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Material price escalation – What is a contractor to do? - by Jared Cohane

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The fallout from the COVID-19 pandemic continues to plague the construction industry in many ways, but perhaps the most significant erosion to the contractor's bottom line has come in the form of market volatility for construction materials. The lack of materials due to worldwide supply chain impacts, as well as increased production costs and tariffs, have caused prices for building materials to soar to unprecedented heights. The usual suspects for price escalation – steel, copper, lumber, engineered wood products and plastic-based materials – have seen wild price fluctuation over the past six months to a degree not seen in decades. In the traditional hard bid, fixed price contracting project delivery method, the contractor usually bears the financial risk of material price fluctuation. That volatility not only threatens a contractor's profit margin on a given project, but also, in some cases, the ongoing viability of some construction firms. Here are some strategies to deal with the economic uncertainty of the current market.

Seeking Contractual Relief for Price Escalation

Fixed price contracts, including unit prices or even cost reimbursable contracts with guaranteed maximum prices, remain equally exposed to market volatility because in the end, it is the contractor that bears the risk of only being paid up to the final fixed price. The only sure-fire manner in which to insulate against price escalation is through negotiation of a material escalation clause. A typical escalation provision acknowledges that the contract price is based on current pricing for building materials, but that certain building materials are considered subject to sudden price increases. Escalation provisions provide for an equitable adjustment if the price increases exceed a certain threshold percentage of the as-bid price. In some instances, material escalation clauses provide for adjustment due to price increases realized from the day the contract is executed by the parties. Such a provision is commonly referred to as a "Day One Escalation" provision and provides that the material prices shall be reimbursed for actual cost of material from the date of purchase plus reasonable overhead and profit – essentially converting the material procurement component to a "cost-plus" scenario.

Owners desire price certainty, and will typically push back against negotiating price escalation clauses, particularly "Day One" or cost-plus types of clauses. One negotiating strategy to make an escalation provision more palatable to an owner is to limit the provision to specific types of materials (i.e., copper, engineered lumber products) based upon a threshold percentage of increase from the as-bid price. Another strategy is to include a commensurate savings provision that account for any decrease in pricing for materials to the owner's benefit. These options, of course, requires cost transparency, adding another administrative level to the billing process, but offers an equitable measure of protection for both sides.

Another option that might already exist in a typical construction contract is the delay provision, which could provide for an equitable adjustment for material cost increases realized due to project delays beyond the control of the contractor. However, contractors need to be mindful of "no damages for delay provisions", which can legally undermine a request for equitable adjustment for price increases incurred due to project delay. Many jurisdictions have common law exceptions to "no damage for delay" provisions, but in an ideal situation, contractors can negotiate express exceptions

to account for price escalation.

Contracts containing “time is of the essence” provisions are another potential delay-related avenue for relief from significant material price increases. Typically, these timing provisions are bilateral – the contractor’s commitment to completing the project on time and the owner’s commitment to providing complete and accurate design information and access to work fronts in keeping with the as-planned construction schedule are opposing sides of the same coin. If a contractor is able to lock in pricing with material suppliers for a given period based upon the anticipated procurement and construction schedule could potentially preserve and strengthen a price escalation claim should there be an event of excusable and/or compensable delay.

Another strategy is to negotiate a financial contingency for material escalation. The contingency can identify specific types of construction material, such as copper or engineered wood products that are traditionally unstable, and set a threshold percentage of increase in pricing that affords the contractor the opportunity to tap into this contingency. The contingency is for the benefit of the contractor but offers some cost certainty and dispute avoidance for the owner.

Finally, negotiating a provision for up-front procurement and storage of materials is another means of protection. Such a provision allows the contractor to procure materials at the very beginning of the job to ensure the procurement occurs while the material supplier’s quoted price at the time of bid remains viable. The contractor receives partial payment for stored materials, and the owner obtains assurance that no claim for material escalation will arise later on in the job.

Other Strategies for Dealing with Price Escalation Problems

While the contract strategies discussed above are the ideal manner in which to deal with price escalation problems, in this competitive market it is difficult for contractors to find the negotiating power to leverage the inclusion of price escalation clauses into their contracts. For instance, the standard AIA contract forms widely used in the construction industry do not contain a price escalation provision, so the contractor needs to be prepared to negotiate its inclusion. However, there is often little incentive on the part of the owner to capitulate to the addition of any provisions that result in cost uncertainty from the owner’s perspective. Therefore, the pressure on the estimating team to find creative ways to account for material escalation while remaining competitive is significant.

Negotiating with material suppliers for extended fixed pricing windows is another way a contractor can limit price volatility risks. This is obviously dependent upon the contractor’s relationship and negotiating strength with its suppliers. Negotiating a 60-90 day hold on pricing at a minimum is critical, especially in circumstances where there is a delay between the bid and the start of construction. Qualifying bid pricing to the owner based upon negotiated windows of held pricing from suppliers is essential to preserving delay-related price increase claims. But that strategy could be fraught with risk, as qualifying the bid could result in its rejection for being non-responsive. Ultimately, if a qualified bid is accepted, it is essential to ensure that the proposal is incorporated into the contract.

If all else fails, there remains potential recourse under change of law, cardinal change or force majeure provisions often included in construction contracts. Change of law provisions offer the strongest option for recapturing price increases in circumstances where the contractor can demonstrate that a change in tariffs or other regulations affecting the trade of construction goods internationally result in an unforeseen cost increase. Price increases alone typically do not support a cardinal change or force majeure event absent extenuating, unforeseeable circumstances. The early impacts of the COVID-19 pandemic is one example where a force majeure clause has been utilized as a legal basis for pushing material cost increases upstream. However, we have been living in the COVID world for more than 18 months, and the strength of the force majeure argument has waned significantly, particularly for projects that bid during the height of COVID once bidding contractors had gained a better understanding of the cost impacts posed by the pandemic.

In the end, open dialogue between contractors and owners during the bid phase to address the economic uncertainty of the current times in a fair and equitable manner remains the best practice for all concerned. By fairly allocating this risk in the beginning, the parties can avoid impacts during construction and, ultimately, litigation. Litigation avoidance is a strategy that proves mutually beneficial to owner and contractor alike.

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