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The Board-Certified Attorney's Tips for Negotiating, Drafting, and Monitoring the Construction Contract Part II

“Identifying the Use of Cost-Plus Construction Contracts or Contracts with Escalation Clauses Made Necessary Due to Increasing Costs Facing the Florida Marketplace”

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Our law firm represents numerous contractors, subcontractors and potential homeowners, all of whom are facing issues as to Florida single family home construction. We previously published an Article on Real Estate Contract Escalation Clauses:

<https://www.jmlawfl.com/news/published-articles/>

I want to continue that discussion and address Cost Plus Contracts and Fixed Price Contracts with Escalation Clauses.

1. Florida's 2021 Real Estate Market and Current Trends in the Marketplace

Currently, it is a “Seller’s Market” in Florida. There is an unprecedented demand for homes and new construction. Sellers are seizing the opportunity to sell at this time when the demand is high. In fact, our law firm, along with our affiliated Title Company, Title Masters, LLC, are handling hundreds of closing this year with many more scheduled in the future.

Due to this demand, a great deal of inventory of single-family residences have been sold off in Southwest Florida. This has created a vacuum, which has resulted due to the lack of single-family homes readily available for purchase in the midst of this unprecedented real estate marketplace.

The old saying goes, “If you are somebody, you go to New York. If you want to be somebody, you go to Los Angeles. If you want to be somebody else, you go to Miami.”

But in 2021, the new saying is “*If you want to be someone, go to Florida. If you are someone, go to Florida. If you were someone, just stay in Florida.*”

For years, Florida has been a state where people have purchased their retirement dream homes. However, the political climate of today has dramatically increased in-migration to Florida and away from “blue states”. Now, people of all ages are moving to Florida, especially Southwest Florida. The reality reiterates the age-old adage, “people vote with their feet.”

This rush to the Sunshine State is based upon a number of factors. New Florida home buyers are fleeing “blue states” for a variety of reasons: high taxes vs. no Florida State Tax, rising crime vs. Florida’s law and order, open schools for our children vs. dismay as to how those “blue states” are being governed, whether it be far too progressive or far too socialistic.

In the light of the ongoing (and what appears to be never ending) COVID-19 crisis, many are flocking to Florida because of the economy and how Florida Governor, Ron DeSantis, has handled the crisis by protecting the state’s most vulnerable citizens while allowing for a reasonable conduct of business. According to a recent article on Axios, “*Florida's largest metro areas are collectively seeing the largest population gains in the country, according to the latest LinkedIn migration analysis shared with Axios*” (source: <https://www.axios.com/florida-migration-gains-pandemic-4ade6fc2-1b5f-4a56-b126-ef53cd65b841.html>). This is also true for secondary markets like Southwest Florida.

Because of this, Florida is experiencing unprecedented real estate closings. Lee County normally has about 14,000 residential listings in any given month. However, recent statistics find that currently there are only approximately 2,000 due to the number of buyer’s closing on homes or available product. In order to fill the vacuum, contractors are rushing to build homes to respond to the increase demand.

When you take into consideration the influx of people and couple that with the current shortage of home inventory along with the significant construction underway to meet the demand, the result is an increase in construction prices, at least in the short term.

With that demand comes the need for more raw construction materials, such as lumber and concrete. The increase in demand also means higher prices for those desperately needed construction materials.

Not only is there a significant rise in construction costs, but potential homeowners will not have as much leverage when it comes to negotiating with their contractor. Facing the realities of the marketplace today, most contractors are now reconsidering their approach to fixed price contracts for homes. Many are opting to do away with fixed price contracts for new construction or remodeling jobs and are now using either cost plus contracts or contracts with escalation clauses in order to pass the risky cost increases on to the consumer, i.e. future homeowner.

We have outlined below the key differences between a cost-plus contract and a contract with an escalation clause.

