F E E S & B U R G E S S, P.C.

S U P P L Y C H A I N M A N A G E M E N T M E M O

Volume 8, Issue 4 November 2011

Accounting for Rising Material Costs When Negotiating Contracts

Construction is one of several industries that has recently been coping with rising material costs affecting their bottom line. Price fluctuations on some of the same commodities that are affecting construction contractors, like steel, are also impacting a wide range of manufacturers. These kinds of price fluctuations for materials pose a particularly acute risk for contractors/manufacturers when doing business with customers under fixed-price contracts. While most customers like the certainty of having a set price and knowing it will not change, the contractor or manufacturer on the other end of the transaction should attempt to gain some contractual protection for significant cost upswings that occur after a price is quoted. There are a few methods that can be used to achieve this goal.

One approach that can be used to allow for price escalations due to changes in material cost is a contract clause stating that the parties will compare the prices for certain materials, as provided under a specified price index (e.g., the Producer Price Index for a particular commodity), at two points in time. If there is a change in the price for those materials between the two specified comparison times, there will be a corresponding change in the price of the goods or services being provided by the contractor/manufacturer. If this method is used, the desired index should be clearly indicated in the contract, as there are sometimes significant differences in the amount of change from period to period between two seemingly similar indices. For long-term agreements, the contract should say that the indices will be compared at regular intervals (e.g., monthly, quarterly, annually) and prices adjusted accordingly.

A second option is to craft contract language that allows the contractor/manufacturer to submit documentation, such an invoices, demonstrating the actual cost paid for materials above the quoted price, with the understanding any upside will be picked up by the customer. This option may be harder to sell to the customer, since it would arguably allow the contractor/manufacturer to quote a low price to get awarded the project then go out and buy materials at their actual, higher cost and get reimbursed. In order to make this approach more palatable for the customer, the contractor/manufacturer could propose a limit on the percentage increase in the price charged based upon material cost increases. For example, the contract might say the customer will pay for the actual, documented cost of materials, but in no event will the customer be required to pay more than 110% of the original price quoted for those materials. Alternatively, the contractor/manufacturer could provide written quotes from material vendors with its initial bid for the project, and have the contract specify the customer will pay for the actual, documented cost paid by the contractor/manufacturer for the materials when purchased from the vendor who provided the quote for those materials that was submitted with the bid provided to the customer.

Another approach is to have the contract say the parties will review the actual cost of materials used on the project at regular intervals and, if there is a significant change in those costs, the parties will equitably adjust the price charged the customer. The parties may wish to define what is a “significant” change in material costs by indicating it is any cost increase over a certain percentage of the original quoted cost.

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Any of these options can be worded in the contract to allow for price increases and decreases, based on downward adjustments in the index, or the purchase of materials at a reduced cost, which may make it easier to sell one of these contract provisions to the customer.

Many customers contracting for construction or manufacturing services expect, rightly or wrongly, that they are receiving a firm-fixed price when a contractor or manufacturer provides a quote or a bid. The contractor/manufacturer's margins are rarely large enough to allow for sizeable cost increases and still have the project remain profitable, if the price is truly fixed. In many cases, the contractor/manufacturer expects that, if there is a significant change in its costs, it can go back to the customer and negotiate a change order to cover the added cost. Even in the best of customer relationships, these kinds of after-the-quote price adjustments are almost always resisted, unless there is some clear contract language dealing with price adjustments due to material cost increases. The contractor/manufacturer should never assume that it will be able to get the customer to pay for these increases and should instead unambiguously state in the contract that there is an expectation the contractor/manufacturer will be compensated for any upswing in material costs.

Alabama Passes New Law Governing Retainage on Real Estate Improvement Projects

Earlier this year, the Alabama legislature passed SB 437, which creates new rules governing the payment of contractors under construction contracts dealing with improvements to real estate. Specifically, the new law specifies the owner of the real estate on a construction contract can only retain 10 percent of: (a) the estimated amount of work properly done and (b) the value of materials stored on site or stored off site and insured, until final completion of the project. After 50 percent of the work has been completed, the owner is prohibited from withholding any further retainage, unless the owner pays interest at 1 percent per month (12 percent per annum) on all excess retainage. After all necessary certificates of occupancy have been issued, the owner has to release and pay all retained funds no more than: (a) 60 days after completion of the contractor's work (as defined in the contract) or (b) 60 days after substantial completion of the entire project, whichever occurs first.

In addition, if a contractor withholds a larger percentage of retainage from its subcontractor than the percentage the owner is withholding on payments to the contractor, the contractor has to pay the subcontractor interest at a rate of 1 percent per month on all amounts withheld above the percentage being withheld by the owner.

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All of the above rules also apply to retainage held by contractors from payments owed to their subcontractors, as well as retainage held by subcontractors from payments owed to sub-subcontractors. These new caps on retainage are not meant to affect a party's ability to refuse payment due to improperly performed work or for reasons stated in the parties' contract as conditions to receiving payment. A party can still condition the payment of any retainage on the other party signing a full release of any liens for the amount of work being paid.

Fees & Burgess, P.C., Calendar of Events

Fees & Burgess, P.C., is proud to present, or participate in the following upcoming events:

Employment Law Survival Training for Managers: 10 Key Areas of Legal and Practical Knowledge

When: January 19, 2012 8:00am-5:00pm CDT
Where: Fees & Burgess, P.C. - Huntsville, Alabama
Cost: $149

This day-long program, presented by Jeffrey Roth, Leah Green, and Ryan Blount, is a must for training managers and supervisors to recognize and deal with challenging employee issues that arise daily in the workplace. Attendees will learn key aspects of critical issues and how to work with existing company policies to address and resolve them.

This highly interactive program includes discussion of real-life scenarios encountered by supervisors, and how, and how not, to respond to each scenario or crisis. This program is designed to help managers and supervisors from small and large businesses recognize high risk situations and minimize, or eliminate, those risks.

This program has been approved for 6.5 (General) recertification credit hours toward PHR, SPHR and GPHR recertification through the HR Certification Institute.

To register, or for more information, please click here or contact us at seminars@feesburgess.com.

For more information on this, and other future events, please visit us online at www.feesburgess.com, or contact us at seminars@feesburgess.com.

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SPEAKERS

FEES & BURGESS, P.C., provides speakers, training programs, seminars, and webcasts for various trade associations; business groups; and clients. For information regarding a program, contact seminars@feesburgess.com.

NEWSLETTERS

FEES & BURGESS, P.C., also publishes *F&B Quarterly Bytes,* focusing on multiple practice areas; and *F&B SCM Memo,* focusing on the supply chain management industry. To receive any of these newsletters, please e-mail newsletters@feesburgess.com with your contact information.

To remove your name from our mailing list, please e-mail newsletters@feesburgess.com.

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