



Legal Beat

By MICHAEL SEAN QUINN

The Business Pursuits Exclusion

Tupperware parties—and activities like them—held in private homes give insurance agents bad dreams. Are they not

part of a business? But are they not also neighborhood socials? What if the homeowner gives one such party or more a week,

and rakes in an enviable annual income? Now suppose a customer/guest trips over a chair, hits her head and is badly injured? Or, what if a guest/customer slips on a to-be-sold plastic dish carelessly left on the floor and gets hurt?

How far should an agent go out of her way to discuss the relationship between business pursuits and the homeowners (HO) policy with applicants? How much should the agent do to be sure that the underwriter knows what there is to know? What advice, if any, should the agent give the homeowner when filling out the application for insurance? Does the fact that such insurance is frequently procured over the telephone make any difference? What about renewals? Not every specific problem can be discussed with every applicant every time.

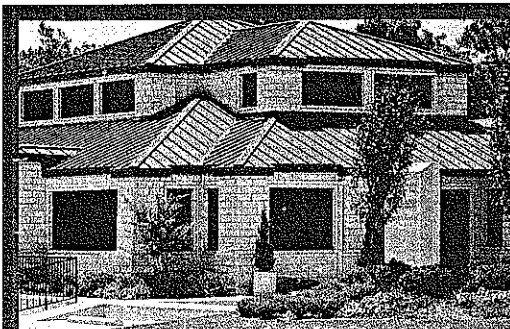
The Texas Supreme Court has decided two cases in the last five years which have implications for these questions. It decided the first case, *State Farm v. Reed*, in 1993. It decided the second one, *State Farm v. Vaughan*, in May 1998. Both of these cases involved HO policies and child care for money in private homes. The *Reed* case was decided by a vote of 6-to-2. Justice Hightower wrote for the majority; Chief Justice Phillips wrote a vigorous dissent, in which Justice Hecht joined; and Justice Enoch did not sit. The *Vaughan* case was a unanimous, unsigned (per curiam) opinion. One wonders if these two cases are consistent.

I.

In *Reed*, an 18-month old child drowned in a puddle of water that had settled on a tarpaulin covering a swimming pool at the residence of a woman who operated a day care service there. The child had crawled through a hole in a fence that separated a play area from the pool. A dog belonging to the owner of the combined home/day care center had created the hole.

The problem in both of these cases arises from an exception to the business pursuits exclusion in the HO policy. That policy covers damages the insured becomes legally obligated to pay because of bodily injury, among other things. The business pursuits exclusions states that the coverage does not apply "to any business pursuits of an insured except activities therein which are ordinarily incidental to non-business pursuits." The issue before the court was whether the exclusion or the exception applied.

A. The majority in *Reed* said, in effect, that there was no rational way to discern what activities triggered the exception to the exclusion. Because that matter could not be determined, the word "activities," which appears in and which triggers the exception to the exclusion, is vague and therefore ambiguous. According to the majority,



Property and Casualty

Our business is to make your business successful. We pride ourselves in making your job easier while creating mutually successful partnerships. Blanch Wholesale Insurance markets and programs are wide ranging and comprehensive.



Energy



Trucking

- Inland Marine
- Brokerage
- Environmental
- Commercial & Personal Umbrellas
- Dwelling
- Farm & Ranch
- Specialty Risks

BLANCH WHOLESALE Insurance Services

Our underwriters are knowledgeable and professional. Call Blanch for a partnership that works for you.

210/734-7751 or 800/844-3434



Watercraft

v 4.10

therefore, it must be construed in favor of coverage.

The majority rejected the idea that home-child-care-for-money automatically precluded coverage for any included activities. Some of them might ordinarily be incidental to non-business pursuits. Thus, the mere fact that a child is present in a home as the result of a commercial endeavor does not preclude the application of the exception.

Furthermore, said the majority, commercial child care in a home is not, in and of itself, automatically and always within the exception to the exclusion. Thus, said the majority, the court must focus on the actual activity which caused the injury, and it must not characterize that activity in any unnatural way so as to generate preconceived results which will strike the public as contrived.

Justice Hightower, for the majority, said that he simply could not figure out how to apply the exclusion to the circumstances, given its exception. He held that the exception was ambiguous. The law is that every genuine ambiguity in an insurance contract must be construed in favor of coverage. There was an interpretation of the exclusion which would generate coverage. Here it is. The activity in question was the maintenance of the fence around the swimming pool. Surely, said Justice Hightower, this activity in a household is ordinarily incident to a non-business pursuit, to wit: the maintenance of the home. On this basis, the six-person majority found coverage.

