

1996

Aspects of Insurance in Aviation Finance

Rod D. Margo

Recommended Citation

Rod D. Margo, *Aspects of Insurance in Aviation Finance*, 62 J. AIR L. & COM. 423 (1996)
<https://scholar.smu.edu/jalc/vol62/iss2/4>

This Article is brought to you for free and open access by the Law Journals at SMU Scholar. It has been accepted for inclusion in Journal of Air Law and Commerce by an authorized administrator of SMU Scholar. For more information, please visit <http://digitalrepository.smu.edu>.

ASPECTS OF INSURANCE IN AVIATION FINANCE

ROD D. MARGO*

TABLE OF CONTENTS

I. INTRODUCTION.....	424
II. THE NATURE OF INSURANCE.....	428
A. INSURABLE INTEREST	430
B. THE DUTY OF DISCLOSURE	430
1. <i>Good Faith</i>	430
2. <i>Nondisclosure and Misrepresentation</i>	431
III. THE INTERNATIONAL AVIATION INSURANCE MARKET	433
IV. THE ROLE OF THE INSURANCE BROKER.....	435
V. CERTIFICATES OF INSURANCE AND LETTERS OF UNDERTAKING	437
VI. TYPES OF COVERAGE	439
A. HULL INSURANCE	439
B. LIABILITY INSURANCE.....	442
1. <i>Passenger Liability Insurance</i>	443
2. <i>Third Party Liability Insurance</i>	444
C. WAR AND ALLIED PERILS INSURANCE	445
VII. PROTECTING THE INTERESTS OF FINANCIERS.....	449
A. PROTECTING THE INTERESTS OF FINANCIERS UNDER A HULL POLICY	449
1. <i>Additional Insured Endorsement</i>	450
2. <i>Loss Payable Clause</i>	450

* Member of the California and District of Columbia bars; Partner, Condon & Forsyth, Los Angeles; Lecturer in law, UCLA School of Law, Los Angeles. I have received helpful advice and comments from individuals too numerous to mention. In particular, I wish to thank Suzanne Lewis for her research assistance and Peter Viccars, Michael Solley, Tom Whalen, Ross Williams, Angela Chua, and John Cruse for providing important insight and comments. I am also grateful to Lloyd's Aviation Underwriters Association for graciously allowing me to reproduce AVN 67B as the Appendix to this Article. Any remaining errors are entirely my own.

3.	<i>Breach of Warranty Coverage</i>	451
4.	<i>Reinsurance Cut-Through Clause</i>	454
5.	<i>Miscellaneous Protective Provisions</i>	455
a.	Waiver of Subrogation	455
b.	Nonliability for Premiums	456
c.	Notice	456
B.	PROTECTING THE INTERESTS OF FINANCIERS UNDER A LIABILITY POLICY	457
1.	<i>Cross-Liability Clause</i>	457
2.	<i>Severability of Interest Clause</i>	458
C.	SPECIALIZED COVERAGE TO PROTECT THE INTERESTS OF FINANCIERS	459
1.	<i>Repossession Insurance</i>	459
2.	<i>Residual Value Insurance</i>	462
3.	<i>Contingent Insurance</i>	465
4.	<i>Miscellaneous Coverages to Protect Financiers</i> ..	466
a.	Repossessed (Parked) Aircraft Insurance	466
b.	Total Loss Insurance	466
c.	Loss of Use Insurance	467
d.	Hull Deductible Repairer's Lien Insurance	467
e.	Breakdown Repairer's Lien Insurance	467
f.	Unearned Premium Contingency	467
g.	Breakage Costs Indemnity Insurance ..	467
VIII.	THE AIRLINE FINANCE/LEASE CONTRACT ENDORSEMENT	468
IX.	CONCLUSION	473

I. INTRODUCTION

AVIATION INSURERS and financiers¹ have traditionally had little in common. They are motivated by different philosophies of risk analysis which lead them to pursue different objectives.² The differing philosophies have sometimes led to friction

¹ For convenience, the term "financier" is used throughout this Article to include lenders, investors, and lessors, including operating lessors. However, it must be acknowledged that an operating lessor is not, strictly speaking, a financier.

² Financiers seek protection against every contingency which might delay or interrupt the flow of lease or loan payments. Insurers, on the other hand, analyze risk in light of the possibility that they will be required to pay in the event of a loss. See Harold Caplan, *The Interface Between Aircraft Finance and Aviation*

as financiers, determined to preserve the margin of profit, sometimes demand forms of insurance, and terms and conditions of coverage, that are either unavailable in the private insurance market or are only available at significant cost.

Traditionally, airlines acquired their aircraft by means of straight purchase transactions, with or without a debt element. With the advent of deregulation in the United States and Europe and the introduction into service of more expensive wide-bodied aircraft, airlines were forced to look to other sources of finance for their aircraft acquisitions. In this regard, various forms of lease finance became popular and financially advantageous to airlines.³

In the airline industry, a broad distinction is drawn between finance leases and operating leases.⁴ A finance lease is a lease that transfers substantially all of the risks and rewards of ownership of an aircraft to the lessee.⁵ Generally, a finance lease is a long-term full payout lease pursuant to which the lessee acquires use of an aircraft for a substantial part of its useful life. Rent payments are structured so that the lessor recovers the cost of the aircraft, plus a return on investment, over the life of the lease. In a finance lease the aircraft is selected by the lessee rather than the lessor; the lessor purchases the aircraft from the supplier or from the lessee by way of a sale-leaseback; the lease is a triple net lease (*i.e.*, the lessee is responsible for taxes, maintenance, and insurance); and title remains with the lessor throughout the lease term and does not pass to the lessee on expiration of the lease.⁶ In the United States, a capital lease is one which complies with one or more of the criteria set out in

Insurance, Address to the Euromoney Conference on Aviation Insurance: Essential Policy Awareness (May 24, 1990).

³ In 1990, some 40% of the world's commercial jet fleet was leased. By 1996, this figure will likely exceed 75%, of which more than 20% will be on operating lease.

⁴ A detailed discussion of aircraft financing and leasing is beyond the scope of this Article. For further treatment, see AIRCRAFT FINANCING (Simon Hall ed., 2d ed. 1993); STEPHEN HOLLOWAY, AIRCRAFT ACQUISITION FINANCE (1992); see also Michael D. Rice, *Current Issues in Aircraft Finance*, 56 J. AIR L. & COM. 1027 (1991); Rod D. Margo, *Aircraft Leasing: The Airline's Objectives*, 21 AIR & SPACE L. 166 (1996).

⁵ Statement of Standard Accounting Practice (U.K.) § 15.

⁶ Article 2A-103(g) of the Uniform Commercial Code provides a standard definition of a finance lease. See also AIRCRAFT FINANCING, *supra* note 4, at 110; HOLLOWAY, *supra* note 4, at 140.

paragraph 7 of Federal Accounting Standard 13.⁷ The term is used in accounting parlance and refers to whether the lease is capitalized from the lessee's perspective and, therefore, to be shown on the lessee's balance sheet.

A lease which does not meet the criteria of a finance lease or a capital lease is known as an operating lease. An operating lease provides for the lessee to receive the right to use an aircraft for a portion of its useful life. The term of an operating lease will typically vary between three to five years, after which the aircraft will be returned to the lessor and either leased again or sold. Usually, aircraft which are the subject of operating leases are acquired by the lessor with no specific lessee in mind.⁸ However, this is not always the case, and sometimes a lessor will acquire an aircraft to satisfy the requirements of a particular lessee.

In addition to the above classification, a distinction is drawn between wet leases⁹ and dry leases,¹⁰ single investor leases¹¹ and leveraged leases,¹² and true leases and leases which are disguised security interests. A tax lease is one which is structured in such a way that one or more of the parties to the lease may take advantage of tax benefits available to such party (usually the lessor). A

⁷ The criteria are (a) ownership of the aircraft is transferred to the lessee at the termination of the lease; (b) the lease gives the lessee an option to purchase the aircraft at a bargain price; (c) the lease term is equal to 75% or more of the estimated economic life of the leased aircraft; or (d) the present value of minimum lease rental payments is equal to 90% or more of the fair market value of the leased aircraft less any investment tax benefits available to the lessor.

⁸ AIRCRAFT FINANCING, *supra* note 4, at 481; HOLLOWAY, *supra* note 4, at 140.

⁹ Under a wet lease, the lessor provides an aircraft as well as the operating crew and fuel. A lease agreement pursuant to which the lessor provides an aircraft and flight crew, while the lessee provides the cabin crew, is sometimes referred to as a "damp" lease.

¹⁰ A dry lease is one in which the lessor provides an aircraft plus related operating equipment. Spare components may be included in a dry lease or made the subject of a separate lease.

¹¹ A single investor lease is one in which there is only one investor at risk with respect to the credit of the lessee.

¹² A leveraged lease comprises at least three parties: lessor, lessee, and nonrecourse lender. In a leveraged lease, the lessor borrows a substantial portion of the capital needed to purchase the aircraft on a nonrecourse basis. This means that the lender's rights do not extend to all of the nonrecourse borrower's assets, but are limited to the equipment (aircraft) which is the subject of the lease. By contrast, in a single investor lease, the lessor provides all the funds required to purchase the aircraft. Although a significant portion of these funds may be provided by a lender, they are borrowed on a recourse basis. This means that the lessor is directly liable for the borrowed funds and must repay the lender regardless of the lessee's ability to make rent payments under the lease.

double dip lease transaction is one in which two or more parties are able to avail themselves of the tax benefits available in two jurisdictions simultaneously.

The separation between aircraft owner and user has forced aircraft financiers to become familiar with the nuances of insurance and the workings of the insurance market so that they can protect their property interest in their aircraft and protect themselves from potential liability to passengers or third parties.

In the early days of aircraft finance, financiers were generally satisfied with a statement in the financing documentation to the effect that "the operator shall ensure that the aircraft is properly insured at all times."¹³ As aircraft values and liability exposures have increased, however, the above formulation has given way to detailed and sometimes complex insurance specifications which financiers demand in relation to their aircraft.

While insurance requirements in financing documentation became more detailed, the insurance aspects of the transactions were routinely neglected until the last moment, forcing insurers and their advisers to become familiar quickly with lengthy, carefully negotiated, and copiously documented finance transactions. This invariably caused confusion, dislocation, and sometimes even resentment as insurers were pressed to respond in short order to appease not only financiers, but also the airline insureds who were eagerly awaiting delivery of their newly acquired aircraft.

In an effort to avoid the disruption and pressure placed on the insurance market by aviation finance transactions, the London insurance market introduced a standard policy endorsement for use in connection with finance and lease contracts. The endorsement, known as the Airline Finance/Lease Contract Endorsement, or by its designation AVN 67B,¹⁴ has not only simplified the procedure for arranging and confirming coverage in the context of a financing, but has also standardized and clarified the coverages provided to financiers by London

¹³ Peter Viccars, *Aviation Insurance: Aircraft Leasing and Financing*, Address to the Aviation Insurance Conference in Asia (Feb. 23, 1994).

¹⁴ AVN 67B appears in the Appendix to this Article [hereinafter AVN 67B]. In the London market, standard clauses and endorsements are adopted for use by the Joint Technical and Clauses Committee (JTCC), which consists of representatives of Lloyd's Aviation Underwriters Association (LAUA) and the Aviation Insurance Offices Association (AIOA). Upon approval, such clauses and endorsements are published under the auspices of the LAUA and given a designated AVN number for purposes of identification.

insurers. As AVN 67B has gained acceptance, it has eased much of the pressure on aviation insurers to the extent that the coverages required by financiers can now be confirmed more expeditiously than before.¹⁵

This Article is intended to provide some insight into the role of insurance in aviation finance transactions.¹⁶ The Article will discuss the nature of insurance, the workings of the international insurance market, the role of the insurance broker, the use of insurance certificates and letters of undertaking, the various coverages available, and the manner in which the interests of financiers may be protected by insurance. While increased capacity, as well as more sophisticated and competitive underwriting by aviation insurers in the United States, France, Italy, Germany, Switzerland, Japan, and Scandinavia, have diminished the dominance of the London insurance market, London still plays a pivotal role in the international insurance market in view of the wealth of insurance expertise that is available there, and the ability of London-based brokers to spread risks to markets in other countries. Accordingly, the manner in which London handles insurance in the context of aviation finance transactions is generally followed by insurers elsewhere, at least for the time being.¹⁷

II. THE NATURE OF INSURANCE¹⁸

Insurance is primarily designed to protect the insured(s) against loss or damage caused by unforeseen or unexpected future events (*i.e.*, events which cannot be predicted or otherwise

¹⁵ See discussion *infra* part VIII and accompanying text.

¹⁶ For convenience, the term "financing transaction" is used in this Article to refer to all transactions involving the finance of aircraft, as well as operating leases, even though operating leases are not, strictly speaking, financing transactions. While reference to aviation finance transactions is broad enough to cover all such transactions, including the finance of general aviation aircraft, the discussion in this Article is limited to the financing of commercial airlines.

¹⁷ Regardless of the identity and location of the participating insurers, the majority of airline insurance placings are still arranged through brokers in London. Although this does not necessarily mean that English law will govern the interpretation of the policies so issued, English law governs many of them. See Rod D. Margo, *Conflict of Laws in Aviation Insurance*, 19 AIR & SPACE L. 1, 2 (1994). Accordingly, this Article cites to numerous English cases for purposes of illustration. Reliance is also placed on United States cases in view of the increasing importance of the U.S. insurance market in international aviation insurance.

¹⁸ For a detailed discussion, see ROD D. MARGO, AVIATION INSURANCE 6 (2d ed. 1989).

guarded against). In hull insurance,¹⁹ insurers will usually cover the insured against the risks of physical loss of or damage to aircraft. Liability insurance protects the insured against liability resulting from loss or damage, including injury or death, to passengers or other third parties.

Since insurers intend to cover events of a contingent nature, they will not insure against future events which are certain to occur.²⁰ Neither will insurance cover loss or damage deliberately caused by the insured.²¹ Thus, insurers will generally not cover the legal liability of a lessor or lessee to the other for intentional breaches of a lease.²² Insurance will not cover fines and penalties imposed on the insured.²³ Insurers will also generally not insure the creditworthiness or financial condition of a party, although certain specialized insurers will sometimes guarantee the residual value of an aircraft.²⁴ In addition, Lloyd's underwriters are prohibited by regulation from writing financial guarantee insurance without the prior written approval of Lloyd's Financial Guarantee Committee.²⁵

¹⁹ The term is derived from marine insurance. See *infra* part VI.A.

²⁰ Except in limited circumstances such as life insurance.

²¹ See, e.g., CAL. INS. CODE § 533 (West 1993); see also *GATX Leasing Corp. v. National Union Fire Ins. Co.*, 64 F.3d 1112, 1117 (7th Cir. 1995); *Certain Underwriters at Lloyd's of London v. Pacific Southwest Airlines*, 786 F. Supp. 867, 872 (C.D. Cal. 1992); *J.C. Penney Casualty Ins. Co. v. M.K.*, 804 P.2d 689, 694 (Cal. 1991); *Allstate Ins. Co. v. Overton*, 206 Cal. Rptr. 823, 827 (Ct. App. 1984).

²² See, e.g., *Insurance Co. of the W. v. Haralambos Beverage Co.*, 241 Cal. Rptr. 427, 431 (Ct. App. 1987). This should not be confused with breach of warranty coverage, where insurers agree to be liable for loss sustained by a lessor or lender even though the lessee has breached one or more conditions or warranties of the insurance policy. See discussion *infra* part VII.A.3.

