



# Construction Damages

## The Rectification of Defects and Issues Surrounding Betterment

Defects are one of the leading causes of disputes and litigation in the construction industry. Most standard forms of contract contain provisions requiring the contractor<sup>1</sup> to rectify defects within a stipulated time period. However, given the differing viewpoints and interests of contracting parties, disagreements often arise as to what constitutes a defect, what appropriate remedial action entails, and whether betterment has been obtained. Here, FTI Consulting's Craig Ballantyne reviews case law to highlight when betterment can be accounted for and how it should be assessed.

In legal terms, a defect is a breach of contract and a common law remedy available to the innocent party is damages.

*“The governing purpose of damages is to put the party whose rights have been violated in the same position, so far as money can do, as if his rights had been observed.”<sup>2</sup>*

In a situation where rectification works have improved a property or asset in some way (i.e. it is larger, newer or has an improved specification), the opposing side will often claim that betterment has been obtained and that a deduction should be made in any award of damages.

### What is Betterment?

In construction there are two typical approaches used to assess damages. These are:

- Cost of cure
- Difference (diminution) in value

**The cost of cure** is essentially the cost of repair or reinstatement, or to put it another way, the cost of making good of the defects.

**Diminution in value** is the difference between the fair market value of a property (if the contract had been properly performed) and the fair market value of a property as built, improperly or with its defects.

In cases of defective work, the difference in market value may be problematic to determine and often construction claims are advanced on the basis of the cost of repair or reinstatement.

*“Betterment is where, following the repair or reinstatement works, the claimant has a newer or better property than they would have had but for the breach.”*

A claimant is generally entitled to the reasonable cost of making good. But what if the property or asset is improved, either because the replacement specification is enhanced, the available products are superior, or the lifecycle and maintenance requirements are improved?

In such circumstances, Keating on Construction Contracts<sup>3</sup> tells us that:

*“A deduction from the damages awarded will usually not be made for betterment if the claimant has no reasonable choice, unless perhaps this would be absurd.”*

## When Can Betterment Be Accounted For?

### 1. No reasonable choice

There are many case examples where a claimant was entitled to recover full repair or replacement costs on the grounds that there was no other reasonable course of action.

One such case is that of *The Gazelle*,<sup>4</sup> where a ship’s engine rotor was damaged in a collision. The claimant replaced the damaged rotor with a new one, thereby extending the engine’s life. The court found that the full cost of repair could be recovered without credit for betterment.

Similarly, in *Bacon v Cooper (Metals) Ltd*<sup>5</sup>, a machine known as a ‘fragmentiser’ used to crush scrap metal was damaged by the defendants who had supplied unsuitable scrap material. The damaged rotor was 3.25 years old with a life expectancy of seven years. Again, the court awarded the full repair cost.

While the above cases relate to the repair of assets, similar outcomes can be found in cases relating to the destruction of property.

In *Harbutts Plasticine Limited v Wayne Tank & Pump Co Limited*,<sup>6</sup> Harbutts engaged a contractor to supply and install equipment in its factory. The equipment proved defective and caused a fire which destroyed the factory; however, Harbutts could not rebuild to the original design due to the refusal of planning permission.

The court held that no credit for betterment was required. Widgey LJ stated:<sup>7</sup>

*“The plaintiffs rebuilt their factory to a substantially different design, and if this had involved expenditure beyond the costs of replacing the old, the difference might not have been recoverable, but there is no suggestion of this here. Nor do I accept that the plaintiffs must give credit under the heading of “betterment” for the fact that their new factory is modern in design and material. To do so would be the equivalent of forcing the plaintiffs to invest*

*their money in the modernising of their plant which might be highly inconvenient for them.”*

Lord Denning MR agreed, adding that:

*“I think they should be allowed the cost of replacement. True it is that they got new for old; but I do not think the wrongdoer can diminish the claim on that account. If they had added extra accommodation or made extra improvements, they would have to give credit. But that is not this case.”<sup>8</sup>*

This judgement also found support in the case of *Dominion Mosaics and Tile Co Ltd v. Trafalgar Trucking Co Ltd*.<sup>9</sup> Here, the claimant’s premises were also destroyed by fire because of the defendant’s negligence. As rebuilding the premises was not a viable option and in order to maintain business operations, the claimant acquired a 36 year lease of another building which had 20% more floor space. The fire also destroyed some nearly new machinery bought by Dominion for a reduced price of £13,500; it was estimated that the machines would cost £65,000 to replace. Dominion had not replaced the machines but claimed £65,000. Dominion was successful in both claims.

