PROOF REQUIREMENTS FOR RECOVERY OF OVERHEAD DAMAGES IN A CONSTRUCTION DELAY CASE

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I. INTRODUCTION

Construction delays cause a variety of problems. Delays can cause the idling or even shutdown of facilities for a period of time during the construction term. Delay can also cause a project to be extended well beyond the stated term of the contract. During periods of delay, a contractor continues to incur general and administrative, as well as fixed, overhead expenses. Through the years, courts have struggled to determine the proper manner in which elements of overhead expense are to be calculated and thus recovered from the party responsible for the delay and the degree of proof of necessary to establish the claim.[1]

The theory behind the recovery of overhead is fairly straightforward. Businesses have fixed overhead (e.g., rent mortgage payments, etc.) and fixed and variable general and administrative expenses (e.g., utilities, salaries, etc.) attributable to the home office of the business. Businesses allocate a portion of the contract price of their work to cover this overhead expense. For example, assuming a business has ten projects and assuming each is for the same amount covering the same period of time, the income from billings on each of these projects in a given month each cover 10 percent of the overhead. If one project is delayed such that no work is performed and no income from billings are received during the month, then 10 percent of the business's overhead expense is unabsorbed and can presumably be attributable to the delay. This is called "unabsorbed home office overhead." Another type of claim for home office expense is called "extended home office overhead" representing additional expense incurred when the completion of a project is prolonged beyond its scheduled completion date.

This paper will address the recoverability of "home office overhead" through an examination of a line of cases dealing with the most frequently used formula used to calculate lost or unabsorbed overhead as first explained in the Armed Services Board of Contract Appeals' holding in *Appeal of Eichleay*, ASBCA No. 5183, 60-2 B.C.A. (CCH) ¶ 2688 (1960).

II. THE "EICHLEAY" FORMULA

The allowance of overhead as an element of delayed damages was first granted to a government contractor in *Fred R. Combs v. U.S.*, 103 Ct. Cl. 174 (1945). In that case, the contractor was allowed to recover its overhead in direct proportion to the number of days its work was delayed while the federal government obtained clear title to the real property on which the project involved. Several years thereafter, the Armed Services Board of Contract Appeals derived

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[1] *See*, Darbyshire, *Home Office Overhead as Damages for Construction Delays*, 17 G. L. Rev. 761, 763 (1983) (inconsistent judicial treatment, lack of precise jurisdiction, failure to distinguish fixed and variable overhead, lack of in-depth analysis, and cursory examination lead to varying results).

a formula to allocate unabsorbed overhead in *Eichleay*. Over the past 35 years, this formula has frequently been utilized to compute unabsorbed overhead as a component of delay damages but not, however, without challenge.

The *Eichleay* formula computes the daily amount of overhead the contractor would have charged to the contract had there been no delay and awards the contractor the amount of overhead for each day of delay that has occurred during performance. The *Eichleay* formula is as follows:

Step 1:

$$\frac{\text{Contract billings}}{\text{Total billings for actual extended contract period (all jobs)}} \times \text{Total overhead incurred during contract period} = \text{Overhead allocable to the contract}$$

Step 2:

$$\frac{\text{Allocable overhead}}{\text{Actual days of contract performance}} = \text{Overhead allocable to contract per day}$$

Step 3:

Daily contract overhead x Number of days of delay = Unabsorbed overhead

Although the formula appears fairly straightforward, many courts have noted problems in application. The central and most significant complaint is that the automatic application of the *Eichleay* formula to delay cases relives the plaintiff of the burden of proving damages. To understand this and other problems associated the use of the *Eichleay* formula, it is necessary to review the appellate decisions which have addressed the formula.

III. THE APPLICATION OF *EICHLEAY*

In *Berley Indus., Inc. v. City of New York*, 45 N.Y.2d 683, 385 N.E.2d 281 (1978), the New York Court of Appeals denied the use of the *Eichleay* formula. In that case, Berley was an HVAC contractor with the city under a two-year, $472,000 contract. Due to delays admittedly caused by the city, Berley was unable to start until several months after its scheduled date of commencement. On the scheduled date of completion, Berley's work was 87 percent complete and only $60,000 remained to be paid under the contract. However, the contact was not completed until 355 days after the scheduled date of completion. The contract with the city was one of 11 projects on which Berley was working aggregating $5.8 million.

