

MANAGING MAYHEM IN THE MARKET

A Legal Guide for Construction Managers

**CMAA Annual Seminar
March 23, 2007**

John Parnass
johnparnass@dwt.com
www.waconstructionlaw.com

© Davis Wright Tremaine LLP 2007

I. INTRODUCTION

Market factors beyond the control of the parties – volatile material prices, shortages or unavailability of supplies, and unanticipated labor stoppages – can play a disruptive role in delivery of construction services. This Article summarizes the current state of law on how such uncertainties are allocated by contract. This Article also proposes a risk allocation matrix and suggests possible tools for use by construction managers in allocating responsibility for market risks while attempting to maintain adherence to key project criteria.

II. GENERAL RULES

The four most common types of construction contracts – (1) lump sum, fixed price contracts, (2) guaranteed maximum price contracts, (3) costs plus fee contracts, and (4) general contractor/construction manager (GC/CM) contracts – all employ varying legal rules to allocate market resource risks such as price volatility and labor shortages.

A. Fixed Price Contracts

In a fixed price contract, it is well established that the risk of a variety of market fluctuations such as cost escalation belongs to the contractor:

The normal risk of a fixed-price contract is that the market price will change. If it rises, the buyer gains at the expense of the seller (except insofar as escalator provisions give the seller some protection); if it falls, as here, the seller gains at the expense of the buyer. ***The whole purpose of a fixed-price contract is to allocate risk in this way.***

Northern Indiana Pub. Serv. Co. v. Carbon County Coal Co., 799 F.2d 265, 275 (7th Cir. 1986) (emphasis added); *Langham-Hill Petroleum, Inc. v. Southern Fuels Co.*, 813 F.2d 1327, 1330 (4th Cir. 1987) (“If fixed-price contracts can be avoided due to fluctuations in price, then the entire purpose of fixed-price contracts, which is to protect both the buyer and the seller from the risks of the market, is defeated.”).

1. Skilled Labor.

To illustrate this general point, consider the need for skilled labor. Most contracts provide that the contractor has sole responsibility to secure sufficient skilled labor on a timely basis to achieve schedule. Unless the contract recognizes an exception, this rule is generally enforced to make the contractor liable for failures to secure sufficient skilled labor. Only in an exceptional case may a contractor seek extra payment from an owner to make up for its inability to supply skilled labor. One such narrow exception involved a situation where the owner knew – but failed to disclose – its intent to construct other projects in the immediate market vicinity, which in turn negatively impacted the local labor market.¹

It is also well-settled that a tight labor market is not a legal excuse to timely performance, particularly when the contractor could have foreseen the situation at the time of its bid. A contractor is generally deemed to have investigated the availability of labor in the work area prior to bid submission. For example, when the tight labor market was common knowledge in the market prior to bid, it is virtually impossible for the contractor to prove excusable delay based on failure to hire skilled labor.²

2. Strikes.

Disruptions due to labor unrest or strikes can also be costly. The general rule under many contracts is that, while delay due to strikes is an excusable delay to the contractor such that the owner may not assess liquidated damages, the contractor is not entitled to extra compensation.³ For example, a strike is not considered to be an unforeseen condition under the Differing Site Conditions clause.⁴ In addition, if a strike or labor unrest is “reasonably foreseeable” at the time

¹ *J.A. Jones Constr. Co. v. United States*, 390 F.2d 886 (1968).

² See generally McBride & Touhey, 5 *Government Contracts* § 36A.170[3] (Matthew Bender 2007).

³ See AIA A201, § 8.3.1.

⁴ *Olympus Corp. v. United States*, 98 F.3d 1314 (Fed. Cir. 1996).

the contractor prepared its bid or entered into the contract, courts generally presume that the delays associated with the strike are included in the contractor's bid and become the contractor's responsibility.⁵

On occasion, a court will also refuse to grant the contractor a time extension for delays due to strikes when a reasonably diligent contractor (or subcontractor) could have taken steps to end the strike sooner.⁶ The rationale for this exception is that no time extension is allowed when the cause of the strike is either within the control of the contractor or is caused by the fault or negligence of the contractor.

