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by

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Construction Defects

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CHAPTER 6

Owners' Damages Arising from Defective Construction*

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I. Introduction

Chapter 3 outlined theories of recovery available in construction defect lawsuits. This chapter focuses on the damages that owners may recover in connection with those legal theories, beginning with an overview of the general measure of damages for breach of contract, breach of warranty, negligence, strict liability, and unfair or deceptive trade practices. It next discusses the elements of damages, including direct versus consequential damages and specific items of direct and consequential damages, including nominal damages, liquidated damages, and punitive damages. Finally, the chapter concludes with a discussion of concepts that limit the recovery of damages, including mitigation of damages, economic waste, betterment, and contractual limitations.

Owners, as a preliminary matter, should carefully consider the following issues regarding damages before filing their claims and counterclaims, conducting discovery, or presenting their cases at trial:

- What are the measures of damages? What damages are recoverable for breach of contract; breach of express, statutory, and implied warranties; strict liability; negligence; and unfair deceptive trade practices? From whom are damages recoverable?
- Are breach of contract damages foreseeable and certain?
- Might the owners' damages be limited by the affirmative defenses of mitigation of damages, economic waste, and betterment?
- Are there contractual provisions that limit owners' potential damages? Have owners agreed to "hold harmless" or "limitations of liability" clauses? Have owners waived consequential damages?
- Are there contractual provisions that expand owners' potential damages? Have owners obtained enforceable indemnification clauses?

II. General Measure of Damages

A. Breach of Contract

Contractually based compensatory damages seek to put owners in the position they would have occupied had the contract been performed properly—the structure constructed without defects, on time, and on budget.[1] When calculating compensatory damages, courts look to the following: (1) direct damages, which arise naturally from the breach of the contract, and (2) consequential damages, which are awarded where the parties have knowledge of special circumstances particular to the contract. Where there are no direct or consequential damages or such damages have not been proven, owners may

1. *See* Restatement (Second) of Contracts §344(a) (stating that damages for the "expectation interest" are "having the benefit of his bargain by being put in as good a position as he would have been in had the contract been performed").

be entitled to nominal damages, which are noncompensatory awards given to "vindicate and judicially establish a right."

When contractors or architects/engineers/consultants breach their agreements and are responsible for defective construction, owners may suffer three types of damage: (1) completion damages, (2) delay damages, and (3) defective performance damages. Owners may be entitled to one or more of these measures of damages.

B. Completion Damages

Owners are entitled to obtain completion of their construction projects for the price specified in the contracts, without defects. Generally, "[w]here there has been part performance on a construction contract, the owner's measure of damages is generally the cost of completion."[2]

AIA Document A201-2007 ¶ 14.2.4 provides for the following relief upon termination of the contract for convenience by the owner in circumstances in which the owner retains a different contractor to complete work under the contract:

> If the unpaid balance of the Contract Sum exceeds costs of finishing the Work, including compensation for the Architect's services and expenses made necessary thereby, and other damages incurred by the Owner and not expressly waived, such excess shall be paid to the Contractor. If such costs and damages exceed the unpaid balance, the Contractor shall pay the difference to the Owner. The amount to be paid to the Contractor or Owner, as the case may be, shall be certified by the Initial Decision Maker, upon application, and this obligation for payment shall survive termination of the Contract.[3]

Accordingly, if the cost to complete construction (correct defects) is less than the unpaid balance of the contract and any approved change orders, the contractor is entitled to the difference. On the other hand, if the cost to complete construction without defects is more than the unpaid balance of the contract and approved change orders, the owner would be entitled to the amount in excess of the unpaid balance.

In *Burdette v. Lascola*,[4] the homeowners sued the builder and its surety when the builder failed to pay subcontractors and complete the project. The

2. Erney v. Freeman, 84 S.W.3d 529, 536 (Mo. Ct. App. 2002); *see also* American Standard, Inc. v. Schectman, 80 A.D.2d 318, 321 (N.Y. App. Div. 1981); Philip L. Bruner & Patrick J. O'Connor, Jr., Bruner & O'Connor on Construction Law § 19.56 (2002).

3. *See* American Institute of Architects, AIA Document A201-2007, *General Conditions of the Contract for Construction*, ¶ 14.2.4 (2007).

4. 395 A.2d 169 (Md. Ct. App. 1978).

trial court awarded the homeowners $10,090.62 for completion damages, including $2,894 to complete a driveway, even though the contract allowance for this item was $1,000. The Maryland Court of Appeals affirmed an award to complete the driveway because such an amount was necessary to give the homeowners the benefit of the bargain.

C. Delay Damages

Owners are entitled to have construction projects completed on time. If the presence or correction of construction defects delays completion, owners may be entitled to direct delay damages and foreseeable consequential delay damages or liquidated damages.[5] Examples of owners' delay damages may include the following nonexhaustive list: lost profits, loss of use of project, loss of use of sale proceeds, excess operating costs, increased financing costs, costs for alternative facilities, extended insurance premiums, and additional administration costs. Many of these examples of owners' delay damages are discussed in more detail below in *Specific Items of Direct and Consequential Damages*.

An owner's entitlement to delay damages for correcting a construction defect depends upon proving that there was a defect that caused a delay to the project and that the contractor or architect/consultant/engineer was responsible for the delay.[6] If owners cannot demonstrate that the contractor or architect/consultant/engineer delayed completion of the project, they will not be entitled to delay damages.[7] Not all defects giving rise to delay will give rise to recoverable damages. Owners are not entitled to delay damages if the cause of the delay is the result of events outside the control of the parties, such as severe weather, labor strikes, wars, and acts of God. Some courts still hold contractors responsible for any cause of delay, even acts of God, unless construction contracts contain force-majeure clauses.[8]

Obtaining delay damages may be complicated, even when there is delay caused by a contractor- or engineer-caused defect, when there are concurrent owner-caused delays. Concurrent delays are two or more delays occurring at

5. *See* Bruner & O'Connor on Construction Law, *supra* note 2, at § 19.63. The elements of damages, including direct damages, consequential damages, and liquidated damages, are discussed in more detail in the section *Elements of Damages*.

6. *See* William Schwartzkopf & John J. McNamara, Calculating Construction Damages § 12.04, at 245 (2d ed. 2001).

7. *See* Exton Drive-In, Inc. v. Home Indem. Co., 261 A.2d 319, 324 (Pa. 1969) (precluding recovery for delay damages where owner did not prove that contractor's actions delayed the opening of the outdoor theater).

8. *See* Alpine Constr. Co. v. Water Works Bd., 377 So. 2d 954, 956 (Ala. 1978) ("Where one by his contract undertakes an obligation which is absolute, he is bound to perform within the terms of the contract or answer in damages, despite an act of God, unexpected difficulty, or hardship, because these contingencies could have been provided against by his contract.").

the same time and having the same effect on the progress of construction.[9] If feasible, courts may attempt to apportion responsibility for concurrent delays between the responsible parties.[10] On the other hand, if courts cannot apportion responsibility, no party will be entitled to delay damages.[11]

D. Defective Performance Damages: Cost to Repair vs. Diminution in Value

When contractors fail to construct a project in conformity with contractual requirements, owners may recover damages under one of two measures of damages: (1) the cost to repair the defective work, or (2) the diminution in value of the project resulting from the defective work.[12] Although both damage measures are available, the majority of courts follow the *Restatement (Second) of Contracts*[13] and provide that the default measure is the cost to repair.[14]

1. Cost to Repair

Under the cost to repair measure, owners are entitled to receive the reasonable costs of repairing the construction defects.[15] To recover under the cost to repair measure, owners must prove the existence of a contract, a breach of the contract, and the costs to repair the construction defects as a result of the breach.

The Louisiana Court of Appeals' opinion in *Nuerge v. Coldewy Corp.* offers a good example of the cost to repair measure.[16] In that case, the homeown-

9. *See generally*, W. Stephen Dale and Robert M. D'Onofrio, *Reconciling Concurrency in Schedule Delay and Constructive Acceleration*, 39 Pub. Cont. L.J. 161 (Winter 2010) (discussing concurrent delay and the impact of schedule analysis techniques on concurrent delay).

10. *See* Raymond Constructors of Africa Ltd. v. United States, 411 F.2d 1227, 1236 (Ct. Cl. 1969) (apportioning one-third of concurrent delays to the government based upon the jury verdict method, despite the lack of a precise allocation of responsibility for delays).

11. *See* Peabody N.E., Inc. v. Town of Marshfield, 689 N.E.2d 774, 780–81 (Mass. 1998) (stating that "where both the plaintiff (contractor) and the defendant (owner) were to blame for the plaintiff's delayed completion of a project, the defendant was not entitled to liquidated damages").

12. *See* Bruner & O'Connor on Construction Law, *supra* note 2, at §19:57.

13. *See* Restatement (Second) of Contracts §348(2)(b).

14. *See* Nuerge v. Coldewy Corp., 14 So. 3d 39, 44 (La. Ct. App. 2009) (finding the amount of damages awarded was based on the cost of replacing plaintiff's roof); Kunkel v. P.K. Dependable Constr., LLC, 902 N.E.2d 769, 774 (Ill. Ct. App. 2009) (finding that the correct measure of damages for defective performance generally is the cost of correcting the defective condition); County Asphalt Paving Co. v. 1861 Group, Ltd., 908 S.W.2d 184, 186 (Mo. Ct. App. 1995) (stating that the preferred method of damages for defective construction is cost to repair).

15. Restatement (Second) of Contracts §348(2)(b); *see also* Schwartzkopf & McNamara, *supra* note 6, at 243.

16. 14 So. 3d 39 (La. Ct. App. 2009).

ers filed a lawsuit against the roofer for faulty workmanship.[17] The trial court entered judgment in favor of the homeowners in the amount of $6,000 to replace the roof and back gable.[18] The expert for the homeowners had testified that it would cost $12,300 to replace the entire roof.[19] Because only 50 percent of the roof needed to be replaced, a panel of the Louisiana Court of Appeals affirmed the trial court award of $6,000 in damages.[20]

Although owners have the right to begin repairs immediately, they still may need to comply with the terms of construction contracts by providing notice to contractors and the opportunity to cure the nonconforming work prior to beginning repairs. By providing contractors with such notice, owners may avoid potential claims from contractors that the repairs destroyed evidence necessary for the owners to prove their case and defend against the owners' claims.[21] Owners also should make efforts to document the repairs and the need for the repairs before proceeding.

Owners have the burden of proof to provide evidence of the cost to repair. Damages need not be proven with "mathematical exactitude," but owners must put forth "sufficient evidence for the trier of fact to make a fair and reasonable estimate."[22] There are two ways in which to establish the cost to repair. First, owners may rely on competent expert testimony as to the estimated costs of repairs.[23] Second, owners can complete the repairs and provide evidence of the necessity and amount of the actual cost of repair.

Due to the passage of time during arbitration and litigation, the cost to repair can vary significantly between the time the defective work was done and when a decision maker awards damages. When calculating damages, the cost to repair typically is measured at the time of the breach or within a reasonable time period thereafter.[24] However, this rule is not universal. Some courts prefer to calculate damages at the time of trial rather than the time of the breach. These courts reason that only after trial will owners actually expend the money to correct defects. For instance, in *Van Busceum v. Continental Builders, Inc.*, a panel of the Ohio Court of Appeals found that measuring

17. *Id.* at 40.

18. *Id.* at 43.

19. *Id.* at 44.

20. *Id.*

21. *See* Gross v. McKenna, 2007 WL 3171155, *1 (Tenn. Ct. App. October 30, 2007) (discussing the builder's claim that "the trial court should have dismissed the case or imposed some other sanction against Homeowners for demolishing the home and thus destroying evidence during discovery without first notifying the court and Builder").

22. Richard K. Allen & Stanley A. Martin, Construction Law Handbook § 30.02[a] at 1177–78 (2d ed. 2009).

23. *See* Gorman v. Tassajara Dev. Corp., 178 Cal. App. 4th 44, 80 (Cal. Ct. App. 2009) ("If the trial court accepted this declaration (and similar ones) as expert testimony, it provided evidence of negligent workmanship by Contractor and its subcontractors.").

