Application of the Cost and Value Theories in Measuring Contractor's Liability

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APPLICATION OF THE COST AND VALUE THEORIES
IN MEASURING CONTRACTOR'S LIABILITY

The problem of determining the damages for which a building contractor may be liable, where his performance is not in exact accord with the contract specifications, has caused much concern in the construction field. The task of properly guarding the interests of both the builder and the owner has never been simple, for too often it appears that one will profit at the expense of the other. The purpose of this note is to bring out the problems inherent in making the proper decisions for awarding damages.

The difficulties involved in deciding when to use the cost rule (cost of completing the contract) as opposed to the value rule (difference in the market value of the contractor's actual performance and the value of full performance) must be considered in order to realize the full scope of the problems. In the ordinary case, the cost rule is the generally accepted mode of determining the damages, but the value rule has proven useful in situations where economic waste is a potential threat if the cost rule is applied without sound discretion. One may feel that he has a right to receive exactly what he contracted for, and fundamentally he should be given that right, but the effect which recognition of such right will have on society, must be reckoned with, and undue waste can hardly be thought of as a benefit to the public welfare.

There are several ways of stating when the value rule may be used instead of the cost rule. Basically, however, these statements may be placed in two broad categories, the distinguishing factor being the weight placed on good faith. In one of the categories are the expressions of Professors Williston and Corbin, along with the provision for measuring damages as contained in the Restatement of Contracts, which omit any reference to good faith as a prerequisite to use of the value rule. In the other category is the statement on the measure of damages as formulated in American Jurisprudence, where the existence of good faith is stressed as a prerequisite to application of the value rule. As a means of developing more fully the implications of these two categories, the views of these four authorities will be set forth and discussed separately.
Williston, after pointing out that where the contractor fails to keep his agreement the measure of the damages should be the sum which will put the employer in as good a position as if the contract had been performed, goes on to say:

If the defect is remediable from a practical standpoint, recovery generally will be based on the market price of completing or correcting the performance, and this will generally be shown by the cost of getting work done or completed by another person. If the defect is not thus remediable, damages are based on the difference between the value of the defective structure and that of the structure if properly completed.\(^1\)

It is significant that in this statement of the rule for measuring damages no mention is made of good faith or lack of wilfulness. Consequently, at least one court has interpreted this statement as "only requiring that the defect not be remediable from a practical standpoint to ‘trigger’ the change" from the cost rule to the value rule.\(^2\) Other courts have interpreted Williston's statement more narrowly. For instance, in *Bellizzi v. Huntley Estates, Inc.*,\(^3\) which involved the construction of a driveway that appeared to be inaccessible at times due to its elevation in comparison to that of the street, it was held error to exclude evidence of the value of the property as delivered and to charge the jury that the measure of damages was the cost of making the driveway conform to the contract. The court said:

> [T]he jury should have been instructed that if there was substantial performance of the whole contract on the part of the defendant, or if there was a breach of contract by defendant *and the failure to perform was not in bad faith*, and destruction and reconstruction were necessary to get a driveway as was agreed to be built, the jury could not allow the cost thereof if such cost would exceed the difference between the value of the premises as they were with the driveway as built and the value with a driveway as it should have been built.*\(^4\) [Emphasis added.]

Williston was cited as an authority for the proposition, thereby indicating an assumption by the court that "good faith" is an essential to use of the value rule even under his theory of damages.

The rule for measuring damages as formulated in the *Restatement of Contracts* emphasizes the need for avoiding economic waste whenever possible. Section 346 provides that the measure of damages for defective or unfinished construction work shall be either:

\(^1\)\(^5\) Williston, *Contracts* § 1363, at 3825-6 (Rev. ed. 1937).


\(^3\) 1 A.D.2d 683, 147 N.Y.S.2d 74 (1955). The purchase price of the house was $16,740, and the jury had rendered a verdict of $5,000 to reconstruct the driveway.

