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September 2024 | Insurance Update | WWW.RIVKINRADLER.COM

California Supreme Court Rejects Restaurant's Illusory Coverage Argument and Holds That Virus Endorsement Did Not Cover Pandemic-Related Loss

John's Grill, a San Francisco restaurant, bought a commercial property insurance policy from Sentinel Insurance Company. The policy had a Limited Fungi, Bacteria or Virus Coverage Endorsement (Virus Endorsement). The endorsement covered virus-related losses that resulted from certain specified losses, such as windstorms, water damage, vandalism, and explosion. But the endorsement otherwise excluded coverage for virus-related losses.

The restaurant lost money during the COVID-19 pandemic and submitted a claim to Sentinel. Sentinel denied coverage because there was no direct physical loss or damage to property, and because the Virus Endorsement excluded coverage.

John's Grill then sued Sentinel for breach of contract and bad faith denial of its claim. It conceded that none of the causes specified in the Virus Endorsement applied. But it argued that any promise of virus-related coverage was illusory because the specified cause of loss limitation was impossible to satisfy. After losing on this issue at the trial court, John's Grill persuaded the intermediate appellate court to reverse. The Court of Appeal found that the promise of coverage was illusory because John's Grill had no realistic prospect of benefitting from the virus-related coverage as written.

But the California Supreme Court wasn't having it. It found the Virus Endorsement to be clear and unambiguous. The endorsement provides virus-related coverage, but only if the virus results from causes specified. The court followed the rules of contract interpretation, which require that the plain meaning of the policy must prevail. As John's Grill could not satisfy the requirements of the endorsement, there was no coverage.

John's Grill argued that the cause of loss limitation in the Virus Endorsement should be disregarded, and that any virus-related loss should be covered regardless of the cause. The California Supreme Court said that it never interpreted the illusory coverage doctrine so broadly, if it even recognized the doctrine at all.

But even if some version of the illusory coverage doctrine exists under California law, the court said that the insured must show that it had a reasonable expectation that the policy would cover the insured's loss. Because John's Grill has not shown it had a reasonable expectation of coverage for pandemic-related losses, it failed to establish that the Sentinel policy created an illusion of coverage that rendered any other policy language unenforceable.

And the court noted that even under John's Grill's articulation of the doctrine, it still could not show that coverage was illusory because the policy offered the insured a realistic prospect for virus-related coverage in some cases.

The California Supreme Court thus reversed the Court of Appeal's ruling.

The case is *John's Grill, Inc. v. The Hartford Fin. Servs. Grp., Inc.*, No. S278481 (Cal. Aug. 8. 2024).

California Court Rules That Russian Seizure of Foreign-Owned Aircraft Following Ukraine Invasion Was Physical Loss Under Insurance Policy

The insured, BABM US LP, leased commercial aircraft to an airline company in which the Russian government was a majority owner. After Russia invaded Ukraine in February 2022, the Russian government banned the export of aircraft out of Russia. BBAM then terminated the leases and demanded immediate return of the aircraft, but the lessees refused. The aircraft continued to be used in Russia without BBAM's consent.

BBAM noticed a claim to its insurer, Tokio Marine Kiln Syndicates Limited (KLN). BBAM later began a coverage suit against KLN in California state court. KLN moved for summary judgment.

The court denied the motion. The issue was whether BBAM had suffered a "physical loss or damage" under the policy. The court held that under California law a seizure of insured property is a physical loss for coverage purposes. The court first observed that "direct physical loss," and "direct physical damage" must have some non-overlapping meaning. Otherwise, the terms would be redundant. As the court observed, while "direct physical damage" to property must include an alteration or impairment of the property itself, a "direct physical loss" was broader and includes a physical deprivation of the property.

The court also rejected KLN's reliance on a "loss of use" exclusion. The court emphasized that "loss of use" of property is different from "loss" of property. "Loss of use" seeks the rental value of the property, while "loss of property" seeks the replacement value. A "loss of use" does not exist, as in BBAM's suit, when the claimant seeks to recover the value of the property lost, here the aircraft. The loss of use exclusion itself drew this distinction, the court suggested, as it barred coverage for "loss of use . . . whether following upon loss of or damage to the insured property or otherwise."