24. *See id.*

damages at the time of trial was the only possible way to ensure that the owner could restore the property to the condition contemplated by the parties at the time of the contract.[25]

Some courts permit owners to recover for the cost of future repairs.[26] In *Rovetti v. City and County of San Francisco*, a panel of the California Court of Appeals found that "reasonable 'contingency' expense items cannot be characterized as speculative."[27] The court relied upon the general principal that uncertainty as to the amount of damages does not defeat damage claims.[28]

Even if the amount of damage claimed to complete repairs is reasonable, courts still may reduce owners' damages if the repairs are unreasonable or unnecessary. One commentator has stated that the reasonableness of costs to repair may be judged by the following factors: "(1) the need to make the repairs in order to permit the owner to be able to use the project for its intended purposes, (2) the requirements of the contract, and (3) the extent to which repair costs exceed the reduction of the property's market value caused by the damages."[29]

Courts that follow the cost to repair measure still will not allow owners to receive a windfall. Courts may limit such cost of repair damages under the "betterment" doctrine. For a more detailed treatment of "betterment," refer to the section *Betterment* below.

2. Diminution in Value

A second measure for defective performance damages is diminution in value. Diminution in value is the diminution in the market value of the property caused by the breach.[30] In other words, diminution in value is the "difference between the value of the property with the defective work and what its value would have been had it been constructed according to the terms of the contract."[31]

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25. 2008 WL 1932310, *8 (Ohio Ct. App. May 1, 2008) ("Courts have not specifically limited the calculation of the reasonable cost of repairs at the time of the breach. We find that pursuant to the above-stated law, it was not error for the jury to consider evidence of what it would reasonably cost in 2006 . . . .").

26. *See Gorman*, 178 Cal. App. 4th at 83.

27. 131 Cal. App. 3d 973, 980 (Cal. Ct. App. 1982).

28. *Id.*

29. *See* Bruner & O'Connor on Construction Law, *supra* note 2, at § 19:58.

30. *See* Restatement (Second) of Contracts § 348(2)(a).

31. County Asphalt Paving Co. v. 1861 Group, Ltd., 908 S.W.2d 184, 186 (Mo. Ct. App. 1995); *see also* Young-love Const., LLC v. PSD Dev., LLC, 782 F. Supp. 2d 457, 461 (N.D. Ohio 2011) (*citing* Ohio Valley Bank v. Copley, 699 N.E.2d 540 (Ohio 1997)) ("[I]f reconstruction and completion involve unreasonable economic waste, damages [are] measured by the difference between the market value that the structure contracted for would have had and that of the imperfect structure provided by the plaintiff.")

3. Economic Waste as a Limitation on Cost to Repair

As previously indicated, the default measure of damages in construction defects cases is the cost to repair.[32] Contractors can rebut the presumptive use of the cost to repair measure by arguing that repairing the project would result in economic waste.[33] When this is the case, courts employ the alternative diminution in value measure.[34]

Courts have found that economic waste occurs when the cost of completing the project as specified by the contract greatly outweighs the benefit to owners or the defect will result in destruction of usable property.[35] In the first instance, courts are willing to apply the alternative diminution in value measure because owners should not receive a windfall.[36] In the second instance, courts are willing to apply the alternative diminution in value measure because destroying usable property would be a waste of assets.[37] Courts particularly favor the diminution in value measure where the work is safe and functional as constructed, the defects are not structural but rather are cosmetic in nature, and the project is built for general commercial purposes rather than unique or special circumstances such as a public park, church, or home.[38]

The doctrine of economic waste has its historical origins in the landmark case of *Jacobs & Young, Inc. v. Kent*.[39] In that case, a contractor overlooked the contract requirement to obtain specified plumbing pipe from the Reading Company.[40] The owner sought to remove the old pipe and compel the contractor to refit the pipe using the specified pipe.[41] The contractor demonstrated

32. *See also County Asphalt Paving Co.*, 908 S.W.2d at 186 (stating that "[t]he diminished value rule is the exception . . .").

33. *See* Granite Constr. Co. v. U.S., 962 F.2d 998, 1007–08 (Fed. Cir. 1992) (upholding award in favor of contractor for cost of removing and replacing work not strictly in conformance with the contract but adequate for intended purposes and well within design safety factors, upon determination that the owner's insistence on strict compliance resulted in economic waste); Heine v. Parent Constr. Inc., 4 So. 3d 790, 793 (Fla. Ct. App. 2009) (finding that the economic waste doctrine applied to a home built at an elevation one foot lower than specified in contract where it would cost $930,000 to tear down and rebuild the home to correct the one-foot elevation difference); American Pest Control, Inc. v. Pritchett, 412 S.E.2d 590, 592 (Ga. Ct. App. 1991) (stating that waste occurs when the repairs would be an "absurd undertaking").

34. *See* Short v. Greenfield Meadows Assoc., 2008 WL 2589659, *4 (Ohio. Ct. App. June 24, 2008) (holding that when repairing the facility would constitute waste, the proper measure of damages is the diminution in value).

35. *See* Bruner & O'Connor on Construction Law, *supra* note 2, at § 11.02[3][d].

36. *See* Hal J. Perloff, *The Economic-Waste Doctrine in Government Contract Litigation*, 43 DePaul L. Rev. 185, 192–93 (Fall 1993).

37. *See id.* at 196.

38. *See* Bruner & O'Connor on Construction Law, *supra* note 2, at § 19.59.

39. 230 N.Y. 239 (1921).

40. *Id.* at 240.

41. *Id.*

that the installed pipe was equal in every respect to the specified pipe.[42] The contractor also demonstrated that replacing the pipe would require the contractor to tear out significant portions of the completed work.[43] The court concluded that to require the contractor to replace the existing pipe with the specified pipe would constitute economic waste and would yield no additional benefit.[44] Accordingly, the owner was only entitled to the diminution in value, which was nominal or nothing.[45]

The burden of demonstrating that the cost to repair would be disproportionate to the loss in value rests solely with contractors.[46] In *County Asphalt Paving Company v. 1861 Group, Ltd.*, the owner presented evidence of the cost to repair before the trial court.[47] When the contractor did not present any evidence that the cost to repair would be an unfair measure of damages, the trial court entered judgment in favor of the owner.[48] On appeal, a panel of the Missouri Court of Appeals affirmed the trial court's holding against the contractor.[49]

In demonstrating that the cost to repair would result in economic waste, the contractor's burden often is quite heavy. As one noted contract law expert has stated, "[a]ny reasonable doubt as to whether curing defects would cause such economic waste should be resolved against the Contractor guilty of the breach."[50] Many courts require that the breaching party prove "affirmatively and convincingly" that the repairs would result in unreasonable economic waste.[51]

Often, the process of accurately calculating the diminution in value can be difficult and cumbersome. The cost of repairing a structure is a process that contractors and owners are accustomed to doing on a regular basis. Indeed, the traditional bid system can be considered a method of cost to repair. Conversely, calculating the appropriate diminution in value of a property inevitably involves a conflict of experts trying to speculate about relative market values.[52] This has led commentators to conclude that "[d]etermining fair market value is a complex and inexact task . . . The difficulties are

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42. *Id.*
43. *Id.*
44. *Id.*
45. *Id.* at 244–45.
46. *See* Panorama Village v. Golden Rule Roofing, Inc., 10 P.3d 417, 428 (Wash. Ct. App. 2000); St. Louis LLC v. Final Touch Glass & Mirror, Inc., 899 A.2d 1018, 1026 (N.J. 2006).
47. 908 S.W.2d at 186.
48. *Id.*
49. *Id.*
50. Arthur Linton Corbin, Corbin on Contracts §60.1 (2005).
51. *See* Construction Law Handbook, *supra* note 22 at §30.02[B] (*citing* Andrulis v. Levin Constr. Corp., 628 A.2d 197, 208 (Md. 1993)).
52. *See* Blair-Naughton LLC v. Diner Concepts, 369 Fed. Appx. 895, 900 (10th Cir. 2010) (stating that "diminution in value" refers to diminution in market value).

likely to be compounded when the aim is to ascertain what the fair market value would have been if the property were in a different condition than it is presently."[53]

Contractors may be precluded altogether from arguing for the diminution in value measure where the building is a unique and distinct project and the only proper way to deal with defects is to impose a heavy burden on contractors. Courts have found that the diminution in value would not apply to "'service-type property' or 'special purpose property' (such as the property of nonprofit, charitable, or religious organizations)[.]"[54] For example, one court found a church to be such a "service-type property" or "special purpose property."[55]

Contractors also may be precluded from arguing for the diminution in value measure where they have engaged in deliberate or intentional conduct.[56] A good example of such a limitation of the diminution in value measure is *Roudis v. Hubbard*.[57] In that case, the homeowners contracted with the contractor to purchase land and construct a modular home.[58] In constructing the modular home, the contractor intentionally omitted the footing drains and Styrofoam required by the specifications.[59] Based upon such intentional conduct, the court refused to apply the diminution in value measure and permitted the homeowners to recover the costs to repair.[60]

Some owners have sought to include "market stigma" damages in their diminution in value calculations. The principal of market stigma recognizes that diminution in value damages may be increased based upon market fears or stigmas about construction defects.[61] Courts will limit such market stigma

53. Carol Chomsky, *Of Spoil Pits and Swimming Pools: Reconsidering the Measure of Damages for Construction Contract*, 75 Minn. L. Rev. 1445, 1162 n.60 (1991).

54. Russell v. City of New Bedford, 910 N.E.2d 404, 411 (Mass. App. Ct. 2009) (explaining that the general rule that the appropriate measure of damages is the difference between the fair market value of the property prior to the loss and the fair market value after the loss "may not apply to a certain category of properties, termed 'service-type property' or 'special purpose property' (such as the property of nonprofit, charitable, or religious organizations)"); *see also* Trinity Church v. John Hancock Mut. Life Ins. Co., 502 N.E.2d 532, 536 (Mass. 1987) (damage to church could not be measured using traditional fair market value measure).

55. *See Trinity Church*, 502 N.E.2d at 536.

56. *See* Schwartzkopf & McNamara, *supra* note 6, at 243; Perloff, *supra* note 36, at 199.

57. Roudis v. Hubbard, 176 A.D.2d 388 (N.Y. App. Div. 1991).

58. *Id.* at 388.

59. *Id.* at 289–90.

60. *Id.* at 290.

61. *See* Smith v. Kan. Gas Serv. Co., 169 P.3d 1052, 1059–60 (Kan. 2007); Farrell v. Lane Residential, Inc., 2006 WL 3371461, *6 (N.Y. Sup. Ct. Nov. 14, 2006) (recognizing the principle of market stigma damages, but finding plaintiff's proof on the issue of stigma inadequate).

damages where they are speculative.[62] Furthermore, not all jurisdictions permit the recovery of market stigma damages.[63]

4. Cost to Repair and Diminution in Value

Owners may not be limited to either cost to repair or diminution in value damages. In instances where some but not all of the defective conditions are repaired, owners' damages may include both the cost to perform the partial repairs *and* diminution in value of the property after repair.[64] In *Northern Petrochemical Co. v. Thorsen & Thorshov, Inc.*, the owner of a new office, warehouse, and manufacturing plant asserted claims against the general contractor and architect as a result of defective construction.[65] In particular, the owner discovered large cracks in the walls and floors, walls were out of plumb and bowed, reinforcing steel was lying on the fill, and the underlying fill had not been properly compacted.[66] The Minnesota Supreme Court found that the owner was entitled to both $346,000 for costs to repair and $147,000 for diminution in value.[67] The court noted the need for some repairs to prevent a collapse of the building.[68] However, "[t]he walls and columns that were pushed out of plumb never rebounded to their original positions, various cracks in the floors and walls remain, and the strain on the building was such that higher maintenance costs were likely in the future."[69] Because some of the construction defects could not be repaired, the owner was entitled to both cost to repair and diminution in value damages.[70]

62. *See Smith*, 169 P.3d at 1060; Fusco v. State Farm Fire & Cas. Co., 57 A.D.3d 939, 940–41 (N.Y. Ct. App. 2008) (finding claimed stigma damages too speculative and conclusory despite expert testimony).

