The Impaired Property Exclusion

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Claims involving faulty work or defective products often introduce complex commercial general liability (CGL) coverage issues, particularly if the claim alleges only damage to property.

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Whether the claim is for "property damage" that is caused by an "occurrence" must usually be confronted *before* consideration is given to application of any CGL policy exclusions. The markedly different interpretations and construction given by the courts to the terms "occurrence" and "property damage" is rather startling. These larger coverage issues may divert attention from an exclusion that is routinely cited but often misunderstood—exclusion m. of the CGL policy, sometimes referred to as the "impaired property" exclusion.

Property Damage

In the battles over what constitutes property damage, it seems there is a tendency to ignore the actual CGL definition of "property damage." The fact is the definition has two parts, both presumably to be given equal weight. Most seem to know there must be *physical injury* to tangible property—but this is only the first part of the definition. Loss of use of tangible property that *has not been physically injured* is the second part of the definition.

In other words, within the CGL insuring agreement is a promise to pay damages for claims because tangible property can't be used [loss of use]—even if the property that can't be used has not suffered *any* scratch, dent, injury, harm, destruction or other physical damage. It is only through the lens of the second definition of property damage—loss of use of tangible property that has not been physically injured—does the need and purpose of the impaired property exclusion come into focus.

Impaired Property Exclusion

Unlike the eccentric uncle at the family wedding, impaired in this context means something a little different. In fact, "impaired property" is a defined term in the CGL policy. In overly simplistic terms, impaired property is someone else's property that cannot be used because your work or your product, which has been incorporated into that property, is inadequate or defective.

Here is a highly technical explanation of the general intent of exclusion m.:

My stuff doesn't work because your stuff, which I incorporated as a component part of my stuff, doesn't work. If your stuff worked, then my stuff would work. If you replaced your stuff, my stuff would work just fine. So I am suing you because I have lost money as my stuff doesn't work—but the only reason my stuff doesn't work is because your stuff is junk.

I know this may be a little esoteric, but bear with me. My stuff is the impaired property—it has not been damaged. Yet, the claim I am making against you—loss of use of my stuff (my stuff is tangible property)—fits within the second part of the CGL definition of property damage. Absent an exclusion, you would have coverage[1] in your CGL policy (to the extent you are legally liable) for the loss of use claim that I have made against you. It is the intent, however, of exclusion m. to eliminate coverage for just this type of claim.

First Illustration: Your Product[2]

Let's say that my stuff consists of scanners that I sell to retail stores that use my product to scan the UPC of items sold. Your stuff [your product] is the printed circuit boards that I incorporate into my scanners. Although we have tested the scanners, once they are put to use by the stores that purchased my scanners, the scanners simply fail to operate. It is determined that your printed circuit boards are defective. Among other things, I sue you for my *loss of use* of the nonoperational scanners. Further, as my scanners are tangible property, your CGL insurer concedes that my claim does qualify as property damage (remember part two of the definition).

However, my scanners are impaired property—my scanners don't operate because your printed circuit board [your product] was incorporated into my scanner *and your product was defective*. For the sake of our illustration, let's further assume that replacing your printed circuit board restores my scanner to its full function and that your printed circuit board didn't damage itself in any way; it just didn't work. In other words, your printed circuit board did not cause any physical injury to itself or any portion of my scanner.

Although you may be liable to me for my loss-of-use claim for my scanners, and in this instance, my claim is for property damage, your CGL insurer will properly deny coverage based on exclusion m.

Second Illustration: Your Work[3]

You are the excavation subcontractor engaged to prepare the site for construction of a college. Part of the scope of your work is to properly compact the soils in order for the foundation to receive adequate support.

You finished the job, but when the general contractor began putting in concrete footings for the foundation, it is discovered that compaction was insufficient, requiring the owner to incur expenses to again compact the soil, this time by the general contractor. The owner of the project brings claim against you, the subcontractor, alleging negligence in the compaction process, and is seeking recovery of costs, including loss-of-use claims because the college did not open as scheduled and the delayed opening resulted in the owner's substantial loss of revenue.

As the lost revenue costs are the result of "impaired property," which in this situation is the construction site for the school that cannot be used because your work [the site compaction] was inadequate, and could have been remedied by again compacting the soil, exclusion m. eliminates coverage for your liability to the owner for the loss of revenue.

Third Illustration: Delay in Performing Your Work

Change the second illustration. Instead of improperly compacting the soil, you as the subcontractor were behind schedule in compacting the soil. In other words, you performed the job perfectly, but 2 months later than your contract required. The result to the owner is the same—loss of revenue from delayed opening of the college. In this third illustration, you have no CGL coverage as exclusion m. applied to the owner's claim against you for loss of revenue not because your work was inadequate or defective, but instead because of your delay in performing the contract.

Impaired Property versus Property Not Physically Injured

While exclusion m. may often be referred to as the "impaired property" exclusion, the exclusion actually applies more broadly—in some instances to property that is not impaired property.

Fourth Illustration: Property Not Physically Injured[4]

You are an application software manufacturer and have released the latest version of your software that is installed in laptops and desktop computers everywhere. After installation, it is discovered there is a "bug" in your software. The "bug" corrupts the computer's operating system, rendering the laptops and desktops unusable. You are sued by numerous purchasers for damages resulting from the "bug"; one of the allegations is loss of use of the laptops and desktops.

