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SURGIN SURGICAL INSTRUMENTATION, INC., Plaintiff and Respondent, v. TRUCK INSURANCE EXCHANGE, Defendant and Appellant.

G015482

COURT OF APPEAL OF CALIFORNIA, FOURTH APPELLATE DISTRICT, DIVISION THREE

1998 Cal. App. LEXIS 562; 76 Cal. Rptr. 2d 303;

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JUDGES: WALLIN, J. WE CONCUR: SILLS, P. J., RYLAARSDAM, J.

OPINION BY: WALLIN

OPINION: [*1411] [**304] OPINION

Introduction

Surgin Surgical Instrumentation, Inc. (Surgin) purchased comprehensive general liability (CGL) insurance, which included coverage for advertising injury, from Truck Insurance Exchange (Truck). Thereafter, Surgin became embroiled in a lawsuit with Alcon Surgical, Inc. (Alcon), one of its competitors. Surgin promptly notified Truck of the litigation and requested a defense. For months, Truck refused to either confirm or deny coverage. Close [*1412] to a year after the initial tender of defense, Truck [***2] issued a reservation of rights letter in which it agreed to conditionally provide Surgin a defense. Despite such agreement, however, Truck refused to do so. Unable for financial reasons to continue its defense, Surgin settled the lawsuit on unfavorable terms.

Surgin then sued Truck for breach of contract, breach of the covenant of good faith and fair dealing, breach of fiduciary duty and quantum meruit, and sought both compensatory and punitive damages. During the course of the lawsuit, Truck engaged in willful discovery misconduct by steadfastly refusing to turn over documents, despite court orders. At Surgin's request, the court ultimately imposed a terminating sanction, striking Truck's answer. Truck's default was entered and a prove-up hearing held in which Surgin presented evidence to support its claim for compensatory as well as punitive damages. With respect to the former, Surgin offered evidence it

had expended approximately $ 270,000 defending the initial lawsuit by its competitor and over $ 300,000 in attorney fees in this action in an attempt to obtain its policy benefits.

As to the latter, Surgin offered evidence of a pattern and practice of bad faith by Truck in dealing [***3] with its other insureds. Finding Truck guilty of "despicable, vile, malicious, fraudulent, [and] oppressive conduct," the court awarded Surgin $ 57,214,379 in punitive damages, 100 times the amount awarded in compensatory damages. Truck appeals, contending, among other things, Surgin's failure to provide notice of the amount it was seeking in punitive damages prior to obtaining its default mandates reversal. We agree.

Background

Surgin develops and manufactures medical devices, one of which broke a monopoly enjoyed by its competitor, Alcon. In April 1989, Surgin filed suit against Alcon for defamation and Alcon cross-complained for false [**305] advertising and unfair competition. Shortly thereafter, Alcon filed two lawsuits against Surgin for patent infringement.

Surgin notified Truck of the Alcon lawsuits and requested a defense. When three months went by without a response, Surgin contacted Truck again and was referred to one of its employees, Howard Hirsch. Hirsch promised a prompt response, but none came.

In March 1990, Surgin's defense counsel, Frisenda, Morris & Nicholson (Frisenda) contacted Truck, again requesting a defense. Truck promised a decision by mid-May. [***4] Later that month, having heard nothing from Truck, [*1413] Surgin sent another letter requesting Truck provide a defense and emphasizing that it was not financially capable of conducting a defense without Truck's assistance. Truck sent a letter to Frisenda indicating the investigation was in its early stages and Truck had not yet reached a decision; however, it requested that Frisenda continue to represent Surgin pending its decision, with the promise it would reimburse Frisenda for fees and costs if it ultimately decided there was coverage.

In June, Surgin again requested a decision from Truck on coverage, indicating the financial drain on the company from the lawsuits had created an urgent situation, necessitating a prompt response. Truck did not respond. The following month, Surgin wrote to Truck twice, detailing the chronology of events and the unreasonableness of its delay. Truck responded with copies of Surgin's insurance policies, but no decision regarding coverage.