²³ See, e.g., CAL. INS. CODE § 533.5(a). In several of the U.S. states, insurers are prohibited from providing coverage for punitive damages on the grounds that it would contravene public policy if an insured was able to pass on to his or her insurers an award of damages intended to punish him or her for outrageous, wilful, or oppressive conduct. See, e.g., *Certain Underwriters*, 786 F. Supp. at 873. There is no authority in English law which precludes an insurer, on the ground of public policy, from covering an award of punitive damages where the policy wording would otherwise allow it. See *Lancashire County Council v. Municipal Mut. Ins. Ltd.*, [1996] 3 All E.R. 545 (Eng. C.A.); *Du Pont De Nemours & Co. v. Agnew*, [1987] 2 Lloyd's Rep. 585, 594 (Eng. C.A.).

²⁴ See discussion *infra* part VII.C.2. Most conventional insurers will not cover this class of business.

²⁵ See Lloyd's Financial Guarantee Insurance Regulation, No. 4 (1989). Whether residual value insurance is financial guarantee insurance is discussed *infra* note 173 and accompanying text.

Two important features distinguish a contract of insurance from other contracts, namely, insurable interest and the duty of disclosure.

A. INSURABLE INTEREST

A contract of insurance is distinguished from a wager by the requirement that the insured have an insurable interest in the subject matter of the insurance.²⁶ This means that the insured should benefit from the subject matter's continued existence or suffer damage by its loss or destruction.²⁷ Any party with a financial interest in an aircraft, including an owner, investor, lender, lessor, or lessee, will ordinarily have an insurable interest in the aircraft.²⁸

B. THE DUTY OF DISCLOSURE

1. *Good Faith*

Insurance policies are contracts *uberrimae fidei*, that is, done in the utmost good faith.²⁹ Because the insured knows information about the risk being insured, he or she must act in the utmost good faith in making disclosures to the insurer either directly or through a broker.³⁰ This disclosure enables the insurer to assess the risk properly, to decide whether or not to

²⁶ See, e.g., CAL. INS. CODE §§ 252, 281 (West 1995); N.Y. INS. LAW § 3401 (McKinney 1985) (no insurance policy "shall be enforceable except for the benefit of some person having an insurable interest in the property insured"); *Osborne v. Security Ins. Co.*, 318 P.2d 94, 97 (Cal. Ct. App. 1957); see also *Davjoyda Estates Pty. Ltd. v. National Ins. Co. of N.Z. Ltd.*, 69 N.S.W. St. R. 381, 387 (1965) (Austl.); *Prudential Ins. Co. v. Commissioner of Inland Revenue*, [1904] 2 K.B. 658, 663 (Eng. C.A.).

²⁷ See *Harrison v. Fortlage*, 161 U.S. 57, 65 (1896) ("[A]ny person has an insurable interest in property, by the existence of which he will gain an advantage, or by the destruction of which he will suffer a loss, whether he has or has not any title in, or lien upon, or possession of the property itself."); *Bonaparte v. Allstate Ins. Co.*, 49 F.3d 486, 489-90 (9th Cir. 1994); *Wyman v. Security Ins. Co.*, 262 P. 329, 330 (Cal. 1927); see also *Lucena v. Craufurd*, 127 Eng. Rep. 858 (1808); *Truran Earthmovers Pty. Ltd. v. Norwich Union Fire Ins. Soc'y, Ltd.*, 17 S.A.S.R. 1, 7 (1976) (Austl.); *Aqua-Land Exploration Ltd. v. Guarantee Co. of N. Am.*, 2 O.R. 181, 189-90 (1964) (Can.).

²⁸ See, e.g., CAL. INS. CODE § 281 (West 1995); 1 CALIFORNIA INSURANCE LAW & PRACTICE § 8.06[2][b] (1992). Both a lessor and lessee have an insurable interest in an aircraft which is the subject of a lease. See U.C.C. § 2A-218(1), (3) (1987).

²⁹ See *Stipcich v. Metropolitan Life Ins. Co.*, 277 U.S. 311, 316 (1928) ("Insurance policies are traditionally contracts *uberrimae fidei* [done in utmost good faith] and a failure by the insured to disclose conditions affecting the risk, of which he is aware, makes the contract voidable at the insurer's option.").

³⁰ *Id.*

accept it, and, if so, to determine at what premium and on what terms.³¹

The duty of good faith applies equally to insurer and insured, but the emphasis may vary from country to country. In the United Kingdom it seems that the duty is considered more frequently in relation to the actions of the insured,³² while in the United States it would seem that the duty is usually viewed in connection with the actions of insurers.³³

2. *Nondisclosure and Misrepresentation*

The duty of utmost good faith requires an insured to make full disclosure of all "material facts" within the insured's knowledge.³⁴ The duty also extends to the disclosure of facts which the insured could have ascertained by reasonable inquiry.³⁵ A material fact is one which would influence the judgment of a reasonable insurer in deciding whether to accept the risk, and if so, for what premium.³⁶

If the insurer receives information from an insured, either directly or through a broker, which should put a prudent insurer on inquiry, but the insurer fails to make such inquiry and accepts the insurance, the insurer will be unable to rely on the insured's nondisclosure.³⁷

The duty to disclose material facts ceases when the insurance contract has been concluded,³⁸ but is revived when the contract

³¹ *Id.*

³² *Pan Atlantic Ins. Co. v. Pine Top Ins. Co.*, [1994] 2 Lloyd's Rep. 427, 430 (Eng. H.L.); *Banque Keyser Ullman S.A. v. Skandia (U.K.) Ins. Co.*, [1987] 1 Lloyd's Rep. 69, 92-93 (Eng. Q.B.), *rev'd on other grounds sub nom. Banque Financiere de la Cite S.A. v. Westgate Ins. Co.*, [1991] 2 App. Cas. 249 (H.L.).

³³ *See, e.g., Crisci v. Security Ins. Co.*, 426 P.2d 173, 176-77 (Cal. 1967); *Comunale v. Traders & Gen. Ins. Co.*, 328 P.2d 198, 201-02 (Cal. 1958) (en banc).

³⁴ *See* CAL. INS. CODE §§ 332, 334 (West 1995); *see also Elfstrom v. New York Life Ins. Co.*, 432 P.2d 731, 738-39 (Cal. 1967) (en banc) (broker has a duty to obtain information from the insured and communicate it to the insurer).

³⁵ *See* sources cited *supra* note 34.

³⁶ *Thompson v. Occidental Life Ins. Co.*, 513 P.2d 353, 360 (Cal. 1973); *Burns v. Prudential Ins. Co. of Am.*, 201 Cal. App. 2d 868, 869-70 (1962); *Miller v. Security Ins. Co.*, 21 P.2d 659, 661 (Cal. Ct. App. 1933).

³⁷ *See* CAL. INS. CODE § 336 (West 1995); *Anaheim Builders Supply, Inc. v. Lincoln Nat'l Life Ins. Co.*, 43 Cal. Rptr. 494, 500 (Ct. App. 1965); *Rutherford v. Prudential Ins. Co. of Am.*, 44 Cal. Rptr. 697, 700 (Ct. App. 1965).

³⁸ *Commonwealth Ins. Co. of Vancouver v. Groupe Sprinks, SA*, [1983] 1 Lloyd's Rep. 67, 77 (Eng. Q.B.).

is renewed.³⁹ The policy wording may also impose a duty on the insured to inform the insurers of any material change in the nature of the risk during the policy period.⁴⁰

The law relative to nondisclosure has recently undergone significant change in the United Kingdom. The traditional rule, as contained in Section 18(2) of the Marine Insurance Act 1906, was that every circumstance was material which would influence the judgment of a prudent insurer in fixing the premium or determining whether he or she would assume the risk.⁴¹ Courts had held that the sole yardstick was the hypothetical prudent insurer, regardless of whether the actual insurer would or would not have been influenced.⁴² In *Pan Atlantic Insurance Co. v. Pine Top Insurance Co.*,⁴³ the House of Lords made it clear that the misrepresentation or nondisclosure must have induced the actual insurer to enter into the contract before the insurer can avoid the contract.⁴⁴ Some Commonwealth countries have adopted legislation aimed at relieving some of the hardship caused by rigidly applying traditional rules on material nondisclosure.⁴⁵

In the United States, the developing trend requires that, in order for an insurer to rely on nondisclosure, the undisclosed fact must be causally related to the loss in question.⁴⁶

The insurer bears the burden of proving a nondisclosure and the materiality of the facts not disclosed,⁴⁷ while the insured

³⁹ *Lambert v. Cooperative Ins. Soc'y Ltd.*, [1975] 2 Lloyd's Rep. 485, 487 (C.A.).

⁴⁰ *Nell v. Santam Ins. Co.*, 1980 U.S. Av. R. 1901, 1927-28 (S. Afr.).

⁴¹ *Lambert*, [1975] 2 Lloyd's Rep. at 487 (holding that the Marine Insurance Act applies to nonmarine insurance and hence to aviation insurance).

⁴² *Id.*; *Container Transport Int'l Inc. v. Oceanus Mut. Underwriting Ass'n (Bermuda) Ltd.*, [1982] 2 Lloyd's Rep. 178, 189 (Eng. Q.B.), *rev'd*, [1984] 1 Lloyd's Rep. 476, 491 (Eng. C.A.).

⁴³ [1994] 2 Lloyd's Rep. 427 (Eng. H.L.).

⁴⁴ *Id.* at 427. For useful commentary on *Pan Atlantic* and its progeny, see J. Hanson, *Incompetent Underwriters Are Still Afforded the Benefit of the Doubt*, REVIEW, May 1996, at 34.

⁴⁵ See, e.g., Insurance Contracts Act, 1985 pt. IV (1984) (Austl.); Insurance Law Reform Act (1977) § 6 (N.Z.); see also A. Moore, *Review of Utmost Good Faith Duty Urged*, LLOYD'S LIST, Oct. 11, 1984, at 6.

⁴⁶ ROBERT E. KEETON & ALAN I. WIDISS, INSURANCE LAW 573 (1988); Stephen W. Thomas, *Utmost Good Faith in Reinsurance: A Tradition in Need of Adjustment*, 41 DUKE L.J. 1548, 1567-69 (1992).

⁴⁷ See also *Adams v. London Gen. Ins. Co.*, [1932] 42 Lloyd's List L. Rep. 56, 57 (Eng. Q.B.); *Babatsikos v. Car Owners' Mut. Ins. Co.*, [1970] 2 Lloyd's Rep. 314, 318 (Austl.); *Reynolds & Anderson v. Phoenix Assurance Co.*, [1978] 2 Lloyd's Rep. 440, 459 (Eng. Q.B.).

bears the burden of proving that disclosure of such facts, or a misrepresentation thereof, has been waived.⁴⁸

III. THE INTERNATIONAL AVIATION INSURANCE MARKET

The world's airlines have long depended on insurance to protect them against loss or liability.⁴⁹ Traditionally, this insurance was placed almost exclusively in the London insurance market, where highly specialized brokers arranged the necessary coverages with equally specialized insurance underwriters. Few airlines understood all the nuances of their insurances. It was sufficient that their brokers knew the details and that the coverage had been placed in London. The security of a London policy was as good as gold. There was none better.

While London has traditionally been the center of the international insurance market, the participation of insurers in other centers has become increasingly significant, and it is rare nowadays to find a large aviation risk that is not subscribed by insurers in several countries. The most important aviation insurers for purposes of an aircraft financing transaction are located in London, the United States, and France.

The London insurance market consists of Lloyd's of London, as well as British and foreign companies that are authorized to transact insurance business under the Insurance Companies Act of 1982. Lloyd's is not a corporation, and Lloyd's itself does not underwrite insurance.⁵⁰ Rather, Lloyd's is an association of underwriting members, known as "Names," who provide insurance coverage at Lloyd's premises in the City of London. Members of Lloyd's are grouped into syndicates whose business affairs are managed by a managing agent. One of the hallmarks of Lloyd's has been the rule that the liability of each Name is several and not joint, and each Name does business with unlimited liabil-

⁴⁸ See, e.g., *De Maurier (Jewels), Ltd. v. Bastion Ins. Co.*, [1967] 2 Lloyd's List L. Rep. 550, 558-59 (Eng. Q.B.).

⁴⁹ Aviation insurance was first written in London in 1908. See INSURANCE INSTITUTE OF LONDON, Report H.R., 10, A SHORT HISTORY OF AVIATION INSURANCE IN THE UNITED KINGDOM (1966); see also I. ORMES, LEADING EDGE—THE PIONEERING YEARS OF AVIATION INSURANCE (1988).

⁵⁰ *Shell v. R.W. Sturge, Ltd.*, 55 F.3d 1227, 1228 (6th Cir. 1995) ("The Corporation of Lloyd's . . . , which was created by an Act of Parliament, regulates the Lloyd's insurance market. The Corporation itself does not underwrite any insurance, but provides facilities and services to assist underwriters."); *Bonny v. Society of Lloyd's*, 3 F.3d 156, 158 (7th Cir. 1993); *Roby v. Corporation of Lloyd's*, 996 F.2d 1353, 1357 (2d Cir. 1993).

ity.⁵¹ After several Lloyd's Names sustained significant underwriting losses in the late 1980s and early 1990s, the Council of Lloyd's decided to admit corporate entities as members of Lloyd's, effective as of 1994.⁵²

The international insurance market has had a favorable record on the payment of claims. However, with significant and controversial losses at Lloyd's and the failure of two underwriting entities in the London aviation market in the early 1990s,⁵³ prudence dictates that airlines and financiers alike assess the financial stability of insurers as one of the factors in the placement of aviation coverage.⁵⁴

Insurers usually limit their exposure by means of reinsurance. Reinsurance is a transaction in which one party, the reinsurer, undertakes to indemnify or assume all or part of the risks underwritten by the primary insurer, also known as the reinsured, in consideration for payment of a premium. Reinsurance can be written to cover a pro rata percentage of proven losses or may cover losses in excess of a given figure.⁵⁵

Aircraft financing documentation will usually require that coverage be placed with insurers of "reputable standing in international aviation insurance." This is a reasonable requirement from the perspective of the airline and insurer, as it should not be difficult to establish if any aviation insurer meets this standard at any particular time. Sometimes financing documentation will require that coverage be placed with "insurers satisfactory to the financier." From the airline's perspective, it is undesirable for the financier to be permitted to dictate which insurers are acceptable for purposes of placing the airline's coverages, although it is understood that financiers would likely act

⁵¹ Lloyd's Act, 1982, § 8(1) (Eng.); *Scott v. Tuff-Kote (Austl.) Pty. Ltd.*, [1976] 2 Lloyd's Rep. 103, 107 (Austl.). For a detailed discussion of how Lloyd's is structured, see MARGO, *supra* note 18, at 28-33.

⁵² Lloyd's Membership Byelaw No. 17 (1993). Corporate members of Lloyd's enjoy limited liability.

⁵³ *Andrew Weir Insurance Co. and English & American Insurance Co.*

⁵⁴ In the United States, financial data on insurance companies may be obtained from credit reporting agencies such as A.M. Best's Rating Services, Standard & Poor's, Duff & Phelps, and Moody's Investor Service. In the United Kingdom, publications such as *Insurer Solvency*, *Troubled Insurer Alert*, and *Reinsurance Security Insider* report on the financial condition of insurers in different markets.

