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UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

GRANITE STATE INSURANCE CO.,

Plaintiff,

-against-

CLEARWATER INSURANCE CO.,

Defendant.

09 Civ. 10607 (RKE)

MEMORANDUM and ORDER

Pursuant to 28 U.S.C. § 636(b)(1)(A) and Fed. R. Civ. P. 72(a), plaintiff Granite State Insurance Company ("plaintiff" or "Granite State") has moved to set aside Magistrate Judge Freeman's June 27, 2011 Order directing plaintiff to produce certain asbestos loss reserve documents in response to Request No. 28 of defendant Clearwater Insurance Company's ("defendant" or "Clearwater") First Request for Production of Documents, dated July 2, 2010 ("Request No. 28"). For the reasons set forth below, plaintiff's motion is denied.

BACKGROUND

In October 2010, defendant moved to compel plaintiff Granite State's response to Request No. 28, which sought "[a]ny and all documents concerning any reviews, analyses, or studies by any consultant or other third party concerning AIG's [(Granite's parent company)] reserves relating to asbestos exposures, claims, and/or losses." According to defendant, this request was intended to discover materials related to its Third Affirmative Defense, which claims that

> Plaintiff failed to implement reasonable and adequate practices and procedures to ensure the proper reporting to Clearwater of notice and related claim information, including, but not limited to, information specifically requested by Clearwater about claims.

By order dated June 27, 2011 (the "Magistrate's Order"), Magistrate Judge Freeman determined that Granite State was required "to produce copies of any final reviews, analyses, or studies conducted by any consultants or other third parties, on the principal subject of the adequacy of Granite State's reserves for asbestos exposures, claims, and/or losses." On June 29, 2011, the Magistrate's Order was stayed pending resolution of Granite State's motion to set it aside.

DISCUSSION

I. Standard of Review under 28 U.S.C. § 636

Pursuant to 28 U.S.C. § 636(b)(1)(A), a district court may only reverse a magistrate's discovery ruling "where it has been shown that the magistrate judge's order is clearly erroneous or contrary to law." An order is "contrary to law" if "it fails to apply or misapplies relevant statutes, case law or rules of procedure." *Catskill Dev. LLC v. Park Row Entn't Corp*, 206 F.R.D. 78, 86 (S.D.N.Y. 2002). An order is "clearly erroneous" when, "although there is evidence to support it, the court upon reviewing the entire evidence is left with the definite and firm conviction that a mistake has been committed." *Highland Capital Mgmt. v. Schneider,* 551 F. Supp. 2d 173, 177 (S.D.N.Y. 2008). Magistrates are afforded "broad discretion" in ruling on discovery issues, and the party objecting to a magistrate's ruling "bears a heavy burden." *Citicorp v. Interbank Card Ass'n*, 87 F.R.D. 43, 46 (S.D.N.Y. 1980).

II. Granite State's Objections

Granite State objects to the Magistrate's Order on two grounds. First, it contends that the Magistrate's Order was contrary to law because it was based on a misinterpretation of the Second Circuit's decision in *Unigard Sec. Ins. Co. v. N. River Ins. Co.*, 4 F.3d 1049 (2d Cir. 1993). In *Unigard*, the Court found that a reinsurer need not show prejudice to raise a successful lack of notice defense under New York law if it demonstrates that the cedent acted in "bad faith" in not providing timely notice.[1] The Court in *Unigard* specifically found:

> "[A] [ceding insurer's] failure to provide prompt notice may entitle the reinsurer to relief without showing prejudice if the [ceding insurer] acted in bad faith." . . . [B]ecause information concerning the underlying risk lies virtually in the exclusive possession of the ceding insurer, a very high level of good faith . . . is required to ensure prompt and full disclosure of material information without causing reinsurers to engage in duplicative monitoring. The question, then, is what good faith requires of a ceding insurer in the notice context.

Unigard, 4 F.3d at 1069 (internal citations omitted). The Court went on to answer this question as follows:

> We thus think that the proper minimum standard for bad faith should be gross negligence or recklessness . . . . If a ceding insurer has implemented routine practices and controls to ensure notification to reinsurers but inadvertence causes a lapse, the insurer has not acted in bad faith. But if a ceding insurer does not implement such practices and controls, then it has willfully disregarded the risk to reinsurers and is guilty of gross negligence.

