

Legal Issues of Steel Shortages

Reducing Risks for Future Bids and Contracts

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All contractors should be aware of the current steel shortage and have plans to protect their companies from or minimize the adverse impacts of the shortage and escalating prices.¹

This article explores the basic law of contracts and purchase orders in shortage situations, and contains some sample clauses to aid in reducing risks for future bids and contracts.

Law Applicable to Shortages and Unexpected Price Increases

A. Contracts and Subcontracts

Unless a fire protection contractor has a cost plus agreement or an allowance for steel pipe and other products in short supply, the risk and loss will generally fall on the lump sum contractor or subcontractor. The current shortage is in part due to free and open trade policies of the government enabling massive shipments of scrap steel to China and other countries. However, even on federal contracts relief is not available because the government as sovereign has implemented policies that increase a contractor's costs of performance. This principle was firmly established by the U.S. Supreme Court decision of *Horowitz v. U.S.*, 267 U.S. 485 (1925) wherein the court stated: "The two characters which the government possesses as a contractor and as sovereign cannot be thus fused; nor can the United States while sued in one character be made liable in damages for their acts in the other." This principle has been consistently followed by federal courts to deny recovery due to escalating prices and/or shortages caused by government acts.

Therefore, even though federal trade policy is a major contributor to steel price increases, legal relief is not available in claims against the government. Also legal relief will be unavailable on fixed price contracts in the private sector, absent contract language or unusual facts providing legal relief. However, on fixed price or lump sum contracts changes may be priced at current prices for increased

work absent unit prices or other contract language prohibiting the use of current costs in pricing changes.

Typical defenses to breach of contract for failure to perform by a contractor may be mistake, economic duress, impossibility of performance, economic or commercial impracticability, unconscionability, discharge from performance because of material breach by the other party, and various procedural defenses. Each factual situation must be examined to determine if legal relief is available. Of course the applicable contract must also be considered. Case law generally reveals that these defenses will fail as legal excuses for failure to perform due to increased steel costs, absent unusual facts or favorable contract language. For example, the defense of "unilateral mistake" (failure to anticipate radical increases in steel prices) will usually fail because the defense of mistake only applies for past or present facts. A mistake in predicting a future fact known to be uncertain (steel prices) cannot be raised as the defense of mistake. The defense of "impossibility of performance" based on higher costs will not be successful. Also supervening shortages that can be overcome by finding materials at higher prices negate an impossibility of performance test.

Although the defense of "commercial impracticability" is often alleged, it is seldom successful in construction contracts. However, it may be one of the best defenses because of the common law as set forth in the Restatement (Second) Contracts § 261:

Where, after a contract is made, a party's performance is made impracticable without his fault by the occurrence of an event the non-occurrence of which was a basic assumption, on which the contract was made, his duty to render that performance is discharged, unless the language or the circumstances indicate to the contrary.

Also, § 266 provides relief if a party

has no reason to know of an existing fact that renders performance impracticable at the time of the execution of the contract. Further, § 269 of the Restatement (Second) provides for suspension of performance during periods of temporary impracticability. The court decisions on the commercial impracticability defense are confusing and conflicting.²

A case analogous to the claim of commercial impracticability based on steel prices is *Missouri Public Service Co. v. Peabody*, 583 SW2d 721 (Mo. App.), cert den. 444 US 865 (1979), which rejected a breach defense based on the economic hardship of the Arab oil embargo in the '70s.

B. Purchase Orders

Suppliers are in a better position than contractors to avoid current agreements because of the applicability of the Uniform Commercial Code ("UCC"). The UCC will apply to agreements whose dominant feature is the sale of goods as opposed to the furnishing of labor and services. Generally purchase orders are covered by the UCC, but subcontracts are not; however, the essence of each agreement will control over its title or form.

The UCC has incorporated the defense of impracticability into Article 2. Section 2.615 may excuse a seller from performance if "performance as agreed has been made impracticable by the occurrence of a contingency the non-occurrence of which was a basic assumption on which the contract was made." The pertinent language is:

"This section excuses a seller from timely delivery of goods contracted for, where his performance has become commercially impracticable because of unforeseen supervening circumstances not within the contemplation of the parties at the time of contracting."

Some steel suppliers and fabricators are taking the position that § 2.615 allows them to increase prices after

agreeing to firm prices, contending that the sudden change in availability and rising prices of steel constitute a "basic assumption when the contract was made." However, fabricators may not be successful in that position because Note 4 to § 2.615 provides:

"Increased cost alone does not excuse performance unless the rise in cost is due to some unforeseen contingency which alters the essential nature of the performance. Neither is a rise or a collapse in the market in itself a justification, for that is exactly the type of business risk which business contracts made at fixed prices are intended to cover. But a severe shortage of raw materials or of supplies due to unforeseen shutdown of major sources of supply or the like, which either causes a marked increase in cost or altogether prevents the seller from securing supplies necessary to his performance is within the contemplation of this section. (See *Ford & Sons, Ltd., v. Henry Leethan & Sons, Ltd.* 21 Com. Cas. 55 (1915, K.B.D.).)"

