2008

Cost of Performance or Difference in Value

Richard S. Wirtz

Follow this and additional works at: https://scholarlycommons.law.case.edu/caselrev

Part of the Law Commons

Recommended Citation
Available at: https://scholarlycommons.law.case.edu/caselrev/vol59/iss1/4
Hog pens installed on a pork farm are too small to accommodate the promised rate of production.\(^1\) Concrete slabs installed as the floor in a "big box" retail establishment are not properly cured.\(^2\) The owners of a new home plead and prove multiple defects in construction, including a sagging roof line, crooked brickwork, crooked columns, windows and shutters not right, and doors out of plumb.\(^3\) The New Haven Parking Authority, proprietor of a newly built parking garage, discovers water pooling on the decks in the garage and cracks in the concrete.\(^4\) A house is misplaced on a lot.\(^5\)

All of these situations present the same issue, viz., the proper measure of damages when a contractor does defective work. Everyone accepts that the object in awarding damages for breach of contract is to put the injured party in as good a position as the one she would have been in if the contract had been fully performed. The problem in these cases is that there are two ways to measure the injured party's expectancy. One, called "cost of performance," results in an award of the reasonable cost of correcting the defects.\(^6\) The other, "difference in value," is the difference between the value of the premises if the contract had been fully performed and its value with the defects.

\(^{1}\) Elvin E. Overton Distinguished Professor of Law Emeritus, University of Tennessee. Thanks to Dwight Aarons, Joseph Cook and Robert Lloyd for their helpful comments on an earlier draft; Nicholas Barca, Jonathan Born, Anica Conner and Douglas Elkins for able assistance in research; and to Gregory Stein for pointing me to an important case.


\(^{4}\) DiMa Homes, Inc. v. Stuart, 873 So. 2d 140, 142 (Miss. Ct. App. 2004).


\(^{6}\) It is sometimes useful to distinguish between rectifying bad work and completing an incomplete performance. In this article I use the phrase "correcting the defects" to apply to both things.
This Article investigates three different rules applied to determine which measure of damages is the right one: the rule of the *Peevyhouse v. Garland Coal and Mining Company* case, and the rules set forth in the first and second Restatements of Contracts. In the course of this discussion, this Article argues that all three of the rules ignore an issue which ought to be at the center of the inquiry, i.e., the intentions of the injured party with regard to correction of the defects.

I. THE *PEEVYHOUSE* CASE

In the 1950s the Garland Coal Company was buying up mineral leases in Oklahoma. They approached a farming couple named Peevyhouse with an offer for a standard lease. The Peevyhouses consented to lease a portion of their farm to Garland Coal, but, unlike their neighbors, insisted on a commitment from the coal company to reclaim the land according to detailed standards which were made a part of the contract. This was the Peevyhouses’ home farm.

Garland Coal took all the coal it wanted from the Peevyhouse property and then refused to do any reclamation. A dispute arose which eventually went to trial. The jury awarded the plaintiffs $5,000. On appeal, the sole issue was the proper measure of the farmers’ damages. The Peevyhouses contended that the proper measure was the amount it would cost them to have the reclamation work done by someone else. Garland Coal contended that the proper measure was the difference in the value of the property with and without the reclamation. The Oklahoma Supreme Court concluded that the evidence showed that under the first approach the farmers would recover $29,000, but under the second they would recover only $300. After due consideration, the court rejected the Peevyhouses’ arguments, and awarded them $300.

In the breasts of many readers, this decision has aroused the sense of injustice. The court justified it on the basis of what it termed “relative economic benefit.”

---

7 382 P.2d 109 (Okla. 1962).
9 *Peevyhouse*, 382 P.2d at 111.
10 Maute, supra note 8, at 1345, 1356-57.
11 *Id.* at 1345.
12 *Peevyhouse*, 382 P.2d at 111.
13 *Id.* at 112, 114.
14 *Id.* at 114.
15 *Id.* at 113 (citing CHARLES T. MCCORMICK, HANDBOOK ON THE LAW OF DAMAGES, § 168 (1935); Jacobs & Youngs, Inc. v. Kent, 129 N.E. 889 (N.Y. 1921)).
In its opinion the court quoted approvingly language from the opinion of the New York Court of Appeals in the case of Jacob & Youngs, Inc. v. Kent:16 ""The owner is entitled to the money which will permit him to complete, unless the cost of completion is grossly and unfairly out of proportion to the good to be attained. When that is true, the measure is the difference in value."17 Though the Peevyhouse court framed its holding narrowly in terms of coal mining leases,18 the case can fairly be read for the broader proposition that in a breach of contract case involving work to be done on specified property, when the cost of rectifying the breach is grossly disproportionate to the difference in value of the property with and without the promised performance, the injured part may recover only the difference in value.19 This Article will refer to this as the rule of the Peevyhouse case, or the Peevyhouse rule.

The idea behind the Peevyhouse rule is that it is irrational to spend X to get Y, if Y is much less than X. The court does not ask whether, if the plaintiff were awarded the amount required to complete the contract, he would in fact spend the money that way. The court stands back and compares two figures. One, the cost of performance, is the benchmark—the amount to which the plaintiff is prima facie entitled. The second figure, the difference in value, must be compared to the benchmark figure. If the figures match, the plaintiff is entitled to the cost of performance. To the extent that the difference in value drops below the cost of performance, the differential represents a potential problem. If the differential is small, the cost of performance is not grossly disproportionate to the difference in value, and the court awards the cost of performance anyway. Once the excess of the cost of performance over difference in value reaches the point of gross disproportionality, however, the plaintiff's recovery must be capped at the level of the smaller figure.20

A. The Virtue of the Rule

The principal argument in favor of the limitation the Peevyhouse rule places on the recovery of the injured party is that, in some instances, the rule prevents unjust enrichment.