⁵⁵ *Continental Casualty Co. v. Stronghold Ins. Co.*, 77 F.3d 16, 20 (2d Cir. 1996). For further details, see MARGO, *supra* note 18, at 333; J. BUTLER & R. MERKIN, *REINSURANCE LAW* (rev. 1988); R.L. CARTER, *REINSURANCE* (3d ed. 1995).

on the advice of experienced brokers in making this decision. Recognizing that financiers have a legitimate interest in the identity of the airline's insurers, it would be reasonable for the financing documentation or lease to specify that coverage be placed with insurers reasonably satisfactory to the financier and to permit the financier to disapprove a particular insurer for good cause (*e.g.*, evidence of financial instability).

It is well established that where numerous insurers jointly participate in insuring an aviation risk, their liability is several and not joint and several. Accordingly, if any insurer is unable to meet its obligations, the other insurers cannot be held liable to the insured for the shortfall.⁵⁶

IV. THE ROLE OF THE INSURANCE BROKER

Most aviation insurance is placed in the market by insurance brokers.⁵⁷ Brokers are used because of their specialized knowledge of prevailing conditions in the insurance market, their ability to deal simultaneously with numerous insurers worldwide, and their expertise in advising clients on their specific insurance needs.⁵⁸ As a general rule, the broker acts as the agent of the insured in the placement of insurance.⁵⁹ The broker may also act as agent for the insurers in delivering the policy and collecting premiums.⁶⁰

In the London market, the placement of insurance is initiated by the preparation of a "placing slip" by the broker which sets out in abbreviated form the coverage being sought.⁶¹ The broker will then select an underwriter whom the broker believes will quote a reasonable premium and whose lead is likely to be respected by other underwriters. The broker will approach this

⁵⁶ *Roby*, 996 F.2d at 1357; *Daly v. Lime St. Underwriting Agencies, Ltd.*, [1987] 2 F.T.L.R. 277 (Eng.); *General Reinsurance Corp. v. Forsakringsaktiebolaget Fennia Patria*, [1983] 2 Lloyd's Rep. 287, 289 (Eng.); *see also* Lloyd's Act, 1982, § 8(1).

⁵⁷ Insurance can only be placed at Lloyd's by an admitted Lloyd's broker. *See* Lloyd's Brokers Byelaw No. 5 § 4 (1988).

⁵⁸ For a detailed discussion of the procedure for placing risks in the international aviation insurance market, *see* MARGO, *supra* note 18, at 66.

⁵⁹ *General Accident Fire & Life Assurance Corp. v. Tanter*, [1984] 1 Lloyd's Rep. 58, 62 [Eng. Q.B.] (per Hobhouse, J.), *rev'd on other grounds*, [1984] 2 Lloyd's Rep. 529; *American Airlines Inc. v. Hope*, [1974] 2 Lloyd's Rep. 301, 304 (Eng. Q.B.) (per Lord Diplock).

⁶⁰ *See, e.g.*, *Transamerica Interway Inc. v. Commercial Union Assurance Co. of S. Afr.*, 97 F.R.D. 419, 421 (S.D.N.Y. 1983).

⁶¹ *See* MARGO, *supra* note 18, at 66.

underwriter and offer him or her a proportion of the insurance to be written. If the parties can agree on the premium and other terms and conditions of the insurance, the underwriter will accept a proportion of the risk and sign the slip, thereby becoming a party to a contract of insurance with the insured.⁶² The underwriter will become known as the leading underwriter or "leader" and will control technical issues such as the wording of the policy and the handling of claims. The remaining portion of the risk will be placed in the market in like fashion, although as indicated earlier, in the case of an airline risk, there is a strong likelihood that the broker will approach underwriters in locations outside London in order to get the most favorable premium rate or the necessary capacity. The majority of airline risks are placed on a vertical basis. This means that the placement is built up from the bottom with the first slice being placed at the cheapest price and further slices being added according to the rates and capacities that are available. Thus, while there will be one policy leader, there may be up to eight or more different sets of premium rates applicable to the airline's total insurance program.

The placement of insurance is evidenced by the issuance of an insurance policy or cover note to the insured. Where third parties, such as financiers, require evidence of the placement of insurance, the brokers representing the insured will issue a certificate of insurance to this effect. In an airline financing, the airline's brokers will usually arrange for the required insurance coverage to be endorsed on the airline's existing policy and issue the appropriate certificate to the financiers. The financiers may also require the brokers to issue a letter of undertaking pursuant to which the brokers agree to inform the financiers of certain information such as whether the airline's insurances are not renewed.⁶³ Where the financed party's broker arranges the coverages required by the financier, although the broker is arguably not acting as agent of the financier, the broker may owe a

⁶² *Eagle Star Ins. Co. v. Spratt*, [1971] 2 Lloyd's Rep. 116, 123 (Eng. C.A.); *Insurance Co. v. Grand Union Ins. Co.*, [1990] 1 Lloyd's Rep. 208, 209 (Hong Kong C.A.).

⁶³ See *infra* text accompanying note 70; *Bank of Nova Scotia v. Hellenic Mut. War Risks Ass'n (Berm.) Ltd.*, [1989] 2 Lloyd's Rep. 238, 252-53 (Eng. C.A.); *First Nat'l Bank v. The W. of Eng. Shipowner Mut. Protection and Indem. Ass'n (Lux.)*, [1981] 1 Lloyd's Rep. 54, 58 (Eng. Q.B.).

duty of care to the financier in the placement or maintenance of the insurance.⁶⁴

Most financiers will engage their own insurance brokers to protect their interests in financing transactions. In these circumstances, the brokers' role will consist of examining relevant documentation or arranging separate coverage, such as contingent insurance, to protect the financier if the insured airline's policy fails to respond for a particular reason.⁶⁵

V. CERTIFICATES OF INSURANCE AND LETTERS OF UNDERTAKING

Insurance certificates are issued by brokers in accordance with the authority vested in them by the participating insurers. Financiers who are concerned that a certificate is being issued by a firm of brokers whose name is not familiar to them should derive some comfort upon receiving evidence that the brokers have been admitted as Lloyd's brokers, since Lloyd's brokers are required to comply with several rigorous requirements relating to financial stability and professional conduct.⁶⁶ The placing slip will usually contain a statement to the effect that the brokers are authorized to issue certificates on behalf of the insurers.

Insurance certificates merely evidence the placement of insurance coverage, and do not on their own constitute policies of insurance. Certificates are invariably issued "subject to policy terms, conditions, limitations, warranties and exclusions." The insurance laws of some states require that an insurance certificate contain a statement to this effect.⁶⁷ This has sometimes

⁶⁴ For a case holding that a broker owes a duty of care to a bank, regardless of whether there is a contractual relationship between them, see *Punjab Nat'l Bank v. De Boinville*, [1992] 1 Lloyd's Rep. 7, 17 (Eng. C.A.).

⁶⁵ See discussion of contingent insurance *infra* text accompanying notes 174-75.

⁶⁶ Lloyd's Brokers Byelaw No. 5. The professional standards of all insurance brokers in the London market, whether admitted as Lloyd's brokers or not, are regulated under the Insurance Brokers (Registration) Act of 1977. See, e.g., §§ 3(1), (2), (3), 10.

⁶⁷ For example, § 384 of the California Insurance Code provides:

A certificate of insurance or verification of insurance provided as evidence of insurance in lieu of an actual copy of the insurance policy shall contain the following statements or words to the effect of:

This certificate or verification of insurance is not an insurance policy and does not amend, extend or alter the coverage afforded by the policies listed herein. Notwithstanding any requirement, term, or condition of any contract or other document with respect to which this certificate or verification of insurance may be issued

caused difficulty to financiers who have contended that the coverage given in the insurance certificate may in fact be excluded under one or more policy provisions. This concern was sometimes difficult to alleviate because of the reluctance of insurers and brokers, as well as insureds, to disclose copies of airline insurance policies to financiers.⁶⁸ AVN 67B, the endorsement adopted for use in connection with airline finance and lease transactions, seeks to deal with this concern by specifying that financiers or lessors, referred to as "Contract Parties," are covered by the policy subject to all terms, conditions, limitations, warranties, exclusions, and cancellation provisions thereof, "except as specifically varied or provided by the terms of this endorsement."⁶⁹ It should be noted that AVN 67B constitutes an endorsement to the policy. Any certificate issued by the brokers will still only confirm what coverages are in place under the policy, as amended or expanded by AVN 67B.

A brokers' letter of undertaking, issued in addition to a certificate of insurance, will set out various obligations which the brokers undertake to fulfill on behalf of the financier. These might include notifying the financier if the airline's policy is cancelled or not renewed, advising the financier of any act or omission or event (including the nonpayment of premium) which might jeopardize the validity or enforceability of the airline's insurances, and advising the financier if the brokers cease to act as brokers on behalf of the airline.⁷⁰ Letters of undertaking are probably enforceable under English law.⁷¹

or may pertain, the insurance afforded by the policies described herein is subject to all the terms, exclusions and conditions of such policies.

CAL. INS. CODE § 384 (West 1995).

⁶⁸ This reluctance is due in part to the fact that insurance policies contain information, including terms, conditions, and premium rates, which have been developed over several years and which are proprietary to the insurers and insured airline.

⁶⁹ AVN 67B, *supra* note 14.

⁷⁰ Lloyd's Insurance Brokers Committee is currently considering the adoption of a standard brokers' letter of undertaking for use in the London insurance market.

⁷¹ See *Kleinwort Benson Ltd. v. Malaysia Mining Corp. Berhad*, [1988] 1 Lloyd's Rep. 556, 562 (Eng. Q.B.), *rev'd on other grounds*, [1989] 1 All E.R. 785 (C.A.).

VI. TYPES OF COVERAGE

Aviation insurance is a broad area, and there are several different types of coverage available.⁷² In the context of an aircraft financing, the principal forms of coverage are hull, passenger and third party liability, and war and allied perils insurance. In the above coverages, the interests of financiers are usually endorsed on the existing policies of the financed airline. Financiers may, however, place or require the placement on their behalf of separate insurance to protect them against additional risks, including repossession insurance, residual value insurance, and contingent coverage.⁷³

A. HULL INSURANCE

Hull insurance is designed to protect the insured airline against physical loss of or damage to its aircraft, including engines and other components. Hull insurance is one of the most important forms of coverage where financiers are concerned. Conventional hull coverage protects the insured with respect to loss of or damage to aircraft caused by such risks as fire, theft, and collision, up to the limits of the policy.⁷⁴

Usually, the obligation of the insurers under a hull policy will be expressed in the form of a general undertaking to cover the insured against all risks of loss, except those which are specifically excluded elsewhere in the policy. Policies of this kind are referred to as "all risks" policies. On the other hand, certain kinds of policies describe the undertaking of the insurers by specifying the particular risks for which coverage is provided (*e.g.*, war and allied perils). These are known as "named perils" or "particular risk" policies.

A hull policy may be placed on an "insured" or "agreed" value basis. Where a policy is placed for an insured value, the parties agree on the maximum amount for which an aircraft is insured. In the event of a loss, the insured will be entitled to recover only the market value of the aircraft at the date and place of the loss up to the value insured under the policy. In the case of an agreed value policy, the parties agree on the value of the aircraft

⁷² For a detailed discussion, see MARGO, *supra* note 18, at 6.

⁷³ See discussion *infra* part VII.C.1-3.

⁷⁴ A hull policy will usually provide for an amount (known as a deductible) to be covered by the insured before the insurers are liable to pay for loss or damage. The average deductible on a wide-bodied aircraft is \$1,000,000. Deductibles usually apply only to partial losses and not to total losses.

to be paid under the policy in the event of a total loss. Should the aircraft be destroyed, then the insurers will pay the agreed value to the insured, regardless of the market value of the aircraft at the time of the loss. Where an aircraft is financed, a hull policy will usually be placed on an agreed value basis so that the parties may be assured of the amount which will be paid under the policy in the event of a total loss.⁷⁵

Operating leases will call for an aircraft to be insured for the "casualty value" or "stipulated loss value" of the aircraft. In the case of a first class airline with a strong operating history, the stipulated loss value could be between 110% and 115% of the acquisition costs of the aircraft. For a "riskier" airline, the stipulated loss value might be as high as 130% of the acquisition costs of the aircraft. The calculation of the casualty value or stipulated loss value of an aircraft for insurance purposes usually takes into account the interruption in lease payments which would occur in the event of the total destruction of the leased aircraft.

Special considerations apply to aircraft engines. In view of the frequency with which aircraft engines fail, insurers will not ordinarily pay for an engine failure unless the engine failure is caused by the ingestion of a foreign object. Insurers will pay for further damage to the aircraft or its components which results from an engine failure. The policy wording may limit claims to loss or damage caused by theft, lightning, flood, outbreak of fire external to the engine, or by sudden and unexpected impact with a foreign object requiring immediate withdrawal of the engine from service.⁷⁶

Airlines frequently remove engines from aircraft in their fleet and replace them with one or more engines leased from sources other than the airframe lessor. Most lease agreements also permit the pooling of aircraft engines and spares so that the newly installed engine may come out of the airline's own inventory or from another airline. In the past, where a spare engine, not belonging to the aircraft lessor, has been installed on a leased aircraft and has been destroyed in an accident, problems have

⁷⁵ For a discussion of the concerns of aviation insurers about the widening disparity in agreed values and market values of commercial aircraft, see P. Hayes, *Profiting from a Loss*, 153 *AIRFINANCE J.* 32 (1993). The author observes that in 1992, the difference between the market values and agreed values of the 26 western-built jet airliner total losses came to just under \$140 million. *Id.*

⁷⁶ See, e.g., AVN 56, Engine Endorsement, reproduced in MARGO, *supra* note 18, at 421. This clause is not frequently used in airline policies.

arisen in determining the insurance proceeds to which the insured airline was entitled and which particular insurers should respond to the loss. To avoid the difficulty created by the fact that the replacement engine may be covered under the airline's policy and another policy simultaneously, insurers and lessors will usually agree that a leased aircraft will be insured for an amount equal to the agreed value of the aircraft lessor, plus the agreed value of each then-installed engine lessor.⁷⁷ On the occurrence of a total loss of the aircraft, the airframe owner will receive the full agreed value for the aircraft, and each engine owner will receive the agreed value for its engine. The insurers will receive title to the salvage of the airframe and the then-installed engines, as well as the remaining good engine originally delivered with the airframe.

While aircraft are frequently leased together with spare engines and components, aircraft spares will sometimes be the subject of a separate lease agreement. In that case, it is possible to effect spares insurance under a separate policy wording, as part of the hull placement, or as part of a more comprehensive policy covering, for example, hulls, liabilities, and spares.⁷⁸

In general, a hull policy will exclude loss of or damage to aircraft resulting from war, hijacking and related perils, radioactive contamination, wear and tear, deterioration, and breakdown. The policy will also exclude defect or failure of any part of the aircraft engines or components unless loss of, or damage to, the aircraft results therefrom. Hull policies also typically include conditions which the insured must fulfill as conditions precedent to the liability of the insurers.

When loss or damage occurs to an insured aircraft, the insurers appoint aircraft surveyors to inspect the hull and report on the circumstances of the accident. In so reporting, surveyors will indicate whether the provisions of the policy, including warranties and conditions, have been complied with and whether the loss or damage falls within any exclusion in the policy. Sur-

⁷⁷ This has been described as the Cumulative Proceeds Method and results in the airline insuring for the full value of the leased aircraft plus delivered engines, as well as for the full value of the then-installed engine(s). It seems possible to minimize the effect of this "overinsurance" by proper structuring of spare engine lease agreements. See AVN 67B, *supra* note 14, § 1.2; *infra* note 187 and accompanying text.