It is worth remembering who was part of the 1993 majority. It included not only Jack Hightower (now in private practice), but Lloyd Doggett (who is now in the U.S. Congress), John Cornyn (who is now running for Texas Attorney General), and Bob Gammage (who has also returned to private practice). The only remaining members of the Reed majority are Justices Gonzales and Spector (and Justice Spector faces a fierce challenge in November).

B. In his dissent, Chief Justice Phillips applied all the same abstract legal principles that the majority utilized. However, he emphasized the facts differently. First, the Reed child care enterprise was a "registered family home" with the Texas Department of Human Resources, and it was authorized to provide day care services for as many as 12 children at a time. Second, the parents of children in the Reed home were charged \$37.50 per child, per 5-day week. The size and scale of this enterprise required two additional employees. Third, TDHR prescribes minimum standards for registered family homes; they expressly require that children be protected from unsupervised access to swimming pools.



11000 Richmond Avenue, Suite 250 • Houston, Texas 77042
(713) 532-4111 • (800) 824-1709 • (713) 532-4121 Fax

INDEPENDENTLY OWNED, WE PROVIDE CUTTING EDGE SOLUTIONS TO TODAY'S RISK MANAGEMENT CHALLENGES

General Liability • Products Liability • Umbrella Liability • Property
Commercial Auto Liability • Professional Liability
Workers' Compensation • Excess Workers' Compensation and Alternatives

Binding Facilities for General Liability, Property & Auto Liability

SPECIAL PROGRAMS & FACILITIES FOR:


Public Entity Risks (All Lines)
Equipment Dealers (All Lines)
School Leaders Liability
Contractors (All Lines)

SEND US YOUR...

APARTMENTS!

CONDOS!

HOTELS!

We Have  Markets For
Property (Including Coastal)
And General Liability!!!

"A" rated carriers! Fast turnaround! Excellent service!



BIG OR SMALL, CRC DOES IT ALL



For more information please contact **Brent Tredway, Bud Brickey,
Tracy Banks, Kim Townsend, Donna Weixel, Chris Adams,
Leanne Bell or Fay Wright**



...Performance is the Difference

Justice Phillips observed that the essence of child care is supervising children. That's what parents pay for. In Justice Phillips' opinion, it was Reed's failure to supervise the child which caused his death. That offense caused the death. Upon this ground, he rejected the idea that the exception to the exclusion applied. In particular, he condemned the notion that the court should look at a more specific activity than child supervision, to wit: the activity of keeping the fence in repair. (Alas, he does not say why.)

C. Notice that the crucial difference between Justice Hightower and Justice

Phillips is how they characterized the exclusion-triggering activity. Justice Hightower said that the activity was maintaining the fence. Justice Phillips contended that the activity was supervising the children. Notice that this is not a disagreement about the facts, and it is not a disagreement about the law. It is a disagreement about how facts should be interpreted and about how they should be characterized.

II.

Vaughan comes to the opposite result from *Reed*. It involves quite different facts. And it involves somewhat different contract

terms. Neither of these differences is dispositive, however.

The insurance policy in *Vaughan* excluded coverage for "bodily injury or property damage arising out of or in connection with a business engaged in by an insured." The exception to the exclusion states that "this exclusion does not apply to activities which are ordinarily incidental to non-business pursuits." Even given the subtle differences, one suspects that the intent of the two policies is pretty much the same.

The facts in *Vaughan* are upsetting. A woman operated a licensed child care facility in her home. Apparently it was too much for her. She strapped a child into a car safety seat, put him in a closet, and placed a blanket over his head. She then left her home. The *Vaughan* child and several other children were thereafter unattended.

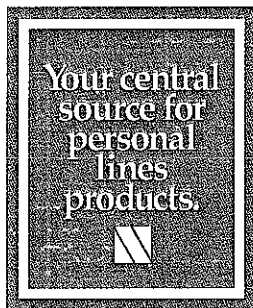
The authorities intervened quickly. The children apparently suffered no bodily injuries, and the insured was convicted on four counts of child endangerment. Subsequently, the *Vaughans* sued the insured seeking damages for emotional distress.

Upon reading these facts, even an ignorant fool would recognize immediately that there could be no insurance coverage. The caretaker walked away, for heaven's sake. She left the premises. Fortunately, no coverage was the court's decision. But what about the *Reed* case. The Supreme Court did not reverse *Reed*. Indeed, the Court cited *Reed* positively over ten times and adopted *Reed's* theoretical approach. It refused to adopt a blanket rule either for or against HO liability coverage for commercial, home-provided child care.

