Assessing Damages Arising from Construction Defects

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In this article, the author explains that the key issues determining business interruption losses focus on when construction the defects arise.

Defects that were introduced during construction can lead to classic legal disputes between owners and contractors where considerable sums of money are involved. It all begins when the defects are first discovered. This become the starting point for the analysis of when economic damages begin, who is impacted and how much, and how long they last.

The following cases illustrate different approaches to the assessment of damages:

Case 1: Large Apartment Complex—Loss of Profits Due to Business Interruption

In the first case, damages gave rise to claimed lost profits plus extra costs the owner had to incur, a method often used in business interruption litigation. Profits expected during a damages period are compared with actual profits and expenses due to remediation are added. In this case defects were due poor roofing of a large apartment complex. Once construction defects in the project were discovered, their impacts became more pronounced, and a cascade of damages arose including the loss of income from paying tenants, an increase in vacancies, and then added costs as management sought to remediate the problems the defects were causing.

Specifically, the project was completed and occupancy grew over the following year. During winter rains, water-intrusion defects first appeared in external stairwells and minor repairs were made by the builder.

During the next two years, as the scope of the defects to the stairwells and external landings became more and more apparent, many tenants complained or moved out, and the rate of new leases fell despite a rent concession program that was already in place to increase lease rates during the winter months, traditionally slow rent periods.

Property management did not begin to capture extra repair costs incurred for another year and a full assessment of the defects was not known for two years. The following year, a systematic, building by building repair and reconstruction program began that continued for many months. During this time, vacancy rates rose as existing tenants moved out and the rate of new leases slowed.

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Tenants who stayed were granted special concessions during the time their building was under renovation. Two "swing units" were set aside during this reconstruction period for day use so that adversely impacted tenants could use those units. This happened in a few instances in which a tenant needed access to their unit during the day but could not due so because an adjacent stairwell or hallway was being repaired. Access to all units was made each night however. As a result, in this case, no tenants were relocated off the property because no repairs were inside units.

After the reconstruction period ended, rent losses continued because it took many months and special efforts to bring occupancy back to the level it would have been "but for" the disruption caused by the construction defects.

The economic damage began once the defect interrupted the enjoyment and use of the property. Damages expanded in many ways during the reconstruction period and they continued well after the construction defects had been repaired. Economic damages lingered due to both excess vacancies and reduced lease rates. Some leases made with concessions during reconstruction could not be raised to normal rates until the following year when the lease contracts expired.

The case illustrates the types of damages that need to be identified, investigated and documented. This case was relatively simple. In general, "but for" profits were compared and contrasted with actual profits and further consideration given the costs of gifts, swing space, extra marketing, and related special factors. Damages assessment also made adjustments for local economic conditions, normal vacancies, economic trend, and seasonality. These cases can become very complex especially if relocation of numerous residential tenants or commercial business operations is involved.

Case 2: Housing development—Claimed Loss of the Housing Value

In another case, poorly-installed windows in a housing development led to a claim of lost home values against the builder by some homeowner plaintiffs who lived in the development. Preliminary analyses of plaintiffs' sold houses did find a loss in average value. However, these preliminary results did not hold up with more rigorous analysis. County tax records for all single family detached homes sold between 1988 to 2007 in the geographic area of interest were obtained. Next, a "repeat sales methodology" was used to measure change in prices of given homes. This method uses multiple regression methods to measure home price changes, an accepted approach published in the *Journal of Real Estate Finance and Economics* and popularized by the "Case-Shiller Home Price Indexes." Once controls were added for trend, non-plaintiffs in the development, home price changes for plaintiffs who sold was not significantly below home prices for others.

Critical Communications Before and During Trial

Real estate construction cases can be very complex. Lawyers for both sides may have to engage and rely on the testimony of a host of experts. The expert list for each side may include contractors, designers, architects, plumbers, electricians, mold specialists, soil engineers, and financial experts. An experienced financial expert typically draws on the other experts' work and provides a summary opinion regarding repair costs, lost rents (or value), and other damages.

Communication and timing issues usually requires people to come together often. This involves scheduling of the real property owners, the residential and commercial property tenants, the various repair and reconstruction contractors, their attorneys, and the experts they engage to prepare for the case. Often a "special master" provides this coordination.

Coordination and information-sharing thus becomes very important to successful outcomes. Clear, ongoing lines of communication are absolutely critical. Simplifying data so the jury can understand can make a huge difference at trial.