

CAN YOU PROTECT YOURSELF AGAINST MATERIAL PRICE INCREASES?

and, if so, how?

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Everyone knows how the prices of materials, particularly steel, copper and aluminium, have skyrocketed in the last year. This has caused obvious strains for contractors and subcontractors who typically enter fixed price contracts for their work. What, if anything, can they do to protect themselves from this market volatility?

The first question is, can contractors get out of fixed price contracts, and renegotiate new ones, when the price of materials escalates rapidly during the course of the project? Essentially, the law gives them virtually no way out unless their contract expressly gives them a way out. There is a doctrine, known as the doctrine of frustration, which allows courts to relieve parties from their contract if there

is an intervening event that was entirely unforeseeable at the time of the contract that renders the contract physically incapable of being performed. This is a very difficult test to meet. Frustration is usually applied only in the event of intervening events, such as insurrections and natural disasters that were never and could never have been contemplated by the parties at the time of the contract.

The difficulty in applying frustration to cases of economic duress caused by price fluctuations is the fact that the risk of price fluctuations is something that the parties contemplated at the time of the contract. Market fluctuations happen all the time. In fact, the stipulated price contract is common in the construction industry primarily



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because the contract concerns work that takes place over some period of time during which the price of material and labour will probably change. The parties were keenly aware of this risk at the time of the contract.

The problem is not so much the allocation of the risk of price fluctuations for steel, copper and aluminium, but the degree to which the prices have changed.

Owners want to avoid the risk and insist on the stipulated price, while contractors build in cushions into the stipulated price to protect themselves. The law will not relieve them of their contract when they have voluntarily taken on this risk.

The problem is not so much the allocation of the risk of price fluctuations for steel, copper and aluminium, but the degree to which the prices have changed. This is what was not contemplated by the contractor. Unfortunately, the law is not very forgiving. Some cases do give some relief under the doctrine of economic

“impracticability,” but again the cases in which it has been applied are rare and extreme.

The next option, other than simply avoiding fixed price contracts altogether (which would be difficult in

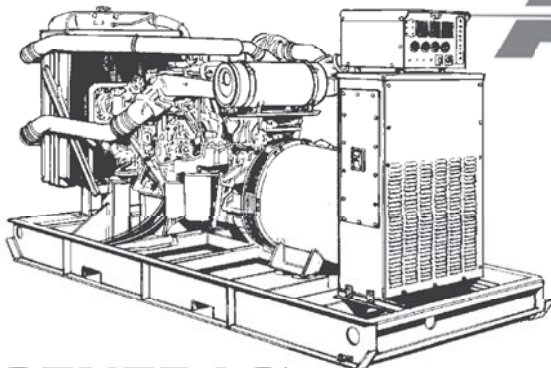
the construction business), is to try and negotiate a clause in the contract that will expressly relieve the contractor from the stipulated price, namely a price escalation clause. These clauses allow the contract price to be adjusted in the event of a specified increase in the costs of materials. The first difficulty with such clauses is the practical one of determining the triggering event for the price increase and then the formula for the actual increase. What is the market against which the contract prices should be compared? By what percentage should the price be increased once the increase is trig-

gered? These are issues that should all be addressed in the clause itself in order to make it more effective in the end.

The problem is getting price escalation clauses incorporated into the contracts. Owners have no incentive to do so and they are the tender-calling authorities who lay out the ground rules for the tender. If contractors take the initiative to amend the tender in order to add the clauses, they will be disqualified for non-compliance. Tendering frowns on such negotiation.

Therefore, the best way to approach owners on this subject is through some industry body that tries to convince owners to structure their tender documents to incorporate these clauses. The argument to the owners would be that, if they do not incorporate these clauses, contractors will have no option in a sharply rising cost market such as this one, but to simply walk away from economically disastrous contracts. This will leave owners with the mess of finishing their projects and filing a law suit against the defaulting contractor that could cost them a lot of money and may lead

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This introduces another problem though. Owners may agree to insert these clauses but no doubt will want some *quid pro quo*. The most likely one is a clause that gives the owner a discount from the stipulated price

not all contractors have. In addition, there is the risk that if the contractor does not complete the contract work, he is left with custom-made material that may not be usable.

- Another form of business protection is to shorten the period over

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in the event the market fluctuates in the other direction. Contractors will be loath to give up the benefit of the stipulated price fixed in that event.

Perhaps then the best protections against sharply rising material costs are the business ones. Here are some of them:

- a Suppliers may be prepared to lock into longer term supply contracts fixed prices.

Such contracts may be extended over the duration of the project, thereby protecting the contractor from the material price escalations altogether. Many contractors have established relationships with suppliers on exactly those terms and it will no doubt be a test for the suppliers as to whether they will stand by such relationships in a rising cost market.

- b If one does not have such a relationship with a supplier, there is the option of prepurchasing the materials one needs for the project *en masse* at the beginning. In the alternative, one could buy futures in the commodities one needs, gambling that the prices for these commodities will eventually exceed the estimated prices. These strategies would however require financial resources that

which your tender price remains open for acceptance. Again, one's ability to do so may be severely restricted by the terms of tender; but one should keep this in mind.

- d Yet another form of protection is to build into the contract price a cushion that accounts for the risk of extraordinary material price increases. Inflating the tendered price does carry with it the greater risk of losing projects, but the question one should ask in such a market is whether one would want to take on projects at prices that do not have such cushions.

A situation of drastic material price increases presents a challenge to contractors who operate in a business dominated by fixed price contracts, such as construction. The law unfortunately gives them little relief. Therefore, it is more up to their business acumen to find ways to weather the storm. In the end, one must always keep in mind that these price escalations usually do not last long.

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