Court of Appeals Finds Coverage in Cyberspace and Criticizes Standard CGL Exclusions: *Computer Corner, Inc. v. Fireman's Fund Insurance Company*

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Any counsel who has been involved with coverage issues in New Mexico probably did a double-take when reading this case found in the May 23, 2002 New Mexico Bar Bulletin. In *Computer Corner*, 2002-NMCA-054, 2002 N.M. App. LEXIS 37, *cert. denied* 2002 N.M. LEXIS 182, the New Mexico Court of Appeals ("Court of Appeals") held that a commercial general liability insurance policy ("CGL") provided coverage for liability arising from the loss of data stored on a computer hard drive, apparently relying on the surprising finding of fact that computer data is "tangible" property. The Court of Appeals so held despite: (1) the district court's finding that the insured, Computer Corner, had expected, and/or intended that the data would be lost; and (2) the district court's conclusion that coverage under the policy was excluded pursuant to standard "business risk/work product" exclusions found in most CGL policies.

This case warrants a second look not only because the Court of Appeals held that a CGL policy provided coverage for a type of loss (computer data) not previously recognized by any reported New Mexico decision, but also because the Court of Appeals took the opportunity to comment on what it believes is the general convoluted nature of insurance policies. For example, the Court of Appeals cited the following language taken from a Kentucky Court of Appeals' decision regarding the difficulty in understanding policy language.

'It would be somewhat ludicrous for us to say this policy is not ambiguous. It is. But no more so than most others. Ambiguity and incomprehensibility seem to be the favorite tools of the insurance trade in drafting policies. Most are a virtually impenetrable thicket of incomprehensible verbosity….The miracle of it all is that the English language can be subjected to such abuse and will remain an instrument of communication. But, until such time as courts generally weary of the task we have just experienced and strike down the entire practice, we feel that we must run with the pack and attempt to construe that which may well be impossible of construction'. . . .

Computer Corner at 21 (*citing Universal Underwriters Ins. Co. v. Travelers Ins. Co.*, 451 S.W.2d 616, 22-23 (Ky. 1970)).

After having cited such language, the New Mexico Court of Appeals went so far as to say: "We decline to 'attempt to construe that which may well be impossible of construction' because by doing so we encourage the perpetuation of the type of unintelligible language of which [the section of Fireman's policy] is a perfect example."

Id. However, despite such expansive language and dicta, a detailed analysis of the Computer Corner opinion reveals that its holding is limited to extending CGL coverage for lost computer data, and that holding is based on a finding of fact that could be challenged in the future.

I. CASE FACTS/PROCEDURAL POSTURE

In *Computer Corner*, a business engaged in the sale and service of computers, performed repairs on a customer's computer hard drive, including reformatting the hard drive, thereby effectively blocking access to preexisting data. Computer Corner then misinformed its customer that the data "could not be retrieved" and subsequently "wrote" over the data, essentially erasing it from the customer's hard drive. The customer incurred the cost of recreating the data and subsequently passed it on to Computer Corner as part of a settlement. When Computer Corner sought coverage from its insurance carrier (Fireman's Fund), the carrier refused to indemnify Computer Corner, concluding that it was not "other damage" covered under the standard CGL policy.

Computer Corner filed a declaratory action, seeking a determination that its insurer was obligated to indemnify Computer Corner for any damages that it paid to its customer for the lost data. The insurer filed a counterclaim, seeking a determination that it had no duty to indemnify Computer Corner. The district court bifurcated the matter and at the first phase of the trial, entered findings of fact and conclusions of law that relieved the insurer of any duty to indemnify. The court also entered judgment in the insured's favor, in accordance with its findings of facts and conclusions of law, and dismissed Computer Corner's declaratory judgment action. The district court made the following key findings of fact and conclusions of law: 1) computer data was tangible property; 2) Computer Corner expected and intended that the data would be lost, and thus, the "Intentional Acts" exclusion barred coverage; and, 3) the "Business Risk" exclusions barred coverage because "there is no liability coverage for substandard work product or services." On appeal, the New Mexico Court of Appeals reversed the district court's findings and held that lost data is considered damage to "other property" and would be covered under the CGL policy.

II. ANALYSIS OF OPINION

To understand this Court of Appeals decision, it is necessary to work through each analytical step taken by the court.

A. Computer Data is Tangible Property.

The court, in writing its opinion, noted that the district court found that the computer data in question "was physical, had an actual physical location, occupied space and was capable of being physically damaged and destroyed." 2002-NMCA-054, at 6. The Court of Appeals also noted that the district court had concluded that "computer data is tangible property." *Id.* Of some significance, the Court of Appeals stated that the parties did not challenge these findings on appeal. *See id.*

As an aside, in a recent federal district court case, *America Online, Inc. v. St. Paul Mercury Insurance Company,* 207 F. Supp. 2d 459, 2002 U.S. Dist. LEXIS 11346 (E.D. Va., June 20, 2002), the court found the exact opposite: computer data is not "tangible" property in the common understanding of the word, and, therefore, there was no coverage for such loss. *America Online,* 207 F. Supp. 2d at 462. In *Computer Corner,* the Court of Appeals apparently relied on the District Court's finding that the data was "tangible property" since neither of the parties challenged that finding and made no separate inquiry about whether the computer data was "tangible property." *See Computer Corner* at 6.

