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Navigating supply chain challenges in construction

Key takeaways

Managing a construction supply chain is complex in the best of markets; however, the COVID-19 pandemic further exacerbated such challenges, resulting in ongoing supply chain disruptions and delays. Innovative approaches to contracting can improve supply chain efficiency and ensure successful project delivery in spite of such challenges and complexities. This article details the construction industry's current state and how parties can successfully navigate the current volatile market.

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1. **The pandemic drastically exposed the imbalance of supply and demand caused by preexisting labor and material shortages.**

   Prior to the rise of COVID-19, the disproportion between available supplies versus the market's needs had already begun posing problems in the construction industry. The pandemic unfortunately exacerbated and accelerated the issue. In general, the construction industry in 2019 and early 2020 was struggling with a lack of trade workers, truck drivers, material suppliers and other labor providers, resulting in increasing delays in inventory production. In particular, the pre-pandemic years saw steel and lumber shortages wreak havoc on projects across the country. In mid-2020, as COVID-19 ravaged the globe, manufacturing and distribution efforts that were already falling behind market demand were quickly refocused on producing and circulating personal protective

equipment all over the world. As a result, the production and supply of construction materials almost immediately significantly decreased.

Coupling the drastic shift of manufacturing and exporting away from construction materials with the steep economic downturn that came with the world shutting down, even fewer materials were able to be produced. This has ultimately led to widespread unpredictability in costs and availability of construction labor and materials, preventing contractors from being able to reliably complete construction projects on time and on budget.

2. **These ongoing material and labor shortages have brought provisions such as force majeure, liquidated damages and savings clauses to the forefront of contract negotiations.**

   Prior to 2020, force majeure clauses, liquidated damages clauses and savings clauses, among others, were occasionally topics of negotiation; however, with the rising volatility of the market, these provisions have become hotbeds of negotiation as parties seek to insulate themselves from risk. Force majeure provisions, which identify specific causes that excuse delays in performance and provide for adjustments to a project schedule and compensation, provide parties the opportunity to clearly define in what instances an owner is willing to accept the risk of delay and nonperformance and to what extent the contractor will be entitled to recover for such delays. Liquidated damages, which are preapproved charges assessed against a contractor for late delivery of a project, can help contractors understand the exact liability they are agreeing to, while also giving an owner peace of mind as to what it can recover in the event the contractor fails to timely perform. Savings provisions, which address what happens when a contractor's actual costs are less than what such contractor listed in its proposal or bid, give the parties the opportunity to benefit from the unpredictable market to the extent prices ultimately wind up being less than what was originally agreed on. While all of these provisions were previously included as an afterthought in most contracts, they now often constitute the points of most negotiation.

3. **Despite the tumultuous market, contractors have developed practical methods to accommodate the ongoing challenges and complexities.**

   With the rise in supply chain issues, good construction industry practices have become more important to implement than ever. Contractors can insulate themselves from regular price fluctuations through the use of price or bid expirations.

   Contractors regularly put expiration dates in their bids, notifying owners that the pricing provided is guaranteed for only a specific period of time. This helps contractors protect themselves from slow-moving owners who may wait months before deciding to move forward with a project. Due to the nature of the current market, contractors who allow owners an indefinite amount of time to move forward with a project assume the risk of having to eat major price increases occurring after the date such proposal was issued.

   Contractors also heavily negotiate the manner in which early delivery will be handled. Owners and lenders typically will not pay for materials that are not delivered to the project site; however, in many instances, contractors need to obtain materials as soon as they can in order to avoid potential price escalations. This gives rise to potential instances in which the contractor is stuck paying for materials without reimbursement due to the timing of such delivery. Parties can contract around these timing issues by expressly outlining payment for and storage of materials prior to commencement of the work. This allows both parties to ensure the contractor is able to obtain the best prices based on the current market.

