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## ADAPTING TO THE UNCERTAINTY OF CONSTRUCTION COSTS: WHY PRICE ESCALATION CLAUSES ARE MORE VITAL THAN EVER

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Long over are the days of predictability in construction prices. The construction industry witnessed prices drastically fluctuate throughout the COVID-19 pandemic. Unfortunately, that reality has remained. Contractors and owners alike have not fully adapted to this new reality, instead relying on old form contract clauses that give a false sense of protection. These clauses generally fall short, and the new reality demands a new approach.

### Price Volatility in the Construction Industry

Prices in the construction industry are at the mercy of varying factors, whether it be the price of raw materials, labor, equipment, or gas and energy that affect the transportation of materials. In effect, this can drastically increase or decrease the costs during the course of the project.

Labor availability and price increases for construction materials and other inputs remains the top two concerns for the construction industry as a whole outside of customer demand.<sup>1</sup> The U.S. saw construction costs increase at an average of 4% in 2023 and costs are set to increase between 3-6% in 2024.<sup>2</sup> In Minneapolis, the cost is predicted to escalate by 4.5%.<sup>3</sup>

### The Status Quo of Construction Contracts

Price volatility has meant that certain materials can see a drastic increase in cost during a project and before a contractor has ordered such materials, often leaving them with the burden. Generally, construction contracts are either cost-plus contracts or a fixed-price contract. In a cost-plus contract, the owner agrees to pay the contractor's direct and indirect expenses plus an additional, separate fee representing the contractor's profit. Due to the uncertainty of costs, this option often leaves owners feeling apprehensive to choose this option. On the other hand, under a fixed-price contract, the owner and contractor set a fixed price to complete the project. This type of contract relies on change orders to deal with the change of scope or prices of materials. Obviously, this

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<sup>1</sup> Tu-Uyen Tran, Fed. Reserve Bank of Minneapolis, *With lower demand, higher costs, construction industry expects leaner months ahead* (May 8, 2023) <https://www.minneapolisfed.org/article/2023/with-lower-demand-higher-costs-construction-industry-expects-leaner-months-ahead>

<sup>2</sup> Kathy Rembisz, GlobeSt., *Construction Costs Expected to Increase as Much as 6% This Year* (Feb. 21, 2024) <https://www.globest.com/2024/02/21/construction-costs-expected-to-increase-as-much-as-6-this-year/?slreturn=20240531104415>

<sup>3</sup> *Id.*

option is advantageous for owners but increases risk for the contractor who may either underestimate the total price or be faced with rapid increased prices in materials.

As previously mentioned, one method that has been used to combat price increases is by executing a change order. While simple in theory and par for the course as the owner revises the scope of work or unforeseen circumstances such as surprise foundation issues necessitate it during the project, owners may not be amenable to signing a change order to increase the cost simply due to the increase of material costs during the project. This predicament increases the risk of a dispute between the owner and contractor down the road.

Another commonly relied upon clause is the *force majeure* clause, which may allow the contractor to an equitable adjustment of the contract price caused by unforeseen circumstances beyond the control of the contractor. While this was certainly applicable during the COVID-19 pandemic, courts around the country have made clear that a *force majeure* clause generally will not protect contractors for rapid price increases due to market volatility absent express language in the *force majeure* clause.

### **Protecting Both the Contractor and the Owner: Price Escalation Clauses**

Price escalation clauses are unique in that they protect both contractors and owners by allocating risk up front for unanticipated and/or uncontrollable price fluctuations in material or other costs. If prices increase, the owner must pay accordingly, and the contractor's bottom line is protected. Contrarily, if prices decrease, the owner enjoys the benefit, and the contractor still retains its profits. In either scenario both sides can make business decisions regarding the level or risk they are willing to bear with respect to unanticipated and/or uncontrollable price escalations after the contract is signed.

To be effective, a price escalation clause should set a baseline price as established by the schedule of values, an escalation ceiling price, and an escalation floor price. It should also be reciprocal and include language that protects both contractors, increasing the baseline price in the event of cost increases, and owners, decreasing the baseline price in the event of cost decreases. Moreover, the price escalation clause should state that any changes, increases or decreases, to the baseline price are based on an objective index, such as a consumer or producer price index, which the parties agree to during the contract formation stage.

Price escalation clauses are generally conditioned on an increase in prices based on a percentage rather than a set sum. The clauses should also include language that protects the owners so that any price increase is not the result of the contractor, such as by contractor unexcused delays in ordering materials. Some clauses will specify materials for which it would apply to such as lumber, plywood, steel, sheet metal, fuel, manufactured products, etc. Thus, the price for any materials to be used on the project increases by a certain percentage or more between the time the contract is signed and materials for the project are purchased. In such a case, the owner shall pay to the contractor, on request, all sums by which the cost to the contractor for any item of materials has increased beyond the certain percentage.

Price escalation clauses offer protections for both the contractor and owner that a typical cost-plus contractor lacks. The cost-plus contract still leaves open the uncertainty of costs and does not offer the general price base line and protections that a price escalation clause does.

## Conclusion

Because price volatility in construction projects is here to stay, relying on old contract clauses often fails to fully afford protections to both the contractor and owner. Incorporating price protection clauses into construction contracts, especially those in connection with prolonged projects, will ensure both the contractor and owner are protected from price volatility. Moreover, price protection clauses will bring a level of certainty in terms of risk and avoid potential disputes as the project proceeds.

