INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE MIS No.: TAM-143949-01/CC:ITA:B5

Chief, Appeals Office

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference: N/A

LEGEND:

Taxpayer =

Fastener Manufacturer =

Government Agency =

Year A =

Year B =

$A =

Period 1 =

Period 2 =

Date 1 =

Date 2 =

Date 3 =

ISSUE:

Whether liability for cover damages, damages for lost profits, inventory carrying costs, and other miscellaneous costs arising out of the breach of contracts for the sale of goods qualify as product liability within the meaning of § 172(f)(4).

CONCLUSION:

Liability for cover damages, damages for lost profits, inventory carrying costs, and other miscellaneous costs arising out of the breach of contracts for the sale of goods do not qualify as product liability within the meaning of § 172(f)(4).

FACTS:

Taxpayer acquired Fastener Manufacturer in Year A and converted it into an operating division of Taxpayer. The division designed and manufactured self-locking fasteners and fastener assemblies (fasteners). Manufacturers ultimately used some of these fasteners in the fabrication of commercial and military aircraft engines and airframes. Taxpayer sold the fasteners to the government and to other customers including fastener distributors.

Taxpayer was contractually obligated to produce fasteners sold to the government and other customers in accordance with various military and commercial specifications. These specifications included inspecting the manufactured fasteners and performing certain fastener qualify assurance tests, some of which required testing every fastener fabricated. Fasteners shipped to customers were required to be accompanied by a "certificate of quality compliance" signed by an authorized Taxpayer agent. These certificates certified that the fasteners satisfied all required specifications including that they had been properly inspected and tested and had passed all required quality assurance tests.

Prior to Period 1 Taxpayer failed to maintain records adequate to verify the proper performance of a manufacturing process required to ensure fastener strength. An internal investigation revealed that the required process was not being performed as specified in some instances. Because of inadequate records, Taxpayer could not trace the manufacturing deficiencies to particular lots.

During Period 2 Taxpayer experienced a change in top management. New management learned of possible deficiencies in the manufacture and testing of fasteners. To determine if systemic problems underlay those deficiencies, new management hired outside counsel to conduct an internal investigation.

The investigation revealed deficiencies in Taxpayer's manufacturing and testing of certain fasteners. On Date 1, Taxpayer notified Government Agency of this and Government Agency subsequently issued a statement disclosing the deficiencies. On Date 2, Taxpayer notified its customers of the problems previously disclosed to Government Agency. It also informed them that it would stop shipping certain fasteners until it was confidant that its manufacturing and testing procedures satisfied all applicable specifications. We will refer to the date when Taxpayer ceased shipping fasteners because of the manufacturing and testing deficiencies as the stop date. Prior to the stop date only a few Taxpayer manufactured fasteners failed while in use. None of the failures caused an accident or resulted in personal injury or physical property damage.

After the stop date Taxpayer tested previously manufactured fasteners for defects relating to the suspect manufacturing processes. Taxpayer also repaired (reworked) a substantial quantity of fasteners, presumably those which tests revealed to be defective. Although the facts are not entirely clear, it appears that Taxpayer tested and/or reworked fasteners in its inventory and fasteners previously shipped to its fastener distributor customers.

When Taxpayer's fastener distributor customers learned of the potential problems some or all of them stopped paying Taxpayer for fasteners previously shipped. After spending a substantial sum of money to test and/or rework fasteners, Taxpayer attempted to collect outstanding accounts receivable from the customers. Some or all of Taxpayer's fastener distributor customers resisted the collection efforts. The resisters maintained that they had suffered damages, for which Taxpayer was liable, greater than the cost to test and repair defective fasteners previously shipped to them. They also contended that these additional damages exceeded any amount due Taxpayer for the fasteners.

On Date 3, Taxpayer's primary fastener distributor customer (Primary Customer) filed a civil action against Taxpayer asserting its claim for additional damages. Primary Customer alleged the following contractual causes of action against Taxpayer: breach of contract, breach of the implied warranty of merchantability, and breach of the implied covenant of good faith and fair dealing. Primary Customer also alleged tort claims for fraud and negligent misrepresentation and in addition made some RICO claims. The tort misrepresentation claims related to allegedly false certificates of quality compliance previously furnished to Primary Customer. Taxpayer answered Primary Customer's complaint denying any liability and asserting various counterclaims.

Primary Customer claimed it incurred several types of damages because of Taxpayer's failure to timely deliver fasteners as specified in the relevant contracts. Primary Customer contended that it could not sell Taxpayer fasteners upon learning of possible problems with them. Primary Customer alleged that Taxpayer failed to test,

rework if necessary, and issue new certificates of quality compliance for certain Taxpayer fasteners that Primary Customer held in inventory, thereby keeping such fasteners unsaleable. Primary Customer asserted that it incurred additional inventory carrying costs as a result.

Primary Customer asserted that it incurred damages because of Taxpayer's failure to perform "current" and "future" contracts. The submission does not make precisely clear what is meant by "current" and "future". It appears that Taxpayer breached fastener sales contracts with Primary Customer either by failing to ship fasteners or by shipping nonconforming fasteners. Taxpayer allegedly also anticipatorily breached contracts to be performed in the future by announcing the cessation of fastener shipments.

To fulfill obligations to its customers Primary Customer procured replacement fasteners from other vendors. Primary Customer may also have entered into contracts to be performed in the future to obtain replacement fasteners from other vendors. Because of this Primary Customer incurred "cover" damages. Cover damages equal the excess of the cost of the replacement fasteners over what, in the absence of breach, Primary Customer would have been contractually required to pay Taxpayer for a like amount of fasteners. Cover damages may also include any incidental or consequential damages incurred pursuant to the cover less expenses saved on account of the breach. § 2-712 of the Uniform Commercial Code (UCC).