Following a favorable verdict, the trial court entered judgment for Berley awarding overhead damages under the *Eichleay* formula. In a footnote, the Court of Appeals applied the facts to the *Eichleay* formula.

$$\frac{\$\ 472{,}000}{\$5{,}800{,}000\ \text{(total contracts)}} \times \text{Total overhead for period } (\$568{,}352) = \$46{,}342$$

$$\frac{\$46{,}342}{806\ \text{days on site}} = \$57.50$$

$\$57.50 \times 335$ (period of delay) $= \$19{,}262$

Id. at 282 n. 1. The primary concern for the Court of Appeals was the seeming automatic application by the trial court of the *Eichleay* formula.

> It is fundamental to the laws of damages that one complaining of injury has the burden of proving the extent of the harm suffered. . . . Delay damages, including ones in overhead, are no exception. . . . A contractor wrongfully delayed by its employer must establish the extent which its costs were increased by the improper acts because its recovery will be limited to damages actually sustained.

Id. At 283. At trial, absolutely no evidence was presented by any of the Berley witnesses other than the mechanical application of the formula. No attempt was made by Berley to correlate the period of delay and its overhead costs.

Although the Court of Appeals acknowledged the difficulty in proving indirect costs as opposed to proving direct costs attributable to a delay, the Court did not excuse Berley's failure to present any evidence of harm. Moreover, the Court of Appeals rejected the trial court's "mechanical imposition of the formula" because it resulted in a "harsh delay penalty." *Id.* at 284. According to the Court, utilization of the *Eichleay* formula would have produced the same amount whether the project was 1 percent complete or 99 percent complete on the scheduled date of completion because it focused on the length of the delay to the exclusion of all other facts.[2] *Id.* As set forth above, the project in this case was 87 percent complete and the contract balance on the scheduled date of completion left only $60,000 payable out of a $472,000 contract.

A few years later, a Washington appellate court reexamined the *Eichleay* formula in light of the New York Court of Appeals decision in *Berley*. In *Golf Landscaping, Inc. v. Century Constr. Co.*, 39 Wash. App. 895, 696 P.2d 590 (1984), a subcontractor sued a contractor for lost or unabsorbed overhead. In that case, the contract period in question was to cover 120 days,

[2]The *Eichleay* formula also assumes home office overhead expenses are fixed which distorts reality. Even so, *Eichleay* is often criticized for its "misguided" view of the formula. Darbyshire, *supra*, at 793-94 n. 1.

however, the project was delayed for 109 days by the contractor. The trial court found the contractor caused the delay and the subcontractor had the ability to comply within the original contract period. The subcontractor was awarded unabsorbed overhead damages.

On appeal, overhead was recognized as a legitimate component of delay damages. The plaintiff complained, because of the delay, it had fewer other projects to which its fixed overhead could be charged and the defendant challenged this evidence as inadequate based upon *Berley*. The Washington Court of Appeals disagreed with the Court's analysis in *Berley*, finding it "fundamentally misconceives the theory behind unabsorbed overhead." *Id*. at 593. According to the Court, the relevant inquiry was whether delay prevented the plaintiff from obtaining other contracts during the delay to absorb ongoing overhead expense rather than whether the overhead increased which the Court found to be irrelevant.[3] The merits of the *Eichleay* formula were not at issue but the degree of proof required was. Since the plaintiff presented evidence of $150,000 in other jobs lost due to the delay the Court of Appeals allowed the recovery of unabsorbed overhead under the *Eichleay* formula.

In *W. G. Cornell Co. v. Ceramic Coating Co.*, 626 F.2d 990 (D.C. Cir. 1980), a contractor sued a pipe manufacturer for delay damages caused by the delivery of defective pipe which stalled the project for a year. At trial, the plaintiff recovered several elements of direct delay damages attributable to retaining a superintendent, cleanup costs, and the fair rental value for idle machinery. However, the plaintiff did not recover indirect damages in the form of overhead attributable to the one-year delay. On appeal, the District of Columbia Circuit Court of Appeals affirmed finding the plaintiff put on no evidence concerning the damage caused by the delay, how the delay prevented it from obtaining other jobs to absorb unallocated overhead or how delay otherwise caused it to refrain from bidding on other projects. As in *Berley*, the Court emphasized its concern over mechanical application of the *Eichleay* formula, stressing the recovery of overhead is not "automatic." *Id*. at 994. A plaintiff must show that its resources were unavailable for other jobs and that other jobs were available. *Id., citing, Kansas City Bridge Co. v. Kansas City Structural Steel Co.*, 217 S.W.2d 370 (Mo. 1958).