⁷⁸ For an example of a policy wording for use in relation to aircraft spares, see LPO 344B, Aircraft Spares Wording, reproduced in MARGO, *supra* note 18, at 446-48.

veyors will also indicate if the aircraft is a total loss or constructive total loss, and, in the case of a partial loss, the extent of the damage together with the estimated cost of repair and the most satisfactory way of carrying out such repair.

In the event of a total loss or constructive total loss, the policy will usually specify that, unless the insurers elect to take the aircraft as salvage, the aircraft shall remain the property of the insured airline who may not abandon it to the insurers. In appropriate cases, the insurers may elect to take over the salvage. Once insurers make this election by physically taking over or acknowledging their right to the salvage, they may be responsible for all costs and expenses relating to it, including the costs of removal and clean up.

B. LIABILITY INSURANCE

Liability insurance usually covers the insured airline against liability resulting from loss or damage arising from an "occurrence." An occurrence is defined in most cases to mean an "accident, including continuous or repeated exposure to conditions, . . . neither expected nor intended from the standpoint of the insured."⁷⁹ Courts have held that an "accident" refers to an event resulting in injury to an individual, whereas an "occurrence" refers to the cause of the damage and not to the number of injuries or claims.⁸⁰ Thus, when an aircraft collides, injuring several passengers, there are several accidents but only one occurrence.⁸¹

⁷⁹ C.P.C. Int'l, Inc. v. Northbrook Excess & Surplus Ins. Co., 962 F.2d 77, 87 (1st Cir. 1992), *certifying questions to Rhode Island Supreme Court*, 46 F.3d 1211 (1st Cir. 1995).

⁸⁰ South Staffordshire Tramways Co. v. Sickness & Accident Assurance Ass'n., [1891] 1 Q.B. 402, 407 (Eng. C.A.); Allen v. London Guar. & Accident Co., [1912] 28 T.L.R. 254, 255 (Eng. K.B.). For a U.S. view, see Michigan Chem. Corp. v. American Home Assurance Co., 728 F.2d 374, 379 (6th Cir. 1984); Uniroyal Inc. v. Home Ins. Co., 707 F. Supp. 1368, 1382-83 (E.D.N.Y. 1988); Buffalo Air Park, Inc. v. National Gen. Ins. Co., 15 Av. Cas. (CCH) ¶ 18,432 (N.Y. Sup. Ct. Sept. 8, 1980) (holding that the collapse of the roof of a hangar that caused damage to 16 aircraft was a single occurrence rather than 16 separate occurrences).

⁸¹ See Kuwait Airways Corp. v. Kuwait Ins. Co., [1996] 1 Lloyd's Rep. 664 (Q.B.). In *Kuwait Airways*, 15 aircraft belonging to Kuwait Airways were captured, starting on August 2, 1990, and flown out of Kuwait by the Iraqis over a period of days. The court held that the aircraft were lost in a single occurrence—the successful invasion of Kuwait, incorporating the capture of Kuwait Airport and with it Kuwait Airways' aircraft on the ground. The factors which influenced the judge in reaching this conclusion were that there was unity of time, location,

From a liability perspective, insurers differentiate between the liability of an airline to its passengers and liability to third parties, that is, persons or property outside the aircraft, although both forms of coverage will usually be placed under the same policy.⁸²

1. *Passenger Liability Insurance*

Passenger liability insurance indemnifies the insured airline for all sums which the airline shall become legally liable to pay as damages for bodily injury (fatal or otherwise) to passengers who are carried by the airline under a contract of carriage by air.⁸³ Although policies may limit the coverage to the legal liability of the insured airline to passengers while embarking into, on board, or disembarking from the insured aircraft, most airline policies provide coverage for injury occurring to passengers outside this period. The policy also covers the legal liability of the insured for the negligence of its employees and may be worded so as to cover the personal liability of such employees while acting in the scope of their employment.

The policy will apply to carriage for reward or gratuitous carriage and may include loss of or damage or delay to baggage or personal articles of the passenger. The policy may require that the insured airline take reasonable steps to ensure that passengers and baggage are carried subject to documentation which limits the liability of the insured to the extent permitted by law. Such steps will include, where appropriate, delivering a correctly completed passenger ticket and baggage check to the passenger within a reasonable time prior to departure. Consequently, where international transportation is involved which is governed by the Warsaw Convention, the insured airline must issue a ticket in accordance with Article 3 of the Convention so that the

cause, and intent. In his detailed analysis of English authority on the meaning of "occurrence," Judge Rix referred, *inter alia*, to the arbitral decision in the *Dawson's Field Award* (March 29, 1972), in which Michael Kerr, Q.C., held that the blowing up of three aircraft in close proximity, more or less simultaneously, within the time span of a few minutes, and as a result of a single decision to do so without anyone being able to approach the aircraft between the first explosion and their destruction, was a single occurrence.

⁸² While a liability policy may contain separate insuring agreements for passenger and third party liability, insurers may lump passenger and third party liability together under a single insuring agreement providing comprehensive airline liability insurance.

⁸³ Airline policies usually provide coverage for bodily injury caused by an "occurrence." See *supra* notes 79-81 and accompanying text.

carrier can rely on the limitation of liability established under Article 22 of the Convention, as modified, where applicable, by amending instrument.⁸⁴ Most passenger liability policies will cover the airline for damages in excess of the liability limitation of the Convention where there has been willful misconduct. Notwithstanding this, if it can be established that the insured has deliberately caused the loss, or there has been an award of punitive damages which may not be reimbursed under local law, United States courts have held that an insured airline may not be entitled to indemnity for such damages.⁸⁵

The policy will usually contain a limit of indemnity for each accident or occurrence. The policy may also specify a combined single limit or "CSL" with respect to claims for bodily injury and property damage. The policy may contain warranties and will contain general exclusions and conditions similar to those found in a hull policy. An additional exclusion will usually be inserted regarding the legal liability of the insured airline to employees acting in the scope of their employment, including flight crew, cabin staff, or other staff travelling on duty.⁸⁶

2. *Third Party Liability Insurance*

This form of insurance covers the legal liability of the insured airline to third parties—other than passengers—for damage to persons or property resulting from the operation of an aircraft. Coverage includes, *inter alia*, loss of or damage to another aircraft and its occupants caused by a mid-air collision, loss of or damage to persons or property on the surface caused by an aircraft in flight, or damage to third parties during taxiing caused, for example, by jet blast.

The policy⁸⁷ will contain the usual warranties, general exclusions, and conditions found in hull and passenger legal liability policies but will also exclude liability for passengers, employees, and their property covered under other sections of the same policy or other policies. It also excludes claims directly or indi-

⁸⁴ Convention for the Unification of Certain Rules Relating to International Transportation by Air, Oct. 12, 1929, arts. 3 and 22, 49 Stat. 3000, 3015, 3019, 137 L.T.N.S. 11. See *Chan v. Korean Air Lines, Ltd.*, 490 U.S. 122, 128 (1989).

⁸⁵ See, e.g., CAL. INS. CODE § 533 (West 1993); *Certain Underwriters at Lloyd's of London v. Pacific Southwest Airlines*, 786 F. Supp. 867, 869-71 (C.D. Cal. 1992). Cf. *Lancashire County Council v. Municipal Mut. Ins. Ltd.*, [1996] All E.R. 545 (Eng. C.A.).

⁸⁶ See, e.g., AVN 68, Crew Exclusion Clause.

⁸⁷ See *supra* note 82 and accompanying text.

rectly occasioned by noise, vibration, pollution, electrical interference, and interference with property unless caused by or resulting from a crash, fire, explosion, or collision.⁸⁸

Most financiers have no involvement in the business operations of the airline whose aircraft they are financing. The conduct of financiers is, therefore, less likely to be implicated in the case of loss or damage, including death, resulting from operational errors.⁸⁹ Financiers, however, may be implicated in an accident, for example, for supplying a defective aircraft or other equipment or performing improper maintenance. Even when a financier has not been directly involved with the operation or maintenance of the aircraft, the presence of a "deep pocket" defendant may make the financier a target for litigation, particularly where the airline is financially unstable or the insurance proceeds of the airline's policy are insufficient to cover the damages suffered by a claimant. Accordingly, financiers will routinely insist that they be protected under the airline's liability policy.

C. WAR AND ALLIED PERILS INSURANCE

War and associated risks, including hijacking and acts of terrorism, pose an extremely high risk exposure to insurers. Aviation hull and liability policies therefore usually contain an express exclusion in respect of such risks.⁹⁰ The war risk exclusion used in the London market, known as AVN 48B, excludes the risks of war, invasion, hostilities, civil war, rebellion, revolution, insurrection, martial law, hostile detonation of atomic weapons, strikes, riots, civil commotions or labour disturbances, acts of a political or terrorist nature, sabotage, confiscation, nationalization, seizure, and hijacking.⁹¹ Although AVN 48B is

⁸⁸ See AVN 46B, Noise and Pollution and Other Perils Exclusion Clause, reproduced in MARGO, *supra* note 18, at 417.

⁸⁹ In some countries, local legislation provides limited protection to aircraft owners or lessors by exempting them from liability for loss or damage to persons or property on the surface occurring as a result of an accident involving their aircraft where such aircraft are leased to, or operated by, third parties. See Federal Aviation Act, 49 U.S.C. § 44112 (1994); Civil Aviation Act, § 76(2) (1982) (U.K.).

⁹⁰ Financiers will also be concerned about the exposure of aircraft to war risks, but will be more concerned about ensuring that proper war risk coverage has been placed.

⁹¹ The full text of the War, Hijacking and Other Perils Exclusion Clause in AVN 48B provides that the policy to which it is attached does not cover claims caused by:

sometimes used in policies issued in the United States, the Common North American War Exclusion Clause or CWEC is also used in the United States. It is worded slightly differently, but it excludes essentially the same risks as AVN 48B.

Certain risks excluded in AVN 48B may be "written back" into a hull or liability all risks policy in return for an increase in premium or an additional premium. Insurers in the aviation market will be prepared to write back into a hull or liability all risks policy the risks specified in the Extended Coverage Endorsements with respect to aircraft hulls and liabilities.⁹² In the case of hulls, these risks include strikes, riots, civil commotions, acts of sabotage, and hijacking.⁹³ In the case of liabilities, all the risks excluded by AVN 48B can be written back into a liability all risks policy except the risk of hostile detonation or explosion of

(a) War, invasion, acts of foreign enemies, hostilities (whether war be declared or not), civil war, rebellion, revolution, insurrection, martial law, military or usurped power or attempts at usurpation of power.

(b) Any hostile detonation of any weapon of war employing atomic or nuclear fission and/or fusion or other like reaction or radioactive force or matter.

(c) Strikes, riots, civil commotions or labour disturbances.

(d) Any act of one or more persons, whether or not agents of a sovereign power, for political or terrorist purposes and whether the loss or damage resulting therefrom is accidental or intentional.

(e) Any malicious act or act of sabotage.

(f) Confiscation, nationalization, seizure, restraint, detention, appropriation, requisition for title or use by or under the order of any Government (whether civil, military or de facto) or public or local authority.

(g) Hijacking or any unlawful seizure or wrongful exercise of control of the Aircraft or crew in flight (including any attempt at such seizure or control) made by any person or persons on board the Aircraft acting without the consent of the Insured.

Furthermore, this Policy does not cover claims arising whilst the Aircraft is outside the control of the insured by reason of any of the above perils. The Aircraft shall be deemed to have been restored to the control of the Insured on the safe return of the Aircraft to the insured at an airfield not excluded by the geographical limits of the Policy, and entirely suitable for the operation of the Aircraft (such safe return shall require that the Aircraft be parked with engines shut down and under no duress).

MARGO, *supra* note 18, at 417.

⁹² AVN 51, Extended Coverage Endorsement (Aircraft Hulls); AVN 52C, Extended Coverage Endorsement (Aircraft Liabilities), *reproduced in* MARGO, *supra* note 18, at 419.

⁹³ AVN 51, *supra* note 92.

a nuclear weapon.⁹⁴ When the risks of war and allied perils (civil war, invasion, rebellion, and the like) are written back into a liability policy, the policy will limit coverage for damage to property on the ground to risks arising from the use of aircraft.

Because insurers in the aviation market are only prepared to write back certain of the risks excluded by AVN 48B in relation to aircraft hulls, additional war risks may be insured in the specialist war insurance market which is part of the marine market. Where such additional war coverage is required, the entire coverage will be placed in the war market, rather than one part being placed in the aviation market and the other part in the war market.

One advantage of writing back the excluded war risks into an all risks policy is that the insured will immediately be indemnified for any loss and will not be faced with a dispute over whether the all risks or the war risk policy covers the loss. Where there are separate all risks and war risk policies, the burden is on the all risks insurers to show that the loss or damage is excluded under the all risks policy before the insured can call upon the war risk insurers to provide coverage.⁹⁵ To avoid the hardship which might fall on an insured in this situation, the London insurance market introduced the 50/50 Provisional Claims Settlement Clause, known as AVS 103.⁹⁶ Pursuant to this clause, the all risks and war risk insurers agree that, in cases of doubt, each set of insurers will pay fifty percent of the total claim to the insured and use arbitration to resolve the liability of one to reimburse the other.⁹⁷ The fact that airline all risks and war risk insurance are placed under separate policies with sepa-

⁹⁴ AVN 52C, *supra* note 92.

⁹⁵ See, e.g., *Pan Am. World Airways v. Aetna Casualty & Sur. Co.*, 505 F.2d 989 (2d Cir. 1974) (the all risks and war risk insurances were placed with separate sets of insurers).

⁹⁶ AVS 103 is a "slip clause," that is, an agreement between the all risks and war risk insurers that does not form part of either the all risks or war risk policies. Because there is no privity between the insurers on the one hand and the insured on the other under a slip clause, such clause is not enforceable by the insured under English law. The situation may be different in the United States, where most states recognize contracts for the benefit of third parties, so-called "third party beneficiary" contracts. For further discussion, see *infra* notes 117-19, 134-35 and accompanying text.

⁹⁷ For a case applying the 50/50 Provisional Settlements Clause to a claim by a primary war risk insurer against its reinsurer, see *Boden v. Hussey*, [1988] 1 Lloyd's Rep. 423 (Eng. C.A.).

rate sets of insurers has been described as undesirable by one airline insurance manager.⁹⁸

One of the hull war risk policies available in the London market⁹⁹ provides coverage for loss of or damage to aircraft caused by, *inter alia*, war, invasion, acts of foreign enemies, hostilities,¹⁰⁰ civil war, rebellion, revolution, insurrection, martial law, strikes, riots, civil commotions, labor disturbances, acts committed for political or terrorist purposes, malicious acts, acts of sabotage, confiscation, nationalization, seizure, restraint, detention, appropriation, requisition for title or use, and hijacking or any unlawful seizure or wrongful exercise of control of aircraft.¹⁰¹ The policy also provides coverage, up to the policy limits, for ninety percent of any payment made because of threats against any insured aircraft, its passengers, or crew and for extra expenses incurred following confiscation, nationalization, seizure, hijacking of an insured aircraft, and related risks.¹⁰² The policy usually excludes, *inter alia*, the risks of war between the five major powers,¹⁰³ confiscation, nationalization, seizure, restraint, detention, appropriation, requisition for title or use by a government designated in the policy schedule, and detonation of a nuclear weapon.¹⁰⁴ The policy ordinarily covers confiscation, nationalization, seizure, restraint, detention, appropriation, and requisition for title or use by any government or public or local authority other than one designated in the policy schedule.¹⁰⁵

As there may be sudden changes in domestic and international political situations, war risk insurers reserve the right to give short notice of cancellation of the coverage, but will consider reinstating the policy prior to expiry of the notice if an agreement is reached with the insured regarding the new rate of premium, the conditions, or geographical limits.¹⁰⁶ The policy is subject to automatic review of the premium, conditions, or

⁹⁸ See John Owen, *The Airline Insurance Market Today—What Do The Buyers Want?* 147 AV. INS. REP. 92 (1996).