Although suppliers may be successful on old agreements, those who entered into fixed price purchase orders in the last six months should have considered the instability of steel prices, which would have been known by any steel fabricator. One cannot simply "estimate" or "guess" wrong and then claim post contract price increases constitute the legal defense of commercial intractability.

Some suppliers may try to take advantage of the current shortage by demanding price increases that they considered or could have considered when providing fixed price quotations. Actions against such suppliers could include the breach of the duty of good faith and fair dealing, which is incorporated into the UCC at § 1.203 and defined at § 2.103 as "honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade."

Some steel suppliers are raising agreed prices and refusing to ship unless they are paid first. Legal remedies against such suppliers may pale in comparison to the damages for delays in construction; therefore, contractors must make careful business decisions during the current shortage.

C. Proposing Substitutions

Sprinkler contractors may try proposing alternatives, such as CPVC or copper, to steel pipe. Most specifications provide for alternatives on an "as equal" basis. The burden of establishing that an alternative will perform as good or better than a specified product or material is on the contractor. Also the risk of performance of the alternative material rests with the contractor. In shortage periods, design

professionals may be more inclined to accept an alternate. A sprinkler contractor seeking an alternate for pipe other than steel pipe should clearly establish the shortage, provide test data supporting the requested alternative material, and an offer of a financial credit, if appropriate.

Presented with the choice of delay or an alternative material and financial credit, many owners and their design professionals will opt for the latter.

However, CPVC and copper may not be suitable or legal for some projects.³

D. Requesting an Equitable Adjustment

Even if there is little or no legal grounds for recovery, a request may be made for relief on the grounds of "if you don't ask, you don't get." Any request should contain detailed information with supporting proof of price increases and/or unavailability of materials since the formation of a contract.

Each contract must be reviewed for compliance with dispute provisions and notice requirements. Although the answer may usually be "no," a request may lead to some adjustments.

Future Bids, Contracts and Time Extensions

Although legal remedies may be lacking in many situations for sprinkler firms caught between lump sum contracts and either no firm prices or refusals of pipe fabricators and other suppliers to honor firm price commitments, steps can be taken to avoid or reduce losses in the future.

The following clauses are examples that can be tailored to various situations. Advice of counsel is recommended prior to adopting and using any of them.

E. Qualifying Proposals⁴

1. Price protection between bid and date of contract.

This proposal is based on the prices of steel building products (such as steel pipe and other steel components) quoted to us as of the date of this proposal. Due to rapidly rising steel prices, this proposal is subject to increase if any steel pipe or other steel products increase prior to the execution of a written agreement, by the amount of increases quoted by our intended suppliers and/or subcontractors. (We will provide you proof of any increase.)

2. If price protection is desired to date of ordering or delivery, use language like the following in a proposal:

Due to erratic price increases in steel, our proposal and any contract we execute must be subject to increased amounts we may be required to pay for steel pipe over the prices quoted us as of the date of this

proposal, provided any increases are not due to any delay or negligence on our part.

F. Contract Language to Reduce or Avoid Risk of Erratic Steel Pipe Prices

1. To qualify a contract for increases over a certain percent, the following should be sufficient.

The amount of this contract is subject to increase if the cost of steel pipe or other steel products increase more than ___% over the amount quoted to us between the date of this contract and delivery of such steel pipe or other steel products to the project. We will provide proof of increases if any.

Another version tied to specific materials with current unit prices stated is:

The parties agree that the contractor has based its bid on certain pricing assumptions of steel materials to be incorporated into the fire protection work. However, the market for steel pipe materials that are specified below is considered by both Parties to be volatile and sudden price increases could occur which are beyond the control of the contractor despite its best efforts. Therefore, the Parties agree that if there is a bona fide price increase to the contractor of the material(s) listed below by more than ___% of the specified unit price, the contractor may, prior to obtaining or contracting for the purchase of the materials, request and obtain an equitable adjustment to this Contract which adjustment shall increase the price per unit to an amount equal to ___% of the price paid for the materials by Contractor or by its subcontractors and passed on to Contractor pursuant to subcontract terms. An equitable adjustment will not be unreasonably withheld by Owner.

| Material | Current Price per (Unit) |
|----------|--------------------------|
| _____ | _____ |
| _____ | _____ |

2. Allowances
Another way of mitigating against erratic prices is to use allowances for pipe and other steel products.

An example of allowance language to protect a contractor or subcontractor over a fixed percentage is:

Price Adjustment for Fluctuations in Price of Steel

The Contract Price includes the following allowances for steel and steel products based upon the vendor or subcontractor quotes attached hereto:

| Item | Allowance | Quote |
|-------|-----------|-------|
| _____ | _____ | _____ |

