

# "Through the Roof"

## Material Price Escalation and Construction Services

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# The Problem

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- Material prices increasing
- Most construction contracts are fixed-price contracts and can take a year or more to complete
- Such contracts are typically based on material prices estimated at the beginning of the project



# The Problem

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- Most construction contracts/projects today have relatively slim profit margins
- Delayed delivery of materials due to shortages
- Can delay an entire project and put contractors at risk of liquidated damages, extended overhead, etc.



# The Problem

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- “Experts” - Rising material prices are now a part of doing business
- Will probably be this way for the foreseeable future.



# Major Materials at Issue

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- Steel
- Copper
- Aluminum
- Cement
- Petroleum
- Natural gas
- Lumber
- Gypsum



# Steel

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- Steel prices have climbed by 30 – 50% since 1/1/2004
- All types of steel have increased in price in 2004. Some statistics:
  - Rebar rose 45.2%
  - Structural steel rose 25.7%



# Lumber and Plywood

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- Large price increases mainly due to increased residential construction
- Low interest rates spurred new residential construction
- Lumber prices increased an average of 25.8%
- Plywood prices increased an average of 21.5%
- Hurricane season repair and construction are further driving up prices



# Cement

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- Some regions of U.S. experiencing dramatic cement price increases
- On national scale, average price increase has only been 2.5%



# Why are prices so high?

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- Skyrocketing international demand for steel
- China's use of steel
- Russia and Ukraine, alternative suppliers of steel, are restricting exports
- Some suppliers in India have halted exports to meet India's own domestic demands



# China

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- In middle of 10th phase of 50 year plan which specifies the construction industry should be promoted, improved and better managed
- Preparing for 2008 Olympic Games and 2010 World Expo
- Construction of the Three Gorges Dam
- Construction of thousands of highways



# China

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- Consumes about 25% of the world's steel supply
- Has redirected previously exported steel to fill its own demand
- Asian steel makers, with low labor costs and little regulatory overhead, pay premium to get scrap metal, iron or coke



# United States

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- Material demand significantly higher due to rise in construction activity
- Fire in West Virginia coke fields
- Higher energy prices
- Supplier bankruptcies
- Consolidation of steel manufacturers
- High transportation costs resulting from increased fuel costs



# United States

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- Mini-mills dependent on scrap as primary material source, which has doubled
- Weakened U.S. dollar made U.S. scrap exports more affordable to U.S. markets and imported steel more expensive for U.S. fabricators



# Effect

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- Harder for builders to offer fixed-price contracts
- Harder to quote firm price
- Increasing prices of materials have put enormous cash strain on contractors under fixed-price contracts
- Public projects frequently are fixed-priced contracts because of competitive bidding systems



# Existing Contracts

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- What about contracts I am already bound to?
- Can I get out of the contract?
- What, if anything, can I do????



# History

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- Oil and energy crisis of 1970's and 1980's
- Volatility in Middle East and OPEC oil embargo affected U.S. consumption of oil and gas
- Companies bound to long-term fixed-price contracts argued they should be excused from performance of their contracts
- But, those cases predominately involved sale of goods covered by Article 2 of UCC, which does not govern contracts for construction services



# History

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- General rule of law is risk of material price increases in fixed-price construction contracts are borne by the contractor
- Courts have historically taken view that fixed-price contract are, inherently, an allocation of risk:
  - Prices go up, bad for seller
  - Prices go down, bad for buyer
- Generally, fact that performance has become economically burdensome is not sufficient legal grounds to excuse performance



# History

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- In absence of specific contract provision, courts rarely rule a party is excused or entitled to a price increase because of unexpected, substantial material price increases
- If material is unavailable courts more receptive to reforming a contract compared with when a material can be obtained at a higher price than expected
- Board of Contract Appeals and the Court of Federal Claims traditionally held a contractor assumes risk of unexpected costs in absence of clause shifting risk to government



# History

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- Four basic arguments to be excused:
  - Impossibility
  - Commercial impracticability
  - Frustration of purpose
  - Force majeure
- Doctrines have much in common – each requires a showing of certain facts to satisfy legal criteria – very difficult and rarely successful



