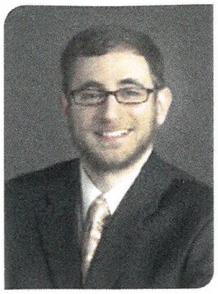

Aaron Evenchik, Esq.
Hahn Loeser & Parks
Developers Council Chairman

Developer's Council Update

Material Price Escalation, Impact on Demand and Risk on Costs

Recent fluctuations in the price and availability of lumber and steel are impacting all facets of the construction industry. Rumors swirl that construction steel is fully consumed by Amazon warehouse projects for the foreseeable future, while home builders see the sharply increasing (and, as of the time of drafting this article, starting to decrease) lumber prices. Increased prices and delayed availability of materials pose risks delayed completion, extended construction and carry costs, increased material costs, and disputes over who owns these time and cost risks – all of which affect profits. While demand for homes currently outstrips supply, it is unclear if material cost-driven home price increases will soften demand.

Although commercial construction contracts may allow contractors to pass these risks to the customer, residential home construction contracts often do not. Instead, in home construction contracts, builders typically provide lump sum amounts for framing, drywall, and utilities, with allowances for finishes. While the customer is ultimately responsible for any allowance cost overruns, unless the contract specifically passes the risk of material price increases on "base contract" items, the builder is left with that risk. Contractors and builders are left to rely on "force majeure" provisions to recover cost and time increases from customers.

To protect against the risks associated with lump-sum pricing in a volatile materials market, builders today can consider alternative pricing and contracting models, including open book plus a fee, so the customer sees and pays exactly the costs that the builder incurs. But the cost-plus-fee model is imperfect because it exposes a builder's profit margins and lacks the cost certainty that customers (and their lenders) may require.

Another alternative is to include a provision in the lump-sum agreement that allows the parties to revise the contract price should the cost of materials exceed a certain threshold (for example, a percentage increase in costs). This approach means that the builder absorbs a certain degree of risk (up to the specified threshold), beyond which the builder can seek a change order adjusting the lump sum. It also means that the customer (and lender) is insulated from risk up to the specified threshold. If materials costs exceed the agreed-upon threshold, and if the parties do not agree to increase the lump sum, the potential unlimited cost risk can be balanced by permitting the customer to suspend the contract for a set time, reimburse the builder for any additional carry costs, and restart work when prices drop. Obviously, the home would need to be weatherized to prevent deterioration.

Most critical in any of these arrangements is clarity. Simple and understandable contract language, sometimes with demonstrative examples, is the best way to ensure that both the builder and the customer understand the allocation of risk, including final delivery of the home. Builders should also provide real time cost and status updates to customers so they can plan.

Aaron Evenchik is the chair of the HBA Developers Council and can be reached at 216-274-2450 and aevenchik@hahnlaw.com.