2. Cost-Plus Contract

Just as the name implies, a Cost-Plus Construction Agreement is a contract in which the owner pays the contractor the actual costs of the materials and labor for the construction plus an additional negotiated fee or percentage over that amount should costs increase.

A cost-plus contract is distinctly different from a fixed price contract. A fixed price contract allows the homeowner to enter into a contract with the contractor to build a specific home (or a specific remodel project) with certain features which contain an allocated list of set prices for certain items as such as flooring, lighting, and appliances.

A cost-plus contract is generally the go-to for commercial contracts but now, due to the price increases to meet demands facing the marketplace, many contractors are turning to the cost-plus contract for the construction of single-family homes save and except for some national builders who may still utilize fixed price contracts for their products.

Unlike a fixed price contract, the cost-plus contract generates, on industry average, FOUR (4) times the amount of litigation and arbitration for both the contractor and the homeowner. That's because in a cost-plus contract, there is an additional fee or fixed price percentage allocated for the contractor's profit margin and some account of obligations and disclosures which alters the original estimate construction cost ("Control Estimate"). Therefore, this shifts all of the risks associated with the project, and all of the benefits of unanticipated changes in material and labor costs, along with the contractor's efficiency (or lack of efficiency) on to the homeowner.

This results in the homeowner bearing the cost for the price increases and any other risks associated with the cost-plus contract.

Therefore, it is important, for both the contractor and the homeowner, that the contract spells out, with specificity, all of the items that are subject to the cost-plus arrangement as well as identify the obligations that the homeowner can expect from the contractor.

To avoid any potential litigation and for peace of mind for both the contractor and the homeowner, the following items should be outlined in clear detail within a cost-plus contract:

- a. Identification of each and every line item where the cost-plus factor will apply.
- b. Identification of the actual cost factor. For example: 15% of each and every line item is designated as the profit margin for the contractor.
- c. Identification of the initial bids on the various components of the home. This creates an initial "Control Estimate" from which increases can be calculated.
- d. A dedicated schedule which the contractor will provide to the owner with an ongoing accounting for all costs for the labor, services, and materials being incorporated into the home. This way the homeowner can monitor the cost of construction as well as the profit margin of the contractor during construction.
- e. A procedure outlined whereby the contractor submits an itemized list of each and every expenditure made during the course of construction and an implicit agreement between the parties that the costs will be reasonable with a built-in provision to shift price increases to the homeowner.

As you can see, careful attention should be made when drafting a cost-plus contract since this contract will be the roadmap for future payments required by the homeowner to the contractor for the new construction. Again, the cost-plus contract needs to be clear and unambiguous, understandable by the owner and the contractor and, as importantly, clear and unambiguous in the event a Trier of Fact (Construction Arbitrator, Judge or perhaps a Jury) has to render a decision.

The Law Office of Jursinski and Murphy PLLC (www.JMLawFl.com) has negotiated, drafted and litigated/arbitrated cost-plus contracts. Our office can assist you in drafting or reviewing your cost-plus contract to ensure guidelines are met and, as importantly, avoid any potential conflicts down the road.

3. Escalation Clauses in Fixed Price Contracts

Contractors are also turning to another type of contract in the face of rising demand and an increase in construction costs: Fixed Price Contracts with Escalation Clauses.

In this situation, the homeowner and contractor agree on a fixed price for the construction along with the aforementioned allowances. However, the contract also includes an escalation clause. This provision allows for the contract amount to escalate to reflect a price increase for certain designated components of the build. That increase in price is passed along to the homeowner.