# Impossibility

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- A party may be excused if performance has become objectively impossible as a result of an unexpected event
- Very rigid doctrine
- To apply, there must be no way for performance to be achieved, not merely uneconomical
- Numerous cases have stated impossibility doctrine will not apply if performance will be excessively expensive



# Commercial Impracticability

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- Not necessary that performance be impossible
- Performance must be extremely costly, time consuming or impracticable
- As a result of changed circumstances that make performance commercially infeasible
- However, because it can be abused easily, courts reluctantly apply it. Courts have stated it is not to be invoked merely because performance has become more expensive than contemplated



# Commercial Impracticability

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- Must exhaust all alternative means of performance
- Unexpected change in circumstances that makes contract performance infeasible
- Unforeseeability is an important factor
- If performance has been made impracticable because of a contingency, the non occurrence of which is a basic assumption of the contract, the doctrine may apply



# Commercial Impracticability

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- 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 a severe shortage of raw materials caused by war, embargo, unforeseen shut down of supply sources, etc. can excuse performance



# Commercial Impracticability

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- Regarding sale of goods (not services), Uniform Commercial Code Section 2-615 codifies the impracticability doctrine
- Official comment states increased cost alone does not excuse performance unless the rise in cost is a result of some unforeseen contingency that alters the essential nature of the performance



# Frustration of Purpose

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- A party's purpose of the contract must be completely, or almost completely, frustrated by a supervening event
- Event must have been a basic assumption of the contract
- Purpose that is frustrated must have been a principal purpose of that party in making the contract
- Without it, transaction would make little sense



# Frustration of Purpose

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- Change in circumstances makes one party's contract performance virtually worthless to the other
- Frustration must be substantial – not enough that the transaction has become less profitable or even would sustain a loss



# Imposs/Imprac/Frustration

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- Proving each of these elements is difficult/problematic
- Generally, higher prices are neither an event nor likely to be found to be unexpected
- Impossibility, commercial impracticability and frustration of purpose generally require the party seeking relief to prove an unforeseen event, no allocation of risk of the unexpected occurrence in the contract, and the unexpected event renders performance commercially impracticable



# Force Majeure

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- Contracts typically contain a “force majeure” clause
- Typical force majeure clause has four factors:
  - An external event
  - Rendering performance drastically different than contemplated at the time of contracting
  - It is unforeseeable
  - An occurrence of the event is beyond the control of the parties
- Courts tend to focus on latter two elements



# Force Majeure

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- In construction contracts, such clauses typically are in the context of allowing a contractor additional time to perform because of circumstances beyond the contractor's control (i.e. floods, earthquakes, fires, explosions, strikes, etc.)
- AIA A201 (Article 8.3.1) states that contract time shall be extended if contractor is delayed by labor disputes, fire, unusual delays in deliveries, unavoidable casualties or other causes beyond his control



# Force Majeure

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- Generally will not be effective to excuse the contractor who is forced to pay much higher prices for materials than estimated
- The remedy is usually additional time
- However, the actual language used in a force majeure clause should be consulted in light of the circumstances of your situation
- Typically, economic hardship alone does not qualify as force majeure



# Courts' Views

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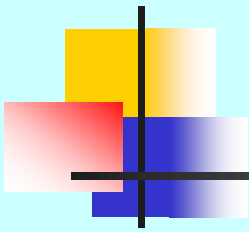
- Courts generally do not view price increases, even when dramatic, to be unforeseen. *Eastern Airlines, Inc. v. Gulf Loyal Corp.* (FL U.S. District Court 1975)
- One significant case did excuse the contractor – *Alcoa v. Essex Group, Inc.* (PA U.S. District Court 1980)
  - Alcoa experiencing 485% increase in production costs as a result of increased electricity costs instigated by 1973 OPEC oil embargo
  - Alcoa would lose \$75 million if the contract were enforced as written
  - Sheer amount at stake drove court to side with Alcoa



# Remember General Rules

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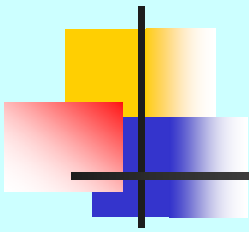
- By entering into a fixed-price contract, the parties assigned the risk of a market increase to the seller and the risk of a market decrease to the buyer
- Incorrect forecast of market conditions is not sufficient to support a defense of impossibility or impracticability and excuse non-performance



