IN-PACTUM

• Universidade Católica de Pernambuco •

CATÓLICA DE PERNAMBUCO

Produção e edição: Mariana Oliveira (DRT 3381)

Diagramação e arte: Luiz Arrais (DRT 3054)

Revisão: Maria Helena Pôrto

Tiragem: 200 exemplares

Impressão: C C S Gráfica

REVISTA JURÍDICA IN-PACTUM, Universidade Católica de Pernambuco, ano 1, n.1, (2008). Recife : Fundação Antônio dos Santos Abranches, 2010-

Quadrimestral, atualmente Semestral

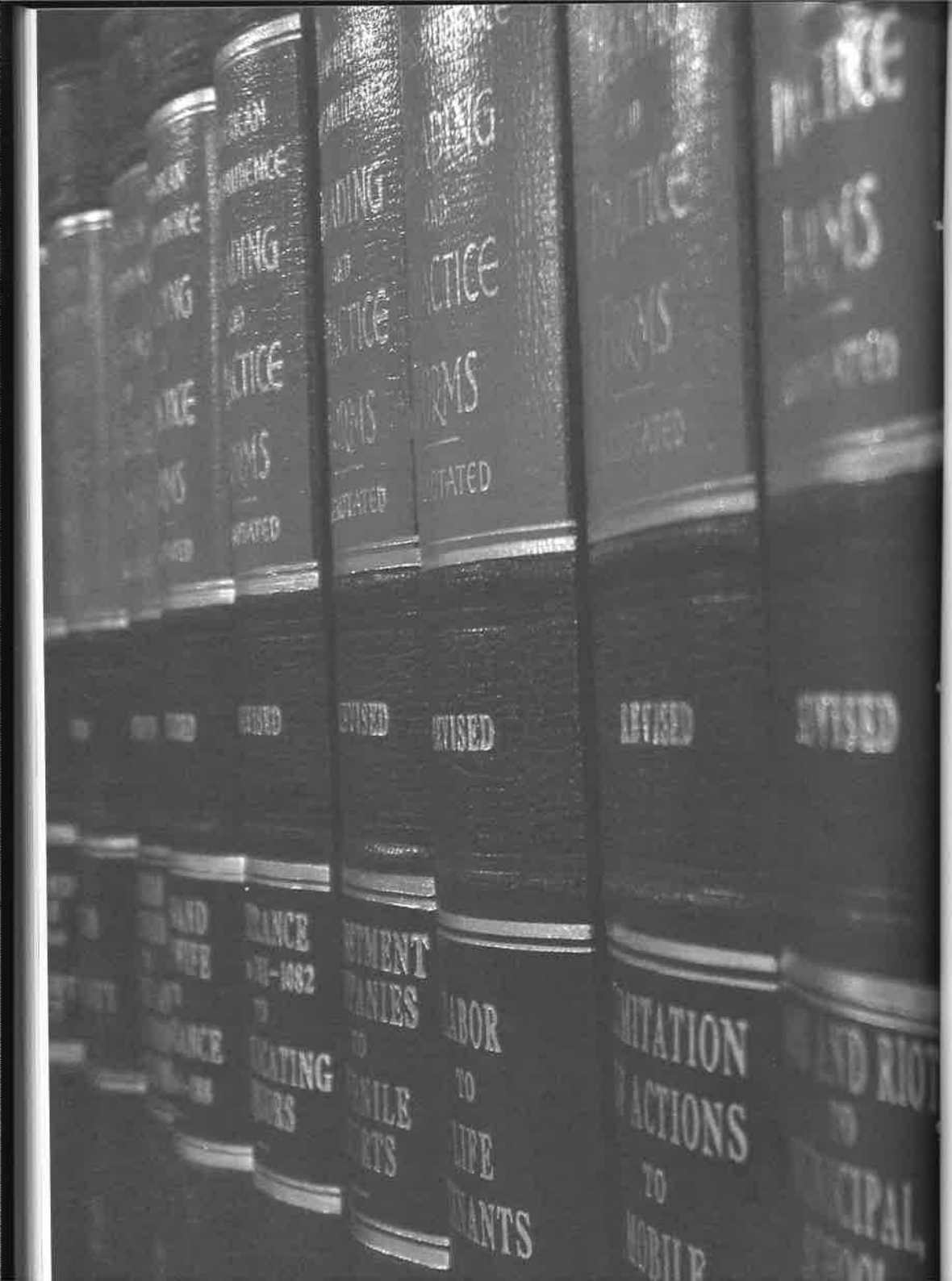
ISSN 1984-3399

1. Direito - Periódicos. 2. Ciências Jurídicas - Periódicos
I . Universidade Católica de Pernambuco - Periódicos

CDU 34

Revista jurídica *In-Pactum*
publicação semestral da Universidade Católica de Pernambuco
ano III – nº 6

