
Insurance Coverage

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THE SWORD AND THE SHIELD: Defending the Carrier from Discovery in Coverage Actions

In the context of insurance coverage litigation, policyholders have cast an increasingly broad net to discover information external to the policy at issue. When defending insurance coverage cases, less discovery is always more. The effective defense of an insurance carrier always requires that its counsel narrow the issues that will ultimately be litigated. This article discusses the policyholder's strategies for obtaining vast materials outside the policy at issue, as well as the carrier's defenses to these arguments. Case law interpreting these strategies is also examined.

I. The Policyholder's Broad Net to Capture Documents External to Policy Negotiation

A. Discovery of Reserve Information

Traditionally, courts would almost uniformly deny discovery requests concerning reserves established by insur-

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ers. More recently, courts have allowed limited discovery regarding reserves, especially where the reserves are set without the advice of counsel.

1. Policyholder Arguments in Favor of Discovery:

Without exception, the most common argument proffered by an insured is that the establishment of a reserve constitutes an admission by the carrier concerning liability. The policyholder argues that if the carrier was not worried about the claim, it would not set any reserve. Along these lines, it is argued that the clearer the liability, the higher the reserve.

2. Insurer Arguments for Resisting Discovery:

Reserves are often set pursuant to statutory requirement, and hence established via a highly regulated formula, which could never be considered tantamount to an admission of liability. Furthermore, reserves may be set at the advice of counsel, and not merely as an independent business decision reflecting the beliefs of an insurer regarding coverage obligations. An insurer may also establish reserves in anticipation of high litigation costs rather than as a consequence of the actual merits of the coverage action. There is also a public policy concern that the insurer should be adequately capitalized for foreseeable risk of litigation associated with coverage. This capitalization can only be accomplished with adequate reserves and should not be construed as an admission.

3. Case Law For Discussion:

• *Independent Petro Chemical Corp. v. Aetna Cas. & Sur. Co.*, 117 F.R.D. 283 (D.D.C. 1986) (reserve information irrelevant)

In *Independent Petro Chemical Corp.*, an insurance coverage action arising out of environmental liabilities, the insured sought discovery of reserve and reinsurance information set by the carrier. After an *in camera* inspection of the documents sought, the magistrate held that the reserves which were the subject of discovery were "of very tenuous relevance, if any relevance at all." In denying the policyholder's request for reserve information, the court held that "a reserve essentially reflects an assessment of the value of a claim taking into consideration the likelihood of an adverse judgment in that such estimates of potential liability do not normally entail an evaluation of coverage based upon a thorough and factual legal consideration when routinely made as a claim analysis." Moreover, the court noted that where the reserves "have been established based on legal input, the results in the supporting papers most likely will be work prod-

uct and may also reflect attorney-client privilege communications."

Hence, *Independent Petro Chemical* is an important case for two reasons. First, it recognizes that reserves are often set as a matter of course and public policy; not to adequately fund potential losses. Moreover, reserve information does not reflect an evaluation or analysis of coverage based upon policy interpretation. Second, the *Independent Petro Chemical* case recognizes that oftentimes reserve information is set with the assistance of counsel. To that extent, then, reserve information may be afforded work product and attorney-client privileges.

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• *In Re: Couch*, 80 B.R. 512 (S.D. Cal. 1987) (discovery of reserve information not discoverable by reason of statutory regulation)

In Re: Couch, represents an important milestone with respect to discoverability of reserve information because there, the court recognized that reserves are often required to be set by statute and/or regulation. Their values are calculated through the use of complicated formulas set by the regulatory body. Accordingly, the court held that because a carrier does not set a reserve according to discretion, but rather regu-

lation, a reserve cannot accurately or fairly be equated with an admission of liability or the value of a particular claim.

In Re: Couch provides an important argument against the disclosure of reserve information where the setting of same is controlled by statute or regulation. To the extent a carrier's hands are tied in their ability to set reserves, the existence of reserves cannot be read to be an admission of liability. Hence, they are irrelevant and not reasonably calculated to lead to the discovery of admissible information.