# Existing Fixed-Price Contracts

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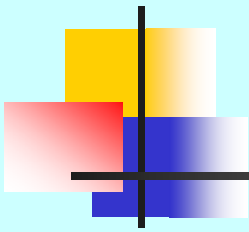
- Relief through courts unlikely
- Actual words of your contract are key
- If AIA A201 contract (often incorporated into construction contracts) Article 4.3.6 allows a contractor to make a claim for additional compensation if he incurs additional costs for several stated reasons and “other reasonable grounds”
- It can be argued that sharp, unexpected increases in material prices because of events beyond your control constitute “reasonable grounds” for additional compensation



# Existing Fixed-Price Contracts

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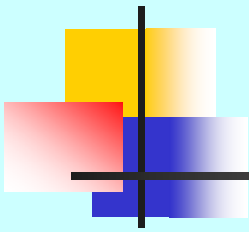
- If you can prove delay is caused by other trades have pushed back completion dates and delayed materials purchases, you may have grounds for additional compensation to recover the price difference an earlier purchase would have made
- Ask for a change order



# Existing Fixed-Price Contracts

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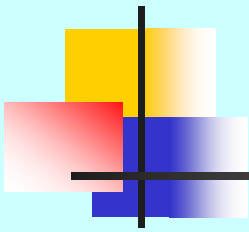
- Consider “practical” remedies:
  - Buy materials as early as possible
  - On projects where it may not be standard practice, if site conditions allow, purchase as much steel or other materials as early as possible and store on site
  - Consider storage, protection and insurance issues



# Existing Fixed-Price Contracts

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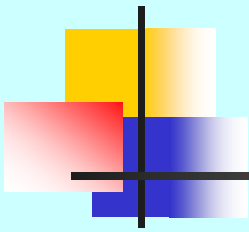
- Consider “practical” remedies:
  - Delay performance until price decreases (if no firm schedule, may help in negotiating extra compensation)
  - Materials management
  - Bulk discounts – if you are purchasing material for multiple projects, purchase at same time to get bulk discounts
  - Better to walk away from contract and be in breach? Doubtful unless your liability is limited in the contract



# Existing Fixed-Price Contracts

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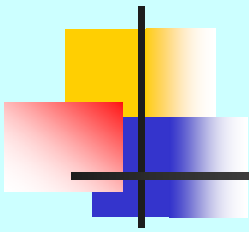
- Don't leave any money on the table, ask for all extras
- Tighten the belt on the job
- Document, document, document
- Jump through contractual hoops for change orders and claims for extra compensation
- Grovel!



# Existing Fixed-Price Contracts

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- Subcontractors should periodically update customer with information on its own performance, on the work of others that adversely impact subcontractor's own completion schedule and on any other events impacting the schedule, in writing, and should make prompt requests for extension of time in the form required by the contract documents



# Existing Fixed-Price Contracts

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- Remember, if you have any old bids out there that you don't want accepted, revoke them in writing!



# Contracting in the Future

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- What should I be doing from now on?
- Bid/Quote form
- Contract language (your supplier and your customer)



# Bid/Quote Form

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- Make changes to your bid/quote form;
  - Price is good for \_\_\_\_ days
  - Subject to increases and prices of materials from the date hereof
  - While you are at it, add other terms and conditions if you don't already have them



# Bid/Quote Form

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- Make sure your quote becomes a part of the contract
- "all of the terms and conditions of subcontractor's bid proposal dated \_\_\_\_" should be added to the enumeration of the contract documents in the contract
- If not, contracts typically provide they are the exclusive, entire agreement and there are no other documents or side agreements
- Without referring to it, the terms of your bid will not survive execution of the contract form



# Bid/Quote Form

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- From ASA “a change in the price of an item of material of more than 5% between the date of this bid proposal and the date of installation shall warrant an equitable adjustment in the subcontract price.”