63. *See Younglove Constr., LLC.*, 782 F. Supp. 2d 457, 461 (finding that Ohio law does not allow stigma damages).

64. *See* Bruner & O'Connor on Construction Law, *supra* note 2, at §19.61; *see also County Asphalt Paving Co.*, 908 S.W.2d at 186 ("In the case of substantial but defective performance by a contractor the measure of damages recoverable by the owner is determined by either or both of two different standards . . . Where there are a number of defects, the diminished value rule may be applicable to some and the cost rule to others"); Murray v. McCoy, 949 S.W.2d 613, 615 (Ky. Ct. App. 1996) (stating the court did not agree that "measures of damages are exclusive of one another and that there cannot be an award for repairs made and the diminished value of the home where it remains defective because of irreparable faults").

65. 211 N.W.2d 159, 163 (Minn. 1973).

66. *Id.* at 164–65.

67. *Id.* at 165.

68. *Id.*

69. *Id.*

70. *Id.*

E. Limitations on Liability

1. Foreseeability

As explained below in *Direct vs. Consequential Damages*, damages generally either are direct or consequential damages. Consequential damages may include lost profits, lost opportunity damages, diminished bonding capacity, unabsorbed home office overhead expense, financing costs, additional insurance and bond premiums, and loss of resale profits.[71]

To recover consequential damages, owners must prove that such damages are "natural and foreseeable consequences of the breach."[72] The genesis of the foreseeability requirement is the seminal case *Hadley v. Baxendale*.[73] In *Hadley*, the owner of a corn mill was forced to shut down after breaking a crank shaft. The owner contracted with common carriers to transport the broken crank shaft to the manufacturer and return with a replacement crank shaft. The common carriers delayed the delivery of the replacement crank shaft, which resulted in a five-day delay in mill operations. At trial, the mill owner sought £300 in lost profits, but only was awarded £25. Nonetheless, the appeal court reversed the trial court and remanded for a new trial because the common carriers could not have known that the failure to deliver the replacement crank shaft would cause such a stoppage of work. In making its ruling, the appeal court outlined the following damage principles that have been universally adopted in American jurisdictions:

> Where two parties have made a contract which one of them has broken, the damages which the other party ought to receive in respect of such breach of contract should be such as may fairly and reasonably be considered either arising naturally, i.e., according to the usual course of things, from such breach of contract itself, or such as may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach of it. Now, if the special circumstances under which the contract was actually made were communicated by the plaintiffs to the defendants, and thus known to both parties, the damages resulting from the breach of such a contract, which they would reasonably contemplate, would be the amount of injury which would ordinarily

71. *See* John H. Dannecker, Jason W. Hill, John E. Kofron, & Dale B. Rycraft, *Recovering and Avoiding Consequential Damages in the Current Economic Climate*, 30 Constr. Law 4, at 32–33 (Fall 2010).

72. *See* First Nat. Bank v. Sanchez, 815 P.2d 613, 618 (N.M. 1991); Fowler v. Campbell, 612 N.E.3d 596, 603 (Ind. Ct. App. 1993) (discussing the fundamental rule of damages that states that "a party injured by a breach of contract may recover the benefit of his bargain but is limited in his recovery to the loss actually suffered").

73. 156 Eng. Rep. 145 (1854).

follow from a breach of contract under these special circumstances so known and communicated.[74]

These declarations by the appeal court can be distilled into the following statements:

1. Direct damages are damages that "aris[e] naturally, i.e. according to the "usual course of things, from such breach of contract;"
2. Consequential damages are damages that arise as "probable result of the breach of [the contract]" as long as they "may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract[.]"[75]

In the case of *Hadley*, the appeal court found that "the only circumstances here communicated by [the owner] and [the common carriers] at the time the contract was made, were, that the article to be carried was the broken shaft of a mill, and [the owner was] the millers of that mill."[76]

Hadley influences American jurisprudence today through the foreseeability requirement for damages.[77] The *Restatement (Second) of Contracts* states that "[d]amages are not recoverable for loss that the party in breach did not have reason to foresee as a probable result of the breach when the contract was made."[78] Direct damages based upon the first principle in *Hadley* are probable or foreseeable if they follow from the breach "in the ordinary course of events[.]"[79] Consequential damages based upon the second principle in *Hadley* are probable or foreseeable if they follow from the breach "as a result of special circumstances, beyond the ordinary course of events, that the party in breach had reason to know."[80]

Professor Farnsworth offers several guidelines in the application of foreseeability.[81] First, "foreseeability is to be determined as of the time of the making of the contract and is unaffected by events subsequent to that time."[82] Second, "what must be foreseeable is only that the loss would result if the breach occurred. There is no requirement that the breach itself or the particular way that the loss came about be foreseeable."[83] Third, "it is foreseeability only by the party in breach that is determinative."[84] Fourth, "foreseeability

74. *Id.* at 151.
75. *See* E. Allen Farnsworth, Farnsworth on Contracts §12.14 at 257 (3d 2004).
76. *Hadley*, 156 Eng. Rep. 145.
77. *See, e.g.,* Cohn v. Norton, 18 A. 595 (Conn. 1889) (referring to the "[*Hadley*] Rule").
78. Restatement (Second) of Contracts §351(1).
79. *Id.* §351(2)(a).
80. *Id.* §351(2)(b).
81. *See* E. Allen Farnsworth, Farnsworth on Contracts §12.14 at 260–62.
82. *Id* at 260.
83. *Id.*
84. *Id.* at 261.

has an objective character."[85] For instance, in a dispute between a general contractor and subcontractor as to additions and alterations to a school, the New Hampshire Supreme Court found the general contractor's insistence that the subcontractor perform punch-list items outside the scope of its contracts could lead to harm to the subcontractor's reputation and economic prospects.[86] Finally, "the loss need only have been foreseeable as a probable, as opposed to a necessary or certain, result of the breach."[87]

2. *Uncertainty*

Owners cannot recover contractual damages unless they can demonstrate damage as a result of the breach with reasonable certainty.[88] The *Restatement (Second) of Contracts* confirms that "[c]ourts have traditionally required greater certainty in the proof of damages for breach of a contract than in the proof of damages for a tort."[89] As other commentators have noted, because construction projects often involve many interdependent parties, parsing out damages caused by one specific party with reasonable certainty can be difficult, and often requires expert testimony.[90] The reasonable certainty requirement, however, applies only to the fact of damage, not the amount of damages.[91] Once the fact of damage is demonstrated with reasonable certainty, uncertainty as to the amount of damages will not preclude recovery.[92]

The level of certainty is "reasonable certainty," not mathematical certainty.[93] Most contract cases require proof by a "preponderance of the evidence" for all aspects of the case and not a higher standard, such as reasonable certainty.

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85. *Id.*

86. *See* Independent Mechanical Contractors v. Gordon T. Burke & Sons, 635 A.2d 487, 489 (N.H. 1993).

87. E. Allen Farnsworth, Farnsworth on Contracts §12.14 at 261.

88. *See* Restatement (Second) of Contracts §352 ("Damages are not recoverable for loss beyond an amount that the evidence permits to be established with reasonable certainty."); Bruner & O'Connor on Construction Law, *supra* note 2, at §19.15.

89. Restatement (Second) of Contracts §352 cmt. a.

90. *See* Bruner & O'Connor on Construction Law, *supra* note 2, at §19.15.

91. *See* Venderbeek v. Dorothy Severson, 50 P.3d 866, 873 (Colo. 2002); *see also* 22 Am. Jur. 2d *Damages* §332 (stating that "[t]he rule that uncertain damages will not be awarded applies to uncertainty as to the fact of damage and not as to its amount").

92. *See* Tull v. Gundersons, Inc., 709 P.2d 940, 943 (Colo. 1985) ("Although an award of damages cannot be based on mere speculation or conjecture, once the fact of damage has been established with the requisite degree of certainty, uncertainty as to the amount of damages will not bar recovery"); *see also* 22 Am. Jur. 2d *Damages* §332 (stating that "where it is certain that damage has resulted, mere uncertainty as to the amount will not preclude the right of recovery").

93. *See* Thorp Sales Corp. v. Gyuro Grading Co, Inc., 319 N.W.2d 879, 884 (Wis. Ct. App. 1982) (stating that "damages need not be ascertainable with absolute exactness or mathematical precision"); Janda v. Iowa Industrial Hydraulics, Inc., 326 N.W.2d 339, 342 (Iowa 1982); *see also* 22 Am. Jur. 2d *Damages* §328 (2011).

If the standard of proof for damages was reasonable certainty, owners would be required to prove breach of a construction contract by a preponderance of the evidence and damages by reasonable certainty. Instead, while courts require damages to be proven with reasonable certainty, the standard of proof for reasonable certainty still is by a preponderance of the evidence.[94]

Proving lost profits is one area in which courts are apt to give teeth to the requirement for reasonable certainty.[95] The difficulty in proving reasonable certainty as to lost profits depends on the circumstances.[96] For instance, proving reasonable certainty where a contractor's failure to complete construction caused the owner to lose a specific sale may not be difficult. On the other hand, when there are no specific buyers, and there are changes in the economy, demonstrating lost profits can be more difficult. A claim that a contractor's failure to complete construction on a specific project caused the owner to lose profits on other projects (not built) is more likely to be deemed speculative.

One of the best methods for owners to demonstrate lost profits as a result of defective construction is through past business performance.[97] Lost profits become more difficult to prove where owners have begun new businesses or if their businesses are subject to large fluctuations in volume, costs, or prices.[98] Even in the face of such increased difficulty, owners still may prove lost profits with reasonable certainty through expert testimony, economic and financial data, market surveys, and analyses.[99]

The case of *Exton Drive-In, Inc. v. Home Indemnity Co.* offers a good example of the application of the reasonable certainty requirement to lost profits.[100] In that case, the owner of an outdoor theater entered into a contract with a contractor for grading and paving.[101] When the contractor failed to promptly complete construction, the owner sued the contractor and individual guarantor for the costs to repair and lost profits, which were $42,500.[102] The trial court granted judgment in favor of the owner in the amount of $13,692.49.[103] On appeal, the Pennsylvania Supreme Court concluded that the evidence did

94. *See Tull*, 709 P.2d at 943; Western Cities Broadcasting, Inc. v. Schueller, 849 P.2d 44, 48 (Colo. 1993).

95. *See* Restatement (Second) of Contracts §352 cmt. a ("The main impact of the requirement of certainty comes in connection with recovery for lost profits.").

96. *See id.*

97. See id., at cmt. b. ("Evidence of past performance will form the basis for a reasonable prediction as to the future.").

98. *See id.* ("However, if the business is a new one or if it is a speculative one that is subject to great fluctuations in volume, costs or prices, proof will be more difficult.").

99. *See id.*; *see also* Drews Co. v. Ledwith-Wolfe Assoc., 371 S.E.2d 532, 536 (S.C. 1998) (*quoting* Restatement (Second) of Contracts §352 cmt. a).

100. 261 A.2d 319 (Penn. 1969).

101. *Id.* at 322.

102. *Id.*

103. *Id.*

not demonstrate that the contractor actually delayed the theater's opening.[104] The owner attempted to claim that the unfinished condition of the theater caused it to experience lower-than-anticipated profits.[105] The court, however, found "that the anticipated profits of a new and untried business which were attributable solely to the unfinished condition of the business premises were too speculative to provide a basis for an award of damages."[106]

F. Breach of Warranties

Chapter 3 outlined the different types of warranty claims that may be brought as a result of defective construction. Owners may bring express, statutory, and implied warranty claims in defective construction lawsuits.[107]

For express and implied warranty claims, the general measure of damages is the "loss directly and naturally resulting, in the ordinary course of events, from the breach."[108] Similar to breach of contract, the preferred method of damages for express and implied warranty claims is the cost to repair, unless the cost to repair is disproportionate to the diminution in value. [109] As with defective performance damages for breach of contract, contractors bear the burden to demonstrate that the cost to repair is disproportionate to the diminution in value.[110] If contractors do not present any such evidence, owners are entitled to their costs to repair, assuming there is sufficient admissible evidence for application of the cost to repair measure.[111]

The case of *Quincy at Southport Condo. Assoc., Inc. v. Czerwiowski* offers a good example of the application of the cost to repair measure for an express warranty claim.[112] In that case, the owner of several buildings entered into a contract with the contractor for the removal of existing asphalt shingles

104. *Id.* at 324 ("Since the motion picture screen itself was not installed until a few days before the schedule opening, the theater could not have opening sooner than it did.").

