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Economic Price Adjustment Clauses: Pricing Pretzels and Pitfalls

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For many, the first look at an economic price adjustment (EPA) clause evokes Kurtz's dying words in *The Heart of Darkness*: "The horror! The horror!"[1] Too often, EPA clauses contain incomprehensible text, inoperable mathematical formulas, and incorrect indices for tracking escalation of prices or costs. In such circumstances, courts have found EPA clauses to be ambiguous, mistaken, and even illegal, resulting in judicial surgery to repair the damaged clause and to achieve a fair allocation of the risk of inflation.

EPA clauses serve to protect the contractual parties from fluctuations in price and/or cost (i.e., inflation or deflation) not predicted at the time the original bargain was struck. Such protection assumes particular importance for contracts where the purchases involve volatile commodity costs, occur during periods of rapidly changing prices, or cover a period of many years. For decades, such clauses have appeared in both Government and commercial contracts for products ranging from petroleum and coal to shovel-handles and spectacle frames.[2]

The discussion below addresses the following key issues associated with the use of EPA clauses: (1) the purpose of EPA clauses; (2) typical defects in such clauses; and (3) common defenses in answer to claims for adjustments under such clauses.

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The Purposes of EPA Clauses

In many cases, the courts and administrative tribunals look to the purposes of EPA clauses to interpret contractual terms and to fashion remedies. In general, EPA clauses serve two purposes: (1) to protect the parties from unexpected economic fluctuations beyond the control of the buyer or seller; and (2) to eliminate contingencies in the contract price associated with such economic fluctuations that may affect the cost of contractual performance.

Protection from Economic Fluctuations

One purpose of EPA clauses is to allocate the risk of, and preserve the parties' original bargain from, unanticipated economic changes - such as commodity shortages or wartime inflation - that may result in significant changes in prices or costs. Indeed, the Federal Acquisition Regulation (FAR) prohibits the use of EPA provisions unless a Government agency specifically determines that such a clause "is necessary either to protect the contractor and the Government against significant fluctuations in labor costs or to provide for contract price adjustment in the event of changes in the contractor's established prices."[3] Similarly, the United States Court of Appeals for the Federal Circuit has held that "the purpose of the EPA clause was to accommodate inflationary/deflationary changes in the costs of labor and materials."[4] In essence, the EPA clause protects the parties' original bargain against the inherent uncertainty of predicting inflationary or deflationary trends:

> [T]he usual purpose of an escalation clause is to preserve, substantially, the benefit of the bargain. Such a clause is intended to protect against unanticipated or unpredictable changes which might render the bargain unduly harsh.

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> An escalation clause is not ordinarily intended to enable one party to render the bargain more profitable to himself.[5]

Elimination of Contingency Pricing

Another purpose of EPA clauses is to allow the buyer to negotiate a lower price by removing from the contract price any contingency costs for escalation. The FAR specifically addresses this function as follows:

> In establishing the base level from which adjustment will be made, the contracting officer shall ensure that contingency allowances are not duplicated by inclusion in both the base price and the adjustment requested by the contractor under economic price adjustment clause.[6]

In some cases, the Government has sought to block recovery under an EPA clause by claiming that a contractor should have included a contingency for such price changes. However, both the courts and the Armed Services Board of Contract Appeals (ASBCA) have readily rejected such arguments:[7]

> Without an EPA clause, the contractor would be forced to submit a higher bid to include a contingency to cover any unexpected increases in its costs. By using an EPA clause, the Government is assured of not having to pay that contingency. In fact, both the FAR and the MAPCO [MAPCO Alaska Petroleum] contract clauses at issue prohibit the contractor from including such a contingency.[8]

In seeking recovery under an EPA clause, a contractor should not overlook the fundamental relationship between the clause itself and a reduced price secured by the Government. If the Government seeks to avoid payment under an EPA clause, the parties' bargain could be rendered one-sided, with the Government receiving its price reduction at contract inception, yet denying the contractor the quid pro quo of protection against unanticipated inflation or deflation. The fact that the Government benefits from a lower price probably helps to explain the vigilance of the courts and the ASBCA in protecting contractors under EPA clauses.

Defects in EPA Clauses

By their very nature, EPA clauses should include a warning: "Fragile - Handle with Care." The clauses usually come with complicated language and mathematical formulas, the referenced indices or benchmarks sometimes change or disappear, and the cost of contract performance often diverges from the parties' chosen benchmark. Not surprisingly, therefore, the courts have encountered many disputes over a wide variety of defects in such clauses, as illustrated by the following examples.

