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Season's Greetings

(Photo by Marty Weiss)

WINTER MEETING — Sunscape Sabor Resort – Cozumel Island, Mexico — Feb. 11-15, 2015

SUMMER MEETING — Watkins Glen Harbor Hotel – Watkins Glen, NY — July 22-26, 2015

INSURANCE TIPS FOR CHARTER CUSTOMERS AND FRACTIONAL OWNERS

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If you have a client who charters aircraft or who owns a fractional share, there is a good chance that your client's net worth exceeds the charter company's net worth, and possibly even the fractional program's net worth. In the event of an accident, your client may be the deep pocket with the most at stake. Although your client may have the most to lose in the event of an accident, your client has no participation in selecting the insurance company nor in drafting the insurance policy. So how do you protect your client? Below are ten key insurance tips.

Named Insured Myth

My first job out of college was as an aviation insurance underwriter. One of the big complaints among the experienced underwriters was the increasing wave of requests for people to be added to the policy as "Named Insureds" rather than "Insureds" or "Additional Insureds." There was a developing myth that it was better to be a "Named Insured." Typically, the "Named Insured" is the one who contracts with the insurer, pays the premium and reports claims, and is the one who may cancel the policy and receive any refunds. Adding charter customers as "Named Insureds" was a terrible concept – any charter customer would have the ability to cancel the policy. Further, if the charter company failed to pay its premiums, charter customers could be on the hook to pay as "Named Insureds."

Unfortunately, insurers, brokers, and operators eventually caved in to the pressure to add customers as "Named Insureds." To combat the resultant mess, insurers created the term "First Named Insured" to distinguish the policyholder from the mass of "Named Insureds." The underwriters intended that the "First Named Insured" would be the entity responsible for paying the premium and the entity with the authority to cancel the policy. Unfortunately, many underwriters were sloppy in implementing the change to "First Named Insured" and neglected to properly change the cancellation provisions, the payment provisions, and the use provisions.

When reviewing an insurance policy on behalf of a client, you need to ensure that there are not hundreds of "Named Insureds" who have the right to cancel the policy, and to ensure that your client is not responsible for premium payment. Policies with hundreds of Named Insureds should specify that only a specific company or a "First Named Insured" has cancellation power and payment obligation.

When you request that a client be added to the insurance policy of a charter company or fractional program, there is no shortcut that will enable you to determine whether your client should be a "Named Insured" or an "Insured." In order to protect your client, you must delve into the weeds and review the provisions of the policy relating to use, premium payment, and cancellation. When reviewing use, be sure that your client will be covered when flying on fleet aircraft as well as when flying on outsourced aircraft arranged by his charter company or fractional program. Only after a thorough analysis will you be able to determine whether your client should be an "Insured" or a "Named Insured." Further, it may be that neither solution will be sufficient. In some cases, an endorsement will be needed to address your client's specific circumstances.

Aircraft Use

Insurance policies cover only the use described in the policy. If the use is "non-commercial" then charter flights or flights for compensation (beyond some de minimis amount) are not covered. If the use is "commercial," then charter flights are covered. The use analysis also requires a review of who may engage in the permitted activity. Is the use restricted to the activities of the charter company or fractional program? Are fractional owners allowed certain uses? Is non-owned coverage restricted to the in-house use of the charter company, or does it encompass the charter company's customers when the charter company arranges outsourced flights? For example, use may be described as "Commercial by the First Named Insured" or "All uses by the First Named Insured." If your client is a fractional owner acting as the aircraft operator under FAR 91 Subpart K, is your client's use within the scope of "all uses by the First Named Insured"? Is your client's use a use by the fractional program manager? These issues are why I recommend less focus on "Named Insured" vs. "Insured," and more focus on ensuring that your client's activities will be within the scope of the permitted use of the policy.

Friends with Planes

Friends with vacation homes, yachts, and exotic cars are wonderful to have. Friends with planes can be a perilous risk. If a client brags about his cheap flights on his friend's plane, your alarm bells should ring. Unless the friend is so generous that he offers your client his plane for free, the flights may violate the non-commercial use provision of his insurance policy. If the flights are outside the policy's use, there is no coverage for the flights: no coverage for the friend and no coverage for your client. Do not assume that your client is out of the woods just because the friend's plane is on a charter certificate. Even if the plane is on a charter certificate, the commercial use provision of the insurance policy may permit payment only to the certificate holder, *e.g.* "commercial use by the First Named Insured." If the friend is receiving direct payment from your client, and if the friend is not the First Named Insured, *e.g.* a charter management company is the First Named Insured, then that commercial use by the friend is outside the scope of the policy.

