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# Mitigating the Impact of Tariffs & Rising Material Costs

In the period leading up to the March 2018 imposition of tariffs on steel (25%) and aluminum (10%), with exemptions for Canada and Mexico,<sup>1</sup> many predicted that materials such as rebar, steel pipe, tubing, and mill products would go up in price.

Indeed, the Associated General Contractors of America (AGC), which publishes pricing index data monthly, showed that the “producer price index jumped by 20% for aluminum mill shapes, 17.4% for copper and brass mill shapes, and 12.3% for steel mill products”<sup>2</sup> after the tariff imposition. However, the pricing index for new construction (what contractors are charging) only rose by less than 4.3%, implying that contractors absorbed the increase in costs and shrank potential profit margins.<sup>3</sup>

As the full impacts of tariffs and rising material costs on the construction industry are being realized, contractors, suppliers, and clients are preparing for recovery. This alters how clients decide to build new projects, and how contractors price these projects while remaining responsive to price-sensitive clients. Fixed price contracts will increase the risk to contractors while reimbursable contracts will increase the risk to clients.

Let’s consider, for example, the steel used in a construction building. The construction industry accounts for 43% of all steel shipments prior to the imposition of tariffs;<sup>4</sup> however, steel accounts for only a portion of a project’s costs. If further tariffs are imposed and domestic suppliers cannot fill in the gap, then construction schedules will also increase in length forcing contractors to shift the risk and uncertainty to clients through price increases and contract clauses.

As a direct result of these tariffs, it is estimated that approximately 30,000 jobs would be directly impacted or lost because of higher steel prices on construction projects.<sup>5</sup>

Steel is used in the construction of several different building components including reinforcing steel in structural concrete, structural steel framing, and miscellaneous metal framing and supports. Although the tariff will affect all of

these components, the single biggest impact will be on structural steel in steel framed buildings.

The cost of structural steel is based on four main components – raw material, fabrication, delivery, and erection on site. While the cost of these can and will vary over time and by geographic location, raw steel has historically been about 30% of the total cost per ton for structural steel.<sup>6</sup>

With prices for raw steel ranging between \$600-700 per ton, a 25% tariff would result in an increase of \$150-175 per ton.<sup>7</sup> Consider a 100,000-square-foot building with a structural steel frame of 20 pounds per square foot:

- Overall cost of building: \$400 per square foot x 100,000-square-foot building = \$40 million
- Quantity of structural steel in building: \$20 per pound per square foot x 100,000-square-foot building = two million pounds = 1,000 tons
- Cost of raw steel: \$700 per ton
- Cost of structural steel: \$2,800 per ton (structural steel costs are typically 3-4 times more than the raw cost, inclusive of material)
- Overall cost of structural steel in building: 1,000 tons x \$2,800 per ton = \$2.8 million
- Application of a 25% tariff to raw steel only = 25% x \$700 per ton x 1,000 tons = \$175,000

The impact of a \$175,000 hit to a steel contractor supplying \$2.8 million to a building is significant and could affect that contractor’s bottom line. Therefore, measures to recover and/or mitigate those costs are vital.

## Look for Relief in Contracts

There are several challenges to recover material escalations in contracts. Typical risks are encountered in lump-sum work where the contractor bears the risk that costs will increase over the life of the contract. This risk is mitigated in costs reimbursable and, in some cases, guaranteed maximum price contracts.



However, in all cases, the contractor should carefully examine the contract language for relief from price escalation. Typical clauses that should be reviewed include: force majeure; delay impacts; escalation clauses; change in law, tax, or regulation; change in conditions; notice requirements; and tariff clauses.

## Force Majeure

Force majeure is a common contract clause that essentially frees both parties from liability or obligation when an extraordinary event or circumstance beyond the control of the parties (war, riot, strike, or an event described as “an act of God,” such as a hurricane, flood, earthquake, volcanic eruption, etc.) prevents one or both parties from fulfilling their obligations under the contract. In practice, most force majeure clauses do not excuse a party’s nonperformance entirely, but only suspends it for the duration of the force majeure.