Granite State argues that *Unigard* does not entitle Clearwater to the requested discovery because, even assuming that the rule is an accurate statement of New York law, the question is whether the ceding insurer has <u>any</u> practices in place. Granite State notes that Clearwater "does

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[1] Granite State also suggests that the bad faith defense has never been adopted by the New York Court of Appeals and, therefore, it not an available defense if New York law governs. A number of cases subsequent to *Unigard*, however, have recognized this defense. Since there is at least a colorable argument that this defense is viable, this discovery motion is not the proper stage for this challenge. If it were beyond a doubt that this defense did not exist, and the information to be produced was irrelevant to the remaining issues in the case, then, perhaps, precluding discovery would be warranted.

not seek discovery regarding the existence of such practices and procedures [but] [r]ather, . . . seeks to challenge the 'adequacy' or 'reasonableness' of one method utilized by Granite State to ensure notification to reinsurers." Pl.'s Mem. Law Supp. Mot. Set Aside ("Pl.'s Mem.") 14. According to Granite State, "*Unigard* . . . does not even imply that if practices and procedures do in fact exist for reinsurer notification, the reinsurer is entitled to support a late notice defense by challenging the adequacy of the practices and procedures." Pl.'s Mem. 14.

For Granite State, then, the relevant issue for determining bad faith is whether there were formal procedures in place, and not whether any such procedures were adequate or reasonable. Pointing to the deposition testimony of its Rule 30(b)(6) corporate representative who stated that there were procedures in place for notifying reinsurers, plaintiff claims that the Magistrate's Order was contrary to law because once it was established that such procedures exist, the inquiry into Granite State's bad faith was at an end. Thus, Granite State insists that the quality of those procedures is irrelevant. Plaintiff, therefore, argues that the documents concerning the adequacy or reasonableness of Granite State or its parent's reserving practices are irrelevant because there is no dispute that Granite State had some notification system in place.[2]

Second, Granite State argues that the Magistrate's Order was "clearly erroneous" because "it is beyond dispute that not only did Clearwater timely receive notice consistent with the terms of the Reinsurance Certificates during the underwriting process in the early 1980s, but that notice

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[2] Granite State also notes that the parties dispute what law governs the claims in this action. According to Granite State, Clearwater is not entitled to the requested documents because Clearwater contends that Illinois law governs. For Granite State, since Illinois law does not require a showing of prejudice to successfully defend on lack of notice grounds, the bad faith inquiry is irrelevant. This issue is contested in the parties' cross-motions for summary judgment. Moreover, as Clearwater points out, it has asserted this same affirmative defense under Illinois law, in addition to its claim that prejudice need not be shown thereunder. Def.'s Opp. 8. Given that it is Granite State that has asserted that New York law governs, and the court has not had an opportunity to rule on this choice of law issue yet, this choice of law dispute does not preclude the discovery sought.

was provided to Clearwater 'manually,' and it was not tied to the reserving of claims." Pl.'s Mem. 15. According to plaintiff, it provides notice of claims to reinsurers in one of two ways – either manually or automatically. The automatic notice procedure sends notice to reinsurers electronically whenever certain reserve levels are met for reinsured policies. Manual notice, on the other hand, is sent to reinsurers when risk management personnel determine that notice is required. Granite State contends that only automatic notice is tied to its claims reserving procedure. In this case, plaintiff asserts, it provided notice manually and in a timely fashion and, therefore, its reserving practices are irrelevant. For Granite State, "because it is beyond dispute that 'manual' notice was timely provided to Clearwater in the 1980s, there is no basis to permit Clearwater to pursue discovery regarding the 'adequacy' of Granite State's alternative method for providing notice based on the setting of loss reserves, i.e., automated notice." Pl.'s Mem. 17.

III. Granite State's Motion To Set Aside Is Denied

Given the broad scope of discovery under the Federal Rules of Civil Procedure, the Magistrate's Order was not contrary to law or clearly erroneous. The Federal Rules

> creat[e] a broad vista for discovery which would encompass any matter that bears on, or that reasonably could lead to other matters that could bear on, any issue that is or may be in the case. The parties must be permitted to scrutinize all relevant evidence so that each will have a fair opportunity to present its case at trial.