• *But see, Champion International Corp. v. Liberty Mutual Ins. Co.*, 128 F.R.D. 608 (S.D.N.Y. 1989) (discovery of reserve information relevant and ordered produced in the absence of claims of privilege)

In *Champion International*, a policyholder sued several of its carriers after the carriers refused to settle underlying product liability cases. *Champion* sought the carriers' reserve information for the underlying claims. Notably, the carriers failed to assert an attorney-client privilege or work product doctrine objection to any of the requests. In an absence of these objections, the court, relying upon a series of unreported cases, recognized that reserve information was sufficiently relevant in coverage cases to be produced. Moreover, because the carriers did not assert that the reserves had been set or influenced by the advice of counsel, discovery of this information could not be protected by attorney-client privilege or work product doctrine.

The lesson learned from *Champion* is that, where available, carriers should always assert a privilege objection to any requests for reserve information.

4. Representative Cases:

California: *Union Oil Co. of Cal. v. Allianz Ins. Co.*, No. BC 028270 (Cal.Super.Ct. Feb. 17, 1993) (discovery allowed);

District of Columbia: *Independent Petrol Chem. Corp. v. Aetna Cas. & Sur. Co.*, 117 F.R.D. 283 (D.D.C. 1986) (discovery not allowed)

New York: *Gold Fields American Corp. v. Aetna Cas. & Sur. Co.*, No. 1987 9/89 (N.Y.Super.Ct. Feb. 24, 1994) (discovery not allowed)

Pennsylvania: *Rhone-Poulenc Rorer, Inc. v. Home Indem. Co.*, 139 F.R.D. 609 (E.D.Pa. 1991) (discovery not allowed)

B. Discovery of Reinsurance Information

The majority of cases passing upon the admissibility of an insurer's reinsurance policies hold that they are not discoverable. Rare cases in which discovery is permitted most often involve "lost policy" issues. Another more ambiguous line of cases will order the disclosure of the reinsurance poli-

cies themselves, but will protect from disclosure communications between a carrier and its reinsurer.

1. Policyholder Arguments in Favor of Discovery:

Policyholders will often argue that the reinsurance contract might contain terms used in the underlying insurance policy, thus aiding the interpretation of same. In addition, communications between the carrier and its reinsurer may also contain explanations and/or clarifications of terms used within the underlying policy and may reflect the carrier's understanding of the terms and provisions contained within its own policy.

2. Insurer Arguments For Resisting Discovery:

The most effective argument is that the policyholder lacks privity of contract with the reinsurers, and thus the contract between the carrier and its reinsurer is irrelevant to the meaning of the underlying policy. Furthermore, carriers argue that the reinsurance policy is irrelevant to the intent of the policyholder and the insurer when each executed the actual policy at issue in the coverage litigation.

As to the communications between the carrier and its reinsurer, the carrier must argue that the similarity or difference of terms or provisions, or communications with respect to the reinsurance policy, has no probative value to understanding the underlying or primary policy, because the reinsurance policy is a separate and distinct contractual relationship among different parties. Moreover, placement of reinsurance necessarily turns on a business decision on the part of the carrier based upon business considerations aimed at minimizing exposure and does not relate to policy interpretation.

3. Case Law for Discussion:

Rule 26(a)(1)(D) of the Federal Rules of Civil Procedure provides for "inspection and copying [of] any insurance agreement under which any person carrying on an insurance business may be liable to satisfy part or all of a judgment which may be entered in the action or indemnify or reimburse for payments made to satisfy the judgment." Cases where courts have ordered the production of reinsurance policies have turned upon the question of whether the policyholder has requested merely declaratory relief or whether a claim for monetary damages is present. Along these lines, if money damages are sought within the coverage litigation, courts are more likely to order the production of reinsurance agreements because declaratory relief is not contemplated by Rule 26.

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• *Medmarc Cas. Ins. Co. v. Arrow International, Inc.*, 2002 WL 1870452 (E.D.Pa. 1002) (production of reinsurance policy required where carrier asserted counterclaim seeking indemnification from policyholder, thus, action sought money damages)

In *Medmarc*, the CGL carrier filed an action against its insured seeking a declaration that it was not responsible to indemnify its insured for punitive damages awarded it in an underlying case. The insured filed a counterclaim seeking a declaration that the insurer had a duty to indemnify the insured with respect to the underlying action. Moreover, the counterclaim contained a count for breach of contract. During discovery, the insured sought reinsurance policies. The Eastern District of Pennsylvania noted that the counterclaim sought money damages and, as such, discovery of the reinsurance policies, themselves, was warranted.

