

COMMON SENSE ABOUT HOME OFFICE OVERHEAD – PART II

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The first part of this article outlined the history of the *Eichleay* formula, the continuing attacks which have been made on it, and two formulas, the Burden Fluctuation Method ("BFM") and the Comparative Absorption Rate ("CAR"), which have been proposed as superior alternatives.

While, in certain circumstances, either of these formulas might be preferred to the *Eichleay* approach, in the sense of producing a more persuasive claim, each of the alternative approaches is capable of producing claims which are incongruent with the facts of a contractor's business and therefore unreasonable. This distortion is most likely when dealing with a large volume contractor.

Consider a large contractor (\$300M/year) whose \$11 million, 20-month contract (which represents a small fraction of the company's business) is affected by differing site conditions and takes 30 months for completion while generating \$2M through change orders. Plotted against this data, the expected performance on such a contract might be compared to actual performance as follows:

	Expected Performance: 20 Months, \$11M	
	First Year	Second Year
Potential Performance	Mo. 1-12	Mo. 13-20
Home Office Overhead	\$1M/month	\$1.3M/month
Contract Billings	\$550,000/month	\$550,000/month
Other Billings	\$25M/month	\$27M/month
Total Billings	\$25.55M/month	\$27.43M/month

	Actual Performance: 30 Months, Change Orders of \$2M		
	First Year	Second Year	Third Year
Actual Performance	Mo. 1-12	Mo. 13-24	Mo. 25-30
Home Office Overhead	\$1M/month	\$1.3M/month	\$1.35M/month
Contract Billings	\$433,333/month	\$433,333/month	\$433,333/month
Other Billings	\$25M/month	\$27M/month	\$22M/month
Total Billings	\$25.43M/month	\$27.43M/month	\$22.43M/month

Potential Total Overhead – \$22.4M
Potential Total Billings – \$527M

Actual Total Overhead – \$35.7M
Actual Total Billings – \$768.9M

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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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Comparing the expected and actual performance charts shows that: (1) the contractor earned \$116,667 per month less than projected from the extended (delayed) contract; (2) home office overhead increased each year (no direct correlation with the extended contract earnings); (3) other billings were higher than projected for one year, and lower than projected for the last 10 months (no direct correlation with extended contract earnings).

Thus, at some time during the delay, additional work was available to absorb overhead costs (overabsorption), but at other times the delayed contract had to support more than its projected portion of the overhead pool (underabsorption). On these facts, the government might argue that home office costs were covered in spite of the extended performance.

If the delay occurred during the first year of performance, when other contract earnings were higher than projected, the owner's argument might have some appeal, but still not constitute an equitable basis for denying home office overhead. Any "overabsorption" in the first year is caused, not by the delayed contract, which is still earning less per month than reasonably projected, but by other factors, such as the contractor's managerial expertise or good fortune. To deny an equitable adjustment on that basis would be to let the government take advantage of the contractor's good fortune or good business judgment to avoid paying for the logical consequences of the delay.

In the second year, the government forced the contractor into a time of high overhead and low earnings which could not have been anticipated. Overabsorption in the first year, which was not caused by the owner, is balanced by underabsorption in the second year, which was a direct consequence of the owner-caused delay. The *Eichleay* formula ignores these considerations and bases the contractor's award on the actual allocated overhead expense and the number of compensable days in the delay period. In comparison with the BFM and the CAR, the *Eichleay* formula not only gives a smaller recovery, but is more realistic:

Eichleay: \$201,196 (\$671/day x 300 calendar days)

Comparative Absorption Rate: \$3.4M (\$11,333/day)

Burden Fluctuation: \$2.94M (\$9,827/day)

While admittedly crude in terms of the number of variables it considers, the *Eichleay* per diem approach gives a daily value for home office support — management and clerical salaries, rent, computers, etc. — which bears a reasonable (common sense) relationship to the value of the affected work (3.65%).

The CAR indicates that the affected project had a reasonable overhead rate (4.2%); however, the reasonable percentage of the Actual Total Billings figure is almost certainly unrelated to the value of the home office function (26% of the value of the contract plus change orders). A company with \$300M a year in gross billings should not be spending \$3.4M to administer a \$13M contract (9.59% of the total overhead on 4% of the work), especially when other contract activity is so high.

The BFM indicates that the potential overhead rate of 2.1% fluctuated to 4.65%, but again produces a figure with no clear relationship to the value of the contract or home office support. Overhead is 6.9% of the contract plus change orders, which is reasonable, but less than the *Eichleay* allocation. The changes in overhead percentage figures also appear reasonable as such, but due to the large figure for Total Billings and Total Overhead, the resulting dollar claim seems too high (22% of the contract value plus change orders).

Ultimately, the contractor must produce a common sense answer to the question of what the reasonable home office overhead should be. A rate of \$670 a day sounds reasonable, even low. This is confirmed by comparing the amount of extended overhead claimed with the company-wide overhead percentage rate applied to the \$2M in change order work ($\$35.7M/\$968.9M \times \$2M = \$92,859$).

In contrast, overhead at 26% of the contract value does not sound reasonable unless other contract earnings have declined more than shown in the example. Regardless of the theoretical merits of the CAR and BFM, if the claim figures they produce are unrealistic, then they are likely to be an embarrassment at trial and a contractor would be ill advised to rely on them.