Primary Customer also alleged damages for lost profits. Primary Customer would incur such damages if it lost profitable sales because of the inability to obtain suitable replacement fasteners through cover. Finally, Primary Customer alleged that it incurred certain other "out of pocket" costs attributable to Taxpayer's breaches including the cost of temporary employees, travel, overtime, legal representation, and accounting fees.

Several other fastener distributor customers of Taxpayer alleged similar types of claims against Taxpayer without instituting formal legal action. Henceforth, we will refer to Primary Customer and this group of customers as the claimants. The submission indicates that Taxpayer has not provided adequate documentation for all of these claims. However, it appears that Taxpayer entered into settlement agreements with each of the claimants under which it neither admitted nor denied the claimant's allegations but agreed to be liable for the amounts at issue in this memorandum. Taxpayer paid a significant amount of the settlements by writing off trade receivables from the claimants. Taxpayer also made a significant cash payment to Primary Customer.

Taxpayer asserts that any cash payments and any accounts receivable writeoffs attributable to the settlements occurred during Year B. Taxpayer incurred a net

operating loss (NOL) for Year B. Deductions attributable to the settlements[1] generated a portion of the NOL that Taxpayer claims qualifies as a product liability loss as defined in §172(f)(1)(A).

LAW AND ANALYSIS:

The Statute and Regulations

Section 172(a) provides for a deduction equal to the amount of the NOL carryovers and carrybacks to the taxable year. The portion of an NOL that qualifies as a specified liability loss may be carried back 10 years rather than being limited to the normal 3-year carryback period provided in §172(b)(1)(A)(i).

Section 172(f)(1)(A) defines a specified liability loss in part as the sum of the following amounts to the extent taken into account in computing the NOL for the taxable year:

> Any amount allowable as a deduction under § 162 or § 165 which is attributable to–
>
> > (1) product liability, or
> >
> > (2) expenses incurred in the investigation or settlement of, or opposition to, claims against the taxpayer on account of product liability.

Section 172(f)(4) defines product liability as:

> (1) liability of the taxpayer for damages on account of physical injury or emotional harm to individuals, or damage to or loss of the use of property, on account of any defect in any product which is manufactured, leased, or sold by the taxpayer, but only if
>
> (2) such injury, harm, or damage arises after the taxpayer has completed or terminated operations with respect to, and has relinquished possession of, such product.

Section 1.172-13(b)(2)(i) of the Income Tax Regulations largely echos the definition of product liability provided in the statute. Section 1.172-13(b)(2)(ii) expands

[1] The actual amount claimed as a product liability loss exceeded the amount of the reported settlements. The reason for this discrepancy should be determined.

upon that definition by providing that the term “product liability” does not include liabilities arising under warranty theories relating to repair or replacement of the property that are essentially contract liabilities. The regulations further provide, however, that a taxpayer’s liability for damage done to other property or for harm done to persons that is attributable to a defective product may be product liability regardless of whether the claim sounds in tort or contract.

Congress first enlarged the carryback period for NOLs attributable to product liability (product liability losses) in the Revenue Act of 1978. This enactment constituted part of a congressional response to a perceived business crisis arising from product liability claims, including an inability to obtain product liability insurance at reasonable prices. Congress provided a larger carryback period for product liability losses because product liabilities tend to be large and sporadic. The expanded carryback period reduces the likelihood that a large product liability loss will exceed taxable income during the carryback period. Staff of the Joint Committee on Taxation, 95th Cong., *General Explanation of the Revenue Act of 1978* 232 (Comm. Print 1979). Taxpayers receiving tax refunds attributable to the larger carryback period could also use those funds to pay product liability claims. 124 Cong. Rec. 34,733 (1978).

When Congress defined product liability for § 172(f) purposes, as now, product liability constituted a dynamic, somewhat confusing, and evolving area of the law. Product liability law exhibited differences among the states. The Conference Report to the 1978 Act provides the following comments regarding state law and the federal tax definition of product liability:

> The definition of product liability ... is intended to include the kinds of damages that are recoverable under prevalent theories of product liability. The laws of the several states regarding product liability are not uniform, but it is believed that the definition of product liability provided in the amendment is sufficiently broad to encompass the kinds of damages that may be recovered under product liability theories in most states. If a type of injury or damage [is] included within the definition of the amendment (such as emotional harm without physical injury) it is to be considered a product liability loss (assuming it otherwise qualifies) even though it may not be recoverable under State law.

H.R. (Conf.) Rep. No. 1800, 95th Cong. 2d Sess. 286-87(1978). Consistent with the legislative history, § 1.172-13(b)(2)(iii) clarifies that for § 172 purposes the federal tax definition of product liability controls rather than state law.

This does not mean that state product liability law has no place in determining the scope of product liability for federal income tax purposes. On the contrary, the legislative history clearly indicates that Congress intended the federal definition to include damages recoverable under prevalent product liability theories. These theories are necessarily creatures of either state or non-tax federal law. Likewise, the federal tax definition of product liability contains, but does not define, certain terms of art such

as “defect”. The only reasonable inference is that Congress intended such terms to be interpreted as generally understood under state and federal product liability law. An examination of the evolution of this law will prove useful in interpreting the federal tax definition of product liability.

A Brief History of Product Liability

“Product liability”, a term of recent vintage, always includes damages caused by defective products for personal injuries and damage to tangible property other than the product itself. Depending on the jurisdiction, the term may also include other types of damages such as damage to the product itself. Product liability may be asserted as a variety of causes of action, the most usual being negligence, breach of express or implied warranty, and strict liability in tort. To a lesser extent product liability claims have also been asserted as fraud claims or other causes of action involving misrepresentation. Plaintiffs usually allege several causes of action in product liability complaints.