In this regard, it is important to realize that the Court of Appeals reviewed the facts under a substantial evidence standard and reviewed the trial court's application of the law to those facts *de novo*. Under these standards, the Court of Appeals presumably could have challenged the finding that computer data was tangible property, but instead chose not to address the issue, other than to state that "these rulings are not challenged on appeal." *Id.* at 6. Moreover, the Court of Appeals gave no apparent guidance to district courts in determining whether computer data is "tangible property." Accordingly, the door has been left open for a carrier to challenge in an appropriate case whether computer data is "tangible property" (perhaps using the simple logic of *America Online* that computer data is not "tangible" under the common understanding of the word), and to distinguish *Computer Corner* on this basis.

B. Intentional Acts Exclusion.

As noted above, the district court concluded that Computer Corner expected and/or intended that the data would be lost. However, the Court of Appeals, reviewing the trial court's application of the law to those facts *de novo*, chose to disregard the District Court's finding. Instead, the Court of Appeals held that the insured, Computer Corner, did not expect and/or intend that the data would be lost because although Computer Corner's technician may have subjectively intended such results, the insured (Computer Corner's owner) did not. The Court of Appeals therefore determined that from Computer Corner's perspective, the loss of the data was a mistake or carelessness that was unexpected or intended and, thus, did not fall under the CGL policy's "Intentional Acts" exclusion. Given the Court of Appeals' finding that the loss was accidental, its conclusion that the "Intentional Acts" exclusion is inapplicable does not depart from traditional insurance coverage analysis.

C. Business Risk/Work Product Exclusions.

The Court of Appeals next looked at whether the standard CGL "Business Risk/Work Product" exclusions excluded coverage for this claim. The three specific exclusions the Court of Appeals analyzed were as follows:

1. "Property Damage to Your Product…" ("Your Product" exclusion);
2. "Property Damage to Your Work… and Included in the Products-Completed Operations Hazard" ("Completed Hazards" exclusion); and,

3. "Property Damage to Impaired Property or Property that has not been Physically Injured…" ("Impaired Property" exclusion).

The Court of Appeals did not challenge the conventional wisdom that the carrier advanced in support of these exclusions: they prevent an insured from using a CGL policy "to underwrite the insured's business warranties, guarantees, and assurances to customers." *Computer Corner*, at 13. Instead, the Court of Appeals held under the facts of this case, the first two of these exclusions were inapplicable and the third exclusion unenforceable.

1. "Your Product" and "Completed Hazards" Exclusions Inapplicable.

The Court of Appeals determined that the standard "Your Product" and "Completed Hazards" exclusions did not apply to the facts of the case by concluding that these types of exclusions, "when read together with defined terms, are confusing and open to numerous interpretations" for an insured standing in Computer Corner's shoes. *Id.* at 14 and 15.

Ultimately, the Court of Appeals determined that the reasonable insured could not read these two types of Business Risk/Work Product exclusions to include computer data that was not Computer Corner's property. Significantly, and as noted earlier, the Court of Appeals had already adopted the District Court's finding that the computer data was tangible property. The Court, while apparently troubled by the language contained in these exclusions, did not hold that such CGL exclusions were unenforceable. Rather, the Court of Appeals based its decision on the fact that the lost or damaged computer data was not the work product of the insured and was property of a third party.

2. "Impaired Property" Exclusion Unenforceable Under These Facts.

The final exclusion the Court of Appeals considered was the "Impaired Property" exclusion, which it found was unenforceable under the facts of this case. In reaching its conclusion, the Court of Appeals took the standard language of the "Impaired Property" exclusion and inserted definitional terms found elsewhere in the policy. Using this methodology, the Court of Appeals found the exclusion unintelligible and unenforceable from the standpoint of the hypothetical reasonable insured operating a computer repair service. *See id.* at 20, 21. The Court of Appeals even went so far as to state that:

Fireman's exclusion appears as much designed to provide Fireman's lawyers with the widest latitude in making arguments against coverage once a coverage dispute has arisen, as to clearly communicate to lay insureds specific limits on the scope of the coverage.

Id.

The analytical underpinning for the decision rendering this exclusion ("Impaired Property") unenforceable, was the court's reliance on analysis of the objective expectations of the insured -- without regard to or reference to coverage manuals,

insurance industry materials, treatises on insurance law, law reviews, or even cases from other jurisdictions:

In construing standardized policy language, our focus must be upon the objective expectations the language of the policy would create in the mind of a hypothetical reasonable insured, who, we assume, will have limited knowledge of insurance law. . . . Accordingly, we will not impute to the hypothetical reasonable insured knowledge of statements about the meaning, policy goals, and purposes of an exclusion contained in coverage manuals and other insurance industry materials, in treatises on insurance law, in law reviews, or in cases from other jurisdictions unless it is fair to assume that such information would be common knowledge among lay insureds….