Sumário



PRINCE SAPRAI[1]

Measuring expectation damages

SUMMARY:

1.Introduction. 2. Expectation Damages. 3.Diminution in Value or Cost of Cure? 4. *Jacobs & Young v Kent*. 5. *Ruxley Electronics and Construction Ltd v Forsyth*. 6. Conclusion

ABSTRACT:

This short article sets out the nature and role of expectations damages in contract law. I show that there are different measures of expectation damages, in particular 'diminution in value' and 'cost of cure' and that choosing between these measures is in cases of defective performance a difficult task. I demonstrate this by considering two leading cases on the award of expectation damages in defectively performed building contracts, the first is from the US: *Jacobs & Young v Kent*, and the second from the UK: *Ruxley Electronics and Construction Ltd v Forsyth*. I argue that these cases explain in a principled manner why in cases where the breach of contract is minor cost of cure is an inappropriate measure of expectation damages.

KEYWORDS:

Expectation damages. Defective performance. Diminution of value. Cost of Cure. Loss of amanity.

1 Introduction

As every law student knows, expectation damages are the primary remedy for breach of contract. In this short article I will set out what expectation damages are. I will also show that there are two different measures of expectation damages: diminution in value and cost of cure, and

that in some cases of defective performance it can be difficult to determine which measure is the most appropriate to award to the victim of a breach of contract. I will then set out and discuss two cases, one from the US and the other the UK, which I will claim offer a principled way forward for determining which measure of expectation damages should be awarded in cases of defective performance.

2 Expectation Damages

It is a basic aim of contract law to uphold agreements. One way that it achieves that aim is through its damages regime. As every law student knows, the purpose of damages for breach of contract is to protect the expectations of contracting parties, i.e., to put them into the same financial position that they would have been in had the contract been performed.[2]

So, for example, if I enter into a contract with you to buy your iPod for $100, and then you in breach of contract sell the iPod to someone else, you now have a duty to pay me 'expectation damages'. These damages require you to put me into the financial position that I would have been in had you performed your contract. Had you performed I would now be the owner of an iPod, the market value of which is say $200. Therefore, assuming that I have already paid you the $100 for your iPod, you have a duty to pay me $200 in expectation damages so that I can be put into the financial position I would have been in had you not breached.

By awarding expectation damages contract law upholds the security of transactions. It means that the promisee can be sure that if there is a breach by the other party she will at the very least be put into the same financial position as she would have been in had the contract been performed. In most cases, that provides people with as much assurance as they need to safely enter into contracts.[3]

3 Diminution in Value or Cost of Cure?

Although the notion of expectation damages seems to be relatively

2 *Robinson v Harman* (1848) 1 Exch 850, 855; 154 ER 363, 365.

3 D Kimel, *From Promise to Contract: Towards a Liberal Theory of Contract* (Hart Publishing, Oxford 2003) 101.

straightforward, in some cases it is by no means clear how to measure expectation damages. This is particular so in cases of defective performance. So, eg, imagine that instead of selling your iPod to someone else, you perform your contract with me. However I discover that the iPod is defective in some way, eg, the sound quality is not what it should be. In this context, it's unclear what the measure of expectation damages should be.

There are two options. The first is called the 'diminution in value' measure. According to this, we should compare the market value of the defective iPod with the market value of a non-defective iPod and award the difference as damages to the buyer. So, if the market value of the defective iPod is say $50 and a non-defective iPod costs $200, then you have a duty to pay me $150 (the difference) to make up financially for the losses that you have caused me because of your defective performance. The sum represents the diminution or reduction in value caused by your breach. Had you performed as promised, i.e., provided me with a non-defective iPod, I would be the owner of a product worth $200. As it is, I am $150 worse off compared to the financial position that I would have been in had the contract been performed.

However, this is not the only way to measure expectation damages in this context. The second option is to look not at the diminution in value, but rather at what is called the 'cost of cure'. It may be that it would cost $75 to have the defective iPod repaired. If that is the case, you could be required to pay $75 in damages to me, enabling me to then get the iPod repaired. If once I receive the damages, I do use the sum to get the iPod repaired I will be put into the position I would have been in had the contract been performed, i.e., I will own a non-defective iPod which is valued at $200 on the open market.

Although both measures of expectation damages achive the same result, i.e., they both put me into the same financial position I would have been in had the contract been performed, it is clear that neither party is going to be indifferent as to which measure is awarded. I am going to prefer to get damages for diminution in value ($150), in that way I can pay $75 to have the iPod repaired and keep the other $75. You are going to prefer to pay cost of cure damages, which here represent the lesser sum ($75).