Product liability law initially evolved in response to perceived inadequacies in then existing law in the context of personal injuries caused by defective products. At one time a person injured by a defective product generally had a cause of action against the product’s manufacturer if the defect resulted from the manufacturer’s negligence, but only if the person was in privity of contract with the manufacturer with respect to the sale of the injury-causing product. The privity of contract requirement often foreclosed bringing a cause of action for personal injury against manufacturers of defective products sold through retailers.

Courts eventually developed exceptions to the privity of contract requirement. Finally, in *Macpherson v. Buick Motor Co.*, 111 N.E. 1050 (N.Y. 1916) Justice Cardozo expanded the primary exception to the privity of contract rule so broadly that it effectively swallowed the rule. Notwithstanding elimination of the privity requirement, plaintiffs injured by defective products still often found it difficult to prove manufacturer negligence in designing or manufacturing a product. It was even more difficult to establish negligence on the part of either the retailer or wholesaler of the product.

Concurrently with the evolution of the negligence cause of action a trend developed to recognize and expand the scope of breach of an implied warranty as a basis for recovery for personal injuries caused by defective products. Nevertheless, a cause of action based on breach of implied warranty did not prove to be an adequate solution in all cases involving personal injury from defective products. To deal with these shortcomings and the inadequacies of the negligence cause of action, and to place the risk of injury on the parties best in a position to bear such risks, courts eventually crafted a new tort cause of action based on strict liability.

In *Greenman v. Yuba Power Products, Inc.*, 377 P.2d 897 (Cal. 1962) the plaintiff was injured when a power tool he was using malfunctioned causing a piece of

wood to hit him in the head. His wife purchased the tool from a retailer and gave it to him as a gift. At trial the plaintiff introduced substantial evidence that the manufacturer's defective design and construction of the tool caused his injuries. Under the circumstances the court concluded that the manufacturer could be held liable in the absence of a contractual warranty or proof of negligence:

> A manufacturer is strictly liable in tort when an article he places on the market, knowing that it is to be used without inspection for defects, proves to have a defect that causes injury to a human being. ... To establish the manufacturer's liability it was sufficient that plaintiff proved that he was injured while using the [tool] in a way it was intended to be used as a result of a defect in design and manufacture of which plaintiff was not aware that made the [tool] unsafe for its intended use.

Id. at 900-01.

Shortly after *Greenman* was decided, the drafters included the principle of strict products liability as part of the RESTATEMENT (SECOND) OF TORTS (1965). If certain conditions are met, § 402A of that restatement provides that one who sells a product in a defective condition unreasonably dangerous to the user or consumer or to his property is subject to liability for physical harm thereby caused to the ultimate user or consumer, or to his property. Section § 402A became part of the law of many states following its promulgation.

Throughout the history of product liability courts have generally treated physical injury caused by a defective product to property other than the product itself akin to a personal injury. See *e.g. United States Radiator Corporation v. Henderson*, 68 F.2d 87 (10th Cir. 1933), *cert. denied*, 292 U.S. 650 (1934) (where plaintiff's house was destroyed by fire attributable to defective boiler plaintiff had valid negligence cause of action against boiler's manufacturer notwithstanding absence of privity of contract—*MacPherson* rule applied to property damage); *Largoza v. General Electric Co.*, 538 F.Supp. 1164 (E.D. Pa. 1982) (Pennsylvania law permits tort recovery under strict product liability theory where only physical property damage is caused by a defective product). *Todd Shipyards Corp. v. United States*, 69 F.Supp. 609, 610 (D. Me. 1947) ("there is no reasonable ground for making a distinction between injury to property and injury to the person").

The Economic Loss Rule

Economic damages, also known as pecuniary damages, in the broadest sense include damages that may be objectively determined based on applying known rules of calculation to reasonably objective data. The data may include a combination of existing facts and reasonable estimates of events that will occur in the future. An

example of such damages includes lost past and future wages attributable to a personal injury.

In the context of product liability courts ascribe a more limited meaning to the term “economic damages” also referred to as economic loss. In that context various courts have defined the term differently. It has been defined as “the loss of the benefit of the user’s bargain, that is, the loss of the service the product was supposed to render, including loss consequent upon the failure of the product to meet the level of performance expected of it in the consumer’s business.” 63B Am. Jur. 2d *Product Liability* § 1909 (1997).

Economic damages attributable to a claim that does not involve either personal injury or property damage constitutes a “pure economic loss”. Courts have often dealt with the question of whether such damages associated with a product may be recovered through a cause of action based on negligence or strict products liability. These cases often arise when plaintiffs allow the statute of limitations to expire on any breach of contractual warranty claim they might have and are forced to timely assert tort causes of action in an attempt to recoup their damages.

With some exceptions, courts generally have concluded that no valid negligence or strict products liability cause of action exists for the recovery of purely economic losses associated with a product. *Id*. § 1913-14. This is the economic loss rule.

In contrast to parties to commercial sales transactions with relatively equal bargaining power, consumers often have little practical bargaining power in dealing with manufacturers or retailers. Some courts have applied the economic loss rule specifically to transactions between commercial parties. Thus, these courts have left open the possibility of holding that a noncommercial buyer could recover in tort for a purely economic loss tort. *Id*. § 1917; Compare *Santor v. A.& M. Karagheusian, Inc.*, 207 A.2d 305 (N.J. 1965) (consumer purchaser allowed to recover in tort for qualitative defect in carpeting–facts predated adoption of UCC by New Jersey) with *Spring Motors Distributors v. Ford Motor Co.*, 489 A.2d 660 (N.J. 1985) (corporate buyer could not recover in tort for economic loss attributable to faulty transmissions in trucks used for commercial purposes).

