Taming a Wild Supply Chain: Mitigating Risks of Material Delivery Delays & Price Volatility

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Covid, shutdowns, the Great Resignation, war, and inflation over the past three years have wreaked havoc on construction material availability and pricing. Contractors and subcontractors who promise to install construction materials for a stated price face enormous risk. Those contractors and subcontractors must understand their risks and take steps to mitigate their risks.

When the contract is silent about supply chain delays and price volatility, the law provides little relief.

In the absence of clear contract terms related to price increases, contractors and subs facing supply chain delays and price volatility sometimes grasp at legal doctrines that excuse performance in some circumstances. The leading candidates are impossibility, impracticability, and mutual mistake. In the context of construction projects, these doctrines rarely provide any relief.

The legal doctrine of impossibility almost never succeeds. It requires near literal impossibility. Impossibility succeeds in the rare case that a contract specifies a particular source for materials and that source is no longer providing materials at all, or when government actions trigger impossibility, such as when the government mandated federal supply priority to support war efforts in Vietnam. If ANY contractor could provide the material despite the troublesome contingency, most courts reject a claim of impossibility.

Impracticability, also called frustration of purpose, is relevant when a change in circumstances so drastically undermines the commercial sensibility of an agreement that courts excuse performance. Impracticability can exist where performance is technically possible, but is economically nonsensical. Contractors and subs seeking to have their performance excused must show, among other things, that the impracticability attaches to the obligation to be performed and not to the inability of the contractor or sub to perform it. A contractor's or sub's fulfillment of a contract to provide materials might be suspended by industry-wide unavailability of a material, but industry-wide price increases do not justify an excuse.

In order to successfully invoke the doctrine of impracticability, the source of the impracticability must have been unforeseeable at the time of contract. Although Covid and the war in Ukraine may not have been foreseeable at the time of many preexisting contracts, now they are common knowledge.

Mistake of fact can be either mutual mistakes between both parties or unilateral mistakes by only one party. Regardless of the form, the mistake must pertain to a fact existing at the time of contract formation. A unilateral mistake, unaccompanied by fraud, imposition, undue influence, or like oppressive circumstances, is not sufficient to avoid a contract or conveyance. While a mutual mistake does not require fraud or other "oppressive circumstances," they do not apply to mistakes regarding future contingencies or uncertain future events. Thus, the doctrine of mistake will almost never apply to supply chain disruptions or price volatility.

The type of contract drives which party bears the risk for material price volatility and unavailability.

Most construction contracts explicitly or implicitly allocate the risks of material price volatility and unavailability. One key indicator of who bears material-related risks is the contract type. Fixed-price contracts will most often make the downstream entity shoulder price burdens. Cost-plus contracts without a guaranteed maximum price (GMP) usually place the price risk on the upstream entity to carry. Somewhere in the middle falls the cost-plus contract with a GMP, because the GMP can act like a deductible of sorts, where the upstream entity pays increased material prices up to the GMP, but the downstream entity covers the surplus beyond the GMP.

Public contracts almost never provide contractors or subs with any relief for price increases. Most public procurement laws require public owners to award fixed price contracts. There is little opportunity to pass price increases to a public owner in the absence of delays or change order work.

Most construction contracts allocate the risk of material unavailability. The most common contract provision allocating the risk is commonly referred to as a force majeure clause. Force majeure is a French term for a legal doctrine sometimes known as "acts of God" clauses. Force majeure clauses usually suspend or excuse a party's performance when the performance is delayed through circumstances outside the party's control. Both the standard AIA contracts and the ConsensusDocs contracts contain a force majeure clause. Section 8.3.1 of AIA A201-2017 states:

> If the Contractor is delayed at any time in the commencement or progress of the Work by (1) an act or neglect of the Owner or Architect, of an employee of either, or of a Separate Contractor; (2) by changes ordered in the Work; (3) by labor disputes, fire, unusual delay in deliveries, unavoidable casualties, adverse weather conditions documented in accordance with Section 15.1.6.2, or other causes beyond the Contractor's control; (4) by delay authorized by the Owner pending mediation and binding dispute resolution; or (5) by other causes that the Contractor asserts, and the Architect determines, justify delay, then the Contract Time shall be extended for such reasonable time as the Architect may determine.

Contractors and subs should beware that standard force majeure clauses provide relief only for the time of performance and do not provide any relief for price increase. Subcontractors should beware that many subcontracts drafted by contractors do not contain any force majeure relief. The most effective force majeure provisions during COVID-19 included "pandemic" among the list of covered events, and many contracts have now added this language.

Most upstream parties will agree to a reasonable force majeure clause that provides excuses for performance when performance is delayed for causes outside the downstream party's control, so long as the downstream party insists on it.

Risk mitigation should begin before signing the contract.

Noting that dispute and litigation avoidance is the best outcome, practical steps can be taken to avoid the possibility of needing to rely on any of the legal doctrines outlined above. First, contractors should take strides to mitigate risk where possible in the bidding or proposal process. For example, proposals could themselves include the price escalation protections detailed below. Additionally, proposals could be available for acceptance on a limited-time basis. Placing an expiration on bids hedges vulnerability to subsequent bidders pricing-in later fluctuations the early bidder could not. Furthermore, contractors should be wary of bid documents that contain terms limiting change orders related to price escalation.

Before signing a contract, a contractor should scrutinize its scope of work and identify materials most susceptible to price volatility or unavailability. Giving those materials special treatment in the contract may be more acceptable to the upstream party than a broad-based price escalation clause. Contractors could include special allowances or larger contingencies for these potentially problematic materials. Compromises with the owner for volatile materials are also possible, like allowing deductions if prices decrease, so long as the owner reciprocates by allowing the contractor leeway for price increases.

