



By Duncan W. Glaholt

HANDLING HOT COMMODITY PRICES

“**PRICE**, n., Value plus a reasonable sum for the wear and tear of conscience in demanding it.” – Ambrose Bierce, *The Devil’s Dictionary*, 1906

Hurricane Katrina pounded refineries in Louisiana. Plastic sheeting, foam, insulation, moldings and extrusions became scarce overnight and wildly expensive even when it could be found. China quietly optioned up most of the base metal scrap in the world. Soon structural steel and rebar steel prices went through the roof. Steel became scarce. Prices skyrocketed. The oil cartels flexed their muscles recently and crude oil prices wet through the roof. Asphalt cement prices followed and went up by 400% in a single year. Good for your mutual fund, perhaps, but bad for anyone committed to a fixed price contract.

When courts are asked to shift losses due to commodity price increases, their response is decidedly cool, and for good reason. In essence, fixed price contracts are gambling contracts. However clearly the bargain is defined, however lengthy the specification, there is always the risk that performance will cost more than the fixed price. The owner gambles that costs will equal or exceed the contract price. The contractor gambles that costs will fall short of the price. Everyone would agree going into a fixed price contract that they bargained for all “foreseeable” risks. Courts make this same assumption.

Two arguments are generally used to try to shift losses due to escalating commodity prices: frustration and “*force majeure*”. Both have had little success.

In order to make it possible for contractors to argue “frustration” of a contract on the basis of commodity price fluctuation, it is necessary to show that the fluctuation was entirely unforeseeable. See *Naylor v. Ellis-Don (2001)* and *Dinicola v. Huang & Danczkay (1996)*. This is harder to prove than it sounds. Commodity price fluctuations are discussed routinely in trade organization meetings and newsletters. Many public buyers in Canada have cost escalation clauses. Newspapers discuss rapid commodity price fluctuations regularly. “Unforeseeability” in this context is very hard to prove indeed.

It has been held that for “frustration” to apply, the post-tender commodity price increase must be so enormous “that no man of common sense would incur the outlay,” to quote the decision in *Kesmat v. Canadian Indemnity (1985)*. In the United States, this concept has been replaced with a concept of “impracticability” which is more liberal and gives measured relief in cases of “extreme and unreasonable difficulty, expense, injury or loss.” U.S. courts, however, have also come to the conclusion that price increases on their own do not make performance impossible or even impracticable. Some other factor is required.

In the United Kingdom, it is a well-established proposition of English law that an increase in expense, however great, will not of itself frustrate a contract. In *Consensus ad Idem: Essays in the Law of Contract in Honour of Guenter Treitel*, author and professor J. Beatson in the United Kingdom has suggested three main reasons why this is so:

1. Courts do not like to reallocate contractual risk. By signing a fixed price contract, one party takes the risk of price fluctuations.
2. Courts like certainty. An absolute bar on price increase as frustrating a contract provides such certainty.
3. Market fluctuations are part of life and therefore within the contemplation of the parties and part of the risk taken by one of the parties. Canadian Courts have consistently applied the U.K. approach. Another legal concept often pressed into service in circumstances of

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rapidly rising or falling commodity prices is “*force majeure*”. In *M.A. Hanna v. Sydney Steel (1995)*, the unconscionable actions of one of the parties and the collapse of the steel market together led the court to apply the concept of *force majeure* to relieve the innocent party of the consequences of its improvident bargain. It is doubtful that increased or even escalating prices alone would have led to the same result.

Can contracts be drafted to get around the problem? Perhaps, but this gives rise to another problem. *Hudson’s Building and Engineering Contracts* suggests that the problem with such clauses is that the system amounts to an invitation to suppliers to raise their prices since, once armed with a fluctuations clause, the contractor has no interest or incentive to resist the imposition of higher prices by suppliers. The bottom line, however, is that a well drafted price escalation clause is the best way to reallocate fairly, before-the-fact, the risk of extreme price fluctuations up or down. Not every contractor is prepared to accept that these clauses work both ways. If there is a drop in the market, the owner is entitled to a credit.

We can expect to see another round of these issues before the Courts over the next years as natural disasters, labour shortages and raw material price volatility affects the marketplace. **B**

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