A product defect may result in damage only to the product itself. If so the issue arises whether the damage may qualify as property damage for product liability purposes. Some courts view damage to the product itself, no matter how caused, as economic loss recoverable only through contractual remedies. Many courts, however, treat damage to the product itself as property damage in specified circumstances. These courts generally engage in what has been called a risk of harm analysis in determining whether harm a product causes to itself constitutes property damage or economic loss. Am. Jur., *supra.* § 1918; *Bellevue South Association v. HRH Construction Corp.* , 579 N.E.2d 195, 199 (N.Y. 1991). This analysis requires considering the nature of the defect, the risk it imposes, and the manner in which the

harm occurs. *Bellevue*, *supra.* To constitute property damage the defect causing the damage must create a serious risk of harm to people or property (safety defect), and generally the damage must manifest itself in an event that falls within the scope of the safety risk presented. *See Russell v. Ford Motor Co.*, 575 P.2d 1383, 1387 (Or. 1978).

The easiest cases for finding property damage rather than economic loss involve safety defects that cause or exacerbate damage incurred in sudden and calamitous accidents. See e.g. *Pennsylvania Glass Sand v. Caterpillar Tractor Co.*, 652 F.2d 1165 (3d Cir. 1981) (damage to front-end loader caused by sudden fire constituted property damage recoverable in tort where loader did not have adequate fire suppression equipment). Some courts require plaintiffs to demonstrate that the defect caused a sudden and calamitous accident in order to recover in tort for damage to the product itself.

In applying a risk of harm analysis one must distinguish safety defects from mere "qualitative" defects. A purely qualitative defect causes the buyer or consumer to lose some or all of the benefit of the contractually agreed to bargain but does not involve an unreasonable risk of harm. In many scenarios determining whether a defect should be classified as a safety or qualitative defect proves problematic.

Appeal's Position

The damages at issue involve no actual personal injury, emotional harm, or physical damage to property. The appeal's officer points out that Taxpayer carries product liability insurance. However, Taxpayer sought no indemnification for the damages at issue and has conceded that its product liability insurance provided no such right. A letter from Taxpayer concedes that the only type of claims recoverable under the policy would have to involve property damage, bodily injury, or death. The officer asserts that all of the damages at issue are for UCC breach of contract claims and constitute purely economic losses. Therefore, such damages cannot generate product liability losses.

Taxpayer's Position

Taxpayer makes two primary arguments. First, Taxpayer contends that the terms "personal injury" or "damage to property" as used in § 172(f)(4) have a broader scope than actual personal injury or property damage. If a product defect threatens personal injury or physical property damage, Taxpayer asserts that any liability attributable to eliminating that threat qualifies as on account of personal injury or damage to property within the meaning of the statute. Taxpayer contends that the fasteners at issue contained a defect that threatened both personal injury and physical property damage.

Second, even if the damages at issue constitute purely economic losses Taxpayer asserts they still satisfy the definition of product liability contained in §

172(f)(4). Damages that may give rise to deductions generating product liability losses include "damage to or loss of the use of property [emphasis supplied] on account of any defect in any product which is manufactured, leased, or sold by the taxpayer." Taxpayer contends that selling property constitutes a "use" of property within the meaning of the statute. In Taxpayer's view all the damages at issue arise from the claimants' inability to sell defective products (or products that would have been defective if manufactured by Taxpayer and timely shipped) manufactured by Taxpayer. Therefore, the damages are for loss of the use of property.

Analysis and Discussion

A. Preliminary Matters

We share Taxpayer's view that the relevant inquiry concerns whether the damages in question satisfy § 172(f)(4)'s definition of product liability rather than whether the damages constitute product liability under state law. However, before directly responding to Taxpayer's arguments we must address some preliminary matters.

To constitute product liability the damages in question must be attributable to a product "defect". As previously noted product defects may be "qualitative" or may constitute "safety" defects. Neither § 172(f)(4) nor the regulations thereunder define the term "defect". The legislative history indicates that Congress intended to craft a federal tax definition of product liability encompassing the kinds of damages recoverable under product liability theories in most states. To effectuate this intent we find it appropriate to adopt, for federal income tax purposes, the definition of defect generally used by most jurisdictions for product liability purposes.

Section § 402A of the *Restatement (Second) Torts* provides for strict liability in tort to one who sells property in a defective condition unreasonably dangerous [emphasis supplied] to the user or consumer or to his property where the defective condition results in physical harm to the ultimate user or consumer or to his property. Likewise, *Restatement (Second) Torts* § 395 provides:

> A manufacturer who fails to exercise reasonable care in the manufacture of a chattel which, unless carefully made, he should recognize as involving an unreasonable risk of causing physical harm to those who use it for a purpose for which the manufacturer should expect it to be used and to those whom he should expect to be endangered by its probable use, is subject to liability for physical harm caused to them by its lawful use in a manner and for a purpose for which it is supplied.

Other restatement sections provide for liability on product providers other than manufacturers for negligently providing unreasonably dangerous products that cause injury.

Personal injury and/or physical property damage generally constitute the hallmarks of product liability under the laws of most jurisdictions. Although product liability recoveries may be obtained through contract actions for breach of warranty, tort actions constitute the only means of recovery in many situations. To successfully maintain either a strict liability or negligence tort action plaintiffs must establish a safety defect in the product. Although some courts have allowed tort recoveries for damages attributable to qualitative defects, the vast majority limit such recoveries to damages attributable to safety defects. Consequently, for § 172(f) purposes "defect" means a safety defect.

Because of the failure to adequately perform certain manufacturing processes, Taxpayer contends the fasteners were subject to cracking under normal operational stresses. Because a cracked fastener could result in the crash of an aircraft, Taxpayer maintains that the fasteners created an unreasonable risk of personal injury or physical property damage and consequently were defective within the meaning of § 172(f)(4)(A).

