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Property Damage Is Not Necessarily Physical In Calif.

By **Catherine Doyle and Jan Larson** (December 10, 2018, 3:10 PM EST)

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In a recent decision, Thee Sombrero Inc. v. Scottsdale Insurance Company,[1] a California appellate court ruled against insurers seeking to limit coverage for loss of use damages related to an ownership interest in tangible property. The appellate court held that the "loss of use" need not be a loss of all possible uses of the property and recognized that the loss of a particular use was sufficient to constitute the required property damage. In addition, the appellate court authorized the use of economic loss calculations as an appropriate measure of this covered property damage. In so holding, the appellate court challenged the reasoning of other opinions in a sister state and elsewhere in California, and its detailed analyses of the more insurer-friendly holdings may provide persuasive support for policyholders facing similar issues throughout the country. We suggest that policyholders facing similar situations familiarize themselves with this opinion when advocating for coverage for loss of a particular use of tangible property, resulting in economic losses.

A unanimous panel of the Court of Appeals for the Fourth District of California recently issued an opinion construing a commercial general liability policy's coverage for property damage as extending to economic losses stemming from a loss of use of that property for a particular purpose. In Thee Sombrero Inc. v. Scottsdale Insurance Company, a judgment creditor of the policyholder brought suit against the policyholder's liability insurer to recover the loss of value that resulted from the revocation of a municipal permit to operate a nightclub. The insurer sought to circumvent coverage by contending that the loss of a permit was merely the loss of an intangible right, and that the plaintiff had only suffered economic damages. The insurer argued the plaintiff's claims therefore fell outside of the scope of the liability policy's coverage for property damages. In ruling in favor of coverage, the appellate court undertook a rigorous analysis that refuted the insurer's arguments and distinguished contrary authority that had taken a more insurer-friendly position.

Thee Sombrero Inc. owned commercial property in Colton, California. Sombrero also possessed a conditional use permit, or CUP, issued by the city, which authorized the operation of a nightclub on the premises. In 2007, Sombrero leased the property to lessees who ran a nightclub under the CUP. Among other conditions, the CUP required city approval of the property's floorplan and mandated that the approved floorplan could not be modified without further city approval. The city inspected the property

in connection with the lease and approved the floorplan, which included a single entrance to the nightclub, equipped with a metal detector.

Crime Enforcement Services was hired to provide security services for the nightclub. Unknown to Sombrero at the time, CES converted a storage area on the property into a "VIP entrance" without a metal detector. On June 4, 2007, a fatal shooting occurred inside the nightclub. Sombrero subsequently learned about the "VIP entrance," and the owner of CES admitted that the gun used in the shooting had entered the club via this unauthorized second entrance.

As a result of the shooting at the nightclub, the city revoked the CUP. Sombrero negotiated with the city and secured a modified CUP, allowing for use of the property as a banquet hall instead of a nightclub. However, this restricted use as a banquet hall was less lucrative than the prior use as a nightclub.

In 2009, Sombrero sued CES for breach of contract and negligence, alleging that CES did not frisk the shooter and that CES's failure to screen the shooter led to the shooting, which in turn caused the revocation of the original CUP. The loss of the CUP "lower[ed] the resale and rental value of the [p]roperty" and caused "lost income," since renting the property as a nightclub had been more profitable than renting it as a banquet hall. Sombrero sought damages against CES for "the reduction in fair market value of the [p]roperty" and "lost income." The president of Sombrero attested that the difference in value of the property under the original CUP versus the modified CUP was $923,078. In 2012, the court entered a default judgment against CES for the $923,078 of lost value.

CES had a general liability policy issued by Scottsdale Insurance Company, which covered CES's liability for "property damage" caused by an occurrence. The policy defined "property damage" as either "[p]hysical injury to tangible property, including all resulting loss of use of that property," or "[l]oss of use of tangible property that is not physically injured." As a judgment creditor of CES, Sombrero initiated a direct action against Scottsdale in 2015 seeking coverage for the loss of use, expressed as the $923,078 in economic losses, caused by CES.

Scottsdale moved for summary judgment, arguing that the revocation of the original CUP was not a loss of use of tangible property. Rather, according to Scottsdale, the loss of the original CUP was merely the loss of an intangible right to use the property in a particular way. Scottsdale further asserted that property damage, as contemplated by the policy, did not include economic loss. Sombrero responded that it lost the use of tangible property because of the revocation of the original CUP and argued that the economic loss resulting from the loss of use of tangible property did constitute property damage covered by the policy. The trial court agreed with Scottsdale and granted the motion for summary judgment in 2016. In its order, the trial court held, "[l]ost value is economic loss, but economic loss is not lost use of tangible property."

Sombrero appealed, reiterating its argument that the loss of use of the property resulting from the revocation of the original CUP constituted "loss of use of tangible property that is not physically injured." The appellate court noted that the interpretation of an insurance policy is a question of law subject to de novo review under settled rules of contract interpretation. Among those well-settled rules of interpreting insurance contracts, the appellate court construes ambiguous language to protect the objectively reasonable expectations of the policyholder.