Suppose that Moors, having drawn up specifications for a house, contracts with Wiggin to build the house for $200,000. Through

---

16 129 N.E. 889 (N.Y. 1921).
17 Peevyhouse, 382 P.2d at 113 (quoting Jacob & Youngs, Inc., 129 N.E. at 891).
18 Id. at 114.
20 Peevyhouse, 382 P.2d at 112–14.
simple carelessness, Wiggin gets many of the interior dimensions wrong, while leaving the total square footage of the house as specified. It will cost $20,000 to correct the mistakes. The proof shows that the buyers who constitute the hypothetical market for the house would be willing to pay just as much for the house Wiggin built as they would for the house he promised to build.

Under the *Peeyhouse* rule, Moors recovers nothing for Wiggin's breach. The cost of rectifying the breach, $20,000, is grossly disproportionate to the difference in value, which is zero.

If we assume that Moors intends to sell the house, a $20,000 payment from Wiggin would be a windfall to her. Her profit on the sale of the house would be the same as it would have been if Wiggin had built the house according to the plans. The $20,000 would be pure gravy. However, applying the *Peeyhouse* rule, she gets nothing—if she were awarded anything in damages, she would be unjustly enriched to the extent of the award.

Note that, on these facts, no rational plaintiff would invest a dollar of the $20,000 in remodeling the house. A rational plaintiff would use the money for other purposes, such as a year in Provence. Moors would get the functional equivalent of what she contracted for, and Wiggin would wind up paying for her vacation. That can't be right.

In contrast, if this house as built would sell for less than the promised house, but the injured party still intends to sell the property, the rule also prevents a windfall. Suppose that in the case of the mis-configured house, Wiggin's deviations from the plans render the property worth $500 less on the market than it would have been had he built the house strictly according to the plans. On this assumption, should Moors now recover the cost of rectifying the contractor's mistakes? Applying the *Peeyhouse* rule, the answer is, once again, no: the cost of performance—the cost of rectifying the breach ($20,000)—is grossly disproportionate to the diminution in value ($500). And this is right: if she received $20,000, Moors would reap a $19,500 windfall—a result the law should strive to avoid.

Suppose now that the difference in value is $500 as before, but the homeowner intends to keep the house rather than sell it. Now, in order to determine whether she would be unjustly enriched by a damage award in the amount of $20,000, we would have to know something more. Since we are exploring here the positive side of the *Peeyhouse* rule, assume that if she were awarded the cost of performance, she would spend no part of it to reconfigure the house. She would say to herself, in substance: I would rather have had the house built according to the plans, but if we are talking about $20,000
of my money, I certainly wouldn’t spend it to fix the problems—what a waste of $20,000!—and I have no intention of spending Wiggin’s $20,000 that way, either. Once again, if she gets the cost of performance, she gets a windfall. Her proper recovery, and her recovery under the rule, is $500.

Finally, suppose that the homeowner attaches significant value to the deviations from the plans, and if she gets the money required to purchase substitute performance, which concededly exceeds the difference in market value by a substantial margin, she will spend it to put the house right. On these facts, the rule unjustly enriches, not the injured party, but the party in breach.

B. The Problem With the Rule

The Peevyhouse rule has a major shortcoming. In some of its applications it frustrates the primary purpose of the law of contract damages in that it fails to put the injured party in as good a position as the one he would have been in had the contract been fully performed. In those instances it unjustly enriches the party in breach.

It is axiomatic that

[t]he basic principle for the measure of damages [for breach of contract] is that of compensation based on the injured party’s expectation. One is entitled to recover an amount that will put one in as good a position as one would have been in had the contract been performed.21

Returning to the example of the house not built according to the plans, now add one fact: if the homeowner receives anything in damages, she will use it to rebuild the house so it conforms as closely as possible to the original plans. Embellishing a little, suppose that in her previous house there was constant wearisome bickering among Moors’ four kids about the relative size of their bedrooms, and her specifications for the new house were drawn up with the end in view of reducing the grounds for such squabbling to a minimum. Suppose the house as built reopens all the old issues in the family, which Moors had sought to avoid. Suppose that the difference in value of the house with and without rectification of the breach is nil. And suppose further that the trier of fact finds that if Moors gets $20,000, the cost of substitute performance to get the job done in compliance with the contract, she will spend it for that purpose.

On these facts, under the Peevyhouse rule, Moors is entitled to nothing. This result emphatically will not put her in as good a position as she would be in if the contract had been fully performed. If the contract had been fully performed, she would have had a satisfactory house. Under the rule of the Peevyhouse case, she gets an unsatisfactory house and no damages.

In a case of this kind—assuming that the injured party will spend the amount required to put matters right on doing just that—if she is awarded that sum, there is no windfall. She is not unjustly enriched; she gets only what she paid for.

Varying the facts from above: if the poor workmanship reduces the market value of the house to a figure $500 below the market value of a house built according to the plans—and operating on the continuing assumption that if she gets the cost of rectifying the breach she will spend it to do just that—again an award of the difference in value does not give Moors the benefit of the bargain. Only an award of $20,000 will do that. Any lower award lets the contractor off the hook for his sloppy workmanship. To the extent that the contractor is held harmless with respect to any part of the cost of setting matters right, it is the contractor who is unjustly enriched.