105. *Id.*

106. *Id.*

107. *See id.*

108. Quincy at Southport Condo. Assoc., Inc. v. Czerwiowski, 2008 Conn. Super. LEXIS 311, *9 (Conn. S. Ct. February 8, 2008).

109. *See* Pennington v. Rhodes, 929 S.W.2d 169, 175–76 (Ark. Ct. App. 1996); General Supply and Equip. Co., Inc. v. Phillips, 490 S.W.2d 913, 919 (Tex. Ct. App. 1972); Fetzer v. Vishneski, 582 A.2d 23, 26 (Pa. Super. Ct. 1990); Rogowicz v. Taylor and Gray, Inc., 498 S.W.2d 352, 354 (Tex. Ct. App. 1973); Schulze v. C&H Builders, 761 S.W.2d 219, 223 (Mo. Ct. App. 1988); Plunk v. Hedrick Concrete Products Corp., 870 S.W.2d 942, 944 (Mo. Ct. App. 1994); Rands v. Forest Lake Lumber Mart, Inc., 402 N.W.2d 565, 568 (Minn. Ct. App. 1987). For a discussion of the cost to repair measure versus diminution in value measure, *see infra Excess Operating Costs*.

110. *See Pennington*, 929 S.W.2d at 176.

111. *See id.*

112. 2008 Conn. Super. LEXIS 311.

and installation of new asphalt siding shingles.[113] After installation, some of the new asphalt siding shingles began to fall off of the buildings.[114] When the original contractor ceased to replace or reinstall the shingles, the owner hired another contractor to replace 80 percent of the shingles as of the time of trial.[115] The original contractor argued that the owner's damages should be limited to the cost of replacing only the improperly installed shingles.[116] The court found that awarding only the cost of replacing the improperly installed shingles would not give the owner the benefit of the bargain.[117] The court also found that replacing only the improperly installed shingles would deprive the owner of the aesthetic appearance for which it bargained.[118] Therefore, the court awarded the owner damages for the cost of replacing all the shingles.[119]

Conann Constructors, Inv. v. Muller demonstrates the application of the cost to repair measure for an implied warranty claim.[120] In that case, the homeowners purchased a home from the contractor that included a septic system in the front yard.[121] Effluence from the septic system later ran into the yards of the homeowners and their neighbor.[122] The trial court awarded the homeowners $10,000 for the cost of repairs, $4,200 for increased maintenance costs, $2,000 for several trees that would be lost during repairs, and $5,000 for mental anguish.[123] A panel of the Texas Court of Appeals confirmed the damage award for cost of repairs, increased maintenance costs, and damages to trees,[124] but reversed the mental anguish award.[125]

The Uniform Commercial Code governs commercial transactions involving "predominantly the sale of goods."[126] While the Uniform Commercial Code would not apply to many construction contracts because they involve "services," it still may apply to equipment and materials provided by subcontractors and suppliers.[127] For a breach of warranty claim pursuant to the Uniform Commercial Code, "[t]he measure of damages . . . is the difference at the time and place of acceptance between the value of the goods accepted and the value they would have had if they had been as warranted, unless

113. *Id.* at *1.
114. *Id.* at *2.
115. *Id.* at *7.
116. *Id.* at *10–11.
117. *Id.* at *11.
118. *Id.*
119. *Id.*
120. 618 S.W.2d 564 (Tex. Ct. App. 1981).
121. *Id.* at 566.
122. *Id.*
123. *Id.*
124. *Id.* at 567.
125. *Id.* at 568.
126. *See* U.C.C. §2-105(1).
127. *See* Bruner & O'Connor on Construction Law, *supra* note 2, at §19.45.

special circumstances show proximate damages of a different amount."[128] Owners also can obtain incidental and consequential damages as well.[129] Incidental damages include "expenses reasonably incurred in inspection, receipt, transportation and care and custody of goods rightfully rejected, any commercially reasonable charges, expenses or commissions in connection with effecting cover and any other reasonable expense incident to the delay or other breach."[130] Consequential damages include "(a) any loss resulting from general or particular requirements and needs of which the seller at the time of contracting had reason to know and which could not reasonably be prevented by cover or otherwise; and (b) injury to person or property proximately resulting from any breach of warranty."[131] Of course, damages for breach of warranty are limited by foreseeability, just as they are limited for breach of contract. In *General Supply and Equip. Co., Inc. v. Phillips*, for example, a panel of the Texas Court of Appeals precluded an award of lost profits for defective PVC paneling installed in greenhouses where the owner had not previously made a profit and the alleged lost profits were based upon the most favorable conditions.[132]

G. Strict Liability

The concept of strict liability arose from the law of products liability, commencing with peculiarly dangerous products, and gradually broadening to mass-produced consumer goods. Some courts have applied this concept to mass-produced housing. Section 402A *Restatement (Second) of Torts* now states that "[o]ne who sells any product in a defective condition unreasonably dangerous to the user or consumer or to his property is subject to liability for physical harm thereby caused to the ultimate user or consumer, or to his property . . . ."[133] In the seminal California case of *Kriegler v. Eichler Homes, Inc.*,[134] the homeowner also asserted claims for negligence and strict liability against the contractors due to the failure of a radiant heating system in a mass-produced new home.[135] The court found that the homeowner was entitled to the diminution in value of the home based upon both negligence and strict liability claims.[136]

One issue that arises with strict liability damages is the economic loss rule: whether owners may recover economic damages to replace a defective

128. *See* U.C.C. §2-714(2).
129. *Id.* §2-714(3).
130. *Id.* §2-715(1).
131. *Id.* §2-715(2).
132. 490 S.W.2d at 920–21.
133. Restatement (Second) of Torts §402A(1).
134. 74 Cal. Rptr. 749 (Cal. Ct. App. 1969).
135. *Id.* at 751.
136. *Id.*

product absent personal injury or physical damage to some other property.[137] In *Loughridge v. Goodyear Tire and Rubber Co.*, homeowners sued various companies relating to defective parts incorporated in radiant heating systems.[138] The United States District Court for the District of Colorado found that strict liability damage was not precluded by the economic loss rule.[139] On the other hand, some courts permit owners to recover in strict liability only where there is personal or property damage other than economic damages to the defective product.[140] A more detailed discussion of the economic loss rule is provided in Chapter 3.

A subissue in applying the economic loss rule to strict liability claims is the question of what is "the product?" In *Jimenez v. Superior Court*, window manufacturers argued that the "product" of a mass-produced home was an entire house, and therefore, the economic loss rule should preclude recovery in strict liability for a defective part, the windows.[141] The California Supreme Court disagreed and concluded that "the manufacturer of a defective window installed in a mass-produced home may be held strictly liable in tort for damage that the window's defect causes to other parts of the home in which it is installed."[142] In contrast, in *Dakota Gasification Co. v. Pascoe Bldg. Sys.*, the owner of a synthetic natural gas production plant in North Dakota sued the contractors and subcontractors after defective steel beams in the roof of the oxygen plant collapsed and caused damage.[143] The Eighth Circuit concluded that "the economic loss doctrine extends to preclude liability in tort for physical damage to other nearby property of commercial purchasers who could foresee such risks at the time of purchase."[144] Accordingly, the court precluded the recovery for damage to the oxygen plant as a result of the defective steel beams.[145]

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137. *See* Hiigel v. General Motors Corp, 544 P.2d 983, 989 (Colo. 1975) ("Since under §402A the burden of having cast a defective product into the stream of commerce falls upon the manufacturer, it appears inconsistent to limit his responsibility to property other than the product sold.").

138. 192 F. Supp. 2d 1175, 1180 (D. Colo. 2002).

139. *Id.* at 1183.

140. *See* E. River S.S. Corp. v. Transamerica Delaval, 476 U.S. 858, 876 (1986) (precluding recovery for repair of defective engine turbines on oil-transporting supertankers under strict liability where only economic damages sustained as to the turbines themselves); Jimenez v. Superior Court, 58 P.3d 450, 456 (Cal. 2002) ("[T]he economic loss rule allows a plaintiff to recover in strict products liability in tort when a product defect causes damage to 'other property,' that is, property other than the product itself. The law of contractual warranty governs damage to the product itself.").

141. *Jimenez*, 58 P.3d at 456–57.

142. *Id.*

143. 91 F.3d 1094, 1096–97 (8th Cir. 1996).

144. *Id.* at 1100–01.

145. *Id.* at 1101.

H. Negligence

Construction negligence claims require the familiar proof that the defendant had a duty of care, that the defendant breached the duty of care, and that it suffered proximately caused damages as a result of the breach.[146] Once liability is established, owners may recover damages in negligence for all "natural and probable consequences" of the defendants' acts.[147] One advantage is that owners' damages are not limited to the "damages within the contemplation of the parties at the time the contract was made."[148] The *Restatement (Second) of Torts* confirms: "the fact that the actor neither foresaw nor should have foreseen the extent of the harm or the manner in which it occurred does not prevent him from being liable."[149] The owners' damages for negligently defective construction are the reasonable costs of repairing the property, unless the cost of repair is disproportionate to the diminution in value.[150]

One problematic area of construction negligence damages is emotional distress. The *Restatement (Second) of Torts* states that "[c]ompensatory damages that may be awarded without proof of pecuniary loss include compensation . . . for emotional distress."[151] In *Erlich v. Mendezes*,[152] the California Supreme Court addressed the issue of whether homeowners may recover for emotional distress as the result of negligent construction.[153] The homeowners contracted for the construction of their "dream home" on an ocean-view lot.[154] After moving into the home, water began to penetrate into the home from the windows, roofs, and in between the floors.[155] The homeowners testified that they suffered emotional distress (including a heart condition) as a result of the defective constructions, fears that the home would collapse, and fears for their daughter's safety.[156] The court initially noted that "[t]he fact that emotional distress damages may be awarded in some circumstances does not mean they are available in every case in which there is an independent cause of

146. *See* Prosser and Keeton on Torts §30 at 164–65 (W. Page Keeton, Dan B. Dobbs, Robert E. Keeton, and David G. Owen eds., 5th ed. 1984).

147. *See id.* at 282.

148. Rawlings v. Apodaca, 726 P.2d 565, 577 (Ariz. 1986); *see also* R.E.T. Corp. v. Frank Paxton Co., 329 N.W.2d 416, 420 (Iowa 1983) (stating that "tort damages are not limited by the reasonable contemplations of the parties. Instead, the amount of direct injury is compensated, whether its extent was contemplated or not").

149. *See* Restatement (Second) of Torts §435 (1).

150. *See* Thurmond & Associates v. Kennedy, 668 S.E.2d 666, 668 (Ga. 2008). For a discussion of the cost to repair measure versus the diminution in value measure, *see* discussion *supra* at II.D.1 and II.D.2 .

151. Restatement (Second) of Torts §905(b).

152. 981 P.2d 978 (Cal. 1999).

153. *Id.* at 985–87.

154. *Id.* at 981.

