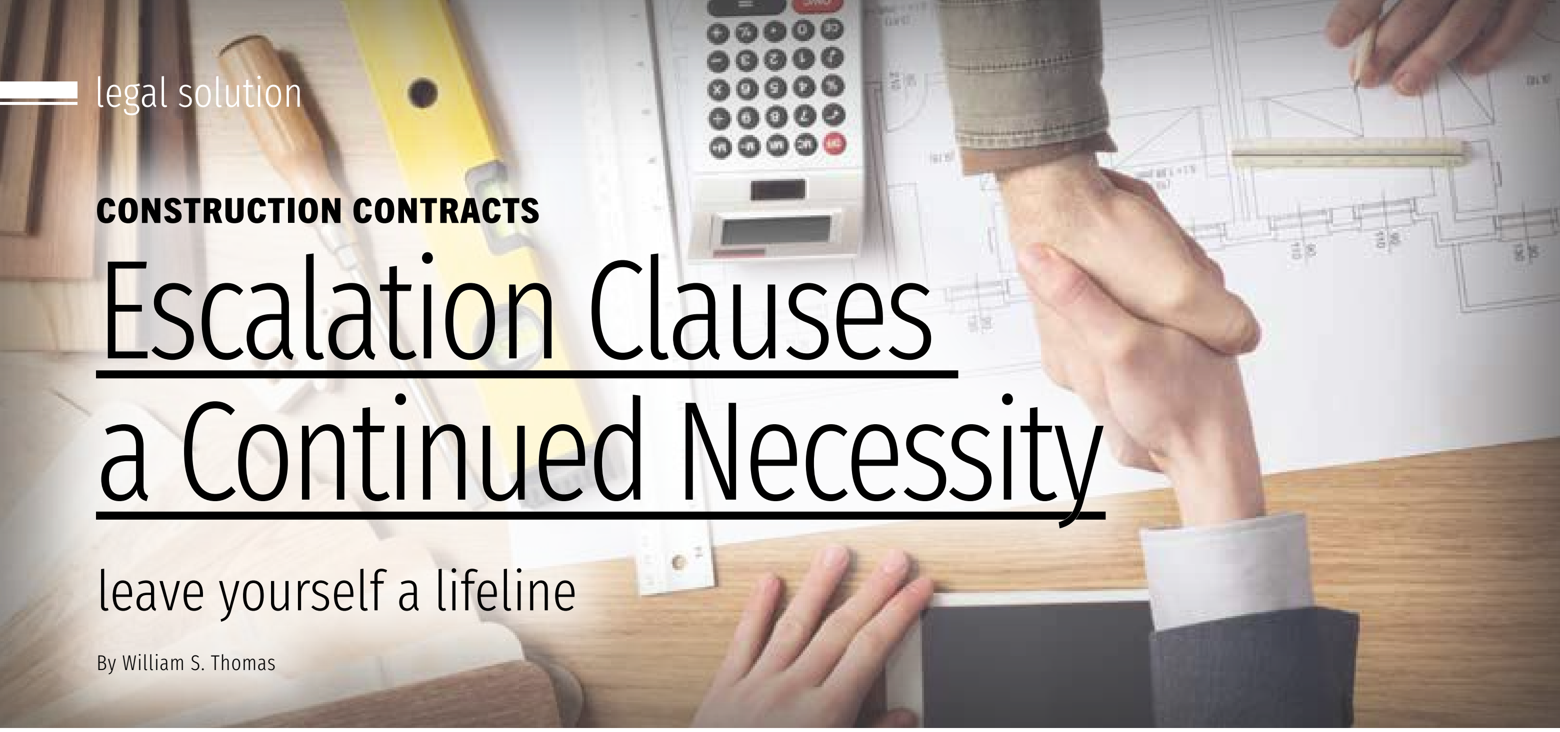

CONSTRUCTION CONTRACTS

Escalation Clauses a Continued Necessity

leave yourself a lifeline

By William S. Thomas

As we embark on another year, we are buffeted by industry analysts' trend reports assessing years past and providing forward-looking advice. Universally, these experts point to continued risk of economic fluctuations and financial uncertainty as the major risk factor in the construction industry. Facing rising material costs, supply chain disruptions, labor shortages, and unpredictable market dynamics, financial stability of construction projects is increasingly under threat. Adrift amongst these challenges, cost and price escalation clauses in construction contracts provide construction professionals a lifeline and remain an essential risk-mitigating tool. Properly designed and implemented, these clauses help buoy risks associated with unexpected increases in project costs, safeguarding the interests of all parties involved.