Consider now the Peevyhouse case. In that case, on the question of whether the Peevyhouses would spend the $29,000 it would cost to reclaim their farm as specifically provided in the lease, there was no finding either way. On the facts, it seems reasonable to suppose that they would. This was, after all, their home farm. There is no indication anywhere that they planned to sell it. During contract negotiations, they specifically insisted on the reclamation provision. (A fact not given in the opinion is that to get the reclamation provision, they gave up the lump sum Garland Coal normally paid landowners up front, not as an advance on royalties but as an additional inducement.) What arouses the sense of injustice is that, on the reasonable assumption that the Peevyhouses intended to continue to live on the land, and would have spent an award of $29,000 to reclaim it as provided in the contract, the paltry sum of

---

22 See Peevyhouse, 382 P.2d at 112 (discussing the "basically unreasonable and unrealistic" outcome that would occur if the court found for the Peevyhouses).
23 Maute, supra note 8, at 1358–63.
24 Id. at 1347, 1363.
25 The official record, of course, contains no finding on this, since the question was never submitted to the jury. In interviews concluded long after the trial and appeal were concluded, the Peevyhouses’ lawyer recalled that the Peevyhouses intended to do the remedial work themselves, using any money left over to pay medical bills. The Peevyhouses specifically denied this. Maute, supra note 8, at 1373. In exchange for the reclamation provisions, the Peevyhouses waived the stipend Garland Coal normally paid in lieu of reclamation. Id. at 1363.
$300 clearly did not give them the benefit of the bargain. It did not put the injured parties in as good a position as the one they would have been in if Garland Coal had done the promised work. This time it is the party in breach who got the windfall. The rule enabled Garland Coal to buy itself out, at a cost of $300, of the duty to spend $29,000 to fulfill its obligations under the contract.

The Peevyhouse opinion creates a picture of the Peevyhouses spending a lot of money uselessly, filling in holes that no one but them would care about.26 It’s silly, isn’t it?—No. As soon as they bargain for it, it ceases to be silly. That’s the way contract law works.27

Drawing reasonable inferences from the facts, the Peevyhouse case was wrongly decided. All the good the Peevyhouse rule does can be accomplished, and all the harm it does can be avoided, by asking one simple question: what will the plaintiffs do with an award of the cost of performance if they get it?

Suppose the Peevyhouse jury had been instructed that it should award the Peevyhouses the amount required to do the reclamation Garland Coal had promised if it found by a preponderance of the evidence that the plaintiffs would utilize an award in that amount to do the reclamation (to achieve the bargained-for result).28 Suppose further that the jury so found, and rendered a verdict of $29,000 for the farmers accordingly, and the judge entered judgment against Garland Coal for $29,000 plus costs. And suppose the jury was wrong. Having collected their $29,000, the Peevyhouses spent it on expensive visits to their extended family, a lot of advanced farm equipment, etc.—everything but reclamation.

Similar things happen all the time. Clearly some people who receive reimbursement from insurance companies for damage to their cars spend it otherwise than on repairs. It may be that we should not care what the Peevyhouses do with their large damage award any

In light of what they gave up to get the reclamation provisions, their version seems more plausible.

26 See Peevyhouse, 382 P.2d at 112 ("It is highly unlikely that the ordinary property owner would agree to pay $29,000 (or its equivalent) for the construction of ‘improvements’ upon his property that would increase its value only about ($300) three hundred dollars. The result is that we are called upon to apply principles of law theoretically based upon reason and reality to a situation which is basically unreasonable and unrealistic.").

27 As was said long ago in Chamberlain v. Parker: "A man may do what he will with his own ... and if he chooses to erect a monument to his caprice or folly on his premises, and employs and pays another to do it, it does not lie with a defendant who has been so employed and paid for building it, to say that his own performance would not be beneficial to the plaintiff." 45 N.Y. 569, 572 (1871) (footnote omitted).

28 This is the jury instruction, and subsequent result, I advocate in this Article.
more than we care what car owners do with their insurance proceeds. But in the contract damages context the unjustifiably large award leads to an undesirable result. The Peevyhouses, who based their case for $29,000 on the cost of restoring their property to something like its original condition, turn out not to have cared for reclamation at all. It seems fair to say that they have been unjustly enriched—just as Moors would be in the case of the wrongly constructed house if she happily accepted the house as built, knowing that the mistakes would not affect its resale value when the time came, and spent the $20,000 she was awarded on college costs and orthodontia.

There is a way to prevent such a thing from happening in these cases: Garland Coal could be required to pay the $29,000 into escrow, with the Peevyhouses given leave to draw it down upon presentation of reclamation receipts.²⁹

Query whether any court would conclude that this procedure was worth the bother and expense. If this procedure is not instituted, then, depending on which rule is adopted, there is a risk of a windfall to the defendant if the plaintiff's intentions are not taken into account, and the risk of a windfall to the plaintiff if they are. Perhaps the way it should play out is this: if someone is to get a windfall, it should be the injured party, not the party in breach. Between the lines in the Peevyhouse case is the suspicion that the Garland Coal Company agreed to do reclamation it never had any intention of performing. Whether or not that was the case, better the loss should fall on them than on the Peevyhouses, who, after all, did everything right.

The Oklahoma Supreme Court's opinion in the Peevyhouse case has been cited respectfully in subsequent opinions.³⁰ Interestingly, the decision appears to have been legislatively overruled.³¹ The chief

²⁹ Thanks to my colleague, Joseph Cook, for this suggestion.
³¹ The Oklahoma Mining Lands Reclamation Act, Section 722, provides in part:

It is hereby declared to be the policy of this state to provide for the reclamation and conservation of land subjected to surface disturbance by mining and thereby to preserve natural resources, to encourage the productive use of such lands after mining, to aid in the protection of wildlife and aquatic resources, to encourage the planting of trees, grasses and other vegetation, to establish recreational, home and industrial sites, to protect and perpetuate the taxable value of property, to aid in the prevention of erosion, landslides, floods and the pollution of waters and air, to protect the natural beauty and aesthetic values in the affected areas of this state, and to protect and promote the health, safety and general welfare of the people of this state.
significance of the *Peevyhouse* rule today—aside from its utility in tormenting Contracts students—is that it points out the pitfalls in zeroing in arbitrarily on a diminution in value as “‘the good to be attained’”\(^3\) in a case involving operations to be conducted on real property. Unfortunately, the rule of the first Restatement of Contracts is not an improvement.

