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Include Materials Price Escalation Clauses in Construction Clauses

Written by: Robert Alfert Jr., Partner, Nelson Mullins Broad & Cassel

The construction sector has been in a bull market for an unprecedented period of time. With the novel impacts from the coronavirus - and all the associated side effects, such as government moratoria, shipping delays, and materials availability - we are now in a market of extreme volatility in pricing, inflation, and increasing capital finance rates. And yet the construction sector continues to plow forward despite uncertainty, producing critical infrastructure, and much necessary housing, among other projects. The signs are that this trend will continue at least through Q1 of 2023, and likely beyond that, especially when you factor into the equation the many billions of dollars being placed into the market through the Bipartisan Infrastructure Law.

It is not surprising, therefore, that the number one issue in construction contracts in 2022 was how parties handle inflation and materials cost escalations in existing contracts and in the negotiations for new contracts. There is no other issue more heavily negotiated, often disputed and hotly debated in the construction sector today.

While this may sound provocative, the private market reality is this: Hard lump sum and guaranteed maximum price contracts are a thing of the past, at least for the near-term future. It's not common to see a hard GMP or lump sum that does not provide some form of relief for unavoidable materials cost escalations. Some projects are proceeding on a cost-plus basis, which, historically, was a contracting model reserved for unique projects with a challenging number of unknown conditions

or incomplete designs. The data is admittedly a bit more unique in the public sector, at least on hard-bid jobs where contractors can bid with a contingency to cover this risk, but it is a line item that is generally not seen in any breakdown. The current reality is that qualified contractors, subcontractors, and suppliers are not likely to provide firm or hard quotes without some form of relief to fairly allocate the risk of inflation. The intent of this column is to identify the current market realities and risk and outline the various contract mechanisms that parties can use to allocate risk and cost in an equitable manner.

CONTRACT OPTIONS

There is no one-size-fits-all solution to handling cost escalation on a construction project. The most common contractual approaches to address the risk allocation for materials cost escalations include the following:

1. Perhaps the most common option is to simply set a benchmark for price increases that become compensable to the contractor. For example, the contract can designate a certain percentage of price increase above the materials or subcontract line item in a schedule of values, say something like 5% and every dollar above that benchmark becomes reimbursable. While the percentage benchmark is obviously subject to negotiation, it is normally correlated to the contractor's fee and rarely higher than the fee. A fair compromise is setting a benchmark that is below the fee, so the contractor's profit is not entirely at risk on one project.
2. Another option is to use a contingency clause as the exclusive remedy for materials price escalations. This option provides the contractor with a bucket of certain monies allocated to the risk of price escalation and, for the owner, caps exposure to a certain negotiated sum. The strategy can be used in a standard construction contingency provision or, in more sophisticated contracts, setting aside a second, specific contingency just for materials price escalations. In the scenario where two contingencies are used, the parties should address whether they are mutually exclusive and how each can be drawn down.
3. Some more sophisticated contracts use a hybrid approach, with a materials price escalation clause that is only triggered after the price escalation of the materials in question exceeds a certain benchmark percentage or amount. Parties can also set up this approach where there is an allocation of liability after the materials escalation clause contingency is exhausted. For example, the contractor carries 75% of the price escalation for the first hundred thousand dollars above the contingency; the parties share the materials price escalation, 50% each, for the next hundred thousand dollars; and, thereafter, the risk is allocated 25% to the contractor and 75% to the owner. Obviously, that "ladder" of risk allocation can be negotiated in a myriad of ways.
4. Some parties are still trying to address materials price escalations in standard force majeure clauses. A standard force majeure clause can be expanded to include unexpected materials price escalations or, more specifically, price escalations tied to specific events such as shipping delays and materials availability. Frankly, this is a less sophisticated approach to risk allocation and one that places more exposure on the contractor, as now the contractor must demonstrate an entitlement to the materials price escalation relief tied to an event of force majeure.

ADDITIONAL CONSIDERATIONS

Regardless of what approach is used to address the risk of materials price escalations, contracting parties should also address some of the following additional considerations.

» A balanced contract should require the contractor to provide timely notice to the owner when a specified materials will exceed the schedule of values and trigger the materials price escalation relief. The notice accords the owner an opportunity to work with the contractor to control the price through some other option, which could include value engineering, materials substitutions, or some other approach.

» Another way to control the risk of price escalations is to put a timeframe on buyout. Generally speaking, the faster the contractor can buy out all of the subcontracts and supply contracts, the less exposure there theoretically should be to significant price deviations from the schedule of values.

» The contract may also include special provisions that allow for the early acquisition and either on-site or off-site storage of the major materials for the project. The intent is to lock down the price of all the key pieces of materials needed for the project rather than waiting until that certain materials is necessary for the project, which could be an important issue for projects of a longer duration.

» The parties need to address how mark-ups on fees and general conditions are handled in circumstances where materials price escalation relief is allowable. The common consensus is that no fee mark-ups should be allocated since the contractor has not necessarily done anything additional in terms of labor by virtue of getting a contract increase solely attributable to market conditions. Mark-up items tied to project value, such as surety bonds and insurance, should be allowed.

- A more sophisticated approach to these price escalation provisions could also include specific designations of materials that are actually subject to price escalation relief, such as higher volatility materials including lumber, asphalt, and steel. This approach would also address whether other cost escalations, such as labor, are subject to relief as well.
- The savings clause and how any savings is allocated between the parties requires greater consideration where the parties use materials price escalation provisions. While these percentages are always subject to negotiation, and the market does not necessarily seem to have a consensus on exactly where the numbers should rest, the data does demonstrate that once the materials price escalation contingency is used, more commonly, any savings reverts 100% to the owner.
- Finally, the parties should also coordinate the other provisions of the contract that could arguably provide additional relief for cost escalations. That way, there is no unintentional double-dipping or conflict. For example, a standard force majeure provision could create grounds for a contractor to seek a change order for additional materials costs attributable to a force majeure delay to the schedule, shipping irregularities, materials available or delay, or some other factor. Absent coordination of provisions, the argument could arise that this type of force majeure provision creates an independent basis for relief and is not tied to either a materials price escalation percentage or a contingency.

Tremendous change has occurred in construction contracts over the last two and a half years, especially in the force majeure and contract price relief context, and it does not appear that 2023 will revert to prior practices. If anything, the market continues to reveal a certain degree of volatility that justifies the parties continuing to apply a more conscientious and customized approach to how they handle the allocation of risk and liability. Hopefully the thoughts expressed in this column will assist parties in negotiating more fair, balanced construction contracts in this ever-increasingly complicated market.

About the Author

Robert Alfert, Jr., is a partner in the construction law and litigation practice of Nelson Mullins Broad & Cassel, where he focuses on construction law and litigation and infrastructure and transportation, including public-private partnerships. He can be reached at Robert.alfert@nelsonmullins.com.

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