

CAN I CLAIM FOR COST ESCALATION?

By Laurence P. Lubka, Esq.

Once again, material costs are inflating. Many predict that price inflation is going to get worse in the next several months. High oil prices will lead to increases in fabricated products. In a time when contractors are bidding at break-even levels, increased prices (which may be followed by increased labor costs), can quickly turn a contract into a money loser. What can a subcontractor or contractor do to limit the risk of increased prices.

FIXED PRICE CONTRACTS STILL PREVAIL

Typically, contracts in the construction industry are still firm-fixed price bids or guaranteed maximum price (GMP) which becomes a fixed price contract at an agreed upon amount. One court stated "[A] fixed price contract is an explicit assignment of the risk of market price increases to the seller and the risk of market price decreases to the buyer..." If the seller wishes to change that relationship, it generally needs to provide for that modified relationship in its contract. Otherwise, it can not pass along the risk of increased prices. The basic presumption is that the contractor closest to the manufacturer/supplier has the best ability to forecast future prices and can knowledgeably take the risk of price increases at the time it submits its bid.

ESCALATION CLAUSES

There are actually a number of mechanisms by which contractors can shift the risk of inflation. During the course of the 1970's, during a period of high inflation, many

companies included escalation provisions in their contract. Escalation clauses can apply to materials or to labor costs. Such clauses reference either a general inflation index or a more specific materials/industry index and list how frequently the price is to be redetermined (monthly, annually, etc.). By example, ENR regularly publishes a set of price indexes.

As a contractual agreement of the parties, escalation clauses are enforceable. The first challenge is to obtain the agreement of the owner to include such a clause. The Federal government and state governments may be willing to do so. For a private owner, there are few reasons to agree to such a clause. Where the parties agree to include a clause, it is incumbent on the parties to draft a clause which is understandable and is easy to apply.

Historically, price adjustments for increased prices do not include additional overhead and profit. Issues also arise where the selected index does not actually reflect the increase in the specific materials used. For example, the Federally published CPI indicates that general inflation to the public is up only about 3.3% for the past year. However, for the same period of time, the ENR index for copper could have increased by 34%, which is 1000% higher than the CPI. A CPI based escalation index would be of little benefit to a contractor where the CPI does not reflect secular increases in a particular material. However, there is not always a published index for every material. One may be forced to use an index that does not perfectly reflect the material a contractor is concerned about.

What is the incentive for an owner to insert an escalation clause? First, it allows the contractor to bid a lower price at the outset, knowing that it can recover escalation. Second, the allocation of escalation can be shared. For example, the parties can split escalation risk 50/50. Third, a contractor subject to escalated prices and a money losing contract is at far greater risk of default. An intelligently structured clause would be in everyone's best interest.

OWNER'S CAN LOCK IN SUPPLY CONTRACTS

Where an owner recognizes that supplies are tight or escalation is a significant risk, it may elect to lock in the price of the materials (or long lead fabricated item), even before it selects a general contractor. It can also simply purchase all the need materials and store them, where the cost of storage is less than the potential cost of inflation. The owner with a locked in purchase order can then later assign the purchase order to the eventual contractor, when it later selects a contractor.

THE PARTIES SHOULD CONSIDER VALUE ENGINEERING

Escalation in one material does not necessarily mean that all costs have escalated equally. Oil prices can run up at the same time as natural gas prices decrease. It is incumbent on all parties to consider value engineering as a way to mitigate increased costs. That means that the owner has an obligation to seriously consider a viable value engineering proposal which mitigates the cost of escalation.

WHAT CAN I DO IF I DON'T HAVE AN ESCALATION CLAUSE?