The point to be gleaned from *Medmarc* is that if the carrier brought its declaratory judgment action, alone, discovery of the reinsurance contracts would be denied. However, once the policyholder brought its counterclaim and sought money damages, in addition to declaratory relief, the claim became subject to Rule 26 of the Federal Rules and thus disclosure of reinsurance policies became warranted. (Despite its ruling that reinsurance contracts were discoverable, the *Medmarc* court, consistent with most other jurisdictions, held that discovery of reinsurance communications was not discoverable.)

• *Rhone-Poulenc Rorer, Inc. v. Home Indem. Co.*, 139 F.R.D. 609 (E.D.Pa. 1991) (aka *Rhone-Poulenc I*) (reinsurance agreements were not discoverable where coverage litigation sought declaratory relief, exclusively)

In *Rhone-Poulenc I*, the Eastern District of Pennsylvania found that reinsurance agreements were not discoverable under Federal Rule 26. The court reasoned that disclosure of reinsurance agreements was not required in cases where the litigation between the policyholder and its carrier was limited to a request for declaratory relief and did not involve a claim for damages. In a declaratory action, no money award is sought, thus Federal Rule 26 is not implicated because any ruling in the case would not require the insurer to be "liable to satisfy part or all of a judgment which may be entered in the action." See also, *American Colloid Co. v. Old Republic Ins. Co.*, 1993 WL 2226781 (N.D.Ill. 1993).

In addition to discovery of reinsurance policies, policyholders also seek to discover communications between insurers and their reinsurers regarding either the claim or coverages at issue. In responding to discovery, the practitioner should distinguish between the reinsurance agreements them-

selves and communications between insurers and their reinsurers. Communications oftentimes are completely irrelevant to the policyholder's claim. However, some courts have permitted discovery of reinsurance communications where they may be relevant to the carrier's efforts to rescind a policy or deny coverage on the basis of late notice.

• *Rhone-Poulenc I, supra* (reinsurance communications irrelevant for purposes of interpreting policy terms)

In *Rhone-Poulenc I*, the court denied discovery of communications between a carrier and its reinsurer aimed at interpreting the terms of the underlying policies. The court held discovery of such information would not shed any light upon the mutual intent of policyholders and the carriers as it related to the actual policies at issue. The court reasoned, "Any information regarding reinsurance would at best be evidence of undisclosed unilateral intention, which would not be material to the interpretation of the insurance contract at issue." Moreover, communications between an insurer and its reinsurer over the meaning of a particular policy provision are not discoverable in the absence of a finding that the term at issue is ambiguous and, thus, necessitates the use of extrinsic evidence to explain the policy.

Hence, *Rhone-Poulenc I* demonstrates that communications between a carrier and its reinsurer are not valuable to understanding the underlying or primary policy. Rather, reinsurance merely represents a business decision on the part of the carrier to minimize or spread risk.

• *Rhone-Poulenc II*, 1991 WL 23763 (E.D.Pa. 1991) (discovery of communications to reinsurers allowed where the carrier asserts late notice and misrepresentation as a defense to coverage)

Following its decision in *Rhone-Poulenc I*, the Eastern District of Pennsylvania was again called upon to rule upon discovery of reinsurance communications. However, this time the carrier asserted affirmative defenses to coverage based upon late notice and misrepresentation, which in the court's view made the discovery sought relevant. Indeed, the court did not reverse itself and reasserted that the discovery was irrelevant to determining the mutual intent of the parties to the insurance contract. However, the discovery of reinsurance information was relevant to the affirmative defenses of late notice and misrepresentation. By raising these defenses, the court noted that the carrier necessarily opens the door to discovery regarding late notice or misrepresentation. If the carriers gave notice to their reinsurers through various communications, the discovery of such communications would, then, either corroborate or undercut their late notice defense as it relates to the policyholder. Accordingly, communications related to the notice issue was warranted.

