**Construction and Design Law: Managing the Network of Interdependent Relationships**

Carl J. Circo

**Lesson 14: Claims Procedures and Measure of Damages**

When construction gives rise to disputes that the parties fail to resolve informally, they and their lawyers must determine what procedures to follow and what legal remedies may be available. Of course, general principles of substantive and procedural law apply to construction industry claims and remedies, but disputes between project participants in a contractual relationship typically involve much more than simply applying those general legal principles. This lesson first briefly considers common contractual claims procedures, and then it considers remedies available to the disputing parties, with an emphasis on damages for breach of contract.

**A. Claims Procedures**

Construction industry contracts commonly include extensive provisions governing claims and disputes. Read Article 15 of AIA A201 (2017), “General Conditions of the Contract for Construction.” Article 15 illustrates features found in many contracts, including those concerning timing, notice requirements, and a “stepped” process for attempting to address claims and disputes first informally, and then through one or more layers of formal dispute resolution before submitting the matter to binding arbitration or litigation. Note that Article 15 includes many details concerning mediation and arbitration (if the owner and contractor opted for arbitration rather than litigation). Also note that Section 15.2 establishes detailed procedures for the “Initial Decision Maker” role. The waivers of consequential damages in Section 15.1.7, while not unusual in industry contracts, can become a contentious negotiating topic. Lawyers advising clients about claims and disputes should carefully review whatever procedures the controlling contract specifies. Indeed, while the cases vary from one jurisdiction to another, courts sometimes strictly enforce contractual claims procedures, which means that a party who fails to follow the specified procedures risks being barred from pursuing a claim. See Phillip L. Bruner & Patrick J. O’Connor, Jr., *Bruner & O’Connor on Construction Law*, §§ 3:41, 4:35-4:41, 18:20 (Westlaw Nov. 2024).

**B. Damages**

Assuming a contracting party has a valid claim, the question becomes what remedies the law affords the claimant. Read Sections 19:1 & 19:2 in volume 7 of *Bruner & O’Connor on Construction Law* (Westlaw Aug. 2023), by Phillip L. Bruner & Patrick J. O’Connor, Jr., which provide an overview of remedies in the construction industry context. As these sections explain, depending on the legal basis for the claim (e.g., contract, tort, equity, or legislation), our legal system recognizes a range of remedies, including damages, indemnification, rescission, restitution, quantum meruit, and injunctive and declaratory relief. These alternative remedies advance different policies, such as protecting the sanctity of contract, preserving the benefit of bargains, respecting reasonable expectations, and righting wrongs based on fault or a party’s ability to manage risk. The law of remedies also establishes constraints based on concepts of causation and mitigation, and by respecting contractual liability waivers and limits consistent with public policy, and also by establishing a boundary between contract and tort (via the economic loss rule, as discussed in other lessons). Due to the somewhat byzantine historical development of the law and to unique aspects of construction industry disputes, which often involve multiple parties, difficult questions of causation and apportionment of fault further complicate matters. The result, to quote from Section 19:1 is a “‘Gordian Knot’ of remedies and damage measures governing modern construction disputes.” While later sections in Chapter 19 of the Bruner and O’Connor treatise goes on to review and analyze this “Gordian Knot” broadly and in detail, our primary interest is much narrower. Rather than attempting to encompass the entirety of that vast body of law, this lesson narrows the focus down to principles governing entitlement to monetary damages for breach of contract and the appropriate measure of damages in the most common construction industry disputes.

 For breach of contract, the fundamental principle dictates that the breaching party should be liable for expectation damages attributable to the breach, thereby affording the claimant the monetary equivalent of the benefit of the bargain. Under this rubric, “damages include all costs and losses flowing either directly or as a foreseeable consequence of a breach.” Phillip L. Bruner & Patrick J. O’Connor, Jr., 7 *Bruner & O’Connor on Construction Law*, § 19:14 (Westlaw Nov. 2024). As you will soon see, applying that seemingly simple standard to construction industry disputes can lead to exceedingly complex questions of proof and to arguments over alternative measures of damages.

A helpful way to gain a clearer understanding of breach of contract damages as applied to the most common industry claims, is to consider the analysis from the distinct perspectives of design professionals, owners, and builders. We begin with damages for common breach of contract claims brought by design professionals, which often allow for relatively straightforward analysis. From there, we move on to the more complex topics of damage claims by project owners and building contractors.

Damages incurred by design professionals

Breach of contract claims brought by design professionals most often involve disputes over payment for services rendered. The services involved may either be ones the designer expressly agreed to provide under the contract or ones the designer characterizes as additional services. If the evidence shows that payment is due for services performed as specified in the contract, then the measure of damages usually may be based on the contract price, which may either be a fixed amount for specified services or a formula. Accounting complications may arise if variable compensation terms apply for different categories of services, but these are generally manageable problems if the design firm maintains sound recordkeeping. For example, different hourly rates may apply based on who performed specific services (such as for senior or junior licensed professionals, drafting personnel, or clerical staff), or for different categories of service (such as preparing plans and specifications, attending meetings, or making site inspections). Indeed, if the contract price is a fixed sum and the evidence shows that the firm performed all services in accordance with the contract requirements, the measure of damages may be as simple as calculating the difference between the contract price and the cumulative payments made against that total, perhaps along with prejudgment or post judgment interest. If the claim is for additional services not within the contract scope, the calculation may also be a relatively straightforward mathematical computation if the contract establishes rates or a formula for additional services. In other circumstances, the measure of damages may be the reasonable value of the services, in which case the parties may submit conflicting testimony concerning industry practices and standards.

