CONTRACTS BULLETIN NO. 110 SHIFTING THE RISK

OF RISING MATERIAL COSTS

Even in the best of times, material shortages and changing prices are disruptive. Commodities, such as asphalt, copper, steel and other materials are subject to global pressures and price fluctuations. More than ever, contractors need to protect themselves from changes in material prices.

Traditionally, contractors bid contracts on a "fixed" basis without any relief for increasing costs. If materials are available (even if at a very high price) a contractor must provide materials under a fixed-price construction contract. Courts are taking a hard line. A contractor cannot be excused from its obligation to fulfill its contract obligations – even if the contractor is doing so at a loss. If, on the other hand, the materials are truly "unavailable" and it is impossible for a contractor to perform, then a contractor may be able to seek some relief.

To minimize risks, contractors should incorporate into their construction contracts provisions which require an owner to share the risks associated with increasing material costs. This article is intended to provide a basic understanding of the legal issues facing contractors. A contractor must contact legal counsel to assess how the contractor's specific contracts and the laws in its area are impacted by the current materials crisis.[1]

CONTRACT ANALYSIS

Contracts between suppliers, owners, contractors, and construction managers must be carefully analyzed to determine the contractor's responsibility. Provisions may be included in ConsensusDocs or AIA contracts, but also may be included on the back of purchase orders or invoices. All of these provisions can impact a contractor's liability, but, in many cases if properly drafted, contract clauses may limit the contractor's liability.

FORCE MAJEURE CLAUSES

The classic clause addressing impossibility or impracticability is a force majeure clause. A force majeure clause is defined by *Black's Law Dictionary* as a clause "allocating the risk of loss if performance becomes impossible or impracticable, especially as a result of an event or effect that the parties could not have anticipated or controlled." Similar clauses are also described as "Act of God" clauses. The goal of all these clauses is essentially the same — to protect a party when events occur outside of that party's control. (See SMACNA Contract Bulletin No. 65: "Force Majeure – A Clause for Our Times"; see also SMACNA Contract

[1] All of the issues and provisions contained in this Contracts Bulletin are provided for general discussion purposes only. SMACNA strongly encourages its members to seek advice from local legal counsel as the law of individual jurisdictions may vary and the circumstances of an individual member's situation may be different than discussed in this Contracts Bulletin.

Bulletin No. 118: "Force Majeure Provisions: COVID-19").

Whenever possible, contractors should include force majeure clauses. For example:

> Force Majeure. If either party to this Contract is delayed, hindered or prevented from the performance of any act required under this Contract by reason of strikes, lock-outs, labor troubles, inability or delay in procuring standard or fabricated materials, failure of power, restrictive governmental laws, regulations, orders, or governmental action or inaction (including failure, refusal or delay in issuing permits, approvals or authorizations, which are not the result of the action or inaction of the party claiming such delay), riots, civil unrest or insurrection, war, pandemic, epidemic, fire, earthquake, flood or any other natural disaster, unusual and unforeseeable delay which results from any interruption of any public utilities (e.g., electricity, gas, water, telephone), severe or unusual weather, or other unusual and unforeseeable delay not within the reasonable control of the party delayed in performing work or doing acts required under the provisions of this Contract, then performance of such act will be excused for the period of the delay and the period for the performance any such act will be extended for a period equivalent to the period of such delay. The provisions of this paragraph will not operate to excuse either party from continuing with performance of those portions of the Contract that are unaffected by any of the foregoing conditions.

Including a provision like this can provide a contractor with protection to the extent materials are unavailable. This clause by itself, however, will not address the issue of where the materials are available, but at a much higher price.[2]

ESCALATION CLAUSE

Assuming performance is not impossible or impractical (topics discussed in more detail below), a contractor may still limit liability by proposing an "escalation clause."[3] As

[2] Other potential ways a contractor can avoid excessive materials prices is by claiming "mistake" or "frustration or purpose." These require a showing that there was a fundamental misunderstanding between the owner and contractor regarding the contractual terms. These claims can prove helpful and are likely to be asserted as "defenses" in a legal action, and do not lend themselves to contractual clauses.

[3] An "escalation clause" should be distinguished from a cost-plus provision. A cost-plus contract inherently assumes that the cost of materials will be borne by the owner. That is, the owner, in a cost-plus contract, bears the risk of increasing materials costs. In contrast, an escalation clause provides that an owner shall only bear the risk of changing materials costs if a certain percentage

with all contract clauses, this provision is only effective if inserted at the time of contract execution. If a problem develops "after the fact," parties are forced to rely on common law doctrines like "impossibility" and "impracticability" referenced above.