To eliminate contingencies because of extreme volatility in the price of the steel construction products and materials scheduled as allowance items above, the Parties agree that the Contract Price includes and is based upon the above allowances and the price shall be adjusted as follows:

a. In the event the total invoice costs actually paid by the Contractor (or subcontractor) (adjusted for any discounts, rebates or refunds received by the Contractor) for any of the items scheduled above is greater than ___% of the scheduled allowance amount, the Contract Price shall be increased by the difference between such total invoice cost actually paid and the stated allowance amount.

b. In the event the total invoice costs actually paid by the Contractor (adjusted for any discounts, rebates or refunds received by the Contractor) for any of the items scheduled above is less than ___% of the scheduled allowance amount, the Contract Price shall be decreased by the difference between such total invoice cost actually paid and the stated allowance amount.

c. With each application for progress payment, the Contractor shall provide supporting invoices and/or other pertinent documents detailing the price changes from the allowance amounts.

d. The Contractor's "Schedule of Values" on the AIA Document G703 (or similar schedule supporting progress payment applications) will include a line item for "Economic Price Adjustment," which shall be updated for each Progress Payment Application to include the amounts of any increases or decreases, and/or other pertinent documents. Any net increase (decrease) in the total price adjustment to date from the previous month's amount shall be added to (subtracted from) the "total completed and stored to date" column for purposes of calculating the progress payment due.

("Subcontractor" should be substituted for "Contractor" and "Contractor" for "Owner" if a subcontract is involved in any of these clauses.)

G. Time Extension Requests

1. For time protection, a contract or subcontract should contain a force majeure clause allowing time extensions due to material shortages. If there is no such clause, or even if there is, the following would aid a contractor or subcontractor:

The parties to this contract recognize a shortage of steel pipe which could possibly delay delivery of steel pipe and other products necessary for performance of the work; therefore, contractor shall be entitled to an extension of time for delays

caused by delivery delays or material shortages which may occur through no fault or negligence of contractor or its subcontractors. Contractor shall provide prompt written notice of any shortages or delays in delivery and use reasonable efforts to mitigate the impacts of such delays.

The parties further agree to cooperate in expediting any required approvals, arrangements for alternate storage, and other reasonable means and materials to avoid delays due to steel pipe shortages and price increases resulting from such shortages.

2. Sprinkler contractors and subcontractors should also be reminded that if they know of delivery delays, they should notify the owner's representative or general contractor, as applicable, promptly within the contract's notice deadlines.

A sample notice to an owner or its architect is:

To: Owner

Re: Notice of Delay and Request for Time Extension

We are requesting an extension of time of ___ days for delays in delivery of needed steel pipe for this project. As you are well aware, there is a severe steel shortage in the United States. This project is one of many that is or will be delayed. We are using all means available to us to improve on the delivery schedule and we will keep you advised of our progress.

If delivery dates cannot be ascertained, an example of a request would be:

We do not currently have a firm shipping date for the steel pipe due to the nationwide shortage of steel pipe; therefore, we request an extension of time for the time it actually takes from the originally anticipated date of _____ until it is actually received at the job site. We will continue our efforts to expedite the delivery of the steel pipe.

Summary

No one knows how long steel prices will remain at or above current levels. The only certainty is that they will change. Fabricators, sprinkler contractors, and general contractors can all be caught in binding contracts with prices far in excess of those contemplated at time of contracting.

Legal relief is questionable but possible in some situations. Future risks can be reduced with appropriate proposal and contract language.

Fabricators and sprinkler contractors must also realize that taking short term advantage of the shortage or failing to honor commitments can cause long term

losses when the shortage is over, as they lose business to those firms that honored their contracts in difficult times. This shortage will pass, but until it does, contractual relationships will be tested and some will be sorted out in expensive legal proceedings. ■

REFERENCES: 1. For general information on steel shortage and the causes, see generally: "Steel Scrap Sizzling" Steel Thermometer, *World Steel Dynamics*, January 29, 2004; Paul Glader, "Steel Prices Jump Spurring Protests From Customers," *Wall Street Journal*, January 23, 2004; Matthew Phillips, "Steel Prices Soar"; *The Business Review*, February 27, 2004; Morgan Allen, Christine Perez, "Steel Shortage Worries Industry Leaders", *Dallas Business Journal*, March 12, 2004. Also see the May 22, 2004 issue of *Engineering News Record (ENR)*, which has a cover story on the crisis; or simply type the words "steel price increases" in any internet search engine.

2. See: Elpfson, "The Dilemma of Changed Circumstances in Contract Law: An Economic Analysis of the Foreseeability and Superior Risk Bearer Tests," 30 *Columbia J. L. & Soc. Prob.* 1, 2 (1996) (Impossibility, impracticability, and frustration of purpose are common law doctrines that attempt to define what changed circumstances should be considered, and how drastic their effect must be, in order to discharge contractual obligations.)

3. For an informative article on substitutions for steel pipe see: Phil Brown and Scott Mitchell, "Alternatives to Steel Pipe," *Sprinkler Age*, April 2004, p. 16.

4. Qualifying a bid on public and federal work can lead to automatic rejection of the bid.

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