In light of these authorities, the commonly held interpretation had been that credit need not be given for betterment when replacing old with new where the claimant had no reasonable choice but to do as he did. In this regard, no reasonable choice would appear to extend to a need to reconstruct to continue business operations or to replace with new where there is no second-hand market for goods.

A clear distinction can be shown in cases where a party has acted through choice. If a claimant rebuilds to a higher standard than strictly necessary through choice then a deduction for betterment would normally be applied.<sup>10</sup>

### 2. Absurdity (reasonableness)

An alternative view of loss evaluation was put forward in the more recent case of *Voaden v Champion*,<sup>11</sup> a case known as the “Baltic Surveyor”. The judge in this case laid down a test of reasonableness that ought to be applied when assessing the proper measure of damages.

The approach is set out in paragraphs 85 to 89 of the judgement, with the main points summarised below.

1. Cases where a claimant recovers more than he has lost, as may happen where betterment occurs without deduction, ought only to occur in exceptional cases.

2. The exceptional cases envisaged are situations where the betterment claimed has conferred no corresponding advantage to the claimant.<sup>12</sup> Though a property may be newer or moderately larger than that which it is replacing, the betterment may give the claimant no advantage.
3. If it can be demonstrated that, for example, a larger property size (or some other aspect of betterment) does confer a monetary advantage to the claimant then this should be considered.<sup>13</sup>
4. Where there is no second-hand market, betterment will often arise because there is no market mechanism for measuring loss. The test of reasonableness has an important role to play and goes further than the suggestion that replacement with new must be absurd for it to be rejected as a measure of loss. Where an item is old and coming to the end of its life the measure of loss should not be replacement with new (even if no second-hand market exists). Damages should also not be measured as replacement with new where it would not be reasonable to do so.
5. The basic principle is not to physically replace what the claimant has lost but to replace it financially (making the claimant whole in financial terms). The proper approach requires a fact-specific review of what the claimant has lost and an attempt to put a figure on it as best as one can.

### How Can Betterment Be Assessed?

There are three common examples of financial benefit obtained following rectification:

1. The property is larger.
2. The property is newer (“new for old”).
3. The specification has been improved.

But when should credit be given and how should it be assessed?

In construction cases, the courts have tended to rely on the opinion of quantum experts when assessing betterment deductions and it is not always possible to identify the basis of the assessment from the judgement.

Some examples of how the courts have approached betterment are provided below.

#### Larger property

In *J Sainsbury v Broadway Malyan, Ernest Green Partnership Ltd*,<sup>14</sup> the claimant had rebuilt their premises which had been destroyed by fire. The sales area was larger following rebuilding (by 105m<sup>2</sup> out of 6,391m<sup>2</sup>) and the court held that credit must be given.

The court accepted the opinion of one of the quantum experts;<sup>15</sup> had the accommodation size been reduced (reflecting the original building size), then the cost of reconstruction could have been reduced by £150,000.

#### Newer property

In the *Baltic Surveyor*, the judge concluded that the claimant was entitled to recover damages for the value of a pontoon which had been lost at sea, which was assessed at £16,000. The basis of the assessment was that a replacement pontoon would cost £60,000 and would have a life of 30 years; however, since the old pontoon had just eight remaining years of life expectancy, he awarded 8/30ths of £60,000.

