

On the Line that Is Dotted

Contractual Remedies to Keep Material Price Escalation from Burying Your Bottom Line

By Bob Huber

The construction industry has absorbed wave after wave of double-digit inflation in materials prices since 2004. These price increases have been caused by an unprecedented worldwide demand for construction materials. Unexpected price increases and sudden market fluctuations raise questions about how they affect existing contracts — especially in terms of each party's obligations under a fixed-price contract.

The potential for market-price fluctuation is a business risk allocated in a fixed-price contract. Contractors assume the risk of a market-price increase, and the owner assumes the risk of a market decrease. As a general rule, a contractor is not entitled to a contract-price increase

when its cost of materials increases; and an owner is not entitled to a contract-price reduction when the contractor's cost decreases. That risk allocation is the primary reason for having fixed-price contracts. However, the rule is subject to a few exceptions.

Price Adjustment Clauses

A typical "price adjustment" clause (or other remedy-granting provision in the contract clause) will specify, usually in terms of percent, a maximum threshold at which the contract price remains unchanged. Contract price is adjusted to the extent that the price fluctuation exceeds the threshold. The use of a price adjustment clause allows contractors and owners to enter into fixed-price contracts

“Risk allocation is the primary reason for having fixed-price contracts. However, the rule is subject to a few exceptions.”

while protecting them from absorbing extreme fluctuations in the cost of materials. There are three types of benchmarks, or baselines, commonly used in price-adjustment clauses:

- Actual costs of labor or material, which is based on increases or decreases in specified costs of labor or material that the contractor actually experiences during contract performance.
- Cost indexes of labor or material, which are based on increases or decreases in labor or material cost standards or indexes that are specifically identified in the contract.
- Established prices, which are based on increases or decreases from an agreed-upon level in published or otherwise established prices of specific items or the contract end items.

Though originally intended to protect contractors from catastrophic price increases, most clauses allow both upward and downward adjustments. Each of the benchmarks has its drawbacks and detractors. The actual-cost method, while theoretically the most appropriate, is susceptible to price manipulation through contractor fraud and contractor/supplier collusion. Contractors are also reluctant to disclose their costs to the owner. The cost-index and established-price methods have the advantage of being objective, but they do not always reflect the contractor's costs.

In one case, a court awarded an owner a \$638,266 downward price adjustment under a cost-index clause—even though the contractor's actual costs rose by 5 percent. The selected price index was the Producers Price Index (PPI) for polyethylene resin, which represented 75 percent of the raw materials used in manufacturing the plastic bags. When the designated PPI fell by 18 percent, the owner requested and was granted a significant price adjustment. The contractor objected that the clause's application was unfair and should not be enforced because it did not reflect changes in the contractor's actual cost of materials. The court rejected the argument, holding the contractor to its bargain. It said:

“[The contractor] thus signed the contract with full awareness of the nature and possible operation of the escalation clause. It did so presumably as a matter of business judgment. It cannot now complain that as a

result of changes in the Price Index, its performance of the contract did not work out financially as it had anticipated and hoped it would.”

States and municipalities are increasingly using price-adjustment clauses in response to the recent spike in the price of asphalt cement (AC). As of September 2005, 22 state departments of transportation were using price-adjustment clauses for AC. Since then, at least 16 state departments of transportation have initiated new price-adjustment clauses. Several contractor associations (including NUCA and AGC) have advocated the use of price-adjustment clauses in future contracts and their insertion into existing contracts, but owners have so far only agreed to their use on future contracts.

Compensable Delays and Accelerations

The second exception is an owner's “compensable” delay of a contractor into a period of a material's price increase. A delay is compensable if caused by the owner's fault. If the contractor would have completed its work before the increase but for the owner-caused delay, then the increased price might be part of the delay damages to which the contractor is entitled.

Subcontractors have the same rights against contractors as contractors have against owners. The contractor's right to these delay damages will depend on the particular circumstances. In another case, a paving subcontractor was awarded a materials-price increase from a contractor who delayed the paving from the fall into the following spring.

Acceleration

What is referred to as an “acceleration” occurs when an owner orders the contractor to complete a project before the specified completion date. If this order requires a contractor to purchase materials at a price peak when it could have otherwise waited, then the price escalation might be part of the change order pricing. As with all claims for extra compensation, the contractor should give any required written notice to avoid waiving its right to an adjustment. The owner might reconsider the acceleration order if it realizes the extent of the associated extra costs.

A “constructive” acceleration occurs when an owner insists on the specified completion date despite a delay, entitling the contractor to a time extension. The effect is the same as an acceleration—less time to perform the contract. If the contract entitles the contractor to suspend performance during periods of material shortages, for example, then the owner must pay the contractor for any increased material costs caused by a refusal to extend the contract period for a reasonable time. A contractor's right to rely on this theory will, of course, depend on the terms of each



Although contractors are generally not entitled to a price increase to cover the rise in materials prices, they may be excused from fulfilling their contracts if events make continued performance “commercially impracticable.”

contract. Unless the contract expressly includes market fluctuations or materials shortages as an excusable delay, courts may be reluctant to recognize them as an excusable delay. Additionally, the wisdom of requesting a time extension will depend on the supplier's commitment to honor this year's prices next year, the effect of any backlog on bonding capacity, and other factors unique to each contractor.