## About the Authors



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## **CHANGES TO MINNESOTA’S INDEPENDENT CONTRACTOR AND EMPLOYMENT LAWS IMPACTING THE CONSTRUCTION INDUSTRY**

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As anyone working in or with the construction industry knows, the 2023 Minnesota legislative session resulted in changes drastically impacting businesses across many genres – and the construction industry was no exception. Not to be outdone, the 2024 Minnesota legislative session brought even more changes that will likely impact the construction industry as well.

Some of the more significant changes likely to impact the construction industry starting in 2024 are the changes to Minnesota’s independent contractor and employment laws. Effective July 1, all employers, as well as their owners, will face substantially increased penalties for misclassifying employees as independent contractors. Undoubtedly created with the noble intention of protecting workers from being forced into unfair working conditions, this change appears to follow the trend from 2023’s changes concerning MN’s wage theft laws. However, the new law will likely create tremendous burdens on employers and owners not only to ensuring their own company complies with the new rules, but also to ensure its independent contractors or subcontractors are also in full compliance. Construction industry employers should endeavor to ensure their contractors are properly classified.

### **I. PRIOR LAW**

Prior to the 2024 change in the law, the question of whether or not an individual providing commercial or residential building construction or improvement services was an employee or an independent contractor was determined under a nine-factor test under Minn. Stat. § 181.723. The test primarily evaluated the autonomy of the individual in performing its duties, its manner of compensation, and the nature of its business. If an individual did not meet all nine criteria, then the individual was presumed to be an employee.

Effective March 1, 2025, determining whether a construction industry worker is an employee or an independent contractor will be determined under a new 14-factor test. The test focuses on whether the individual is operating a separate business entity and whether the contractual relationship is a legitimate business-to-business transaction “at the time the services were provided or performed.”

Importantly, among many other requirements, an independent contractor needs to operate under a written contract that is signed and dated by both the independent contractor and the person for whom services are provided, and needs to provide for compensation on a commission or per-job or competitive bid basis and not on any other basis.

The fourteen-factor test applies to everyone who provides or performs building construction or improvement services anywhere in Minnesota. Building construction or improvement services include all public or private sector commercial or residential building construction or improvement services except for the following:

1. the manufacture, supply, or sale of products, materials, or merchandise;
2. landscaping services for the maintenance or removal of existing plants, shrubs, trees, and other vegetation, whether or not the services are provided as part of a contract for the building construction or improvement services; and
3. all other landscaping services, unless the other landscaping services are provided as part of a contract for the building construction or improvement services.

## II. IMPLICATIONS

Under the new law, *all* employers are subject to liability for: (1) failing to classify, represent, or treat an individual as an employee under local, state or federal law; (2) failing to report or disclose a person as an employee to any government agency when required; or (3) requiring an individual who is an employee to enter into an agreement or complete paperwork that misclassifies an individual as an independent contractor. In general, the following penalties for noncompliance include the following:

1. **Compensatory Damages:** These may include, among other things, employee benefits.
2. **Fines for Misclassification:** Each worker incorrectly classified can result in a fine between \$5,000 and \$10,000.
3. **General Violation Fines:** Each specific violation of these rules can result in up to a \$10,000 fine.
4. **Non-cooperation Penalty:** Anyone who hinders the investigation into violations under this section is subject to a \$1,000 fine for each day they delay or obstruct the process.

Effective July 1, 2024, employers may face penalties of up to \$10,000 for each individual violation. Individual owners, officers, or agents who knowingly or repeatedly engage in any of the prohibited activities may also be held liable.

In addition, the Department of Labor and Industry (“DOLI”) may order the employer to pay compensatory damages to each affected worker, including those for minimum wage, overtime, shift differentials, vacation pay, sick pay, health insurance, life and disability insurance, retirement plans, savings plans and other employment benefits, as well as employer contributions to unemployment, Social Security, and Medicare.

There are also substantial construction industry-specific liabilities, fines, and fees imposed by the new law. For example, construction contractors may also incur liability by: (1) misrepresenting themselves as independent contractors even those that do not meet the fourteen-factor test articulated above; (2) requiring an individual who is an employee to register with DOLI as a construction contractor or agree to be classified as an independent contractor as a condition of payment; or (3) requiring an employee to register as a construction contractor. And in addition to the penalties available in general industry, construction contractors may also face penalties of up to \$10,000 each time a person is misclassified under the fourteen-factor test, or for each employee they require to register as an independent contractor. Construction contractor owners, officers, or agents who knowingly or repeatedly engage in any of the prohibited activities may be held individually liable.

General contractors in particular are subject to increased liability for misclassifying those who perform construction services for them. For instance, if a subcontractor fails to meet each of the fourteen factors **at the time the services were provided**, all its employees will be deemed to be employees of the business entity with whom it contracted.

## Conclusion

Contractors in the construction industry operating in Minnesota need to carefully evaluate their independent contractors and whether those with whom they conduct business are properly classified under Minnesota law. Prior to March 1, 2025, construction contractors should review their contracts and paperwork to ensure that their subcontractors meet **every** prong of the new fourteen-factor test **at the time their services are provided**. This includes, among other things, ensuring they have in place for every independent contractor a written contract that is signed and dated by both the independent contractor and the person for whom services are provided. Such contract must, among other things, provide for compensation on a commission or per-job or competitive bid basis - and not on any other basis. In addition, construction contractors will need to ensure that their subcontractors' registrations and licenses remain valid for the duration of time when they are performing work for the contractor, as lapses in registrations or licenses could lead to significant misclassification concerns, which in turn could lead to significant fines and damages assessed against the contractor.

## About the Author



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