⁹⁹ LSW 555B, Aviation Hull "War and Allied Perils" Policy.

¹⁰⁰ Whether war be declared or not. *Id.* § 1(a).

¹⁰¹ LSW 555B § 1. The policy also covers claims excluded from the insured's hull all risks policy from occurrences while an insured aircraft is outside the control of the insured by reason of any of the above perils. *Id.*

¹⁰² *Id.* § 2.

¹⁰³ United States, the Russian Federation, People's Republic of China, United Kingdom, and France. *Id.* § 3(i)(a).

¹⁰⁴ *Id.* § 3(ii).

¹⁰⁵ *Id.* § 1(e).

¹⁰⁶ *Id.* § 5(1)(a).

geographical limits upon hostile detonation of any nuclear weapon.¹⁰⁷ However, if the revised terms are not acceptable to the insured, the policy will be cancelled seven days after the time of the detonation which triggered the review.¹⁰⁸ The right is also reserved for both the insured and the insurers to cancel the coverage by giving notice to the other at least seven days prior to the end of each three-month period from inception.¹⁰⁹

The coverage may automatically terminate upon an outbreak of war between any of the major powers¹¹⁰ provided that if the aircraft is in the air when such outbreak of war occurs, the policy will continue in effect until the insured aircraft has completed its first landing thereafter.¹¹¹ The policy will usually apply worldwide, subject to the exclusion of certain countries.

As a result of the conflict in the Persian Gulf, insurers introduced maximum aggregate limits in hull war risk policies. Insurers may thus limit the amount they will pay to an insured with respect to hull war risks in any specified period. Excess aggregate war risk coverage is available to deal with this situation. Some war policies will provide for reinstatement at an agreed premium, although this will not increase the policy limits for any one loss.

VII. PROTECTING THE INTERESTS OF FINANCIERS

A. PROTECTING THE INTERESTS OF FINANCIERS UNDER A HULL POLICY

In any financing transaction, the financiers will require that adequate hull insurance be available to protect their interests. This is usually accomplished by having the financiers endorsed on the insured airline's policy as additional insureds, by endorsing the airline's policy with a loss payable clause in favor of the financiers and by placing breach of warranty coverage in favor of the financiers. In addition, where the airline's policy has been primarily underwritten by a single insurer or a small number of insurers who do not retain any significant portion of the risk, financiers may require the use of a reinsurance cut-through clause to protect against the possibility that the primary insurer(s) may be unable to respond to a loss for any given rea-

¹⁰⁷ *Id.* § 5(1)(b).

¹⁰⁸ *Id.*

¹⁰⁹ *Id.* § 5(1)(c).

¹¹⁰ *Id.* § 5(2); *see supra* note 103.

¹¹¹ *Id.* § 5(2).

son. There are also miscellaneous provisions which may be inserted into a hull policy to provide added protection to financiers.

1. *Additional Insured Endorsement*

Hull insurers will frequently agree to have a financier endorsed on the policy as an additional insured up to the extent of the financier's interest in the insured aircraft. The financier then becomes a party to an independent contract of insurance with the insurers, which protects the interest of the financier in the insured aircraft. One consequence of this is that, in the event of a claim, the insurers will be obligated to settle the claim directly with both the financier and the original insured. Another consequence of the use of an additional insured endorsement is that the financier is fully protected under the policy up to the extent of the financier's interest; the financier does not acquire its rights under the policy derivatively through the original insured. Because English law does not allow contracts to be enforced by persons who are not a party to them, that is, by persons who are not in contractual privity, financiers will be particularly concerned to ensure that they are endorsed as additional insureds on any policy which is governed by English law.¹¹²

2. *Loss Payable Clause*

A loss payable, or loss payee, clause provides that in the event of a loss, the proceeds of the policy will be paid to the person or entity named in the clause.¹¹³ The wording of the clause will usually be agreed upon by the insurers and the financier, through the intermediate services of the broker.¹¹⁴ The loss payable clause in AVN 67B, for example, provides that in the case of a total loss, payment shall be made to the order of the parties to the finance or lease agreement.¹¹⁵ With respect to other claims, payment shall be made to such parties as may be necessary to repair the insured aircraft or equipment and, where necessary under the finance or lease agreement, to the parties to such

¹¹² See discussion *infra* notes 117-18, 134-35 and accompanying text.

¹¹³ U.C.C. § 2A-218(5) (1987) (providing that the parties to a lease may agree among themselves who is to obtain, pay for, and be named beneficiary in a contract of insurance on the goods that are the subject of the lease).

¹¹⁴ The loss payable wording most commonly used is § 1.1. of AVN 67B, *supra* note 14.

¹¹⁵ *Id.*

agreement.¹¹⁶ Some leases and finance agreements will specify that the proceeds of partial losses up to a certain amount shall be payable to the insured airline, unless the airline is in default under the lease or financing agreement. In the event of a total loss or constructive total loss, payment is usually made to the lessor or financier.

Under English law, a loss payable endorsement acts as a direction to the insurers to pay the policy proceeds to the loss payee. Absent other language in the policy, such as an additional insured endorsement or an assignment, the loss payee will not be entitled to enforce any rights under the loss payable endorsement because there is no privity of contract between the insurers and the loss payee.¹¹⁷ The Law Commission recently recommended that the rule on privity of contract, the so-called "third party rule," should be reformed to enable contracting parties to confer a right of enforcement on a third party in appropriate circumstances.¹¹⁸ In the United States, however, a loss payee appears to be in the position of a third party beneficiary and, thus, is entitled to enforce a loss payable endorsement against the insurers.¹¹⁹

3. *Breach of Warranty Coverage*

Under English law, breach of a warranty of the policy by the insured, even if it is not causally related to the loss, entitles the insurer to refuse an indemnity under the policy and to elect to

¹¹⁶ *Id.*

¹¹⁷ See *Iraqi Ministry of Defence v. Arcepey Shipping Co. S.A.*, [1979] 2 Lloyd's Rep. 491, 497 (Eng. Q.B.) ("[A] loss payable clause gives no rights to the loss payee unless it also constitutes or evidences an assignment of the assured's rights under the policy or evidences the fact that the designated person is an original assured.").

¹¹⁸ LAW COMMISSION REPORT NO. 242, PRIVITY OF CONTRACT: CONTRACTS FOR THE BENEFIT OF THIRD PARTIES (July 1996). Among the reasons given by the Law Commission for its recommendation are that the third party rule thwarts the intentions of the original contracting parties, causes injustice to the third party, and prevents a third party suffering a loss from recovering, while the promisee may not be able to or wish to recover the loss for the third party's benefit. The Law Commission also pointed out that there has been widespread criticism of the third party rule in common law countries, including the United States, Australia, and New Zealand, whereas most members of the European Union allow third parties to enforce contracts. *Id.* at 39-41.

¹¹⁹ See *Air Separation, Inc. v. Underwriters at Lloyd's of London*, 45 F.3d 288 (9th Cir. 1995); *In re Master Mortgage Inv. Fund, Inc.*, 165 B.R. 453 (Bankr. W.D. Mo. 1993); *First Mo. Bank & Trust Co. v. Bayly, Martin & Fay Aviation Ins. Servs., Inc.*, 739 F.2d 348 (8th Cir. 1984).

avoid the policy.¹²⁰ In the United States, the same result may be achieved in many states although the emerging trend is to require a causal connection between the breach of warranty and the loss.

Financiers obviously do not want the insurance coverage under the insured airline's policy to be prejudiced by the airline's policy violations or other neglect. Insurers will accordingly provide breach of warranty coverage, the purpose of which is to protect financiers against any act or omission of the insured which violates the warranties or conditions of the policy. Breach of warranty coverage is usually included in the policy of the insured by an endorsement in favor of the financier and is limited to the financier's financial interest in the insured aircraft.¹²¹

The precise legal effect of breach of warranty coverage has not been clearly established. In the United States, for example, some courts have held that a breach of warranty provision creates a separate contract of insurance between the insurers and the financier.¹²² Other courts have determined that breach of warranty coverage is merely an extension of the original policy and does not create a separate insurance contract in favor of the financier.¹²³

The significance of the above is that if a breach of warranty provision does not constitute a separate policy in favor of the financiers, the insured airline and the financiers are insured

¹²⁰ *Forsikringsaktieselskapet Vesta v. Butcher*, [1989] 1 App. Cas. 852, 869; *Dawson's Ltd. v. Bonnin*, [1922] 2 App. Cas. 413, 424-25.

¹²¹ In the United States, most breach of warranty endorsements are modeled on the "standard" or "union" mortgagee clause often contained in fire insurance policies issued in New York. Under the standard mortgagee clause, the mortgagee's interest in the mortgaged property is not impaired or invalidated by the acts or omissions of the mortgagor. See *Grady v. Utica Mut. Ins. Co.*, 419 N.Y.S.2d 565, 569 (1979).

¹²² *Ingersoll-Rand Fin. Corp. v. Employers Ins.*, 771 F.2d 910, 911 (5th Cir. 1985), *cert. denied*, 475 U.S. 1046 (1986) (applying Louisiana law) ("The standard mortgage clause creates a separate contract of insurance between the insurer and the mortgagee, and this clause provide[s] that the interest of the mortgagee shall not be impaired 'by any act of or omission or neglect' of the mortgagor-owner . . ."); *Underwriters at Lloyd's, London v. United Bank Alaska*, 636 P.2d 615, 618 (Alaska 1981); *American Nat'l Bank & Trust Co. v. Young*, 329 N.W.2d 805, 809-11 (Minn. 1983); see also *Canadian Imperial Bank of Commerce v. Insurance Corp. of Ireland Ltd.*, 75 D.L.R. (4th) 482 (Can. C.A. 1990).

¹²³ *Aero Int'l, Inc. v. United States Fire Ins. Co.*, 713 F.2d 1106, 1109 (5th Cir. 1983) (applying Mississippi law). This view has been adopted in New Zealand. See *New Zealand Ins. Co. v. Harris*, [1990] 1 N.Z.L.R. 10 (C.A. 1989); *Opossum Exports Ltd. v. Aviation & Gen. (Underwriting Agents) Pty. Ltd.*, H.C.N.Z. (1984) in 1987 ANNALS AIR & SPACE LAW 438.

under the same contract of insurance. Insurers may, therefore, rely on pre-inception misrepresentations and nondisclosures of the insured airline to deny coverage to both the airline and the financiers. If, however, a breach of warranty provision creates a separate policy between the insurers and financiers, the insured airline's pre-inception misrepresentations and nondisclosures will be relevant only to the original policy and will have no impact on the separate policy in favor of the financiers. Some financiers require special language in the breach of warranty provisions issued in their favor to ensure that the pre-inception conduct of the insured airline will not be relied upon vis-à-vis the financier¹²⁴ or that the breach of warranty coverage will be treated as a separate policy in favor of the financier.¹²⁵

AVN 67B, the Airline Finance/Lease Contract Endorsement, contains a breach of warranty provision which provides: "The cover afforded to each Contract Party by the Policy in accordance with this Endorsement shall not be invalidated by any act or omission (including misrepresentation and non-disclosure) of any other person or party which results in a breach of any term, condition or warranty of the Policy, PROVIDED THAT the Contract Party so protected has not caused, contributed to or knowingly condoned the said act or omission."¹²⁶

This wording clarifies the extent of the coverage provided and removes any doubt about whether pre-inception misrepresentation and nondisclosure is covered. It does not, however, clarify whether operation of the insured aircraft outside the territorial or geographical limits of the policy would constitute a breach of warranty, or whether this would amount to operation of the aircraft in circumstances where the policy provides no coverage. Since most airline all risks policies are written on a worldwide basis, this situation is unlikely to arise except in relation to war risk coverage or the insurance of smaller operators where insurers will usually specify territorial limits in the policy.

In the United States, some cases have held that a financier on whose behalf breach of warranty coverage has been effected is entitled to recover under the policy where the insured aircraft

¹²⁴ See AVN 67B, *supra* note 14, at § 3.2.

¹²⁵ See *id.* § 2.1 (containing a separate policy provision relative to liability insurance). The preamble to AVN 67B refers to the payment of an additional premium. This additional consideration suggests an intention to create a separate contract.

¹²⁶ *Id.* § 3.2.

was operated beyond the territorial limits of the policy.¹²⁷ While there is no clear authority in English law, it would seem that if the aircraft is operated beyond the territorial limits of the policy, there is no coverage under the policy. Likewise there is no coverage under any breach of warranty endorsement unless operation of the aircraft outside the territorial limits of the policy results in the breach of a term, condition, or warranty of the policy.¹²⁸ Since there is room for ambiguity and the subject is not addressed under AVN 67B, the matter should be clarified by insurers and financiers alike.¹²⁹ The approach adopted in some U.S. cases would seem to be consistent with the concern of financiers to be protected against any noncompliance with the requirements of the policy, whether or not a warranty or condition has been breached.

4. *Reinsurance Cut-Through Clause*

Because of their concern that primary insurers may be unable to respond to a loss, whether because of financial instability or through operation of law,¹³⁰ financiers will sometimes insist on the insertion of a reinsurance "cut-through" clause in the reinsurance policy issued to the hull insurers of the insured airline.¹³¹ Under a cut-through clause the reinsurers agree with the primary insurers that the reinsurers will make payment of the reinsurance proceeds to the primary insureds¹³² despite the fact that there is no privity of contract between the primary insureds and the reinsurers.¹³³ While cut-through clauses are gen-

¹²⁷ See e.g., *Young*, 329 N.W.2d at 812; *Underwriters at Lloyd's, London v. American Aviation Ground Servs., Inc.*, 421 So. 2d 12, 13 (Fla. Dist. Ct. App. 1982); *Avemco Ins. Co. v. Jefferson Bank & Trust Co.*, 613 S.W.2d 436, 438 (Mo. Ct. App. 1980); *America's Aviation & Marine Ins. Co. v. Beverly Bank*, 229 So. 2d 314, 316 (Fla. Dist. Ct. App. 1969).

¹²⁸ Similarly, there would be no coverage if certain specified areas were expressly excluded under the policy.

¹²⁹ Financiers may be able to obtain coverage for breach of policy exclusions under a contingent policy. See discussion *infra* note part VII.C.3. and accompanying text.

¹³⁰ For example, the introduction of currency exchange controls.

¹³¹ In this context, the original airline insurers are known as primary insurers.

¹³² For example, airline and financiers.

¹³³ The following is an example of a reinsurance cut-through clause:

The Reinsurers and the Reinsured hereby mutually agree that in the event of any claim arising under the reinsurances in respect of a total loss or other claim where as provided by the Lease Agreement such claim is to be paid to the person named as sole loss payee under the original insurances, the Reinsurers will in lieu of

erally enforceable in the United States as third party beneficiary contracts,¹³⁴ they are unenforceable under English law because of the lack of privity between the insureds and the reinsurers.¹³⁵ In order for a cut-through clause to be enforceable under English law, it would be necessary for there to be a tripartite contract between reinsurer, reinsured, and original insured.¹³⁶

5. *Miscellaneous Protective Provisions*

In addition to the above, financiers will frequently require that the policy of the insured airline specify one or more of the following:

a. *Waiver of Subrogation*

Pursuant to this provision, the insurers waive any rights of subrogation that they may have against the financiers.¹³⁷ This provision is usually required by financiers to protect themselves against the possibility of an action by the airline's insurers who,

payment to the reinsured, its successors in interest and assigns, pay to the person named as sole loss payee under the original insurances effected by the original insured that portion of any loss due for which the Reinsurers would otherwise be liable to pay the reinsured (subject to proof of loss), it being understood and agreed that any such payment by the Reinsurers will (to the extent of such payment) fully discharge and release the Reinsurers from any and all further liability in connection therewith.