\(^4\) 147 N.Y.S.2d at 76.
(i) the reasonable cost of construction and completion in accordance with the contract, if this is possible and does not involve unreasonable economic waste; or
(ii) the difference between the value that the product contracted for would have had and the value of the performance that has been received by the plaintiff, if construction and completion in accordance with the contract would involve unreasonable economic waste.\(^5\)

The comments to this section point out that the purpose of allowing recovery is to put the injured party in a position comparable to that for which he bargained. But this does not mean that he is to be placed in the "same specific physical position." The injured party is allowed either a "sum of money sufficient to produce the physical product contracted for" or "the exchange value that that product would have had if it had been constructed."\(^6\) The two may at times be equal, but where they are not, consideration must be given to whether it would be "imprudent and unreasonable" to tear down and reconstruct the structure in question. If it is unreasonable, then "[t]he law does not require damages to be measured by a method requiring such economic waste."\(^7\)

The intent of the *Restatement* provision to make the injured party whole and no more can be seen in the case of *Ficara v. Belleau.*\(^8\) There the contract price for installing a heating and cooling system was $6,200. After receiving $4,200, the contractor wilfully abandoned the contract. It was found by an auditor that the owner reasonably paid $2,361 to another contractor to complete the job. However, the injured party was allowed to recover only $361 rather than the sum paid to complete the contract, since the latter would have meant the plaintiff was obtaining a $6,200 heating and cooling system for $4,200. The court declared, "It is not the policy of our law to award damages which would put a plaintiff in a better position than if the defendant had carried out his contract."\(^9\)

A third formulation of the rule for measuring damages which also omits any reference to good faith is that provided by Corbin. The similarity between his formulation of the rule and that contained in the *Restatement* can be easily detected. He says:

For breach of defective construction, whether it is partial or total, and for a total breach by refusal and failure to complete the work, the injured party can get a judgment for damages measured by the reasonable cost of reconstruction and completion in accordance with

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\(^5\) *Restatement, Contracts* § 346 (1)(a) (1932).

\(^6\) *Id.*, comment b.

\(^7\) *Ibid.*

\(^8\) 331 Mass. 80, 117 N.E.2d 287 (1954).

\(^9\) 117 N.E.2d at 289.
the contract, if this is possible and does not involve unreasonable economic waste.\textsuperscript{10}

In the following section Corbin adds:

If it is made to appear that physical reconstruction and completion in accordance with the contract will involve unreasonable economic waste by destruction of usable property or otherwise, the damages awarded for the contractor's breach will be measured by the difference between the market value that the structure contracted for would have had and that of the imperfect structure received by the plaintiff.\textsuperscript{11}

The application of this rule, just as with the rules set forth by Williston and the Restatement, will not guarantee that the injured party will obtain a completed structure meeting the exact specifications of the contract, but his pecuniary position will be as good.

The remaining authority, American Jurisprudence,\textsuperscript{12} is specific in requiring lack of wilfulness as a prerequisite to use of the value rule. First it states as a general rule one is entitled to have what he contracts for or its equivalent and that a majority of jurisdictions apply the cost rule where the defects are such as can be remedied without unreasonable reconstruction so as to make the work conform to the contract. This authority then goes on to say:

But where, in order to conform the work to the contract requirements, a substantial part of what has been done must be undone, and the contractor has acted in good faith, or the owner has taken possession, the latter is not permitted to recover the cost of making the change, but may recover the difference in value.\textsuperscript{13} [Emphasis added.]

Such a rule as this can give rise to a rather harsh result. It can be interpreted so as to invoke the cost rule even though correction of defects would involve "unreasonable economic waste" and even though the result is to award damages which are greater than the difference in value between the work as done and as it ought to have been done.\textsuperscript{14} Take, for example, the case of Groves v. John Wunder Co.\textsuperscript{15} The defendant contractor agreed to remove sand and

\textsuperscript{10} Corbin, Contracts § 1089 at 408-9 (1951). Professor Corbin in § 1090 makes the statement that where there are alternative methods for the measuring of damages, the choice may depend upon the character and quality of the conduct of the party guilty of the breach. It is submitted, however, that Professor Corbin intends such a choice to be made only in cases where the builder had "intent to cheat and defraud," and that the availability of such a choice would not preclude the use of the value theory where the threat of economic waste prevailed.