Nestle Foods Corp. v. Aetna Cas. & Sur. Co., 135 F.R.D. 101, 104 (D. N.J. 1981) (internal citations omitted); Fed. R. Civ. P. 26(b)(1) ("Parties may obtain discovery regarding any nonprivileged matter that is relevant to any party's claim or defense . . . . For good cause, the court may order discovery of any matter relevant to the subject matter involved in the action. Relevant information need not be admissible at the trial if the discovery appears reasonably calculated to lead to the discovery of admissible evidence."). Applying this standard, it is clear

that the information sought by Request No. 28 has "possible relevance" to Clearwater's Third Affirmative Defense and is, therefore, discoverable. *See Arkwright Mut. Ins. Co. v. Nat'l Union Fire Ins Co.*, No. 90 Civ. 7811 (KC), 1993 WL 437767, at *1 (S.D.N.Y. Oct. 23, 1993) ("The scope of discovery in federal litigation is quite broad, encompassing information which has any possible relevance to the subject matter of the action . . . . Relevance is construed more loosely at the discovery stage than at trial.").

Reports and analyses regarding Granite State's reserve procedures are directly relevant to its defense that Granite State acted in bad faith by not having adequate and reasonable reserve procedures in place.[3] Plaintiff's contention that these documents are irrelevant based on its contested construction of the scope of this defense is not a sufficient basis to deny discovery. Indeed, based on a review of *Unigard* and its progeny, it appears that Granite State construes the bad faith defense's scope too narrowly. As Clearwater points out, if the issue is whether a cedent has exercised good faith in implementing procedures to ensure prompt and full disclosure to its reinsurer, it would make little sense to allow the defense to be defeated, ipso facto, by the existence of any procedure, regardless of how unlikely it was to ensure that notice to a reinsurer was prompt and full.

Further, even if Granite State's construction of the bad faith defense could ultimately prevail on summary judgment or at trial, discovery of documents relevant to that defense would not be precluded in light of the broad scope of discovery under Rule 26(b)(1). This is because "a discovery motion is not the proper forum for deciding the merits of [a defense]. If [plaintiff] desires to contest the legitimacy of its opponent's claim, it should do so with the appropriate

[3] The court recognizes that many if not all of the documents to be produced may relate to American International Group Inc.'s ("AIG") reserve practices. It is the court's understanding, however, that AIG is Granite State's parent, and that AIG was largely responsible for establishing reserves for policies issued by Granite State.

motion." *Arkwright*, 1993 WL 437767 at *3. As defendant notes, Granite State did not move to strike Clearwater's Third Affirmative Defense under Fed. R. Civ. P. 12(f).

Likewise, Granite State's claim that it timely provided notice to Clearwater goes to the merits of the defense, and not to the permissibility of the discovery sought. Contrary to Granite State's contentions, it is not undisputed that it provided notice to Clearwater in accordance with the parties' reinsurance contracts. Rather, Clearwater does dispute that it received timely notice from Granite State, as evidenced by its cross-motion for summary judgment. Evidence concerning the adequacy and the reasonableness of Granite State's notification procedures is not only relevant to whether Granite State acted in good faith in providing notice to Clearwater, but also as to whether notice was sent in any form. Whether that evidence is sufficient to raise an issue of material fact or to establish a defense by a preponderance of the evidences is to be determined at summary judgment or at trial. In order to allow Clearwater an adequate opportunity to prove its case at those stages, Granite State is required to disclose the information sought at this stage.

For the foregoing reasons, plaintiff's motion to set aside the Magistrate's Order is DENIED.

Although finding that plaintiff is obligated to produce the documents sought in accordance with the Magistrate's Order, the court finds merit in plaintiff's concerns regarding the sensitive and proprietary nature of the information required to be produced. Accordingly, it is

ORDERED that the parties confer and stipulate to a mutually-agreeable protective order to govern the use of the documents produced by plaintiff pursuant to the Magistrate's Order by no later than May 7, 2012. *See* Fed. R. Civ. P. 26(c). It is further

ORDERED that plaintiff produce documents in response to Request No. 28, to the extent required by the Magistrate's Order, by no later than May 14, 2012.

It is SO ORDERED.

Dated: April 30, 2012
New York, New York

/S/ Richard K. Eaton
Richard K. Eaton, Judge*

* Judge Richard K. Eaton of the United States Court of International Trade, sitting by designation.