Nine months after Surgin's original tender of defense, Truck issued a reservation of rights letter, in which it agreed to provide Surgin a defense, while preserving its right to contest coverage. Despite this belated [***5] agreement to defend, however, it never did so. Specifically, it never paid any of Surgin's legal fees.

In November 1990, Frisenda advised both Surgin and Truck that unless its outstanding fees, by then $ 150,000, were paid, it could no longer continue its defense. It also advised Truck that without an aggressive defense, Surgin was in danger of losing the lawsuit.

Financially unable to continue the lawsuit, Surgin settled with Alcon and sued Truck. What followed was one of the most flagrant examples of discovery abuse this court has seen. However, because we reverse on due process grounds, we need not detail Truck's misconduct; suffice it to say, it was reprehensible. In short, at the heart of the discovery dispute was a claims procedure

manual that Truck was bound and determined not to turn over. Despite court orders and the imposition of a monetary sanction, Truck remained steadfast in its refusal to cooperate.

Finally, Surgin filed a motion for terminating sanctions. At the hearing, the court found Truck had willfully and repeatedly disobeyed discovery orders. It struck Truck's answer and entered its default.

At the two-day prove-up hearing, Surgin offered evidence regarding [***6] its claims for compensatory and punitive damages. With respect to the propriety of awarding punitive damages, Surgin offered evidence as to Truck's bad faith misconduct in connection with the Alcon litigation. Surgin also offered evidence of a pattern and practice of bad faith by Truck in dealing with its other insureds.

[*1414] With regard to the appropriate size of the award, Surgin offered the following evidence: (1) Truck's financial statement for 1992 showing a net worth of $ 229,402,753; (2) Truck's participation in a "pooling arrangement" with other Farmers Group companies through which their premiums, losses and expenses are pooled and shared, resulting in Truck being responsible for only 10.24 percent of a punitive damages award or 2.54 percent of its net worth. n1

n1 Under this pooling arrangement, a punitive damages award is allocated among the members of the pool according to their assigned shares.

With respect to compensatory damages, Surgin presented evidence that it had expended $ 270,622 in fees and [***7] costs defending the Alcon actions, and $ 303,663.29 in fees and costs to obtain its policy benefits.

[**306] At the close of the hearing, the court found Truck's conduct constituted insurance bad faith and awarded Surgin the costs it incurred in defending the Alcon actions and obtaining its policy benefits, but refused to award it lost profits. The total award of compensatory damages was $ 574,284.79.

The trial court found that from the first notice of claim through the litigation, Truck's misconduct rated an 11 on a scale of 1 to 10. This conduct was part of a pattern and practice by Truck. It further found Truck was able to shoulder a substantial punitive damages award and that it was necessary that it do so in order to deter future misconduct and set an example for others. It then awarded punitive damages of $ 57,214,379.

I.

DUE PROCESS RIGHT TO NOTICE

BEFORE ENTRY OF DEFAULT n2

n2 Truck raises numerous issues, including challenges to the entry of default. Most of the issues need not be addressed since we reverse the judgment on due process grounds.

[***8]

Truck challenges the judgment, contending it is void to the extent it exceeds the amount prayed for in the complaint, i.e., $ 270,000.

Section 580 of the Code of Civil Procedure n3 limits the amount a plaintiff may recover in a default proceeding to the amount demanded in the complaint. This is so because a defendant has a due process right to notice of its potential maximum liability when deciding whether to defend a lawsuit or let it proceed by way of default. This is true whether the default is a result of inaction on the part of the defendant or willful discovery abuse. (*Greenup* v. *Rodman* (1986) 42 Cal. 3d 822, 231 Cal. Rptr. 220, 726 P.2d 1295.)

n3 All statutory references are to the Code of Civil Procedure unless otherwise indicated.

"Normally this notice is provided by the complaint. [Citation.] However, where the plaintiff is prohibited by statute from stating the amount of [*1415] damages in the complaint . . . the plaintiff must provide the defendant with separate notice of the damages sought [***9] to be recovered. [Citations.] [P] This notice requirement . . . also applies . . . where a default is entered after the defendant's answer is stricken as a discovery sanction. [Citation.]" (*Cummings Medical Corp.* v. *Occupational Medical Corp.* (1992) 10 Cal. App. 4th 1291, 1296.)

