



# MATERIAL PRICE ESCALATION CLAUSES: A MODEST PROPOSAL

By Edward J. "Ned" Parrott

Imagine returning to a jobsite early one morning to find that all copper wiring and air-conditioning tubing has been ripped out of the rough frame of the building. Or imagine the projected profits on a multi-year, fixed-price contract turning into severe losses as the price of steel, concrete, plastic, and fuel escalate wildly beyond expectations. These real world scenarios have been impacting contractors with great frequency over the past several years. Material price escalation has led to a rise in the incidence of theft of jobsite construction materials, lack of firm price quotes, higher project costs, delayed or cancelled projects, and increased litigation.

In an increasingly trying economic climate, this is yet another hardship that construction contractors and owners do not need. Contractors, as well as owners, may experience a whole host of problems should an unexpected escalation in material costs occur following the execution of a fixed-price contract. This article presents a summary of the traditional legal approaches to price escalation issues, and concludes with a superior alternative contractual approach.

## TRADITIONAL LEGAL APPROACHES

The historically harsh approach to the risk of an increased cost of performance has been based on the old Latin phrase, *pacta sunt servanda*, which means generally, "the contract is law." American courts have tried (and largely failed) to account for unforeseeable risks in a more equitable fashion, through both legal and contractual remedies, including force majeure clauses, impossibility of performance, mutual mistake, and commercial impracticability.

- Force majeure is an exculpatory clause that excuses performance upon the occurrence of an event beyond a party's control that would invariably lead to the nonperformance of a contract. The events are typically bad weather, war, acts of God, and political instability. If a contractor can show that such an extraordinary event caused the price increase, it *may* be able to rely on this clause.
- Impossibility arises when a contractor is bound to build according to plans and specifications prepared by the owner, but defects in the plans and specifications arise for which the contractor is not responsible. A contractor *may* be able to rely on the scarcity of a particular material or an exorbitant price increase to state a claim for impossibility.
- In order for a contractor to argue that a mutual mistake voids the contract, thereby allowing for the escalation of material costs, a contractor must show that the mistake was one of fact; the mistake was related to a basic assumption underlying the contract; the mistake caused a severe imbalance in the contract; and the party seeking relief must not have accepted the risk. Proving each of these elements is not an easy task.
- Finally, the concept of commercial impracticability suggests that a contractor should not be unfairly burdened by the unforeseeable change of a basic assumption upon which the contract was based, such as the price of construction materials. With all the recent history of escalation, however, proving that the material price increases were "unforeseeable" may also be difficult.

The traditional legal approaches outlined above have met with limited success. Courts overall remain reluctant to contravene *pacta sunt servanda*. Despite events that may have affected a contractor's performance of a contract, if a fixed-price contract is in place, it will



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be difficult to convince a court to alter the terms. To avoid such uncertainty, it is recommended that fixed-price contracts incorporate a material price escalation clause.

### MATERIAL PRICE ESCALATION CLAUSES

Fixed-price contracts already contain a clause that could serve as a model for a material price escalation clause: the differing site condition clause. The differing site condition clause is a risk-shifting device that places the burden of an unforeseen site condition on the owner, by providing that the owner pay additional construction expenses caused by the unknown condition. With the differing site condition clause, the owner pays only for unforeseen conditions that actually are encountered.

Federal contracting law has already recognized and codified material escalation clauses that could serve as a model for private, fixed-price contracts. The Federal Acquisition Regulations provide that "fixed-price contracts with economic price adjustments can be used when there is serious doubt concerning the stability of the market or labor conditions that will exist during an extended period of contract performance." FAR § 16.203-2. Three types of clauses are recognized by the federal government for government contracts: (1) escalation clauses based on established prices; (2) escalation clauses based on actual costs of labor or materials; and (3) escalation clauses based on cost indexes of labor or materials. FAR § 16.203-1. As an example, below is a sample price escalation clause, which even addresses responsibility for project delay arising from material shortages:

If during the performance of this contract, the price of \_\_\_ significantly increases, through no fault of contractor, the price of \_\_\_ under this agreement shall be equitably adjusted by an amount reasonably necessary to cover any such significant price increases. As used herein, a significant price increase shall mean any increase in price exceeding \_\_\_ percent (\_\_\_%) experienced by contractor from the date of the contract signing. Such price increases shall be documented through quotes, invoices, or receipts. Where the delivery of \_\_\_ under this agreement is delayed, through no fault of contractor, as a result of the shortage or unavailability of \_\_\_, contractor shall not be liable for any additional costs or damages associated with such delay(s).

Deal points to be considered and negotiated for material price escalation clauses include: (a) adequate definition of controlling price index; (b) notice requirements; (c) careful definition of qualifying materials; (d) mark-up on material adjustment; (e) adjustment for both upward and downward price changes; and (f) tipping points and maximums to govern when the material price escalation adjustment will be initiated and ended.

In light of the substantial fluctuations of material prices over the past several years, coupled with the limited and unpredictable success of invoking traditional legal doctrines, a contractor would be best served by inserting a material price escalation clause in its fixed-price contract. Owners also will be served by more accurate project pricing, as well as a potentially increased bidding pool. ■

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