M e m o r a n d u m

295.0168

To: Audit Review and Refunds
(R. Buntjer)

September 13, 1989

From: E. L. Sorensen, Jr.

Subject: Defective Merchandise (Regulation 1655(b) and
Court Ordered Settlements

DEFECTIVE MERCHANDISE DEDUCTION

On May 15, 1989, Mr. David Levine of our staff responded to the Audit Review and Refund Unit's request for advice regarding a claim for refund of L--- C--- Co., Inc., SR -- XX-XXXXXX. On July 6, 1989, Mr. Rick Kinoshita of your unit requested that Assistant Chief Counsel Gary Jugum review Mr. Levine's May 15 advice. Mr. Kinoshita was concerned that Mr. Levine's advice with respect to the application of Regulation 1655(b) was not consistent with our prior administrative interpretation of the regulation.

The area of concern related to Mr. Levine's conclusion that the defective merchandise deduction was applicable in situations where defective merchandise was returned by the purchaser to the seller. We understand that at some time in the past it had been our administrative position that if defective merchandise was returned to the seller, no allowance for defective merchandise was permissible. The language of the regulation is neutral on this point. However, since at least 1979, Audit Manual section 0413.35 has been quite specific in allowing the deduction in situations where merchandise is returned, by providing:

> "When defective merchandise is returned to the seller, under conditions not meeting the requirements of Regulation 1655 (0413.05), a deduction may be taken only for the amount credited or refunded because of the defective condition of the merchandise. No deduction can be allowed for the amount refunded or credited because of the return of the merchandise. Accordingly, where the returned defective merchandise has some value, the amount refunded or credited to the customer must be reduced by the value of the merchandise in its defective condition." (AM § 0413.35.)

In view of the clear language of the Audit manual, it is our view that the defective merchandise deduction is applicable whether or not the defective merchandise is returned to the seller by the purchaser. As discussed below, this conclusion does not apply to court ordered settlements.

COURT ORDERED SETTLEMENTS

Our review of the L--- C--- matter indicates that the merchandise returned in that case was returned pursuant to a court ordered settlement. Mr. Kinoshita's July 6 correspondence stated that there may be several other claims for refund which raise issues similar to those raised in the L--- C--- matter. With respect to L--- C--- and any other matters which involve court ordered settlements, the question of a defective merchandise deduction is never reached. This is because amounts returned to a buyer pursuant to a court ordered settlement are not considered price adjustments which alter the original sales price but, rather, are in the nature of damages which do not differ in any realistic sense from any other damages paid by a seller as a result of the seller's wrongful actions in the conduct of the sale transaction (See Southern California Edison Co. v. State Board of Equalization, 7 Cal. 3d 652). Consequently, in the case of court ordered settlements, there is no basis for any post sale "sales price" adjustment pursuant to the defective merchandise deduction mechanism.

ELS:jb

cc: Mr. Gary J. Jugum
Mr. Donald Hennessy
Mr. Robert Pieroni
Mr. Rick Kinoshita – Audit Review and Refund Unit