Taxpayer knew that in some instances it had failed to comply with specified manufacturing procedures or testing standards. However, Taxpayer did not know which fasteners actually had structural flaws. After the stop date Taxpayer tested a large number of previously manufactured fasteners. No information has been provided regarding the results of the tests. Fasteners determined upon testing to satisfy applicable quality standards, however, are not defective. Thus, damages attributable to those fasteners could not generate a § 172(f) product liability loss.

Whether a product defect constitutes an actual safety or qualitative defect depends in part on how the product is used. The instant case appears to involve damages, attributable to structurally flawed fasteners, incurred prior to the incorporation of the fasteners in a final manufactured product. Prior to their use in a safety critical capacity in an actual operational aircraft the fasteners only had the potential to give rise to an unreasonable danger of personal injury or physical property damage. However, it is not necessary for us to determine what portion of the structurally flawed fasteners may be said to satisfy § 172(f)(4)(A)'s defectiveness requirement. Even if all the flawed fasteners were defective for § 172(f)(4) purposes, we would still conclude that the damages at issue do not qualify as product liability.

To constitute product liability for federal income tax purposes § 172(f)(4)(B) requires that such injury, harm, or damage arise after the taxpayer has completed or terminated operations with respect to, and has relinquished possession of the product. It appears that some of the damages claimed may be attributable to Taxpayer's failure

to ship fasteners to the claimants. If so, the damages do not satisfy § 172(f)(4)(B)'s requirements and consequently cannot generate a product liability loss.

B. Threat of Harm as Personal Injury or Property Damage

Damages attributable to defective fasteners incurred after the fasteners' initial shipment to the claimants must satisfy additional statutory tests to qualify as product liability. Liability for such damages may qualify as product liability if on account of physical injury or emotional harm to individuals (personal injury) or for damage to property.

Taxpayer points out that the claimants were, as a practical or legal matter, unable to sell fasteners previously acquired from Taxpayer. They were unable to do so because the fasteners contained or may have contained structural defects that could lead to fastener failure under normal operating stresses. The failure of fasteners employed in a flight critical function might cause an aircraft crash resulting in personal injury and/or physical property damage. It was reasonable to expect that had the fasteners been sold without testing and/or reworking some portion of them would have contained structural problems and would have been used as flight critical elements in airframes or airplane engines. Accordingly, Taxpayer contends that prior to testing and reworking the fasteners posed a threat of personal injury or physical property damage.

For purposes of the discussion that follows we will assume, *arguendo,* that any structurally impaired fasteners posed an unreasonable threat of personal injury or physical property damage. As previously noted, however, we express no actual opinion on the question of whether all of the structurally deficient fasteners qualify as defective for § 172(f)(4)(A) purposes.

Taxpayer recognizes that the damages at issue do not involve actual personal injury or physical property damage. Nevertheless, Taxpayer asserts that any liability incurred resulted from actions taken to eliminate the threat of personal injury or physical property damage and therefore qualifies as product liability.

To support its position Taxpayer points to a number of cases involving the cost of removing asbestos containing materials from buildings and replacing them with safe alternatives. Asbestos that may be crumbled by hand is said to be friable. Alex J. Grant, Note, *When Does the Clock Start Ticking?: Applying the Statute of Limitations in Asbestos Property Damage Actions*, 80 CORNELL L. REV. 695, 711 n.92 (1995). Friable asbestos may deteriorate causing the release of minute asbestos particles into the air. *Id*. Inhaling a sufficient number of airborne asbestos particles has been shown to cause serious lung diseases, often involving a substantial period between asbestos exposure and disease manifestation. Eliminating a possible disease source constitutes the primary motivation for either eliminating and replacing or encapsulating asbestos contained in buildings.

In the typical asbestos abatement case a plaintiff attempts to hold a manufacturer of asbestos-containing building materials liable for the abatement of asbestos in the plaintiff's building. In these cases the defendant invariably contends that the damages sought are purely economic and therefore recoverable only through a contractual breach of warranty action. In most cases expiration of the statute of limitations would bar the plaintiff from recovering using such an action.

Courts have overwhelmingly rejected the argument that the damages are purely economic, concluding that plaintiffs may recover through negligence, strict product liability, or other tort actions. See e.g *City of Greenville v. W.R. Grace & Company*, 640 F.Supp. 559 (D. S.C. 1986), *aff'd*, 827 F.2d 975 (4th Cir. 1987) (negligence and breach of implied warranty); *Northridge Co. v. W.R. Grace and Co.*, 471 N.W.2d 179 (Wis. 1991) (motion to dismiss denied with regard to negligence and strict products liability claims); *School District of the City of Independence Missouri v. U.S. Gypsum Co.*, 750 S.W.2d 442 (Mo. Ct. App. 1988) (strict products liability). Because asbestos abatement cases involve no actual personal injury, Taxpayer contends they establish the principle that for product liability purposes damages incurred to eliminate the threat of personal injury merit the same treatment as damages for actual personal injury. It follows that for product liability purposes damages incurred to eliminate the threat of physical property damage should be treated the same as actual physical property damage.

Without doubt, airborne asbestos's disease causing potential plays a dominant role in court decisions approving the bringing of tort claims to recover asbestos abatement costs. Even so most of these decisions fall short of adopting the view that for product liability purposes costs incurred to eliminate a threat of personal injury equate to damages for actual personal injury.

Courts generally support the conclusion that asbestos abatement costs fall outside of the ambit of pure economic damages on two primary pillars of reasoning. First, courts look to the primary function of the asbestos containing building material, for example providing fireproofing, insulation, or soundproofing, to determine if the damages at issue relate to the failure of the material to work for the general purposes for which it is sold. Because purely economic losses generally involve a loss in the benefits of a contractual bargain, and because plaintiffs make no claim that the materials have failed to perform their primary function, courts consider this a factor that militates against classifying the losses as purely economic. *See e.g. Northridge,* 471 N.W. 2d at 185-86; *Livingston Board of Education v. United States Gypsum Co.*, 592 A.2d 653, 655 (N.J. Super. Ct. App. Div. 1991); *Drayton Public School District No. 19. v. W.R. Grace & Co.*, 728 F.Supp. 1410, 1413 (D. N. D. 1989). In contrast to the asbestos cases, in the instant case the defects adversely affect both the benefit of the bargain and the potential safety of the fasteners. Nevertheless, we believe that a defect that both impairs the benefit of the bargain and creates an unreasonable danger of personal injury should be treated as a safety defect for product liability purposes.