An "escalation clause" permits the contract price to be changed to the extent raw materials or components significantly change in price. While traditionally used on large commercial projects where the job duration will exceed one year, the increased volatility of construction materials has led contractors to propose these clauses for smaller projects. These terms are not a part of the standard ConsensusDocs or AIA, however, they can be suggested as "additional provisions" or amendments and can provide contractors with substantial relief from escalating prices. ConsensusDocs now publishes ConsensusDocs 200.1 as an escalation clause amendment to its Standard Agreement and General Conditions Between Owner and Constructor. The following is an example of an escalation clause:

> "Owner agrees to the amounts and to payment on the terms setforth above in the "Contract Price." The Contract Price shall not change for the Term of this Agreement, except (a) in the event of changes authorized pursuant to other provisions in this Agreement; or (b) in instances where raw materials or component costs increase in an amount greater than __ percent (___%) of the Contract Price. In the latter situation, the Contractor shall be entitled to an escalation of raw material or component costs which shall be passed through to the Owner. No price change shall be effective unless the Contractor gives notice to the Owner of such a price change at least (__) days prior to the effective date of the price change. In the case of a __ percent (__%) or greater increase, the Contract Price shall be increased proportionately to reflect the entire increase in the cost of raw materials or component costs. The Owner agrees to pay these escalated costs consistent with the terms above. To qualify for such reimbursement, the Contractor will be required to maintain accurate records of costs and quantities of materials consumed and shall file a written claim presenting all required data for determining the amount of reimbursement.

While these clauses can be an attractive alternative, they should have clear definitions of when prices can be increased. They also place a burden on the parties to establish a baseline for prices and document price increases for materials which trigger the escalation clause provision.

The reason an owner may be willing to consider such a provision, is it allows the parties to avoid future disputes concerning pricing or a claim by a contractor that materials need not be

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or amount of cost increases. Put another way, in a cost-plus contract, the owner bears all of the risk of materials price changes, whereas in an escalation clause, the contractor bears the risk up to a specified threshold.

provided under the doctrines of impossibility, impracticability, or under a force majeure clause. The escalation clause decreases uncertainty and permits allocation of how and to what extent additional costs will be absorbed.[4] As with all such contractual provisions, a contractor should discuss the proposed language with its attorney.

IMPOSSIBILITY OF PERFORMANCE

Regardless of contract provisions, a contractor may still be able to avoid its obligations to perform if obtaining materials is "impossible." The doctrine of "impossibility" has existed under American and English common law for centuries. This doctrine provides that a party may be excused from performing under a contract if it can be demonstrated that performance is truly "impossible."

It is difficult to show "impossibility." There are numerous cases which hold that a party will not be excused from performance merely because having to perform will be excessively expensive. Economic hardship alone will not excuse a contractor's performance under the doctrine of impossibility.

The key issue is whether the event giving rise to the "impossibility" was foreseeable. The question that arises is whether the parties could have reasonably expected that such an event might occur. Under the doctrine of "impossibility" a contractor will have a difficult time successfully asserting that performing the contract is legally "impossible," unless it can be demonstrated that the materials were absolutely unavailable "at any price."

IMPRACTICABILITY OF PERFORMANCE

A contractor may also seek to be excused from providing materials relying on the doctrine of "impracticability." The impracticability doctrine is similar to the doctrine of "impossibility," although the courts have been somewhat more willing to allow the "impracticability" defense than the "impossibility" defense discussed above. "Impracticability" is discussed in the Uniform Commercial Code ("UCC") §§ 2-615 and 2-616. The UCC is a set of statutes which have been adopted in all states (although many states have slightly modified their terms).

An assessment of impracticability under the UCC focuses on whether the event barring performance was reasonably foreseeable. Such an assessment will determine if the current event was contrary to the basic assumptions implied in the contract, and what costs or hardships will be imposed on each of the parties if a party is permitted to escape liability under the doctrine of impracticability.

The UCC also contains provisions (under § 2-615) which discuss how to allocate materials, to the extent they are available, among available buyers. The statute also has a

[4] Escalation clauses often are paired with companion provisions allowing for time extensions for shortages in materials. These provisions allow time extensions for unforeseen circumstances delaying materials.

provision (under § 2-616) setting forth how a party can respond to a claim of impracticability.

The crucial point in being able to claim impracticability is that no "substitute" is available. A party cannot claim impracticability if the material can be purchased, even at a higher price. The great challenge of claiming impracticability is demonstrating that:

(1) Materials are not available, even at a higher price; and
(2) The price increase was not "reasonably foreseeable."

As a general rule, impracticability defenses have been very difficult to sustain in matters involving changes in the price of goods. However, a skillful lawyer, who has carefully read the contracts between the parties, may be able to construct an argument to a contractor's advantage.

OTHER WAYS TO LIMIT LIABILITY

If a contractor is providing a fixed quote, it is important the bid limit the term of the fixed price contract. That is, if contractors are "forced" to enter into fixed price contracts (in addition to including the force majeure provision referenced above), then the price should be "good" only for a certain number of days. Thus, if the owner's acceptance of the contract is significantly delayed the contractor does not bear the risk of increasing prices over the period of delay.

Additionally, wherever possible, contractors should include change order provisions that entitle it to compensation if circumstances change or unknown conditions are discovered requiring price modification. (Also See SMACNA Contracts Bulletin No. 98: "Change Orders and Extra Work: Tools for Change"; SMACNA Contracts Bulletin No. 48: "The Change Order"; and SMACNA Contracts Bulletin No. 3: "Changes in Scope of Work.")

CONCLUSION

A crucial asset in any negotiation is a full understanding of the strengths and weaknesses of the contractor's position. Understanding exposure to rising materials costs can make the difference between a successful project and financial ruin.