Filed 12/21/05 Adlvanced Marketing Services v. Sup. Ct. CA4/1

NOT TO BE PUBLISHED IN OFFICIAL REPORTS

COURT OF APPEAL - FOURTH APPELLATE DISTRICT

DIVISION ONE

STATE OF CALIFORNIA

ADVANCED MARKETING SERVICES, INC., Petitioner, v. THE SUPERIOR COURT OF SAN DIEGO COUNTY, Respondent;	D046866 (San Diego County Super. Ct. No. GIC832603)
FEDERAL INSURANCE COMPANY et al., Real Parties in Interest.	

Proceedings in mandate after the superior court granted a motion compelling a deposition. Patricia A.Y. Cowett, Judge. Petition granted in part.

Advanced Marketing Services, Inc. (AMS) brought this action against its insurance carriers, seeking declaratory relief and damages for breach of contract and

breach of the implied covenant of good faith and fair dealing; AMS alleged that the director and officer liability policies (D&O policies) issued by its primary and excess insurers provided coverage for defense costs incurred in connection with criminal investigations and shareholder actions arising out of its restatement of earnings for fiscal years 1999 to 2003. The superior court granted a motion by one of the carriers that had issued an excess D&O policy to AMS for the relevant period, to compel the deposition of AMS's person most knowledgeable on designated subjects, including AMS's applications for insurance and the underlying investigations and civil actions. AMS seeks a writ of mandamus requiring the superior court to vacate its order compelling it to comply with the deposition subpoena and to enter a new order granting AMS's related motion for a stay of discovery by the moving carrier and another excess carrier, or a protective order limiting the scope of the deposition.

FACTUAL AND PROCEDURAL BACKGROUND

AMS is a publicly-traded corporation headquartered in San Diego that provides customized wholesaling, distribution and publishing services for book retailers and publishers. In 2003, AMS purchased a $5 million director and officer liability reimbursement policy from CNA Financial Corporation or its affiliates (collectively, CNA) for the period of April 2003 to April 2004. AMS also purchased excess reimbursement policies (each also in the amount of $5 million) for the same period from Liberty Mutual Insurance Company (Liberty) and Federal Insurance Co. (Federal). (CNA, Liberty and Federal are collectively referred to herein as the Insurers.)

In July 2003, the Federal Bureau of Investigations (the FBI) conducted a search of AMS's offices and the United States Attorney issued a subpoena requiring AMS's custodian to testify before a grand jury relating to an investigation for mail fraud, wire fraud and other criminal offenses. Several months later, the United States Securities and Exchange Commission (the SEC) issued an investigative order regarding certain officers' possible violations of federal securities laws. In October 2003, AMS notified CNA of these pending investigations; CNA responded that there was no coverage under its policy to cover the costs of defending those investigations.

In November 2003, the SEC subpoenaed several AMS officers to testify and produce documents in connection with its investigation. In January 2004, an AMS employee was indicted for engaging in conduct that falsely inflated AMS's advertising earnings and AMS announced publicly that it would be restating its financial statements for the fiscal years 1999 through 2003 and issuing revised earnings guidance for its fiscal year ending March 31, 2004. The announcement caused the price of AMS stock to drop significantly, which triggered a number of securities class action and derivative shareholder lawsuits against AMS and its officers and directors. The SEC ultimately filed complaints against several AMS employees for violations of federal securities laws.

In May 2004, CNA acknowledged that it had an obligation to reimburse AMS for certain costs relating to the defense of the lawsuits, but reiterated its position that there was no coverage for the pending criminal investigations; in July 2004, AMS filed this action against CNA. Shortly thereafter, Federal filed a complaint in federal court seeking a declaration that it had no obligation under its policy to reimburse AMS for its defense

costs. After AMS amended its state complaint to add Federal and Liberty as defendants, Federal apparently dismissed its federal action, answered AMS's state complaint and cross-complained against AMS and certain of its current and former officers and directors for declaratory relief. Liberty also answered and filed a similar cross-complaint.

In March 2005, Federal served AMS with a subpoena to depose AMS's "person most knowledgeable" on the following subjects:

1. AMS's application for the excess policy issued by Federal;
2. AMS's application for the excess policy issued by Liberty;
3. AMS's application for the primary policy issued by CNA;
4. AMS's knowledge, prior to the issuance of Federal's excess policy, of any wrongful act or any director or officer of AMS or any fact, circumstance or situation that might result in a claim made against any of the directors or officers of AMS;
5. AMS's January 2004 announced restatement of its financial statements for the fiscal years in the five year period ending March 31, 2003;
6. AMS's financial condition during its fiscal years ending from March 31, 1998 to the present;
7. AMS's public disclosures regarding its financial condition from March 31, 1998 to the present;
8. The activities of AMS's audit committee from March 31, 1998 to the present;
9. The activities of AMS's compliance committee from March 31, 1998 to the present;
10. The underlying civil and investigative actions against AMS and/or its officers and directors and the facts, events and/or circumstances alleged therein;
11. The FBI investigation;
12. The US Attorney's investigation; and
13. The SEC investigation.