   Value engineering is another method of contracting around the unpredictability of the construction industry. Value engineering involves all parties of the project working together to determine if there are other ways to design and build the project that can increase cost savings or decrease the time needed for construction. Finally, both owners and contractors can exercise termination or suspension rights under a contract in the event of price escalations or shortages. Sometimes the parties realize that a project just isn't going to work at the current price and schedule, and so it is better to cut the parties' losses at that point and avoid further strife.

   While the above options utilize formal contracting methods of accommodating market change, contractors also utilize less formal approaches to mitigate pricing and delay risks, such as leaning on long-established industry relationships. Many contractors look to suppliers and subcontractors that they frequently work with for help through hard times with the idea that once such contractors are through the rough patch, they will assist those industry partners similarly in the future.

4. **There are multiple ways to negotiate construction contracts to ensure successful project delivery despite the unprecedented supply chain challenges.**

   While industry forms, such as those prepared by the American Institute of Architects, are popular for good reason, most forms provide only minimal language (if any) addressing price escalations

and labor shortages. Therefore, it's important for parties to work closely with counsel to create customized language appropriate for their respective projects.

The first option, which is very common throughout the industry, is the use of price adjustment clauses. In general, there are three types of price adjustment clauses, each of which can provide greater certainty as to the risks assumed by a contractor and owner under a construction contract. First, the parties can utilize a "blank check" style provision, which provides the contractor a "day-for-day" and "at-cost" adjustment for delays and price escalations. This is most beneficial for the contractor, as it removes all risk of delay or increase.

General certainty is the second option; it involves the parties determining different thresholds of risk assessment, such as splitting the cost if there's a certain increase in cost or delay or utilizing percentage-based responsibility wherein the contractor may be responsible for cost increases up to a certain, negotiated percentage and beyond that threshold, the owner is obligated to cover additional increases.

The third type of price adjustment provision is a limited-certainty style, wherein the parties prepare a clause that addresses all the specifics surrounding a permitted increase, including the types of materials covered, the permitted delays involved, pricing, risk allocation of such prices, and other additional details, such as what substitutions will be permitted.

Force majeure provisions can also help allocate the risks associated with shortages and price escalations. What constitutes an event of force majeure varies from contract to contract, and this flexibility allows the parties to specifically carve out issues such as price escalations or the unavailability of materials or labor as permitted excuses for delay.

Finally, suspension and termination rights can be wielded by both owners and contractors to cover certain escalations or shortages. In many instances, parties have negotiated the right to suspend the project during such time as the pricing of certain materials surpass an agreed-on threshold, with the obligation to resume work conditioned upon the prices decreasing back to pre-approved levels. Depending on the time frame of such suspension, the parties can also negotiate for the right to terminate the project altogether if pricing does not decrease within a specified time frame.

5. **All parties to a construction project can strategically manage the supply chain and labor shortage challenges facing the industry.**

There are five specific strategies that members of the construction industry can utilize to manage the current supply chain and shortage challenges. First, contractors and owners alike should stay informed about material price escalations, supply chain disruptions and the market in general. Knowing which markets are experiencing shortages can help parties forecast costs, needs and the viability of future projects.

Second, parties need to notify and communicate with each other early and often. Sitting on supply chain problems and not maintaining an open, ongoing line of communication with all parties will typically only exacerbate an issue. Third, parties need to be flexible. A combination of offering solutions, engaging in value engineering and being willing to meet in the middle is what ultimately gets troublesome jobs across the finish line. Fourth, communication is key. Timely and properly communicating with all parties to the project, and documenting such communication, is critical to keeping a project on track and preserving a party's rights in the event of delays or other issues. Without proper documentation, a claim typically lacks merit.

Finally, regularly update form contracts. Every project is unique, and having a dynamic and flexible contract that can be modified to meet each project's specific needs is crucial to success. While it is easier to have a "one size fits all" form, these forms do not typically meet the specific needs of every project they are used on. Actively reviewing, negotiating and revising forms will help ensure that all parties' needs are addressed and decrease the chances of future disputes.

If you want more information about supply chain challenges in construction, listen to this BakerHosts podcast authored by Michael Cortez: [Building Better: Navigating Supply Chain Challenges in Construction]