Damages incurred by owners

An owner’s damages often involve claims of defective work or services. See Josh M. Leavitt & Daniel G. Rosenberg, *Toward A Unified Theory of Damages in Construction Cases: Part I—Navigating Through the Diminution of Value vs. Cost of Repair Debate in Defect Cases and Allocating Burdens of Proof*, 2 J. Am. Coll. Constr. Laws 1 (Issue No. 1, 2008). In the simplest cases, such as where the evidence establishes one or a few discrete defects, the measure of damages may be the cost required to correct the problem. Even then, however, the defendant may dispute what was necessary for that purpose and whether the owner paid more than a reasonable price for the corrective work or services. In more complex defect cases, the parties may dispute whether repairs or modifications should be sufficient to compensate the owner or, instead, whether parts of the project should be removed and replaced. In many jurisdictions, either by statute or case law, a general contractor may have a right to a formal notice of the alleged defects and the option to fix the problem rather than to pay damages.

Many other questions may fuel debates over an owner’s damage claim. Are the circumstances such that some or all damages the owner seeks to recover are too speculative? Instead of the cost to correct, is the just measure of damages the diminished value of the project as completed versus as designed? In a famous opinion addressing this issue, Justice Cardozo proclaimed the principle now known as the economic waste doctrine: “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.” *Jacob & Youngs v. Kent*, 230 N.Y. 239, 244 (N.Y. 1921). At other times, the question is whether a repair or replacement made to correct the breach gave the owner something exceeding the benefit of the bargain. This question most often arises in defective design cases, such as a case in which paneling that an architect specified for a hospital project did not conform to the applicable fire safety code and was therefore replaced with code-compliant paneling of a higher quality and cost. The court held that the hospital was not entitled to a windfall recovery “in the form of the more expensive Micarta paneling and the extra labor costs required by its more difficult installation, merely because its architect initially failed to specify it.” *St. Joseph Hosp. v. Corbetta Const. Co*., 316 N.E.2d 51, 62 (Ill. App. Ct. 1974). At the other extreme, if the owner establishes a breach so substantial as to defeat the object of the agreement, the owner may have an equitable right to rescind the contract and be entitled to restitution of all payments made under the contract. See *Lanier Home Ctr., Inc. v. Underwood*, 557 S.E.2d 76, 78–79 (Ga. Ct. App. 2001) (home’s septic system located on unsuitable soil).

When an owner seeks to recover delay damages, even more difficult questions arise. See Phillip L. Bruner & Patrick J. O’Connor, Jr., 7 *Bruner & O’Connor on Construction Law*, §§ 19:86-19:91 (Westlaw Nov. 2024). In such cases, owners may seek to recover lost profits, loss of use, extended construction financing costs, substitute facilities costs, and extended project administration. Such damage claims are especially susceptible to the argument that the owner’s damage evidence is too speculative. Another common defense to an owner’s delay damage claim may apply if the contract includes a waiver of consequential damages, which is a common feature of construction contracts, albeit one that may entangle the factfinder in the difficult process of drawing a line between direct and consequential damages. Additionally, the contracting parties sometimes use a liquidated damages formula to simplify the delay damage calculation, but such provisions can raise questions of enforceability or disputes over the length of the delay.

Damages incurred by building contractors

While damage claims by owners often involve serious complications, contractors’ breach of contract damage claims present some of the most complex problems of all. For that reason, this lesson affords detailed attention to these aspects of the law of damages. Two reading assignments cover the most important considerations.

Read Sections 19:92-19:97 in volume 7 of *Bruner & O’Connor on Construction Law* (Westlaw Aug. 2023), by Phillip L. Bruner & Patrick J. O’Connor, Jr. These sections of the Bruner and O’Connor treatise explain the basic principles governing a contractor’s damages for an owner’s breach, and they introduce the practical problems contractors may face in proving discrete damage components. These considerations apply not only to an owner’s default in making payments for work expressly covered by the contract, but also to disputes over changes and additional work and for delays, suspensions, disruptions, and interruptions to the progress of the work for which the owner is responsible. Section 19:94 covers alternative methods for measuring the contractor’s damages when the owner wrongfully terminates the contractor or when the owner’s material breach justifies the contractor’s abandonment or repudiation of the contract. Section 19:95 explains that even when the contractor wrongfully fails to complete the project, the equitable principle of unjust enrichment may afford the contractor a right “to recover at least the reasonable value by which the work enhanced the value of the owner's property.” Section 19:96 lists “building blocks” that may comprise a contractor’s compensatory damage claim.