In the example used here, *Eichleay* is a more reliable and persuasive method of allocating home office overhead to the affected contract. Other formulas might be useful in establishing the general proposition that total contract earnings did not absorb overhead properly allocable to the delayed contract, but, focusing on the facts in this example, *Eichleay* is a more convincing measure of the claim amount. This is not to suggest that the *Eichleay* formula will be appropriate for every large-volume general contractor, but that *Eichleay* should be evaluated with other available techniques against the hard standards of common sense.

In some situations, particularly with subcontractors, the facts should be analyzed carefully to see if any formula approach is reasonable. Take, for example, a mechanical or electrical subcontractor (\$5M/year gross receipts) who has billed his work at 97% complete as of the reasonably anticipated completion date, but it then forced to install fixtures or equipment originally required by the subcontract in a "delay period" of nine months.

The value of the work in the delay period taken from the subcontractor's schedule of values was \$24,000, and the subcontractor spent slightly more than that on direct cost items during the delay period. Yet, because the "delay period" was long, and the total company-wide overhead expenses during the period were substantial (even though only 14% of volume), an *Eichleay* formula recovery would exceed both the value of and the cost of the work performed. A subcontractor with company-wide overhead of 14% is very unlikely to be spending more than a dollar in overhead for every dollar spent on direct costs, no matter how long the delay.

Without a showing of exceptional circumstances, e.g., the subcontractor had no other business during the delay period, such a result is unrealistic. Any claimant who insists that the *Eichleay* case mandates such a recovery will insure

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that the law of home office overhead recovery remains in a state of uncertainty.

Conclusion

The contracting industry should welcome *Eichleay's* return. However, *Eichleay* neither guaranteed a recovery for extended home office overhead nor provided a legally unassailable method for allocating home office overhead to the affected contract. Disappointingly, none of the alternatives proposed during the *Capital Electric* debate are necessarily more fool-proof than *Eichleay*. Examples can, no doubt, be devised to discredit any formula.

In any event, choosing which formula to use is only part of presenting a claim for home office overhead. The contractor must also define a pool of overhead costs and consider if those costs should be segregated into fixed (time-related), variable (volume-related), and semi-variable costs. A general contractor with limited marketing, research and internal engineering costs is likely to present a very different home office overhead picture than the supplier of specially built industrial equipment.

Depending on the costs involved, the contractor might choose a combination of extended and percentage claims with some provisions taken to safeguard against a double recovery. If the contractor's top decision-makers have been heavily involved in the government-caused delay or disruption, an additional factor for distortion of the managerial function should also be considered, possibly supported by an expert's analysis and testimony. The applicability of any formula to subcontractors should also be analyzed carefully. The situation of an excavation subcontractor on a delayed tunnel project is going to be very different from the work extension of the mechanical subcontractor considered above.

In the final analysis, the contractor's claim for home office overhead, including its choice of allocation formula, must be supported by the facts of each particular case and the hard standards of common sense. The amount claimed must bear a reasonable relationship to the injury incurred. In many cases, the flat daily rate of *Eichleay* could be the best approach. In others, a variety of approaches like the BFM and the CAR could be considered for illustrative value, if not for calculation of the claim amount. The *Eichleay* formula is still a good analytical starting point, but there is no substitute for a detailed analysis of the facts and common sense.

STATUTE OF LIMITATION APPLIED TO MANUFACTURER OF BUILDING PRODUCT

STATUTE OF LIMITATION; SUPPLIERS

320; 335

Catanzaro v. Wasco Products, Inc.

489 A.2d 262 (Pa.Super. 1985)

A Pennsylvania court has ruled that that state's statute of limitation protecting designers and constructors also applies to manufacturers of building products.

A laborer employed by a high school fell through an acrylic skydome located on the roof of the building. The injured worker filed suit against Wasco Products, Inc., manufacturer and seller of the skydome.

Wasco moved for summary judgment based on 42 Pa.C.S. Sec. 5536. That statute disallows any action seeking recovery for personal injuries arising out of alleged deficiencies in the planning, design or construction of an improvement to real property brought more than 12 years after completion of the improvement.

The trial court granted summary judgment. The injured laborer appealed, arguing that the statute of limitation is not intended to protect "mere manufacturers" of building products. The plaintiff argued that manufacturers should be protected only if they had to customize the product to the real estate and assist in its installation.

The Superior Court of Pennsylvania disagreed with this argument and upheld the summary judgment. The Court said that, as the manufacturer, Wasco necessarily planned, designed and constructed the skydome. When installed, the skydome became part of the improvements to the real estate.

The Court said that the statute should be construed liberally to protect any party, regardless of trade or occupation, who performs one of the listed activities. This includes manufacturers selling standardized products used in the project. The Court cited cases applying the statute of limitation to manufacturers of elevators, revolving doors and furnaces.

Editor's Note: A good argument can be made to exclude manufacturers of non-customized building products and many states do so. Manufacturers are able to standardize their production processes and implement testing and quality control procedures. Designers and constructors have a very limited opportunity to do this, as each project is unique. Therefore, designers and constructors have a need for protection which manufacturers do not share.