Rise and fall clauses could be another tool to hang on a constructor's belt

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AT A GLANCE

- Rise and fall clauses have been floated as a remedy to the current cost pressure situation in the construction sector.
- A rise and fall clause shifts key project pricing risks from the contractor to the principal.
- While relatively uncommon in modern contracting regimes, rise and fall clauses have a long history.
- There are a range of issues to consider when deciding if rise and fall clauses are fit-for-purpose, including being a relevant factor for insurers assessing construction risk.

> A rise and fall clause should be considered as another tool that a contractor can use to ensure the successful delivery of a project

INTRODUCTION

As the volume of construction projects in the pipeline continues to rise, the supply chains relied on by the industry for delivery are experiencing acute (and perhaps unprecedented) pressure. This is a result of the amount of work, but also other factors, including:

- restrictions on migration causing labour shortages
- decreases in production and other supply disruptions causing materials shortages, and
- legislative reforms causing an increase in business costs and overheads.

As a result, industry participants have seen an increase in construction costs across the board. This means the costs to complete works are rising in circumstances where the predominant contracting regime in Australia is based on a fixed 'lump sum' price. For contractors delivering large volumes of projects, there is a risk they will experience a profitless construction boom. The conflating factors have also caused a rise in insolvencies across the construction sector, as highlighted by several recent high-profile collapses.

Rise and fall clauses have been floated as a remedy to the current cost pressure situation. While relatively uncommon in modern contracting regimes, rise and fall clauses have a long history.

WHAT IS A RISE AND FALL CLAUSE?

A rise and fall clause (also referred to as a cost escalation clause) is a provision in a lump sum or long-term contract that allows the contractor to be paid an increased or decreased sum if certain costs rise or fall from a prescribed point in time (e.g. contractor's tender, the date of the contract or some other date). Costs are calculated by a pre-determined mechanism contained within the clause.

Construction is generally inflationary, so while they are called rise *and* fall clauses, the contract sum usually increases due to changes in the prescribed costs.

Generally, the parties determine what costs will be subject to rise and fall in a construction contract. There are also rules in some jurisdictions (usually to protect consumers) that govern their implementation. For example, rise and fall clauses may not be allowed in domestic or residential building contracts unless the works are over a certain cost, or unless approved by the regulator.

Costs that are commonly included in the operation of rise and fall clauses are labour, materials and government-imposed costs (e.g. taxes). Pegging shipping container rates has become commonplace in many contracts, however there is no particular reason why other costs could not be factored in, such as structural steel for example.

Parties should use precise language when describing the relevant cost. Courts have previously found that rise and fall clauses that apply to wages do not cover increases in holiday pay, because wages are paid for work performed, but holiday pay is not.

The rise and fall clause usually includes a mechanism to calculate the rise or the fall. Again, it is a matter for the parties to determine what that mechanism is. A common method is to use an independent yardstick, such as statistics (e.g. ABS statistics), indices (e.g. CPI) or awards (e.g. Fair Work), to calculate any rise or fall. Another method is to use more general language to indicate that prices may change, but this mechanism tends to involve more risk as the imprecision may cause the clause to be struck out as void for uncertainty.

ARE THEY NECESSARY?

A common aphorism used in construction contracting is that risk should sit with the party that is best placed to manage it. So, who should manage pricing risk?

A contractor's price will include a contingency for things that may or may not arise, which means that principals are already paying for pricing risk. As a result, a rise and fall clause appears to present a better outcome for the principal and may be the only way to address the challenges caused by rising costs. However, it's worth noting modern construction contracts already allow a degree of flexibility on price.

It is common for the amount paid to a contractor at the end of a project to be different from the amount agreed at its commencement. Clauses dealing with variations, EOTs, statutory changes, prime costs and provisional sums (among others) provide a mechanism for the contractor to be paid more or less for work performed.

Participants in the construction industry are already familiar with these clauses, and it is becoming increasingly common for creativity to be exercised in amendments to these clauses to deal with increasing costs in the industry.

Even if a rise and fall clause is arguably necessary, principals often want certainty around price before committing to a project and seek to have the contractor 'take the risk' on changes to price. A rise and fall clause shifts key project pricing risks from the contractor to the principal.

On the one hand, this means that there is less risk that the contractor's margin will be eroded or the project will be unprofitable for the contractor. However, it also means that the principal has reduced price certainty, which can cause difficulties when assessing project viability and obtaining project finance.

Contractors should consider these issues when assessing whether to include a rise and fall clause in a standard contract or a schedule of contract departures.

COULD THE CLAUSES IMPACT INSURANCE?

A contractor insured's contracting regime is a relevant factor for insurers assessing risk. Insurers may look more favourably on a contractor or project that includes mechanisms to safeguard the financial health of a project. This is because it is less likely a contractor will attempt to get 'back to black' by claiming on policies that have been put into place for the project.

Disputes about cost via a rise and fall mechanism are likely to come to a head during the project, rather than at its end. As a result, parties may be more likely to adjudicate their disputes through the relevant Security of Payments (SOPA) regime. Generally, an insurance policy is unlikely to respond to a SOPA claim and may also include 'cost escalation' exclusions.

It is also possible that insurers could consider a perceived lack of familiarity with rise and fall clauses, and difficulty in interpreting and applying them, as being likely to lead to a rise in disputes. While this might be true, it is common for certain construction-related insurance policies to include an exclusion for professional fees. Therefore, depending on the drafting of such an exclusion, it is likely to exclude claims arising from rise and fall clauses for this reason.

A NEW TOOL IN THE BOX?

A rise and fall clause should be considered as another tool that a contractor can use to ensure the successful delivery of a project. As with any tool, it is important to know when and how to use it.

Construction insureds should consider their particular circumstances and assess whether the rise and fall clause tool is one to add to their belt or whether it's better to use other 'old faithfuls' that they are more comfortable applying in a slightly different scenario.

Need to know more?

For more information, please contact our authors.

Aaron Bolton
Senior Associate (Sydney)
T: +61 2 9064 1892
aaron.bolton@wottonkearney.com.au

Robert Finnigan
Partner (Sydney)
T: +61 2 8273 9850
robert.finnigan@wottonkearney.com.au

Andrew Moore
Partner (Sydney)
T: +61 2 8273 9943
andrew.moore@wottonkearney.com.au