155. *Id.*

156. *Id.*

action founded upon negligence."[157] The court determined that homeowners' recovery for emotional distress damages for negligent construction is limited to the following conditions:

1. If "the defendant has assumed a duty to plaintiff in which the emotional condition of the plaintiff is an object" or
2. "[I]f the emotional distress arises out of the defendant's breach of some other legal duty and the emotional distress is proximately caused by [breach of the independent duty]" and the "breach of the duty must threaten physical injury, not simply damage to property or financial interests."[158]

The court offered the following commentary about the home-building process:

> [The homeowners] may have hoped to build their dream home and live happily ever after, but there is a reason that tag line belongs only in fairy tales. Building a house may turn out to be a stress-free project; it is much more likely to be the stuff of urban legends—the cause of bankruptcy, marital dissolution, hypertension and fleeting fantasies ranging from homicide to suicide.[159]

Ultimately, the court found that the homeowners were not entitled to emotional distress damages because the defective construction did not cause any physical injury.[160] The court did find that one homeowner sustained heart disease, but concluded that this physical injury was the result of the emotional distress and not the negligent construction.[161]

Courts in other jurisdictions also have precluded the recovery of emotional distress damages associated with defective construction.[162] Furthermore, the *Restatement (Second) of Contracts* confirms that "[r]ecovery for emotional disturbance will be excluded unless the breach also caused bodily harm or the

157. *Id.* at 985 (*quoting* Merenda v. Superior Court, 4 Cal. Rptr. 87, 90 (Cal. Ct. App. 1992)).

158. *Id.*

159. *Id.* at 987.

160. *Id.*

161. *Id.* ("The only physical injury alleged is [the homeowner's] heart disease, which flowed from the emotional distress and not directly from the negligent construction.").

162. *See* Blagrove vs. JB Mechanical, Inc., 934 P.2d 1273, 1275–77 (Wyo. 1997) (finding that emotional distress damages were not permitted for negligent construction without accompanying physical injury because it would "result in unacceptable burdens for both the judicial system and defendants"); Hancock v. Northcutt, 808 P.2d 251, 258 (Alaska 1991) (precluding emotional distress damages where the court found that "breach of a house construction contract is not especially likely to result in serious emotional disturbance. Such contracts are not so highly personal and laden with emotion as contracts where emotional damages have typically been allowed to stand on their own").

contract or the breach is of such a kind that serious emotional disturbance was a particularly likely result."[163]

I. Unfair and Deceptive Trade Practices

Owners may be able to pursue statutory claims in addition to the breach of contract claims. The National Conference of Commissioners on Uniform State Laws proposed the Revised Uniform Deceptive Trade Practices Act in 1966 with the stated purpose to define unfair trade practices for uniform application throughout the states.[164] Many states have adopted a version of the Revised Uniform Deceptive Trade Practices Act, and other states throughout the country have increasingly promulgated their own Consumer Protection and Unfair and Deceptive Trade Practices Acts.[165]

These acts favor owners because they often authorize treble damages and attorney's fees.[166] For example, in *Campbell v. Teague*, the homeowner discovered numerous defects in the property including foundation problems, mold, and methane gas.[167] The homeowner asserted claims for the defective construction and for misrepresentations made by the contractor. The court agreed with the homeowner and awarded damages, prejudgment interest, and attorney's fees.[168]

These acts often broadly apply to consumers and all persons involved in the stream of commerce.[169] Depending on the state, both homeowners and sophisticated commercial owners may be covered. For example, in *PPG Indus. v. JMB/Houston Centers Partners*, JMB purchased an office building from another commercial entity for $375 million.[170] The windows were defectively installed in the office building, causing fogging and discoloration. JMB sued and prevailed at trial under Texas's Deceptive Trade Practices Act.[171] The Texas

163. Restatement (Second) of Contracts §353.

164. *Available at* http://www.law.upenn.edu/bll/archives/ulc/fnact99/1920_69/rudtpa66.htm (last visited January 15, 2012). As of the date of this publication, 14 states have adopted the Revised Uniform Trade Practices Act. *See* http://www.law.cornell.edu/uniform/vol7.html#dectr; *see also, e.g.*, 815 Ill. Comp. Stat. 510/4 ("This Act shall be construed to effectuate its general purpose to make uniform the law of those states which enact it.").

165. *See, e.g.*, N.C. Gen. Stat. §75-1.1; Tenn. Code Ann. §§47-18-101 *et. seq.*; Wash. Rev. Code §§19.86.010 *et. seq.; see also* E. Richard Kennedy & Ellen Hirsh de Haan, *Litigation Involving the Developer, Homeowners' Associations, and Lenders*, 39 Real. Prop. Prob. & Tr. J. 1, 12 (Spring 2004).

166. *See, e.g.*, N.C. Gen. Stat. §75-16 and Tenn. Code Ann. §47-18-109.

167. 201 Tenn. App. LEXIS 239, *2–5 (Tenn. Ct. App. March 31, 2010).

168. *Id.* at *37–54; *see also* Quate v. Caudle, 381 S.E.2d 842, 845–47 (N.C. App. 1989) (awarding treble damages under Consumer Protection Act for delays caused by contractors).

169. *See* Bruner & O'Connor on Construction Law, *supra* note 2, at §9:9.

170. 146 S.W.3d 79 (Tex. 2004).

171. *Id.* at 83.

Supreme Court ultimately reversed due to an improper assignment of the claims, but did provide, *in dicta*, that Texas's statute only exempts businesses with $25 million in assets or more, thereby indicating that sophisticated entities with less than $25 million in assets can bring Consumer Protection Act claims.[172]

III. Elements of Damages

A. Direct vs. Consequential Damages

Contractual damages generally are composed of direct and consequential damages. The distinctions between direct and consequential damages caused by defective construction are important because many industry form agreements, such as those published by the AIA, ConsensusDOCS, and the Engineers Joint Contract Documents Committee (EJCDC), include a waiver of consequential damages.[173] There is considerable confusion surrounding the delineation between direct and consequential damages, and this can impact owners' rights and remedies.

The difficulty is illustrated with the following example. Consider an owner who hires a contractor to construct a condominium building. Immediately following construction of the building, the owner discovers significant construction defects that require it to hire another contractor to perform repairs. While the defects are repaired, the owner incurs additional interest costs on its construction loan, additional expenses for its own personnel to administer the construction project, permanent financing becomes more expensive, and the owner cannot rent or sell any condominium units.

Direct damages are those that flow directly from the breach. They have a direct causal connection to the breach at issue. In the above example, the costs to repair the construction defects by the subsequent contractor would be direct damages. Consequential damages, by contrast, are damages that do not flow directly from the breach but arise because of the party's unique circumstances.[174] In the above example, the lost profit in renting or selling condomin-

172. *Id.* at 103 (citing Tex. Bus. & Com. §17.45).

173. *See* American Institute of Architects, AIA Document A201-2007, *General Conditions of the Contract for Construction* ¶ 15.1.6 (mutual waiver of claims for consequential damages); ConsensusDOCS 240 §5.4.1; EJCDS C-700 (2007) §5.07(B) (Owner's waiver of consequential damages).

174. For a detailed description of the difference between direct and consequential damages, *see* Roanoke Hospital Assoc. v. Doyle & Russell, Inc., 214 S.E.2d 155, 160–62 (Va. 1975) ("Direct damages are those which arise 'naturally' or 'ordinarily' from a breach of contract; they are damages which, in the ordinary course of human experience, can be expected to result from a breach. Consequential damages are those which arise from the intervention of 'special circumstances' not ordinarily predictable."). For a discussion of the types of consequential damages that could be claimed by contractors, owners, and developers, see Dannecker, Hill, Kofron, & Rycraft, *supra* note 71, at 32–33 (listing consequential

ium units likely would be consequential damages. However, not all courts treat lost profits as consequential damages. Similarly, whether the additional interest costs would be direct or consequential damages is an open question.

Court decisions provide disappointingly little guidance for distinguishing between direct and consequential damages. Over the last 20 years, there have been few occasions for courts to distinguish between direct damages and consequential damages. One court, opining on the issue, defined the distinction as follows: "Direct damages are those that *flow naturally and necessarily* from the breach[ ]," while "[c]onsequential damages are those which *result naturally, but not necessarily,* from the breach."[175] While this definition may not be theoretically meaningless, it is difficult to know in practice whether a court will characterize damages as flowing "naturally and necessarily" or "naturally, but not necessarily." The Fifth Circuit has acknowledged the imprecision of any definition for consequential damages and found the term ambiguous without some guidance by the parties: "[W]e note especially that [the term 'consequential damages'] is never explained or clarified anywhere in the contract. So, we, too, have no way of knowing what [the parties] meant by use of the term 'consequential damages . . . arising out of the breach of the contract[.]'"[176]

Contractual definitions, however, can also be challenging. For example, AIA Document A201-2007 defines owner consequential damages as "[D]amages incurred by the Owner for rental expenses, for losses of use, income, profit, financing, business and reputation, and for loss of management or employee productivity or of the services of such persons[.]"[177] This definition is ambiguous and may be in internal conflict with other AIA provisions.[178] Despite the popularity of AIA Document A201-2007 and its inclusion of a mutual waiver of consequential damages since 1997, the meaning of "consequential damages" has not been substantially advanced.[179] Other commentators have noted that "[i]t would seem that a comprehensive list of direct and consequential delay damages in the construction context would have been developed by

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damages for unabsorbed home office overhead expense, lost profits, lost opportunity damages, diminished bonding capacity, financing costs, additional insurance and bond premiums, increased labor or fuel expenses resulting from delayed installation of energy-efficient equipment, and loss of resale profits).

175. Tennessee Gas Pipeline Co. v. Technip USA Corp., 2008 Tex. App. LEXIS 6419, *6 (Tex. Ct. App. August 21, 2008) (emphasis added).

176. Gulf Am. Indus. v. Airco Indus. Gases, 573 So. 2d 481, 489 (La. Ct. App. 1990).

177. American Institute of Architects, AIA Document A201-2007, *General Conditions of the Contract for Construction* ¶ 15.1.6.

178. *See* Dannecker, Hill, Kofron, & Rycraft, *supra* note 71, at 32–34.

179. *See id.* at 28 ("Contract waivers of consequential damages add a dimension of complexity because these clauses often do not clearly define what damages are 'consequential,' and the term is not self-defining.") (*citing* Gulf Amer. Indus. v. Airco Indus. Gases, 573 So. 2d 481, 489 (La. Ct. App. 1990)).

now."[180] Unfortunately, "deciding whether construction defect damages are *direct* or *consequential* will be difficult for parties and the courts alike."[181] And right they are.

Perhaps recognizing the impossibility of applying any meaningful distinction between direct and consequential damages, some courts ignore the distinction and attempt to establish an outside boundary of what constitutes legally cognizable damages. These courts often do not care to which category damages belong. In Tennessee, the two leading "definitions" of consequential damages are:

- "In addition, however, the [plaintiff] may recover special [i.e., consequential] damages, if any, that arise out of the breach of contract in order to compensate the [plaintiff] for any loss or injury actually sustained by reason of the [defendant's] breach. These special damages, though, must be within the reasonable contemplation of both parties, at the time the contract was made."[182]
- "[A]ny loss resulting from general or particular requirements and needs of which the seller at the time of contracting had reason to know and which could not reasonably be prevented by cover or otherwise."[183]

These definitions retreat to the general concept of foreseeability and do not attempt to draw lines along the direct/consequential border.

Owners who desire to be fully compensated for construction defects should take care to draft any construction contract in a manner that properly defines the term "consequential damage" because courts and commentators have yet to clearly define the term.

B. Specific Items of Direct and Consequential Damages

1. Lost Profits and Lost Use

What makes a bright-line test for direct versus consequential damages even more elusive is the fact that the characterization of certain types of damages varies by jurisdiction. The categorization of lost profits is a good example. In *Malbco Holdings, LLC v. Amco Ins. Co.*, the United States District Court for the District of Oregon found that lost profits were consequential damages and available so long as they were reasonably foreseeable.[184] In contrast, a Texas court has held that loss of use, lost opportunity, and lost profit damages are

180. R. Harper Heckman & Benjamin R. Edwards, *Time Is Money: Recovery of Liquidated Damages by the Owner*, 24 Constr. Law 28, Fall 2004, at 29 (2004).