Likewise, for delay due to strike to be excusable, the strike must not have been foreseeable at the time of bid submission.⁷

3. Materials.

Unless the contract allows otherwise, the contractor ordinarily also bears the cost and responsibility of supplying specified materials in a timely manner.⁸ And while project specifications frequently call for specific products or materials to be incorporated in the work, the owner does not generally warrant that the specified materials are commercially available.⁹

Most issues concerning material availability instead revolve around the contractor's request for substitution of an equivalent product or material. Regardless of whether the contract documents literally allow the contractor to propose an equivalent product, the owner in good faith should entertain such substitution proposals in good faith and either approve or reject them on a functional (rather than hyper-technical) basis.

⁵ *John F. Miller Co. v. George Fichera Constr. Corp.*, 388 N.E.2d 1201 (1979).

⁶ *See Appeal of Shipco Gen. Inc.*, ASBCA 86-2 BCA 18, ¶ 18,973 (1986). This same rule is now embedded in the federal procurement rules, 48 CFR § 22.010-2(B).

⁷ *McBride & Touhey*, 5 *Government Contracts*, § 36A.110[2].

⁸ *See Appeal of Aoccupacia Constr.*, 88-2 BCA (CCH) ¶ 208-20 (1988) (contractor should have foreseen possibility of backlog of orders among companies fabricating pipe; no time extension granted).

⁹ *Franklin Penny Co. v. United States*, 524 F.2d 668 (1975).

In addition, if the project specifications sole-source equipment or material to a company now unable to deliver (e.g., due to bankruptcy or other cause), the owner is bound to allow reasonable substitution and may not hold the contractor to the impossible task of complying with a sole-source provision that becomes commercially unavailable.

4. Extensions of Time.

Because extra compensation is generally not allowed, contractor recourse for market risks is instead typically limited to a potential extension of time. For example, the right to request a time extension under A201 is governed by Article 8.3.1, which reads:

If the Contractor is delayed at any time at the commencement or progress of the Work by . . . labor disputes, fire, unusual delay in deliveries, unavoidable casualties or other causes ***beyond the Contractor's control*** . . . then the Contract Time shall be extended by Change Order for such reasonable time as the Architect may determine.

Article 8.3.1 is generally known as a Force Majeure clause. Since a “force majeure clause is not intended to buffer a party against the normal risks of a contract,” including the risk in a fixed price contract of exposure to market gyrations, however, provisions such as Article 8.3.1 are ***not*** mechanisms for extra ***compensation***. *North Indiana Public Service Co. v. Carbon County Coal Co.*, 799 F.2d 265, 275 (7th Cir. 1986).

Moreover, the time extension allowed under Article 8.3.1 for causes “beyond the Contractor’s control” has well-established limits. Principally, the contractor must establish reasonable efforts to mitigate or work-around the disruption beyond its control before invoking the protection of Article 8.3.1:

The Supreme Court has interpreted this phrase of a similar clause to mean that if plaintiff has an excuse enumerated in or within the meaning of the contract, it must go beyond merely proving the excuse. Plaintiff must also prove that it took all reasonable action to perform the contract notwithstanding the occurrence of the excuse.

Jennie-O Foods, Inc. v. U.S., 580 F.2d 400, 408 (Ct. Cl. 1978).

B. Guaranteed Maximum Price (GMP) Contracts

The most widely used form of GMP contract – the AIA A111 (1997) – is based on the same two-step rule which generally forbids monetary recovery of market risk costs under a fixed price contract: (1) absent an approved Change Order, the contractor cannot recover sums in excess of the agreed GMP and (2) there is ordinarily no contractual mechanism for requiring the Owner to execute a Change Order to cover unanticipated cost escalation and associated market costs.