Where a supplier, subcontractor or contractor finds itself in the unfortunate position where the prices have gone up so much that it impairs its ability to either perform the contract or even run its company, there are certain legal arguments available which may be able to limit the impact of the price increase on the supplier or subcontractor. It is important to understand that these legal arguments are of narrow application, rarely used and not frequently used successfully. The great weight of legal cases supports the strict enforcement of firm-fixed price contracts, rarely providing price relief to the claimants. The arguments most typically used are:

1. Force Majeure

Force Majeure clauses may provide an excuse to performance, although that excuse may simply be to provide more time to perform. Force Majeure events can be the basis for an excuse to performance where there are price escalation events which are beyond the control of the contractor and which were not contemplated by the contract. Generally, the courts do not recognize escalation as being beyond the control or contemplation of the parties. However, where a price increase is due to an act of war or natural disaster, a subcontractor may be entitled to more time to obtain the material, during which time the cost may decline. In general, force majeure does not excuse performance where the issue was caused by increased prices.

With Force Majeure, or with any of the legal theories described below, a subcontractor usually has an obligation to mitigate damages and try to work with

the other parties to find alternate sources of supply, alternate materials and/or lower costs suppliers in an effort to make the contract work.

In Steel Industries, Inc. v. Interlink Metals and Chemicals, Inc., 969 F.Supp. 1046 (E.D. Mich. 1997), the Court stated that a contractor "was excused only after employing, to no avail, all reasonable, practical alternatives of fulfilling the contract, for only after exhausting all reasonable alternatives would it have been Interlink's reasonable control to deliver the steel. [citation omitted] (holding that a force majeure provision did not relieve seller of its contractual obligation to deliver the liquid products; such a provision obligated the seller to employ reasonable alternative means to fulfill its obligations which seller did not do). . ."

2. Doctrine of Impossibility

A subcontractor is excused if it is impossible to perform the contract.

Impossibility requires objective impossibility. This typically means that no one could perform the contract. This excuse to performance would rarely apply to the purchase of materials. However, if the material was simply unavailable as a result of an act Congress or has been banned for a particular use (see force majeure), the theory can apply. An issue could arise, by example, where China was the sole source of a rare earth material needed for solar panels and China had now banned export of that material, where the specific solar panels had been specified by the owner.

3. **Doctrine of Commercial Impracticability**

If it no longer makes commercial sense to proceed with a contract, the doctrine of commercial impracticability may apply. Simply losing money, no matter how much, is not sufficient to trigger a claim for commercial impracticability. A review of the cases indicate that the loss must imperil the survival of a company. It is not in the best interest of the law to enforce contracts at the cost of the existence of a company and its employees. However, one would need to prove with certainty that the company would collapse as a result of the specific contractual obligation.

With regard to impracticability, many courts have looked to the Uniform Commercial Code ("UCC") Section 2-615. UCC Impracticability contemplates that a party must deal with a contingency, the non-occurrence of which was a basis assumption of the contract. Similarly, UCC Section 2-614(1) provides "Where without fault of either party the agreed berthing, loading, or unloading facilities fail or an agreed type of carrier becomes unavailable or the agreed manner of delivery otherwise becomes commercially impracticable but a commercially reasonable substitute is available, such substitute performance must be tendered and accepted." The UCC applies to suppliers, not to subcontractors. In short, if it was expected that the material was available and it became unavailable, there may be impracticability. However, if a substitute is available, that argument is lost.

Whether a risk was foreseeable or the risk of the occurrence of a problem was allocated to one or the other party is a question involving a review of the contract. In Transatlantic Financing Corporation v. United States, 363 F.2d 312 (D.C. 1966), the Court astutely stated "Parties to a contract are not always able to provide for all the possibilities of which they are aware, sometimes because they cannot agree, often simply because they are too busy. Moreover, that some abnormal risk was contemplated is probative but does not necessarily establish an allocation of the risk of the contingency which actually occurs." Often, a court will simply look to the custom and practice in an industry, or consider which party was in a better position to obtain insurance against the contingency.

