CASE STUDY PREPARED FROM ORIGINAL PUBLISHED OPINION

ERNEST A. LONG
Alternative Dispute Resolution
Resolution Arts Building
2630 J Street, Sacramento, CA 95816
ph: (916) 442-6739 • fx: (916) 442-4107
elong@ernestalongadr.com • www.ernestalongadr.com

Three Sombrero v Scottsdale Insurance Company *10/25/18*

Insurance Coverage; (Ins. Code, § 11580, subd. (b)(2)) ; Loss of Use; Diminution in Value as Measure of Damages

Thee Sombrero, Inc. (Sombrero) owned a piece of commercial property in the city of Colton. A conditional use permit (CUP) had been issued authorizing the use of the property as a nightclub. One of the conditions of the CUP was that the city had to approve the floor plan for the property, and thereafter, the floor plan could not be modified without city approval.

In 2007, Sombrero leased the property to new tenants who operated it as a nightclub called El Sombrero. In connection with the new tenancy, the city inspected the property; it approved a floor plan, and it found that the property was in compliance with the floor plan. As part of the floor plan, the club had a single entrance door, equipped with a metal detector.

Crime Enforcement Services (CES) provided security guard services at El Sombrero. It had a corporate general liability policy issued by Scottsdale. The policy covered CES's liability for "property damage" caused by an "occurrence." **"Property damage" was defined as either (a) "physical injury to tangible property, including all resulting loss of use of that property," or (b) "loss of use of tangible property that is not physically injured."** "Occurrence," for present purposes, was defined as "an accident."

On June 4, 2007, one patron of El Sombrero shot and killed another. After the shooting, Sombrero learned that CES had converted a storage area into a "VIP entrance" to the club. The VIP entrance had no metal detector. The owner of CES admitted that the gun used in the shooting got into the club through the VIP entrance.

As a result of the shooting, the city of Colton revoked the conditional use permit. Sombrero managed to negotiate a modified CUP, which allowed it to operate the property as a banquet hall rather than as a nightclub.

On May 26, 2009, Sombrero sued the security company, CES, for breach of contract and for negligence. The **complaint alleged** that CES failed to frisk the shooter and that this failure caused the revocation of the CUP. The revocation of the CUP, in turn, "**lowered the resale and rental value of the Property" and caused "lost income**." As damages, the complaint sought "the reduction in fair market value of the Property" as well as "lost income."

On May 24, 2012, Sombrero obtained a default judgment against CES for $923,078. Henry Aguila, the president of Sombrero, submitted a declaration in support of the default judgment in which he stated:

"The property went from being valued at $2,769,231 . . . with its large occupancy and nightclub entitlement, to being valued at $1,846,153 after the modified conditional use permit allowing for private banquet use . . . . The difference in value is $923,078."

"Sombrero is seeking negligence damages against CES . . . in the amount of $923,078, which represents the loss in value due to the modification of the conditional use permit."

Sombrero then filed this direct action (Ins. Code, § 11580, subd. (b)(2)) against Scottsdale Insurance Company (Scottsdale), the security company CES's liability insurer.

Scottsdale filed a motion for summary judgment. It argued that the loss of the CUP was not a loss of use of tangible property but merely the loss of an intangible right to use property in a certain way. It also argued that property damage does not include economic loss.

In its opposition, Sombrero argued, among other things, that it lost the use of tangible property due to the revocation of the CUP. It also argued that, when an economic loss results from the loss of use of tangible property, it is covered as property damage.

On October 11, 2016, after hearing argument, the trial court granted the motion. It explained: "The underlying judgment against CES was set in the amount of $923,078 based on lost value after the permit was revoked. This amount is what Sombrero is seeking to recover from Scottsdale in this case and is described by Sombrero as economic loss. Lost value is economic loss, but economic loss is not lost use of tangible property. Accordingly, the coverage in Scottsdale's policy for property damage does

not extend to Sombrero's economic losses caused by Scottsdale's insureds." On November 7, 2016, the trial court entered judgment accordingly.