Civil Code section 3295, subdivision (e) prohibits a plaintiff from stating the amount sought in punitive damages either in the complaint or in the prayer for relief. The statute does not specify how a plaintiff should notify the defendant of the amount of punitive damages sought. However, "the Code of Civil Procedure contains several sections intended to ensure defendants who decline to contest lawsuits do not subject themselves to open-ended liability. [Citations.] Code of Civil Procedure section 425.10--a statute similar to Civil Code section 3295, subdivision (e)--provides in an action for personal injury or wrongful death the amount of damages shall not be specified in the complaint. Code of Civil Procedure section 425.11 provides in such case the plaintiff must give notice to the defendant of the amount of special and general damages sought before a default may be taken. That requirement [***10] ensures defendants are given notice of exactly what they may lose under a default judgment that may be assessed against them. . . . [P] In *Greenup* v. *Rodman, supra,* 42 Cal. 3d at p. 822, a case antedating section 3295, subdivision (e), involving a default entered as a discovery sanction, the superior court awarded plaintiff more damages than specified in the complaint. The Supreme Court decreased the award to those sums pleaded. The court stated: 'We conclude that due process requires notice to defendants, whether they default by inaction or by willful obstruction, of the potential consequences of a refusal to pursue their defense. Such notice enables a defendant to exercise his right to choose--between (1) giving up his right to defend in exchange for the certainty that he cannot be held liable for more than a known amount, and (2) exercising his right to defend at the cost of exposing himself to greater liability. [Citation.] The [**307] court also stated: 'We conclude that in all default judgments the demand sets a ceiling on recovery.' [Citation.] Similarly, we conclude because [plaintiff's] complaint was silent as to the amount of punitive damages sought, [plaintiff] [***11] should have furnished [defendant] with notice of the amount sought before requesting entry of default. [Citation.]" (*Wiley* v. *Rhodes* (1990) 223 Cal. App. 3d 1470, 1472-1473, 273 Cal. Rptr. 279.)

It is clear, therefore, that a plaintiff seeking punitive damages by default, must provide the defendant with notice, *prior to taking the default,* of [*1416] the defendant's potential liability. In fact, a plaintiff seeking punitive damages is now required to serve a defendant with a statement of damages prior to taking his or her default or 60 days before trial. n4

n4 Section 425.115, which became effective January 1, 1996, provides that a plaintiff preserves the right to seek punitive damages upon default by serving the defendant with a statement of damages setting forth the amount being sought, prior to taking the default.

It is undisputed that Surgin did not serve Truck with a statement of damages; the dispute is over the effect of such failure. In *Schwab* v. *Rondel Homes, Inc.* (1991) 53 Cal. 3d 428, [***12] 280 Cal. Rptr. 83, 808 P.2d 226, plaintiffs brought an action against defendants for housing discrimination. The prayer of the complaint "sought damages for mental and emotional distress and for 'further monetary and pecuniary losses and damages' in amounts according to proof, treble statutory damages also in amounts according to proof 'but in a sum no less than $ 250,' attorney fees, and punitive damages of $ 500,000." Defendants did not answer the complaint and their default was taken. At the prove-up hearing, plaintiffs were awarded "'the principal sum of $ 50,000,'" and punitive damages of $ 100,000. (*Id.* at pp. 430-431.)

Thereafter, defendants successfully moved to set aside the default judgment on the basis plaintiffs should have served defendants with a statement of damages pursuant to section 425.11. The Court of Appeal reversed the order setting aside the default, and affirmed the judgment, including the award of punitive damages, with the exception of the amount awarded in general damages, which it limited to $ 25,000 per plaintiff. (*Id.* at p. 431.)

The Supreme Court disagreed. It was unpersuaded by plaintiffs' argument that although they failed to serve a statement [***13] of damages, they were still entitled to a default judgment because defendants had constructive notice that plaintiffs were seeking, at a minimum, the jurisdictional limit of damages in superior court. (*Id.* at p. 433.) It held that a defendant's constructive knowledge of the jurisdictional minimum of the court in which the action is brought does not satisfy the requirement of section 425.11 of *actual* notice of the amount of special and general damages being sought. (53 Cal. 3d at pp. 434-435.)

