Material Price Escalation: Workable Compromises Versus Traditional Allocation of Risk Expectations

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Rapid material price escalation is a costly reality of today?s construction industry. How long this escalation will be a reality is anyone?s guess. In the meantime, there are workable solutions; but those pressing for solutions are fighting the headwinds of the traditional allocation of risk for material price changes, and therein lies the rub.

In the past, it was the rare contract that included terms or clauses allowing adjustment for material price increases. This is because material price increases generally have been viewed as an assumed risk of the general contractor or subcontractor/supplier in the absence of specific terms or clauses providing affirmative relief for material price escalation.

Project owners, particularly public entities that use low bid fixed-price contract procurement and standard form contracts, are not now typically receptive to negotiating changes for material price escalation or accepting the risk of price escalation when they have not done so in the past. General contractors who cannot get relief for material price increases from the project owner are likewise inclined not to grant subcontractors? or suppliers? requests for adjustments due to material price increases.

In the alternative to specific material escalation contract clauses, contractors have attempted to substantiate their requests for material price increases by citing to a contractual force majeure or acts of God clause or to the common law principles of impossibility or commercial impracticability. These arguments typically have failed.

1. Force Majeure/Acts of God Contract Clauses

Force majeure or acts of God clauses are common in most contracts. Typically, the clause identifies specific events or circumstances outside the control or responsibility of the general contractor or subcontractor/supplier, which upon occurrence and impact on performance will provide for non-compensable, time extension relief.

The events or circumstances often included in these clauses are: riot, insurrection, fire, earthquake, governmental acts, severe weather, strikes and other like events. The courts strictly construe such clauses and limit the circumstances of relief to those events or circumstances specifically identified in the clauses. For example, recently, contractors have attempted to expand the coverage of such clauses to argue the COVID-19/pandemic effects on the labor market were a force majeure or act of God. Courts generally have rejected these arguments on the basis that ?epidemic? or ?pandemic? was not specifically identified in the clauses at issue and therefore not a force majeure or an act of God event entitling the contractor to time extension relief.

As a result, and to the extent a general contractor or subcontractor can negotiate the terms of its contract, it is recommended that you seek to add the terms ?epidemic,? ?pandemic? and ?governmental health mandates? to the force majeure or acts of God clause. You should also attempt to add ?unusual delay in material deliveries? to the force majeure or acts of God clause. Private project owners appear more willing to accept such terms versus public project owners with their standard form contracts and procurement regulations. Likewise, general contractors for private projects have tended to be more flexible with such additional terms. As a good practice, instead of just accepting the incorporation of the general contractor?s contract into the subcontract, subcontractors should request and review the general contractor?s contract with the Project Owner to see if the force majeure clause in the general contract matches up with the subcontract clause in the listing of excusable events.

Note, however, even with the expansion of covered events, a force majeure or act of God clause generally only provides for time extension relief, not additional compensation. So, while such an expanded clause could protect a contractor or subcontractor against liquidated damages for delayed completion, the typical clause does not provide compensation relief.

2. Impossibility or Commercial Impracticability

At common law, the doctrines of impossibility and commercial impracticability of performance excuse a contractor?s failure to perform its contract. The doctrines are different in definition and application, through often spoken of as if the same.

The doctrine of impossibility means actual, objective impossibility for the industry as a whole, not just for the claimant contractor. A common example is specifications that require performance beyond the state of the art such that neither the claimant, nor any other contractor, could accomplish the specified work. This argument rarely succeeds except in cases of defective specifications, rather than price escalation circumstances.

In contrast, commercial impracticability relates to a specific contractor, and means for that contractor the increased cost of performance is so great, as compared to the anticipated cost, that the performance is commercially senseless; though not objectively impossible. When considering the increased cost, courts look to the effect of the price increase on the contract as a whole and not solely the price escalation of a particular material, labor or service.

As an example, for a contract to replace tube sheets in a high temperature water generator, a claimed loss of 30.4% was not enough to excuse the contractor?s performance; the loss had to be substantially greater. In another case, a federal board of contract appeals found a 6.62% increase in the cost of a dredging contract, due to diesel fuel costs spiking during the Gulf War, did not rise to the level of commercial senselessness. In yet a third case, a steel fabrication/erector subcontractor experienced substantially increased costs for prefabricated steel amounting to 23% over the estimated costs for the same steel. The subcontractor contended the cost increase was due to ?unforeseen steel cost increases? due to the ?global steel crisis.? The federal board of contract appeals rejected the application of commercial impracticability, finding the 23% steel price increase amounted to less than a 5% cost overrun of the subcontract price.

