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PRACTICAL ADVICE FOR MANAGING PRICE ESCALATION THROUGHOUT A CONSTRUCTION PROJECT

Introduction

As recently discussed by a panel of construction industry leaders in the Washington DC Metropolitan area, material price escalation is the biggest concern facing the construction industry this year.¹ The prices of raw construction materials, particularly steel and lumber, have been rapidly increasing since early 2020. The Associated Builders and Contractors recently reported that iron and steel prices were up 15.6% from January of 2020 to January of 2021, and that softwood lumber prices had increased by as much as 73% during the same period. As a result, there has been a dramatic discrepancy between ultimate input costs and bid prices submitted by subcontractors for raw materials. That has led to significant economic risk, which has fallen disproportionately onto the shoulders of NECA members.

NECA members are struggling with this issue and the associated risk. The question addressed here is how can a NECA member attempt to manage this risk? The answer depends upon what phase is the project in; bidding, contract negotiation, or performance. Each phase requires different strategies to manage the risk.

While there is certainly no magic bullet, and members are encouraged to seek competent local legal counsel and financial advice, we trust that this white paper will assist with some general guidance and practical advice.

I. The Bidding Phase

During the bidding phase it is extremely important for your team to identify potential materials that could be subject to escalation during the life of the project. Builders have typically factored in inflation in material prices via historical data and forward-looking trends alone. This is no longer; however, a thorough enough examination to mitigate the risk.

We live in a global society and construction materials are manufactured and shipped world-wide. Thus, it is time to factor in the risks of supply chain interruption.² Additionally, material fabrication can be unexpectedly interrupted.³ Finally, unusually severe weather in other parts of the world can impact price by damaging facilities or simply delaying production,

¹ “DC Construction and Development Forecast,” BISNOW (Feb. 11, 2021).

² No one expects that a container ship will get stuck for a week in the Suez Canal causing a cascade of delayed shipments, but we are now all keenly aware that it can happen.

³ A power outage in China could damage, or substantially delay, production of cable at a manufacturing facility on which the subcontractor’s work depends.

resulting in supply challenges for projects. Natural disasters may also delay either the completion or start of a project, which increases the potential for cost escalation by drawing out the overall schedule.

Historical data related to cost or durations that worked a year ago are now hopelessly outdated due to supply chain issues, labor costs and availability, and COVID-19. NECA members should pay special attention to improving the accuracy of this information continuously. It would be a wise use of time to assign your estimating department the task of monitoring these trends so that they can factor in the most accurate information to the project estimate. One of the best sources for such monitoring is the Producer Price Index put out by the U.S. Bureau of Labor Statistics <https://www.bls.gov/ppi/>. The index can help you track increases in everything from copper, insulation, iron and steel and regular gas, just to mention a few.

Another action to remove some exposure to escalation during bid phase, is to consider identifying high-risk scopes, and then contemporaneously educating the general contractor and owner on the risks associated with that particular scope. Additionally, collaborating with the general contractor and the owner to get the related design early so that at risk scopes are fully completed and clear can help mitigate the risk.

Another potential opportunity to mitigate the risk is to reach agreement on a focused and phased bidding, as opposed to a full and final bid to spread the required bidding knowledge to periods when the scope is truly clearer. The downside of this strategy, however, is that later scopes are more exposed to escalation if the overall procurement time frame stretches out. A big picture thought process is needed under this approach.

Often, time really is money. The construction schedules you commit to are a key encountering and mitigation of escalation risks. Subcontractors, in conjunction with their general contractor, should examine the schedules in the drafting stages for areas where escalation risks can be mitigated. This could entail accelerating portions of the project to reduce the duration and limit exposure to forces contributing to escalation. It could also entail building additional time into the schedule or increasing float to allow for a more reliable or cost-effective supply chain to be used.

Another way to limit risk in the bidding phase is to limit the term of the fixed price contract bid. That is, if a subcontractor is "forced" to enter fixed price, then it should make clear in its bid that the price is only "valid" for a limited number of days. Thus, if the acceptance of the contract is significantly delayed the subcontractor does not bear the risk of increasing prices over that period and can re-assess and reprice accordingly.

II. The Contract Negotiation Phase

An incredibly important phase to mitigating material escalation risks is during the negotiation of the contract. There are certain clauses and contractual agreements that are particularly important for this issue. These terms are:

A. The Escalation Clause;

- B. The Force Majeure Clause;
- C. The Equitable Adjustment and Changes clauses; and
- D. Other Miscellaneous Contract Terms.