181. *Id.*

182. Turner v. Benson, 672 S.W.2d 752, 754–55 (Tenn. 1984).

183. Tenn. Code. Ann. §47-2-715(2)(a).

184. 2010 U.S. Dist. LEXIS 2007, *24 (D. Or. January 1, 2010).

direct damages and not impacted, therefore, by a waiver of consequential damages.[185]

An owner may obtain lost resale profits because the "likelihood of lost profits from related or derivative transactions is so obvious in these situations that the breaching party must be deemed to have contemplated them at the inception of the contract."[186] If a contractor breaches a contract with the owner to construct a residential subdivision, it will be difficult for the contractor to claim that the likelihood of lost profits from reselling properties was not contemplated at the inception of the contract. In *South Carolina Federal Sav. Bank v. Thornton–Crosby Dev. Co.*, the South Carolina Supreme Court found the breaching contractor knew that the owner was building the condominium units in order to resell units.[187]

An owner also may obtain lost operating or rental profits due to delays in completing construction.[188] In *Northern Petrochemical Co.*, the owner had been delayed by eight months in operating its new office, warehouse, and manufacturing plant by the general contractor and architect.[189] In addition to other damages, the Minnesota Supreme Court awarded the owner $267,000 for loss of profits because they were proven with reasonable certainty.[190] In *Cinnamon Valley Resort v. EMAC Enters*, a panel of the Arkansas Court of Appeals stated that "when a contractor delays completion of a building, the proper measure of damages is the rental value of the building during the time that the owner is deprived of its use."[191] Finally, in *McDevitt & Street Co. v. Marriot Corp.*, the contractor's delay in completing a hotel caused the owner to lose lease revenue.[192] The United States District Court for the Eastern District of Virginia awarded such lost lease revenue to the owner because it was reasonably foreseeable.[193]

Courts will preclude the recovery of lost operating or rental profits where owners cannot demonstrate the fact and amount of such damages with

185. *Tennessee Gas Pipeline*, 2008 Tex. App. LEXIS 6419 at *21 ("We conclude that Article 19.1, 'Consequential Damages' does not preclude the recovery of direct damages involving loss of use, opportunity, or profits"); *see also* Irwin Indus. Tool Co. v. Worthington Cylinders Wisc., 747 F. Supp. 2d 568, 576 (W.D.N.C. 2010) (finding that "lost profits are *direct* damages resulting from" the breach of the agreement and therefore not subject to a waiver of consequential damages provision) (emphasis in original).

186. Lewis Jorge Constr. Management, Inc. v. Ponoma Unified Sch. Dist., 102 P.3d 257, 264 (Cal. 2004).

187. 1990 S.C. App. LEXIS 155, *8 (S.C. Ct. App. November 8, 1990).

188. *See* Bruner & O'Connor on Construction Law, *supra* note 2, at § 19.65.

189. 211 N.W.2d at 163–65.

190. *Id.* at 166.

191. 202 S.W.3d 1, 7 (Ark. Ct. App. 2005).

192. 713 F. Supp. 906, 931 (E.D. Va. 1989), *rev'd on other grounds,* 911 F.2d 723 (4th Cir. 1990).

193. *Id.*

reasonable certainty.[194] In *Cason v. King*, a newly constructed septic system leaked into a newly constructed lake.[195] In addition to cost of repair damages, the trial court awarded the homeowners $5,000 for loss use of the lake to water their cattle.[196] The homeowners had presented no evidence at trial as to the costs that they would incur to supply their cattle with water without use of the lake.[197] The only evidence presented by the homeowners was testimony that the lake cost over $10,000 to construct.[198] A panel of the Missouri Court of Appeals reversed the $5,000 judgment and remanded for a new trial.[199]

Contractors may attempt to argue that owners are limited in their recovery of lost profits by a liquidated damages provision.[200] In *Northern Petrochemical Co.*, the contractor argued that the owner was precluded from obtaining lost profit damages based upon the liquidated damages provision.[201] The court, however, disregarded the liquidated damages provision and applied common-law damages, finding that the liquidated damages provision was intended to apply only to "'normal' delays, not to an extraordinary 8-month delay resulting from defective construction[.]"[202]

Owners should be careful to preserve their rights to recover lost profits when executing agreements. Particular attention should be paid to contract clauses that waive the right to recover consequential damages. For example, in *AGIP Petroleum Co. v. Gulf Island Fabrication, Inc.*,[203] the mud mats on a platform jacket broke loose and had to be brought back to shore. The owner incurred over $15 million in damages, consisting mostly of "lost revenues from delayed oil and gas production."[204] None of this damage was recoverable by the owner because the parties' contract included a mutual waiver of "special, punitive, indirect or consequential damages, including, but not limited to, loss of capital, loss of product, loss of profit or loss of use."[205]

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194. *See* Terrones v. Tapia, 967 P.2d 216, 219 (Colo. Ct. App. 1998) (entering summary judgment against the owners as to lost profits due to the lack of a genuine issue of fact).

195. 327 S.W.3d 543, 546 (Mo. Ct. App. 2010).

196. *Id.* at 545, 552–54

197. *Id.* at 554.

198. *Id.*

199. *Id.*; *see also* Dill v. Chastain, 507 S.E.2d 872, 873–84 (Ga. Ct. App. 1998) (denying the recovery of lost profits where the contractor failed to introduce evidence of his usual percentage of profit, costs of additional materials, labor costs, and time to complete performance).

200. *Northern Petrochemical Co.*, 211 N.W.2d at 166.

201. *Id.*

202. *Id.*

203. 920 F. Supp. 1330 (S.D. Tex. 1996).

204. *Id.* at 1335.

205. *Id.* at 1340–41.

2. Loss of Use of Sale Proceeds

In *McDevitt & Street Co.*, the contractor entered into a contract to construct a Courtyard by Marriot hotel.[206] The contract stated that the owner "may suffer great financial loss if the Work is not completed by [December 20, 1986]."[207] Because of 131 days of inexcusable delay by the contractor in completing the hotel, the owner was unable to sell the hotel.[208] The United States District Court for the Eastern District of Virginia found that the owner was deprived of the use of the $6,256,000 in sale proceeds, which could have been used to pay down its corporate borrowings and to reduce its interest expense.[209] Using the owner's average weighted borrowing rate, the court awarded the owner $202,875 for such loss of use of sale proceeds.[210]

3. Excess Operating Costs

Owners may be entitled to additional operating costs caused by delays to correct defects. In *Northern Petrochemical Co.*, the owner was delayed eight months in operating its new office, warehouse, and manufacturing plant by the general contractor and architect.[211] Along with other damages, the Minnesota Supreme Court awarded the owner $50,000 for "excess operating costs while awaiting occupancy of the building."[212] The court noted that such additional operating costs were a measure of lost profits instead of a distinct measure of damages.[213] Courts will preclude an award for additional operating costs if they are too remote or speculative.[214]

4. Financing Costs

When a contractor delays the construction project, owners incur additional financing costs on their construction loans. Increased financing costs, generally, are recoverable as foreseeable consequential damages.[215] One court found that increased interest costs as a result of increased rates are consequential (rather than direct) damages because interest rate increases are caused by "variable pressures and counter-pressures affecting supply and demand in the money market," not delays in construction."[216] On the other hand,

206. 713 F. Supp. at 908.
207. *Id.* at 929.
208. *Id.* at 929–30.
209. *Id.* at 930.
210. *Id.*
211. *Northern Petrochemical Co.*, 211 N.W.2d at 163–65.
212. *Id.* at 165.
213. *Id.* at 166.
214. *See* Indianhead Truck Line, Inc. v. Hvidsten Transport, Inc., 128 N.W.2d 334, 348 (Minn. 1964) (finding an award of damages for operating cost savings to be too speculative and remote).
215. *See* Construction Law Handbook, *supra* note 22 at §31.03[B].
216. *Roanoke Hospital Assoc.*, 214 S.E.2d at 160.

some courts consider delay-related interest costs to be recoverable as direct damages.[217]

In *Metropolitan Transfer Station v. Design Structures Inc*, the owner of a garbage transfer station contracted with a contractor to remodel the facility.[218] After the remodel was completed, the owner discovered a number of defects that caused the facility to extend the amount of time it had to remain closed.[219] The owner was obligated to pay the additional interest expenses resulting from the delay required to repair defective construction.[220] The court found that the owner was entitled to additional financing costs resulting from project delay because such costs were reasonably foreseeable and proximately caused by the contractor.[221]

Note that AIA Document A201-2007 specifically waives damages for increased financing costs.[222] If owners are obtaining substantial construction loans as part of large-scale construction projects, they would be prudent to either not enter into broad waivers of consequential damages or limit the scope of any such waivers.

5. Alternative Facilities

Owners may be forced to rent alternative facilities while delayed construction is completed or construction defects are repaired. Unless waived,[223] owners may obtain the increased costs of such alternative facilities.[224]

C. Nominal Damages

As an alternative to direct and consequential damages, courts may award nominal damages in several circumstances. In *City of Westminster v.*

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217. *See id.* ("[D]elay in completion requires an extension of the term of construction financing. The interest costs incurred and the interest revenue lost during such an extended term are predictable results of the delay and are, therefore, compensable direct damages.").

218. 328 N.W.2d 532, 534 (Iowa Ct. App. 1982).

219. *Id.*

220. *Id.* at 535.

221. *Id.* at 536.

222. *See* American Institute of Architects, AIA Document A201-2007, *General Conditions of the Contract for Construction* ¶ 15.1.6; *see also* Bartram, LLC v. C.B. Contractors, LLC, 2011 U.S. Dist. LEXIS 34972, *7–8 (N.D. Fla. March 31, 2011) (holding that increased financing costs are considered consequential damages, thus the owner was precluded under a waiver of consequential damages from recovering such costs); Roanoke Hospital Ass'n v. Doyle & Russell, Inc., 214 S.E.2d at 160–61 (holding that extended financing costs as a result of delay in completion were compensable direct damages, while increased interest rates were non-recoverable consequential damages).

223. *See* American Institute of Architects, AIA Document A201-2007, General Conditions of the Contract for Construction ¶ 15.1.6.

224. *See* Bruner & O'Connor on Construction Law, *supra* note 2, at § 19.67.

Centric-Jones, a Colorado court held that nominal damages are appropriate for a breach of contract even if no actual damages resulted or if the amount of actual damages has not been proven.[225] In *Evans v. Werle*, the homeowners proved that the roof installed by the contractor leaked and regularly lost shingles during storms.[226] The homeowners sued based on an express warranty contained in a contract.[227] During trial, the homeowners were unable to prove damages under the applicable cost of repair measure.[228] The court, nonetheless, found that the homeowners were entitled to recovery of nominal damages because they had proven the existence of a contract and its breach.[229] One might not think of nominal damages as particularly meaningful, but in many jurisdictions, the recovery of nominal damages may allow the claimant to recover attorney's fees and/or costs, as occurred in *Evans v. Werle*.[230]

D. Liquidated Damages

One way that owners protect themselves from contractor-caused delay is the inclusion of a liquidated damage provisions in the construction contract. In the context of construction, liquidated damage provisions stipulate an agreed-upon amount as damages for each day of delay after the scheduled completion date.[231] There are several advantages to liquidated damage provisions for owners. First, a liquidated damage provision avoids the pitfalls of attempting to prove actual damages. As explained above, courts may preclude the award of damages based upon the uncertainty of the fact of damage or speculation about the amount of damage.[232] Second, by eliminating the need to prove actual damages, a liquidated damage provision may save time and reduce the cost of litigation.[233] Finally, liquidated damage provisions provide an incentive for contractors to perform contractual obligations.[234]

There also may be disadvantages to liquidated damage provisions for owners. First, agreed liquidated damages generally preclude the recovery

225. City of Westminster v. Centric-Jones Constructors, 100 P.3d 472, 481–82 (Colo. Ct. App. 2003).

226. 31 S.W.3d 489, 491 (Mo. Ct. App. 2000).

227. *Id.*

228. *Id.* at 492.

229. *Id.*

230. *Id.* (upholding attorney's fees and costs as the homeowners were the successful parties).

231. *See* Scott M. Tyler, *No (Easy) Way Out: "Liquidating" Stipulated Damages for Contractor Delay in Public Construction Contracts*, 44 Duke L.J. 357 (1994).

232. *See* discussion *supra* at II. E.