In the normal case, therefore, a GMP contract is just that – a contract establishing a maximum price at a firm figure over which the contractor bears the risk of cost escalation.¹⁰ The best way to mess up this arrangement is to use poorly drafted language. In one case, a contract believed by the owner to be a GMP contract was in fact declared to be a time and material, cost-plus arrangement due to poorly written GMP language.¹¹ A similar outcome can also stem from the failure to arrive at a binding GMP in the first instance, such as where the price was to be developed “as soon as design development drawings are complete.”¹²

C. GC/CM Contracts

In Washington, the GC/CM contract is both akin to the fixed-price/GMP model for purposes of market risk allocation and somewhat different. As with the fixed price/GMP contracts, the contractor in a GC/CM framework commits to a guaranteed cost of construction

¹⁰ *TRW Inc. v. Fox Dev. Corp.*, 604 N.E.2d 626 (Ind. 1992).

¹¹ *Professional Servs. Indus. Inc. v. J.P. Constr. Inc.*, 491 N.W.2d 351 (1992) (holding that contract value included in contract was nothing more than an estimate).

¹² *Bouten Constr. Co. v. M&L Land Co.*, 877 P.2d 928 (Idaho 1994). This case, in particular, illustrates the risk that a GMP can be made illusory by conditions imposed in the contractor’s or bidder’s clarifications and assumptions or by the design team’s failure to furnish final, biddable GMP drawings.

(Maximum Allowable Construction Cost or “MACC”) which is deemed to include the cost of the work, specified general conditions, the contractor’s fee and sales tax.¹³

But the GC/CM statute contains two provisions – one mandatory, one optional – which provide a point of distinction from the GMP model. *First*, the GC/CM statute requires the owner to carry a “reasonable budget contingency totaling not less than five percent of the anticipated contract value.” RCW 39.10.070(1)(c). But because neither the amount of the contingency nor the risks to be covered by the contingency are identified in the statute, both subjects are open to negotiation. The GC/CM contingency has evolved in practice to include a range of risks, including cost escalation and labor volatility.

Second, the GC/CM statute allows the owner to include an incentive clause in the contract for any savings of either time or cost or both from the original negotiated deal.¹⁴ The incentive may not exceed five percent (5%) of the MACC and may be applied “for early completion, cost savings, *or other goals* if such payment are identified in the request for proposals.” RCW 39.10.070(2) (emphasis added).

D. Cost Plus Contracts

The owner bears full responsibility for price volatility under a cost plus contract. The only curb against runaway costs is a fairly loose requirement that the contractor demonstrate that “such costs [are] at rates not higher than the standard paid at the place of the Project” under the standard industry contract.¹⁵ This essentially amounts to an audit check of the contractor’s billing, whereby the owner can refuse payment if the billing is inconsistent with generally prevailing market conditions. But where the billing does satisfy this relatively loose

¹³ See RCW 39.10.061(5).

¹⁴ See RCW 39.10.060(8).

¹⁵ See AIA 114-2001, § 7.1.

requirement, the owner is fully responsible for extra cost incurred (unless otherwise stated in the contract).

III. EXCEPTIONS

These general rules have certain exceptions whereby contractors may seek extra compensation to cover severe price increases or similar market risks. The two most notable exceptions are (1) the doctrine of commercial “impracticability” and (2) the doctrine of owner-caused delay. The related problem of delay caused by third parties for whom the owner may be liable is also addressed.

A. Commercial Impracticability.

The most commonly invoked exception to the general rule is the doctrine of commercial impracticability. Under this doctrine, performance is excused when costs become excessive and unreasonable due to unforeseen supervening events not contemplated by the contracting parties. To have its fixed-price performance excused under this doctrine, the contractor must show all four elements of the following legal test:

- (1) A supervening event making performance impracticable;
- (2) The non-occurrence of the event was a basic assumption upon which the contract was based;
- (3) The occurrence of the event was not the contractor’s fault; and
- (4) The contractor did not assume the risk of the occurrence.

