

LEGALLY SPEAKING

by Bob Dunlevey

CONSTRUCTION CONTRACTS – CONTROLLING ESCALATING COSTS

Material shortages and price escalations are wreaking havoc on the construction industry. Be it steel, cement, asphalt, copper, or whatever other commodity that is in demand, the pressures of the global economy and the recent jumps in the cost of petroleum based products are making it very difficult for contractors to enter into fixed-price contracts without absorbing unnecessary risks of financial ruin. Because projects are priced and bid months or even years in advance of actual construction, the current volatility of the materials market puts a contractor at significant risk when attempting to guess what the purchase price of these materials will eventually be. Who should bear the risk of the volatile and escalating price of materials? Traditionally, the contractor has been required to perform the contract without relief from escalating costs. But, risk transfer to the owner is attempting to be utilized by many savvy contractors – especially now when the cost of materials is going through the roof. Traditional contract principles have been shown to be very inadequate in according relief to contractors through change orders and this is why risk transfer needs to be considered.

Developers and contractors are well familiar with certain techniques for meeting escalating costs such as value engineering, substitution of materials, strategic advance purchasing of materials and other such methods. Hand-in-hand with these strategic methods is the need for contractors to develop, negotiate and incorporate within their construction contract provisions the sharing of risk of escalating material costs. These

types of clauses can take many forms, including cost-base clauses which seek to compare actual incurred cost with bid cost, and index-based clauses which track and adjust prices based upon numerous existing material price indexes.

The general rule of law is that material price increases in fixed-price construction contracts are borne by the contractor. Courts have historically taken the view that fixed-price contracts are inherently an allocation of risk – “prices go up – bad for seller” – “price goes down – bad for buyer.” Merely because performance becomes economically burdensome, it is not sufficient legal grounds to let a contractor out of performing. In the absence of specific contract provisions, courts rarely rule a party is excused or entitled to a price increase because of unexpected, substantial material price increases. However, if material is unavailable, courts are more receptive to reforming a contract compared with merely when a material can be bought at a higher price than expected.

The Board of Contract Appeals and the Court of Federal Claims traditionally hold that a contractor assumes the risk of unexpected cost in the absence of clauses shifting risk to government. But, four basic arguments do exist for a contractor to be excused from performance: impossibility – commercial impracticability – frustration of purpose – force majeure. Each of these theories requires a showing of certain facts to meet legal criteria and these principles seldom meet with favor before the courts.

The doctrine of “impossibility” permits the party to be excused if performance has become objectively impossible as a result of an unexpected event. For it to apply, there must be no way for performance to be achieved, not merely uneconomical. For commercial impracticability, it is not necessary that performance be impossible, but it

must be extremely costly, time consuming and impracticable. Because the courts recognize that this principle could be abused, they have stated that it is not to be invoked merely because performance has become more expensive than contemplated. For the excuse of “commercial impracticability” to be applicable, the contractor must exhaust all alternative means of performance. The impracticability must come from an unexpected change. A rise or collapse in the market is not a justification because that is exactly the type of business risk fixed-price contracts are intended to cover. But, severe shortages of raw materials caused by war, embargo, unforeseen shutdown of a supply source and the like can excuse performance. “Frustration of purpose” is another defense to performance but the parties’ purpose of the contract must be almost completely frustrated by supervening events. Frustration must be substantial – not that the transaction has become less profitable or would sustain a loss. “Impossibility”, “commercial impracticability” and “frustration of purpose” generally require the party seeking relief to prove an unforeseen event, no allocation of risk for the unexpected occurrence in the contract, and the unexpected event must render performance commercially impracticable. These are large hoops to jump through.

The final excuse to avoid performance is force majeure. Contracts typically contain a force majeure clause. In construction contracts, these clauses customarily allow a contractor additional time to perform because of circumstances beyond the contractor’s control – flood, earthquakes, fires and strikes. AIA contracts and other similar form contracts usually address this issue. But, courts generally do not view price increases, even when dramatic, to be unforeseen.

What should you do now to avoid future risks beyond using contract escalation clauses? Make changes to your bid/quote forms now. Limit your price to be good for a certain number of days. Qualify your bid/quote to be subject to increases in prices of materials and benchmark the prices. Make sure your quote which contains the escalating price provision becomes part of the contract. Specify that if a change in price of a certain material is more than 5% between the date of the bid proposal and date of installation it shall warrant an "equitable adjustment" in the price. As to your contract with suppliers, make sure the commitment you receive from a supplier parallels the obligations you have with your customer. Most importantly, review your construction contracts with a construction attorney and put clear price escalation clauses in your new contracts. Some standard form construction contracts require the parties to agree on a method to establish the baseline price of the material and calculate an adjustment based on market conditions. The purpose is to shift the risk (or possibly the benefit) of price changes to the owner (or contractor above you). If the owner resists, negotiate the clause to allow the owner to benefit if material prices decrease or give the owner the benefit if the volume of that material increases in magnitude. Explain to the owner that insisting on fixed-price contracts with no escalation clause will cause contractors to quote higher numbers to cover themselves.

In this volatile period of escalating material prices, contractors should not leave any money on the table but instead should ask for extras. All contractual hoops should be jumped through for change orders and claims for extra compensation. Perhaps a claim of delay is the best method to seek compensation for escalating costs provided it is not the contractor's own fault that the delay occurred.

Remember, there are basically three types of price escalation clauses – “day one - dollar one,” “significant dollar increase,” and “delay.” The remedies are either extra compensation or the right to terminate the contract. Day one – dollar one escalation clauses reimburse the contractor for cost of any price increase in material that occurs after the signing of the contract or the acceptance of the bid. The other party pays the difference in the cost of materials between the date of contract bid and the time of installation – dollar for dollar. Such a clause would read:

“The prices of materials and equipment contained in this bid or contract are those in effect as of [date]. Subcontractor shall be reimbursed for all increases in the cost of material and equipment as of the date of installation plus ___% overhead and ___% profit.”

Significant dollar increase escalation clauses reimburse the contractor only for large price increases between the bid or contract date and the date of installation. A sample clause reads:

“In the event of significant delay or price increases of material, equipment or energy occurring during the performance of the contract through no fault of the subcontractor, the contract sum, time of completion or contract requirements shall be equitably adjusted by change order in accordance with the procedures of the contract documents. A change in price of an item of material, equipment or energy will be considered significant when the price of an item increases ___% between the date of this contract and the date of installation.”

Delay escalation clauses allow the contractors to receive escalation if the job is delayed beyond a given number of days or a specified date. It reimburses the contractor for price increases and expenses arising during the delay. Such a clause reads:

“It is contemplated that the performance of the subcontractor’s work will be completed by [date]. In the event that subcontractor’s work is not completed by that date, through no fault of the subcontractor, then the subcontractor shall be reimbursed for all increases in the cost of labor, material and equipment by reason of said delay including reimbursement for extended onsite supervision and overhead plus ___% general overhead and ___% profit.”

Two additional strategies if you can’t get an open ended escalation clause would be to consider combining escalation clauses with a guaranteed maximum price. In effect, this would be submitting two prices by combining a price on current market prices of materials and equipment to be increased by some form of escalation with a maximum price. The other approach would be to submit one price based upon escalation and another lump sum price and give the general contractor or owner the choice.

For other sample price escalation clauses, visit the Dunlevey, Mahan & Furry website at www.dmfdayton.com and go to the Library under Media. A complete slide presentation with clauses exists in the topic “Through the Roof – Material Price Escalation and Construction Services”, or contact Bob Dunlevey at (937) 223-6003.