

# ON THE LEVEL

## CONSTRUCTION LAW UPDATE

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## Price escalations in construction projects: How to protect against the unpredictable

Owners, contractors and subcontractors alike have experienced the all too familiar thorn in the side of the construction industry these past few years: unpredictable price escalations. Beginning in 2020, problems first caused by the COVID-19 pandemic and more recently due to a volatile economy have led to skyrocketing labor and material costs. Labor shortages, supply chain disruptions and surging inflation continue to affect nearly every project. During this uncertain time, there are ways to try to mitigate such risk and price uncertainty.

### Soaring costs cut into profits

The fluctuating costs of supplies and labor, which are usually baked into construction contracts early on, can make or break the profit margin on a project. For example, the Associated General Contractors of America recently issued a Construction Inflation Alert noting a 19.6% year-over-year increase in construction costs between December 2021 and December 2022, compared to a 12.5% increase in bid prices.

Over the past few months, however, bid price escalation has outpaced cost escalation. Per the Bureau of Labor and Statistics, May 2022 was the first month since September 2020 that bid prices rose at roughly the same rate as construction costs. Since May, bid prices have risen at a faster rate than costs. On average, construction costs from August 2021 to August 2022 have risen by 13%, while bid prices have risen 23.9%. In short, some of the ground lost over the past few years has been recovered. But with the current instability of the market, this positive trajectory is not guaranteed to continue. Many owners and builders remain skeptical.

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Our Construction law team has seen many clients negatively impacted by severe price escalations following bid submission, or contract formation. Although many owners, general contractors and construction managers will work cooperatively with a contractor to share the pain of a major price increase, others will not. Because the contractual risk of loss from such price increases typically falls on the shoulders of the lower-tiered contractor, a contractor faced with skyrocketing material costs and an unsympathetic owner, GC or CM can quickly find itself in financial distress.

### Five protections against rising costs

Fortunately, there are a few avenues available to protect against the risk and uncertainty of unpredictable price escalations:

- **Price escalation clauses:** An escalation clause allows a contractor to shift the risk of price increases upon an owner (or a higher-tiered contractor) if there are sharp increases in the price of materials or labor during the contract period. The clause is usually tied to a material price index and will typically permit the contractor to recover all or a portion of a price increase above a certain negotiated threshold (i.e. a 10% rise in the index). These clauses are not provided in standard form American Institute of Architects (AIA) contracts, and generally must be negotiated into the contract. However, they can be a powerful tool — especially where a lump sum/fixed fee is used in a long and complex construction project.
- **Force majeure clauses:** Force majeure clauses allow the parties to change certain contractual obligations if an event beyond the parties' control occurs, such as strikes, floods, earthquakes, acts of God and acts of war. However, force majeure provisions are not always found in construction contracts and, even where they are, they don't necessarily cover pandemics (like COVID-19), and the remedy is often limited to additional time to complete, rather than additional compensation. Even when a force majeure clause contemplates additional compensation, it is often limited to extended general conditions and excludes material cost escalation. Consequently, it is usually advisable to negotiate a stronger force majeure clause that explicitly spells out labor shortages or global pandemics as "excusable events" and defines which associated cost increases are recoverable.
- **Delay damages:** Where the contract does not contain a price escalation clause, contractors might instead be able to recover material and labor costs for price escalations that occur as a result of owner-caused delays or suspensions. For example, if an owner unreasonably delays a project for weeks or months and the price of materials or labor dramatically increase during that time period, contractors may have a claim for direct damages tied to that delay. Where possible, terms of such recovery should be negotiated before contract execution.
- **Impossibility of performance:** Although it is always best to negotiate price protections directly into the contract, courts will sometimes step in on their own. In extreme circumstances, some courts have allowed

parties to modify or be excused from performing a contract where the contract would be impractical or impossible to perform. Unfortunately, these types of arguments rarely succeed and are generally used as a last ditch effort to escape burdensome contractual obligations. However, in some limited instances where the contractor can prove that the devastating increase in materials and labor costs have required it to bear excessive and unreasonable costs, the court may grant relief in the form of contractual modification or cancellation.

- **Grow and nurture supplier relationships:** Anticipating an issue before it arrives can be critical towards avoiding claims and conflicts. Construction material suppliers often have the best and most current information regarding limitations on a given product's supply chain. Consequently, establishing long-term, trusted relationships or partnerships with reliable suppliers may not only give material purchasers a competitive edge, it may also provide critical supply-chain-related information that can help avoid unnecessary risk.

For more information, please contact [Chris Dutton](#) or any member of Porter Wright's [Construction Practice Group](#).