In *Parish* v. *Peters* (1991) 1 Cal. App. 4th 202, the plaintiff filed a personal injury action against the defendant, served him by publication and subsequently took his default. Defendant moved to have the default set aside because plaintiff failed to serve him with a statement [*1417] of damages. The trial court denied the motion, ruling a statement of damages was not required. n5

n5 This is so because a statement of damages is required only before default is entered. When service is made by publication, the matter proceeds directly to judgment, upon the written request of the plaintiff. (§ 585, subd. (c).)

[***14]

Although the appellate court agreed with plaintiff that there was no express statutory requirement for serving a statement of damages in the case before it, it disagreed as to the effect of

this lack of legislative directive. The notice requirements set forth in sections 580 and 425.10 are designed to ensure that defendants' due process rights are protected. They are of constitutional dimension and cannot be disregarded due to legislative oversight. Therefore, "to protect the due process rights of defendants while allowing personal injury plaintiffs to seek default judgments against runaway defendants, we must hold as a matter of constitutional law [**308] that the *equivalent* of a section 425.11 statement of damages be served in the same manner as a summons prior to entry of a default judgment against a defendant served by publication." (*Id.* at p. 210, italics added, fn. omitted.)

The court then went on to say that since plaintiffs failed to serve a statement of damages or its *equivalent*, the default judgment could stand only if the complaint imparted sufficient notice. (*Id.* at p. 213.) As *Greenup* and *Schwab* made clear, to provide adequate notice, "a specific amount [***15] of damages must be averred, either in the prayer or in the body of the complaint." (*Id.* at p. 214.) Plaintiffs' complaint as well as their prayer for relief did not specify a dollar amount. It simply sought damages "according to proof." (*Id.* at p. 216.) The court held that under *Greenup* and *Schwab*, this was insufficient. (1 Cal. App. 4th at pp. 216-217.)

At the time relevant to this lawsuit, all that was required was that Truck receive *actual* notice of the amount of damages sought by Surgin. (*Schwab* v. *Rondel, supra,* 53 Cal. 3d at pp. 434-435.) In *California Novelties, Inc.* v. *Sokoloff* (1992) 6 Cal. App. 4th 936, this court interpreted *Schwab* as simply requiring a determination of whether "minimum standards of due process have been met." (*Id.* at p. 945.)

Surgin contends it sent two letters to Truck, one before and one after the default hearing, which constitute the due process equivalent of a statement of damages. We quickly dispose of the argument regarding the letter which followed the default hearing. Clearly that did not provide *timely* notice of the damages being sought. (*Hamm* v. *Elkin* (1987) 196 Cal. App. 3d 1343, 242 [*1418] Cal. Rptr. 545.) [***16] The question then is whether the one which preceded entry of default was adequate. n6

> n6 As a reminder, in this portion of the opinion, we deal only with the issue of notice regarding punitive damages. Surgin set forth the amount it sought in compensatory damages in the body of the complaint. That amount was $ 270,000.

That letter, entitled "Settlement Demand" states "the issue of punitive damages for Truck's unreasonable delay in investigating, adjusting and paying the legal fees incurred by Surgin in the underlying litigations will most certainly result in a punitive damage award. The certainty of such an award can be borne out by the juries' decisions in other similar cases . . . . The only issue with respect to punitive damages will be the amount awarded by a jury. We believe a minimum of $ 2-3 million will be awarded by a jury. This is a conservative estimate given the recent award against Truck in the amount of $ 62 million in [*Waller* v. *Truck Ins. Exchange*] n7 for identical claims mishandling [***17] as occurred in this case. [P] Given our analysis of Truck's liability in this matter, it would be a gross understatement to say that Surgin's settlement demand of $ 825,000 is reasonable. Frankly, I cannot imagine Truck wishing to run the risks that exist in this case when it can settle the matter for one-quarter of the compensatory damages incurred."

n7 At the time the *Waller* case was on appeal. The Supreme Court reversed the jury verdict on grounds unrelated to this appeal. (*Waller* v. *Truck Ins. Exchange* (1995) 11 Cal. 4th 1, 900 P.2d 619.)