Which of these two measures of expectation damages the courts should award for breach is a difficult but profoundly important question.

It arose in the context of two hugely significant cases concerning buildings contracts.

4 *Jacobs & Young v Kent*

The first case, *Jacobs & Young v Kent*, is from the United States.[4] A building contractor was bound to build a house using 'Reading' pipes. The house was constructed but the builder did not use Reading pipes. Instead, a different brand of pipes was used which were for all practical purposes identical to Reading pipes. The builder could not remedy the defect by simply substituting the correct pipes; that would have involved the very costly process of knocking down parts of the house. The defendant owner of the property refused to pay on the basis that, by using the wrong pipes, the builder had breached.

Cardozo J held that the breach was 'unintentional and trivial', and that the builder could make up for it not by paying the cost of cure or replacement, 'which would be great' and 'grossly and unfairly out of proportion to the good to be attained', but by paying the diminution or difference in value between the Reading pipes and the pipes that were actually used, which as it happened was 'nominal or nothing'.[5]

However, McLaughlin J issued a powerful dissenting judgment (with which Pound and Andrews JJ concurred). McLaughlin J argued that allowing the builder to get away with paying the difference in the value between the two pipes disrespected the sanctity of contract:

> The defendant had a right to contract for what he wanted. He had a right before making payment to get what the contract called for. It is no answer to this suggestion to say that the pipe put in was just as good as that made by the Reading Manufacturing Company, or that the difference in value between such pipe and the pipe made by the Reading Manufacturing Company would be either 'nominal or nothing'. Defendant contracted for pipe made by the Reading Manufacturing Company. What his reason was for requiring this kind of pipe is of no importance. He wanted that and was entitled to it. It may have been a mere whim on his part, but even so, he had a right to this kind of pipe, regardless of whether some other kind, according to the opinion of the contractor, or experts, would have been 'just as good, better, or done just as well'.[6]

4 *Jacobs & Youngs v Kent* 129 NE 889 (NY Ct of Apps 1921).

5 ibid., 891.

The logic of McLaughlin J's reasoning requires that cost of cure is the appropriate measure of damages for a breach of this kind, and not, as Cardozo J argued, diminution of value.

However, I would contend that, despite appearances, McLaughlin J's reasoning does not sustain the conclusion that cost of cure is the appropriate measure of expectation damages in this kind of case. McLaughlin J's argument is premised on a concern for the defendant's autonomy, or his freedom to enter into whatever contract he desires. If he contracted for Reading pipes then that is what he is entitled to have. The logic of this reasoning is that cost of cure enables the defendant to get what she wanted, whereas a diminution of value measure would mean that the defendant is stuck with pipes that she did not desire.

However, Dori Kimel has shown that an autonomy-based argument of this kind is unsatisfactory. The reason is that the autonomy interest at stake in this case was a trivial one: a person's desire to have Reading pipes, rather than another brand of pipes which were for all practical purposes identical.[7] Given this, it would be out of all proportion to the trivial nature of the autonomy interest at stake to award as damages the significant costs of curing this minor defect.

Another way of putting this would be that if cost of cure were to be awarded it would significantly overcompensate the defendant. The reason is that due to the trivial nature of the autonomy interest at stake, the defendant's loss from the breach of contract is nominal. In all other respects, the builder has substantially performed the contract. The defendant has been put into the financial position he would have been in had the contract been performed.

In that context, it would overcompensate the defendant to award cost of cure. Were cost of cure awarded, the defendant would own the house *and* have the money needed to knock down and rebuild it. According to the law as it stands the defendant need not spend any of that money on replacing the pipes, and would therefore be left with a windfall. Such a result goes against the very purpose of expectation damages, which is to

6 ibid., 892.

7 Dori Kimel, *From Promise to Contract: Towards a Liberal Theory of Contract* (n 2) 128-129.

put the parties into the financial position that they would have been in had the contract been performed.[8] The result of awarding cost of cure would be that the defendant is placed in a much better position financially than he would have been in had the contract been performed. To avoid that result, the appropriate measure of damages should be diminution of value.

5 *Ruxley Electronics and Construction Ltd v Forsyth*

The second case in which the issue of the appropriate measure of expectation damages arose is the English decision of the House of Lords in *Ruxley Electronics and Construction Ltd v Forsyth*.[9] The case concerned a contract to build a swimming pool in the defendant's garden, which stipulated that the pool should be seven feet six inches. The claimants in breach of contract built a pool that was six feet nine inches. The shallower pool was still safe for diving. It was also worth the same as the contractually specified pool would have been, and therefore there was no diminution of value. The question for the House of Lords was whether the defendant could recover damages for the cost of rebuilding the pool, which would have amounted to £21,560.

