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Hot Topics in Construction and Surety Risk Management

Construction accounting and legal expertise—insights from construction CPAs and attorneys serving on the NASBP Advisory Councils.

Question:
Material Price Escalation—Can Contractors and Sureties Mitigate Market Volatility Risk?

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Answer: As a result of the COVID-19 pandemic, global supply chain disruptions, natural disasters, war, fuel cost increases, and inflation, prices for critical construction materials have soared to unprecedented heights. This price volatility threatens not only the profitability of a project, but also can threaten the ongoing viability of contractors. This results in more defaulting contractors, more bond claims, and more risk for sureties.

Contractors should attempt to negotiate contract terms and conditions that shift and/or seek to share the risk of price volatility with owners. During the bid phase, contractors and owners should hold an open dialogue about how they will address the current economic uncertainty in a fair and equitable manner. That said, the only sure-fire way to insulate against price escalation is by negotiating a material escalation clause, which provides for an equitable adjustment if price increases exceed a certain threshold percentage of the as-bid price. A second option is to strengthen contractual delay provisions, which could provide for an equitable adjustment for material cost increases that result from project delays beyond the contractor’s control. Other options include negotiating "time is of the essence" provisions, a contractor contingency for material escalation, and upfront procurement and storage of materials.

If attempts to contractually negotiate risk fail, contractors may seek relief for material price increases under more standard contractual provisions, including change of law and *force majeure* provisions. While not as strong or certain as material price escalation provisions, these provisions may provide relief, depending on the language of the provisions and factual circumstances.

It is critical to include flow-down provisions into subcontracts and purchase orders that bind subcontractors and suppliers to the same contractual terms that bind a contractor to an owner. Contractors should limit any relief subcontractors and suppliers receive for material price increase claims to the same relief that contractors obtain from owners. In addition, contractors may be able to negotiate with subcontractors and suppliers for extended fixed pricing windows.

Other than negotiating contractual provisions that shift and/or share the risk of material price volatility, contractors may attempt to excuse performance based on common law doctrines of impossibility, impracticability, or frustration of purpose, which discharge contractual duties when an unexpected event frustrates the underlying purpose of the contract and prevents or substantially impacts a party's ability to perform. However, these equitable remedies are difficult to prove; and courts are often reluctant to grant such relief for pricing increases alone.