Omission of Relevant Cost Index

The courts often have held that the inflation index included in an EPA clause must be a reasonably accurate reflection of the contract costs the seller will likely bear.[9] As such, an EPA clause may prove to be defective due to use of a cost index that does not track costs relevant to a contract's performance. For example, one case involved an EPA clause that omitted a cost index for aluminum - the principal construction material for tank pump units to be delivered under the contract.[10] The court concluded that if the EPA clause's cost index did not have a logical relationship to the type of contract costs being measured, the clause violated the applicable regulations:

> The government concedes, as it must, that the purpose of the EPA clause was to accommodate inflationary/deflationary changes in the costs of labor and materials.
>
> * * *
>
> If the index failed to achieve its purpose (and the government does not dispute that the index did not approximate the change in [the contractor's] materials costs), then on its face the [regulation] was violated.
>
> * * *
>
> If the contract is in violation of the [regulation], and does not meet the requirement that an index be selected that approximately tracks the economic changes affecting this contract, then reformation is appropriate.[11]

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Use of Unauthorized Index

The FAR authorizes adjustments under four types of EPA provisions: (1) adjustments "for standard supplies that have an established catalog or market price"; (2) adjustments "for semistandard supplies for which the prices can be reasonably related to the prices of nearly equivalent standard supplies that have an established catalog or market price"; (3) adjustments "based on actual cost of labor or material"; and (4) adjustments "based on cost indexes of labor or material."[12] The courts and the ASBCA have long held that the procurement regulations are the "law which governs the award and interpretation of contracts as fully as if it were made a part thereof."[13]

If an agency uses an EPA clause not specifically authorized by the procurement regulations, the rogue clause may be illegal. For example, the Defense Fuel Supply Center (now the Defense Energy Support Center) developed an EPA clause in the early 1980s that used a price index reported in the Petroleum Marketing Monthly (PMM).[14] This PMM price index reflected average prices of petroleum refiners or, as one court stated, "an amalgamation of the previous month's petroleum sales data."[15] The PMM did not represent an "established catalog or market price" because it did "not reflect any specific vendor's current price," but simply an average of market prices.[16] Furthermore, the PMM did not constitute a "cost" index because it consisted of average prices, not costs.[17] As a result, the courts found the agency's EPA clause to be unauthorized under the governing regulations and therefore illegal.[18]

Failure to Make Adjustment to Base Period

As discussed above, one purpose of an EPA clause is to preserve the parties' original bargain from unanticipated cost or price fluctuations. To accomplish this purpose, the EPA clause's adjustments must relate back to the original base price negotiated by the parties. Indeed, the FAR refers to "establishing the base level from which adjustment will be made . . . ."[19] Similarly, the Department of Defense's FAR Supplement (DFARS) provides for adjustments from a base period that link to the beginning of the contract.[20]

In one case, an agency's EPA clause only permitted an adjustment for the first 6-month period to tie back to the base level price:

> The Government's EPA clause . . . measures price adjustments by using successive new index base periods, which are subject to change every six months . . . . As such, it merely measures market trends in separate and distinct six month increments, rather than accounting for all potential economic fluctuations within the original contract period of performance, DODFARS 16-203-4(d)(3)(iii).[21]

The ASBCA found the clause to be contrary to the regulations, to the purpose of EPA clauses, and to the parties' intent. Accordingly, the ASBCA reformed the contract "by deleting the requirement for incremental index measurements" and requiring "adjustments based on cumulative index changes from a fixed index base."[22]

Failure of the Benchmark Price or Index

What happens when the benchmark price or index is no longer a good benchmark? Such a failure can happen in a number of ways, including: (1) the methodology for calculating the index changes;[23] (2) the benchmark is split into two prices (e.g., one price is subject to price controls and one is not);[24] or (3) the benchmark price or index ceases to exist. In some cases, the EPA clause may expressly address these types of contingencies, such as by requiring the parties to negotiate new terms if the benchmark index changes.[25] When the EPA clause is silent, however, the courts have employed a variety of legal theories to reach a common result - reformation of the EPA clause to produce a reasonable price consistent with the parties' original bargain and the purpose of EPA clauses.[26]

Typical Government Defenses and Counterclaims

In cases involving defective EPA clauses, the Government has attempted to avoid liability in a number of ways. For example, the Government has argued that: (1) a contractor has lost its right to object as a result of waiver or estoppel; (2) a claim has been made too late; and/or (3) the Government has offsets greater than a contractor's claims.

Waiver and Estoppel

The Government has often asserted the defenses of waiver and estoppel against contractors' claims for flawed EPA clauses. The success of these arguments

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may depend upon the unique circumstances in which they are asserted. Nonetheless, the courts and the ASBCA have repeatedly rejected such defenses.