In *Morgan* v. *Southern Cal. Rapid Transit Dist.* (1987) 192 Cal. App. 3d 976, 237 Cal. Rptr. 756, the plaintiff filed a personal injury action against the defendant and was therefore precluded by section 425.10 from specifying the amount of damages he was seeking. Defendant answered the complaint; however, it refused to answer interrogatories despite court order and monetary sanctions. The trial court ultimately struck the defendant's answer and entered [***18] its default. (*Morgan* v. *Southern Cal. Rapid Transit Dist., supra,* 192 Cal. App. 3d at p. 979.)

On appeal, the defendant contended the ensuing judgment was invalid because the plaintiff failed to serve a statement of damages before taking its default. The court agreed, holding that the due process requirements enunciated in *Greenup* v. *Rodman, supra,* 42 Cal. 3d 822, compelled such a holding. (*Morgan* v. *Southern Cal. Rapid Transit Dist.,* [**309] *supra,* 192 Cal. App. 3d at p. 985.) The plaintiff argued that despite the failure to serve a statement of damages, the defendant had actual notice of the amount of damages sought through the plaintiff's answers to interrogatories as well as settlement discussions. (*Id.* at p. 986.)

The court rejected plaintiff's argument for several reasons. First, it held the language of section 425.11 unambiguously required that a separate [*1419] document be served setting forth the amount of damages sought. The availability of the information from some other source was not deemed sufficient to satisfy the requirements of section 425.11 or the holding in *Greenup.* Second, plaintiff's position would unnecessarily involve the court in the parties' [***19] discovery proceedings. (*Morgan* v. *Southern Cal. Rapid Transit District, supra,* 192 Cal. App. 3d at pp. 986-987, disapproved on other grounds in *Schwab* v. *Rondel Homes, Inc., supra,* 53 Cal. 3d at p. 434.)

In *Debbie S.* v. *Ray* (1993) 16 Cal. App. 4th 193, plaintiff brought an action against the corporate owner of the apartment building in which she was injured. Although the defendant answered the complaint and participated in discovery proceedings, it did not appear for trial. A trial was held in defendant's absence, and judgment was entered in favor of plaintiff. Thereafter, Ray was appointed receiver of the defendant and moved to vacate the judgment on the grounds plaintiff failed to serve a statement of damages 60 days before trial as required by section 425.11. The trial court granted the motion to vacate and plaintiff appealed, contending that various settlement demands made before trial satisfied the actual notice requirements of section 425.11. (*Debbie S.* v. *Ray, supra,* 16 Cal. App. 4th at pp. 198-199.)

The Court of Appeal rejected that argument, holding that the "function of settlement negotiations between counsel is, of course, to facilitate settlement [***20] on an agreed upon figure, rather than to fix the potential judgment to be awarded at trial." (*Id.* at p. 199, fn. omitted.) Hence, "an 'indication' of the value of a case made in the course of settlement discussions between counsel for the parties is not the actual notice of special and general damages required by section 425.11, as interpreted by the Supreme Court in *Schwab* v. *Rondel Homes, Inc., supra,* 53 Cal. 3d at p. 435." (*Debbie S.* v. *Ray, supra,* 16 Cal. App. 4th at p.199.)

We agree with the *Debbie S.* court that settlement demands do not constitute adequate notice of the defendant's potential liability. However, even if that were not so, the letter relied upon by Surgin would be wholly inadequate to provide notice. It is not clear whether Surgin is seeking $

825,000, $ 2-3 million, or $ 62 million in damages. The purpose of requiring notice to the defendant of the damages sought is to provide the defendant with ""one 'last clear chance' to respond to the allegations of the complaint and to avoid the precise consequences . . . [of] a judgment for a substantial sum . . . . [without] any actual notice of . . . potential liability." [Citations.]'" ([***21] *Schwab* v. *Rondel Homes, Inc., supra,* 53 Cal. 3d at p. 433.) The letter did not provide Truck with the information necessary to determine [*1420] whether to fight the lawsuit or let it proceed by default because it did not set forth the amount Surgin intended to seek in punitive damages.