The Court in Seaboard Lumber Company v. United States, 308 F.3d 1283 (Fed. Cir. 2002) stated "It is thus not enough for Seaboard to show that it was incapable of performing on the contract; it must show that no similarly situated contractor could have performed. The market fluctuation did not make Seaboard's contract impossible to perform, only unprofitable."

The Court also stated "Even if we assume without deciding that Seaboard's performance is impracticable because it would bankrupt the company, Seaboard must show that the non-occurrence of a slump in the timber market was a basic assumption of the What contract."

4. Frustration of Purpose

The Court in Seaboard also addressed "frustration of purpose". "Under the frustration defense, the promissor's performance is excused because changed

conditions have rendered the performance bargained from the promisee worthless, not because the promisor's performance has become different or impracticable. . . . 'The [non-performing party] bears a heavy burden in proving the defense of frustration.' Id. To meet its burden, Seaboard must show that (1) a supervening event occurred that should excuse performance, (2) did not bear the risk of the event, and (3) did not render the value of the performance worthless to Seaboard. Id."

COST TYPE CONTRACTS

For a sophisticated owner that has the capability of auditing its contractors, there is always the alternative of a cost type contract. Often, this can be the fairest means of both assuring that there is a constant supply of materials, while allowing the owner to determine that it is getting the best available price. Given the low risk to the contractor of a cost type contract, the overhead and profit which is allowed is often minimal. The owner may require that there is no overhead and profit on escalated costs. The Federal Acquisition Regulations provide a multitude of tools to allow management of a cost type contract.

ANTITRUST

It may be that prices have escalated as a result of the manipulation of the market by other companies, not as a result of normal market forces and unforeseeable events. The price increases may be due to the action of one or more companies trying to control the market or pushing up market prices. A number of decades ago the price of silver doubled when a few buyers tried to corner the market. Where price increases are due

to improper actions which are subject to antitrust and related laws, there may be recourse against the suppliers who caused the price increase. A claimant might collect increased costs, lost profits and even treble damages.

IS IT THE FAULT OF THE CONTRACTOR OR OWNER?

The best hope for a claim of escalation is where the problem can be laid at the feet of the owner (or contractor if you are a subcontractor). This ability to shift escalation costs is most notable where there has been a delay which is not attributable to the claimant. Where an owner causes a delay (e.g. late notice to proceed), the contractor can claim resulting escalation costs from the owner. Although a "no pay for delay" clause may be a defense for an owner in many situations, delays caused by the owner usually will allow the claimant to avoid that defense. With such a claim, the claimant will need to show the total term of the delay and its impact on the price (once again, an appropriate price index will be needed).

COOPERATION

The practicalities of business, good will and common sense will often lead an owner to share some or all escalation costs. Where a subcontractor is facing heightened costs or having trouble finding materials at all, replacing the subcontractor could lead to greater problems finding the same materials or lead to even higher costs. Further, the delays of replacing a subcontractor could lead to increased project costs to an extent that could never be recovered from the contractor or subcontractor. An owner facing such a situation may decide that absorbing some of the increased costs is a better alternative than to deal with a failed subcontractor.

It is in the best interests of the subcontractor, contractor, owner and architect to identify escalation and supply problems early in the design / construction process. Value engineering can go a long way to reducing material costs. In fact, in an escalation environment, owners might agree to front end ordering of materials, while placing the costs of storage of those materials (including insurance) on the subcontractor as a way of mitigating anticipated escalation.

CONCLUSION

Inflation and escalation are an omnipresent threat to any project. A period of low inflation is almost a guarantee of a later period of higher inflation. Through it all, firm fixed price contracts will usually be enforceable, shifting almost all of the risk of material escalation and supply to the contractor, subcontractor or supplier. A contractor or subcontractor is not without recourse. There are a number of legal theories that could allow the subcontractor to avoid some or all of the risk of material escalation. In turn, a subcontractor could simply work with the owner to share some of the costs, redesign to avoid some of the costs or to find some alternative to share or reduce the impact of rapid price escalation.