On appeal, Sombrero contends that "the loss of use of the property by the revocation of the CUP constitutes . . . 'loss of use of tangible property that is not physically injured.'"

The Fourth District Court of Appeal began its opinion by noting that: "Liability insurance obligates the insurer to indemnify the insured against third party claims covered by the policy by settling the claim or paying any judgment against the insured. **Where judgment is obtained against an insured in an action based on bodily injury, death, or property damage, the plaintiff (now a judgment creditor) may bring an action against the insurer on the policy, subject to the policy's terms and limitations, to recover on the judgment. In short, the '"judgment creditor may proceed directly against any liability insurance covering the defendant, and obtain satisfaction of the judgment up to the amount of the policy limits."'** Among the elements that must be proven is that '"the policy covers the relief awarded in the judgment. . . ."' " (*Howard v. American Nat. Fire Ins. Co.* (2010) 187 Cal.App.4th 498, 512–513.)

"An insurer's duty of indemnification requires a determination of actual coverage under the policy. In contrast, **'"a liability insurer owes a duty to defend its insured when the claim creates any *potential* for indemnity.'"** 'The insurer must defend in some lawsuits where liability under the policy ultimately fails to materialize; this is one reason why it is often said that the duty to defend is broader than the duty to indemnify.' " (*Advanced Network, Inc. v. Peerless Ins. Co.* (2010) 190 Cal.App.4th 1054, 1060–1061.)

Sombrero persistently argues that Scottsdale had to show that there was no *potential* for coverage. However, as it acknowledges, this standard applies to the duty to defend, not the duty to indemnify. "'While an insurer has a duty to defend suits which potentially seek covered damages, **it has a duty to indemnify only where a judgment has been entered on a theory which is *actually* (not potentially) covered by the policy.'"** (*Palmer v. Truck Ins. Exchange* (1999) 21 Cal.4th 1109, 1120.) Thus, Scottsdale only had to show that there was no *actual* coverage.

This does not mean that cases dealing with a duty to defend are irrelevant. If a case holds that there is no duty to defend on facts similar to those here, it necessarily follows that there is also no duty to indemnify.

Contrariwise, if a case holds that there is a duty to defend, because there is a *potential* that the facts *might* turn out to be similar to the facts here, it follows that there *is* a duty to indemnify on these facts.

According to the allegations of Sombrero's complaint against CES, CES's negligence caused the revocation of the CUP, which caused Sombrero to lose the ability to use the property as a nightclub. **The loss of the ability to use the property as a nightclub is, by definition, a "loss of use" of "tangible property."** It defies common sense to argue otherwise.

Nevertheless, there is some contrary authority. Scottsdale relies on a case with strikingly similar facts, *Scottsdale Ins. Co. v. International Protective Agency, Inc.* (2001) 105 Wash.App. 244. There, Scottsdale insured a security services company, IPA. One of IPA's clients was a restaurant owned by Northwest Visions. Northwest Visions sued IPA, alleging, among other things, that IPA negligently allowed a minor to enter the restaurant and, as a result, Northwest Visions lost its liquor license. Scottsdale refused to defend, on the ground that Northwest Visions was not claiming property damage. Northwest Visions obtained a default judgment against IPA. Scottsdale then filed an action for a declaratory judgment regarding its

duty to defend. The trial court denied Scottsdale's motion for summary judgment.

The appellate court reversed. It held that Northwest Visions' "complaint does not allege loss of use of *tangible* property. . . . A liquor license is merely representative of a privilege granted by the state and, as such, is intangible property. . . . The complaint alleges that Northwest Visions lost its *liquor license* thereby destroying its *business*. There is no allegation or evidence in the record that Northwest Visions lost its use of or right to occupy the premises. Even if it had, a right to occupy premises is not a tangible property interest. . . . Scottsdale correctly argues that there was no property damage within the meaning of the policy because the complaint does not allege that Northwest Visions . . . lost the use of the premises or building for 'any purpose, as owner or lessee, other than one that involves the sale of liquor.' " (*Scottsdale Ins. Co. v. International Protective Agency, Inc.*, at pp. 249–250)

IPA is helpful, because it outlines the arguments that can be made against the common-sense position, but the Justices find it is ultimately unpersuasive, for three reasons.

