

## Litigation Alert: Combatting Material Escalation with the Implementation of Contract Escalator Clauses

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Over the last year, the COVID-19 pandemic has wreaked havoc on fixed-price contracts that rely on the price of raw materials. For example, NJ.com reported the cost of lumber has increased threefold—from approximately \$350 per thousand board feet a year ago to nearly \$1,050 for the same amount. The pharmaceutical industry has also seen a drastic shortage in the production of glass vials—the very vials used to store the COVID-19 vaccine. These shortages, resulting in unprecedented price increases, affect suppliers, manufacturers, distributors, and contractors (just to name a few) who are required to produce, distribute or deliver a final product. So how do price fluctuations affect contract obligations and the ability to perform under a contract when prices of materials or labor have unexpectedly soared? The answer depends on your agreement. *And now, due to the volatility in the marketplace, it is the best time to review your company's contracts and vendor contracts.*

Indeed, many are mistakenly under the impression that if the cost of performance becomes too high to bear—the company can escape its contractual obligations under a *force majeure* provision or the common law doctrines of frustration of purpose and commercial impracticability. But these doctrines do not always provide protection. See generally, *Tilcon New York, Inc. v. Morris Cty. Co-op. Pricing Council*, A-5453-10T3, 2014 WL 839122, at \*17-21 (N.J. Super. Ct. App. Div. Mar. 5, 2014) (finding contractors were not entitled to relief under the doctrines of frustration of purpose and impracticability of performance). In fact, courts have noted that “[t]he substantial weight of authority supports the principle that the mere increase in the cost of a party’s performance does not afford the defense of frustration of purpose or commercial impracticability.” *Id.* at \*19. In other words, courts are unlikely to relieve a party of its contractual obligations under an agreement that sets forth a “fixed-price” because one party ultimately agreed to assume the risk of material escalation. See *Id.*, \*17-21.

So, this begs the question: how can a business protect itself, and its profit margins, in this volatile marketplace? The inclusion of an “escalator clause” in your contracts may provide some protection. An escalator clause is a clause allowing for an increase in the price of a contract upon the occurrence of certain defined events. For example, an escalator clause may shift the marginal cost of lumber to a counterparty if lumber prices increase by a defined percentage. The parties can craft the escalator clause in advance, therefore escalator clauses are a more predictable way for a company to protect itself against price increases rather than *force majeure* provisions.

An escalator clause is an important contract term that can protect your company from unexpected and unanticipated price increases, due to factors beyond the control of either party that affect your bottom line. Without an escalator clause, even though the parties did not foresee or anticipate the increase, only one party may be forced to bear the risk.

There are generally two types of escalator clauses: (i) “cost-based” and (ii) “indexed based.” A “cost-based” escalation provision contrasts the actual cost incurred by the supplier/manufacturer/contractor with the stated amount in the parties’ agreement (bid/estimate). An “index-based” provision tracks material prices based on indexes, e.g., the Producer Price Index.

Now is the time to be proactive rather than reactive. Contracts should be carefully reviewed to ensure that your company is protected against the risk of unforeseen and unanticipated events. Legal counsel is necessary to review contracts to ensure that necessary provisions are included to protect your company. Brach Eichler is available to review your company’s contracts to ensure that your company is protected, as well as provide guidance on the appropriate escalation clause that meets your company’s needs.

For additional information please contact:

**Rose Suriano**, Member and Co-Chair, [Litigation Practice](#), at [rsuriano@bracheichler.com](mailto:rsuriano@bracheichler.com) or 973-403-3129