A. The Escalation Clause.

Development of mutually acceptable, contractual material price escalation provisions can provide a fair sharing of risk and save the project from controversy during construction. Such a clause allows the parties to adjust the price based on some agreed-upon metric. For example, the measure could be the difference between the price quoted at bid time and the price of the material when delivered if the price change exceeds an agreed-upon percentage threshold.

One way to argue for inclusion of an escalation clause is to point out that the provision can also work as a savings clause if material prices decrease beyond a certain threshold. Communicating this shared commitment to pricing changes can be a useful incentive to facilitate the inclusion of an escalation clause in your contracts.

Escalation clauses typically fall into two categories; cost-based clauses which seek to compare actual incurred costs with bid costs and index-based clauses which track and adjust prices based upon numerous existing material price indexes. Examples of material price escalation clauses to consider are as follows:

The contract price for this construction project has been calculated based on the current prices for the component building materials. The market for the building materials that are hereafter specified is volatile, and sudden price increases could occur. The subcontractor agrees to use its best efforts to obtain the lowest possible prices from available building material suppliers, however, should there be an increase in the prices of these specified materials that are purchased after execution of contract for use in this residential construction project, the general contractor agrees to pay that cost increase to the subcontractor. Any claim by the subcontractor for payment of a cost increase, as provided above, shall require written notice delivered by the subcontractor to the general contractor stating the increased cost, the building material or materials in question, and the source of supply, supported by invoices or bills of sale.

<i>Building Material / Current Price per (Unit of Measurement) / Date / Supplier</i>			
1)	_____ / _____	_____ / _____	_____ / _____
2)	_____ / _____	_____ / _____	_____ / _____
3)	_____ / _____	_____ / _____	_____ / _____
4)	_____ / _____	_____ / _____	_____ / _____
5)	_____ / _____	_____ / _____	_____ / _____

Another simpler example is:

If, during the performance of this contract, the price of significantly increases, through no fault of subcontractor, the price of shall be equitably adjusted by an

amount reasonably necessary to cover any such significant price increases. As used herein, a significant price increase shall mean any increase in price exceeding ___% experienced by subcontractor from the date of the contract signing. Such price increases shall be documented through quotes, invoices, or receipts. Where the delivery of is delayed, through no fault of subcontractor, because of the shortage or unavailability of _____, subcontractor shall not be liable for any additional costs or damages associated with such delay(s).

There are numerous iterations of price escalation clause out in the world. These are just two examples of what might help to mitigate the risk. Lastly, NECA members may want to invest in a subscription to <https://www.consensusdocs.org/>, as they have a price escalation template that has been developed through peer review.

B. The Force Majeure Clause.

We have all become intimately familiar with the *force majeure* clause during this time of global pandemic.⁴ Generally, the clause excuses a contractor's performance for catastrophic or otherwise unanticipated events identified in the contract, such as extreme weather, wars, strikes, and changes in the law that would make performance impossible. In short, the parties must be blameless for the cause of the delay. A well-drafted *force majeure* clause will identify:

1. Who is entitled to relief under the provision,
2. The circumstances under which a party is entitled to relief,
3. The type of relief given for the event, and
4. When and how a party must provide notice of the underlying condition.

Unfortunately, the relief under these clauses are generally limited to extensions of time only. If that is the case, you may request an extension of time—which may help you deal with extended material lead times—but you are not entitled to monetary relief for the price escalation.

That does not mean that the *force majeure* clause is not important in the case of a material price escalation. It is still important because often material escalation is the result of supply chain interruption. Under that circumstance, since no party on the project is technically responsible for the issue that caused the delay that led to the escalated costs, time extensions are an important method to stave off liquidated or other delay damages.

C. The Equitable Adjustment Clause.

If you do not have a *force majeure* clause that actually permits adjustments to price (rare), or a material escalation clause, you might consider requesting relief by way of equitable adjustment or change order based on the commercial impracticality of the price increase. Some courts have found that unforeseen price increases can be significant enough to merit an adjustment or reformation of a contract. But other courts have been less sympathetic to this type of argument.

D. Other Miscellaneous Contract Terms.

⁴ If you are a federal contractor, then you know the functional equivalent of a *force majeure* clause is FAR 52.249-14 (Excusable Delay).

Finally, there are several other places that you can make changes to terms in the contract which can limit the risk of a material price escalation.

1. Materials Pre-purchase and Storage

General contractors have options related to the procurement of materials, and a strategic delivery/storage plan that may reduce escalation risk. The general contractor may facilitate this via payment for stored materials. Negotiation of terms related to material pre-purchase may substantially reduce this risk. It should be noted, however, that the subcontractor must consider the logistic and insurance expenses associated with pre-purchase and storage when negotiating this pre-purchase.