II. THE RULE OF ECONOMIC WASTE

The rule conventionally applied now to determine the measure of damages in a case involving breach of a construction contract is framed not in terms of relative economic benefit, but in terms of “economic waste.”\(^3\)

---

\(^3\) *Peevyhouse v. Garland Coal & Mining Co.*, 382 P.2d 109, 113 (Okla. 1962) (quoting Jacob & Youngs, Inc. v. Kent, 129 N.E. 889, 891 (N.Y. 1921)).

\(^32\) *Peevyhouse v. Garland Coal & Mining Co.*, 382 P.2d 109, 113 (Okla. 1962)

The conventional rule has been variously stated. One version expressly adopted by some courts is set out in Section 346(1)(a) of the first Restatement of Contracts, Damages for Breach of a Construction Contract:

(1) For a breach by one who has contracted to construct a specified product, the other party can get judgment for compensatory damages for all unavoidable harm that the builder had reason to foresee when the contract was made, less such part of the contract price as has not been paid and is not still payable, determined as follows:

(a) For defective or unfinished construction he can get judgment for either

(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 [owner], if construction and completion in accordance with the contract would involve unreasonable economic waste.\(^{34}\)

A comment to this provision of the Restatement indicates that what the drafters had in mind when they used the term "economic waste" was the situation in which, if the structure were built and completed in accordance with the contract, some of the work done by the contractor would have to be destroyed.\(^{35}\)

In this Article I will try to show that the rule of economic waste puts the emphasis on the wrong thing, and that, once again, the important question is what the owner will do with an award of the cost of completion if she gets it.


\(^{35}\) Restatement (First) of Contracts § 346 cmt. b ("Sometimes defects in a completed structure cannot be physically remedied without tearing down and rebuilding, at a cost that would be imprudent and unreasonable. The law does not require damages to be measured by a method involving such economic waste.").
A. The Rule Pro and Con

If rectifying the breach of a construction contract will entail destroying a significant amount of work done by the contractor, it is worth asking whether the game is worth the candle.

There are two problems with the approach taken in the first Restatement: (1) there is no agreed-upon criterion for "unreasonable" economic waste; and (2) like the Peevyhouse rule, the rule of economic waste ignores a critical factual issue—the intentions of the injured party in regard to correction of the defects.

A convenient case to illustrate the problems is Vezina v. Nautilus Pools, Inc. In that case the Vezinas contracted with Nautilus to install a swimming pool with a "bowled" center on their property at a price something over $7,000. The pool installed did not have a bowled center. The Vezinas sought damages in the amount of $5,694.78, the cost of retrofitting the pool to conform to the contract.

Applying the rule of economic waste, the court must first ascertain the cost of construction and completion according to the contract. In Vezina that was approximately $5,700. To determine whether an award in that amount would involve unreasonable economic waste, the court must compare the benchmark figure to some other relevant figure. In Vezina the court chose the contract price for the pool, a sum slightly in excess of $7,000. The court held that "the cost of rectifying the defendant's omission is so great in comparison to the cost of the purchase of the pool itself" as to constitute unreasonable economic waste, and remanded the case for a finding as to the difference in value of the pool with and without a bowled center.

Assume, as seems to be generally true in these cases, that the difference in value is much less than the cost of completion. Now the plaintiffs have a pool inferior to the one they contracted for, which they can only rectify by spending a lot more of their own money.

The Vezina court did not cite the Restatement definition of "economic waste," which the Restatement defines as the waste resulting when work done under color of compliance with the contract has to be undone and done again. The court may, however,

---

37 Id. at 1314.
38 Id. at 1315.
39 Id. at 1319.
40 RESTATEMENT (FIRST) OF CONTRACTS § 346(1)(a)(i).
41 See id. § 346(1)(a)(ii).
42 Vezina, 610 A.2d at 1319.
43 RESTATEMENT (FIRST) OF CONTRACTS § 346.
have been thinking along those lines. This illustrates the first problem with the Restatement rule: there is no articulated criterion for determining when the cost of "tearing down and rebuilding . . . would be imprudent and unreasonable."44

In the *Vezina* case the court chose the contract price as its figure for comparison with the cost of performance.45 Though this has some intuitive appeal, on reflection it is hard to see what the contract price has to do with anything. What has happened is that the contractor has put himself in a position where he or someone else (presumably someone else) will have to do almost as much work as the contractor had to do when he installed the pool in the first place.46 It is hard to see why that should be the owner’s problem. Some courts have held that if there is a problem of this sort it should be the contractor’s problem, not the owner’s.47

Indeed, courts generally put the burden of proving economic waste on the contractor.48 That may signify mistrust of the economic waste rule. If this allocation of the burden of proof has any effect, the effect is bound to be beneficial.

44 Id. § 346 cmt. b.
45 *Vezina*, 610 A.2d at 1319.
46 Id. (noting that it would have cost "approximately $200 to $300" to install the correct pool at the time of construction, but "would cost $5694.78" to fix the pool after the fact—"the cost of repair was nearly the same as the purchase price of the pool").

> Defendants concede that the trial court had discretion to apply a measure of damages other than diminution in value, but argue that doing so in this case was economically wasteful because the Association’s damage estimate of approximately $6.5 million exceeded defendant’s original construction cost. We are unaware of any authority that imposes this test for economic waste.


> "By virtue of the age of the building and its present condition, the cost of reconstruction is not an appropriate measure of plaintiff’s loss. This is so because the cost of repairs vastly exceeds the contract price and the probable market value of the property. It would be anomalous to compel defendant to provide plaintiff with what essentially amounts to a totally refurbished home, which would be a result far exceeding what is necessary to make plaintiff whole. Rather the diminution in value caused by defendant’s deceit better reflects plaintiff’s actual loss and satisfies the reasonable expectations of the parties."

*Id.* at 935 (quoting Correa v. Maggiore, 482 A.2d 192, 198 (N.J. Super. Ct. App. Div. 1984)).
Some courts have attempted to get a clear fix on the concept of economic waste. In Greg Allen Construction Co. v. Estelle, an Indiana appellate court made a determined effort:

Economic waste has been found in situations where the cost of restoring the property would exceed the value of the property in its restored condition, where usable property is destroyed, where the cost to repair would result in unreasonable duplication of effort, and where the contractor's work would be substantially undone.