It was held that he could not for exactly the same reasons that motivated the Court in *Jacobs & Young*. To award cost of cure would have been over-compensatory given the loss that the defendant actually suffered.[10] To award cost of cure would take no account of the fact that the defendant has actually received most of what he bargained for. Given this, his loss is less than it would have been had the claimant refused to perform at all. Therefore, damages should only be for that loss, and not the loss that would be occasioned by a complete failure to perform. In the words of Lord Jauncey:

> ... in the present appeal the respondent has acquired a perfectly serviceable swimming pool, albeit one lacking the specified depth. His loss is thus not the lack of a useable pool with consequent need to construct a new one. Indeed were he to receive the cost of building a new one and retain the existing one he would have recovered not compensation for loss but a very substantial gratuitous benefit, something which damages are not intended to provide.[11]

8 It would also for this reason violate the harm principle. ibid 101-104.

9 [1996] AC 344 (HL).

10 M Chen-Wishart, *Contract Law* (2nd edn OUP, Oxford 2005) 531.

Therefore, as in *Jacobs & Young*, the justification for refusing to award cost of cure rests in the fact that in this context this measure of expectation damages would not protect the claimant's expectations, or put them into the position that they would have been in had the contract been performed, but rather overcompensate them and put them into a far better financial position than they would have been in had the contract been performed.

It could be argued that a refusal to award cost of cure takes no account of the defendant's subjective preference for a deeper pool. However, the Court recognised that this preference was a non-pecuniary loss that could be compensated for without the need to award cost of cure damages. Instead, the Court awarded £2,500 as damages for 'loss of amenity' to reflect the non-pecuniary loss suffered by the defendant because of the frustration of his subjective preference for a deeper pool. This is a third kind of measure of expectation damages.

Of course, it may be difficult to know what sum to award for these non-pecuniary losses. However, this worry is mispaced, as Lord Mustill said in the case: 'in several fields the judges are well accustomed to putting figures to intangibles, and I see no reason why the imprecision of the exercise should be a barrier, if that is what fairness demands'.[12]

An obvious criticism of the decision is that loss of amenity damages fail to protect the defendant's interest in the performance of the contract that was actually agreed. However, this kind of criticism fails to attach any weight to the fact that in this case the defendant did actually receive most of what he bargained for, i.e., a serviceable pool. Performance is a matter of degree. Given that the claimant had to a large extent performed the contract, the defendant's interest in performance related only to the issue of the depth of the pool. That non-pecuniary interest could be protected by the payment of relatively modest damages for loss of amenity. To award cost of cure would be as Lord Mustill rightly said 'wholly disproportionate to the non-monetary loss suffered' by the defendant.[13]

11 *Ruxley Electronics and Construction Ltd v Forsyth* (n 8) 358.

12 ibid., 361.

13 ibid.

This is not to say that cost of cure should never be awarded. Cost of cure may be required where there is a substantial failure to perform.[14] The claim is only that in cases such as *Jacobs & Young* and *Ruxley* there is no substantial failure, and therefore no need from the point of view of protecting expectations to award cost of cure. Where there is non-pecuniary loss, that loss can be compensated for by the more modest 'loss of amenity' measure of damages. However, the fact that performance deviates from contractual specifications does not necessarily mean that there will be non-pecuniary loss, in *Jacobs & Young* no award of loss of amenity damages was contemplated because the fact that the pipes were not Reading pipes did not cause *any* loss, whether pecuniary or non-pecuniary.[15] The existence of non-pecuniary loss depends on the facts of the case.

6 Conclusion

I have shown that there are different measures of expectation damages for breach of contract: diminution of value, cost of cure and loss of amenity. Deciding which measure is most appropriate in a particular case can be very tricky. However, that decision is made easier if we keep in mind that the ultimate aim of damages for breach of contract is to put the contracting parties into the financial position that they would have been in had the contract been performed. *Jacobs & Young* and *Ruxley* demonstrate how in certain contexts the choice of cost of cure over diminution of value and loss of amenity as the measure of expectation damages may violate the underlying principle behind awards of damages for breach of contract, which is that they should aim to compensate the promisee, and not confer a gratuitous benefit on her.[16]

Recebido em 30 de setembro de 2010.

14 ibid., 358.

15 M Chen-Wishart, *Contract Law* (n 9) 532-533.

16 *Ruxley Electronics and Construction Ltd v Forsyth* (n 8) 358.