At the outset of its analysis, the appellate court declared that it "defies common sense to argue" that Sombrero's loss of its ability to use its property as a nightclub is not, by definition, a loss of use of tangible property. The appellate court then dispatched conflicting authority, including a Washington

appellate court decision also involving Scottsdale with "strikingly similar" facts.[2] In Scottsdale Insurance Co. v. Int'l Protective Agency, the dispute centered on the loss of a restaurant's liquor permit caused by the negligence of Scottsdale's policyholder, a security company that permitted a minor to enter the restaurant. The opinion in IPA did not persuade the appellate court in Thee Sombrero to abandon its "common-sense position." In the view of the appellate court, the coverage analysis properly focused on the loss of use of property that results from the loss of an entitlement and not the loss of the intangible entitlement itself. Although a permit or license is not tangible property itself, its loss means the owner of the property can no longer use that property in a particular way. Furthermore, the reasonable expectations of the policyholder would construe "loss of use" to include the loss of any significant use of the property, not merely the total loss of all possible uses. Finally, the appellate court parted ways, in dictum, with the IPA court's assertion that a right to occupy premises is not a tangible property interest. To the contrary, at least under California law, a lease is considered a conveyance of an estate in real property. Moreover, regardless of the technical legal contours, a policyholder would understand "tangible property" in an insurance policy to include leased real property. In any event, the appellate court determined that Sombrero, as the owner of the property at issue, plainly owned an interest in tangible property.

Having disposed of Scottsdale's argument that Sombrero had only lost an intangible right to use its property in a particular way, the appellate court went on to address other points of disagreement with the trial court's ruling. The trial court had granted summary judgment for Scottsdale under the rationale that a "mere economic loss" is not property damage. Generally speaking, strictly economic losses — such as lost profits, loss of an investment, loss of goodwill or loss of an anticipated benefit of a bargain — will not constitute tangible property damage as contemplated by a commercial general liability policy. However, where the intangible economic losses provide a measure of damages to tangible property that is covered by the policy, the policy will provide coverage for those damages. In other words, loss of economic value is an appropriate method of measurement to calculate property damage in the commercial general liability policy context. The diminution of property value is not merely economic loss but damages sustained because of property damage. Therefore, the appellate court articulated that the correct principle is not that economic losses can never constitute property damage; rather, only losses that are exclusively economic and that lack any accompanying physical damage or loss of use of tangible property are not property damage. Under this principle, Sombrero suffered a loss of use of tangible property under the policy. Further, the loss of value was a proper measure of those damages. Sombrero's use of the diminution of value calculation to measure its damages did not provide an escape hatch for Scottsdale to avoid coverage.

The appellate court also dispensed with other precedent offered by Scottsdale. Referring back to the policy language, "[l]oss of use of tangible property that is not physically injured," the appellate court distinguished a California Supreme Court case that sided with an insurer on claims based on the loss of an easement, which was not itself tangible property, and resulting in loss in value but no physical damage to the injured party's property.[3] The appellate court also distinguished a 2007 decision from the Second District appellate court involving a case brought by a lessee against its landlord for the landlord's failure to maintain the property in the condition in which the landlord had contracted to maintain it, as this amounted to a breach of contract claim over leasehold interests and not the loss of use of tangible property.[4] Although the appellate court in Thee Sombrero again expressed doubt, in dictum, over the expressed proposition in the Golden Eagle opinion that leasehold interests are not tangible property, it relied upon Sombrero's status as property owner to hold that its claim for diminution of value or its ownership interest constituted a claim for loss of tangible property.

Since the appellate court ruled in favor of Sombrero on grounds that the loss of the original CUP was

anchored to the covered loss of use of tangible property and was properly measured by the loss of value economic damages, the court declined to address alternative arguments raised by Sombrero. Questions of whether the loss of the original CUP itself constituted a loss of use of tangible property and whether the construction of the unauthorized VIP entrance constituted physical damage to tangible property (arguably not an "occurrence," defined as an "accident" by the policy) were thus reserved for another day.

The appellate court's opinion in Thee Sombrero underscores the benefit to policyholders of express policy language that encompasses the loss of use of tangible property that has not sustained physical damage. We recommend policyholders review their commercial general liability policy provisions, including the definitions, and consider the appellate court's analysis in Thee Sombrero when evaluating whether their policy may extend to claimed loss of use damages, even where property is not physically damaged. Policyholders may find persuasive support in the methodical examination of the practical, "common sense" connection between the loss of a right to use tangible property and the covered loss of use of such property. The opinion also provides an analytical foundation for the applicability of economic losses as the correct measure of the property damages. The strongest support may be for property owners above lessees in Thee Sombrero, although the appellate court articulated certain reservations that suggest it may be persuaded by future arguments regarding similar loss of use claims made by lessees, as well.

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[1] Thee Sombrero Inc. v. Scottsdale Insurance Company, 239 Cal. Rptr. 3d 416 (Cal. Ct. App. 2018)

[2] Scottsdale Ins. Co. v. Int'l Protective Agency Inc., 19 P.3d 1058 (Wash. Ct. App. 2001) (IPA).

[3] Kazi v. State Farm Fire & Cas. Co., 15 P.3d 223 (Cal. 2001).

[4] Golden Eagle Ins. Corp. v. Cen-Fed Ltd., 56 Cal. Rptr. 3d 279 (Cal. Ct. App. 2007).