¹³⁴ See, e.g., *Bruckner-Mitchell v. Sun Indem. Co.*, 82 F.2d 434, 444 (D.C. Cir. 1936), *cert. denied*, 298 U.S. 677 (1936); *China Union Lines, Ltd. v. American Marine Underwriters, Inc.*, 755 F.2d 26, 30 (2d Cir. 1985); *American Reinsurance Co. v. Insurance Comm'n*, 527 F. Supp. 444, 453 (C.D. Cal. 1981), *aff'd*, 696 F.2d 1267 (9th Cir. 1983); *O'Hare v. Pursell*, 329 S.W.2d 614, 620 (Mo. 1959). *But see* *Mercantile & Gen. Reins. Co., PLC v. Spanno Corp.*, 573 N.Y.S.2d 102, 104-05 (1991) (cut-through clause unenforceable because it failed to expressly provide that the reinsurer would pay the insured directly or assume the insurer's liability to the insured).

¹³⁵ See, e.g., *Woodar Invs. Dev. Ltd. v. Wimpey Constr. (U.K.) Ltd.*, [1980] 1 All E.R. 571, 582-83 (Eng. Q.B.); *Green v. Russell*, [1959] 2 All E.R. 525, 531 (Eng. C.A.); GEOFFREY C. CHESHIRE ET AL., *LAW OF CONTRACT* 440-42 (11th ed. 1986). See *supra* note 118 and accompanying text.

¹³⁶ Although a tripartite cut-through clause would *prima facie* be enforceable, it could conceivably result in a voidable preference under § 239 of the U.K. Insolvency Act of 1986 to the extent that one creditor of the insurer (the insured) would be in a more favorable position than other creditors of the insurer.

¹³⁷ For a discussion of the effect of a waiver of subrogation clause, see *National Oilwell (U.K.) Ltd. v. Davy Offshore Ltd.*, [1993] 2 Lloyd's Rep. 582, 602-04 (Eng. Q.B.); *Enimont Supply SA v. Chesapeake Shipping Inc. (the "Surf City")*, [1995] 2 Lloyd's Rep. 242 (Eng. Q.B.).

at common law, are subrogated to all rights which the insured airline may have against third parties, including financiers.¹³⁸

Under English law, a waiver of subrogation clause cannot be relied upon by a person who is not also a party to the insurance contract.¹³⁹ Thus, unless the financier has also been endorsed as an additional insured under the airline's policy, a waiver of subrogation will likely be unenforceable for lack of privity of contract.¹⁴⁰ Ironically, however, a waiver of subrogation is probably unnecessary where the financier is endorsed as an additional insured under the airline's policy because it is clearly established that an insurer cannot exercise any rights of subrogation against its own insured.¹⁴¹

b. Nonliability for Premiums

Financiers will frequently seek to ensure that, as additional insureds, they will not be liable for any insurance premiums payable by the airline, except by way of set-off against the proceeds of the policy.¹⁴²

c. Notice

Financiers will usually require that they be given written notice within a specified time of any material alteration, nonrenewal, or cancellation of the policy. While insurers will generally not provide notice of nonrenewal of an insured airline's policy, they will provide notice of the cancellation or material alteration of the coverage provided under AVN 67B.¹⁴³ A broker may agree to provide additional notice to financiers over

¹³⁸ For a waiver of subrogation wording, see AVN 67B, *supra* note 14, §§ 3.4, 3.5.

¹³⁹ *National Oilwell*, [1993] 2 Lloyd's Rep. at 602.

¹⁴⁰ *Id.* See also *supra* notes 117-18 and accompanying text.

¹⁴¹ See, e.g., *Bow Helicopters Ltd. v. Bell Helicopter Textron*, [1980] Can. Ins. L.R. 1141, § 1-1298 (Can. Q.B.), *aff'd*, [1981] 125 D.L.R.3d 386 (C.A.); *Simpson & Co. v. Thompson*, 3 Eng. L. Rep. 279, 284 (1877). Under English law, insurers have been held unable to exercise rights of subrogation against parties who, while not formally endorsed as insureds or co-insureds on an insurance policy, were held to be entitled to the benefits of the policy. See *National Oilwell*, [1993] 2 Lloyd's Rep. at 602-04; *Mark Rowlands Ltd. v. Berni Inns Ltd.*, [1985] 2 Lloyd's Rep. 437 (Eng. C.A.); *Petrofina (U.K.) Ltd. v. Magnaload Ltd.*, [1983] 2 Lloyd's Rep. 91 (Eng.).

¹⁴² Cf. AVN 67B, *supra* note 14, § 3.4.

¹⁴³ Under AVN 67B § 3.6, the insurers agree that, except for cancellation or automatic termination specified in the policy or any endorsement thereof, the coverage provided under AVN 67B may only be cancelled or materially altered upon the giving of thirty days written notice to the appointed broker.

and above that given by insurers, including notice of nonrenewal.¹⁴⁴

B. PROTECTING THE INTERESTS OF FINANCIERS UNDER A LIABILITY POLICY

Insurers are willing to provide coverage against the liabilities to which financiers may be exposed in the course of an aircraft financing. This is most frequently done by having the financier endorsed on the liabilities section of the airline's policy as an additional insured for its respective rights and interests. The implications of having the financier endorsed as an additional insured under an airline's hull policy are considered earlier in this Article.¹⁴⁵

In view of the potential liability exposure which may result from breach of a warranty or condition in the policy by the insured airline, insurers are also willing to provide breach of warranty coverage to financiers in connection with the liabilities section of a policy.¹⁴⁶

In addition, financiers may require that a cross-liability or severability of interest clause be inserted in the policy to ensure that their liability exposure is protected to the fullest extent. Financiers will also generally seek an undertaking from the airline's insurers that the liability coverage is primary and noncontributing.¹⁴⁷

1. Cross-Liability Clause

A cross-liability clause is a provision in a liability policy under which it is agreed that the inclusion of more than one insured in the policy will not preclude the right of the original insured to recover for claims made against the original insured by additional insureds or their employees. A cross-liability clause in this form is known as a "one-way" cross-liability clause since it applies only in favor of the originally named insured.¹⁴⁸ A "two-way"

¹⁴⁴ This may be done by means of a broker's letter of undertaking. See discussion *supra* notes 70-71 and accompanying text.

¹⁴⁵ See *supra* part VII.A.1.

¹⁴⁶ AVN 67B, *supra* note 14, § 2; see *supra* part VII.A.3.

¹⁴⁷ This is provided for in AVN 67B § 2.2. While financiers will sometimes seek a similar undertaking in relation to an insured airline's hull and spares insurance, insurers usually will not agree to it.

¹⁴⁸ For an example of a one-way cross-liability clause, see AVN 63, the Cross-Liability Clause approved for use in the London market. AVN 63 is reproduced in MARGO, *supra* note 18, at 425.

cross-liability clause will provide for all parties insured under the policy to receive the benefits of the clause by providing that each such party is considered a separate and distinct unit, and the term "the insured" is to be considered to apply to each party in the same manner as if a separate policy had been issued to each of them.

2. *Severability of Interest Clause*

A severability of interest clause provides that the policy to which it is attached operates as if each insured were the subject of a separate policy.¹⁴⁹ The clause is subject to the provision that the insurers shall not be liable, in any circumstances, for any sum in excess of the limits of liability under the policy, with respect to liability to all insureds under the policy. To the extent that a severability of interest clause comes close to providing an entirely separate contract of insurance in favor of the financier, this kind of endorsement is regarded as highly desirable by aircraft financiers.

A severability of interest clause operates in almost the identical manner as a two-way cross-liability clause. Financiers, however, will still sometimes seek to insist on the inclusion of both types of clauses in the liabilities section of an airline's policy.

In some instances, aircraft financiers, pursuant to some form of "belt and suspenders" approach, seek to require the placement of breach of warranty coverage simultaneously with the introduction of a severability of interest clause. Some insurers have expressed the view that including breach of warranty coverage and a severability of interest clause in the same policy is redundant and that the presence of breach of warranty coverage should obviate the necessity for a severability of interest clause. To the extent that it is arguable that a breach of the policy by one insured would result in the denial of a claim to all insureds notwithstanding the presence of a severability of interest clause, it may be suggested that a severability of interest clause on its own, without breach of warranty coverage, may not be completely protective of a financier's interests. It is equally arguable, however, that the breaches of one insured are not to be held against any other insured and that under the circumstances a severability of interest clause on its own would be sufficient to protect the interests of any financier. The authority is

¹⁴⁹ See AVN 67B, *supra* note 14, § 2.1.

unclear, and financiers should be aware of the potential problem.

C. SPECIALIZED COVERAGE TO PROTECT THE INTERESTS OF FINANCIERS

1. *Repossession Insurance*

The increased financing of aircraft which are to be registered and operated abroad, particularly in countries which are politically unstable, has led to the introduction of a form of political risk insurance known as aircraft repossession insurance.¹⁵⁰ This form of insurance is designed to protect financiers from being unable to recover their aircraft as the result of the action or inaction of the foreign host government, where the right of recovery would otherwise be available.¹⁵¹ Repossession risks usually include:

(a) refusal or failure of the host government to permit de-registration of the aircraft;

(b) inability to obtain an export certificate of airworthiness;

(c) inability to obtain physical possession of the aircraft (e.g., the airline may deny the financier's right to repossess, and its position is supported by the local judiciary);

(d) refusal or failure of local authorities to issue an export license;

(e) refusal or failure of local authorities to issue entry visas or grant license endorsements to a flight crew sent to repossess the aircraft;

(f) exchange control restrictions, which prevent loan or lease payments from being remitted in the appropriate currency;

(g) existence of government or third party liens over aircraft, including liens for unpaid taxes or unpaid withholding taxes;

(h) confiscation or requisition of the aircraft by the host government;

(i) the withholding of technical records or delivery of incomplete records.¹⁵²

¹⁵⁰ For a useful discussion, see Paul Davidson, *Aviation Political Risks*, 148 *AV. INS. REP.* 83-86 (1996); Colin Thaine, *Political Risks: The Necessary Cover*, Address to the Aviation Insurance Conference (Mar. 21, 1990); see also *Running for Cover*, *AIRLINE BUSINESS*, Sept. 1996, at 108.

¹⁵¹ Davidson, *supra* note 150, at 83. Aircraft repossession insurance is also variously known as political risk insurance, repatriation insurance, confiscation insurance, and collateral deprivation insurance.

¹⁵² See generally Thaine, *supra* note 150.

Although policy wordings vary, most repossession policies cover one or more of the following:¹⁵³

(i) confiscation, seizure, appropriation, expropriation, nationalization, restraint or detention of the insured aircraft by a foreign government;

(ii) refusal of the foreign government to permit the insured to exercise its rights to repossess the insured aircraft pursuant to the lease;

(iii) refusal of the foreign government to permit the insured to remove the aircraft following repossession under the lease;

(iv) refusal of the foreign government to allow the insured to de-register the insured aircraft following the repossession of the aircraft under the lease;

(v) refusal or failure of the foreign government following a compulsory sale of the aircraft to forward the proceeds of such sale in hard currency following an occurrence as set out in (i), (ii), or (iii), above.¹⁵⁴

The policy may also cover the refusal or failure of the foreign government to allow the insured to obtain the proceeds of the sale, disposal, or other divestiture of the aircraft in U.S. dollars or in another currency which is freely convertible into U.S. dollars.

The policy will typically define the "foreign government" to mean the government or governmental authority (whether civil, military or *de facto*) of the state in which the lessee or operator of the aircraft is located.¹⁵⁵ This will usually also be the state of registry of the aircraft.

Repossession insurance, in its present form, is a fairly recent development, and there are some aspects which are still of concern to financiers. Thus, most policies require a waiting period of 180 days during which the insurers will not be liable under the policy. If the insured aircraft is recovered at any time before the waiting period has elapsed, there is no claim under the policy. This can be significant because commercial aircraft can deteriorate rapidly if not in regular use. In some cases, insurers will agree that where there is no reasonable prospect of the action by the foreign government being reversed or cancelled during the waiting period, the insurers will pay the agreed value to the insured even though the waiting period has not expired.

¹⁵³ See, e.g., LSW 147, Repossession of Leased Aircraft Policy.

¹⁵⁴ *Id.* § 1(a-e).

¹⁵⁵ *Id.* at Definition § 5.

Repossession policies do not cover physical loss of or damage to aircraft which may occur during the waiting period. Thus, it is important that hull all risks and war risk coverage remain in force during this period.¹⁵⁶

A repossession policy may also cover the loss of technical records for the aircraft or engines from any of the insured perils. In the event of such loss, the insurers will pay the insured an amount equal to the cost incurred by the insured in reconstituting such technical records and carrying out any maintenance, checks, or repairs necessary to effect the same.

Under a repossession policy, insurers require the insured to obtain a legal opinion from independent counsel in the host country which confirms that, as of the date of the opinion, the laws of the host country do not prevent or hinder the insured's exercise of its rights under the lease agreement.¹⁵⁷

Repossession policies commonly exclude loss arising from material default by the insured airline in the performance of its obligations under the loan or lease agreement, loss arising from war or allied risks, loss arising from noncompliance with any law including foreign exchange regulations, and loss arising from the failure of the insured airline to obtain the necessary permits and authorizations as may be stipulated by the foreign government during the currency of the policy. The precise scope of some of the conditions and exclusions commonly inserted in repossession policies has not yet been determined.

Repossession insurance should not be necessary unless there is reason to anticipate some form of instability or unpredictability on the part of the host government. Financiers who require repossession insurance will usually seek to impose the cost of such insurance on the airline. This has caused concern among airlines in several developing countries who consider it unfair for them to pay the premium for insurance that does not directly benefit them and that covers risks which are entirely beyond their control.¹⁵⁸

In addition to the conventional insurance market, repossession insurance may be purchased through governmental agencies such as OPIC (U.S.A.), ECGD (U.K.), COFACE (France)

¹⁵⁶ B. Moss, *Political Risk Insurance*, AIRFINANCE ANNUAL, 94 (1993/94). For some of the more significant differences between a repossession policy and a hull war policy, see Davidson, *supra* note 150, at 85.

¹⁵⁷ LSW 147 at Warranty § 4.

¹⁵⁸ Moss, *supra* note 156, at 94.

and HERMES (Germany). In view of the high premiums charged for this form of coverage, it is advisable to obtain quotes from as many sources as possible. Insurance brokers specializing in the insurance aspects of aircraft finance can provide assistance in this regard.

The limited market and high premiums for repossession insurance may also prompt financiers to consider other means of protecting their property interests in their aircraft. For example, financiers may consider requiring the country in which the financed airline is located to ratify the Geneva Convention on the International Recognition of Rights in Aircraft.¹⁵⁹ This would increase the financier's prospects of being able to enforce a lien or security interest in an aircraft in the courts of the host country.¹⁶⁰ Also, some financiers will accept a letter or certificate signed by the civil aviation authority of the host country attesting to the fact that the authority will consent to, and will take all reasonable steps to assist in the deregistration and export of the aircraft upon termination of the lease. In some cases, financiers may require the airline to execute a power of attorney which authorizes the financiers to take all steps necessary, on behalf of the airline, to arrange for the deregistration and export of the financed aircraft. In addition, financiers may seek to rely on the services of local persons with high-level government contacts in order to secure the release of aircraft in situations where conventional methods are unsuccessful.