Because there was a covered "direct physical loss" and the loss of use exclusion didn't apply, the court denied KLN's motion for summary judgment.

The case is *BBAM US LP, et al. v. KLN 510 Tokio Marine Kiln, et al.*, Case No. CGC-22-603451 (Cal. Super. Ct., Aug. 2, 2024).

California Appellate Court Finds No Occurrence for Alleged Loss of Use of Commercial Property Based on Traffic Caused by Adjacent Starbucks Drive-Thru

Rancho Oaks Investments, LLC leased a property for commercial use to Lighting & Bulbs Wholesale Supply, Inc (L&B). For a time, L&B operated a store with sole and exclusive use of the property, including the driveway and parking lot in the front of the store's entrance.

The Winchester Family Trust owned the adjacent property. In October 2011, Rancho informed L&B that it intended to enter into a reciprocal easement agreement with the Trust. Racho represented to L&B that this easement would directly benefit L&B because its customers would be allowed to access the store

from more entry points. Rancho said a new business would be located on the Winchester Property but did not tell L&B that this new business would be a drive-thru only Starbucks.

Starbucks began operating. Over time, the Starbucks store became more popular. Traffic problems arose as cars for the Starbucks drive-thru would line up directly in front of L&B's customer parking spaces. This allegedly interfered with L&B's business.

L&B sued Rancho for, among other things, breach of the lease and implied covenants, and negligent misrepresentation. L&B also raised claims against Starbucks for nuisance and trespass.

Farmers Insurance Group insured Rancho. Mid-Century insured the Winchester Family Trust. The policies covered property damage "caused by an 'occurrence.'" The policies defined an "occurrence" as an accident. Farmers refused to defend Rancho, claiming there was no potential for coverage under the policy because the claims against Rancho were contractual or intentional and thus did not seek recovery for property damage "caused by an 'occurrence.'"

Rancho sued Farmers in California state court. The trial court granted the insurers' motion for summary judgment. Rancho appealed.

To begin with, the California Court of Appeals held that the insurers were not bound by employees' emails opining that the L&B action raised a potential for a coverage and a duty to defend. The court noted that these statements were not testimony but merely opinions expressed by employees in otherwise confidential internal communications. Binding the insurer to these opinions would discourage free discussions among insurance company employees.

As to the merits, the court held that the insurers were entitled to judgment as a matter of law because any alleged property damage was not caused by an "Occurrence" or "accident."

Under California law, an accident refers to the insured's act, not its unexpected consequences. Damage caused by an insured's deliberate act could never have been an accident unless some additional, unexpected, independent, and unforeseen happening occurs that produces the damage. And an insured's subjective intent is irrelevant.

The court then found no accident. Rancho intentionally sought the reciprocal easement and intentionally leased the Winchester Property to Starbucks. It was irrelevant that Rancho did not intend to interfere with L&B's operations or that the Starbucks became "unexpectedly popular." The damage was created by Ranchos' drafting of the reciprocal easement and the Starbucks lease without any real limit on Starbuck's easement rights. It was thus reasonably foreseeable that the traffic problems caused by the drive-thru Starbucks would occur.

The court affirmed the trial court's judgment.

The case is *Rancho Oaks Invs. v. Mid-Century Ins.,* No. B330122 (Cal. Ct. App. Aug. 20, 2024). Note: This decision is unpublished. California Rules of Court Rule 8.1115(a) prohibits courts and parties from citing or relying on unpublished decisions except as specified by Rule 8.1115(b).

Seventh Circuit Upholds Rescission Because Policyholder Failed to Disclose That Business Was Embroiled in a Name Fight

Insurers may rescind policies if the policyholder provides false information in its application for insurance and that false information materially affects the risk assumed by the insurer.

That was the situation for principles of SBC Flood Waste Solutions, a family-run Chicago waste hauling business that failed to disclose to its insurer when applying for insurance that it was involved in a dispute over the use of the name "Flood" in its business.

Mike Flood founded a waste collection and hauling company called Flood Brothers Waste Disposal Company. Mike's son Brian, and his grandchildren, Chris and Shawn, worked at Flood Brothers. Chris also had a side business, Flood, Inc., which provided waste collection and hauling services for clients not serviced by Flood Brothers.