# Contract Consistently!

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- Lock in material prices
- Make sure commitments you receive from supplier parallel the obligations you have to your customer
- If supplier says he can only provide quotes for item shipped within a certain number of dates, be sure your proposal contract contains an identical provision
- Make sure whatever conditions and contingencies that are part of the suppliers quote are part of your proposal and contract with your customer
- If you can't make parallel arrangements with a supplier and customer, consider using different supplier or substitute products



# Contracting in the Future

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- As immediate remedy, construction companies are consulting with attorneys to include price escalation clauses in new contracts
- Associated General Contractors (AGC) calling on public and private owners to include “equitable adjustments” for material price increases in fixed-price construction contracts
- AGC document number 2000 – Amendment number 200.1 – addresses market fluctuations
  - Requires parties to agree on a method to establish the “baseline price” of the material and calculate an adjustment based on market conditions



# Price Escalation Clauses

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- Purpose is to shift the risk (or possibly the benefit) of price changes to the owner (or contractor above you) -
  - if owner resists, negotiate the clause to allow the owner to benefit if material prices decrease or give owner the benefit if volume of that material increases in magnitude
- Explain to owner that insisting on fixed-price contract with no escalation clause will cause contractors to quote higher numbers to cover themselves
- In current market, owner might actually save money basing price on current price with escalation clause than if the quote was a “padded” fixed-price



# Price Escalation Clauses

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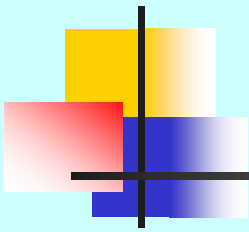
- Three basic types:
  - Day one – dollar one
  - Significant dollar increase
  - Delay
- Differing remedies:
  - Extra compensation
  - Right to terminate contract

# Day One – Dollar One Escalation Clauses



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- Reimburse you for costs of any price increase in materials that occur after the signing of the contract or acceptance of bid
- Other party pays difference in the cost of materials between the date of contract or bid and the time of installation – dollar for dollar



# Sample Day One – Dollar One Escalation Clause

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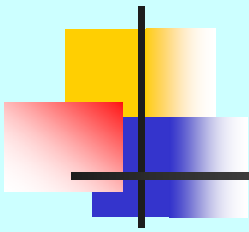
“The prices of materials and equipment contained in this bid or contract are those in effect as of [date]; subcontractor shall be reimbursed for all increases in the cost of material and equipment as of the date of installation plus \_\_\_% overhead and \_\_\_% profit.”



# Significant Dollar Increase Escalation Clauses

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- Reimburse you only for large price increases between the bid or contract date and the date of installation
- Places burden of small price increases on you, but shifts risk of significant price increases to other party



# Sample Significant Dollar Increase Escalation Clause

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“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

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- Fixed-price in effect for original schedule, but allow you to receive escalation if the job is delayed beyond a given number of days or a specified date
- Reimburses you for price increases and expenses that arise during the delay period

# Sample Delay Escalation Clauses



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“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.”

# Sample Price Escalation Clauses



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"The construction industry currently is experiencing rapidly escalating prices and material availability problems. The availability and pricing of certain materials currently are subject to sudden significant changes beyond the control of construction contractors. Because of the difficulty in obtaining firm prices for certain materials from suppliers, subcontractor cannot provide fixed, firm prices for future projects. If there is an increase in the price of materials charged to subcontractor subsequent to making this proposal/contract, the price set forth in this proposal/contract shall be increased to reflect the additional cost to subcontractor upon subcontractor's submittal of written documentation of the increased charges."

# Sample Price Escalation Clauses



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“Due to rapidly escalating prices and extreme volatility in the pricing of construction materials, the price set forth in this proposal/contract applies only to orders that are ordered and paid for within \_\_\_ days of the date of this proposal/contract. All other orders shall be subject to change based on changes in the price of materials charged to subcontractor.”

# Sample Price Escalation Clauses



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"Subcontractor shall perform the work described at the price quoted subject to the following adjustment: In the event the price of any materials to be used in this work should increase or decrease by \_\_\_ percent or greater from the price at which the material was available to Subcontractor at the time of submission of this proposal/contract, the price quote shall be increased or decreased to reflect the additional or reduced cost to obtain the material."