In the Scottish Case of *Anderson & Ors v International Oil Pollution Compensation Fund*,<sup>16</sup> the claimants alleged that the defendants caused damage to their asbestos cement roof while using dispersants to treat an oil spill from a tanker. The court awarded the replacement cost of the roof subject to a betterment deduction.

It was held that betterment should be calculated on the basis of a serviceable life of 55 years despite evidence that manufacturers of this material guaranteed it for only 30 years. The basis of assessment adopted by the court was:<sup>17</sup>

*“Taking X to represent the cost of repair at the valuation date and Y to represent the age of the property in years at the same date, I would assess the value of each claim, after deduction for betterment, by the following formula:*

$$\frac{X(55-Y)}{55}$$

This assessment method would also lead to the same result as the approach adopted in the *Baltic Surveyor*.

#### Improved specification

In *Tonkin & Anor v UK Insurance Ltd*,<sup>18</sup> a betterment deduction was made from the damages awarded in relation to the reinstatement costs of an old barn destroyed by fire as several improvements in specification were made, including:

- Uninsulated brick flooring replaced with insulated oak flooring;
- Additional dry lining and insulation to walls;
- Roof insulation provided which was not there previously;
- Central heating system added; and
- Single glazed windows replaced with double glazed windows.

In *Twinmar Holdings Ltd v Klarius UK Ltd & Anor*,<sup>19</sup> a case concerning a dilapidations claim between a landlord and tenant of a warehouse building and offices, the entrance gates and barrier had been removed, so the tenant was obliged to reinstate them. Although the original posts for the height barrier remained in place, the claimant installed new posts and an opening height barrier. The original barrier was a rigid structure which was slotted over the posts at each end.

The courts found that the replacement barrier represented betterment; it was better because it could open and was more robust. The court awarded one third of the sum originally claimed for the replacement barrier. This was in line with the opinion of one of the experts.

In *British Westinghouse Electric & Manufacturing Co Ltd v Underground Electric Railways Co of London Ltd*,<sup>20</sup> one of the first cases to consider betterment, the turbines and alternators installed by British Westinghouse were found to be defective. They consumed more fuel, generated less power and produced more waste than the contract stipulated.

Underground Electric used the turbines for a few years and even tried to modify them to achieve better performance; however, this proved unsuccessful, and the turbines and alternators were eventually replaced with those from a different manufacturer.

The replacement turbines were more powerful and were also more efficient than the Westinghouse turbines would have been even if they had been as contracted for.

In this case the court held that credit must be given for the betterment obtained.

### Industry Examples of Calculating Betterment

A method of calculating betterment that is widely used in the utilities sector is known as the “Bacon Woodrow” formula.

The formula is intended to be used where utility replacement arises due to diversion, and it calculates the financial benefit obtained from the deferment of the time required for renewal of the utility apparatus.

The use of the formula is approved in The New Roads and Street Works Act 1991<sup>21</sup> Code of Practice for Diversionary Works.<sup>22</sup> The formula is provided in Appendix E of the Code of Practice (“CoP”) and is set out below for reference.

$$B = C \left[ \frac{(1 + R)^b - 1}{(1 + R)^L} \right]$$

- where C = Cost of undertakers' works
- R = Rate of interest
- L = Number of years of estimated full life of apparatus
- b = Number of years of expired life of apparatus
- B = Financial benefit

The financial benefit calculated is the interest saved on capital expenditure through the deferment of the time required for renewal. The results using this method of assessment can be contrasted with the calculation in the *Baltic Surveyor*. To recap, in the *Baltic Surveyor* an assessment was made of what was lost (i.e. a pontoon with eight years remaining life expectancy). This meant the plaintiff was awarded 8/30ths of the £60,000 replacement cost.

The two methods of assessment can produce very different results. Take for example, a situation where equipment was replaced that was 50 years old, had a life expectancy of 100 years and cost £500,000 to replace. The award following deduction for betterment/financial benefit derived by applying each method is set out below.