There was a falling out, and Brian, Chris, and Shawn were pushed out of Flood Brothers. Mike's attorney sent Brian and Chris a cease-and-desist letter, demanding they stop using the Flood name commercially.

Brian and his sons formed a new company called SBC Flood Waste Solutions, Inc. They then sought to obtain commercial liability and auto insurance for the business.

When asked in the application about its loss history, SBC said there was "none" and did not mention the name dispute. When asked about other business ventures, SBC did not disclose Flood, Inc., Chris's side business. Believing there was no loss history or potential claims, the insurer went ahead and issued the policy.

Three months later, Flood Brothers sued SBC alleging improper and unfair use of the Flood name in connection with SBC's waste collection and hauling services. SBC sought a defense from its insurer and the insurer sought a declaratory judgment for rescission. The court permitted the insurer to rescind the policy because SBC made materially false statements in its insurance applications. SBC appealed.

The Seventh Circuit affirmed.

It first considered whether SBC made misrepresentations. It found that SBC omitted to disclose the dispute over the Flood name despite being "acutely aware of a live dispute." And it found that SBC never disclosed the existence of Flood, Inc. despite being asked about other business ventures for which coverage was *not* being sought. SBC argued that it did not have to mention Flood, Inc. in the application because that was a separate company. But the court rejected this argument, finding that there was no such qualification in the application. The application asked for "other business ventures," and none were disclosed. The court said that was a misrepresentation.

The court next considered whether the misrepresentations were material. It noted that materiality under Illinois law is measured objectively. Failing to disclose a dispute that already led to letters threatening litigation, the court said, was material. This is especially so, given that Flood Brothers' demand on SBC to cease and desist using the Flood name led directly to the lawsuit for which SBC seeks a defense.

Similarly, failing to disclose the existence of Flood, Inc. was material because the businesses were operating in the same industry in the same area. In the trial court, there was testimony from the insurer's underwriter that suggested failing to disclose Flood, Inc. would not have definitively led to a rejection of

SBC's application. But the underwriter testified that the insurer would have requested more information about Flood, Inc. before deciding whether to issue the policy. This omission was thus material to the risk assumed by the insurer. The Seventh Circuit thus upheld rescission.

The case is *Grinnell Mut. Reinsurance Co. v. SBC Flood Waste Sols., Inc.*, No. 23-1847 (7th Cir. Aug. 21, 2024).

Massachusetts Appellate Court Holds That Cost of Repairing Construction Defects Was Not "Property Damage" under CGL Policy

In a case of first impression under Massachusetts law, the Appeals Court of Massachusetts held that a commercial general liability insurer did not have to indemnify a contractor for a judgment by homeowners arising from the contractor's faulty construction. There was no evidence that the construction defects caused injury to other property.

The homeowners hired Havens to build a single-family house. The homeowners discovered problems with the quality of construction, which compromised the structural integrity of the house. Aside from these structural issues, there were many other problems with the construction. The homeowners sued Havens and were awarded damages for various defects.

Havens had a CGL policy with Main Street America Assurance Company (MSA) that covered "property damage" caused by an "occurrence." The insurer raised several defenses to coverage, but the Massachusetts appellate court looked no further than the definition of "property damage."

"Property damage" under the policy meant "physical 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."

Massachusetts courts had not addressed the issue. But other courts have held that the costs to repair or remove construction defects are not covered by a CGL policy. That's because "physical injury" suggests that the property is not defective at the start but damaged later. As faulty construction is defective at the outset, courts differentiate between claims for the cost of repairing construction defects from claims

for the cost of repairing damage to other property caused by the construction defects. An improperly installed window, for example, is not "property damage," but the resulting water damage to the wall is.

The Massachusetts appellate court followed this reasoning and found that there was no evidence that Havens needed to repair anything but his own faulty work. Thus, MSA had no duty to indemnify Havens for the homeowners' judgment because there was no claim for "property damage" within the meaning of the policy.

The case is *Lessard v. R.C. Havens & Sons, Inc.*, No. 23-P-346 (Mass. App. Ct. Aug. 14, 2024).