In *Beta Systems*, the contractor sought reformation of its contract based upon the legal theories of mutual mistake and violation of the applicable procurement regulation, because the EPA clause's index did not accurately track the costs of contract performance.[27] In this case, the contractor had initially objected to the EPA index during contract negotiations, but later capitulated and accepted the EPA clause into its contract.[28] The Government defended against the contractor's claim by asserting that the contractor had already waived its rights by knowingly accepting the defective EPA clause.[29] The Federal Circuit, however, found the Government's argument as defective as the EPA clause:

> If the . . . index that was selected does not comply with [federal regulations], even approximately, it is not controlling whether or not [the contractor] or the government foresaw, or accepted the risk of failing to foresee, this defect in the index. . . If the contract is in violation of [regulations], and does not meet the requirement that an index be selected that approximately tracks the economic changes affecting this contract, then reformation is appropriate.[30]

In a second case presenting similar facts, the court found that the EPA clause was "plainly inconsistent with the FAR,"[31] but the government argued that the contractor "waived its right to protest the contract by acquiescing to the Government's insistence that the [invalid index] be included in this and other contracts . . . ."[32] In response, the Court of Federal Claims concluded:

> When a contract clause drafted by the Government is inconsistent with the law, whether the appellant inquired, protested, accepted or otherwise assumed any risks regarding the same is not controlling; the impropriety will not be allowed to stand.[33]

Such waiver and estoppel arguments by the Government have also failed before the ASBCA.[34]

Late Contractor Claims

For contracts awarded after October 1, 1995, the FAR specifies that a contractor must generally submit its claim to the Government "within 6 years after accrual of a claim."[35] In addition, the contract itself may establish a time by which the claim must be submitted. In *Bataco Industries, Inc. v. United States*, the contractor alleged and the Government conceded that the contract's EPA clause incorporated the wrong index (although the agency disagreed with the contractor regarding which index should have actually applied).[36] Still, the Government defended by asserting that the contractor failed to comply with another provision of the clause - a requirement for making any requests for economic price adjustments within a 180-day period.[37] The court agreed with the Government, finding that the 180-day period had passed; therefore, even if the index was flawed, the contractor could obtain no relief due to its tardy claim.[38]

Government Offsets

As another defense, the Government may claim offsets to the contractor's damages flowing from a defective EPA clause to the extent that the Government has made overpayments under the contract or related contracts. In *Barrett Refining Corp. v. United States*, the contractor claimed that its fuel supply contracts contained a flawed (and therefore illegal) EPA clause, resulting in payment at less than a fair price.[39] The contractor sought an upward adjustment in the contract price to reflect fair market value.[40] Because the EPA clause violated the applicable procurement regulations, the trial court held that Barrett was entitled to a price increase to reflect the fair market value of the contract.[41]

However, the Government also asserted offsets for amounts it paid to the contractor under three other contracts that contained the same invalid EPA clause.[42] On appeal, the Federal Circuit concluded that, because the Government made these payments pursuant to an illegal contract clause, the payments were unauthorized and "the government has a right to seek and recover the unauthorized payments it made" in excess of both the fair market value and the base contract price.[43] Still, on remand, the Court of Federal Claims found no factual basis for the Government's claimed offsets because, while the payments exceeded fair market value, the

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Government did not make payments "in excess of the base price."[44]

Conclusion

With all of the litigation spawned by EPA clauses, the sound drafting of such provisions would seem to require an English professor's writing expertise, an economist's quantitative abilities, and a prophet's foresight. Nonetheless, careful selection of the benchmark price or index, attention to the regulatory requirements, and precision in drafting the terms will generally serve the purposes of an EPA clause, which are to protect the contractual parties against unanticipated cost and/or price escalation and preserve the parties' original bargain. If such measures fail to serve these purposes, the courts and the ASBCA stand ready to enforce the regulations.

Footnotes

[1] Joseph Conrad, *The Heart of Darkness*, reprinted in M. H. Abrams *et al.*, *The Norton Anthology of English Literature*, 3d Ed., Vol. 2 at 1896 (1974); These words were popularized by Marlon Brando playing the character of Kurtz in the film, *Apocalypse Now* (Zoetrope Studios, 1974).

[2] *See Ames v. Quimby*, 96 U.S. 324 (1877) ("long shovel-handles"); *Cub Fork Coal Co. v. Fairmount Glass Works*, 33 F.2d 420 (7th Cir. 1929) (coal); *American Optical Corp. v. United States*, 592 F.2d 1149 (Ct. Cl. 1979) (gold-filled spectacle frames); *Gold Line Refining v. United States*, 43 Fed. Cl. 291 (1999) (military jet fuel).

[3] FAR §16.203-3.

[4] *Beta Systems, Inc. v. United States*, 838 F.2d 1179, 1185 (Fed. Cir. 1988).