As for the discovery of reinsurance communications related to misrepresentations of the policyholder, the court held that the defense clearly puts at issue the question of what the defendants knew at the time the disputed policies were issued. Although the reinsurance communications are not relevant to the issue of policy interpretation, such information may be extremely relevant to whether the policyholder made a misrepresentation to the carrier. Accordingly, the communications were subject to discovery.

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In *Minnesota School Boards*, the policyholder sued its carrier over coverage for a fire loss. The carrier produced a portion of its reinsurance file but asserted that other documents were protected by privileges afforded by the work product and common interest doctrines. The court was called upon to determine whether the withheld communications were discoverable. The policyholder argued that the carrier waived any and all protection over the documents when they were sent to reinsurers by way of insurance brokers. The court rejected this argument and held that the broker acted as a mere conduit for protected communications between the carrier and its reinsurer. Moreover, the court noted that the documents were disclosed to the broker and the reinsurers with the expectation that their confidentiality would be preserved and that, above all, the common interest doctrine as it applied to the carrier and its reinsurers would protect the documents from disclosure.

Indeed, the increasing emphasis upon discovery of reinsurance communications places carriers in a difficult position. In order to narrow the issues to be litigated, it is imperative that the carrier protect from discovery red herring documents that are external to the policies themselves. However, carriers also operate under an extremely important duty for a frank and honest disclosure to their reinsurers whenever presented with a potential claim.

Carriers can reduce exposure and keep the issues at trial narrow by carefully considering whether the defenses they assert in a coverage litigation unwittingly make reinsurance documents relevant. Furthermore, it is advisable for insurers engaged in litigation between themselves to not seek discovery of reinsurance communications that will result in reported cases which may undercut their legal positions in subsequent coverage litigation with policyholders.

II. The Policyholder's Broad Net to Capture Documents Related to Policy Negotiation and Application

A. The Production of Underwriting Files and Claims Manuals

1. Policyholder Arguments in Favor of Discovery:

These documents may show that the carrier's legal position with respect to the meaning of a term or a provision at issue is contradicted by the interpretation the carrier communicated to its own underwriting and/or claims personnel. As such, to the extent any of these documents exist, they should be produced.

Thus, carriers in insurance coverage actions have solid arguments against the disclosure of reinsurance communications. It is almost universally recognized that such communications are irrelevant to policy interpretation and merely reflect business decisions in the operations of risk allocation. However, as *Rhone-Polenc II* demonstrates, an insurance carrier may unwittingly open the door by raising affirmative defense such as late notice, lost policies, or misrepresentation. Inherent in these defenses are questions as to what the insurer knew with respect to the claims and when they were on notice of same. Presumably, the insurance carrier would keep its reinsurers informed to the best of their knowledge with respect to these issues. Accordingly, discovery of such communications goes to the heart of these affirmative defenses as raised by insurance carriers.

• *Minnesota School Boards Association Ins. Trust v. Employers Ins. Co. of Wausau*, 183 F.R.D. 627 (N.D.Ill. 1999) (discovery of reinsurance communications protected by work product and common interest doctrine)

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Claims manuals are particularly relevant in that they disclose the manner in which a disputed term or provision is customarily applied and understood by the carrier within its own organization and throughout the industry. Furthermore, the underwriting file may contain the carrier's instructions to its employees on marketing and servicing the policies at issue. To the extent that these directions contradict the legal position taken by the carrier in coverage litigation, it will be useful to the policyholder.

2. Insurer Arguments For Resisting Discovery:

Internal documents kept in-house by the carrier, explaining the insurer's underwriting practices, do not reflect the mutual intent of the parties to the policy at issue. As such, any document reflecting the unilateral intent of either the insurer or the insured is irrelevant to deciding the mutual intent of the contracting parties. Along these lines, claims handling manuals are similarly useless in determining the meaning of an insurance policy as it applies to a specific claim.

3. Case Law For Discussion:

More than any other type of extrinsic evidence, policyholders seek claims manuals through discovery in the hope that it will demonstrate an inconsistency between the carrier's internal policies and their claims handling practices. An effective defense of a carrier requires staunch opposition to this type of discovery premised on the fact that the unilateral and internal intent of the carrier is simply irrelevant to the meeting of the minds with respect to the insurance contract and will not assist in interpreting the policy.