Excused Performance

Although contractors are generally not entitled to a price increase to cover the rise in materials prices, they may be excused from fulfilling their contracts if events make continued performance “commercially impracticable.”

Performance may be commercially impracticable if unforeseeable circumstances cast an excessive burden or expense on the contractor. One factor that courts consider in considering a claim of commercial impracticability is whether the party seeking to be excused had contractually assumed the risk of the unexpected occurrence giving rise to the claim.

Few courts have been asked to apply the impracticability doctrine to unexpected price increases. The Restatement (Second) of Contracts has described circumstances that may justify a refusal to fulfill a contract. Because courts are

reluctant to interfere with commercial contracts, however, the circumstances must be extreme. This is especially true when the unforeseen circumstance is a price spike, for the purpose of a fixed-price contract is to allocate the risk of market fluctuation.

It is too early to tell whether any court will find that today's price increases will make any particular construction contract commercially impracticable. In earlier cases, however, courts have rejected the arguments of contractors who asked to be excused from fulfilling their duties under fixed-price contracts. Their decisions in those cases are based on the well-known volatility of the Middle East, which

made sudden oil price increases reasonably foreseeable.

The fact that performance may not be legally excused does not mean that all owners will insist that contractors perform. To promote competitive bidding in future years, some public contracting authorities may be willing to help a contractor by terminating the contract for convenience. If a price rise threatens a company's existence, a contracting authority may elect to let the contractor out of the contract. This remedy, however, is not a matter of right for the contractor and is entirely dependent on the discretion of the owner.

Obligations of Suppliers to Contractors

A contractor has not suffered any loss if it has fixed-price contracts with suppliers that are delivering materials at the agreed prices. Just as rising material prices do not generally excuse a contractor from performing its fixed-price contracts, they do not excuse suppliers from honoring their fixed-price contracts. The contractor, therefore, may have a claim against suppliers that are not honoring their fixed prices or are claiming a shortage that forces the contractors into supplementing its supply of materials from other sources at higher prices.

Unlike most construction contracts, the standard sales agreements of most suppliers include seller's

exemption clauses, which are a type of force majeure clauses. A force majeure clause allocates risk when performance becomes impossible or impracticable, especially as a result of an event or effect that the parties could not have anticipated or controlled.

Seller's exemption clauses relieve the supplier from its duty to supply material in specified circumstances that would make performance unduly burdensome — like fire, flood, strikes, accidents to plants or machinery, failure of or unusual conditions surrounding the usual source of supplies or material or other causes. In contrast, the force majeure clauses in almost all construction contracts limit the contractor's relief to a time extension and do not allow the contractor to walk away from its obligation to complete the work.

After Hurricane Katrina and Hurricane Rita devastated the Gulf Coast in 2005 and knocked out most PVC production, for example, most PVC pipe manufacturers relied on seller's exemption clauses and refused to provide pipe. When PVC pipe once again became available, contractors were forced to pay higher prices.

The standard terms of one pipe supplier included the typical clause that excused the supplier of its contract obligations "for failure to deliver or delays in delivery, occasioned by causes beyond the control of seller of seller's suppliers or subcontractors, including, but not limited to unavailability or excessive cost of material, floods, storms, adverse weather, unusually severe weather, delay or unavailability of carriers." The contract allowed the pipe supplier extra time to deliver the

pipe and "an adjustment in the purchase price for the resulting additional costs to seller.

For a seller's exemption to be effective: (1) the excusing contingency must be stated with particularity and not in general language; (2) its occurrence must actually prevent or delay the supplier's performance; (3) the supplier must make reasonable efforts to perform despite the contingency; and (4) the supplier must give the contractor timely notice that the contingency has occurred.

If the contractor decides not to contest the supplier's claim of excuse, then he may either: (1) accept the delay in delivery or the allocation of available product; or (2) terminate the contract and discharge the supplier from any further obligation. A contractor who does not accept the supplier's claim of excuse should immediately notify the seller in writing, but after consulting an attorney.

Conclusion

There are no easy answers for a contractor facing potentially crippling rise in prices of construction materials, particularly without a price-adjustment clause to shield the contractor from catastrophe. The best course for each contractor will hinge upon a review of each of its contracts with owners and suppliers, the effect of the price increase on each contract and the cumulative impact of the increase on the contractor.

Bob Huber is head of the construction law department at Leonard, Street and Deinard, P.S., Minneapolis, Minn., and a member of NUCA's Construction Attorneys Forum.

**Do You Have
THE GREEN?**

by **CERDA
INDUSTRIES**

TRENCH SHORING PRODUCTS
Tough • Durable • Innovative • Versatile

MADE IN AMERICA
PROVIDE MEMBER

OSHA
CONSTRUCTION

**CERDA
INDUSTRIES**
A Full Service Manufacturing Company

**Proudly
Made in the U.S.A.**

713.242.7700 • Fax 713.242.7711 • Houston, TX • www.cerdaindustries.com

DEALER INQUIRIES WELCOME