233. *See* Restatement (Second) of Contracts § 356 cmt. a.

234. *See* Robert A. Hillman, *The Limits of Behavioral Decisions Theory in Legal Analysis: The Case of Liquidated Damages*, 85 Cornell L. Rev. 717, 725 (2000).

of actual delay damages.[235] Liquidated damages may not cover the actual damages. Second, owners may be precluded from recovering liquidated damages where there are concurrent owner-caused delays.[236] Contractors still may be liable for liquidated damages if the delay can be apportioned.[237] Owners also may be entitled to recover liquidated damages where there are sequential delays. [238]

The enforceability of liquidated damage provisions depends upon whether the agreed-upon amount is a reasonable estimate of damages at the time the contract is made.[239] An agreed-upon amount that is unreasonably large will be stricken by the court as unenforceable.[240] Additionally, if liquidated damage provisions are intended as a method to punish contractors, courts will find them an unenforceable penalty.[241]

Generally, liquidated damages may be recovered even if the owner has not suffered any actual damages.[242] This is not unreasonable given that the enforceability of a liquidated damage provision depends upon the approximation of the anticipated loss at the time of contracting; it is not based upon the actual loss.[243] Nonetheless, some courts have refused to enforce liquidated damage provisions where there were no actual damages.[244] Some courts also will examine actual damages in determining the reasonable estimate of damages at the time of contracting.[245]

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235. *See* Wechsler v. Hunt Health Sys., 330 F. Supp. 2d 383, 426 (S.D.N.Y. 2004); *see also* Construction Litigation: Representing the Owner 365 (Robert F. Cushman, Kenneth M. Cushman, and Stephen B. Cook, eds., 1990).

236. *See* United States v. United Eng'g & Constr. Co., 234 U.S. 236 (1914); PCL Constr. Servs. v. United States, 53 Fed. Cl. 479, 484–85 (2002).

237. *See* George Sollitt Constr. Co. v. United States, 64 Fed. Cl. 229, 243–44 (2005).

238. *See* Sunshine Constr. & Eng'g, Inc. v. United States, 64 Fed. Cl. 346, 372 (2005).

239. *See* Restatement (Second) of Contracts §356; Bruner & O'Connor on Construction Law, *supra* note 2, at §15.82.

240. *See* Restatement (Second) of Contracts §356(b)

241. *See id.* cmt. a ("[T]he parties to a contract are not free to provide a penalty for its breach."); *see also* Bruner & O'Connor on Construction Law, *supra* note 2, at §15.82.

242. *See* Southwest Eng'g Co. v. United States, 341 F.2d 998, 1003 (8th Cir. 1965); Kirchdorfer, Inc. v. United States, 229 Ct. Cl. 560, 566–67 (1981); *Appeal of Paragon Mechanical*, ASBCA No. 23006, 80-2 B.C.A. ¶ 14,667 (1980); Wallace Real Estate Inv., Inc. v. Groves, 881 P.2d 1010, 1016–17 (Wash. 1994); *see also* Restatement (Second) of Contracts §356 cmt. b.

243. *See* Restatement (Second) of Contracts §356 cmt. b.; *see also* Gaines v. Jones, 486 F.2d 39, 46 (8th Cir. 1973) ("To measure the reasonableness of a liquidated damages stipulation by proof of the actual amount of damages incurred invokes hindsight judgment guided by events that actually occurred rather than by the intention of the parties at the time the contract was executed as to what the probable damages might be.").

244. *See* Norwalk Door Closer Co. v. Eagle Lock & Screw Co., 220 A.2d 263, 268 (Conn. 1966).

245. *See* Shapiro v. Grinspoon, 541 N.E.2d 359, 604 (Mass. Ct. App. 1989).

E. Punitive Damages

In addition to direct and consequential damages, courts may award punitive damages when the party liable for the damage has acted in some particularly reprehensible manner. Victims do not receive punitive damages as a form of compensation. Rather, courts award punitive damages to punish the wrongdoer and deter future wrongdoing.

Punitive damages may be available under the common law or by statute. Under the common law, the traditional view is that "[p]unitive damages are not recoverable for a breach of contract unless the conduct constituting the breach is also a tort for which punitive damages are recoverable."[246] In *Myers Building Industries v. Interface Technology, Inc.*, a panel of the California Court of Appeals precluded an award of punitive damages in a breach of contract action where there were no factual findings of fraud or other tort cause of action.[247]

Courts have set out two common-law tests for punitive damages. One test requires that the construction defect cause physical injury or damage to other property.[248] A second test involves an examination of the contractor's "evil intent" or wrongful motive.[249] One example of the second test is *Goff v. Elmo Greer & Sons Const. Co., Inc.*[250] In that case, the landowners sued for breach of contract, nuisance, and punitive damages against a highway company for negligently constructing a roadway and burying waste tires on their property.[251] The Tennessee Supreme Court upheld an award of punitive damages against the contractor for intentionally and willfully creating a nuisance on the landowners' property.[252]

The contractor's conduct must be extreme. A panel of the Mississippi Court of Appeals refused to award punitive damages where a home was constructed with an uneven kitchen and family room floor.[253] In that case, the homeowners notified the contractor about the defective floor, but the contractor refused to make repairs.[254] In refusing an award of punitive damages, the

246. Restatement (Second) of Contracts §355; *see also* Bruner & O'Connor on Construction Law, *supra* note 2, at §19.4.

247. 17 Cal. Rptr. 2d 242, 248 (Cal. Ct. App. 1993).

248. *See* Morrow v. L.A. Goldschmidt Assoc., Inc., 492 N.E.2d 181, 185 (Ill. 1986) ("We cannot agree that a breach of contract becomes a tort just because the breach was willful and wanton. Where the construction defects do not cause physical injuries or damage to other property, we are unwilling to impose tort liability on a builder for breach of his contract . . . even if the breach was willful and wanton.")

249. *See* Tri Aspen Construction Co. v. Johnson, 714 P.2d 484, 488 (Colo. 1986) (stating that to support a claim for exemplary damages one must demonstrate evil intent or wrongful motive).

250. 297 S.W.3d 175 (Tenn. 2009).

251. *Id.* at 179.

252. *Id.* at 199.

253. Johnson v. Black Brothers, Inc., 879 So. 2d 525, 527 (Miss. Ct. App. 2004).

254. *Id.* at 529.

court noted the following: (1) there was no proof of damage beyond the need to fix the floor, and (2) the case lacked the "requisite malice or gross negligence in order to consider punitive damages."[255] The Illinois Supreme Court also refused to award punitive damages in a case arising from defectively constructed floors.[256]

IV. Limitations on Damages

A. Mitigation of Damages

Owners who have sustained damages as a result of the actions and inactions of contractors or architects/consultants/engineers have an affirmative obligation to mitigate their damages. The *Restatement (Second) of Contracts* states that "damages are not recoverable for loss that the injured party could have avoided without undue risk, burden or humiliation."[257] The obligation to mitigate damages begins upon discovery of the breach of contract.[258] The party asserting the affirmative defense of mitigation of damages bears the burden of proof.[259] The question of whether owners have failed to mitigate their damages also is a question for the trier of fact.[260]

Mitigation of damages only requires owners to make reasonable efforts to mitigate their damages. Owners are not required to incur unreasonable expenses or enter into risky contracts.[261] Owners are not required to make the "best choice," as long as they act reasonably in selecting different methods to mitigate damages.[262] "Where a choice is required between two reasonable courses of action, the party that caused the injury may not complain that one course, rather than the other, was chosen."[263] If an owner completes a construction project after the contractor breaches the construction contract, it has an obligation to mitigate completion damages by obtaining the lowest bid

255. *Id.*

256. *See Morrow*, 492 N.E. 2d at 186.

257. Restatement (Second) of Contracts §350.

258. *See* Conner v. Southern Nev. Paving, 741 P.2d 800, 801 (Nev. 1987); Holland v. Green Mountain Swim Club Inc., 470 P.2d 61, 63 (Colo. Ct. App. 1970).

259. *See* Fairway Builders v. Malouf Towers Rental Co., 603 P.2d 513, 526 (Ariz. Ct. App. 1979); Maraldo Asphalt Paving, Inc. v. Harry D. Osgood Co., 220 N.W.2d 50, 52 (Mich. Ct. App. 1974).

260. *See Fairway Builders*, 603 P.2d at 526.

261. *See* Restatement (Second) of Contracts §350 cmt. g.

262. *See* Entergy Nuclear Vermont Yankee, LLC v. United States, 95 Fed. Cl. 160, 182 (2010); Citizens Fed. Bank. v. United States, 66 Fed. Cl. 179, 185 (2005), *aff'd*, 474 F.3d 1314 (Fed. Cir. 2007) (stating that "Monday-morning quarterbacking is irrelevant to an award of mitigation costs").

263. Sacramento Mun. Util. Dist. v. United States, 70 Fed. Cl. 332, 367 (2006), *reversed and remanded on other grounds*, 293 Fed. Appx. 766 (Fed. Cir. 2008).

reasonably obtainable.[264] In some instances, the "appropriate course may be to complete performance instead of stopping."[265] For example, if a contractor repudiates a contract for the construction of a residence during construction of the roof, the owner may have an obligation to mitigate its damages by completing the roof to prevent any damage due to weather. Of course, an owner who incurs reasonable expenses in mitigating its damages may seek such expenses from the breaching contractor.[266]

B. Economic Waste

The cost to repair defective work may not be disproportionate to the diminution in value.[267] Where the cost of repair is manifestly excessive in light of the nature of the damage, the value of the work at issue, the value of the project in general, and the diminution in value, a court may not award the cost of repair as the measure of damages based upon the doctrine of economic waste.[268] One commentator has referred to the doctrine of economic waste as "corollary to the doctrines of substantial performance, betterment and mitigation, and a counter-weight to the doctrine of strict performance[.]"[269]

C. Betterment

Betterment is a form of unjust enrichment where the nonbreaching party, or owner, is placed in a better position than it would have been had the contract been performed by the contractor, engineer, or architect.[270] When defective work is corrected, the original design is often enhanced. However, courts will preclude an owner from recovering the cost of any enhancement exceeding the quality evidenced in the original contract documents.[271] If the nonbreaching

264. *See* Lewis-Brady Builders Supply, Inc. v. Bedros, 231 S.E.2d 199, 201 (N.C. Ct. App. 1977).

265. Restatement (Second) of Contracts §350 cmt. g.

266. *See* Entergy Nuclear Vermont Yankee, LLC v. United States, 95 Fed. C1 160, 182 (2010); Indiana Michigan Power Co. v. United States, 422 F.3d 1369, 1375 (Fed. Cir. 2005) (finding "no reason why efforts to avoid damages in contemplation of a partial breach should not also be recoverable").

267. *See supra* Section II(D).

268. *See* Construction Law at 694 (William Allensworth, Ross J. Altman, Allen Overcash, and Carol J. Patterson eds., 2009)

269. *See* Bruner & O'Connor on Construction Law, *supra* note 2, at §19.30.

270. *Id.*

271. *See* Construction Law, *supra* note 268, at 695 (*citing* Grossman v. Sea Air Towers, Ltd., 513 So. 2d 686 (Fla. Ct. App. 1987), *rev. denied*, 520 So. 2d 584 (Fla. 1988)); *see also* O&G Indus. v. All Phase Enters., 963 A.2d 676, 687 (Conn. Ct. App. 2009) (stating that repairs "may not result in improvements to the property, in the sense that they may not be of a different and superior type than they would have been had they been constructed as warranted").

party is in fact better off, the breaching party is credited by the amount the nonbreaching party has been "bettered." The breaching party asserting betterment has the burden of proof to demonstrate that the nonbreaching party is better off than intended under the contract.[272]

In *Main St. Corp. v. Eagle Roofing*, the owner contracted for a roof with a five-year guarantee.[273] After two years, the owner noticed that the roof leaked and replaced the roof with a new five-year roof.[274] In awarding damages for breach of warranty, the court offset the value of the roof by 60 percent because the owner had already received three years of benefit from the guaranteed roof.[275] Thus, betterment may allow the breaching party to offset the cost to repair damages incurred by the nonbreaching party.

