CLAUSES AND CONTRACTS

Price Escalation

addressing price increases on your projects

By Christopher S. Drewry

Construction industry participants—from owners down to subcontractors and suppliers—have become all too familiar with dramatic increases in the price of certain construction materials since the COVID-19 pandemic began disrupting global trade in early 2020. While the prices for many materials had started to recede from their early-pandemic peaks, the war in Ukraine and other economic factors over much of the past year have once again driven prices for certain materials through the roof. From lumber to steel, concrete to copper, glass to fuel—or more likely, most or even all of the above—companies are suffering severe financial consequences from price increases, often *substantial* price increases. In such a volatile economic climate, it is especially important for project participants to pay close attention to contract terms allocating the risk of the cost increases and overruns relating to these unforeseen spikes in materials pricing.

THE CLAUSE

Generally speaking (and in the absence of an express provision stating otherwise), the contractor bears the financial risk of price increases unless there is an express price escalation clause included in the contract with the owner. Similarly, the subcontractor will bear the same risk relative to its upstream contractor. For instance, in Indiana, ordinarily a contractor is not entitled to a price adjustment for unforeseen difficulties or unexpected losses that may arise during the performance of a firm, fixed price contract. *See Appeal of B&W Press, 1984 WL 148109 (G.P.O.B.C.A. 1988).* Such risks include increased costs attributable to inflation. "Absent a price escalation clause in a fixed price contract that would shift the risk of price increases from the contractor to the Government, the risk of unanticipated price increase by a supplier of material needed by a contractor is assumed by the contractor." *Id.* (internal citations omitted).

THE CONTRACT

As a result, there has been an industry-wide response to address potential issues with price escalation. Unsurprisingly, much of this response has to do with contract language and/or contractual risk allocation. As a threshold matter, it is critically important to carefully read and review any contract terms in order to ensure that all parties fully understand and agree to the allocation of risks for increased materials pricing on any given project. For a contractor or subcontractor performing work on a project, this risk is especially important in fixed-price projects, where that contractor or subcontractor can easily end up underwater on a job when material prices increase. On the other hand, an owner or developer (or a contractor subcontracting work out) may be more concerned with price increases on jobs contracted on a cost-plus basis, where material price increases may dramatically increase the total amount owed to the contractor to complete the project.

Regardless of the type of contract and what the party's role is on a project, everyone needs to be aware of basic contract considerations. With respect to materials and the potential for price increases, the focus should be on the inclusion of language in the initial proposals and whether (and how) it is addressed both upstream and downstream. Additionally, there can be upfront negotiating for if and when price increases occur and when it may result in adjustments to the contract. For instance, is there a period during which prices are "locked"? Is there a mechanism for recovery for price *decreases*? It is also important to pay close attention to the materials that are included and/or specified by the contract documents. The initial negotiation process can also address how best to factor in long lead times on certain items, how to address the timely ordering of materials, and the usage of contingencies or allowances.

The list goes on and the possibilities are seemingly endless, but the initial contract language can be critical.

MANAGING THE RISK

The *primary* means of managing post-contract price escalation risk, however, is through the use of a material price escalation clause. Big picture, a material price escalation clause entitles a contractor to a change order where the price of certain types of materials increases either between the time of bid submission or the time the contract is effective and when the contractor orders the material. Such a clause is the answer to the situation described above, where there is otherwise no entitlement to a price adjustment in the absence of a provision.

There are different ways to address the price escalation itself. It could be handled based upon an open-ended increase that occurs any time between bidding or signing the contract and actual construction, or it could be established at a certain threshold or percentage increase where the contractor may be entitled to additional compensation only if the price escalations exceed a certain percentage or amount. Alternatively, it could be a "delay escalation" clause where it freezes a fixed price for a set period of time and allows the downstream contractor additional compensation if the project is delayed beyond the established number of days or a specified date.

It is also important to point out that price escalation clauses can go both ways. While such clauses currently are critical for contractors and subcontractors in order to address rising construction costs, there may very well be situations going forward where the owner may prefer such a clause. In this instance, it effectively serves as a price *de-escalation* clause where there may be a price *reduction* in materials.

CLOSING THOUGHT

Price escalation clauses serve as the contractual mechanism for proper risk allocation associated with price increases (or decreases, as the case may be) on a project. As such, it is imperative that owners, contractors, and subcontractors alike consider the risks involved in changing material prices between the time of the bid and ordering of the materials and establish each party's expectations through specific contract terms prior to contract execution. ■

about the author

Christopher S. Drewry is a partner with the law firm of Drewry Simmons Vornehm, LLP, in Indiana (**www.dsvlaw.com**), where he focuses his practice on construction law and litigation, as well as labor and employment law and litigation. Chris is the immediate past chair of the Construction Law and Litigation Committee of the International Association of Defense Counsel, and he can be reached at cdrewry@dsvlaw.com.