Following closely on the heels of *Cornell*, was the case of *Guy James Constr. Co. v. Trinity Indus., Inc.*, 644 F.2d 525 (5th Cir. 1981) involving the delays experienced on the construction of the Dallas/Fort Worth Airport. In that case, the general contractor's recovery of home office overhead against a supplier for the delay in the delivery of girders was denied, again, for lack of evidence of damage.[4] In that case, the president of the company testified the company's home office overhead was fixed and would have been incurred regardless of the delay; no equipment was left idle because of the delay; the delay did not prevent the company from taking

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[3]Neither *Berley* nor *Golf* drew a distinction between "extended" and "unabsorbed" home office overhead as have very few other courts.

[4]Field office overhead was, however, allowed by this Court and affirmed by the Fifth Circuit. Apparently, the contractor's commitment to the project required a full-time superintendent to remain on site for a significant period of time.

on other work; and there was no evidence that any bids were not made because of the contractor's commitment to the delayed project. *Id.* at 532-33. In addition, the Fifth Circuit, relying on *Cornell* and *Kansas City Bridge*, held a plaintiff was required to prove "additional" overhead expense was the proximate result of the delay–that is, expense in excess of the fixed expense item normally incurred and attributable to a delay which inhibits performance of other available construction projects. *Id.*

As set forth above, there are two types of overhead damage: (1) extended home office overhead; and (2) unabsorbed home office overhead. None of the decisions previously discussed made any distinction between the specific type of home office overhead sought.[5] Indeed, with the exception of *Golf*, the litigants in each of the cases were apparently relaying on the automatic or mechanical application of the *Eichleay* formula with almost no correlation to the harm suffered attributable to the delay. In that setting in 1984, the General Services Board of Contract Appeals rejected the use of the *Eichleay* formula to calculate "unabsorbed overhead" in delay claims. This holding was reversed on appeal by the Federal Circuit Court of Appeals in *Capital Elec. Co. v. U.S.*, 729 F.2d 743 (Fed. Cir. 1984).

In *Capital*, the prime contractor sued the government and sought to recover overhead for a 303-day suspension of the work pursuant to the *Eichleay* formula. The government argued the contractor sought the automatic application of *Eichleay* in order to escape the burden of proof to establish injury. On the contrary, the Court of Appeals found the plaintiff demonstrated it could not have taken on another large construction job during the periods of delay due to the uncertainty of the length of the delay and because its bonding capacity was reduced and limited due to its commitment to the project. *Id.* at 745. According to the Court, this was evidence of harm reflecting the economic realities of the construction industry and allowed recovery. Although only mentioned in a footnote, the Court addressed the distinction between the two types of overhead damage in response to the government's position that *Eichleay* was unavailable. The Court determined the *Eichleay* formula was available for either type of home office overhead damage conditioned upon a proper evidentiary showing.

Following *Capital* was the case of *George Hyman Constr. Co. v. Washington M.A.R.T.*, 816 F.2d 753 (D.C. Cir. 1987). In that case, the Court observed disruption, suspension, or delay caused by the government can reduce the stream of direct costs in a contract, making it appropriate to use *Eichleay* to calculate "extended home office overhead," however, recovery would not be permissible unless the delays were sudden, sporadic, and of uncertain duration making it impractical to take on other work during the delay period. *Id.* at 757. The District of Columbia Circuit Court based this holding on a footnote in *Capital* which described the innumerable and unanticipated delays experienced by the contractor in that case. *Capital*, 729 F.2d at 746 n. 5.

[5]Due to the lack of discussion in these cases of the evidentiary background or foundation on the types of harm caused by and sought for the delay, the failure of these courts to discuss the types of overhead damages is understandable.

The next case to draw the distinction between the two recoverable types of home office overhead was *Southwest Eng'g Co. v. Cajun Elec. Power Co-op, Inc.*, 915 F.2d 972 (5th Cir. 1990). In that case, an engineering firm sued the power company for damages following suspension and then cancellation of its contract. There, work was suspended in April of 1983 when the engineering firm's work was 60 percent complete and the contract was finally terminated in September 1984–almost 18 months later. The trial court awarded the unabsorbed overhead and the Fifth Circuit affirmed.[6] *Id.* at 975.