A fixed price contract with an escalation clause should include the following categories (which can be expanded as needed):

1. Identification of the total estimated build cost at the time of the contract.
2. Identification of the actual component costs of the build as to major categories that will be subject to the price escalation clause:
 - a. Concrete bid/estimate
 - b. Framing and truss package
 - c. Electrical package
 - d. HVAC and mechanical package
 - e. Plumbing package
 - f. Appliances
 - g. Labor

Using the above specified (or a more amplified component list), with each line item allocated a specific amount agreed upon by homeowner and contractor, a sample escalation clause (there are a variety to create) within a fixed price contract could read as follows:

“Homeowner and Contractor agree that in the event the pricing of designated line item increases over the initial cost estimate for such line item, then in such event the contract price shall be equitably adjusted by a written Change Order. In the event of a price increase that is more than 5% over the original estimated amount”, then in such event the homeowner shall

remit payment to the contractor for the increased price in excess of 5% over the original estimated amount. “

Using this above-captioned escalation clause, this provision could be expanded to provide an example:

“By way of example and not limitation and assuming the lumber/truss package is \$40,000 and prices increase by 20%, the final lumber and truss package would be the sum of \$48,000.

In such event a change order is signed by Contractor and Homeowner so that the Homeowner pays the excess of the amount which exceeds 5% of the original estimate, and using the \$40,000 lumber/truss package with a 20% increase, the Contractor would absorb the first 5% or \$2000 and the homeowner would be responsible for the balance so that the Change Order reflects an increase cost of the lumber/truss package to the homeowner of \$6000 (\$40,000 original estimate, contractor pays the first 5% or \$2000 and the owner pays the remainder of \$6000).”

The Owner would then have to remit payment for the price increase after a change order is submitted. This paragraph can also reflect that 100% of the price increase goes to the homeowner since there are a variety of formats and negotiating positions.

There are a number of scenarios as it relates to a fixed price contract with an escalation clause. The homeowner and contractor could agree to any of the following:

- a. That the full cost increase is passed along to the homeowner on every line item in the component list;
- b. That the cost increase is passed along to the homeowner with the contractor adding a profit margin onto the price increase; or
- c. That a percentage of the price increase is shared by the homeowner and contractor and the contractor does not get a profit on the price increase.

Regardless of the above format agreed to by homeowner and contractor, when a contractor utilizes an escalation clause in a fixed price contract, this generally shifts all risk, or a substantial amount of risk, on to the homeowner.

By utilizing an escalation clause, subcontractors can also place bids freely and compete for jobs without fear of having to increase their initial bids to account for price increases. And due to the reality of today's marketplace, most subcontractors are not holding their prices for more than 30 days. In fact, many are specifying in their contracts that their initial bids are subject to change as and when the component item is billed to contractor. In that way, the subcontractor will notify the General Contractor of an increase in prices for labor or materials and their subcontract can be adjusted.

And if there aren't any increases in prices, or if there is a decrease or change as to the labor, construction, or materials on the project through a written change order, the contractor can draft in a "de-escalation provision" or credits to the homeowner in the event that prices for materials and labor drop, which could subsequently lower the contract price.

The Law Office of Jursinski and Murphy PLLC (www.JMLawFL.com) can negotiate, draft and if necessary, arbitrate or litigate the construction escalation clauses. Again, it is important to pay careful attention to the drafting of the escalation clause in a construction contract. This fixed price contract with escalation clause will be prevalent during times of rapid price increases. It needs to be clear and unambiguous, as well as understandable by both the homeowner and the contractor. It also needs to be clear and unambiguous in the event a Trier of Fact (Construction Arbitrator, Judge, or perhaps a Jury) has to render a decision on the document.

Closing

Homeowners, contractors, real estate investors and real estate professionals are warned that the use of a Cost-Plus Contract or Fixed Price Contract with Escalation Clause, unless done properly, may result in an unenforceable contract and may lead to litigation, which is not consistent with the goals of homeowner or contractor, both of whom want to enter into the best contract that meets their respective needs and avoids costly construction litigation.

As such, contractors as well as future homeowners wanting to have a home built by a contractor need to familiarize themselves with the parameters of Cost-Plus Contracts or Fixed Price Contracts with Escalation Clauses. Recognizing the significance of the various billing formats and identifying those in the contract so that both of future homeowner and contractor can have a clean, unambiguous construction contract reflecting the intent of both parties.

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