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PERSPECTIVE

Rulings disagree: Is loss of use of a leasehold 'property damage'?

By Peter S. Selvin

Is a party's loss of use of a leasehold or other interest in real property considered "property damage" within the meaning of a comprehensive general liability policy? Two recent cases go in different directions on this point.

The starting point is the CGL's Coverage A, which typically provides coverage for "bodily injury and property damage liability." In turn, "property damage" is typically defined to include the "loss of use of tangible property that is not physically injured." The key question addressed by the following cases is whether a party's leasehold or other interest in real property constitutes "tangible property."

In *Thee Sombrero v. Scottsdale Insurance Company*, 28 Cal. App. 5th 729 (2018), there was a fatal shooting at a nightclub which resulted in the revocation of a conditional-use permit to operate the premises as a nightclub. That conditional-use permit was replaced with a modified permit which provided that the property could be operated only as a banquet hall.

In the underlying liability action, the nightclub owner had brought suit against its former security company for negligence. In that suit, the nightclub owner asserted that the security company's negligence caused the shooting, which in turn caused a diminution in the value of the property. The nightclub owner obtained a default judgment against the security company.

The security company was insured under a CGL policy issued by Scottsdale. Following the security company's default in the underlying liability action, the nightclub owner brought a direct action against Scottsdale under Insurance Code Section 11580(b)(2) in which it sought to recover damages representing the diminution in the value of the property.

Finding that the nightclub owner's claim for damages represented "economic loss [that] is not lost use of tangible property," the trial court granted Scottsdale's motion for summary judgment. The Court of Appeal reversed.

The Court of Appeal rejected the notion that the underlying injury was solely for economic loss. In this regard, the court noted that "[a] building is tangible. Dirt is tangible. Hence, a lessee in possession has a tangible property interest in the leased premises." In so reasoning, the court distinguished an earlier appellate decision, *Golden Eagle Ins. Corp. v. Cen-Fed, Ltd.*, 148 Cal. App. 4th 976 (2007), which determined that a bank's claim that it was deprived of use of leased space due to its landlord's failure to maintain and repair the premises "rested entirely on [the landlord's] alleged breach of the lease and the resulting economic damage."

The *Thee Sombrero* court acknowledged that "losses that are *exclusively* economic, without any accompanying physical damage or loss of use of tangible property, do not constitute not constitute property damage" (emphasis in original). But since "dirt is tangible," the court reasoned that the modified permit's restrictions on the use of the property satisfied the requirement that the nightclub owner had suffered a "loss of use of tangible property that is not physically injured."

Significantly, the court in *Thee Sombrero* held that "loss of use" in the CGL context "means the loss of *any* significant use of the premises, not the total loss of all uses" (emphasis in original). Thus, the diminished use to which the nightclub premises had been restricted under the modified permit satisfied the policy's "loss of use" benchmark. *See also Modern Equipment Co. v. Continental Western Ins. Co., Inc.*, 355 F.3d 1125 (8th Cir. 2004) (diminished use of warehouse due to collapse of several sections of storage racks constituted property damage).

Thee Sombrero was followed by *Conway v. Northfield Ins. Co.*, 399 F. Supp. 3d 950 (N.D. Cal. 2019). There, the lessee of commercial restaurant space brought an action against her commercial landlord (Conway) for various acts of interference, which ultimately resulted in the tenant having to close her business after many years of operation. In essence, the tenant asserted that the landlord's actions had deprived her of the ability to use the restaurant premises.

Conway tendered the suit to his liability carrier (Northfield) which declined to provide a defense in respect to the tenant's suit. Conway then sued Northfield, alleging, among other things, that the tenant's allegation of deprivation of use of the restaurant space satisfied the "property damage" requirement under the policy.

The court in *Conway* ultimately found coverage for the landlord, but not on the ground that the tenant's allegation of deprivation of use of the restaurant space rose to the level of "property damage" under the policy. Characterizing the "dirt is tangible" language from the *Thee Sombrero* decision as dictum, the court cited *Golden Eagle* to support its view that leaseholds do not constitute tangible property. On this basis the court held that the tenant's action did not raise a potential claim for "loss of use of tangible property" arising out of the tenant's inability to use the restaurant premises. *See also Scottsdale Ins. Co. v. Darke*, 424 F.Supp.3d 638 (N.D. Cal. 2019) (citing *Conway* with approval on this point).

But the court in *Conway* nevertheless found coverage for the tenant's suit on the theory that the tenant's suit involved a potential claim for loss of use of the tenant's own property, including equipment, fixtures, tables and chairs, in the operation of the restaurant. In so holding the court cited *Riverbank Holding Co., LLC v. N. H. Ins. Co.*, 2012 WL 2119046, at * 8 (E.D. Cal. 2012) for the proposition that a loss of use of a tenant improvement does meet the requirement of "loss of use of tangible property," thereby triggering coverage under the CGL policy.

It is difficult to reconcile *Thee Sombrero* with *Conway* and *Darke* and authoritative guidance will have to await a decision from the California Supreme Court. In the meantime, the debate on this point between policyholders and insurance carriers will continue. ■

Peter S. Selvin *is a partner at Ervin Cohen & Jessup LLP. You can reach him at pselvin@ecjlaw.com.*