2. *Residual Value Insurance*

The owner of a leased aircraft will obviously be concerned about its value on the date of the termination of the lease (*i.e.*, the so-called residual value). Residual value insurance (RVI) indemnifies the owner of an aircraft in respect of the difference between a previously agreed upon future value and its actual market value at an agreed upon future date. RVI, also known as asset value insurance, is well suited to assets like modern com-

¹⁵⁹ Convention on the International Recognition of Rights in Aircraft, June 19, 1948, 4 U.S.T. 1830, T.I.A.S. No. 2847, 310 U.N.T.S. 151 (The Convention is also known as the "Mortgage Convention.").

¹⁶⁰ So too would the proposed UNIDROIT Convention on International Interests in Mobile Equipment, which is currently in the early drafting stage. Strongly supported by aircraft and engine manufacturers, lenders, and aircraft lessors, this proposed convention, according to the current draft, will cover aircraft leases. For general background, see Jeffrey Wool, *UNIDROIT Convention*, 186 AIRFINANCE J. 38 (1996).

mercial aircraft which generally hold their value over extended periods.

RVI is used most frequently in the context of operating leases where the lessor wants to guarantee a minimum residual value for its aircraft upon termination of the lease. It is also used, however, in the context of other aircraft financings, including leveraged and finance leases, term loans, and transactions involving bridging finance.

The use of RVI enables parties to negotiate reduced lease payments because of the relative certainty in establishing the residual value of the aircraft at the termination of the lease. RVI also permits the use of certain accounting procedures such as the writing up of asset values and the more accurate prediction of profits.

RVI policies are written in two essential ways.¹⁶¹ The first involves a guarantee by the insurers of a predetermined value of the insured aircraft as against the fair market value of the aircraft on a future specified date. In determining the fair market value each party appoints appraisers. Depending on the policy wording, the insurers may either pay the difference between the guaranteed minimum value and the fair market value, or they may indemnify the insured for the guaranteed minimum value and assume title to the insured aircraft.

The second form of RVI cover contemplates the sale of the insured aircraft at a future specified date. Pursuant to the policy, the insurers will guarantee the difference between the minimum guaranteed value of the aircraft and the actual gross proceeds derived upon the sale of the aircraft. This form of policy will usually obligate the owner or its representative to procure offers for the purchase of the aircraft in advance of the termination date of the transaction.

RVI can provide protection to the beneficial owner of an aircraft where there has been an actual decrease in the fair market value of the aircraft or where there has been a change in currency exchange rates which causes the same result.

Is RVI truly insurance, or is it simply a species of put option or call option?¹⁶² The answer is not merely of academic signifi-

¹⁶¹ For a specimen policy wording, see Tony Forster, *Residual Value Insurance*, in *AIRCRAFT FINANCING*, *supra* note 4, at 239, 243.

¹⁶² *Gordon & Co. v. Board of Governors of Fed. Reserve Sys.*, 317 F. Supp. 1045, 1046 (D. Mass. 1970). A put option, also known as a put option guarantee, is an option to sell an asset to another for a fixed price at a certain future date. A call option, or forward purchase contract, is an option to purchase an asset from

cance. If RVI is insurance, then underwriters of RVI could conceivably be required to register as insurers under the insurance laws of various countries. Under English law, while it has been said that it is uncertain whether a satisfactory definition of insurance will ever be evolved,¹⁶³ it would appear that in order to constitute insurance, a contract must (i) provide that the insured will become entitled to something on the occurrence of some event, (ii) which event must involve an element of uncertainty, and (iii) the insured must have an insurable interest in the subject matter of the contract.¹⁶⁴ In the case of RVI, the first two elements are easily satisfied. There is a question, however, whether the insured under a contract of RVI would have an insurable interest sufficient to make the contract one of insurance.¹⁶⁵

The concept of insurable interest has been narrowly defined in English law.¹⁶⁶ According to Macgillivray and Parkington, the mere hope or expectation of a future benefit is not sufficient to constitute an insurable interest in any event which, if it happened, would prevent such hope or expectation being raised.¹⁶⁷ While it may be suggested that RVI does not satisfy the requirement of insurable interest because the insured suffers no damage to a right recognized by law when the insured's aircraft is worth less than was hoped, this may misconstrue the requirement of legal or equitable right or relation.¹⁶⁸ The law does not require *interference* with that right as such, but merely the *existence* of such a right in the property which is the subject of the insur-

another for a fixed price at a certain future date. BLACK'S LAW DICTIONARY 204-05, 1237 (6th ed. 1990).

¹⁶³ Medical Defence Union v. Department of Trade, [1980] Ch. 82, 95 (per Megarry V.C.) (Eng. 1978).

¹⁶⁴ Department of Trade and Indus. v. St. Christopher's Motorists Assoc. Ltd., [1974] 1 All E.R. 395, 400 (Eng. 1973); Prudential Ins. Co. v. Commissioners of Inland Revenue, [1904] 2 K.B. 658, 663 (Eng.).

¹⁶⁵ A contract of RVI is unlikely to be held invalid as a wager. See Tote Investors Ltd. v. Smoker, [1968] 1 Q.B. 509, 516 (Eng. C.A.); Earl of Ellesmere v. Wallace, [1929] 2 Ch. 1, 9 (Eng. C.A. 1928); Carlill v. Carbolic Smoke Ball Co., [1892] 2 Q.B. 484, 491 (Eng. C.A.). Indeed, as a contract it is likely to be held specifically enforceable under § 63 of the Financial Services Act of 1986, ch. 60(v), § 63 (Eng.); see also City Index Ltd. v. Leslie, [1992] 1 Q.B. 98, 103 (Eng. C.A. 1991).

¹⁶⁶ Macaura v. Northern Assurance Co., [1925] App. Cas. 619, 626-27; Lucena v. Craufurd, 127 Eng. Rep. 858 (1808).

¹⁶⁷ E. J. MACGILLIVRAY & MICHAEL PARKINGTON, INSURANCE LAW ch. 1, § 4, at 21 (8th ed. 1988).

¹⁶⁸ I am grateful to Professor Malcolm Clarke of St. John's College, Cambridge, for the benefit of his views on the status of RVI under English law.

ance and (the potential for) interference with the property itself, such as damage or loss or, in the case of RVI, loss of value. If that right exists, interference is required only in the hypothetical sense, in that if it occurs, it will affect the insured's *economic* interest, that is, he will be worse off.¹⁶⁹ One commentator has suggested that it would be strange if the English courts did not enforce RVI as a form of insurance as courts have done in the United States.¹⁷⁰ New York insurance law, for example, specifically defines RVI as a form of insurance which may be authorized in New York.¹⁷¹ The shifting of risk to an independent RVI insurer will likely also constitute insurance in other states.¹⁷² Under English law, it is not clear if RVI constitutes financial guarantee insurance, which may not be written by Lloyd's underwriters without special dispensation.¹⁷³

3. *Contingent Insurance*

While the simplest manner of protecting financiers is by endorsing their interests on the existing policy issued to the financed party, this will not protect financiers in every case. The protection provided under the insured airline's policy is only as good as the policy itself, and if the policy fails to respond in the event of a loss, financiers could conceivably be prejudiced. An airline's policy could fail to respond for a variety of reasons, including restrictions on the export of the policy proceeds, gaps in coverage occasioned by termination or nonrenewal of the air-

¹⁶⁹ See *Wilson v. Jones*, [1867] 2 L.R.-Ex. 138 (Eng.), where Judge Willes said that the "thing insured was the value of the plaintiff's shares, or rather his interest in the profits to be [successfully] derived from his shares" *Id.* at 144.

¹⁷⁰ M.A. CLARKE, *THE LAW OF INSURANCE CONTRACTS* 742 (2d ed. 1994).

¹⁷¹ N.Y. INS. LAW § 1113(a)(22) (McKinney 1985).

¹⁷² See, e.g., CAL. INS. CODE § 22(a) (West 1993); *Wells Fargo Credit Corp. v. Arizona Property & Casualty Ins. Guar. Fund*, 799 P.2d 908, 911 (Ariz. Ct. App. 1990); *Commonwealth ex rel. Schnader v. Fidelity Land Value Assurance Co.*, 167 A. 300, 302 (Pa. 1933); *Seattle-First Nat'l Bank v. Washington Ins. Guar. Ass'n*, 804 P.2d 1263, 1269 (Wash. 1991) (RVI characterized as casualty insurance).

¹⁷³ In accordance with the Financial Guarantee Insurance Regulation, No. 4 of 1989, underwriters at Lloyd's may not underwrite financial guarantee insurance without the prior written approval of the Financial Guarantee Committee. The regulation defines financial guarantee insurance to include, *inter alia*, the financial failure, default, bankruptcy, liquidation or winding up of any person whether or not a party to the contract of insurance; an undertaking to indemnify an insured with respect to the financial failure of any venture; the lack of or insufficient receipts, sales, or profits of any venture; a change in levels of interest rates; a change in currency exchange rates; and a change in the value or price of land, buildings, securities, or commodities. Arguably, RVI does not fit into any of the above categories.

line's policy, or by differences in dates of inception or anniversary dates for different types of coverage. Financiers may therefore obtain contingent insurance (also referred to as contingency insurance), the principal forms of which are contingent hull, contingent war, and contingent liability insurance.¹⁷⁴

Contingent hull all risks and war risk insurance is designed to protect the financier in circumstances where the hull all risks or hull war risk coverage of the financed airline is cancelled or not renewed for any reason. Contingent liability insurance will cover the financier in the event that the airline's liability policy is cancelled or not renewed. In addition, coverage will exist if the policy limits of the airline's policy prove to be insufficient to meet liabilities or if the airline's liability policy fails to respond for any reason. Depending on the policy wording, contingent insurance could be broad enough to cover a financier for risks excluded under the insured airline's policy. Contingent insurance does not, however, provide protection against the bankruptcy of an airline's insurers.¹⁷⁵

4. *Miscellaneous Coverages to Protect Financiers*

In addition to the foregoing types of coverage, there are several other risks which financiers may face in the course of financing aircraft with respect to which insurance may be placed, including the following:

a. *Repossessed (Parked) Aircraft Insurance*

This form of insurance is designed to protect an aircraft financier—usually a lessor—with respect to hull and liability risks in connection with an aircraft which is in the care, custody, or control of the financier. This might occur after the aircraft has been redelivered at the end of a lease pending delivery of the aircraft to another lessee.

b. *Total Loss Insurance*

Where the market value of the financed aircraft exceeds the casualty value or stipulated loss value in the financing agreement, the financier may consider placing total loss insurance.

¹⁷⁴ For a specimen policy, see LSW 610, Contingent Aircraft Hull (Including Spares and Equipment) and Contingent Liability Insurance Policy, published by the Sturge Syndicate at Lloyd's.

¹⁷⁵ See, e.g., LSW 610 § 1 (exclusion 2(f)).

This would have the effect of "topping up" the insured value payable to the financier in the event of a total loss.

c. Loss of Use Insurance

This form of coverage is effected by the airline and is designed to protect the airline from loss of the income stream, and hence inability to make loan or lease payments, should the aircraft be out of service during the term of the loan or lease. Financiers may consider requiring the airline to effect loss of use insurance where the financial viability of the airline may be in question should the aircraft become unserviceable.

d. Hull Deductible Repairer's Lien Insurance

This covers the financier for up to \$1 million to cover situations in which damage is discovered after the return of an aircraft in a bankruptcy, and the repairer refuses to release the aircraft until the policy deductible has been paid.

e. Breakdown Repairer's Lien Insurance

This coverage protects the financier with respect to engine breakdown damage discovered after the aircraft has been returned in a bankruptcy. The hull policies of most airlines exclude coverage of mechanical breakdown.

f. Unearned Premium Contingency

This protects the financier in cases where there is an outstanding premium owing under the airline's policy, and the insurers are entitled to deduct the extent of the outstanding premium from any policy proceeds which are payable.

g. Breakage Costs Indemnity Insurance

Numerous financial benefits are lost when an aircraft hull is declared a total loss. These include loss of tax benefits, cancellation charges for letters of credit, and swap breakage charges. Insurance coverage is currently under development in the London insurance market, pursuant to which financiers will be able to insure against the loss of these benefits.¹⁷⁶

¹⁷⁶ The preliminary indications are that this form of coverage will not violate the prohibition on financial guarantee insurance at Lloyd's. *See supra* note 173 and accompanying text.

VIII. THE AIRLINE FINANCE/LEASE CONTRACT ENDORSEMENT

In February of 1991, the London aviation insurance market introduced AVN 67, a policy endorsement, in an effort to streamline the procedure for arranging insurance coverage in connection with finance and leasing transactions and to clarify the coverages being provided to financiers and lessors. Upon its introduction, AVN 67 met with strong resistance from the aircraft financing community, and its use was not generally accepted by the insurance advisers of the majority of financiers and lessors. As a result, a working group consisting of representatives of the insurance and financing communities was established in early 1992 to discuss the form of AVN 67 and determine if any agreement could be reached on amending it. As a result of these efforts, the working group amended AVN 67 in several significant respects and issued a revised endorsement designated AVN 67A in May of 1993.

While AVN 67A represented a significant improvement in the wording of the endorsement and included several concessions on points raised by representatives of the financing community, numerous complaints were still levelled against it, notably by financiers based in the United States.¹⁷⁷ After further discussions between representatives of the insurance and financing communities, further revisions were made in AVN 67B which was issued in 1994.¹⁷⁸

In the preamble, AVN 67B records the fact that entities other than the original insured—referred to as “Contract Party(ies)” —have an interest in the equipment under the lease or financing agreement.¹⁷⁹ The preamble to AVN 67B also confirms that the insurance afforded under the original insured’s policy is “in full force and effect.”¹⁸⁰ This provision not only confirms that coverage is in force, but also prevents insurers

¹⁷⁷ See, e.g., Ruth L. Lansner, Analysis of the New Lloyd’s Airline Finance/Lease Contract Endorsement—AVN 67A, Address to the American Bar Association (Aug. 10, 1993).

¹⁷⁸ AVN 67B actually consists of two separate endorsements, the Airline Finance/Lease Contract Endorsement for use with an all risks policy and the Airline Finance/Lease Contract (Hull War) Endorsement for use with a hull war policy. The two endorsements are virtually identical. Unless otherwise indicated, references in this Article are to the former, a copy of which appears as the Appendix to this Article.

¹⁷⁹ This was a concern that was raised on behalf of the financing community in relation to AVN 67.