Instead, the justices said that courts should concentrate on the specific activity/allegations against the insured, that they should try to find a natural description of the activity which might trigger the exception, but that they should not describe that activity in such a way as to reach contrived results. The parents of the *Vaughan* child accused the insured of negligence in leaving the child completely unsupervised while being paid to care for the child. This accusation focused specifically on how the insured conducted her business pursuit. That was the focus of the litigation. Hence, the exception to the exclusion could not possibly apply.

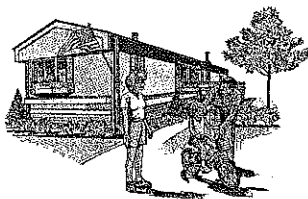
III.

Several observations are in order. First, my bet is that State Farm set the *Vaughan* case up artificially. It thought that the rule in *Reed* was pernicious and wanted the holding reconsidered. Probably, this strategic decision involved very high-ranking claims people. Money was not the issue. The evidence for my speculation is



*Consistently
Exceptional
Service.*

*Attentive and
responsive to
your needs.*



*Financially stable
A+ rated group
of companies.*



**SOUTH & WESTERN
GENERAL AGENCY, INC.**

P.O. Box 551119
Dallas, Texas 75355
(972) 855-2900 • (800) 492-5351
FAX (972) 855-2970

Representing A+ rated Northland Insurance Companies and other fine carriers.

that State Farm had perfect coverage defenses, even without the business pursuits exclusion. The Vaughan parents apparently sued for negligent infliction of emotional distress.

Several years ago, the Texas Supreme Court held that negligent infliction of emotional distress was not a viable cause of action in Texas. Moreover, the only relevant coverage in the HO policy at issue was for bodily injury. Pure emotional distress, just by itself, is not bodily injury and therefore not within the terms of the contract. Finally, there was no act of negligence and hence no insured accident. Everything that happened was intentional.

None of these absolute policy defenses played any role in this case. State Farm knows all about these policy defenses; it has asserted them up many times. State Farm is in general a rational entity. What it does in a litigation, it means to do. Consequently, a reasonable guess is that State Farm wanted to test the business pursuits exclusion again, so it relied upon nothing else. It was right to do so, as things turned out.

Second, *Reed* contains a major flaw. It does not reflect upon the idea of an activity at all. An activity exists only if someone undertakes a pattern of action. The injury in *Reed* did not result from an activity. Rather, it resulted from inactivity. Reed omitted to repair a fence. Surely, that inaction was the proximate cause of the child's death. That condition of inactivity—that continuing pattern of neglect—was not an activity. Because it was not an activity at all, it could not be classified as an activity within a business pursuit. Justice Phillips was right, the activity at issue was the supervision of children in a commercial context.

IV.

Reed and *Vaughan* are not consistent. One of them must be wrong. Did sympathy and compassion influence the decision of the majority in *Reed*? These are both fine virtues, of course, and they should play a role in some legal decision-making. They should not by themselves animate legal decisions about contractual terms, however, even for personal lines insurance policies.

But if *Reed* is wrong, why didn't the *Vaughan* court overrule it? The opinion contains not even one critical word about the 1993 case. Instead, the 1998 court seemed to go out of its way to laud *Reed*. What in the world is going on?

The current Texas Supreme Court loves continuity. Of course, the common law has always worshipped before this icon, and rightly so. Social and business life are inconceivable without it. But, today's justices have an intense passion for seamless evolution. They will go to almost any lengths to preserve a sense of unfolding yet

unbroken tradition in the law. Today's court regards overruling past cases as anathema.

There is much good in *Reed*. The principles it enunciated and applies are all uncontroversial. There is no need to revise any of them. The holding was wrong, but the error arose outside the explicit articulation and application of legal rules. It arose from an error in classifying and interpreting the facts. This is a mistake of formulation and conception. As such, it falls in a gap between an error of fact and an error of law. Today's court believes such errors should be passed over in silence.

In *Vaughan* the defendant/insured was accused of negligence in leaving a child completely unsupervised while being paid to care for the child at her in-home day care business. In *Reed* the defendant/insured was accused of negligence in supervising the child sloppily, while being paid to care for the child at her in-home day care business. If the complaint in the *Vaughan* focuses specifically on the way the defendant/insured conducted her business pursuit, so does the complaint in *Reed*. The cases contradict each other near the bottom line. Should errors in that "location" be passed over mutely?



WHOLESALERS

If you're looking for . . . *capacity* ★ *competitive rates* ★ *A-rated paper (admitted and non-admitted)* ★ *rapid quote response, and* ★ *high commissions* . . . you need to look for First Capital of Texas. This brightest insurance star in the Lone Star State will make you sparkle for your customers.