First, **the appropriate focus is not on the loss of the entitlement, but rather on the loss of use of tangible property that *results* from the loss of the entitlement.** The Court agrees that in *IPA*, the liquor license was not tangible property. Nevertheless, the loss of the liquor license meant that Northwest Visions could no longer use its premises for the remunerative purpose of selling diners alcohol along with their food. Here, identically, the revocation of the CUP meant that Sombrero could no longer use the property as a nightclub.

Second, the reasonable expectations of the insured would be that **"loss of use" means the loss of *any* significant use of the premises**, not the total loss of all uses. (*Liberty Mut. Ins. Co. v. Wheelwright Trucking Co., Inc.* (Ala. 2002) 851 So.2d 466, 494–495) California law is in accord. In *Hendrickson v. Zurich American Ins. Co. of Illinois* (1999) 72 Cal.App.4th 1084, a group of growers sued Crown Nursery, alleging that it sold them strawberry plants that had been damaged by an herbicide. Zurich insured Crown Nursery, but Zurich refused to defend, arguing that the growers had not alleged any property damage. The appellate court disagreed: "Here, the growers' complaint may reasonably be construed as alleging that as a result of Crown Nursery's negligent delivery of defective plants, the growers suffered a loss of strawberry production, and thereby a loss of

the use of their land. The policies in this case expressly state that 'loss of use of tangible property that is not physically injured' constitutes 'property damage.' Thus, the DCA concludes that the growers' action presents a potential for coverage which requires a defense." *Hendrickson* therefore supports the Court's view that **a loss of a particular use of tangible property can be property damage.**

Scottsdale argues that *Hendrickson* involved a physical injury rather than a loss of use; it asserts, "The court found the insured's contaminated strawberries could have potentially ruined tangible property, namely, the claimants' strawberry crop." Not so. As quoted above, the court specifically concluded that "the growers suffered . . . *a loss of the use of their land*." (*Hendrickson v. Zurich American Ins. Co. of Illinois*, at p. 1091)

Third, the Justices question IPA's statement that "a right to occupy premises is not a tangible property interest." (*Scottsdale Ins. Co. v. International Protective Agency, Inc.*, at p. 250) At least under California law, "a lease is . . . a conveyance of an estate in real property . . . . " (*Avalon Pacific-Santa Ana, L.P. v. HD Supply Repair & Remodel, LLC* (2011) 192 Cal.App.4th 1183, 1190.) A building is tangible. Dirt is tangible. Hence**, a**

lessee in possession has a tangible property interest in the leased premises.

In any event, the issue is not whether, as a technical legal matter, a leasehold is tangible property. Rather, it is whether an insured, reading his or her policy, would understand "tangible property" to include real property that he or she leases. If your leased apartment was rendered uninhabitable by some noxious stench, you would conclude that you had lost the use of tangible property; and if a lawyer said no, actually you had merely lost the use of your intangible lease, you would goggle in disbelief.

Most important, though, this discussion point is dictum, because the case on appeal is distinguishable. Here, Sombrero is the owner of the property, not a lessee. As such, it plainly has an interest in tangible property.

The trial court did not actually rely on Scottsdale's argument (based on *IPA*) that Sombrero lost only an intangible right to use property in a certain way. Instead, it ruled that Sombrero suffered an economic loss, and that this is not property damage. Scottsdale therefore argues that a "mere economic loss" is not a loss of use of tangible property.

"Strictly economic losses like lost profits, loss of goodwill, loss of the anticipated benefit of a bargain, and loss of an investment, do not constitute damage or injury to tangible property covered by a comprehensive general liability policy." (*Giddings v. Industrial Indemnity Co.* (1980) 112 Cal.App.3d 213, 219.) However, as *Giddings* added, "**A complaint seeking to recover damages of this nature from an insured does fall within the scope of the insurance coverage . . . where these intangible economic losses provide 'a measure of damages to physical property which is within the policy's coverage.**' " "In the liability policy context, **diminution in market value is accepted as a *proper method of measurement* of any property damages** which may have been sustained. " (*Pruyn v. Agricultural Ins. Co.* (1995) 36 Cal.App.4th 500, 510; accord, *Mid-Continent Cas. Co. v. Circle S Feed Store, LLC* (10th Cir. 2014) 754 F.3d 1175, 1184; *Lucker Mfg. v. Home Ins. Co.* (3d Cir. 1994) 23 F.3d 808, 818, fn. 12.)