In order to successfully invoke the doctrine of commercial impracticability, a claimant typically must establish four elements of proof:

1. a supervening event, either an Act of God or an act of a third-party made performance impracticable,
2. the nonoccurrence of the event was a basic assumption upon which the contract was based,
3. the occurrence of the event was not the claimant?s fault, and
4. the claimant did not assume the risk of the event?s occurrence.

In some cases, courts and federal boards of contract appeals have added to the elements of proof to include the claimant bearing the burden of showing that it explored and exhausted alternatives before concluding that the contract was commercially impracticable to perform.

Further, most cases address commercial impracticability in disputes involving a contractor?s reliance on the doctrine as a defense to delay or default/termination for non-performance. In the federal government contract sphere, federal courts may treat a finding of impracticability as a constructive change to a contract.

In sum, commercial impracticability is a viable doctrine in a time of material price escalation, but its application is difficult to prove and may not be a basis for affirmative relief.

3. Price Escalation Clause

At this time, a price escalation clause in your contracts is the better course of action for affirmative relief rather than amending the force majeure clause. The difficulty with such a course of action is two-fold: 1) the other contracting party?s unwillingness to negotiate price escalation terms, let alone even consider the possibility of accepting such a clause, and 2) agreeing on the appropriate terms. The alternative for project owners and general contractors to such a clause, however, is higher contract prices as general contractors, subcontractors and suppliers bid to protect themselves against material price escalation without bidding themselves out of the market, along with the risk of contractor, subcontractor or supplier default during performance when unable to secure specified materials at commercially practicable prices. In essence, a price escalation clause would shift the traditional allocation of risk for material price escalation from the general contractor or subcontractor to the project owner, much like the differing site condition clause shifted the traditional allocation of risk for unanticipated subsurface conditions from the contractor to the project owner.

If the other party to the contract is willing to consider a price escalation clause, there are important points to consider when drafting such a clause.

1. The material prices must increase the subcontract price by more than a certain amount, e.g. 5%. The mutual risk sharing is the key to acceptance of this clause; the contractor or subcontractor assumes the risk of material price increases that occur so long as the contract price does not increase more than the specified % threshold, but over that % level it is the risk of the other party, and the contract is adjusted for the cost increase. A possible compromise would entail fine tuning the clause so that the project owner or general contractor would adjust the subcontract price for only that portion of the total cost of the material price increases in excess of the % threshold, but not for the portion of costs increasing the contract cost less than the specified % threshold. Also, as part of the mutual sharing of risk, the clause could exclude markup on the adjustment amount.
2. The clause should provide for notice from the claimant once it is aware of material price increases; and the parties should ?endeavor? to jointly determine, but not to guarantee, use of substitute or as-equal material.
3. The clause should provide for a listing of material prices as of the time of contracting, to be shown as an Exhibit to the contract or subcontract. This sets the baseline from which the price escalation can be measured from an agreed starting point, and the effect on the contract cost can be determined.

The terms of the escalation clause can be expanded or modified as the parties may agree. The goal here is to suggest terms that might be workable for your next project.

4. Contingencies

Another less used alternative is to negotiate a contingency line item in the contract or subcontract to be used solely in the event of material price increases. The subcontract price would include the contingency amount, only to be spent to compensate for material price increases. The expenditures would have to be documented and the price increases substantiated before expenditure from the contingency. The contingency sum would be shown in the original schedule of values; and expenditures would be shown in a pay application billing against the contingency, like other work line-item billings. The contingency could be capped at a maximum sum, which, in contrast to the escalation clause, puts the risk of material price increases in excess of the contingency cap on the contractor or subcontractor. To the extent the contingency sum is not spent, a deductive change order would be issued to reduce the contract or subcontract price in the same amount (or other % of such savings) equal to the ?savings? on the contingency line item.

A contingency may have more appeal to an owner or general contractor because the escalation cost is capped at the amount of the contingency, and there is a potential recovery of savings to the Owner or general contractor if the increased material costs, if any, do not exceed the contingency.

Conclusion

Economists and the Congressional Budget Office are saying that material price increases are here to stay for 2022 through 2023, and may not fall back until 2024. While the traditional allocation of risk for material price increases has been long-standing, higher contract prices and performance defaults may cause a presentday re-evaluation of that traditional allocation. There are alternatives - 1) price escalation clauses, and 2) contingency sums with savings credited back against the contract or subcontract price ? that can be the basis for a mutual sharing of this risk.

For more information on this topic, please contact Bob Cox (703.760.5227 or bcox@williamsmullen.com) or any member of the Construction team.

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