Unfortunately, such efforts have not advanced matters very far. In every "economic waste" case, the court must compare the cost of correcting the defect with something else. But what else? In Andrulis v. Levin Construction Corp., the court, adopting the Restatement rule, observed that economic waste turns on a finding of disproportionality; the cost of repair must be disproportionate in relation to something. As the reference point, the court chose diminution in value, and remanded the case for a finding on that point. Now the court had arrived at the Peevyhouse rule through the back door.

---

49 762 N.E.2d 760 (Ind. App. 2002).
50 Id. at 777 (citing Willie's Constr. Co. v. Baker, 596 N.E.2d 958, 961 (Ind. Ct. App. 1992)).
51 The first situation—in which the cost of completion exceeds the value of the property in its restored condition—would obtain if, for example, the cost of correcting the defects in the hypothetical case of the mis-configured $200,000 house were $210,000 rather than $20,000. Such situations are presumably quite rare. The second situation probably occurs fairly often, and the court may have a point: perhaps the destruction of usable property, such as the pool in the Vezina case, requires greater justification than the destruction of useless property, such as electrical work done so badly that it violates a city ordinance. This point is developed more fully later in this Article. See discussion infra Part II.B. The third criterion, unreasonable duplication of effort, potentially reaches every case in which work is done defectively rather than left incomplete, which would surely be wrong, and there is no good way to draw the line. The fourth criterion—the contractor's work would be substantially undone—appears to be the third criterion stated a different way.
52 628 A.2d 197 (Md. 1993).
53 Id. at 207.
54 See, for example, Mayfield v. Swafford, 435 N.E.2d 953 (Ill. App. Ct. 1982), in which the court adopted the economic waste rule and said: [It would cost the defendant $11,381 to furnish the plaintiff with a $7,000 pool. The disproportion in the cost-benefit ratio involved here demonstrates the "economic waste" that can be involved and serves to explain the foundation which underlies that aspect of the rule which bases the damages for faulty or incomplete construction upon the diminution in value. Id. at 956. The court held that the plaintiff was entitled to receive the lesser of the cost of repairs or the diminution in value of the property. Id. at 957-58.]
All in all, in the typical case, couching the criteria for an award of the cost of performance in terms of “unreasonable economic waste” requires the courts to “set sail on a sea of doubt”—never desirable in the law if there is a way to avoid it.

The second problem with the first Restatement’s rule of economic waste is that it does not consider the question of whether the owners, if they are awarded the cost of performance, will be unjustly enriched.

Whether the result in the Vezina case is the correct result or not depends on whether the plaintiffs, if they got an award equal to the cost of retrofitting the pool with a bowled center, would spend it that way. If not, they would get a pool substantially satisfactory to them, and an additional $5,700. That would be a windfall to them—a result the court’s decision avoids. But we don’t know. For all that appears, what the Vezinas wanted was a pool that people could safely dive into, and they did not get one. Quite possibly, if they got the $5,700, they would have spent it to rectify the breach. In that event the court’s decision was wrong. It failed to put the owners in as good a position as the one they would have been in if the pool contractor had performed the contract according to its terms.

If vagueness were the only vice of the rule of economic waste, perhaps we would tolerate it, as we often do in other areas of the law, such as negligence. The more serious problem is that the rule fails to take into account what the owner will do with an award of the cost of performance if he gets it. In the pool case, as in the case of the poorly constructed house, if the breach is rectified, work done will have to be undone. Some of the contractor’s expenditures will be wasted in that sense. It is wrong to focus narrowly on that fact, and overlook the crucial point that the original work was botched work. The owner should not be penalized because the contractor invested resources in building something that the contract did not call for.

The rule of economic waste is ultimately no better than the rule of the Peevyhouse case. A better rule, this Article contends, would be

---

55 The expression comes from an opinion dear to the hearts of antitrust scholars, the opinion of Judge William Howard Taft in United States v. Addyston Pipe & Steel Co., 85 F. 271 (6th Cir. 1898), aff’d as modified, 175 U.S. 211 (1899). The full quote is:

It is true that there are some cases in which the courts, mistaking, as we conceive, the proper limits of the relaxation of the rules for determining the unreasonableness of restraints of trade, have set sail on a sea of doubt, and have assumed the power to say, in respect to contracts which have no other purpose and no other consideration on either side than the mutual restraint of the parties, how much restraint of competition is in the public interest, and how much is not.

Id. at 283–84.

56 At least the Peevyhouse rule is tailored to prevent unjust enrichment in some cases. See discussion supra Part I.A. The rule of economic waste is not.
that when a contractor breaches a construction contract, the owner is entitled to recover the cost of construction and completion if, but only if, he intends to spend that sum on rectifying the breach; otherwise, he may recover only the difference in value of the property with and without the promised performance.

Some courts applying the rule of economic waste hint at this. In Lyon v. Belosky Construction, Inc., the issue was the measure of damages for defective construction of a home ostensibly built to the specifications of the owners. As constructed, the roof was seriously misaligned, and as a result the main entrance was defective in several respects. The court stated the economic waste rule and applied it:

[T]here is evidence that, under the circumstances presented here, the defect was substantial. Plaintiffs contracted to build a custom home at significant expense which, in fact, exceeded the fair market value of the home as completed per the drawings. Because they were away from the work site during most of the construction, plaintiffs retained and relied upon various professionals to assist them in successfully completing the project. It is clear from the record that the aesthetic appearance of the home, both inside and out, was of utmost importance to plaintiffs. Our review of the photographs of the home as constructed compared with the design drawings convinces us that plaintiffs did not get the benefit of their bargain and that requiring defendants to remedy the problem would not, under these particular circumstances, result in unreasonable economic waste. Accordingly, we find that the Supreme Court [of New York] applied the appropriate measure of damages.

