Assessing Damages Arising from Construction Defects

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In this article, the author discusses the key issues determining business interruption losses: when construction defects are realized, and the time and cost to repair.

Defects that were introduced during construction can lead to classic legal disputes between owners and contractors in which considerable sums of money are involved. It all begins when the defects are first discovered. This becomes the starting point for the analysis of when economic damages begin, who is impacted, how much disruption to fix the problem, and for how long, and the time it takes to resume normal operations.

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 revenue plus additional costs incurred by the owner, a model often used in business interruption litigation. The actual profits plus expenses due to remediation are totaled and compared to the profits projected from a prior period. In this case, defects mainly consisted of poor roofing of a large apartment complex. Once the defects 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 caused by the defects.

Specifically, here is how it happened. The construction of the apartment complex had been completed. Tenants moved in and occupancy grew over the following year. During winter rains, water-intrusion defects first appeared in external stairwells. Minor repairs were made by the builder.

Over 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 number of new leases decreased. This decrease occurred in spite of a rent concession program already in place to increase lease rates during the winter months.

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 reconstruction for day use by adversely impacted tenants (NOTE: such units were provided free to impacted tenants increasing the economic damages from lost rents). This happened when a tenant needed to access their unit during the day but could not do so, because an adjacent stairwell or hallway was being repaired (access to all units was made available each night). In this case, no tenants were relocated off the property because no repairs took place 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. Lingering economic damages included 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.

This case, while relatively simple, illustrates the types of damages that need to be identified, investigated, and documented. The "but for" profits were compared and contrasted with actual profits, with further consideration given to the costs of gifts, swing space, extra marketing, and related special factors. Damages assessment also included adjustments for local economic conditions, normal vacancies, economic trend, and seasonality. These cases can become complex if the relocation of numerous residential tenants or commercial business operations is involved. Also, because rent rates typically set for a year, concessions made during repair phase can prolong damages until normal rates resume.

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 homeowners. Preliminary analyses of the plaintiffs' sold houses did find a loss in average value. However, these preliminary results did not hold up with more rigorous econometric analysis. County tax records for all single family detached homes sold between 1988 and 2007 in the geographic area of interest were obtained. Next, a "repeat sales methodology" was used to measure change in prices of given homes using multiple regression equations 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 and non-plaintiff homes in the development, the home price changes for plaintiffs who sold was not significantly below home prices for others.

Critical Communications Before and During Trial

As noted, construction cases can be very complex. Lawyers may have to engage a host of experts. The expert list for each side may include contractors, designers, architects, plumbers, electricians, mold specialists, soil engineers, and financial experts. (One case involving repairs of a facility for dementia patients also required health care 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 require those involved to meet frequently in person or virtually. 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. Simplifying data so the jury can understand can make a huge difference at trial.

ADDENDUM

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Examples of construction defect cases include the following:

- Failure to provide an adequate moisture seal under a large manufacturing facility of hi-tech equipment (compromised integrity of manufacturing precise equipment)
- Failure to note the new hospital for dementia patients was constructed atop an earthquake fault line (it led to cracks in exterior walls of the facility)
- Failure to prevent water leaks and mold in a new condominium (many units unfit for occupancy)
- Failure to prevent water intrusion around windows in a housing development (created claim of lost value of re-sales)

In each case, determining economic damages meant working closely with a multi-discipline team, typically headed by an engineer. Damages in these cases included special and costly adjustments such as temporary relocation of dementia patients during hospital reconstruction, and special expenses (gift certificates and lease rate discounts) for new or existing condo tenants. Financial remedies can be significant in such cases and the damages expert must be thorough and precise. Moreover, it is net economic loss that is measured, so a comparison with normal lease rates, normal vacancy rate, and adjustments for external factors generally captured by seasonality and trend is needed.