2. Allowances

Another potential place to mitigate the risk of unanticipated price escalation is to specifically create an allowance in the contract. In the interest of sharing risk, the allowance may be written so that, unlike in other circumstances, it could not be used or triggered for any other purpose than a material price increase.

3. Termination rights

Finally, negotiation of special terms into the subcontract related specifically to termination rights for substantial material escalation costs. For example, one might add the following to the contract terms:

Should there be a rise in the cost of any specified building material or materials, exclusive of any other price changes, that would cause the total contract price to increase by more than ___(%), the subcontractor shall, before making any additional purchases of specified material or materials, provide to the general contractor a written statement expressing the percentage increase of the contract price, the building material or materials in question, and the dollar amount of the price increase to be incurred. The general contractor may then, at its option, terminate the contract by providing within ___business days both written notice of termination to the subcontractor, and payment to the subcontractor for all costs expended in performance of the contract to the date of termination, plus payment of a prorated percentage of the subcontractor's profits based on the percent of completion.

Should both notice of termination and full payment not be forthcoming within ___business days, as provided herein, the subcontractor shall have the option to terminate the contract, or to proceed with the contract and purchase the specified building materials at the increased price. If termination is elected, the subcontractor shall provide to the general contractor a written notice of termination, and the general contractor shall be required to pay the subcontractor for all its costs expended in performance of the contract to the date of termination, plus payment of a prorated percentage of the subcontractor's profits based on the

percent of completion. If the subcontractor elects to proceed on the contract, it may then purchase the specified material or materials at the increased price, and the general contractor shall be required to pay the increased cost incurred.

Of course, all these suggestions require careful attention to the contract terms and a willingness to negotiate those terms to spread the risk fairly amongst the parties. Consult your attorney when making changes to the contract language to best help to mitigate this risk before you enter the contract.

III. The Performance Phase

Finally, there is the last relevant phase of the project to address material escalation, i.e., the performance phase.⁵ First and foremost, a subcontractor should always monitor its costs versus the estimate over the entirety of the project. As mentioned earlier, strong pre-construction service during bidding is essential for setting costs and scheduling. Monitoring the project during performance and determining alternative methods and solutions and providing early identification of issues and risk management when an escalation occurs or looks likely to occur is equally as important.

In this situation, the subcontractor has signed a firm fixed price subcontract and an unexpected material price escalation has cropped up for the work. There is no material escalation clause, allowance, or other mechanism to deal with the problem. What can be done?

The absolute key in this situation is communication. As soon as the subcontractor receives or suspects that it will receive a notice of price escalation from its supplier, it should put the general contractor on written notice of the potential issue. Ignoring an impending potential price increase serves no one, particularly the subcontractor.

Engaging in an open dialogue, particularly if you can bring all stakeholders in the project together, can go a long way towards resolving the problem fairly. The subcontractor must make it clear that the price increase is substantial and unexpected. The subcontractor should be prepared to prove this with relevant bid and contract documents, as well as notices and invoicing from its supplier.

Unless, the subcontractor can convincingly document the increase, it has little hope of achieving the goal, re-negotiation of the contract. Once the increase is documented, the subcontractor should openly begin discussing how the pain of the increase could be shared.

Additionally, the subcontractor must make clear the obvious potential outcome if the pain is not shared, namely that in that situation the subcontractor is least likely to be able to bear the costs and could result in it being unable to complete. Ultimately, should that happen, the costs to complete will be greater (which is always the case when someone takes over the work), and the general contractor and the owner will still bear the price increase. Also, even if the general

⁵ This paper does not address the post contractual claims phase because the intent is to stave off or address the risk during construction.

contractor wins a judgment there is simply no guarantee that it will collect it from the subcontractor, despite the terms of the contract.⁶

Re-negotiation via contract change order or REA ultimately is the most prudent course for all involved in the project, but it falls to the subcontractor to adequately plead the case.

Conclusion

There are several issues to consider as a subcontractor proceeds through the phases of the project. First, the subcontractor must accurately bid its work and do more to anticipate potential price escalation. Additionally, all the parties should address the issue of material price escalation during the contracting phase of a project by adding an escalation clause, an allowance for escalation or some other mutually agreed mechanism before signing the contract. Finally, a subcontractor must not wait until escalations begin affecting the project, profitability, or the company's sustainability to try to convince the general contractor and owner that they should absorb, or assist in absorbing, the price increases. Communication is the key to the success of any project, and never more so than with material price escalation.

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⁶ As a Contracts Law professor loved to say: "A judgment and a dollar gets you a ride on the bus." In other words, the dollar is the only truly valuable thing. A judgement still needs to be collected upon.