Seaboard Lumber Co. v. U.S., 308 F.3d 1283, 1294-95 (Fed. Cir. 2002); *see also* Restatement (Second) of Contracts § 261.

1. Most “Impracticability” Claims Fail.

Most claims of impracticability stumble on one or more of these four legal requirements. In the *Seaboard* case, for example, the contractor signed a fixed price contract to harvest timber from certain parcels. When timber prices dropped, the contract became severely unprofitable to

perform. The contractor contended it was excused from performance under the impracticability doctrine. The court disagreed, holding that a “non-occurrence of a slump in the timber market was not a basic assumption of the contract.” Emphasizing the fixed price nature of the contract and the fact that the “normal risk” of such a contract lies with the contractor, the court held that the contractor “bet that the timber market would remain strong.” *Seaboard Lumber*, 308 F.3d at 1295.

A similar case is *Raytheon Company v. White*, 305 F.3d 1354 (Fed. Cir. 2002), where a government contractor sought price adjustments on military supply contracts. The Court of Appeals held that a cost overrun of 57% was not enough by itself to establish commercial impracticability, relying in part on case law precedent that a contractor is not entitled to relief “merely because he cannot provide a productive level sufficient to sustain his anticipated profit margin.” *Raytheon*, 305 F.3d at 1367.

The courts have thus generally refused relief where the price increase is less than 100% of the bid price.¹⁶ In truly catastrophic situations, however, the courts have recognized exceptions to the rule.¹⁷

2. “Global Steel Crisis” Cases.

In a recent decision arising from 2003-2004 volatility in the steel market, the U.S. Armed Services Board of Contract Appeals rejected the contractor’s claim that a fixed price subcontract had become “commercially impracticable” to perform because of a 23% cost escalation in the price of steel. *Spindler Constr. Corp.*, 06-2 BCA (CCH) ¶ 33,376 (copy attached at Exh. A).

The Board held that the 23% price increase did not make performance impracticable because (in

¹⁶ See, e.g., *Publicker Indus. v. Union Carbide Corp.*, 17 UCC Rptr. Serv. 989, 992 (E.D. Pa. 1975) (no relief for increase less than 100%); *Iowa Elec. Light & Power v. Atlas Corp.*, 467 F. Supp. 129, 140 (N.D. Iowa 1979) (no relief for cost increase less than 50%).

¹⁷ See, e.g., *Soletanche Rodio Nicholson (JV)*, 94-1 BCA (CCH) ¶ 26,472 (1993) (compliance would have taken more than 17 years at cost of more than \$400 million rather than 720 days at a price of \$17 million).

part) the increase was less 5% of the total subcontract price. Moreover, because the parties had entered into a fixed price contract, the contract allocated the risk of price increases to the contractor and therefore the doctrine was inapplicable.¹⁸

The only other “global steel crisis” case to our knowledge is *Chain Works, Inc. v. Webco Indus., Inc.*, 2006 WL 461 251 (W.D. Mich. 2006) (copy attached at Exh. B), where a steel tubing supplier sought extra compensation for escalated steel costs due to commercial impracticability. The court rejected the claim, first noting that “it is abundantly clear to the Court that increased cost, without more, does not support a claim of impracticability.” Interestingly, the Court went on to observe that “the parties knew that the steel market was volatile and that an increase in raw material cost was foreseeable” prior to entering into the contract.

B. Owner Delay.

In a variety of circumstances, delay attributable to the owner can push the contractor into an extended schedule and thereby open the contractor to market risks that would not otherwise have been incurred.

A good example is a situation where a roadway contractor locks in a bid price with its asphalt subcontractor for the duration of the original schedule. If the original schedule is extended due to the fault of the owner, the subcontractor’s price quote may expire and in turn lead to added owner costs.