Writing through Reliance Group Holding Companies, First Capital of Texas offers highly competitive rates and the capacity you demand for both residential and commercial real estate. We also underwrite restaurants, caterers and light manufacturing.

Count on us for same-day quotes and loss-control engineering inspections within thirty days after binding coverage.

You'll be dazzled by service provided by the experienced First Capital of Texas team, led by Paul Warmingham, President, and Jerry Miller, Vice President. Plus they're backed by the entire First Capital Group, with offices in California, Illinois, Pennsylvania and New York.



Help ensure an even brighter future for your agency.
Contact First Capital of Texas today!

1-800-924-1687

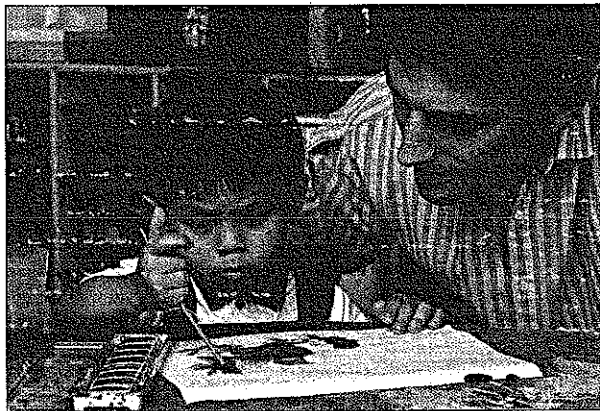
There is a real problem in the reasoning of the majority in *Reed* which needs addressing. It said that the word "activity" in the exception to the business pursuits exclusion is ambiguous. The *Vaughan* court passed over this crucial point. If the word was ambiguous in 1993, it is ambiguous now. The argument of the *Vaughan* opinion makes it clear that the 1998 court has quietly rejected the thesis of ambiguity. Wouldn't it have been better to say so explicitly? Does not the word at issue, or its cognates, appear in other policies? Perhaps the court wants to let these two cases simmer together for a while, and see what happens. Sometimes doctrinal tension and resultant uncertainty can be creative.

V.

So, what does this pair of cases mean for the insurance business? For carriers, it means that they can deny coverage under HO policies for accidental injuries to children in home day care centers. They need not fear statutory bad faith cases. *Reed's* continuing vitality entails this consequence. Judicially created claims confusion immunizes insurers from bad faith.

For insurance agents, *Vaughan* means that providers of in-home day care services should not expect coverage under home-

owners policies for accidents which injure the children in their care. Agents should explain this fact. They should also make clear the inconsistent, and therefore, uncertain state of the law. Where does baby-sitting—which is probably covered—end, and commercial in-home day care—which is



probably not covered—begin? This tension needs careful thought.

Policyholders should expect insurers to contest coverage, and they should consider obtaining some sort of commercial coverage. Should they buy CGL coverage? That policy is awfully expensive and way, way, way too broad. Can they buy special commercial child care HO endorsements? Do home child

care centers need special auto coverage?

Agents should be informing policyholders about these complexities. It may not be enough simply to ask a customer whether there is any business pursuit conducted in the home. Certainly, if an agent knows that a policyholder is conducting a day care center in her home, the agent needs to make appropriate disclosures both to the customer and to the underwriter. If a special home daycare endorsement is offered, the agent should study it carefully. Should agents search surplus lines markets for different endorsements? Should big-time agencies perhaps try drafting a new endorsement?

Attorneys advising insurers are telling them to consider filing rescission actions against in-house day care centers which have only HO insurance. Such actions would be based upon material nondisclosures and upon fraud. Obviously, rational insurance agents do not want to get dragged into the middle of those squabbles. ■

Quinn is an Austin-based attorney with the law firm of Sheinfeld, Maley & Kay. He was recently selected to receive the 1998 Outstanding Law Journal Article Award by the Texas Bar Foundation.

are all WORKERS' COMP PROGRAMS truly alike?

In a word, no. It's the people behind the program that make the difference and that is why Centrum has been chosen in Texas to represent Harbor Specialty (A-) for their Workers' Comp program. Program highlights include:

- Texas management team for Texas agents' accounts
- An understanding that the insured is our mutual customer
- Superior claims service with injury management service
- Interactive claims systems
- In-house risk management

Find out why our agents are so impressed with our fast, friendly service, professionalism, and commitment to doing the job right.

Centrum Management, Inc.
1320 Greenway Drive, Suite 760
Irving, Texas 75038

Isn't it time you called?
800/550-6161 or 972/550-6161
fax 972/550-6167