In the same vein, Carter v. Quick held that in a case involving a residential dwelling, cost of correction is more fitting than difference in value. The court explained that the owner is interested "in having defective construction corrected so that he and his family may enjoy a properly constructed dwelling and he is not concerned with offsetting any loss on a possible resale of the property."

---

58 Id. at 401.
60 563 S.W.2d 461 (Ark. 1978).
61 Id. at 465. See also Willie's Construction Co. v. Baker, 596 N.E.2d 958 (Ind. Ct. App. 1992), and text accompanying notes 107–09 infra.
B. Some Additional Cases

In some instances it makes no difference whether the rule applied is the rule of economic waste or what I argue is the "better rule," because they lead to the same result. An instructive case is Ervin Construction Co. v. Van Orden. A builder brought suit against a home-owning couple, alleging that they had breached their contract for construction of a log house by terminating it without giving him a reasonable opportunity to cure the defects in the initial construction. The trial court held for the plaintiff on the issue of the homeowners' breach, and the Supreme Court of Idaho affirmed. However, since the home as built was defective, the homeowners were entitled to damages for the builder's breach. The supreme court applied the conventional rule, and held that since the correction of the defects did not involve unreasonable economic waste, the homeowners were entitled to the cost of performance. Under the better rule, the case would have come out the same way. By the time of trial the homeowners had already paid another contractor to correct the defects and were seeking to recover what they had spent, so there was no question as to their intent.

Another case in which the court got to the right result without asking the right question was Mort Wallin of Lake Tahoe, Inc. v. Commercial Cabinet Co. Defendant contracted to build a men's store in a casino for the store operator, replacing a store that had been destroyed by fire. The total cost of construction was $158,058. The store was to have been paneled with Philippine mahogany veneer, but apparently there were flaws in the paneling job. The store operator sought damages in an amount in excess of $340,000, which its experts testified would be the cost of replacing the paneling. The Nevada Supreme Court refused to award judgment in that amount, holding that it would be economically wasteful to award the cost of replacement where the total cost of building the entire building was far less than that.

63 Id. at 508–09.
64 Id. at 508, 510.
65 Id. at 514.
66 Id. at 508.
69 Mort Wallin of Lake Tahoe, Inc., 784 P.2d at 955.
In this instance, if the court had followed the better rule, it would have asked whether the plaintiff would have spent a $340,000 damage award to correct a paneling defect in a $158,000 structure. The answer has to be probably not. If that is the answer, the plaintiff was entitled to recover only the difference in value of the store with and without conforming paneling. Since the plaintiff failed to establish the difference in value at trial, it properly took nothing on this phase of its complaint.

Sometimes, however, the outcome will differ depending on whether the rule applied is the rule of economic waste or the better rule.

In *Thomas v. Schmidt* the plaintiff, a homeowner, appealed from a judgment in her favor in a suit against a contractor for breach of contract, contending that the trial court had applied the wrong rule in assessing her damages. Plaintiff proved at trial that the roofs defendant installed on her house and garage were discolored, and correction of the defect would require re-roofing the buildings. Plaintiff sought damages in the amount of $2,160, the cost of new roofs. Applying the majority rule of economic waste, the appellate court held that since the defects were merely aesthetic, an award of the cost of correcting the defects would result in “gross economic waste.” However, it appears that the court got it wrong. On these facts, it seems entirely probable that if the plaintiff got the $2,160 she would have spent it on new roofs, and that the court’s award of $325 failed to put her in as good a position as the one she would have been in if the contract had been fully performed.

The better rule I argue for in this Article has modest support in the cases. In *Advanced, Inc. v. Wilks*, homeowners brought suit against a contractor, contending that the contractor had breached its contractual duty to build an elliptical earth-sheltered home in a workmanlike manner. The trial court awarded the plaintiffs $150,402.75 as the cost of correcting defects in the contractor’s performance. On appeal the contractor argued that this award was excessive when compared to the difference in value of the house with and without correction of the defects. The Supreme Court of Alaska gave careful consideration to the contention, and concluded that it

---

70 Id.
72 Id. at 376–77.
73 Id. at 377.
74 711 P.2d 524 (Alaska 1985).
75 Id. at 525.
76 Id. at 526.
improperly failed to account for the injured parties' intentions with regard to expenditure of the larger damage award:

An owner's recovery is not necessarily limited to diminution in value whenever that figure is less than the cost of repair. It is true that in a case where the cost of repair exceeds the damages under the value formula, an award under the cost of repair measure may place the owner in a better economic position than if the contract had been fully performed, since he could pocket the award and then sell the defective structure. On the other hand, it is possible that the owner will use the damage award for its intended purpose and turn the structure into the one originally envisioned. . . . If he does this his economic position will equal the one he would have been in had the contractor fully performed. The fact finder is the one in the best position to determine whether the owner will actually complete performance, or whether he is only interested in obtaining the best immediate economic position he can.77

Sometimes the failure to inquire into the intentions of the injured party gives that party a substantial windfall. An extreme case is Corbello v. Iowa Production.78 The plaintiffs granted Shell Oil Company an oil and gas lease on 120 acres of land.79 In the lease, Shell Oil agreed ""that upon termination of th[e] lease it w[ould] reasonably restore the premises as nearly as possible to their pre[vious] condition.""80 In the landowners' suit, the jury awarded the plaintiffs $33 million as the cost of doing the restoration which the tenants failed to do.81 On appeal, the tenants contended that $33 million was an excessive award in light of the fact that the value of the leased property was only $108,000.82 The Supreme Court of Louisiana affirmed the jury's award, holding that in contract cases of this kind the party in breach was liable for the full cost of performance of its contractual commitment to restore the land, market value notwithstanding.83 In all probability this barely credible result would have been avoided if the jury had been instructed to determine

77 Id. at 527 (footnotes omitted).
78 850 So. 2d 686 (La. 2003).
79 Id. at 691.
80 Id. at 694.
81 Id. at 691.
82 Id. at 692.
83 Id. at 693–94.
whether the plaintiffs, if they were awarded the $33 million, would spend it to restore land worth $108,000 to its original condition.