- **Safeguard Lighting Systems Inc. v. North American Specialty Ins. Co.**, 2004 WL 3037947 (E.D.Pa. 2004) (claims manuals not reviewed or utilized by claims handler in connection with underlying claim not relevant or reasonably calculated to lead to discoverable material)

In *Safeguard Lighting*, the insureds sought their carrier's claims manuals through discovery. The carrier objected to the production of such documents as not relevant or reasonably calculated to lead to admissible information. Along these lines, the carrier objected that it maintained a huge library of insurance literature including a technical claims manual that provided a general outline of claims handling for general liability business. However, the carrier claimed that the claims manager relied on his 15 years of experience rather than on this manual when adjusting the claim at issue. Hence, production of a claims manual not utilized in adjusting the claim was both irrelevant and not reasonably calculated to lead to

the discovery of admissible evidence. The Eastern District of Pennsylvania agreed with the carrier that requiring the production of its entire claims manual library would be unduly burdensome. However, to the extent the adjuster utilized any internal material or instructions, to adjust the claim at issue, such material was ordered produced.

“When responding to discovery of this nature, the practitioner should be sure to discuss with the claims handler whether she referred to any internal memoranda to adjust the claim.”

The *Safeguard* case is important in that it illustrates that claims manuals which are otherwise irrelevant, may become relevant to the extent that the adjuster depended on the same to adjust the claim. When responding to discovery of this nature, the practitioner should be sure to discuss with the claims handler whether she referred to any internal memoranda to adjust the claim. To the extent any internal claims manuals were not utilized, the practitioner should object that their production is irrelevant and not reasonably calculated to lead to discovery of admissible material.

- **Garvey v. Nat'l Grange Mut. Ins. Co.**, 167 F.R.D. 291 (E.D.Pa. 1996) (discovery of claims manuals not permitted as they were irrelevant to policy interpretation)

In *Garvey*, the Eastern District of Pennsylvania examined the discovery of claims manuals. This time, the court reasoned that because the internal procedures within the manual were trade secrets and not related to a plaintiff's claim as to whether his loss was covered under the relevant insurance contract, discovery of the claims manual was not permitted. Furthermore, the court noted that straying from internal procedures within a manual does not establish, in and of itself, a claim for bad faith.

The *Garvey* case is another instructive touchstone insofar as it illustrates the importance of raising an objection based

upon proprietary information. Generally, where available, the practitioner should raise an objection that the claims manuals are trade secrets. As such, any production of same should be either *in camera* or under seal.

Whether claims manuals are discoverable also depends on whether the policyholder has alleged bad faith. If bad faith is at issue, then the production of the claims manual may well be compelled. *See, e.g., Reavis v. Metropolitan Property & Liab. Ins. Co.*, 117 F.R.D. 160 (S.D.Cal. 1987) (ordering the production of claims information where policyholder has sufficiently alleged a cause of action for bad faith). Thus, in order to narrow the issues presented to the court, it is important for the practitioner to seek the dismissal of any bad faith counts before answering responsive pleadings. If the practitioner is successful in eliminating the bad faith count, the policyholder will not be able to argue that the claims materials should be produced because they are irrelevant to the issue of the carrier's conduct and alleged bad faith.

4. Representative Case Law:

Delaware: *E.I.U. duPont de Nemours & Co. v. Admiral Ins. Co.*, 1993 WL 19662 (Del.Super.Ct. Jan. 8, 1993) (discovery allowed)

Florida: *Industrial Indem. Ins. Co. v. Crown Auto Dealership, Inc.*, 935 F.2d 240 (11th Cir. 1991) (discovery allowed)

Illinois: *United States Fidelity & Guaranty Co. v. Specialty Coatings Co.*, 535 N.E. 2d 1071 (Ill. App.), appeal denied, 545 N.E. 2d 133 (Ill. 1989) (discovery allowed)

New Jersey: *Morton Int'l, Inc. v. General Accident Ins. Co.*, 134 N.J. 1 (1993) (discovery allowed)

West Virginia: *Joy Technologies, Inc. v. Liberty Mutual Ins. Co.*, 421 S.E.2d 493 (W.Va.1992) (discovery allowed)

C. The Discovery of Advertising and Marketing Materials

More recently, policyholders are seeking to obtain advertising and marketing materials in an attempt to demonstrate that the policyholder was led to believe that claims at issue would be covered based upon the representations made by the carrier. Now that a claim is filed, the carrier relies upon the "fine print" to undercut the commercial expectations of the policyholder.