\textsuperscript{11} Corbin, Contracts § 1090, at 411 (1951).


\textsuperscript{13} Ibid.

\textsuperscript{14} Id. (Supp. 1959).

\textsuperscript{15} 205 Minn. 163, 286 N.W. 235 (1939). See also Annot., 123 A.L.R. 515 (1939).
gravel from the plaintiff's property and to leave the land in a uniform grade and at a required level. The defendant removed certain amounts of the sand and gravel as he chose and did not leave the ground in a uniform grade. The lower court found that it would cost around $60,000 to complete the work, but that the reasonable value of the land, if the contract had been completed, would have been only $12,160. The trial judge awarded this latter sum with interest. On appeal, the court in very strong language emphasized the bad faith nature of the defendant's conduct. They said:

Defendant's breach of contract was wilful. There was nothing of good faith about it. Hence, that the decision below handsomely rewards bad faith and deliberate breach of contract is obvious. That is not allowable. 16

The court held that such a wilful breach did not entitle the defendant to the benefits of the equitable doctrine of substantial performance and that the proper measure of damages was the cost of doing what the contractor had promised. The court could not find any grounds for considering the economic waste involved since, in the opinion of the judges, this defense can be invoked only when a structure already erected must be taken down. 17

At first glance it may be thought that there is little practical difference among the aforementioned rules. No doubt this is true of the first three which omit any reference to good faith. Perhaps in the ordinary case they could be used interchangeably, and the results would be the same. But this would not hold true with reference to the fourth rule. As illustrated by the Groves case, under the same set of facts the application of the fourth rule can give a different result than if one of the other three rules were applied.

To further illustrate this potential difference, the situation which arose recently in Shell v. Schmidt 18 can be given as an example. There, the defendant contractor had built numerous houses under a government contract. A group of purchasers brought an action as third party beneficiaries wherein it was found that the houses did not meet the contract specifications, and that the defendant had not substantially performed the contract. On an appeal involving the question as to the proper method of computing damages, the plaintiff homeowners asked for the application of the cost theory, while the

16 286 N.W. at 236. The defendant was engaged in a sand and gravel business, which explains why he would be interested in removing this sand and gravel despite the high cost.
17 It is of interest to note in the dissent that this opinion was decided by a minority of the court. Two members were ill, and two dissented.
18 Shell v. Schmidt, supra note 2.
defendant maintained that the value rule should be applied. The California court found that some of the deviations had been intentionally made, and that such intent meant the defendant's conduct was willful in making the alterations. Therefore, the court concluded there was a lack of good faith and applied the cost rule. In connection with this conclusion, it is interesting to note that defendant contended for the rule as stated in *American Jurisprudence.*19 That rule, as already pointed out, demands that there be good faith on the part of the builder. When the defendant was found to have intentionally deviated from the contract, and it was established that such deviation in California constituted a wilful deviation, then it followed that the defendant could not successfully invoke the value theory under a rule which requires as a prerequisite lack of willfulness.

It is submitted the position of the California court that “intentional” conduct constitutes “wilfulness” is questionable. At least one authority, Corbin, disagrees with the court’s conclusion that substantial performance cannot exist when any part of the variance from the contract specifications is “intentional.” He says with reference to the case:

[T]he court [has] laid down too strict a rule, and ... the defendant was entitled to offer proof that his performance was ‘substantial performance,’ although the variances were so great that he probably would have failed in his effort. The question is a question of fact, requiring more than the mere application of a supposed rule of law. This author agrees with the court that the degree and kind of variance may be such that performance is less than ‘substantial’ even though it has a market value equal to that of the exact performance promised; also, that the intention (or wilfulness) of the contractor is a factor for consideration by the jury (but not in itself decisive).20

Corbin goes on to disagree with the court’s interpretation of the legal effect of substantial performance as constituting full performance, declaring that substantial performance is never full performance. Corbin submits that anything less than full performance is a breach, but he concedes that breaches are not all the same size or