Some courts have resolved this issue by reference to the aesthetic importance of the breach. On the face of the matter it is unclear why aesthetic importance should make any difference. It may be, however, that aesthetic importance is the key to the injured party’s intent. In City School District v. McLane Construction Co., the defendant contracted to build a swimming pool for the plaintiff which included a roof supported by wooden beams. As the appellate court noted, these were no ordinary beams:

The appearance of the beams was central to the aesthetics of the architectural scheme as they were to contrast their natural beauty with the relatively stark unfinished concrete that comprised the balance of the structure. Even the effectiveness of the indirect lighting system depended on the beams. As the building was to be a showplace, the site of large regional swimming competitions, the design was intentionally dramatic.

The beams as installed were stained, discolored, and permeated with dirt—a far cry from what the contract called for. The jury rendered a verdict in an amount equal to the total cost of replacing the nonconforming beams. On appeal the supplier of the beams contended that the proper measure of damages was the diminution in value of the structure. The court of appeals rejected that contention, noting that “[o]ne of the school district’s principal objectives was to have an aesthetically prepossessing structure, and that goal has by all accounts been frustrated.” The court did not say why the fact that aesthetics were involved should matter. It seems reasonable to suspect that what the court had in mind was that if the plaintiff were awarded the cost of getting the aesthetically pleasing beams called for by the contract, it would spend the money to do just that.

---

85 Id. at 259–60.
86 Id. at 260.
87 Id.
88 Id.
89 Id.
90 In Asp v. O’Brien, 277 N.W.2d 382 (Minn. 1979), the court, applying the economic waste rule, stood the City School District argument on its head:

In the present case the cost of reconstructing the cabinets would greatly exceed the original cost of building them. The cabinets were functional as built. The defects were essentially cosmetic rather than structural. Thus, the trial court did not err in using diminution in value as the measure of damages.
As a final case that tests the limits of what I call the better rule, consider the famous case of Jacob & Youngs, Inc. v. Kent.90 A builder contracted to build a country home for a Wall Street lawyer. While the contract provided that only Reading pipe would be used in the structure, the builder installed various kinds of pipe in the house, all apparently very good.91 The principal issue before the New York Court of Appeals, couched in today’s terms, was whether the builder had substantially performed its duties under the contract. In an opinion by Judge Cardozo, the court ruled that it had.92 One factor in the court’s decision was that in order for the contractor to replace the non-conforming pipe with Reading pipe, a great deal of perfectly good work done in accordance with the contract would have to be ripped out.93

The court held that the contractor was entitled to its final payment, but the homeowner was entitled to offset this payment against the amount of his damages from the breach.94 The court stated that in a case of this kind, where the cost of completion was “grossly and unfairly out of proportion to the good to be attained,”95 the appropriate measure of damages was not the cost of completion, but the diminution in value of the property—which, Judge Cardozo noted, would be “nominal or nothing,” since in market terms Reading pipe was no better than the pipe the builder installed.96

In this way, the court applied an early version of the rule of economic waste. Its decision rested in substantial part on the expense involved in tearing out the walls of a completed structure to cure the defects in the contractor’s performance.97

Under what I have been calling the better rule, the court was remiss in not inquiring as to what Kent would have done with an award equal to the cost of completion had he received it. In fact it is reasonable to suppose that he would not have spent it to tear out the contractor’s work and re-plumb the house. Between the lines in the opinion there is the suspicion that the owner was using the pipe issue as a pretext to rook the contractor out of the final payment to which he was entitled. But, under the better rule, Kent would have had a

Id. at 384. In view of my stance in this Article, the court was mistaken.
90 129 N.E. 889 (N.Y. 1921).
91 Id. at 890.
92 Id. at 890–91.
93 Id. at 891.
94 Id. at 891–92.
95 Id.
96 Id.
97 Id. at 891.
shot at the larger award if he could convince the trier of fact that the
difference between Reading pipe and the other pipe was crucial to
him.

Perhaps this is carrying a basically sound idea too far. In the
typical case of what the first Restatement calls "economic waste," the
work that has to be replaced is botched work, i.e., work not done in
accordance with the contract. The Jacob & Youngs, Inc. case is
distinctive in that replacing the pipe would have required the
destruction of a great deal of competent work that was done entirely
in compliance with the contract. Perhaps, in this very limited class of
cases, the rule of economic waste should apply.

III. THE RULE OF LOSS IN VALUE

In the second Restatement of Contracts, the drafters, expressing
dissatisfaction with the rule of economic waste, crafted a new rule.
Section 348(2) of the second Restatement provides:

(2) If a breach results in defective or unfinished
construction and the loss in value to the injured party is not
proved with sufficient certainty, he may recover damages
based on

(a) the diminution in the market price of the property
caused by the breach, or

(b) the reasonable cost of completing performance or
of remedying the defects if that cost is not clearly
disproportionate to the probable loss in value to him.⁹⁸

In Comment c to this rule, the drafters observed:

Sometimes . . . such a large part of the cost to remedy the
defects consists of the cost to undo what has been improperly
done that the cost to remedy the defects will be clearly
disproportionate to the probable loss in value to the injured
party. Damages based on the cost to remedy the defects
would then give the injured party a recovery greatly in excess
of the loss in value to him and result in a substantial windfall.
Such an award will not be made. It is sometimes said that the
award would involve "economic waste," but this is a
misleading expression since an injured party will not, even if
awarded an excessive amount of damages, usually pay to

have the defects remedied if to do so will cost him more than the resulting increase in value to him.\(^9\)

Though a number of courts have adopted the rule of the second Restatement,\(^10\) in most jurisdictions the law on the books is still the first Restatement’s rule of economic waste. Presumably this is true because the seminal decisions were rendered before the second Restatement was published. There seem to be only two cases in which a court has compared the two rules and opted for the second one.\(^11\)

This rule resembles the *Peevyhouse* rule in that it emphasizes disproportionality. However, this rule also appears to be different. Whereas the reference point in the *Peevyhouse* rule is diminution in value, the reference point in this rule is the “loss in value” to the injured party. For the sake of convenience, this Article will refer to this rule as the “rule of loss in value.”

