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Escalation Claims and Clauses

Thomas F. Quilling

This article summarizes the possible legal and contractual remedies available to owners/contractors in the event of excessive escalation in material costs for existing contracts, and offers alternative protections for future contracts, through sample escalation clauses for new construction contracts.

Construction contractors are facing yet another challenge in the industry. A construction project could end in tragedy for both the contractor and the owner/developer should an escalation in material costs occur following the execution of a fixed price contract. This article presents a summary of possible legal and contractual remedies in the event of excessive escalation in material costs for existing contracts and offers alternative protections for future contracts, through sample escalation clauses for new construction contracts.

The problem that triggered this new contractor crisis was the escalation of steel prices in late 2003 to early 2004. The steel prices increased 45 to 65 percent for most steel products, and as much as 200 percent for some steel products due to several factors including but not limited to China's, Turkey's, Korea's, and the United States' recent increases in steel consumption. Additionally, other wholesale prices for building materials, including concrete, cement, and framing lumber have followed the path of cost escalation similar to steel.

The possible remedies for existing construction contracts include both legal and contractual remedies. The legal remedy arguments include:

(1) mutual mistake,

(2) impracticability,

(3) frustration of purpose, and

(4) Uniform Commercial Code Section 2-615.

The contractual remedy arguments include *force majeure* and delay damages.

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Mutual Mistake

The following requirements must be met in order for a contractor to argue that a mutual mistake voids the contract, thereby allowing new negotiations for the escalated material costs:

(1) mistake must be one of fact;

(2) it must be related to a basic assumption underlying the contract;

(3) it must cause a severe imbalance in the agreed exchange; and

(4) the parties seeking relief must not have accepted the risk.

Impracticability

The following requirements must be met in order to support an argument of impracticability of contract:

(1) the impracticability must be a result of changed circumstances that make performance impracticable from a commercial point of view;

(2) the non-occurrence of the event must have been a "basic assumption" on which both parties made the contract;

(3) a mere change in the degree of difficulty or expense due to such causes as increased wages, prices of raw materials, or costs of construction, unless well beyond the normal range, does not amount to impracticability, since it is this sort of risk that a fixed price contract is intended to cover;

(4) party seeking relief must exhaust all alternate means of performance;

(5) party seeking relief has burden of proof; and

(6) the impracticability must not be the fault of the party who seeks relief.

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Frustration of Purpose

Frustration of purpose arises when a change in circumstances makes one party's performance virtually worthless to the other. The frustration must be substantial. (It is not enough that the transaction has become less profitable for the effected party or even that he will sustain a loss.) The frustration must be so severe that it is not fairly to be regarded as within the risk that he assumed under the contract. The frustration must not be the fault of the party who seeks relief. The Doctrine of Frustration focuses on a party's severe disappointment caused by circumstances that frustrate his principal purpose for entering the contract. The Doctrine of Frustration has been limited to cases of extreme hardship so that businessmen who must make their arrangements in advance can rely with certainty on their contracts. The burden is on the party seeking relief to prove that the risk of the frustrating event was not reasonably foreseeable and that the value of counter-performance is totally or nearly totally destroyed for frustration. Frustration of Purpose is no defense if it was foreseeable or controllable by the promisor or if counter-performance remains valuable.

Uniform Commercial Code Section 2-615

Section 2-615 of the UCC provides that delay in delivery or non-delivery in whole or in part by a seller is not a breach of the seller's duty under the contract for sale if performance as agreed has been made impracticable by the occurrence of a contingency, the nonoccurrence of which was a basic assumption on which the contract was made, or by compliance in good faith with any applicable foreign or domestic governmental regulation or order whether or not it later proves to be invalid.[1]

Force Majeure

Force majeure is defined as a clause in a contract that covers the occurrence of an unforeseeable event that is beyond a party's control that would lead to the nonperformance of a contract. The events are typically bad weather, war, acts of God, and political risks. The factors considered for a *force majeure* include:

(1) an external event;

(2) rendering performance radically different than originally contemplated at the time of contracting;

(3) that is unforeseeable (objective standard) or at least unforeseen (subjective standard); and

(4) an occurrence of the event is beyond the control of the parties.