	Baltic Surveyor	Bacon Woodrow
Equipment Replacement Cost (Full Damages Valuation as Claimed)	£500,000	£500,000
Life Expectancy (years)	100	100
Remaining Life of Original (years)	50	50
<b>Deduction to be applied</b>	<b>£250,000</b>	<b>£73,497</b>
<b>Reduced Damages Valuation</b>	<b>£250,000</b>	<b>£426,503</b>

While Appendix E of the CoP relates to betterment obtained for the deferment of renewal, Appendix F (itself titled ‘Betterment’) sets out other occasions where financial benefit should be credited. The two scenarios put forward are:

- a) When increasing the capacity of the apparatus (except where due to using the nearest available size); and
- b) When using material which enhances network capability (not including material which is in present day use for the same duty).

In these examples the CoP proposes that betterment is assessed as the difference between the cost of laying the increased capacity or enhanced duty apparatus and the estimated cost of laying the same capacity or the same duty.

### Focusing on the Facts

For an award of damages to be reduced for betterment it is necessary to show that the claimant has received some form of financial benefit or advantage.<sup>23</sup> The mere fact that something is newer or larger may not be sufficient.

It should be a rare occasion that a claimant is placed in a better position than he would have been without the breach; however, exceptions will always exist. If, for example, improvements are a result of complying with statutory requirements current at the time of rectification, would it be reasonable for a damages award to be reduced?

*“It is necessary to consider what is reasonable to make the claimant whole in financial terms and this will involve a fact-specific review of what has been lost.”*

There is no one size fits all solution; when it comes to the valuation of betterment, it is left open to parties, typically through their quantum experts, to persuade the courts on the most appropriate method to apply, depending on the precise facts in each case.

**For more information on calculating betterment, please contact Craig Ballantyne on the details below.**

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## Endnotes

- 1 During the course of construction and the defects liability period
- 2 Asquith L.J. in *Victoria Laundry Ltd v. Newman Ltd* [1949] 2 K.B. 528 at 539, CA
- 3 Keating on Construction Contract 10th Edition at 9-076
- 4 (1844) 2 W Rob 279
- 5 [1982] 1 All ER 397
- 6 [1970] 1 QB 447
- 7 *Ibid*, 473B
- 8 *Ibid*, 468A
- 9 [1990] 2 All ER 246
- 10 *Richard Roberts v. Douglas Smith Stimson* (1988) 46 B.L.R. 50 at 69; see also *Tonkin & Anor v UK Insurance Ltd* [2006] EWHC 1120 (TCC) where a betterment deduction was made from the damages awarded in relation to the reinstatement costs of an old barn destroyed by fire as a number of improvements in specification were made to the reconstructed barn.
- 11 [2002] EWCA Civ 89
- 12 The exceptional cases cited are those raised earlier in this article. Namely, *The Gazelle and Bacon v Cooper* (in relation to the repair of chattels) and the *Harbutts and Dominion* cases (in relation to the destruction of buildings where replacement is necessary to prevent collapse of the business or loss of profits).
- 13 This follows the decision in *British Westinghouse v Underground Electric Railways*, where defective machines were replaced with new machines of superior efficiency.
- 14 [1998] EWHC Technology 302
- 15 The precise method of assessment is not stated.
- 16 [2001] Scots CS 34
- 17 *Ibid*, 247
- 18 [2006] EWHC 1120 (TCC)
- 19 [2013] EWHC 944 (TCC) (19 April 2013)
- 20 [1912] AC 673 (HL)
- 21 The New Roads and Street Works Act 1991 (NRSWA), supported by relevant Regulations and Codes of Practice, provides a legislative framework for street works by undertakers (including utility companies) and works for road purposes – to the extent that these must be co-ordinated by street authorities.
- 22 Diversionary works is a term associated with projects that involve utilities. Diversionary works are sometimes required to accommodate highway improvement schemes and may be used when it becomes necessary to reroute utility services.
- 23 The evidential burden of demonstrating betterment lies with the defendant see: *Oswald v Countrywide Surveyors Ltd* (1996) 50 Con. L.R. 144.