Id. at 7 (*citing Rodriguez v. Windsor Ins. Co.*, 118 N.M. 127, 130-31, 879 P.2d 759, 762-63 (1994)).

By using this analysis, the Court of Appeals sidestepped the abundant authority that stands for the proposition that the "Impaired Property" exclusion, together with the related "Business Risk" exclusions bar coverage for the work product of the insured and under certain circumstances property impaired by the insured's work. *See e.g., Blake Indus., Inc. v. General Agents Ins. Co. of Am.*, 2000 Tenn. App. LEXIS 490 *10 (Tenn. Ct. App. July 27, 2000) (recognizing that "the standard comprehensive general liability policy does not provide coverage for an insured-contractor for a breach of contract action grounded upon faulty workmanship or materials, where the damages claimed are the cost of correcting the work itself" under the "Impaired Property" exclusion); *Culp v. Erie Ins. Exch.*, 2000 U.S. Dist. LEXIS 19225 *11 (N.D.W. Va. November 16, 2000) (recognizing that while a CGL policy covers damages resulting from an insured's negligence, coverage does not extend to defective work or workmanship and to the business risk of repair or replacement of defective workmanship that a builder performs because that is considered a "business risk"); *Standard Fire Ins. Co. v. Chester-O'Donley & Assocs., Inc.*, 972 S.W.2d 1, 9 (Tenn.Ct.App. 1998) (recognized that the "Impaired Property" exclusion does not cover a loss of use claim when the insured's failure to provide quality work on products caused the loss and there is no injury to property other than to the insured's work). In fact, the Court of Appeals did not cite to any authority from other jurisdictions regarding the unenforceability of this exclusion. Ultimately, the Court of Appeals concluded that a reasonable insured would not understand that the "Impaired Property" exclusion excluded coverage for lost computer data. Again, as an aside, it is interesting that the U.S. District Court, in the *America Online* case, specifically found enforceable the impaired property exclusion under a similar fact pattern. *See America Online*, 207 F. Supp. 2d at 470-71.

IV. CONCLUSION

In conclusion, *Computer Corner* ultimately can be cited in support of the position that a CGL policy may provide coverage for liability arising for the loss of data stored on a computer hard drive. *Computer Corner* does leave open the door to a carrier proposing a finding of fact that computer data is not "tangible" property. Where parties have directly

requested such a definition (e.g. America Online), at least one U.S. District Court has agreed. Under the typical CGL policy, if a state district court determined that lost computer data does not constitute property loss of "tangible property," there typically would not be coverage for the same. *See e.g., State Auto Property and Casualty Insurance Co. v. Midwest Computers & More*, 147 F. Supp.2d 1113, 1116 (W.D. Okla. 2001) (relying on the ordinary meaning of the term "tangible," the court succinctly found that "computer data cannot be touched, held, or sensed by the human mind; it has no physical substance); *Travelers Insurance Company v. Eljer, Mfg., Inc.*, 757 N.E. 2d 481, 502 (Ill. 2001)(holding that "under its plain and ordinary meaning, the term physical injury to tangible property unambiguously connotes damage to tangible property causing an alteration in appearance, shape, color or in other material dimension."); *MAI Sys. Corp. v. Peak Computer*, 991 F.2d 511, 518 (9th Cir. 1998) (discussing whether Random Access Memory is a "material object" under the Copyright Act); *Potomac Ins. Co. of Ill. v. Peppers*, 890 F. Supp. 634, 645 (S.D. Tex. 1995) (applying Texas law that economic loss is not covered by the "property damage" provision, which is based on the assumption that tangible property, unlike economic loss, is subject to physical injury or destruction); see also generally Symposium, *Insurance and Technology: In Search of Coverage in Cyberspace: Why the Commercial General Liability Policy Fails to Insure Lost of Corrupted Computer Data*, 54 SMU L. REV. 2055 at 2068-70 (reviewing authority holding that injury to, or loss of, ideas and concepts, without damage to the medium in which they are stored, does not qualify as harm to tangible property).

The *Computer Corner* case is also interesting because the Court of Appeals focused on objective expectations of the reasonable insured without reference to insurance manuals, materials, or even case law from other jurisdictions. Nevertheless, it is important to recognize that although the Court of Appeals did question the difficulty in understanding the standard "Business Risk/Work Product" exclusions, it did not generally find such exclusions unenforceable; rather, it held that such exclusions would not be interpreted to include lost computer data belonging to a third party. Given the somewhat broad dicta found in this case, it is likely that this case will be often cited in future New Mexico coverage opinions. Upon close inspection, however, the actual holding of the case -- that the loss of data stored in a computer is covered under a CGL policy -- is actually quite limited.