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Contractual terms should allocate the risk of price increases.

Price escalation clauses most commonly take one of three forms: (1) any-increase escalation clauses; (2) threshold escalation clauses; and (3) delay escalation clauses.

An any-increase escalation clause calls for equitable adjustment of the contract sum at the "first-dollar." This theoretically means contractors could expect a dollar-for-dollar adjustment in light of material price increases. An example of an any-increase escalation clause is:

> An increase in the price of any construction materials used in the Work between the date of Contractor's bid and the date of installation shall warrant an equitable adjustment of the Contract Sum.

Similar verbiage is observed in the ConsensusDocs 200.1 Amendment No. 1 § 3.2. Because any-increase escalation clauses can be risk-laden for the owner, a compromise could be identifying risky materials more prone to cost increases or unavailability during the project and designating only those as "covered materials."

Threshold escalation clauses practically operate as a deductible. They establish a dollar amount or percentage by which the price of materials must increase before an increase in contract price is triggered. Operationally, this calls for the contractor to shoulder the financial risk of materials increasing in price below the threshold amount, just as one might have to self-insure damage to their car before damage would be covered by insurance. This is an example of a threshold escalation clause:

> An increase in the price of any construction materials used in the Work of more than 5% between the date of Contractor's bid and the date of installation shall warrant an equitable adjustment of the Contract Sum.

Delay escalation clauses provide a contingency in the event of material unavailability and material delivery delays. This type of provision corresponds to a contractor's inability to obtain materials entirely, as opposed to a mere increase in price. A delay escalation clause might, for example, say:

> The Contract Sum assumes that the Project will reach Substantial Completion on or before [DATE]. If the Project is delayed through no fault of a Contractor or its Subcontractors more than [NUMBER OF DAYS] beyond the aforementioned date, the Contract Sum shall be equitably adjusted to account of any price escalations incurred as a result.

In conjunction with incorporating contractual clauses that share price risk into the contract, contractors and subs should establish baseline prices for materials. Baseline prices can be derived from independent sources, not controlled by any party to the contract. Examples of independent sources are lumber prices on Nasdaq or the NYSE American Steel Index. A baseline price provision could read:

> The Contract Sum has been calculated based on the prices for materials identified in the following chart (collectively, the "Baseline Prices"). In the event of an increase or decrease between a Baseline Price and the actual cost incurred by Contractor in procuring the materials identified below, the Contract Sum shall be equitably adjusted to account for such increase or decrease upon written notice from Contractor to Owner identifying the actual cost incurred for such materials.

Material	Price Per Unit	Date	Supplier

Other contractual methods to share price risk. Similar to a threshold escalation clause, upstream entities might be inclined to use thresholds to cap price escalations; for example, by allowing equitable adjustments for price variations after the first 5%, but then capping the adjustment at no more than 10%.[1] An escalation threshold could also be used to trigger a negotiated price-point at which the owner permits the purchase and storage at cost of impacted materials. This could be pre-established at the inflection point where storage expenses become cheaper than the materials would be at further inflated costs. The mutual benefit is that storage under these circumstances aids in facilitating timely project completion that might otherwise prove elusive.

Another method to share risk of price volatility is to establish allowances or contingencies for key materials. AIA Document A503-2017 Guide for Supplementary Conditions, suggests including certain materials in allowances to accommodate price increases.

Sometimes owners will agree to share some of the risk of price increases so long as they get the benefit of price decreases. In other words, the parties agree on baseline prices. When prices increase, the owner pays more money. When prices decrease, the owner pays less.

Apart from ensuring contracts share risks, some prudence can further mitigate risks associated with material price escalations and unavailability.

Apart from negotiating, contractors must continue taking steps after contracting in order to minimize their risk. Here are some suggestions:

- Closely monitor costs and pricing changes, and have a plan to provide immediate notice to upstream parties.
- Consider purchasing materials as soon as possible; many owners appreciate and share a desire to create certainty and will pay for stored materials.
- Consider various design solutions and value engineering to make less material stretch further.
- Have a designated system for reporting actual pricing and comparing that with any documented baseline prices.
- Build the risk of material price increases into your prices or contingencies.
- Look for opportunities to submit change orders and claims. Delays or scope changes caused by the upstream party often create a reason to pass price increases upstream.
- Communicate with the other parties in the project. Generally, everyone benefits from the project moving forward, and few truly benefit when litigation ensues.

Owners recognize that the industry is facing unprecedented times of material unavailability and price volatility. Owners are the ones choosing to build here and now. Owners are the ones who stand to reap benefits of a hot economy. If they are pressed, many of them will agree to accept some risk of material unavailability and price escalation. Contractors and subs must take steps to protect themselves.

Author Bios

Eric Biesecker is an attorney in Nexsen Pruet's Greensboro, N.C. office, and the leader of the firm's construction practice group. He represents a variety of clients in the construction industry, including owners, contractors, subcontractors, and suppliers, and has handled hundreds of matters from lien and bond claims, to defect and delay disputes, bidding challenges, and scope-of-work conflicts. He assists landowners in eminent domain/condemnation matters, and also represents a wide range of clients in real estate disputes and other types of commercial litigation.

Jacob Farrell is an Associate in Nexsen Pruet's robust Construction Practice Group. As an accomplished military veteran, he utilizes his communication and strategic planning experience in every matter. Jacob earned his J.D. from the University of North Carolina School of Law, with honors. In law school, Jacob was published in the NC Journal of Law & Technology, and competed on UNC's National Negotiation Team. Jacob uses these skills to secure the best possible client outcomes.

1. See, e.g., Federal Acquisition Regulations §§ 52.216-2, 52.216-3 (2022) (incorporating a 10% aggregate threshold cap).