THE RISK THAT KEEPS ON GIVING

Historically, the construction industry has grappled with how to best handle financial unpredictability, with recent economic trends only exacerbating this issue. Analysts predict that while claims are most likely to result from scope changes, incorrect or incomplete design, or workmanship issues, underlying these currents are the ever-present threat of cost escalation due to extended project timelines or delays. These trends may have the simple effect of significantly and artificially increasing bids to hedge against inevitable unpredictability. Most contracts are silent, prohibit claims for cost escalation, or fail to properly address price escalation issues, which cannot be rectified as easily after-the-fact once issues arise. Owners who fight contractors and suppliers on these costs risk the project's success, as it may create downward pressures to perform in the absence of payment, leading to further delays, insolvency or even greater expense, or significantly higher bids to protect suppliers.

Cost and price escalation clauses are designed to address these cost variability and unpredictability issues during the lifetime of a project. They allow for adjustments to the contract price based on volatile changes in material, labor, and other direct costs. The primary aim is to allocate risk of cost fluctuations between the contracting parties in a fair and predictable manner. Given the sea change we have seen in the world economy, the language of these clauses will inevitably come under scrutiny. Critics argue that standard clauses are often too vague or overly broad, leading to disputes and room for interpretation and potential conflict. Reform efforts are focused on creating more precise and equitable language. This includes clearly defining the threshold for cost increases, specifying the indices or benchmarks to be used (such as specific construction cost indices or inflation rates), and outlining a transparent process for calculating adjustments. Some have urged for the inclusion of "de-escalation" clauses should prices significantly decline.

CRAFTING EFFECTIVE ESCALATION CLAUSES

Creating effective escalation clauses in construction contracts is a nuanced process that requires careful consideration of various factors, and it should involve your legal counsel. These clauses must be robust enough to protect parties from significant financial risks while being fair and transparent. They should be specific, and clearly define what constitutes a cost increase. They should specify the types of costs covered, such as materials, labor, or regulatory changes. They should have some triggering event and clear criteria for when the clause is activated. This could be tied to specific indices, such as the U.S. Producer Price Index, or some commodity specific index, or a set percentage increase in costs. The clauses should have a detailed calculation method, and outline a clear, agreed-upon formula for calculating cost adjustments. These clauses could employ a "cap and collar" approach, which imposes cap (maximum) and collar (minimum) limits on adjustments to protect both parties from extreme fluctuations. Regular review periods built in for adjusting costs ensure timely responses to market changes. Finally, there should be dispute resolution mechanisms for resolving disagreements over cost adjustments to maintain project continuity.

STRIKING A BALANCE – SEEKING FAIRNESS

The negotiation and implementation of cost-escalation clauses require a delicate balance of transparency, fairness, and foresight. These clauses are not just about protecting financial interests; they are also about fostering a mutual understanding and trust between the contracting parties. To do so, the process must begin with an open dialogue. Discussing potential risks of cost fluctuations on certain elements of the job or components at the outset can only promote this trust. Both parties should express their concerns and objectives, and seek a balanced agreement, perhaps with escalation/de-escalation language. Current market data can be used to inform the negotiation. Understanding recent trends in material and labor costs can provide a realistic foundation for the clause. Detailed records should always be kept of the negotiations and the agreed-upon terms.

Given trends in global economics, escalation clauses are expected to become more common, and endure. They may also grow more complex, incorporating a wider range of variables and more sophisticated adjustment mechanisms. With the explosion of artificial intelligence (AI), future escalation clauses might leverage advanced data analytics and real-time market indices. This could lead to more dynamic and accurate adjustments, eliminating disputes over cost changes entirely.

Most likely there will be a shift towards drafting clauses that are more equitable for all parties involved. This could involve shared risk models where cost increases or decreases are more evenly distributed between the contractor and owner. Escalation clauses are likely to be viewed not just as contractual necessities but as integral parts of broader risk-management strategies in construction projects.

Better to be surfing through than drowning in an ocean of added cost claims. Strategic incorporation of cost and price escalation clauses has become an immutable necessity. These clauses should become a standard part of your contract checklist. Staying abreast of market trends and economic indicators can inform more accurate and fair clauses. ■

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