¹⁸⁰ AVN 67B, *supra* note 14 (preamble).

from subsequently claiming that some act or omission had voided the policy prior to the inception of the endorsement.¹⁸¹

AVN 67B is intended to provide coverage during the time that the original insured has physical possession of the aircraft and is responsible for insuring it. The endorsement accordingly states that the coverages provided under AVN 67B are expressed to apply to losses occurring "during the period from the Effective Date until the expiry of the Insurance or until the expiry or agreed termination of the Contract(s) or until the obligations under the Contract(s) are terminated by any action of the Insured or the Contract Party(ies), whichever shall first occur. . . ."¹⁸² This language was decided on after extensive discussion and covers most of the situations which can cause termination of the insurance coverage. The terminology recognizes that once the aircraft has been returned or the finance or lease contract terminated, the insurance needs of the contract parties are different.¹⁸³

Paragraph 1 of AVN 67B contains a loss payable provision for hull and aircraft spares insurances. It provides that where any claim on an aircraft becomes payable as a total loss, settlement shall be made to, or to the order of, the contract party(ies).¹⁸⁴ Settlement of all other claims shall be made, less any relevant policy deductible, with such parties as may be necessary to repair the equipment,¹⁸⁵ unless otherwise agreed after consultation between the insurers and insured and, where necessary under the contract, the contract party(ies).¹⁸⁶ Paragraph 1 of AVN 67B

¹⁸¹ *Id.*

¹⁸² *Id.*

¹⁸³ This language has been criticized by at least one representative of the financing community on the basis that where a financier terminates a finance or lease contract because of an airline's breach, this could conceivably constitute termination of the obligations under the contract by action of the Insured or Contract Party, thus resulting in termination of the insurance coverage even though the aircraft has not been returned to the financier. See Lansner, *supra* note 177 (commenting on similar language in AVN 67A).

¹⁸⁴ AVN 67B, *supra* note 14, at § 1.1.

¹⁸⁵ Such as a manufacturer or fixed base operator.

¹⁸⁶ AVN 67B, *supra* note 14, at § 1.1. This provision has been criticized on the grounds that both the financier and operator of the aircraft may be paid settlement proceeds notwithstanding contrary contractual arrangements between them. See Lansner, *supra* note 177 (commenting on similar language in AVN 67A). The wording represents a practical compromise of a difficult problem for insurers (*i.e.*, ensuring that those with a property interest in the aircraft are paid the proceeds of any settlement in such a manner that no one is preferred over another and the proceeds can be distributed by the recipients in the manner required by any agreement(s) between them).

also provides that insurers shall be entitled to the benefit of salvage of any property for which a claims settlement has been made.¹⁸⁷

Paragraph 2 of AVN 67B contains a severability of interest clause relative to liability insurance which is specifically declared not to apply to any claim arising under the hull or spares insurances of the insured. This provision also specifies that the total liability of the insurers with respect to all insureds shall not exceed the limits of liability stated in the policy.¹⁸⁸ Paragraph 2 also provides that the insurance provided under the endorsement shall be primary and without right of contribution from any other insurance which may be available to the contract party(ies).¹⁸⁹ This provision relates only to the liability insurances effected on behalf of the parties and does not affect the hull and aircraft spares insurances. As stated previously, while insurers will be prepared to specify that liability coverage is primary, they will want to retain their rights of contribution where other insurance is available for the aircraft hull and spares.¹⁹⁰ Finally, paragraph 2 of AVN 67B provides that the "[e]ndorsement does not provide coverage for the [c]ontract [p]arty(ies) with respect to claims arising out of their legal liability as manufacturer, repairer, or servicing agent of the [e]quipment."¹⁹¹ This provision makes it clear that the endorsement is not intended to cover any of the contract parties for claims arising from products liability.

Paragraph 3 of AVN 67B relates to both hull and liability insurances and provides for the inclusion of the contract party(ies) as additional insured(s).¹⁹²

The breach of warranty provision in AVN 67 provided in pertinent part that "... the interests of each Contract Party ... shall not be prejudiced by any act or omission of any other person or party PROVIDED THAT the Contract Party so protected had no actual or constructive knowledge of, has not condoned, caused

¹⁸⁷ AVN 67B, *supra* note 14, at § 1.2. This provision is designed to emphasize that insurers are entitled to salvage where, for example, a total loss occurs involving an aircraft on which a substitute leased engine has been installed. Having paid the full agreed values to both the airframe and engine lessors, insurers are entitled to the removed engine, or its monetary equivalent, as salvage.

¹⁸⁸ *Id.* § 2.1.

¹⁸⁹ *Id.* § 2.2.

¹⁹⁰ See *supra* note 147 and accompanying text.

¹⁹¹ AVN 67B, *supra* note 14, at § 2.3.

¹⁹² *Id.* § 3.1.

or contributed to the said act or omission. . . ."¹⁹³ While several criticisms were levelled at this wording, one of the main concerns of the financing community was the notion that coverage would be excluded if the financier had constructive knowledge of any act or omission which might invalidate the policy. Another concern expressed by the financing community was that financiers did not have any breach of warranty protection with respect to pre-inception violations by the financed party such as misrepresentations and nondisclosures.¹⁹⁴

AVN 67B now provides that "the cover afforded to each Contract Party by the Policy in accordance with this Endorsement shall not be invalidated by any act or omission (including misrepresentation and non-disclosure) of any other person or party which results in a breach of any term, condition or warranty of the Policy PROVIDED THAT the Contract Party so protected has not caused, contributed to or knowingly condoned the said act or omission."¹⁹⁵

The above wording is clearer than that used in AVN 67 and provides a number of concessions to financiers. First, it is now clear that financiers are protected against pre-inception misrepresentations and nondisclosures by other contract parties, including the financed party. Second, the words "constructive knowledge" have been omitted from the endorsement, thus eliminating one of the more significant criticisms of the financing community. Under AVN 67B, it is now clear that financiers will be deprived of breach of warranty coverage where they have caused, contributed to, or knowingly condoned any act or omission of any other person or party which results in a breach of the policy.¹⁹⁶

Paragraph 3.3 of AVN 67B incorporates another policy endorsement, AVN 70—the Other Interests Clause—into AVN 67B. Paragraph 3.3 provides that the provisions of AVN 67B apply to "the Contract Party(ies) solely in their capacity as financier(s) or lessor(s) in the identified contract(s) and not in any other capacity."¹⁹⁷ This provision was designed to provide comfort to financiers who had expressed concern that the breach of warranty protection extended to them under AVN 67A could be

¹⁹³ AVN 67 § 3.2.

¹⁹⁴ Cf. *supra* notes 124-26 and accompanying text.

¹⁹⁵ AVN 67B, *supra* note 14, § 3.2. The amendment was originally introduced in AVN 67A.

¹⁹⁶ *Id.*

¹⁹⁷ *Id.* § 3.3.

lost if they acquired knowledge in another capacity (*e.g.*, as a manufacturer).¹⁹⁸

Paragraph 3 of AVN 67B also confirms that the contract party(ies) shall have no responsibility for payment of any premium. It also provides that the insurers shall waive any right of set-off or counterclaim against the contract party(ies), except for outstanding premiums for the equipment.¹⁹⁹

Paragraph 3 of AVN 67B provides further that upon payment of any loss or claim to or on behalf of any contract party(ies), the insurers shall to the extent of such payment be subrogated to all legal and equitable rights of the contract party(ies) indemnified thereby, but such right of subrogation shall not be exercised against any contract party.²⁰⁰ The contract party(ies) shall do all things reasonably necessary to assist the insurers to exercise the right of subrogation.²⁰¹ It is not clear, from this wording, whether insurers intend to be able to exercise the right of subrogation against the insured airline in the event of payment of a claim. It is submitted that, to the extent that subrogation against an insured is generally prohibited at common law,²⁰² the wording is unclear and may be interpreted against this result.²⁰³

Paragraph 3.6 of AVN 67B provides that, except for any cancellation or automatic termination provision specified in the policy or any endorsement, the coverage provided under AVN 67B may only be cancelled or materially altered in a manner adverse to the contract party(ies) on thirty days written notice to the appointed broker.²⁰⁴

One of the closing provisions of AVN 67B provides that, except as specifically varied or provided by the terms of the endorsement, the contract party(ies) are covered by the policy subject to all terms, conditions, limitations, warranties, exclu-

¹⁹⁸ *Id.*

¹⁹⁹ *Id.* § 3.4.

²⁰⁰ *Id.* § 3.5.

²⁰¹ *Id.*

²⁰² See *supra* note 141 and accompanying text.

²⁰³ The same can be said about AVN 28A, the Aircraft Financial Interest Endorsement, used in general aviation finance. Paragraph 5 of AVN 28A provides:

Upon payment of any loss or claim to the Party, Insurers shall to the extent and in respect of such payment be subrogated to all legal and equitable rights of the Party. At the expense of Insurers the Party shall do whatever is necessary to assist the Insurers to exercise such rights.

²⁰⁴ AVN 67B, *supra* note 14, at § 3.6. See also *supra* notes 143-44.

sions, and cancellation provisions thereof.²⁰⁵ This makes it clear that the coverages provided in the endorsement take precedence over any provision to the contrary in the policy, while at the same time confirming that in all other respects the coverage so extended to the contract party(ies) is subject to the terms and conditions of the policy. Finally, AVN 67B provides that the policy shall not be varied by any provisions contained in the contract(s) which purport to serve as an endorsement or amendment to the policy.²⁰⁶ Although this would seem to be obvious, this nevertheless confirms that no language in the financing agreement which purports to form part of the insurance policy can in fact do so.

The schedule to AVN 67B provides for the identification of the financed equipment, the contract party(ies), the contract(s), the effective date, and any additional premium.²⁰⁷ While insurers may elect not to assess any significant additional premium for the benefits provided to financiers under AVN 67B, the reference to additional premium has been included to ensure that the endorsement does not fail for lack of consideration.²⁰⁸

AVN 67B represents a significant change and improvement over its predecessors. The wording is clearer, and the coverages provided thereunder are more generous. Given the concessions made by insurers, it is appropriate that financiers and their representatives are now providing the opportunity for the endorsement to be tested in the real world.

IX. CONCLUSION

There are many advantages which financiers may derive from the proper use of insurance. The most obvious of these is the protection of the financier's property interest in the asset being financed. Also, by seeing to it that the airline is properly insured, the financier can avoid an interruption in lease or loan payments which might occur should the airline experience an accident and be unable to continue its business operations. As will be apparent from the foregoing, however, the purpose of insurance is to protect against unexpected loss, damage, or liability. Insurance is not designed to protect against financial

²⁰⁵ *Id.* (final provision 1).

²⁰⁶ *Id.* (final provision 2).

²⁰⁷ *Id.* (schedule 1-3).

²⁰⁸ *Id.* (preamble); see also *supra* note 125.

risks of financiers, and having regard for the current system under which premiums are assessed, such risks are not appropriately run by aviation insurers.

Financiers and insurers have not always seen eye to eye on matters relating to insurance. However, the flexibility of the insurance market and the willingness of its members to accommodate the needs and interests of financiers, as evidenced by the adoption of AVN 67B, and its predecessors, has considerably improved the relationship between them. No doubt, as financiers and insurers continue to communicate with each other in this important area, their relationship will grow stronger.

APPENDIX

AIRLINE FINANCE/LEASE CONTRACT ENDORSEMENT

It is noted that the Contract Party(ies) have an interest in respect of the Equipment under the Contract(s). Accordingly, with respect to losses occurring during the period from the Effective Date until the expiry of the Insurance or until the expiry or agreed termination of the Contract(s) or until the obligations under the Contract(s) are terminated by any action of the Insured or the Contract Party(ies), whichever shall first occur, in respect of the said interest of the Contract Party(ies) and in consideration of the Additional Premium it is confirmed that the Insurance afforded by the Policy is in full force and effect and it is further agreed that the following provisions are specifically endorsed to the Policy:

1. *Under the Hull and Aircraft Spares Insurances*

- 1.1 In respect of any claim on Equipment that becomes payable on the basis of a Total Loss, settlement (net of any relevant Policy Deductible) shall be made to, or to the order of the Contract Party(ies). In respect of any other claim, settlement (net of any relevant Policy Deductible) shall be made with such party(ies) as may be necessary to repair the Equipment unless otherwise agreed after consultation between the Insurers and the Insured and, where necessary under the terms of the Contract(s), the Contract Party(ies).

Such payments shall only be made provided they are in compliance with all applicable laws and regulations.

- 1.2 Insurers shall be entitled to the benefit of salvage in respect of any property for which a claims settlement has been made.

2. *Under the Legal Liability Insurance*

- 2.1 Subject to the provisions of this Endorsement, the Insurance shall operate in all respects as if a separate Policy had been issued covering each party insured hereunder, but this provision shall not operate to include any claim howsoever arising in respect of loss or damage to the Equipment insured under the Hull or Spares Insurance of the Insured. Notwithstanding the foregoing the total liability of Insurers

in respect of any and all Insureds shall not exceed the limits of liability stated in the Policy.

- 2.2 The Insurance provided hereunder shall be primary and without right of contribution from any other insurance which may be available to the Contract Party(ies).
- 2.3 This Endorsement does not provide coverage for the Contract Party(ies) with respect to claims arising out of their legal liability as manufacturer, repairer, or servicing agent of the Equipment.

3. *Under ALL Insurances*

- 3.1 The Contract Party(ies) are included as Additional Insured(s).
- 3.2 The cover afforded to each Contract Party by the Policy in accordance with this Endorsement shall not be invalidated by any act or omission (including misrepresentation and non-disclosure) of any other person or party which results in a breach of any term, condition or warranty of the Policy PROVIDED THAT the Contract Party so protected has not caused, contributed to or knowingly condoned the said act or omission.
- 3.3 The provisions of this Endorsement apply to the Contract Party(ies) solely in their capacity as financier(s)/lessor(s) in the identified Contract(s) and not in any other capacity. Knowledge that any Contract Party may have or acquire or actions that it may take or fail to take in that other capacity (pursuant to any other contract or otherwise) shall not be considered as invalidating the cover afforded by this Endorsement.
- 3.4 The Contract Party(ies) shall have no responsibility for premium and Insurers shall waive any right of set-off or counterclaim against the Contract Party(ies) except in respect of outstanding premium in respect of the Equipment.
- 3.5 Upon payment of any loss or claim to or on behalf of any Contract Party(ies), Insurers shall to the extent and in respect of such payment be thereupon subrogated to all legal and equitable rights of the Contract Party(ies) indemnified hereby (but not against any Contract Party). Insurers shall not exercise such rights without the consent of those in-

demnified, such consent not to be unreasonably withheld. At the expense of Insurers such Contract Party(ies) shall do all things reasonably necessary to assist the Insurers to exercise said rights.

- 3.6 Except in respect of any provision for Cancellation or Automatic Termination specified in the Policy or any endorsement thereof, cover provided by this Endorsement may only be cancelled or materially altered in a manner adverse to the Contract Party(ies) by the giving of not less than Thirty (30) days notice in writing to the Appointed Broker. Notice shall be deemed to commence from the date such notice is given by the Insurers. Such notice will NOT, however, be given at normal expiry date of the Policy or any endorsement.

EXCEPT AS SPECIFICALLY VARIED OR PROVIDED BY THE TERMS OF THIS ENDORSEMENT:

1. THE CONTRACT PARTY(IES) ARE COVERED BY THE POLICY SUBJECT TO ALL TERMS, CONDITIONS, LIMITATIONS, WARRANTIES, EXCLUSIONS AND CANCELLATION PROVISIONS THEREOF.
2. THE POLICY SHALL NOT BE VARIED BY ANY PROVISIONS CONTAINED IN THE CONTRACT(S) WHICH PURPORT TO SERVE AS AN ENDORSEMENT OR AMENDMENT TO THE POLICY.

*SCHEDULE IDENTIFYING TERMS USED IN THIS
ENDORSEMENT*

1. Equipment [Specify detail of any aircraft, engines or spares to be covered]:
2. Policy Deductible(s) applicable to physical damage to the Equipment [Insert all applicable Policy deductible(s)]:
3. (a) Contract Party(ies):
AND (b), in addition, in respect of Legal Liability Insurances:
4. Contract(s):
5. Effective Date [being the date that the Equipment attaches to the Policy or a specific date thereafter]:
6. Additional premium:

7. Appointed Broker.