Shortly thereafter, Liberty propounded several discovery requests and deposition notices seeking information on similar subjects.

AMS objected to Federal's deposition subpoena on the ground that the insurer's discovery could be prejudicial to its defense of the underlying actions or investigations and that, in accordance with *Haskel, Inc. v. Superior Court* (1995) 33 Cal.App.4th 963 (*Haskel*), such discovery should not go forward until after those actions and investigations were completed. Federal filed a motion to compel the deposition and AMS filed a cross-motion to stay discovery by Federal and Liberty or, alternatively, for a protective order limiting the disclosure of the discovery.

The superior court granted Federal's motion and denied AMS's cross-motion based on findings that the analysis of *Haskel* was only applicable to a primary insurer who had a duty to defend its insured and thus did not apply to Federal and Liberty as excess carriers. The court also held that *Haskel* was inapplicable in light of the excess insurers' allegations that the policies were void *ab initio* as a result of AMS's misrepresentations in obtaining the policies. In ruling on the motions, the court granted a request to strike AMS's separate statement filed in support of its cross-motion.

AMS filed a petition for a writ of mandate, asking us to require the superior court to vacate the order compelling it to comply with the deposition subpoena and to enter a new order granting its related motion for a stay of discovery by Federal and Liberty or a protective order limiting the scope of the deposition. We issued an order to show cause why we should not grant the requested relief and stayed the superior court's order pending further order from this court.

DISCUSSION

The Legislature intended that discovery be allowed whenever consistent with justice and public policy. (*Irvington-Moore, Inc. v. Superior Court* (1993) 14 Cal.App.4th 733, 738.) A party to a civil action is entitled to discovery that is relevant to the subject matter of the pending action, provided the requested information is admissible or reasonably calculated to lead to the discovery of admissible evidence. (Code Civ. Proc., § 2017.010.) A party seeking to limit or stay discovery has the burden to show good cause therefore. (Code Civ. Proc., §§ 2019.020, subd. (b), 2019.030, subd. (a)(1); *GT, Inc. v. Superior Court* (1984) 151Cal.App.3d 748, 754.) Because management of discovery is generally within the sound discretion of the trial court, we review a trial court's discovery rulings for an abuse of discretion. (*Britt v. Superior Court* (1978) 20 Cal.3d 844, 867.) Here, AMS contends that the superior court abused its discretion in compelling the AMS depositions in accordance with the analysis of *Haskel*.

In *Haskel*, insureds that were subject to environmental remediation orders issued by federal and state agencies brought an action for declaratory relief against their insurers to determine whether the insurers had a duty to defend them in connection with the orders. (*Haskel, supra*, 33 Cal.App.4th at pp. 970-971.) While the remediation orders were still pending, the insureds filed a motion for summary adjudication on the duty to defend issue, but the trial court took the motion off calendar and ordered that the motions could not be refiled until after the insureds complied with the insurers' outstanding discovery requests. (*Id*. at pp. 972-973.) The insured challenged the trial court's order and the court of appeal issued a writ of mandate requiring in relevant part that the

superior court (1) stay all discovery in the action pending a factual determination as to whether any of the insurers' pending discovery was "so logically related to the issues in the underlying action that further pursuit of that discovery would [have prejudiced the insured's] interests in that action"; and (2) if such prejudice was found, make the discovery stay permanent unless the court concluded that a confidentiality order would be adequate to fully protect the insured's interests. (*Id.* at pp. 980-981.)