When negotiating force majeure provisions, clients generally seek a narrow and specific definition frequently resulting in the inclusion of a defined and exhaustive list of occurrences that constitute a force majeure event.

By contrast, contractors usually prefer a broader definition such as “any event beyond the reasonable control of the parties including, but not limited to” specified events. If the definition must include an exhaustive list (i.e., every single possible event of force majeure listed), then it should be as comprehensive as is reasonably possible. Substantial price escalation could constitute a force majeure event, which would excuse both parties from having to perform. This price escalation is usually due to an unforeseen act of government via a tariff, rather than a market-driven escalation, and has greater potential to constitute a force majeure event if it makes it unreasonable or unable to perform the work.

## Delay Impacts

A contractor may be able to recover the cost of the tariff escalation under a contract provision allowing for recovery of delay damages. If a client caused delay (such as not approving submittals timely) or prevented a supplier or contractor from timely purchasing materials before the tariff/material escalation, then there may be a right to recover for the delay. The necessary provisions would need to be in the contract and flow down provisions.

Most contract documents include a provision that requires the contractor to provide the client with a schedule of submittals that require client approval and are to be submitted prior to when the construction schedule requires.

Both ConsensusDocs and AIA contracts have provisions in their general conditions related to submittal and approval. The submittal schedule required by AIA A201 General Conditions is discussed in Section 3.10.2, which states that the contractor shall prepare and keep current, for the architect’s approval, a schedule of submittals that is coordinated with the contractor’s construction schedule and allows the architect reasonable time to review submittals.<sup>8</sup>

Should a client delay approval of submittals, thus preventing procurement and fabrication of the necessary materials and subjecting those materials to the impact of tariffs, then the contractor can draw a clear distinction on why the tariff impact should be passed on to the client.

## Escalation Clauses

Some contracts have specific adjustment clauses for certain materials including time periods or durations for which the risk is identified and allocated to the appropriate party. Clients establish a price for specific materials and a methodology for both establishing that price and the method of calculating escalation. Both parties to the contract (client and supplier) are entitled to make an adjustment based on that clause. Contractors should also include adjustments for any time extension and delay compensation.

When utilizing price indexes as the basis of any claims under the escalation clause, it is important that contractors use actual prices to compare to the index increase. Claiming any costs (based on an index) that are more than the actual paid amount raises the potential for a false claim.

There are three methods for calculating escalation costs in contracts:

- 1) *As-Bid* escalation clause – requires the client to pay for any material escalations once a contract has been executed. In this instance, contracts will typically have detailed lists of which materials are subject to this method and the baseline cost.
- 2) *Ceiling* (or threshold) clause – requires clients to pay for material price increases above a defined ceiling. In this method the contractor has risk exposure up to the ceiling, but the client carries all risk above the ceiling.
- 3) *Delay* escalation – holds the fixed price for a limited period but allows the contractor to recover costs if a project is delayed or if the contractor is unable to procure the materials in a timely manner. When using a delay escalation, it is helpful to tie these materials to milestones within a contract.

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## **Change in Law, Tax, or Regulation**

Most contracts contain a change in law, tax, or regulation provision that allows for recovery if the change occurred after the date of the agreement and affects the performance of the work. Ideally these will also define laws, regulations, or both. Contractors and clients should take the time to answer a set of questions:

- Do laws include every local license requirement?
- Do laws include only those items imposed by a legislating body with jurisdiction over the project?
- Do laws include treaties and tariffs that were imposed via executive order?

If those questions are not defined, then clients and contractors will be subject to interpretation based on the applicable case law (local, state, or federal).

Form contracts, such as ConsensusDocs, AIA, and Federal Acquisition Regulation (FAR), all contain provisions related to changes in laws. Federal contracts have a provision permitting reimbursement for changes in federal excise taxes and duties. However, the tariffs in place are enacted by executive order, and the question of whether this constitutes a change of tax remains unanswered. This is limited to the tariff itself. If there are other impacts, such as an increase in domestic materials due to market conditions, then those changes may not be recoverable. Other limitations include if the contractor has procured equipment or products manufactured with steel or aluminum even though the price has increased due to material escalation or tariffs.