Second, and most importantly, most courts[2] fit the asbestos cases into the historical parameters of product liability by concluding that asbestos fibers may cause property damage to a building by contaminating it. *See e.g. Northridge,* 471 N.W.2d at 186 (motion to dismiss complaint inappropriate where complaint contained allegations that release of toxic substances caused damage to shopping centers) ; *Drayton Public School District,* 728 F.Supp. at 1413; *Greenville*, 640 F.Supp. At 564. Although the cases involve no actual structural damage to the buildings, it is not unreasonable to say that a building has been damaged when microscopic toxic substances may be found on building surfaces and within interior air spaces thereby adversely affecting the building's value and practical uses because of the threat of personal injury.

Moreover, extending our view beyond the arena of asbestos and other toxic substances contamination cases reveals numerous examples of courts rejecting the view that a product defect that threatens but does not cause personal injury or physical property damage merits a tort recovery for the costs of eliminating that threat. In *National Crane Corp. v. Ohio Steel Tube Co.*, 332 N.W.2d 39 (Neb. 1983) a crane manufacturer incurred costs to replace defective welded steel tubing used in the tilt cylinder mechanism of cranes previously sold to customers. None of the tilt cylinder mechanisms involved in the retrofit program actually failed. However, the tilt cylinder mechanisms of several other cranes previously sold to customers and incorporating the same type of welded steel tubing had failed. One of the failures resulted in a loss of life. The welded steel tubing clearly presented an unreasonable threat of personal injury or damage to property.

The manufacturer brought suit to recover the retrofitting costs from the steel tubing supplier. The manufacturer asserted several causes of action including negligent manufacture and strict products liability. Because it incurred the costs to avoid potential tort liability for personal injury or property damage, including that of the steel tubing supplier, the manufacturer asserted that recovery of such costs from the supplier through tort actions was appropriate. However, the court upheld the dismissal of the manufacturer's negligence and strict product liability claims because the damages in question did not involve actual personal injury or property damage. *See also Cinncinnati Gas & Electric Co. v. General Electric Co.*, 656 F.Supp. 49 (S.D. Ohio 1986) (without actual personal injury or property damage, costs utility incurred to determine how to repair a nuclear power plant to make it safe and the repair costs themselves not recoverable from plant's designers and builder through negligence or strict products liability actions); *Niagara Mohawk Power Corp. v. Ferranti-Packard Transformers, Inc.*, 607 N.Y.S.2d 808 (N.Y. App. Div.), *leave to appeal denied*, 615 N.Y.S.2d 878 (N.Y. 1994) (costs incurred to replace undamaged transformers with a

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[2] For explicit adoption of Taxpayer's view that the mere creation of a substantial and unreasonable risk of personal injury from asbestos results in tort liability see *Huntsvilles City Board of Education v. National Gypsum Co.*, No. CV83-3251, slip. op. at 47 (Ala. Ct. Comm. Pleas., Aug. 27, 1984).

dangerous defect placing them in imminent danger of catching on fire not recoverable in negligence or strict product liability); *Sacramento Regional Transit District v. Grumman Flxible*, 204 Cal. Rptr. 736 (Cal. Ct. App. 1984) (plaintiff using buses for commercial purposes could not recover in strict product liability or negligence for costs to repair cracked fuel tank supports in the buses and costs to make prophylactic repairs to bus fuel tank supports that had not yet cracked but had a high probability of cracking).

Like the instant case, T*rans World Airlines, Inc. v. Curtiss-Wright Corp.*, 148 N.Y.S.2d 284 (N.Y. Sup. Ct. 1955), *a'ffd*, 153 N.Y.S.2d 550 (N.Y. App. Div. 1956) involved product defects with the potential to cause aircraft crashes. In *Trans World* an airline claimed that latently defective aircraft engines failed to operate while in regular service making airplanes containing the engines imminently dangerous to life and property. The airline asserted a negligence claim against the manufacturer of the engines, with which it was not in privity of contract, to recover the costs of eliminating the defects. The court concluded that in the absence of an actual accident the airline could not recover in negligence from the engine manufacturer. The court viewed the airline's claim as one for inferior quality, a claim best suited to a breach of contractual warranty claim. Thus, most courts continue to view the cost of eliminating safety defects from products as a pure economic loss not recoverable in negligence or strict product liability.[3]

The damages in the instant case: cover damages, loss profits, excess inventory carrying costs, etc. may be causally linked to the defects but do not constitute actual costs to eliminate the defects. These damages compensate the claimants for their disappointed pecuniary interests. Consequently, Taxpayer's facts present a much weaker case for the imposition of tort liability than the fact patterns of the pure threat of harm cases previously discussed.

Moreover, even if it could be shown that most jurisdictions impose tort liability on manufacturers for the cost of eliminating product safety defects and the damages at issue were for the repair of defects, this would not carry the day for Taxpayer. As Taxpayer points out, the critical inquiry is whether the liabilities in question satisfy § 172(4)'s definition of product liability. Section 172(f)(4)(A) requires that the damages be on account of physical injury or emotional harm to individuals or damage to property.