In *Hendrickson*, the insurer argued that the growers' claims for lost strawberry production "do not allege a loss of use of property, but claim only economic losses associated with the property, which does not constitute property damage." (*Hendrickson v. Zurich American Ins. Co. of Illinois*, at p. 1090.) The appellate court disagreed: "The alleged loss of

profits or diminution in property value are **not solely economic losses, but damages because of property damage**, and therefore constituted alternative measures of any property damage allegedly sustained."

The correct principle, then, is *not* that economic losses, by definition, do not constitute property damage. Like the court in *Auto-Owners Insurance Company v. Southeastern Car Wash Systems* (E.D. Tenn. 2016) 184 F.Supp.3d 625, the Justices "find it difficult to conceive of loss-of-use damages as anything *other* than economic losses." Rather, the correct principle is that **losses that are *exclusively* economic, without any accompanying physical damage or loss of use of tangible property, do not constitute property damage.**

Here, for the reasons already stated, Sombrero did suffer a loss of use of tangible property. Moreover, **the diminution in value of the property was a proper measure of the damages from that loss of use**. Thus, the mere fact that Sombrero was seeking to recover damages calculated on the basis of diminution in value falls short of showing that it was not seeking to hold CES liable for a loss of use of tangible property.

At oral argument, Scottsdale asserted for the first time that *Kazi v. State Farm Fire & Cas. Co.* (2001) 24 Cal.4th 871 is on point. There, the Tollaksons sued the Kazis, claiming that they had an implied easement over the Kazis' land and that the Kazis had interfered with their easement. Moreover, they claimed that, absent the easement, their own land "was not buildable." They alleged that the interference with the easement had diminished the value of their own land by $400,000.

The Kazis had three separate insurance policies that covered liability for property damage. One defined property damage as "'physical injury to or destruction of tangible property, including loss of its use.'" (*Kazi v. State Farm Fire and Cas. Co.*, at p. 876.) Another defined it as "' . . . damage to or loss of use of tangible property." The third defined it as "'physical damage to or destruction of tangible property, including loss of use of this property.'" The insurers failed to defend.

The Supreme Court held that there was no potential coverage, and hence no duty to defend, for two reasons. First, an easement is not tangible property. (*Kazi v. State Farm Fire and Cas. Co.*, at pp. 880-885.) Second, the Tollaksons had not claimed that there was any physical damage to their own land.

Kazi is not controlling here because there is a crucial difference between the policy language in *Kazi* and the policy language in this case. *Kazi* relied extensively (see *Kazi v. State Farm Fire and Cas. Co.*, at pp. 874-875, 878-884, 887) on the earlier case of *Gunderson v. Fire Ins. Exchange* (1995) 37 Cal.App.4th 1106. *Gunderson* had held, among other things, that when a policy defines property damage as "physical injury to or destruction of tangible property, including loss of its use," it does *not* cover the loss of use of property that has *not* been physically damaged. Thus, in *Kazi*, the Supreme Court rejected any coverage for loss of use of the Tollakson's own land on the sole ground that **it had not been physically injured.**

Here, however, the policy expressly defined property damage as including "loss of use of tangible property *that is not physically injured*." Thus, unlike in *Kazi*, the mere fact that Sombrero's property was not physically damaged is not dispositive of the question of whether there was coverage for loss of use of that property.

Sombrero's claim for the diminution in value of its ownership interest, even though it was a claim for economic loss, was a claim for

loss of use of tangible property. Sombrero's loss of the ability to use the property as a nightclub constituted property damage, which was defined in the policy as including a loss of use of tangible property.

The judgment is reversed. Sombrero is awarded costs on appeal against Scottsdale.