By contrast, contractors have been denied application of the betterment doctrine where replacements are reasonable and cost-effective remedies, even if not identical to the original plan. In *O&G Indus. v. All Phase Enters.*, a college preparatory school entered into a contract for the construction of an athletic and fitness center.[276] Upon completion, there were severe leaks in the steel roof of the center. The roof was replaced with a rubber membrane, not part of the original design, and the trial court awarded $80,530.73 in damages. The appeal court refused to apply the betterment doctrine to reduce the damage award because it found the rubber membrane roof was "a reasonable and cost-effective way to remedy the defect in time for the upcoming hockey season."[277]

D. Contractual Limitations

1. Indemnification Clauses and Limitations on Liability

Owners may take advantage of or be limited by two common risk-allocation clauses: the indemnity clause and the hold harmless or limitation of liability clause. A typical indemnification clause may state the following:

> THE CONTRACTOR SHALL INDEMNIFY AND HOLD HARMLESS THE STATE, its officers and employees, from all suits, actions or claims of any character brought because of any injuries or damage received or sustained by any person, persons or property on account of the operations of the said contractor or on account of or in consequence of any neglect in safeguarding the work; or through use of unacceptable material in constructing the work; or because of any act or omission, neglect or misconduct of said contractor; or because of any claims or

272. *See* Chemical Express Carriers, Inc. v. French, 759 S.W.2d 683, 689 (Tex. Ct. App. 1988).

273. 168 A.2d 33, 34 (N.J. 1961).

274. *Id.*

275. *Id.* at 35–36.

276. 963 A.2d at 679.

277. *Id.* at 688.

> amounts recovered from any infringements of patent, trademark or copyright; or from any claims or amounts arising or recovered under the Workmen's Compensation Act or any other law, ordinance, order or decree.[278]

Courts will always permit a contractor to indemnify an owner for the negligence of the contractor or its agents, such as subcontractors.[279] However, many courts and legislatures will not permit an owner to require a contractor to indemnify the owner for the sole negligence of itself or its agents.[280] New Mexico has a particularly prohibitive anti-indemnity statute, which appears to void an indemnity clause any time the indemnitee is partly at fault:

> A provision in a construction contract that requires one party to the contract to indemnify, hold harmless, insure or defend the other party to the contract, including the other party's employees or agents, against liability, claims, damages, losses or expenses, including attorney fees, arising out of bodily injury to persons or damage to property caused by or resulting from, in whole or in part, the negligence, act or omission of the indemnitee, its officers, employees or agents, is void, unenforceable and against the public policy of the state.[281]

Arizona permits an owner to require a contractor to indemnify the owner for the sole negligence of itself or its agents if the agreement is clear and unambiguous about the scope of the indemnity.[282] California permits indemnity clauses, except such clauses may not provide for indemnification of the "sole negligence or willful misconduct" of the indemnitee.[283] Before including a broad indemnification clause in a construction contract, owners should check the current status of the applicable law.

The second common method of risk allocation is a "hold harmless" or "limitation of liability" clause. Such a contractual clause may limit the ability of parties to sue another for particular claims or limit the amount of recoverable damages.[284] Courts will generally enforce "hold harmless" or "limitation of liability" clauses unless they are oppressive, operate to exclude a party from

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278. Hauskins v. McGillicuddy, 852 P.2d 1226, 1234 (Ariz. Ct. App. 1992).

279. *See id.*

280. *See, e.g.,* Tatar v. Maxon Constr. Corp, 294 N.E.2d 272, 274 (Ill. 1973); *see also, e.g.*, N.M. Stat. Ann. §56-7-1(a).

281. N.M. Stat. Ann. §56-7-1(a).

282. Washington Elementary Sch. Dist. No. 6. v. Baglino Corp., 817 P.2d 3, 7 (Ariz. 1991); *see also* Minnesota Breast Implant Litig. v. McGhan Med. Corp., 36 F. Supp. 2d 863, 878 (D. Minn. 1998) (stating that a party may seek to be indemnified for its own negligence where the indemnification clause specifically provides for such indemnification).

283. Cal. Civ. Code §2782(a).

284. *See* Construction Law, *supra* note 268, at 696.

meaningful responsibility for its own misconduct, or involve one party at an obvious disadvantage.[285] Courts are willing to uphold such "hold harmless" or "limitation of liability" clauses based upon the freedom of contracts.[286] Some states even have statutes authorizing limitation of damages by certain parties to construction contracts. For instance, California has codified the following statute:

> Nothing contained in Section 2782 shall prevent a party to a construction contract and the owner or other party for whose account the construction contract is being performed from negotiating and expressly agreeing with respect to the allocation, release, liquidation, exclusion, or limitation as between the parties of any liability (a) for design defects, or (b) of the promisee to the promisor arising out of or relating to the construction contract.[287]

2. Waiver of Consequential Damages

Courts generally will uphold contract clauses waiving consequential damages.[288] Such contract clauses may be void and unenforceable if the consequential damage waiver is unconscionable.[289] One court stated that a waiver of consequential damages clause would not be unconscionable among commercial parties of relatively equal bargaining position.[290] Such contract clauses also may be void and unenforceable if a party acted in bad faith.[291]

The AIA's standard forms waive consequential damages that owners might otherwise have assumed to be available as direct damages.[292] Section 15.1.6 of AIA Document A201-2007 waives the following damages:

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285. *See id*.; s*ee also* Piedmont Arbors Condominium Ass'n v. Bpi Constr. Co., 397 S.E.2d 611, 612 (Ga. Ct. App. 1990) (stating that "contracting parties are free to 'contract to waive numerous and substantial rights,' including the right to seek recourse in the event of a breach by the other party") (*quoting* Orkin Exterminating Co. v. Stevens, 203 S.E.2d 587 (Ga. Ct. App. 1973)) (internal citations omitted); *Steiner Corp.*, 683 P.2d at 439.

286. *See, e.g., Steiner Corp.*, 683 P.2d at 439.

287. Cal. Civ. Code §2782.5.

288. *See* Potomac Plaza Terraces v. QSC Prods., 868 F. Supp. 346, 353 (D.D.C. 1994) (finding that clauses excluding consequential damages are valid); *Bartram, LLC*, 2011 U.S. Dist. LEXIS 34972, *7–8 (finding a waiver of consequential damages based upon AIA, Document A201-1997, *General Conditions of the Contract for Construction*, ¶ 4.3.10 (1997)); Wheeler Peak, LLC v. L.C.I.2, Inc., 2009 U.S. Dist. LEXIS 46551, *27–28 (D. Or. 2009) (upholding a waiver of consequential damages as there was no "basis for finding a contractual limitation on consequential damages between two sophisticated parties to be unconscionable").

289. *See Potomac Plaza Terraces*, 868 F. Supp. at 353.

290. *See id*. at 353 n.10.

291. *See id*.

292. *See generally* Construction Law Handbook, *supra* note 22 at §31.05[A] (discussing the AIA's mutual waiver of consequential damages). *See also Bartram, LLC*, 2011 U.S. Dist. LEXIS 34972, *7–8.

§15.1.6.1 damages incurred by Owner for rental expenses, for losses of use, income, profit, financing, business and reputation, and for loss of management or employee productivity or of the services of such persons; and

§15.1.6.2 damages incurred by the Contractor for principal office expenses including the compensation of personnel stationed there, for losses of financing, business and reputation, and for loss of profit except anticipated profit arising directly from the Work.[293]

Courts have noted that this list of consequential damages is nonexhaustive.[294] For instance, one court has found that it includes a waiver of increased financing.[295] Another court found that an identical consequential damage waiver clause applied to lost bonding capacity.[296]

As noted by some commentators, there are questions about the interaction of the Section 15.1.6 waiver of consequential damages and other sections of AIA Document A201-2007.[297] For example, AIA Document A201-2007 also provides that "the Contractor shall, before starting each portion of the Work, carefully study and compare the various Contract Documents relative to that portion of the Work, as well as the information furnished by the Owner pursuant to Section 2.2.3, shall take field measurements of any existing conditions related to that portion of the Work and shall observe any conditions

293. American Institute of Architects, AIA Document A201-2007, *General Conditions of the Contract for Construction* ¶ 15.1.6 (emphasis added). The ConsensusDocs form also includes a waiver. ConsensusDocs §6.6 provides the following: "[T]he Owner and the Contractor agree to waive all claims against each other for any consequential damages that may arise out of or relate to this Agreement, except for those specific items of damages excluded from this waiver as mutually agreed upon by the Parties and identified below. The Owner agrees to waive damages including but not limited to the Owner's loss of income, profit or financing related to the Project, as well as the loss of business, loss of financing, principal office overhead and expenses, loss of profits not related to this Project, loss of reputation, or insolvency. The Contractor agrees to waive damages including but not limited to loss of business, loss of financing, principal office overhead and expenses, loss of profits not related to this Project, loss of bonding capacity, loss of reputation, or insolvency[.]"

294. *See Bartram, LLC*, 2011 U.S. Dist. LEXIS 34972, *9; Wal-Mart Stores, Inc. v. S.C. Nestel, Inc., 2010 U.S. Dist. LEXIS 54367, *8–9 (S.D. Ind. June 2, 2010) (finding an identical wavier of consequential damages to be a nonexhaustive list); *see also* Optimal Interiors, LLC v. Hon Co., 774 F. Supp. 2d 993 (S.D. Iowa 2011) (finding that a wavier clause for "SPECIAL, INCIDENTAL, CONSEQUENTIAL DAMAGES INCLUDING, WITHOUT LIMITATION, LOST PROFITS OR REVENUES . . ." did not only include lost profits and lost revenues as they merely were illustrative).

295. *See Bartram, LLC*, 2011 U.S. Dist. LEXIS 34972, *9–10.

296. *See Wal-Mart Stores, Inc.*, 2010 U.S. Dist. LEXIS 54367, *8–9.

297. *See* Dannecker, Hill, Kofron, & Rycraft, *supra* note 74, at 32–33.

at the site affecting it."[298] The contractor also must "promptly report to the Architect any nonconformity discovered by or made known to the Contractor" as to whether "the Contract Documents are in accordance with applicable laws, statutes, ordinances, codes, rules and regulations, or lawful orders of public authorities."[299] The contractor's failure to comply with these obligations requires the payment of "such costs and damages to the Owner as would have been avoided if the Contractor had performed such obligations."[300] If a contractor fails to review contract documents and take field measurements pursuant to Section 3.2.2, the owner is entitled to its costs and damages as a result, which could include consequential damages pursuant to Section 3.2.4. A question remains about the impact of the waiver of consequential damages in Section 15.1.6.[301] Neither Section 3.2.4 nor Section 15.1.6 reference each other.[302] Therefore, it is unclear whether an owner's right of recovery is limited only to direct damages or whether an owner's damages would include consequential damages if a contractor fails to properly inspect and investigate before proceeding with the work.

If owners enter into AIA Document A201-2007 or similar construction contracts, they must consider all such potential ambiguities and inconsistencies before agreeing to a mutual waiver of consequential damages.

V. Conclusion

Owner's damages arising from defective construction seek to compensate the owner as if the structure had been constructed without defects, on time, and on budget. The owner's ability to recover its damages is affected by the law of the applicable jurisdiction and the contractual limitations it accepts from its designers and contractors. Careful analysis of the applicable law and contractual limitations on the recovery of damages on the front end of a project can avoid surprising results for the owner. Further, awareness of the numerous measures of damages available to an owner is necessary before an owner files any claims and counterclaims, conducts discovery, or presents its case at trial.

298. *See* American Institute of Architects, AIA Document A201-2007, *General Conditions of the Contract for Construction* ¶ 3.2.2.

299. *Id.* at ¶ 3.2.3.

300. *Id.* at ¶ 3.2.4.

301. *See* Dannecker, Hill, Kofron, & Rycraft, *supra* note 74, at 33.

302. *Compare* American Institute of Architects, AIA Document A201-2007, *General Conditions of the Contract for Construction* ¶ 3.2.4, *with id.* ¶ 15.1.6.