Federal and Liberty contend, and the trial court agreed, that *Haskel* is distinguishable, and thus its analysis does not apply here, because the insurance policies at issue in that case involved a potential duty to defend and the insureds were in fact seeking a judicial determination that such a duty existed. However, this assertion is based on a misreading of *Haskel*. There, the existence of a dispute about whether the insurers had a duty to defend was relevant to the issue of whether the trial court erred in taking the insureds' motion for summary adjudication off calendar pending the insureds' compliance with discovery. (*Haskel, supra*, 33 Cal.App.4th at pp. 975-976.) The court of appeal concluded that, because a duty to defend existed unless and until the insurer could establish facts showing there was no potential for coverage under its policy, the outstanding discovery requests were simply not relevant to whether the insurer had an existing duty to defend. (*Id*. at pp. 976-978.) It held "[t]he court should have heard and ruled upon the [insureds'] motion [for summary adjudication]. Upon remand, it will be required to do so. Assuming . . . that [the insureds'] moving papers demonstrate a potential for coverage, it will then be necessary for the insurers to produce undisputed

evidence conclusively establishing that there was no potential for coverage. If they do not, then the motion should be granted." (*Id*. at p. 978, fn. omitted.)

The appellate court went on to acknowledge that even if the insureds' summary adjudication motion was granted, the insurers would nonetheless be entitled to "pursue all appropriate discovery" to determine whether facts defeating the potential for coverage existed. (*Haskel, supra,* 33 Cal.App.4th at p. 978.) It quoted the general principles set forth in *Montrose Chemical Corp. v. Superior Court (Montrose I)* (1993) 6 Cal.4th 287, 301-302 governing a declaratory relief action brought to determine coverage issues while the underlying claim for which the insured claims coverage is still pending, as follows:

> "'To eliminate the risk of inconsistent factual determinations that could prejudice the insured, a stay of the declaratory relief action pending resolution of the third party suit is appropriate when the coverage question turns on facts to be litigated in the underlying action. [Citations.] For example, when the third party seeks damages on account of the insured's negligence, and the insurer seeks to avoid providing a defense by arguing that its insured harmed the third party by intentional conduct, the potential that the insurer's proof will prejudice its insured in the underlying litigation is obvious. This is the classic situation in which the declaratory relief action should be stayed. By contrast, when the coverage question is logically unrelated to the issues of consequence in the underlying case, the declaratory relief action may properly proceed to judgment.'" (*Haskel, supra*, 33 Cal.App.4th at pp. 978-979, quoting *Montrose I, supra,* 6 Cal.4th at pp. 301-302.)

As noted by the *Haskel* court, the foregoing principles address three concerns that would otherwise arise where trial of the coverage issues necessarily turns on the facts to be litigated in the underlying action. The first of these is that the insurer, which is supposed to be on the side of its insured and with which it has a special relationship, would be permitted to effectively attack its insured, indirectly providing assistance to the

underlying claimant. Second, allowing such a declaratory relief action to proceed would require the insured to expend resources to fight a two-front war, one with the underlying claimant and one with its insurer, thus undercutting a primary reason for purchasing liability insurance in the first instance. Third, if the declaratory relief action proceeded to trial before the underlying action, the insured might be collaterally estopped to contest issues relating to its liability in the underlying action. (*Haskel, supra*, 33 Cal.App.4th at p. 979; *Montrose Chemical Corp. v. Superior Court (Montrose II)* (1994) 25 Cal.App.4th. 902, 910.)

The foregoing concerns exist irrespective of whether the coverage issue in question relates to the duty to defend or the duty to indemnify. (See *Haskel, supra*, 33 Cal.App.4th at p. 980 [acknowledging that the trial court's earlier denial of the insureds' request to stay the declaratory relief action as to all issues except the insurers' duty to defend essentially raised the same issue as the insureds' request to stay all discovery in the declaratory relief action that was logically related to the issues affecting their remediation liability].) In fact, these considerations provide an even more compelling basis for limiting discovery in a case, like this one, where the insurer does not have a duty to defend, because such an insurer does not have the same urgent need to conduct discovery as does an insurer that has a duty to defend until the time it establishes the absence of coverage under its policy. For these reasons, we reject the Insurers' contentions that the analysis of *Haskel* is inapplicable here.

The Insurers also point out that *Haskel* was based on policy considerations arising out of the existence of a special relationship between the insurer and its insured. They

contend that AMS made fraudulent misrepresentations or concealed material information in applying for the insurance policies at issue and that accordingly they are entitled to have the policies declared void *ab initio*, negating the existence of any special relationship. (Ins. Code, §§ 331, 359; see generally *Craig v. U.S. Fidelity & Guaranty Co.* (1936) 11 Cal.App.2d 644, 645.) However, the Insurers' argument is premised on the assumptions that the policies are in fact void, something that has not yet been established, and that they are thus entitled to rescind the policies, something that has not yet occurred. Further, they do not cite, nor have we found, any authority establishing that a mere contention of fraud is sufficient to eliminate the existence of a special relationship or to automatically rescind an insurance policy. Thus the Insurers have not shown that their proffered basis for distinguishing *Haskel* is valid.