Clearly, the laptops and desktops are tangible property. In addition, the courts have determined your software has not done *physical injury* to the computers. In its decision, the court observed:

By analogy, when the combination to a combination lock is forgotten or changed, the lock becomes useless, but the lock is not physically damaged. With the retrieval or resetting of the combination—the idea—the lock can be used again. This loss or alteration of the combination may be a useful metaphor for damage to software and data in a computer. With damage to software, whether it be by reconfiguration or loss of instructions, the computer may become inoperable. *But the hardware is not damaged*. The switches continue to function to receive instructions and the data and information developed on the computer can still be preserved on the hard drive.

> While the loss of the idea represented by the configuration of the computer switches or the combination for the lock might amount to damage, *such damage is damage to intangible property. It is not damage to the physical components of the computer or the lock, i.e., to those components that have "physical substance apparent to the senses."* [Emphasis added]

America Online, Inc. v. St. Paul Mercury Ins. Co., 347 F.3d 89 (4th Cir. 2003) at 96.

In sum, the claim against you is not for physical injury to tangible property caused by your software; it is for the loss of use of tangible property that has not been physically injured—loss of use of the laptops and desktops.

However, when your CGL insurer denies coverage based on the "impaired property" exclusion, you quickly point out that the definition of impaired property only applies if such property [the laptops and desktops] can be restored to use by removal or replacement of your product—the software. And since your software corrupted the operating system, simply removing or replacing your software will not restore the laptops and desktops to operation. In short, you contend that the laptops and desktops are not "impaired property."

You are a bit suspicious and more than a little surprised when your insurer agrees—the laptops and desktops are *not considered impaired property*. Does that mean exclusion m. does not apply? Unfortunately, the answer to that question is "no."

A closer reading of exclusion m. reveals that it applies not only to "impaired property," but also to property that is not physically injured, provided the loss of use results from your defective product[5]—your software. Exclusion m. applies in this instance even if the loss of use is for property that is *not* impaired property as the exclusion encompasses any property that is not physically injured if the property damage results from your defective product.

Exclusion M.—The Exception

There is an exception to exclusion m. that applies when your product or work abruptly *damages itself* after the property into which your work or product has been incorporated has been put to its intended use. Using our initial very technical explanation, my stuff doesn't work because your stuff broke apart once my customers started using my stuff.

Fifth Illustration: Exception to Exclusion M.

Go back to the first illustration, the one about the scanners. While the scanners were impaired property, let's change the facts a bit. An engineering report offered this analysis of why your printed circuit boards failed:

> We also observed separation in random areas between internal copper foil layers and the plated copper barrel. This condition was present only after thermal stressing ... Testing also indicates that interconnect separation has likely contributed to or caused open circuits.... It is common for product to pass visual and electrical screening testing, only to develop intermittent and/or open circuits in the field.

In our case, the court then concluded from the engineering report that the nature of the physical damage described in the report to your printed circuit board, separation only upon thermal stressing, strongly suggests the damage may have occurred suddenly.[6]

If your printed circuit boards abruptly came apart once the scanners were being used, the exception to exclusion m. applies, and you would have coverage in your CGL for my claim against you—my damages arising of the loss of use of my scanners.

Conclusion

According to the U.S. District Court for the Northern District of Georgia, Florida courts have outlined three rules regarding the applicability of exclusions such as Exclusion m.

> The first rule is that if the complaint fails to allege injury to other property, and merely alleges economic loss resulting from injury to [or failure of] the product itself, the exclusion applies, thus precluding coverage.
>
> The second rule is that if the complaint alleges or otherwise establishes damage to other property, the exclusion will not apply.
>
> The third rule is that the exclusion does not apply to situations arising from a sudden and accidental injury to the product which results in economic loss.

Pinkerton & Laws, Inc. v. Royal Ins. Co. of Am. and Md. Cas. Co., 227 F. Supp. 2d 1348 (at 1354).

While these three rules of thumb may not be very descriptive, such rules are a good starting point in determining when exclusion m. of the CGL policy applies.

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[1]This presumes an "occurrence" was determined to have taken place. This also presumes the so-called economic loss doctrine is not accepted as a coverage defense in lieu of a liability defense.

[2]This illustration is loosely based on *Anthem Elecs., Inc. v. Pacific Employers Ins. Co. and Fed. Ins. Co.*, 302 F.3d 1049 (9th Cir. 2002). The facts and opinion of the court varies from this illustration.

[3]This illustration is loosely based on *H.E. Davis & Sons, Inc. v. North Pac. Ins. Co. and CGU Ins. Co.*, 248 F. Supp. 2d 1079 (D. Utah). The actual facts and opinion of the court differ substantially from the illustration.

[4]This illustration is loosely based on *America Online, Inc. v. St. Paul Mercury Ins. Co.*, 347 F.3d 89 (4th Cir. 2003). The actual facts and opinion of the court differ from the illustration.

[5]*America Online, Inc. v. St. Paul Mercury Ins. Co.*, 347 F.3d 89 (4th Cir. 2003) at 98.

[6]*Anthem Elecs., Inc. v. Pacific Employers Ins. Co. and Fed. Ins. Co.*, 302 F.3d 1049 (9th Cir. 2002) at 1059, 1060.

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