1. Policyholder Arguments in Favor of Discovery:

Discovery of advertising materials may demonstrate that the carrier made public representations that certain types of losses are covered by its products. Marketing and advertis-

ing materials may uncover representations by the carrier, which are at odds with its current legal position.

2. Insurer Arguments for Resisting Discovery:

Advertising and marketing materials are not part of the insurance contract and therefore cannot alter or change the scope of coverage that is provided by the language of the policy itself.

In cases where the insured is a large or sophisticated corporation, perhaps equipped with its own risk management personnel, it is preposterous to believe that the insured was duped by the carrier's mass marketing or advertising campaign.

Furthermore, depending on the breadth of the policyholder's discovery request, searching for all potentially responsive advertising and/or marketing materials would be extraordinarily burdensome, costing a great deal of personnel-hours and taking an unreasonably long time.

3. Case Law for Discussion:

Reported case law regarding discovery efforts to obtain advertising material of carriers is scarce. Those cases that do exist, however, oftentimes provide little analysis behind the reasons for their respective discovery rulings. As such, reported case law is inconsistent and a coherent jurisprudence has yet to emerge.

• *Hoechst Celanese Corp. v. National Union Fire Ins. Co. of Pittsburgh, PA*, 623 A.2d 1099 (Sup.Ct.Del. 1991) (discovery of advertising materials held to be irrelevant)

Here, the insured filed a motion to compel answers to interrogatories and production of documents related to the advertising and marketing efforts. The policyholder argued that advertising and promotional material would provide evidence of the carrier's pre-litigation interpretation of the standard form CGL policy and their coverage intent. The court disagreed, finding that advertising and promotional materials were irrelevant to the interpretation of the policy, and, in any event, were not likely to lead to the discovery of admissible evidence. Because the policyholder failed to make an adequate showing of the relevance of the information sought, their motion to compel was denied.

• *State Farm Mut. Auto. Ins. Co. v. Engelke*, 824 S.W.2d 747 (Tx.App. 1992) (discovery of advertising materials compelled where materials were relevant to claim of bad faith)

Here, the insurer sought *mandamus* after the court ordered it to produce advertising materials as part of a discovery request. The carrier objected that the production of advertising materials was irrelevant because the plaintiff had not

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shown that she relied on any advertising in purchasing her insurance policy. The court disagreed and ordered the production of advertising materials because such materials would show the disparity between the carrier's promises to consumers and its treatment of those consumers when they actually file claims. This was particularly relevant, the court reasoned, because of the plaintiff's claims of punitive damages and bad faith.

Again, the *Engelke* case, illustrates the importance of narrowing the claims against the carrier when defending it and eliminating bad faith claims wherever possible.

D. Representative Case Law:

Delaware: *E.I.U. duPont de Nemours & Co. v. Admiral Ins. Co.*, 1993 WL 19662 (Del. Super. Ct. Jan. 8, 1993) (discovery allowed)

Conclusion

In recent years, policyholders have cast an aggressive and broad net to discover information external to the policy at issue. The practitioner defending these actions must seek to narrow the issues that will be presented in the litigation. Efforts to properly frame issues which will ultimately be presented begin in discovery. It is imperative, then, that the practitioner resist discovery efforts which will take the court's eye off the ball and divert attention away from the insurance policy which is the actual subject of the litigation. Oftentimes the policyholder's attempts to obtain external documents is nothing more than a campaign designed to cast the carrier in a poor light or portray the insurance company as "speaking from both sides of its mouth." A court must always be reminded that this is a simple contract action and that the majority of the documents sought by the policyholder are simply unrelated to the meaning of the contract at issue.

Indeed, case law passing upon these issues is both sparse and inconsistent. The purpose of this article is to provide the defense bar with strategies which will aid in coping in this environment.