Federal requests that we take judicial notice of a motion for judgment on the pleadings that AMS filed in the superior court during the pendency of this writ proceeding. It argues that AMS's motion establishes that AMS is attempting to use *Haskel* and *Montrose II* to preclude it from conducting discovery that would permit it to defeat the motion. Although we grant Federal's request in accordance with Evidence Code section 452, subdivision (d), we also conclude that the making of this motion has no effect on the legal question of whether the analyses of *Haskel* and *Montrose II* apply here. A motion for judgment on the pleadings merely tests the sufficiency of the allegations of a pleading. (*Smiley v. Citibank* (1995) 11 Cal.4th 138, 145-146.) AMS's motion challenges the Insurers' rescission defenses on the ground that the language of the policies does not provide for a complete rescission of the policy for misrepresentations

made in the application process, but instead voids coverage only as to those who were responsible for, or knowledgeable about, the misrepresentations, thus preserving coverage for innocent insureds. Federal fails to explain what discovery it would need to respond to AMS's motion that would be precluded under the analysis of *Haskel* or *Montrose II*. Moreover, to the extent that Federal could establish the need to conduct discovery on this issue, in accordance with the case on which Federal relies, such a need would require a denial of AMS's motion for judgment on the pleadings rather than AMS's participation in discovery that might prejudice its interests in the underlying proceedings. (See *Mobil Oil Corp. v. Exxon Corp.* (1986) 177 Cal.App.3d 942, 947-948.)

The Insurers finally contend that even if the analysis of *Haskel* applies, AMS did not make the showing necessary to support the issuance of a stay on discovery. Notably, however, because the trial court concluded that *Haskel* was inapplicable, it did not analyze whether AMS had made an appropriate showing to justify a limitation on the discovery Federal was seeking. The parties' representations as to the nature of the underlying investigations and lawsuits and a brief review of the categories of information sought in Federal's deposition subpoena (as well as other outstanding discovery requests propounded by Liberty) suggest that at least some of the requests are logically related to issues affecting the criminal and civil liability of certain of AMS's current and former officers and directors and thus should be stayed pending the outcome of the underlying proceedings unless a confidentiality order will suffice to protect AMS's interests (and those of its officers and directors). The trial court did not make this determination, but

must now do so in accordance with the standards set forth in *Haskel, supra*, 33 Cal.App.4th at pages 978-980.

A final point raised by the parties is whether the trial court erred in striking AMS's separate statement filed in support of its motion for a stay of discovery or for a protective order. AMS contends that the trial court erred while the Insurers argue that the court acted within its discretion in doing so because the law does not authorize the use of a separate statement in connection with challenging the content of a deposition notice.

As relevant here, California Rules of Court, rule 335 provides in part:

> "(a) [Separate statement required] Any motion involving *the content of a discovery request* or the responses to such a request shall be accompanied by a separate statement. The motions that require a separate statement include:
> (1) a motion to compel further responses to requests for admission;
> (2) a motion to compel further responses to interrogatories;
> (3) a motion to compel further responses to a demand for inspection of documents or tangible things;
> (4) a motion to compel answers at a deposition;
> (5) a motion to compel or to quash the production of documents or tangible things at a deposition;
> (6) a motion for medical examination over objection; and
> (7) a motion for issue or evidentiary sanctions.
> "(b) [Separate statement not required] A separate statement is not required when no response has been provided to the request for discovery." (Italics added.)

Here, Federal and Liberty issued deposition subpoenas and propounded other discovery requests and AMS objected to those subpoenas and requests as including some matters as to which discovery should be stayed under *Haskel*. Here, *the content* of outstanding discovery requests was at issue and thus the filing of a separate statement was not only

authorized, it was required. (Cal. Rules Court, rule 335.) Thus, the superior court erred in striking AMS's separate statement.

DISPOSITION

Let a peremptory writ of mandate issue directing the superior court to (1) vacate its orders compelling AMS to comply with Federal's deposition subpoena and striking AMS's separate statement; (2) conduct further proceedings to determine whether all or part of the outstanding discovery is logically related to the issues in the underlying criminal and civil actions, such that further pursuit of that discovery would prejudice AMS's interests relating to those actions, and, if so, whether a confidentiality order will be adequate to protect AMS from any prejudice to its interests in the underlying criminal and civil actions; and (3) stay all discovery in the action until the court has determined these issues. The stay issued on August 5, 2005 will be vacated when the opinion is final as to this court. Costs in the writ proceeding are awarded to AMS.

McINTYRE, J.

WE CONCUR:

McCONNELL, P.J.

IRION, J.