¹⁸ While the Washington courts have not addressed the specific issue of the 2003-2004 steel market, the Board’s holding is consistent with Washington law. *See Washington State Hop Producers, Inc. v. Goschie Farms, Inc.*, 112 Wn.2d 694, 773 P.2d 70 (1989) (holding in part that mere decline in expected profits is not enough to invoke commercial impracticability doctrine).

Before acknowledging responsibility for such added costs, the owner should assess the factors identified in the chart on page 13 to make sure the contractor qualifies for extra compensation on an equitable basis.

A. Scoccolo v. City of Renton.

While not a true market risk, the risk of delay caused by third parties (*i.e.*, power or cable television companies whose facilities or transmission lines must be relocated to make way for the project) can have time and cost impacts to the contractor. The *Scoccolo Construction v. City of Renton* case handed down by the Washington Supreme Court in October 2006 (copy attached at Exh. C) provides useful guidance on when the owner can be financially responsible for delays caused by such third parties.

The case arose out of a contract awarded to Scoccolo to widen a road in Renton from two to four lanes. The project necessitated relocating existing utility lines and power poles located within the project limits which were operated by Puget Power, TCI Cable and US West Communications. The contract between the City and Scoccolo provided that the “Contractor shall be entirely responsible for coordination” of the utility relocation and that “***no additional compensation*** will be made to the Contractor for reason of delay caused by the actions of any utility company. . . .”

By Washington statute, this type of “no pay for delay” clause is made void and unenforceable in situations where the delay is caused by acts or omissions of the owner “or persons acting for” the owner. *See* RCW 4.24.360. Applying this statute, the Supreme Court in *Scoccolo* held that the City of Renton was financially responsible for delays to the contractor caused by the failure of the third parties to relocate utilities in a timely fashion. The total judgment, with interest and legal fees, exceeded \$1,000,000. The Supreme Court’s conclusion

that the third parties “acted for” the City and thereby made the City liable for the delays caused by third parties is summarized in the Court’s opinion as follows:

We find by virtue of their contracts with the City, Puget and TCI were “acting for” the City for purposes of RCW 4.24.360. Under the terms of the franchise agreements, the City had the power to compel Puget and TCI to relocate their facilities at their own expense. . . . And as a matter of contract right, the role of Puget and TCI is indistinguishable from any other contractor the City may have hired: all would have been “acting for” the City by virtue of performing under a contract to relocate certain facilities for the purposes of a municipal improvement project.

The concurring opinion by Justice Madsen suggests that the scope of the court’s decision is unsettled and is to be clarified in subsequent rulings.

IV. TOOLS TO MANAGE MARKET RISK

The industry is in a state of flux on what constitutes an acceptable (or effective) way to allocate and manage the risk of market fluctuation and resource shortage. At this time, while there is no consensus in the industry, an example from history illustrates that prevailing industry contracts may eventually adapt to include standard cost escalation and resource risk provisions in the future.

A. An Example from History.

That example is what today is referred to as the Differing Site Condition (DSC) Clause. Not too long ago in historical terms (*i.e.*, 50 years ago), such clauses were not part and parcel of the standard construction contract. Because no contractual mechanism existed for paying the contractor extra costs associated with unforeseen subsurface conditions, disputes were instead governed by a well settled – and from the perspective of the contractor, a very harsh – common law rule. That rule stipulated that the risk of unanticipated subsurface conditions rested solely

with the contractor. Indeed, this rule remains the common law rule today in Washington,¹⁹ and thus if a contract entered into today does not contain a DSC Clause, the risk of subsurface conditions still defaults to the contractor as a matter of law.

This example is meant to illustrate that construction contracts evolve over time and come to reflect industry consensus on appropriate allocation of risk. In the case of a Differing Site Conditions Clause, the owner is now presumed to own the risk associated with the site, specifically subsurface and latent conditions not readily apparent to the contractor on routine site investigation.