In that case, the defendant claimed the engineering firm was required to but failed to demonstrate it had incurred additional overhead and failed to show it could have gotten other work but for the delay, relying in *Guy James*, 644 F.2d at 533. The Fifth Circuit distinguished the defendant's reliance on *Guy James* by finding it involved "extended overhead" whereas the facts in *Southwest Eng'g* triggered an analysis of the "unabsorbed overhead." According to the Fifth Circuit, the only requirement for the recovery of unabsorbed overhead is to "show some further impact of the suspension itself, such as idling of its forces due to the inability to secure replacement work because of the uncertain nature of the suspension or the lack of bonding capacity." *Id.* at 978. Southwest Engineering was unable to obtain replacement work; it tried but was unable to absorb the overhead which could and should have been allocated to this job; and was forced to allocate a greater share of its overhead to other jobs and make up the difference from its profits. According to the Court, the evidence presented established a claim for "unabsorbed" rather than "extended" overhead.[7]

Southwest Eng'g is significant because it also distinguished between the types of proof necessary to establish each of the two kinds of overhead damage.

> The requirement of *Guy James* that a contractor show added overhead costs, which exceed its normally incurred fixed expenses attributable to ongoing operations, is a sound one for extended overhead but not for unabsorbed overhead. In an extended overhead situation, where a job spills over into the time frame not allocated for that job, a contractor may still be able to complete the work without incurring "added" overhead costs because of, for instance, a plant's under-capacity. In such circumstances, it would be appropriate to require a showing that the contractor has incurred added overhead costs resulting from the prolongation. . . . Unabsorbed overhead cases, on the other hand, present a

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[6]The *Eichleay* formula was not used in this case. The contract between the parties called for an adjustment for overhead in periods of suspension.

[7][E]xtended overhead is a concept unique to construction contracting" and is defined as the additional costs incurred when a job's performance period is prolonged. Unabsorbed overhead, on the other hand, is more closely related to manufacturing cost accounting and occurs when the overhead for a fixed segment of manufacturing time must be spread out among fewer jobs, because one of the jobs assigned to that time period has been suspended or delayed. The costs sought by SWECO, which occurred during the suspension period, are part of its ordinary fixed overhead that would normally be allocated to all jobs and not additional costs attributable to an extended performance period as in *Guy James*." *Southwest Eng'g*, 915 F.2d at 978 (emphasis added).

> different situation. In such cases, damage awards are made because overhead resources have been furnished for a particular job that is subsequently suspended. Under these circumstances we would not expect to see "added" overhead costs, and, indeed, we may even see a drop in overhead costs if, for example, employees are laid off. A damage award in these cases, however, is made not because of "added" overhead costs, but because a portion of existing overhead costs, which would have been absorbed by the suspended job, must now be spread out among the remaining jobs.

Id. at 978. The Firth Circuit's analysis is the most cogent publication of the distinction between "extended" and "unabsorbed" overhead and the quantum of proof required to trigger and to recover overhead. Understandably, with the exception of *Capital*, all of the other cases blurred this distinction due in no small part to a failure of the parties in those cases to distinguish between the types of overhead themselves.

IV. WILL TEXAS FOLLOW *EICHLEAY*?

The overriding theme in all of the cases cited above is the notion a claimant must make some threshold showing of harm caused by the delay. Mere mechanical application of the *Eichleay* formula is routinely rejected. The latest case dealing with the application of *Eichleay* to a claim for overhead comes from Texas and follows this theme. In *Chilton Ins. Co. v. Pate & Pate Enter., Inc.*, No. 04-94-00028-CV; 1996 W.L. 121112 (Tex. App.--San Antonio, Dec. 11, 1996), a surety company appealed a damage award in favor of the general contractor including home office expenses based upon a modified *Eichleay* formula. According to the Court, the contractor sought "extended home office overhead" rather than "unabsorbed home office overhead" based upon the distinguishing characteristics discussed in *Southwest Eng'g*, *Capital*, and *Guy James*. Because the plaintiff identified no additional costs incurred because of the delay and because it "admitted that the damage claim was the product of a mathematic formula derived from normal overhead costs," the Court found little to substantiate plaintiff's claim it incurred overhead expenses beyond those costs which would have accrued whether the project was delayed or not. This Court reversed the judgment in this respect finding it against the great weight and preponderance of the evidence.