## **Change in Conditions**

Even if a contract does not have a provision related to a change in law, there may be some relief in the change order provision via the right to request a change in conditions. The change in conditions provision may also reference changes in laws.

If the change in conditions references “conditions not reasonably foreseeable to contractor,” “conditions not reasonably inferable from the contract documents,” or “conditions or circumstances beyond the reasonable control of the contractor,” then the contractor has another avenue for potential relief.

## **Notice Requirements**

Clients and contractors should also carefully review their respective contracts to determine the notice requirements to recover increased costs and lost time. The usefulness and applicability of the previously cited clauses may be contin-

gent upon the satisfaction of simple, but often overlooked, requirements to provide timely notice.

## **Equitable Theories of Mutual Mistake**

In the event an existing contract does not provide adequate avenues for relief to the tariff, the contractor might consider the equitable theories of mutual mistake (commercial impracticability). However, these arguments are difficult to make and should only be considered as a last resort.

A mutual mistake is an assumption or fact that both parties (client and contractor) believed to be true at the time of contract execution but is no longer true due to external or other factors. An assumption in this instance is that the U.S. government would not unilaterally impose tariffs. However, when making this argument, there are several items that must be confirmed:

- The mistake must go against a basic assumption of the contract. In other words, the mistake is why both parties entered the contract in the first place.
- The mistake must have a material effect on the performance or cost of the contract.
- The risk of the mistake must not have been assumed at contract execution. In other words, the contractor must not have assumed that there is a risk of escalation tied to the tariff and ignored it.

These arguments are difficult to make and should only be used in the extreme case that there are no other contract provisions supporting the contractor.

## **Tariff Workarounds & Exclusions**

When contractors face the uncertainty of tariffs and their impacts, they can often employ innovative methods to expand their material options. Some contractors can find domestic sources, and more frequently, they can employ a design workaround to reduce the amount of materials that are imported.

For example, switching from steel piles to concrete reinforced piles can reduce (not eliminate) the amount of imported steel and thus the cost. Composite materials, such as fiber reinforced plastics and other alternates, are also gaining popularity. Exploring those solutions with clients can often lead to a less-contentious process for resolving a tariff issue than pursuing a change related to direct increased costs of steel prices.

The last method of resolving the impacts of tariffs is to apply for an exclusion. The U.S. government established a process



by which contractors (and other industries or companies) can apply for the exemption of certain products subject to tariffs.

To qualify for a tariff exemption, the contractor (or client) must pass the following three-part test:

- 1) Whether the material is only available from abroad, and whether the contractor made any efforts to source the material from domestic providers.
- 2) Whether the additional tariffs will cause severe economic harm to the contractor or other pertinent interests.
- 3) Whether the product is strategically important.

This is a difficult bar to clear for a typical construction project and contractors should not depend on case-by-case exclusions to mitigate these impacts.

### Recommendations

First, every contractor should perform a full analysis of all applicable contract provisions, whether they are included in the items listed here or otherwise. Parties often overlook provisions or other acknowledgements modified into unsuspecting but somewhat related provisions. Clauses specifically surrounding escalation, changes in law, force majeure, delay damages, or any provision that might support an argument for transferring the increased risk of escalation due to tariffs should be analyzed.

Second, include a cost adjustment for the escalation clause and change in law/tax clause into the contracts. The right to recover costs for escalation should be broad enough to allow for recovery of these costs, regardless of reason. This includes a change in law or tax clause.

The lesson learned is to include clauses in the contracts or subcontracts to protect the contractor in the future. The starting point is a cost adjustment for the escalation clause that specifically provides the right to recover if the cost of certain products escalates for any reason. This clause should be broad enough to allow for the recovery of other costs, such as delay damages or the escalation in the cost of equipment or products containing the material. ■

*The information in this article should not be construed as legal advice from the author. Contact your legal counsel for specific legal advice and actual contract drafting or review.*

### Endnotes

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