This same analysis does not neatly apply to all market or resource risks. These risks, unlike subsurface site conditions, are often outside the control of both owner and contractor. And yet, certain market risks are within some degree of control by both owner and contractor. The owner dictates the schedule completion date, which in turn necessarily exposes the contractor to market risks which the contractor could avoid if schedule flexibility existed.

So too the contractor has some control over market risks. For example, it is uniquely positioned to buyout its supplier and subcontract needs in a timely manner. Based on its relationships with its industry partners, is generally more knowledgeable about when and how to time market purchases than owners.

B. Risk Allocation Factors.

As the general rule illustrates, market risks generally belong to the contractor under current law. It is nonetheless possible to derive five factors for possible use in negotiating an allocation of market risks in a particular factual context as summarized in the following chart. Using this chart may be of assistance in situations where the owner desires to reach a

¹⁹ *Dravo Corp. v. Seattle*, 79 Wn.2d 214, 218-220, 484 P.2d 399 (1971).

compromise with its contractor in situations where no entitlement would otherwise be due as a legal matter. No one factor is determinative in all cases.

MARKET RISK ALLOCATION FACTORS	
FACTOR	APPLICATION
Control	Generally, the party with the best ability to control the risk ought to bear the risk
Foreseeability	If the risk should have been anticipated at bid submission or contract execution, it is less likely to be excusable
Fault	A risk created or made worse to either party's negligence or breach generally ought to be allocated to that party
Causation	Unless the risk actually caused delay to critical path work, it is no excuse for lack of performance
Mitigation	A mere market risk, by itself, is not excusable where the impacted party fails to execute reasonable efforts to work-around

C. Suggested Tools.

Various contractual clauses should be considered in the management of unexpected market risks. Given the state of flux in the industry, each option presents a unique set of questions. Among the primary tools are:

- ***Cost Escalation Clauses and Allowances***

Because some degree of cost escalation is to be expected, the question here is what magnitude of escalation will trigger the clause? And does the clause apply only to certain items such as asphalt, fuel, concrete and the like? One approach is based on a banded cost sharing, whereby the first increment of escalation (5-10%) is borne by the contractor and the next increment (10%) is borne by the owner. Any further escalation can be borne solely by the contractor or owner or based on a split. Confirming the baseline bid assumption is critical to proper enforcement of an escalation clause. Escrow bid documents may be useful.

- ***Contingency Funds***

Under the GC/CM statute, for example, at least 5% contingency is required and the parties are free to negotiate how to use the contingency. Clarity in defining the rules for use of a contingency is critical, particularly in making sure that the contingency does not become a fund for covering contractor mistakes in procurement (*see* Market Risk Allocation Factors).

- ***Enhanced Savings Split Clauses and Incentive Clauses***

Particularly when used in conjunction with a tightly controlled contingency fund, a more generous savings clause can result in a win-win program for contractor and owner.

- ***Prepurchase or Early Purchase Arrangements***

Early procurement of critical items can avert price shock. The issues here tend to be two-fold. Logistically, are the early-secured products to be stored in a bonded warehouse and, if so, at whose expense? Legally, who finances the early procurement in situations where the owner (or its lender) have no obligation to pay unless and until the product or work is incorporated into the building site?

For an excellent summary of these options and practical pointers, see Exh. C (excerpt from Construction Briefings/December 2006).

D. Road Ahead – De-Escalation Clauses?

All of these options, however, are based on a fundamental assumption that the contractor will give up the inherent advantage it has in a fixed price contract. While such contracts plainly pose risks, they equally contain rewards if contractors are able to buy out suppliers and subcontracts on terms more competitive than assumed at the time of bid submission. Whether contractors will agree to forfeit that advantage – by, for example, agreeing to use a two-way price clause to capture price *drops* and credit them to the owner – remains to be seen.