[5] *Bethlehem Steel Co. v. Turner Constr. Co.*, 2 N.Y. 2d 456, 462-63, 161 N.Y.S. 2d 90 (1957) (Conway, Ch. J., dissenting) (emphasis in original).

[6] FAR §16.203-2(a). Similarly, FAR §16.203-2(ii) provides for use of an EPA clause when "contingencies that would otherwise be included in the contract price can be identified and covered separately in the contract." *See Optic-Electronic Corp.*, ASBCA No. 24962, 83-2 BCA ¶16,677 at 83,006 (regulation provided for exclusion of "contingency 'allowances' or speculative growth factors associated with each item subject to EPA").

[7] *See, e.g., MAPCO Alaska Petroleum, Inc. v. United States*, 27 Fed. Cl. 405, 412-13 (1992); *Hettich and Co., GmbH*, ASBCA No. 29072, 86-3 BCA ¶19,043 at 96,177 ("[T]he Army knew it could not obtain the advantages of low-prices arising out of long term contracts without making provisions for some protection again constant escalation of labor costs for contractors").

[8] *MAPCO*, 27 Fed. Cl. at 413.

[9] *See, e.g., Firestone Tire & Rubber Co. v. United States*, 444 F.2d 547, 553 (Ct. Cl. 1971) ("plaintiff's interpretation, unlike that of defendant, provides for escalation on the basis of factors having a direct and specific relationship to performance of the contract); *Dynamics Corp. of America v. United States*, 10 Cl. Ct. 275, 281 (Cl. Ct. 1986) (plaintiff's interpretation served the EPA clause's goal of accurately estimating inflation since "the escalation factors were tied to performance").

[10] *Beta Systems*, 838 F.2d 1185.

[11] *Id.* at 1185-86.

[12] FAR §§16.203-4(a), (b), (c), and (d).

[13] *Chris Berg, Inc. v. United States*, 426 F.2d 314, 317 (Cl. Ct. 1970). *Accord, Beta Systems*, 838 F.2d at 1185; *BDM Management Services*, ASBCA No. 28003, 84-1 BCA ¶17,206 at 85,669-70.

[14] *MAPCO*, 27 Fed. Cl. at 407.

[15] *Id.* at 410.

[16] *Id.* at 411.

[17] *Id.*

[18] *Id.* at 411-13, 416. *Accord, Barrett Refining Corp. v. United States*, 242 F.3d 1055, 1060 (Fed. Cir. 2001) ("price escalation clause was unauthorized and unenforceable"); *Gold Line Refining, Ltd. v. United States*, 43 Fed. Cl. at 296 ("For the reasons explained in *MAPCO*, the only legally available types of indexes are those described in FAR §16.203-1(b) and (c)").

[19] FAR §16.203-2(a).

[20] DFARS §16.203-4(d)(3)(ix).

[21] *Craft Machine Works, Inc.*, ASBCA No. 35167, 90-3 BCA ¶ 23,095 at 115,968.

[22] *Id.* at 115,969.

[23] *Dynamics Corp. of America v. United States*, 17 Cl. Ct. 60, 65 (1989).

[24] *North Central Airlines, Inc. v. Continental Oil Co.*, 574 F.2d 582, 584-86 (D. Cir. 1978).

[25] *See, e.g., Dynamics Corp.*, 17 Cl. Ct. at 66.

[26] *See, e.g., Pennzoil Co. v. Federal Energy Regulatory Comm.*, 645 F.2d 360, 389-90 (5th Cir. 1981); *North Central Airlines*, 574 F.2d at 593. Cf. U.C.C. 2-305(1) providing for a "reasonable price" if a price to be determined fails, in fact, to be set.

[27] *Beta Systems*, 838 F.3d at 1185.

[28] *Id.* at 1184.

[29] *Id.*

[30] *Id.* at 1186.

[31] *MAPCO*, 27 Fed. Cl. at 408.

[32] *Id.* at 416

[33] *Id.*

[34] *Craft Machine Works, Inc.*, ASBCA No. 35167, 90-3 BCA ¶ 23,095 at 115,969.

[35] FAR § 33.206(a).

[36] *Bataco Indus., Inc. v. United States*, 29 Fed. Cl. 318, 320 (1993).

[37] *Id.* at 326.

[38] *Id.* at 328.

[39] *Barrett Refining Corp. v. United States*, 242 F.3d 1055 (Fed. Cir. 2001).

[40] *Id.* at 1060-61.

[41] *Id.* at 1061.

[42] *Id.*

[43] *Id.* at 1064.

[44] *Barrett Refining Corp. v. United States*, 50 Fed. Cl. 567, 569 (2001).