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[3] Some courts do allow tort recoveries for the elimination of safety defects prior to actual personal injury or property damage where the defect involves residential real property construction. See *Council of Co-Owners Atlantis Condominium, Inc. v. Whiting-Turner Contracting Co.,* 517 A.2d 336 (Md. 1986) (condominium owners association allowed to recover in tort from builder for cost to repair utility shafts and related electrical work to eliminate potential fire hazard). Moreover, some courts also allow tort recoveries for qualitative defects where the defect involves residential real property construction. See case cites *Id*. at 344.

We believe the plain meaning of the statute requires actual physical injury, emotional harm, or property damage, and we find no compelling reason to deviate from that interpretation in the legislative history.

C. Loss of the Use of Property

Section 172(f)(4) treats as product liability damages to or loss of the use of property [emphasis supplied] on account of any defect in any product which is manufactured, leased, or sold by the taxpayer. The statute does not require that the loss of the use of property be attributable to property damage but only that the loss of use arise from the defect. Taxpayer maintains that selling property constitutes a "use" of property within the meaning of the statute. In Taxpayer's view the damages at issue arise from the claimants' inability to sell defective products (or products that would have been defective if manufactured by Taxpayer and timely shipped[4]) manufactured by Taxpayer. Therefore, argues Taxpayer, the damages are for loss of the use of property.

Neither the statute nor the regulations define the phrase "loss of the use of property" We must look to other sources to discern its meaning. Black's Law Dictionary does not specifically define the phrase. It does, however, define use value as "[a] value established by the utility of an object instead of its value upon selling or exchanging it". BLACK'S LAW Dictionary 1550 (7th ed. 1999). It also defines "use" as "[t]he application or employment of something; esp., a long-continued possession and employment of a thing for the purpose for which it is adapted, as distinguished from a possession and employment that is merely temporary or occasional". *Id*. at 1540. These definitions support the conclusion that "the use of property" is limited to employing it to derive the services the property may provide based on its functional characteristics.

In replevin cases, courts draw distinctions between the sales and use value of property. Many replevin opinions contain some version of the following rule:

> [W]here property has a value on account of the use to which it may be put, as distinguished from its value for sale or consumption, a successful plaintiff in replevin is entitled to recover as damages for its detention the value of such use during the time that the property was wrongfully detained.

Bozeman Mortuary Ass'n v. Fairchild, 86 S.W.2d 979, 980 (Ky. 1935); *See Ablah v. Eyman*, 365 P.2d 181, 190 (Kan. 1961). Likewise, note 1 of the official comment to § 2-314 of the UCC provides that "the warranty of merchantability applies to sales for use as well as to sales for resale."

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[4] As already pointed out, any damages attributable to Taxpayer's failure to deliver fasteners would not satisfy the requirements of § 172(f)(4)(B).

In *L. Ray Packing Co. v. Commercial Union Insurance Co.*, 469 A.2d 832 (Me. 1983) the plaintiff and other fish processors were sued by fishermen alleging violations of the Sherman Act and various breaches of contract. The fishermen accused the plaintiff and others, who purchased herring from the fishermen, of conspiring to fix herring purchase prices. Plaintiff had a comprehensive general liability insurance policy (CGLIP) with one of the defendants and an excess umbrella liability insurance policy with the other defendant. Whether the terms of those policies required one or both of the defendants to defend plaintiff in the fishermen's action constituted the issue before the court. Whether the allegations in the complaint alleged property damage as defined in the insurance policies proved the critical question for resolving this issue.

The insurance policies defined property damage in part as "[l]oss of use of tangible property which has not been physically injured or destroyed provided such loss of use is caused by an occurrence during the policy period". *Id*. at 835. The fishermen alleged they loss revenue they otherwise would have received in the absence of a conspiracy to pay artificially low prices for herring. The plaintiff contended that the inability to sell herring in a free market constituted a loss of use of tangible property. The court characterized the fishermen's cause of action as one for lost profits rather than tangible property damage as defined in the insurance policies. Because herring undeniably qualifies as tangible property, the court's conclusion implicitly rejects the argument that the inability to sell herring in a free market constitutes a loss of use of the herring. *See also Hawaiian Insurance & Guaranty Co. v. Blair Ltd.*, 726 P.2d 1310, 1315 (Haw. Ct. App. 1986) (palming off of fake products causing loss profits due to adverse effect on sale of genuine products not a loss of use of property within the meaning of CGLIP); *Nutmeg Insurance Co. v. Pro-Line Corp.,* 836 F.Supp. 385, 388-89 (N.D. Tex. 1993) (lost sales of products supplied by a party other than insured but caused by insured's actions not a loss of use of property within coverage of policy).

In *Lucker Manufacturing v. Home Insurance Co.*, 23 F.3d 808 (3d Cir. 1994) a manufacturer contracted to produce an ocean floor anchoring device, known as a lateral mooring system (LMS), for an oil company. The manufacturer contracted with a third-party pursuant to which the third party was to manufacture steel castings, in accordance with the manufacturer's design and specifications, for use in the construction of the LMS.

Load testing of the third party manufactured castings resulted in a catastrophic failure of one of them. The oil company refused to complete the purchase of the LMS unless the manufacturer employed more stringent standards in the production and testing of the steel used in the castings then originally envisioned. The manufacturer complied with the additional requirements incurring additional costs and then brought an action against the steel castings provider to recover various damages. The third party had a CGLIP which covered loss of use of tangible property. The manufacturer settled the action with the third party by accepting cash and an assignment of the bulk

of any claim that the third party might have against its insurer for defense costs and indemnification relating to the castings suit.

The manufacturer alleged that the LMS design constituted tangible property. It also alleged that selling the LMS design to the oil company and other customers constituted its use of that item. The testing failure caused the oil company to refuse to accept a LMS manufactured pursuant to the original design and testing specifications, notwithstanding that a LMS properly manufactured in accordance with the original specifications would have adequately served its intended purpose. The manufacturer contended that its inability to sell the original LMS design constituted a loss of use of property within the coverage of the CGLIP.