Despite occurrences that may have affected the performance of a contract, if a fixed-price contract is in place, it will be difficult to convince a court based on a *force majeure* argument because the acknowledgement of risk in regards to market changes is assumed in a fixed-price contract.[2]

Delay Damages

A project delay is the time during which some part of the construction project has been extended beyond what was originally planned due to an unanticipated situation. The recovery of damages for a particular delay depends on whether the delay was excusable (outside the control of the contractor and not foreseeable at the time of contracting), compensable through the contract, and critical to the project completion. Types of damages include:

(1) cost of idle workers and equipment;

(2) unabsorbed overhead;

(3) loss of efficiency;

(4) cost of performance in a later period (escalation of labor and/or material costs).

In one case,[3] a contractor was allowed to use *Engineering News Record* price indices to prove escalation in material costs. Based on a similar theory, material escalation costs have occurred if the supplier's delivery is delayed beyond the performance period defined in its contract. A material contract should be examined closely as it may expressly define material costs for different periods of performance or may limit the amount of time that a particular price is fixed.

Escalation Clauses

The purpose of an escalation clause is to cope with and provide some insurance for inflation in long-term sales and purchase contracts. Escalation clauses essentially offer protection for both parties in a contract for price fluctuation for goods, such as building materials.

Escalation clauses are also referred to as price adjustment clauses. Escalation clauses benefit owners by eliminating the need for contractors to include large contingencies in situations where neither party can accurately predict the economic conditions of the future. 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."[4] Escalation clauses, fairly negotiated, avoid the risk of uncertainty from deciding the escalation issue in litigation or arbitration, a process that creates substantial economic risk for all parties involved in a construction project. The owner may be best able to deal with the price increases through redesign, and an owner with an escalation clause would be in a position to consider the redesign options. Without an escalation clause, subcontractors may be forced to make the difficult business decision of declining to bid on projects, building large contingencies into bids, or simply walking away from jobs that become too expensive, causing delays and disruptions to projects.

Three types are recognized by the federal government for government contracts: (1) escalation clauses

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based on established prices. (2) escalation clauses based on actual costs of labor or materials; (3) escalation clauses based on cost indexes of labor or materials.[5]

The American Institute of Steel Construction recommends that its members adopt a clause that takes one of two forms:

(1) Payment or credit based on substantiated "actual" costs incurred by the party supplying goods or services. The final cost of supplied goods would be verified from actual invoices and compared to the original estimate or published industry prices at the time of contract. This type of clause is considered the fairest to both parties but requires the contractor to be willing to disclose detailed purchase documents; and

(2) Price escalation tied to a published material index, either chosen from commonly accepted industry publications or developed by a governmental agency. This type of clause is less burdensome to administer but lacks the accuracy of the actual cost comparison.

Whether a contractor or owner is under pressure due to an existing fixed price contract or contemplating entering into a new construction contract, this brief overview provides potential methods available to contractors and owners to protect themselves from cost escalation problems in construction contracts.

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[1] Examples of case law discussing the rulings of courts under the four legal remedies presented discussed above include: *Transatlantic Financing Corp. v. United States*, 363 F.2d 312 (D.C. Cir. 1966); *Eastern Air Lines, Inc. v. Gulf Oil Corp.*, 415 F. Supp. 429 (S.D. Fla. 1975); *Appeal of Southern Dredging Co.*, ENGBCA. No. 5843, 92-2 B.C.A. (CCH) ¶ 24,886, 1992 WL 47920 (1992); *Publicker Industries Inc. v. Union Carbide Corp.*, 17 UCC Rep. Serv. 989, 1975 WL 22890 (E.D. Pa. 1975); *Aluminum Co. of Am. v. Essex Group, Inc.*, 499 F. Supp. 53 (W.D. Pa. 1980); and *Mineral Park Land Co. v. Howard*, 172 Cal. 289 (1916).

[2] Examples of case law discussing *force majeure* include: *Northern Indiana Public Service Co. v. Carbon County Coal Co.*, 799 F.2d 265 (7th Cir. 1986); *Langham-Hill Petroleum Inc. v. Southern Fuels Co.*, 813 F.2d 1327 (4th Cir. 1987); *Seaboard Lumber Company v. U.S.*, 308 F.3d 1283 (Fed. Cir. 2002).

[3] *Appeal of George Hyman Construction Co.*, ENGBCA No. 4541, 85-1 B.C.A. (CCH) ¶ 17,847, 1985 WL 16440 (1985).

[4] Federal Acquisition Regulations § 16.203-2.

[5] Federal Acquisition Regulations § 16.203-1.