The lesson to be learned from all of these cases is to ensure that the record reflects injury or harm caused by the delay. These cases provide examples of the type of proof necessary to substantiate such harm. These cases also demonstrate the need to identify the exact nature of the overhead claim either in terms of "extended home office overhead" or "unabsorbed home office overhead." The San Antonio Court's handling of the claim for and calculation of overhead under *Eichleay* indicates it will probably be allowed in Texas given a proper record.

V. VARIATIONS OF "*EICHLEAY*"

The opinions in *Capital* and *Chilton* both make reference to a "modified" *Eichleay* formula. While the Court in *Chilton* did not discuss the elements or merits of such a modified

formula, the Court in *Capital* did. In *Capital*, a modified formula produced a daily contract overhead rate of $446 whereas under the standard *Eichleay* formula the daily contract overhead was only $311. Without explanation or noting the difference, the Court of Appeals chose to follow the lower *Eichleay* formula. The Court also failed to explain why the *Eichleay* formula is an accurate measure to both "unabsorbed" and "extended" overhead cases.

As recognized by the New York Court of Appeals in *Berley*, one of the chief concerns over the *Eichleay* formula is its failure to focus on anything other than the number of days of delay. The formula does not take into account situations where the claimant works on the project, albeit at a reduced capacity, during the period of delay. A variety of commentators have echoed these concerns and others.[8] One commentator poses the following hypothetical which demonstrates *Eichleay*'s failure to take into account the actual level activity on a job during the delay period.[9] Assume a $600,000 contract to be performed over a seven-month period of time with scheduled billings of $50,000 the first month, $100,000 for the next five months, and $50,000 in the seventh month. Further assume that no other contracts exist and a general and administrative expense rate of 5 percent. Finally, assume a delay which reduced work and billings in the third and fourth months to only $50,000, moving the seventh month's billings to the eighth. The result which flows from the *Eichleay* formula is as follows: Since the numerator and denominator for contract and total billings are the same ($600,000), the 5 percent general and administrative expense rate produces overhead of $30,000. The overhead divided by the days of contract performance (210) produces a daily overhead rate of $142.86 which, when multiplied by the 30 days attributable to the delay equals an overhead unabsorbed of $4,286.

In the above hypothetical, *Eichleay* does not take into account the actual but reduced level of work on the job caused by the delay. The commentator suggests an alternative formula to *Eichleay*. Since billings on the project during the original seven-month period were reduced by $50,000, it is suggested the amount <u>not</u> billed as planned during the original contract period be multiplied by the general and administrative ratio to arrive at the overhead figure ($500,000 x 5% = $2,500).[10]

It should be recognized the hypothetical presents an "unabsorbed" overhead scenario. The disparity between the number produced by the *Eichleay* formula and the suggested alternative is significant, especially in light of the simplicity of the hypothetical. Indeed, the hypothetical does not assume other projects and encompasses only one 30-day delay. A variety of modifications to the *Eichleay* formula have been discussed by commentators to address varying aspects of the *Eichleay* components and problems with each. An exhaustive analysis of all these variations is

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[8]Darbyshire, 17 Ga. L. Rev., at 791-809, *supra*, n. 1; McGeehin, *A Farewell to Eichleay?*, 14 Pub. Contract L.J. 276 (1984); Elger & Darbyshire; *Recovering Home Office Overhead as Damages for Delay*, Constr. Litigation Rep., Nov. 1983 at 172.

[9]McGeehin, at 281-82.

[10]McGeehin, 281-81.

beyond the scope of this paper. However, once a claimant decides to pursue and can establish a claim for overhead, unabsorbed or extended, *Eichleay* and many of its modifications can be an effective measure of the loss.

VI. CONCLUSION

The realities of the construction industry clearly reflect that the number of delays, extent of delays, duration of delays, and uncertainty of delays, considered along with other pending projects, can present serious proof concerns with regard to extended or unabsorbed home office overhead. The utilization of a formula to compute overhead damage greatly simplifies the task of litigants. However, a formula, in light of the cases discussed in this paper, should never be applied automatically or mechanically. A quantum of proof is necessary to establish the threshold existence of injury. The nature of the contractor's damage attributable to either unabsorbed or extended home office overhead should be addressed and supported by evidence. With that threshold showing, courts will more readily allow such a claimant to utilize a formulaic measure to calculate the damage. As evidenced by the Court of Appeals' decision in *Chilton*, Texas courts are no less exacting in the proof they require.