19 Supra note 10. With regard to the American Jurisprudence rule, it should be noted that before the value rule will be applied the defendant must prove that “a substantial part of what has been done must be undone.” By contending that he had substantially performed the contract and that the value of his completed work was equivalent to that required by the contract, the defendant in the Shell case tended to defeat his own argument. Instead of pointing out that there would be economic waste in making the work conform to the contract as required by the rule, the defendant alleged that his performance was substantially that contracted for, and that it would not be necessary to undo any of the work.

of the same degree of importance. He concludes that a "trivial" breach should not prevent substantial performance, thereby causing use of the cost rule, even if the breach is "intentional," for too often actual completion would cause unreasonable economic waste.\textsuperscript{21}

The defendant in the \textit{Shell} case might have presented a better defense if he had adopted one of the versions of the damage rule not specifically requiring good faith. As pointed out previously Williston requires only that the defect not be remedial from a practical standpoint before the value rule may be applied. Corbin requires only a showing of unreasonable economic waste, a view also reflected in the \textit{Restatement}. Hence, it appears that under any one of these statements of the rule the defendant would not have had to allege lack of wilfullness in order to shift the measure of damages from the customary cost theory to the value theory.\textsuperscript{22}

There is much to be said against placing too much significance on the terms "wilful" and "intentional." The court in the \textit{Shell} case has given them great weight and in some respects has distorted their true meanings so as to support the opinion. Professor Corbin points out that such words are "epithets characterizing the quality of the conduct of one guilty of a breach of contract and expressing the mental attitude of the court."\textsuperscript{23} These words ought to be used with discretion, and it should always be kept in mind that the rules surrounding them are flexible. The operation of these terms should be such that "punishments are not 'cruel and unusual,' so that 'the penalty may fit the crime.' Not even a 'wilful' wrongdoer is an outlaw; and the enrichment of even an injured man may become unjust."\textsuperscript{24} Corbin takes a realistic view with regard to the interpretation of these terms, and consequently makes one realize that there is always room for leniency.

In support of this plea for leniency, it is interesting to note that there is an extremely liberal variant rule which provides that a defendant contractor is entitled to either the cost rule or the value rule, whichever proves to be the less costly of the two. This doctrine is

\textsuperscript{21}Ibid.

\textsuperscript{22}However, had the defendant invoked one of these versions of the damage rule, the problem would still remain whether he forfeited use of the value theory when he offered proof that the work he had performed was substantially the same as that which he had agreed to do and could be corrected without destruction of the structure. See note 19 \textit{supra}. The defendant should have pointed out that there would be unreasonable economic waste in making the work conform to the contract, and from the facts of the case the defendant might well have been able to prove this. Quite possibly this defense was disregarded due to a mistaken idea that substantial performance alone would invoke the value theory.


\textsuperscript{24}Corbin, \textit{Contracts} § 1123, at 548 (1951).
admittedly a minority view, but the fact that it does exist lends support to the idea that courts do use discretion in determining what damages to apply.25

The difficulties involved in determining when the value theory should be "triggered" into action should be evident from the above discussion. There are times when the work performed will be of no value to the owner despite its monetary value, as where the structure produced cannot be used for the purpose of the contract. But there are other instances "where it is clear that in contracting for the work in question the owner was not seeking a result dictated by whim or personal taste but was contemplating practical value. . . ."26

In the latter case, it is felt that a contractor who has intentionally deviated within reasonable limits should be allowed to ask for the application of the value theory. Society frowns on waste in our national economy, and to award costs which will entail needless destruction of existing structures creates an undesirable situation.

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25 See 5 Corbin, Contracts § 1089, at 48 (1951). Corbin rejects the variant rule as such, but nevertheless it is recognized. To point out further the discretion that a court might exercise, Cassinelli v. Stacy, 238 Ky. 827, 38 S.W.2d 980 (1931), would allow the cost of correction for minor defects but the difference between the contract price and the value of the structure for a major defect, such as an "unlevel floor."