Loss in value, the concept central to the rule, is somewhat baffling in this context. It seems to mean the difference between the value of the promised work and the value of the work done. How to compute those values? One way would be to assign, as the value of the promised work, the value of the premises if the work had been properly done, and to assign as the value of the work actually done the value of the premises with the defective work. If this is what the drafters meant, they revived the rule of the *Peevyhouse* case. But it is by no means certain that that is what they meant. It does not help matters that the rule provides that cost of performance is available as a remedy only when “[actual] loss in value” cannot be proven with reasonable certainty and the cost of performance is not disproportionate to the “probable loss in value.”\(^12\)

Understandably, the courts have had difficulty with “loss in value.” Some simply gloss over it.\(^13\) Some confuse loss in value with economic waste.\(^14\) Some appear to treat loss in value as equivalent to

---

\(^9\) Id. § 348 cmt. c.
\(^12\) RESTATEMENT (SECOND) OF CONTRACTS § 348(2) (emphasis added).
\(^13\) See, e.g., Flom, 569 N.W.2d 135.
diminution in value, converting the rule of loss in value to the rule of the *Peeryhouse* case. 105

Notwithstanding this uncertainty, courts manage to get to a result under § 348, and the result in almost all of the cases available is that the injured party recovers the cost of correcting the defects if she wants it. 106 Under the better rule, the injured party is entitled to the cost of correction if, but only if, it is more probable than not that she will spend it to correct the defects, and not for something else. This means that under the rule of loss in value, the contractor is very seldom unjustly enriched, though the injured party may be. Arguably, if one party is to get a windfall, it ought to be the injured party rather than the contractor at fault.

Some courts in the loss in value cases espouse views that are similar to mine in this Article. This is particularly likely to happen in cases involving the construction of homes custom-built to the owners' specifications. In *Willie's Construction Co. v. Baker*, 107 the court reasoned that "the difference in market value ... 'is rather discriminate against a plaintiff":

"What if a plaintiff does not want to sell his property? In this posture the effect of the rule would be where the restoration costs exceed the "before and after" measure, a plaintiff would receive that latter. Consequently, if he did not desire to sell the building, he would not receive damages sufficient to restore the building to its original condition. The "before and after" test, if used in cases of non-permanent injury, is in reality forcing the plaintiff to sell the building in order to restore himself to the same position enjoyed before the injury. Certainly such a measure of damages partially compensates a plaintiff for injury done to his building and affords some protection to a part of his property rights. However, it would seem more proper to place the plaintiff in a position where he could be unrestricted in the exercise of his property rights of continued ownership or alienation. When these considerations are weighed against the possible "windfall" that might be

---


given to a plaintiff, the former takes precedence over the latter."\textsuperscript{108}

The court also said:

The fair market value of a home does not necessarily reflect the value to the homeowner. As many homeowners discover, it is not unusual to find that the cost of additions or improvements made in order to conform a home to the owner's personal tastes, often do not result in a corresponding increase in the home's market value. The provision in the contract [in suit] requiring one hundred inch basement walls was an unusual one for which there was an extra $414.00 charge. Walls taller than eighty-eight inches are extremely rare according to Willie's experts. This was a feature that the Bakers wanted from the beginning and Willie's specifically agreed to provide it. It is difficult to put a valuation on the difference in height because the Bakers wanted this modification as a matter of personal taste, not because it would increase the value of their home.\textsuperscript{109}

A common thread in these cases is that the courts assume—in this instance because a residence is involved and there appears to be nothing to indicate that the owner wants to sell it—that if the owner recovers the cost of completing the work according to the contract, that is the way she will spend the money. That, I submit, is exactly the sort of reasoning we should hope to find in the cases.

All in all, given the slant in the cases toward giving the injured party the cost of correction or completion, the rule of loss in value is preferable to the rule of economic waste and the \textit{Peevyhouse} rule. By and large, apart from the two cases just cited, the courts tend to ignore what I have argued should be the decisive factor in cases of this kind, i.e., whether or not the injured party, if she gets the larger award, will actually spend it to correct the adverse consequences of the breach. In other words, in the typical case arising under § 348 of the second Restatement, the courts get to what in many instances appears to be the right result by the wrong path.

\textsuperscript{108} Id. at 961–62 (quoting Gen. Outdoor Adver. Co. v. La Salle Realty Corp., 218 N.E.2d 141, 151 (Ind. App. 1966)).

\textsuperscript{109} Id. at 961. In the same vein, see Lyon v. Belosky, 669 N.Y.S.2d 400 (N.Y. App. Div. 1998), Carter v. Quick, 563 S.W.2d 461 (Ark. 1978), and \textit{supra} text accompanying notes 57–61.
IV. CONCLUSION

In cases involving construction contracts where the contractor fails to perform his part in full, the Peevyhouse rule, the now conventional rule of economic waste, and the newer rule of loss in value are all defective in the same respect. Because they leave out of account the question of whether the injured party will probably spend an award of the cost of performance on obtaining that performance, they have the tendency to deny to that party his full expectancy.

What I have been calling the better rule in this Article would permit the injured party to recover the cost of substitute performance in full, if she proves that more probably than not she will spend that sum on remedial work.

No rule does away completely with the possibility that on the facts of a particular case, one party or the other will get a windfall. The better rule is best calculated to minimize those instances, and to ensure that if such a thing does occur, no benefit accrues to the party in the wrong—i.e., the contractor who did a lousy job and walked away from it.