The Law of Economic Waste in Virginia

By Josh Morehouse, Esquire[1]

Like virtually any type of litigation, construction cases consistently present issues of damages. Take for example a typical construction action: a contractor completes a project, but makes a mistake, resulting in a defect in the construction. The project's owner wants the contractor to repair the defect, or else to pay to have someone else make the repairs. The contractor agrees that the project is technically defective but believes that the defect is minor or negligible. In the contractor's opinion, it is not worth repairing. Then, instead of the cost of repair, the contractor offers the owner a small setoff to make up for the decrease in the project's value.

The parties agree that the contractor erred. They agree that the project is defective. They may even agree that the owner is entitled to damages. But they disagree on how those damages should be measured. The owner wants the contractor to pay the cost of repair, called the "cost measure" of damages. The contractor, on the other hand, believes that the proper measure of damages is the "value measure," or the difference in value between the project as promised and the project as delivered. It so happens that the cost measure leads to a significant recovery for the owner, while recovery under the value measure is small.[2] What does the owner deserve? Which measure correctly values the damage the owner has suffered?

To answer this question, it is best to begin with the purpose of an award of damages. Damages should place the aggrieved party "in as good a position as if the contract had been performed."[3] In theory, both the cost and value measures do that. The cost measure does so by allowing the owner to have the defective work repaired, thus receiving the product it bargained for. The value measure does something similar, allowing the owner to sell the defective product and buy an equivalent, non-defective product. In that case the owner has lost only the difference in value between the two, which it has recovered from the contractor.

The difference lies in what the owner actually ends up with. Under the cost measure, the owner can have the project repaired to the condition it bargained for. Under the value measure, the owner can buy an equivalent of the project it bargained for. So, the cost measure allows the owner to receive precisely what it bargained for, while the value measure simply allows for an equivalent. For that reason, courts and commentators usually prefer to award the cost measure.[4] Further, as a matter of proof, it is far easier to obtain an estimate to repair or replace defective work than to obtain an opinion on fair market value of the work as-built versus as-planned. There are times, though, when awarding the cost measure of damages does not make sense. For example, in situations when repairing the defect would involve "unreasonable economic waste," the owner will not be entitled to the cost of repair. [5] In these situations, the value measure usually provides a better measure of damages. This is called the economic waste doctrine.

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[2] Although this article assumes that the value measure yields a smaller recovery than the cost measure, the reverse can also be true. The modern Restatement acknowledges that either the cost measure or the value measure of damages can be defeated by economic waste.

[3] 24 Williston on Contracts § 66:17 (4th ed.); *Mann v. Clowser*, 190 Va. 887, 904 (1950) (citing Williston).

[4] *See* Williston on Contracts § 66:17; Restatement (First) of Contracts § 346; Restatement (Second) of Contracts § 348.

[5] *Nichols Const. Corp. v. Va. Mach. Tool Co., LLC*, 276 Va. 81, 90, 661 S.E.2d 467, 472 (2008).

The economic waste doctrine traces back to a 1921 New York Court of Appeals opinion by Judge Benjamin Cardozo: *Jacob & Youngs v. Kent*,[6] sometimes called the Reading Pipe Case. In that case, a contractor built a house with the wrong type of pipe. The contract called for pipe manufactured in Reading, Pennsylvania, but instead the contractor used different but equivalent pipe. The owner took issue with this decision and refused to pay until the Contractor replaced all of the house's pipe with Reading pipe. Cardozo's opinion held that, since the mistake was trivial, and since the pipe the contractor used was just as good as the pipe required by the contract, it would be unreasonable to require the contractor to tear out and replace all of the house's pipe.[7] Instead, the owner was only entitled to the difference in value caused by the contractor's mistake. In Cardozo's opinion, that difference was nominal or nonexistent.

Cardozo wrote his opinion over a dissent by Judge McLaughlin, who argued that the owner was entitled to have the contract performed exactly as it was written. While Cardozo won out in *Jacob & Youngs*, the tension between his opinion and McLaughlin's provides a snapshot of the competing interests in every economic waste case. On one hand is the court's reluctance to "visit venial faults with oppressive retribution."[8] On the other hand is the owner's right "to get what the contract called for."[9]

This conflict of interests still lies at the heart of a modern court's decision to apply the economic waste doctrine. It is why courts prefer the cost measure - the measure that allows the owner to receive exactly what it bargained for. And litigants typically seek the cost of repair anyway, since it tends to be higher than the difference in value of a construction defect. But a preference is not a mandate, and the cost measure proves ill-suited to many particular fact patterns. Which measure is proper thus depends on the "facts and circumstances of the particular case," as well as the "character and extent of the defective construction."[10] While the cost measure is often preferred, it will not be applied "in cases where the property must be substantially demolished before it can be brought into compliance with the contract provision or in cases where the cost of compliance is grossly disproportionate to the benefit to be achieved."[11]

There are two key practice points when a litigant deals with the economic waste doctrine. First, the defendant bears the burden of showing that the cost measure would lead to economic waste.[12] Hence, unlike in some other kinds of claims, a defendant cannot simply wait for the plaintiff to put on evidence of cost-of-repair and then move to strike on the ground that the plaintiff has not proved the proper measure of damages. Instead, a defendant must affirmatively show that the cost measure of damages would be economically wasteful when compared to the value measure. Of course, this requires the defendant to put on evidence of the decrease in value caused by the defect.

Second, the proper measure of damages is a fact-intensive inquiry. It depends not only on the dollar amount that repair will require compared to the dollar value added by that repair, but also

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[6] 230 N.Y. 239, 129 N.E. 889.
[7] *Id.* at 242, 891.
[8] *Id.*
[9] *Id.* at 247, 892 (McLaughlin, J. dissenting).
[10] *Mann v. Clowser*, 190 Va. 887, 904, 59 S.E.2d 78, 86 (1950).
[11] *Lochaven Co. v. Master Pools by Shertle, Inc.*, 233 Va. 537, 544, 357 S.E.2d 534, 538 (1987).
[12] *Nichols Constr. Corp.*, 276 Va. at 91, 661 S.E.2d at 473.

on the purpose of the parties in entering into the contract.[13] For example, in *Lochaven Co. v. Master Pools by Shertle, Inc.*, the cost of rebuilding a swimming pool that was slightly too shallow for the use of a diving board was held to unreasonably outweigh the value added by an extra few inches' depth.[14] As such, the Virginia Supreme Court opted for the value measure of damages over the cost measure.[15] But that same Court has held the cost of rebuilding an unusable roof to be an acceptable measure of damages, even when that cost significantly outweighed the purchase price of the building on which the roof was built.[16]

Both owners and contractors must be aware of the doctrine of economic waste when proving damages. When applicable, it can and will drastically change the damages aspect of a case. Yet because the doctrine applies only when the cost of repair far exceeds the diminution in value caused by the lesser quality work, invoking the doctrine is not always applicable or even advantageous for a litigant. As such, dealing with economic waste requires a party to thoughtfully review the defects in the work, the reasonable cost to repair the defects, and whether the defects, in the first place, affect the purpose, use, and enjoyment of the work. As *Lochaven* teaches, not all defective work is treated the same for damages purposes.

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[13] *Appalachian Power Co. v. John Stewart Walker, Inc.*, 214 Va. 524, 535, 201 S.E.2d 758, 767 (1974).
[14] *Lochaven*, 233 Va. at 544, 357 S.E.2d at 539.
[15] *Id.*
[16] *Nichols*, 276 Va. at 91, 661 S.E.2d at 473.