Section 19:97 explains the judicial preference for determining a contractor’s breach of contract damages by requiring the contractor to provide evidence of “segregated” or actual and itemized costs attributable to the breach. As that section further notes, however, because this preferred method is not always feasible as a practical matter, the authorities recognize that “reasonable estimates supported by expert opinion or by “objective” formulas accepted by the construction industry and by courts may serve as a basis for proving damages.” In other words, where a contractor can prove that it incurred damages for which the owner should be responsible but cannot provide sufficient evidence to calculate those damages using the actual cost method, the law may permit alternative measures of damages.

Now read *Measuring the Contractor's Damages by "Actual Costs"-Can It Be Done?,* 25 Constr. Law. 31 (Winter 2005), by Allen L. Overcash & Jack W. Harris. (Because some databases do not display the graphic material in this article, you may wish to download a pdf version from a source such as HeinOnline.) This article is especially useful (1) for explaining the accounting challenges involved in proving a contractor’s damages and (2) for its review of alternatives to the actual cost method for measuring damages. Pay close attention to the authors’ coverage of the total cost, modified total cost, jury verdict, and measured mile alternatives, as well as to their comments about the limitations of expert opinions, industry studies, and construction cost accounting practices. The article concludes with practical advice to help owners and contractors anticipate and manage the risks involved.

Legions of contractors’ breach of contract cases document recurring problems of proof and debates over acceptable measures of damages. Read the following two cases, which serve merely to illustrate how litigators and courts must often struggle with these issues:

* *New Pueblo Constructors, Inc. v. State*, 696 P.2d 185 (Ariz. 1985). This case deals with disputes over a contractual claims procedure, alternative measures of damages, liquidated damages, and recovery of attorney’s fees and litigation expenses. Feel free to skip parts IV-VI of the opinion, which address the proper interpretation of Arizona law concerning recovery of attorney’s fees and expenses.
* *C.B.C. Enterprises, Inc. v. United States*, 978 F.2d 669 (Fed. Cir. 1992). Here, a contractor on a federal project sought to recover “unabsorbed extended home office overhead,” a potential damage component that can be especially difficult to prove. The court refused to allow the contractor to resort to the Eichleay formula, a method established under federal contract cases to compensate the contractor for certain costs incurred during a government-caused delay, disruption, or suspension of work. (The formula takes its name from *Appeal of Eichleay Corp*., ASBCA No. 5183, 60-2 B.C.A. (CCH) ¶ 2688 (July 29, 1960).)

For Review and Discussion

1. What policies justify the judicial preference for the segregated or actual cost method?
2. Why might a contractor who has been wrongfully terminated by the owner assert a right to rescind the contract and seek recovery in quantum meruit for the work completed prior to the termination rather than suing for breach of contract damages? (Refer back to Section 19:94 of the Bruner and O’Connor treatise.)
3. The Eichleay formula provides a method for calculating a special category of indirect costs that contractors may incur in connection with delay, suspension or disruption for which the owner is responsible. First announced and applied in federal government cases and later embraced by some state courts, the formula has long been controversial. See Phillip L. Bruner & Patrick J. O’Connor, Jr., 7 *Bruner & O’Connor on Construction Law*, § 19:108 (Westlaw Nov. 2024). Supplemental information about the Eichleay formula appears on the last page of this lesson. Review that information and answer the questions at the end of that supplemental information.

**Eichleay Formula**

Eichleay Formula for computing “unabsorbed” home office overhead associated with delay, suspension, or disruption for which the owner is responsible. The usual conditions for resort to the Eichleay formula: (1) contractor was obliged to remain on “standby” due to owner delay, suspension, or disruption and (2) the contractor had no reasonable opportunity to reduce overhead or obtain replacement work to cover ongoing overhead.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Step # 1 | Total Contract Billings (for the specific project before any adjustment for the delay) Divided by Total Contractor Billings (all projects) for Performance Period | MultipliedTimes | Total Home Office Overhead Incurred During Performance Period | Equals Overhead Allocable to Contract |
|  |  |  |  |  |
| Step # 2 | Home Office Overhead Allocable to ContractDivided by# of Days of Contract Performance |  |  | Equals “Daily Contract Overhead” |
|  |  |  |  |  |
| Step # 3 | Daily Contract Overhead | Multiplied Times | Number of Days of Compensable Delay  | Equals Unabsorbed Home Office Overhead |

Assume that a project owner, for its own convenience, orders a 10-day suspension of work on a project for which the original contract provides for a $200,000 contract price and a 50-day completion schedule. Assume that the contractor’s home office overhead expenses for the fiscal year equal $100,000 and that the total value of the contractor’s contracts over that year equals $1,000,000. Using this information and the Eichleay formula, what additional compensation is due to the contractor for unabsorbed home office overhead as the result of the 10-day suspension (during which the contractor was forced to be on standby with no reasonable opportunity to reduce overhead or obtain other work that might “absorb” any of the overhead during the suspension)?