How to Handle Construction Cost Escalations Due to Tariffs and Other Market Forces

Related Professionals

Jeffrey M. Reichard
336.387.5139
jreichard@nexsenpruet.com

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Over the past year, the imposition of tariffs on foreign goods and potential trade wars have caused prices for various construction materials to increase dramatically. Current tariffs affecting the construction industry include tariffs on steel, aluminum, Canadian lumber and a plethora of Chinese imports, while the threat of a trade war and potential sanctions have wreaked havoc on materials such as asphalt, copper, quartz and other building materials. In fact, absent a deal between the United States and China before March 1, 2019, a large number of US tariffs on Chinese imports could increase to 25%. This begs the question: Who in the contracting chain bears the risk of these price increases? Is it the owner, the general contractor, subcontractors or material suppliers? The answers to these questions usually are determined by contractual terms between the parties and the stage of contract formation on a particular project at the time of the price increase. For example, after the parties have signed a binding fixed-price contract, it may be more difficult to obtain additional compensation for price escalations than before a contract is signed. A contracting party, however, may mitigate its risks associated with price escalations at any stage in the construction project.

Handling Price Escalations *After* Contracting

Since a written contract typically governs the relationship between the parties, the terms of the contract must be examined to determine whether a contractor or supplier is entitled to additional compensation as a result of a price increase which occurs after contracting. More and more contracts these days are including price escalation clauses. An example of a standard-form price escalation clause is the ConsensusDocs 200.1 Amendment No. 1 Potentially Time and Price-Impacted Materials. Price escalation clauses typically come in one of three types: (1) any-increase escalation clauses, (2) threshold escalation clauses and (3) delay escalation clauses. Under the first type, a downstream contractor or supplier is entitled to reimbursement for any price increases that occur after the signing of the contract. These provisions often identify the specific types of materials which are subject to the clause and baseline prices for those materials.

Threshold escalation clauses, on the other hand, only allow the downstream contractor or supplier additional compensation if significant price increases occur after signing the contract which exceed a certain percentage or dollar amount. Like any-increase clauses, threshold escalation clauses typically identify the specific types of materials that are subject to the clause and include baseline prices, which often are tied to actual pricing, a published material cost index, established catalog pricing or other objectively verifiable ways to identify cost and market fluctuations. The third type of escalation clauses, which is known as a delay escalation clause, holds a fixed price for a limited period of time and allows the downstream contractor additional compensation if the project is delayed beyond a given number of days or a specified date. It is intended to reimburse the downstream contractor for increased costs that occur during the delay. Any type of price escalation clauses also may include a cap on the total amount or percentage increase allowed for post-contracting price increases. For example, the Federal Acquisition Regulations (FAR) allow price escalation clauses in certain circumstances, but FAR §§ 52.216-2 and 52.216-3 default to a 10% maximum allowable increase in the contract price. Of course, each of these types of price escalation clauses can be modified to provide more protection for an owner, contractor or supplier.

Even if a contract does not include a price escalation clause, contractors and suppliers might be able to find relief for price escalations through other contractual provisions. For example, some contracts allow extra compensation for changes in law that occur after the parties sign a contract. One such example is the ConsensusDocs 200 Owner/Constructor Agreement, which states in Section 3.21.1 that "The Contract Price or Contract Time shall be equitably adjusted by Change Order for additional costs or time needed resulting from any change in Law, including increased taxes, enacted after the date of this Agreement." Of course, how the term "change of law" is defined in the contract and the timing of the change of law will impact whether the escalation is compensable. Whether a tariff constitutes a "change in tax" or a "change in law" remains unresolved.

Force majeure clauses are another type of contractual provision which may provide some relief to contractors and suppliers facing tariffs and related material procurement issues. Force majeure clauses usually address delays caused by Acts of God, wars, strikes and similar events beyond the control of the downstream contractor. For instance, Section 8.3.1 of the AIA A201-2017 General Conditions allows for a time extension for, among other things, "labor disputes, fire, unusual delay in deliveries, unavoidable casualties, adverse weather conditions . . ., or other causes beyond the Contractor's control." However, it is unclear whether a tariff qualifies as a force majeure event, and force majeure provisions, typically allow additional time to perform, but do not allow additional compensation.

If a construction contract does not include any of these types of provisions, a contractor or supplier may attempt to rely on legal or equitable arguments to support a contract price increase, such as commercial impracticability, impossibility, frustration of purpose and mutual mistake. However, it may be difficult to prevail on these arguments, especially if the terms of the contract provide otherwise. In any event, it generally is a better practice for the parties to specifically identify how they intend to handle material price escalations in the contract itself than to rely on uncertain legal and factual arguments after the fact. Therefore, we suggest negotiating price escalation clauses in your construction contracts going forward.

Handling Price Escalations *Before* Contracting

In light of the current volatile construction materials market, construction stake holders should be proactive in addressing the risks associated with potential price escalations during bidding, contract negotiation and procurement.

Since communication is the key to a successful project, discussions regarding price escalation should begin as early as possible on a project. Addressing potential price escalation up front allows for more certainty on the project and increases the likelihood of the project being completed on time and under budget.

During the bidding phase of a project, contractors and suppliers should identify which materials are most likely to be affected by tariffs, trade wars, or other market factors that may cause price escalations. Downstream contractors and suppliers should be wary of bidding requirements which require them to bear the sole risk of any price escalations and should modify their standard bidding forms and proposals to include price escalation clauses. For example, a contractor or supplier may include language in its proposal stating that any price increases directly or indirectly caused by changes in taxes, tariffs or other market changes occurring after the date of the proposal are not included in the contract price and shall give rise to an equitable adjustment of the contract price and time. If price escalation clauses are not included in the bids, contractors and suppliers may attempt to include allowances or large contingencies to account for potential price escalation or shorten the timeframe in which their bids are open for acceptance. Including price escalation language in a bid also may benefit the owner because it may reduce the bid amounts since large contingencies for potential price escalation can be avoided.

During contract negotiation, general contractors should advocate for price escalation clauses in the prime contract with the owner and also ensure that similar price escalation clauses are included in any downstream subcontracts because the general contractor doesn’t want to get caught in the middle of a price escalation battle. To persuade an owner to include a price escalation clause in a contract, a general contractor may need to educate the owner on potential volatility of certain construction costs and discuss their effect on contingencies and value engineering. Depending on the type of price escalation clause used, owners may request that the contractor provide support for their contract prices, such as actual subcontractors’ bids, building cost indices or catalog pricing, to ensure they reflect accurate market prices. Owners also may require that a price escalation clause includes a cap on the amount or percentage of price increase allowed and ensure that the contract sum is decreased by any price decreases which occur after the contract is executed.

During the construction and procurement phase, a contractor should regularly monitor its costs in relation to its estimate and provide notice of any price escalations as soon as they are identified and, in any event, no later than is required by the terms of its contract. A contractor also may mitigate some of the effects of potential price escalation by purchasing materials with the most volatile prices as early as possible or purchasing materials for multiple projects at once. However, early and/or bulk purchases may cause increased storage or material handling costs. As always, early communication is important to avoid a dispute related to cost escalations during the construction phase.

Whether your project is in the design phase, contracting phase or construction phase, it is better to proactively implement the changes suggested in this article now than to procrastinate until additional tariffs or other market forces adversely affect construction material prices and your bottom line.

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