Truck was entitled to actual notice of the amount of damages sought before its default was entered. Having said that, we must fashion a remedy which will restore what Truck has lost, in a meaningful way, n8 while at the same time not unduly prejudicing Surgin.

n8 For example, we cannot simply reverse the punitive damages award and remand the matter for a full trial solely on the issue of punitive damages because that would not adequately address the due process violation. Truck would still have been deprived of the opportunity to decide, upon adequate notice, whether to comply with discovery or let the matter proceed by default. On the other hand, simply reducing the award to the amount demanded in the complaint ($ 270,000), of which Truck clearly had notice, would be a grave injustice to Surgin.

[***22]

[**310] Since Truck was deprived of its due process right to notice of its potential liability *before* its default was taken, the only way to adequately remedy that loss is to return this matter to the discovery phase of the proceedings. Truck will then have the opportunity to decide whether to comply with Surgin's discovery requests. If Truck chooses to remain steadfast in its refusal to cooperate, Surgin will have the opportunity to renew its request for a terminating sanction, making certain that before it does so, it serves Truck with a statement of damages.

Although Truck appears to receive an undeserving second bite at the apple, its prior discovery abuse need not go unpunished. The trial court shall have the discretion, upon remand, to impose a suitable monetary sanction for Truck's egregious and wilful discovery misconduct. n9

n9 Truck also contends the award of punitive damages violates due process in that it is excessive and the result of passion, prejudice and bias. Because we have reversed the judgment on due process grounds, we need not address this issue.

[***23]

II.

DUTY TO DEFEND

Truck contends the lawsuits against Surgin by Alcon were primarily composed of patent infringement claims. Since it is now clear under *Aetna Casualty Surety Co.* v. *Superior Court* (1993) 19 Cal. App. 4th 320 that there is no potential for liability for patent infringement claims

under a policy covering "advertising injury," Truck argues it had no duty to defend against Alcon's lawsuit and cannot be liable for bad faith in failing to do so. (*Id.* at p.327.)

Truck is correct in its assertion that patent infringement claims are not covered under a policy for advertising injury. Nevertheless, "an insurer [*1421] must defend a case which *potentially* seeks damages in the coverage of the policy. (*Aetna Casualty & Surety Co.* v. *Superior Court, supra*, 19 Cal. App. 4th at pp. 320, 327.) "It is by now a familiar principle that a liability insurer owes a broad duty to defend its insured against claims that create a potential for indemnity. [Citation.] As [the Supreme Court] said in *Gray[v. Zurich Insurance Co.* (1966) 65 Cal. 2d 263, 419 P.2d 168, 54 Cal. Rptr. 104], 'the carrier must defend a suit which *potentially* seeks damages within the coverage of the policy.' [Citation.]" [***24] (*Horace Mann Ins. Co.* v. *Barbara B.* (1993) 4 Cal. 4th 1076, 1081, 846 P.2d 792.)

Surgin is insured for advertising liability, which is defined by the policy as "(1) libel, slander or defamation; [P] (2) Infringement of copyright or of title or of slogan; [P] (3) Piracy or unfair competition or idea misappropriation under an implied contract; [P] (4) Invasion of right of privacy; [P] (5) committed or alleged to have been committed in any advertisement, public article, broadcast or telecast and arising out of the named insured's advertising activities."

Alcon's cross-complaint alleged that Surgin made intentionally false and misleading statements in its advertisements that one of its products had been FDA approved, when in fact, it had not. That cause of action falls within the policy definition of advertising injury. As such, Truck had a duty to defend, even if, as it contends, the bulk of the defense to be waged was for noncovered losses. (*Aetna Casualty & Surety Co.* v. *Superior Court, supra*, 19 Cal. App. 4th at p. 327.)

The judgment is reversed. The entry of default is stricken as is the order striking Truck's answer to the complaint. The trial court may, [***25] in its discretion, impose a reasonable monetary sanction for Truck's previous discovery abuse. Each party to bear its own costs on appeal..

WALLIN, J.

WE CONCUR:

SILLS, P. J.

RYLAARSDAM, J.