# Sample Price Escalation Clauses



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"If materials Subcontractor is to furnish become unavailable or commercially impracticable to use on this project or prices for such materials escalate subsequent to the execution of this proposal due to material shortages or other causes beyond the control of Subcontractor, Subcontractor shall notify the Customer of the material unavailability and delay in obtaining the materials and/or price escalation and discuss the options to proceed with the work. Subcontractor shall be excused from the requirement of furnishing the materials and Subcontractor shall seek to obtain alternative materials. Customer agrees to pay Subcontractor an increase in cost between the materials that have become unavailable and the cost of the closest substitute that is then reasonably available. In the event of a substitution resulting in a material cost decrease, Subcontractor will credit Customer the amount of the decrease."

# Sample Price Escalation Clauses



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"In the event of a significant delay or price increase of a material specified for use in this project occurring between the date of the contract and when the job is ready for subcontractor's performance, the contract sum, time of completion or contract requirements shall be equitably adjusted by change order in accordance with the procedures for changes in the contract documents. A change in price of \_\_\_ % will be considered significant."

# Sample Price Escalation Clauses



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"Certain construction materials are sometimes subject to unusual and severe price volatility and availability due to political and other conditions that are beyond the control of Subcontractor. If there is a substantial increase in any materials to be used in this project between the date of this proposal and time when the work is to be performed, the amount of this proposal/contract may be increased to reflect the additional cost to obtain the materials upon advance notice and submittal of written documentation to Customer."



# Sample Clause from ASA

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“In the event of significant delay or price increase of material occurring during the performance of the contract through no fault of the contractor, the contract sum, time of performance, and 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 shall be considered significant when the price of an item increases \_\_\_% between the date of this contract and the date of installation.”



# SAMPLE PRICE ESCALATION CLAUSES

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“The contract price for this project has been calculated based on the current prices for the component building materials. However, the market for the building materials that are hereafter specified is considered to be volatile or subject to unanticipated changes, and sudden price increases could occur. [Subcontractor] agrees to use reasonable efforts to obtain the lowest possible prices from available building material suppliers, but should there be an increase in the prices of these specified materials that are purchased after execution of this Agreement for use in this project, [Contractor] agrees to pay that cost increase to [Subcontractor]. Any claim by [Subcontractor] for payment of a cost increase, as provided above, shall require written notice delivered by [Subcontractor] to [Contractor] stating the increased cost, the building material or materials in question, and the source of supply, supported by invoices or bills of sale.”

# SAMPLE PRICE ESCALATION CLAUSES

- (with termination right):

“Should there be a rise in the cost of any specified building material or materials, exclusive of any other price changes, that would cause the total contract price to increase by more than \_\_\_\_\_(%), [Subcontractor] shall, before making any additional purchases of specified material or materials, provide to [Contractor] a written statement expressing the percentage increase of the contract price, the building material or materials in question, and the dollar amount of the price increase to be incurred. [Contractor] may then, at his option, terminate this Agreement by providing at least \_\_\_\_\_ business days written notice of termination to [Subcontractor], and payment to [Subcontractor] for all costs expended in performance of this Agreement to the date of termination, plus payment of a prorated percentage of [Subcontractor’s] profits based on the percent of completion. Should both notice of termination and full payment not be forthcoming within \_\_\_\_\_ business days, as provided herein, [Subcontractor] shall have the option to terminate this Agreement, or to proceed with this Agreement and purchase the specified building materials at the increased price. If termination is elected, [Subcontractor] shall provide to [Contractor] a written notice of termination, and [Contractor] shall be required to pay [Subcontractor] for all his costs expended in performance of this Agreement to the date of termination, plus payment of a prorated percentage of [Subcontractor’s] profits based on the percent of completion. If [Subcontractor] elects to proceed on this Agreement, he may then purchase the specified material or materials at the increased price, and [Contractor] shall be required to pay the increased cost incurred.



# Other Strategies

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- If you can't get open-ended escalation clauses into contract, consider combining escalation clause with a guaranteed maximum price
- In effect, this would be submitting two prices by combining a price based upon current market prices of materials and equipment to be increased by some form of escalation with a maximum price
- Other approach – submit one price based upon escalation and another lump sum price and give the general contractor or owner the choice



# CONTRACT FORMATION

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- When is a contract formed?
- What are its terms?
- Must know at what point (or in what document) to include your provisions.
- Easy to tell if there is a formal “Agreement” with an “integration clause.”