The court concluded that the manufacturer could not recover under the CGLIP because the LMS design did not constitute tangible property. However, in contrast to the authorities cited above, the court concluded that a loss of customer acceptance, in other words an impairment in the ability to sell tangible property, could constitute a loss of use of that property within the meaning of a standard CGLIP. The court viewed the inability to sell the LMS design as the loss of an economic use that in its view fell within the terms of the CGLIP.

Likewise, in *Henderson v. Spring Run Allotment*, 651 N.E.2d 489 (Ohio Ct. App. 1994), *appeal denied*, 1995 Ohio Lexis 1272 (Ohio 1995), the court addressed the computation of damages in the context of a temporary nuisance involving land that the owner wished to develop and sell as residential lots. Under Ohio law a landowner whose real property has suffered a temporary injury is entitled to recover reasonable restoration costs subject to certain limitations plus the reasonable value of the loss of the use of the property between the injury and the restoration. 651 N.E.2d at 494. In *Henderson* the temporary nuisance caused a delay in the sale of the lots. The developer claimed additional financing costs incurred because of the delay in the sale of the lots as loss of use damages. The court rejected this view concluding that lost profits on the sale of the lots constituted the proper measure of loss of use damages. For this purpose the court defined lost profits as the excess, if any, of the profits that would have been earned if the nuisance had not delayed the sale of the lots over the actual profits made on the sale of the lots. Because the developer had not offered any evidence of lost profits no recovery was allowed. However, the case supports the proposition that, in at least certain contexts, losses attributable to a delay in the sale of property may constitute a loss of use of that property.

Accordingly, there is judicial support both for and against the view that an inability to sell property or an impairment of the ability to sell property or to sell it at a particular price constitutes a loss of use of that property. As has been pointed out:

> [I]f the term “use” is construed to embrace all its possible meanings and ramifications, practically every activity of mankind would amount to a “use” of

> something. However, the term must be considered with regard to the setting in which it is employed.

Great American Indemnity Co. of New York v. Saltzman, 213 F.2d 743, 747 (8th Cir.), *cert. denied*, 348 U.S. 862 (1954); *Accord Erie Insurance Exchange v. Transamerican Insurance Co.,* 533 A.2d 1363 (Pa. 1987) (concluding that "use" of automobile did not include the actions of a 3½ year old child that happened to set a car in motion). Unquestionably, a parent buying a child an expensive violin based on the child's emphatic promise to "use" the violin would not view the covenant as adequately fulfilled if the child were to sell the violin and dissipate the proceeds at the county fair in a ill-fated attempt to win a stuffed Saint Bernard.

In *Lucker* the trial court rejected the position that the inability to sell the original LMS design constituted a loss of use of the design. As the appellate court observed:

> Apparently, the district court saw a distinction between the loss of the ability to physically use the LMS design and the loss of the ability to sell the LMS design. One was use and the other was non-use. ... In everyday English, the district court's distinction makes sense. The term "use" conjures the idea of some kind of physical application of property, as when a carpenter uses a hammer. ... "Ordinary language" interpretations of phrases are not the only plausible interpretations of insurance contracts, especially when the contract is between sophisticated business entities. It is important to ask what function "loss of use" was intended to perform in a CGL policy before relying on a common sense or lay distinction between physical use and other uses.

23 F.3d at 815.

In weighing *Lucker* to resolve the instant case it must be recognized that most if not all state courts construe ambiguous language in insurance contracts in favor of the insured. See e.g. *Gracey v. Heritage Mutual Insurance Co.*, 518 N.W.2d 372, 373 (Iowa 1994); *Erikson v. Nationwide Mutual Insurance Co.*, 543 P.2d 841, 845 (Idaho 1975); *American Family Insurance Co. v.* Walser, 628 N.W. 2d 605, 609 (Minn. 2001); "We must construe ambiquous language to provide coverage." *Lucker*, 23 F.3d at 814. As previously noted, even in this most favorable environment for a broad interpretation of the word "use" several courts have rejected the notion that an impairment on one's ability to sell property constitutes a loss of use.

A temporary nuisance that forces a developer to delay selling land undoubtedly may cause the developer to incur damages. In *Henderson* the articulation of the remedy for temporary injuries to land as a loss of use of the land was well established. The opinion does not address whether the vacant land at issue could be rented. Had the court concluded that lost profits attributable to the delay in the sale of lots did not constitute a loss of use of the land, the effect could have been to deny recovery in

situations in which a tort undeniably causes damages, that is, lost profits. To avoid that result, it is certainly understandable why in the context of *Henderson* the court concluded that lost profits could constitute a loss of use.

In the instant case Congress intended the definition of product liability for federal income tax purposes to encompass the kinds of damages that may be recovered under product liability theories in most states. As pure economic losses relating solely to frustrated commercial expectations, the damages at issue qualify as product liability in few if any states. Granted, where there is no reasonable basis to argue that an activity does not constitute a use of property, damages attributable to a safety defect that prevents that activity must be treated as product liability for federal income tax purposes irrespective of whether the damages are generally recognized as product liability under state law. However, where ambiguity exists regarding whether an activity falls within the scope of the phrase “loss of the use of property”, the ambiguity should be resolved in a manner that makes the federal tax definition of product liability as consistent with the general notion of product liability under state law as possible.

Based on the preceding authorities and analysis we conclude that the inability to sell defective fasteners because of product defects does not constitute a loss of the use of property within the meaning of § 172(f)(4)(A). In the instant case securely joining other parts together constituted the fasteners’ primary function. None of the damages in question relate to the claimants’ inability to use fasteners to fasten parts together. Therefore, we conclude that the damages in question do not arise from a loss of the use of property within the meaning of § 172(f)(4)(A).

CAVEAT

A copy of this technical advice memorandum is to be given to Taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.