolproof or applicable in every case.*
- D. *Alternative formulae such as the Comparative Absorption Rate and Burden Fluctuation Method are not necessarily better or more convincing than Eichleay.*
- E. *In choosing an overhead allocation formula, the contractor or subcontractor must rely on common sense and experience to present a claim that bears a reasonable relationship to the length of delay, the type and amount of overhead, and other contract activity.*

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Fortunately for the construction industry, the Court of Appeals for the Federal Circuit ("CAFC") reversed *Capital Electric* and *Savoy* and reinstated *Eichleay* as an accepted basis for computing home office overhead as part of a claim for delay or suspension of work. *Capital Electric Co. v. United States*, 729 F.2d 743 (CAFC 1984).

While this reaffirmation of *Eichleay* should have ended the debate, this has not been the case. Instead, cases¹ and critics² have renewed attacks on extended home office overhead in general and the *Eichleay* formula in particular. Much of this criticism, however, misstates the rule in *Eichleay*, distorts the significance of the *Eichleay* formula, offers substitute formulas which are not necessarily more convincing than *Eichleay* and needlessly stirs up an aspect of the law that should now be relatively well-settled.

Eichleay: A Practical, But Not Magical, Allocation

Too often, criticism of the *Eichleay* formula relies on an overly strict reading of the case itself. Considering the facts of the case and the language of the opinion, the Board established, not a panacea, but a practical, *ad hoc* approach. The *Eichleay* opinion may be summarized as follows: (a) extended home office overhead is recoverable as part of an equitable adjustment for government-caused delays or suspensions of work; 62-2 BCA at 13,574; (b) the contractor cannot be expected to reduce his work force or re-assign employees during temporary or partial suspensions; 60-2 BCA at 13,573; (c) the government bears the burden of showing that the contractor failed to mitigate damages, 61-1 BCA at 15,117; (d) the amount of extended home office overhead need not be proved exactly, it is only necessary to determine a fair allocation of home office overhead to the effected contract, 60-2 BCA at 13,573; (e) there is no set formula for determining the amount of extended home office overhead, 61-1 BCA at 15,118; (f) the allocation method to be used will depend on the facts of each case, 61-1 BCA at 15,118.

There has, thus, never been anything magic about the *Eichleay* formula. On the facts of that case it was merely found to be better than the government's alternative, 61-1 BCA at 15,118. Nor has the CAFC's affirmation of *Eichleay* created magic that the original decision lacked. If not magic, however, the *Eichleay* formula is highly practical in presenting a delay claim for the following reasons: (a) *Eichleay* is based on the actual amount of allocated overhead incurred by the delayed contract and should, therefore, prevent a double recovery; (b) *Eichleay* relates the home office overhead recovery directly to the duration of the compensable delay so that if the contractor is awarded fewer compensable delay days than claimed, the overhead award is adjusted accordingly. When compared with the proposed alternatives, the *Eichleay* formula's practicality becomes even clearer.

Two recent articles³ in CCM by Phillip R. McDonald and W. John Irwin, II have proposed the "Burden Fluctuation Method" ("BFM") (also known as the *Allegheny* method after *Allegheny Sportswear Co.*, 58-1 BCA ¶1684) and "Comparative Absorption Rate" ("CAR") as superior alternatives to the "Eichleay" formula. The BFM and CAR both attempt to calculate underabsorption by comparing a "potential" or "reasonable" overhead absorption rate against an "actual" one for purposes of determining the effect of the delay on the contractor's company-wide overhead absorption. Under both of these methods, if the percentage of overhead allocated to the contract was not changed by the delay, there could be no recovery.

Both authors use examples to show that these methods are analytically superior to *Eichleay*. The examples used, however, are of a small volume contractor (total billings of \$400,000-\$500,000/month), with small, constant home office overhead (\$40,000/month), a short-term contract and a short delay. With these relatively homogeneous examples, the results are fairly close to the *Eichleay* formula result. In Irwin's example based on the *Capital Electric* facts, the BFM was 2% higher than the standard *Eichleay* formula recovery. For McDonald's example, the BFM was 1% lower than the *Eichleay* recovery, and the CAR was 17% higher than *Eichleay*. The use of simple examples, however, can be deceptive.

Using the BFM and the CAR in another situation highlights the different results produced by the formula and shows the amount of trial and error that still remains in presenting a claim for home office overhead. The second part of this article will show, with use of figures from an actual case, that when a large contractor (\$30 million annual gross receipts) has an \$11 million contract extended by 10 months, the BFM and CAR both produce results which would be an embarrassment at trial, while the *Eichleay* formula produces a claim that is reasonable both in terms of the total amount claimed and in its relationship to the contractor's business.

¹*Appeal of Vepco, Inc.*, ASBCA No. 26993 (March 19, 1984); *Appeal of Bromley Contracting Co., Inc.*, DOTCAB No. 1284 (March 27, 1984) (*Eichleay*-based recovery held unjustified in addition to a general overhead markup of 50.8 percent of direct costs); Both cases are reported in CCM, July 1984, p. 5.

²W. John Irwin, II, "The Return of *Eichleay*: Is It Here To Stay; Parts I & II," 6 CCM Nos. 6 & 7 (June and July, 1984).

³Phillip R. McDonald, Esq., "Recovery of Home Office Overhead - A Different Point of View," 5 CCM No. 12 (December 1983); Irwin, *supra*; Note 5.