# CONTRACT FORMATION

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- Not so easy to tell when several documents are sent back and forth.
  - Request for Quote
  - Quote
  - Purchase Order
  - Order Acknowledgement
  - Invoice
  - Others



# CONTRACT FORMATION

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- Those documents will have conflicting and inconsistent terms.
- Often a contract is performed, or partly performed, and then a dispute arises.
- What are the terms of the contract? Those contained in the quote? In the purchase order? Other?



# CONTRACT FORMATION

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- To form a contract, the acceptance must be communicated to the offeror before (i) the time that the offer expires by its terms, (ii) the offer is revoked, or (iii) the passage of a reasonable time from the time the offer was communicated to the offeree.
- As an offeror, one important control is to specify the time period during which the offer (quote) may be accepted. Avoid floating indefinite offers. While courts may say that an indefinite offer expires after a “reasonable time”, litigating what is a “reasonable time” is both expensive and uncertain.



# CONTRACT FORMATION

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- What if the “acceptance” is different (even if only slightly) from the offer? Has a contract been formed?
- What if the “acceptance” contains materially different terms than the offer, but the parties go ahead and perform the contract anyway?



# CONTRACT FORMATION

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- There are two different sets of rules, depending on whether the contract is for the purchase/sale of goods, or the purchase/sale of services.
- If the contract contains both goods and services, a court would determine which aspect dominated (the goods or the services) and the corresponding set of rules applies.



# CONTRACT FORMATION

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- Services – offer and acceptance constitute a contract only if no material variance exists between them.



# CONTRACT FORMATION

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- Classic scenario -- Buyer sends a request for quote to seller with buyer's boilerplate terms on the back. Seller then provides a quote with his boilerplate terms on the back. Buyer then sends a purchase order, again with buyer's set of boilerplate terms on the back. Seller in turn responds with an order acknowledgment or invoice, again with seller's set of boilerplate terms. Neither parties' boilerplate terms, however, are mentioned in any preliminary negotiations. Buyer and seller have no idea that the offer and acceptance are not in accord. The issue then becomes: does an enforceable contract exist and, if so, under what terms?



# CONTRACT FORMATION

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- This is what is known as the “battle of the forms.” Your documents should be set up to maximize your chance of winning the “battle of the forms.”



# CONTRACT FORMATION

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- Sample provision for your forms to help you win the “battle of the forms” so that your terms stand a better chance of being part of the contract:

“This Agreement constitutes your offer to us upon the terms and conditions stated herein and shall become a binding contract on the terms and conditions stated herein when our acceptance is indicated by our signature. This Agreement expressly sets forth the terms and conditions under which we will \_\_\_\_\_. Any additional or different terms or conditions proposed by you are objected to and are hereby rejected. You hereby assent to and shall be bound by each and every term and condition set forth herein, notwithstanding and irrespective of any terms and conditions in your [quote, purchase order, acknowledgement] or other documents (whenever issued) which may be different than or inconsistent with those stated herein. Upon acceptance, this Agreement shall constitute the entire Agreement between you and us. Except as expressly provided herein, this Agreement may not be modified or altered except in a writing duly executed by each of the parties.”



# SUMMARY

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- Exiting contracts – legal relief is unlikely and expensive. Consider “practical” remedies discussed
- From this day forward – beef up your quote form and use price escalation clauses in contracts



# GENERAL DISCLAIMER

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**THE INFORMATION CONTAINED IN THIS PRESENTATION IS PROVIDED AS A SERVICE, AND DOES NOT CONSTITUTE LEGAL ADVICE. ALTHOUGH WE TRY TO PROVIDE QUALITY INFORMATION, WE MAKE NO CLAIMS, PROMISES OR GUARANTEES ABOUT THE ACCURACY, COMPLETENESS OR ADEQUACY OF THE INFORMATION CONTAINED IN THIS PACKET. AS LEGAL ADVICE MUST BE TAILORED TO THE SPECIFIC CIRCUMSTANCES OF EACH CASE, AND BECAUSE THE LAWS VARY FROM STATE TO STATE AND ARE CONSTANTLY CHANGING, NOTHING PROVIDED HEREIN SHOULD BE USED AS A SUBSTITUTE FOR THE ADVICE OF COMPETENT COUNSEL.**



# ANTITRUST WARNING

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