In addition to the insurance issue, the use of a friend's plane may create FAA and IRS complications. An FAA charter certificate allows only for payment to be made to the certificate holder. Unless your friend has his own charter certificate, he is likely violating the FARs by accepting reimbursement directly from your client. For turbine-powered multiengine airplanes, FAR 91.501 strictly limits compensation in the absence of a charter certificate. While your client may not be violating any FARs by paying for his flights, he is contributing to a compliance problem for his friend and for his friend's pilots. If something happens on one of the flights and the attention of the FAA is aroused, your client may be forced to testify to the FAA. That testimony could unleash enforcement action against the friend. If an accident is involved, that same testimony could lead the insurer to deny coverage due to the commercial use by the friend (rather than by the charter company).

The IRS complication stems from the federal excise tax on air transportation. If your client is paying his friend for air transportation (provision of an aircraft and crew), Federal Excise Tax (FET) of 7.5% is due to the IRS along with passenger segment fees. According to IRS Publication 510 (page 28), "The person paying for taxable transportation is liable for the tax." If your client is paying for these flights through a business entity, or if the friend is receiving the funds within a business entity, an IRS audit is likely to flag the FET deficiency.

Do not accept your client's assurances that his friend is a sophisticated, knowledgeable businessman and undoubtedly has his bases covered. It is probable that the airplane-owning friend is blissfully ignorant of this aviation esoterica.

Non-Owned Coverage

Non-owned coverage is critically important for both charter customers and fractional owners. Charter companies and fractional programs both have peak demand days and occasions where aircraft have mechanicals. In these circumstances, the companies may rely upon outside charter vendors to cover your client's trip. You may have carefully vetted your client's charter provider or fractional program to verify that it carries $200 million in liability coverage. What if your client is outsourced to a charter company that carries only $25 million? Do you need to scramble to vet the insurance of this substitute charter company and to arrange higher limits? No, not if the charter company's or fractional program's insurance policy includes non-owned coverage with the same limit as fleet aircraft. In our example, if the fractional program carries $200M non-owned coverage, then your client has the same level of protection even if he is outsourced to a charter company that has only a $25 million limit. In fact, your client is slightly better off when outsourced: there is $25 million of coverage through the outsourced company plus $200 million non-owned on top of that ($225 million total).

There are two traps to watch for with non-owned coverage:

1. You need to ensure that the non-owned coverage is not just for flights used by the charter/fractional company itself, but also encompasses flights arranged by the company on behalf of your client.

2. The non-owned coverage should include non-owned hull, technically known as hull legal liability. It is acceptable for this coverage to be a sublimit of the $200 million limit in our example, since the exposure is capped at the value of the aircraft (perhaps $50 million). If your client speeds on the ramp and drives his car into the outsourced charter aircraft, or if his child carelessly swings her golf club as she boards, the owner of the aircraft or its insurer may come after your client for the aircraft damage - as well as for the resultant diminution in value created by the damage history. Non-owned hull is your client's protection in these scenarios.

Waiver of Subrogation and Waiver of Rights of Recovery

"Waiver of subrogation" seems to be the Holy Grail of insurance. The phrase offers the perfect mix of compactness and sophistication. Do not be lulled into complacency by a waiver of subrogation – it is meaningless in the absence of its oft-overlooked companion: the waiver of rights of recovery.

A charter customer has exposure for negligently damaging the charter company's aircraft (whether by car or by golf club). Likewise, when a fractional owner uses aircraft owned by other people in the fractional program, the fractional owner has exposure for negligently damaging those aircraft.

If your client damages an aircraft, the aircraft owner may prefer to recover his loss directly from your client. This keeps the owner's insurance loss record cleaner and provides the owner with the opportunity to recover the diminution in his aircraft's resale value caused by the damage history. Diminution in value is not covered by the aircraft owner's insurance policy, so your client is the owner's sole target. In order to avoid claims by the aircraft owner, your client needs the owner to waive his rights of recovery against your client for damage to his aircraft. In other words, the aircraft owner needs to agree that his insurance will be his remedy for hull damage and that he will not pursue a claim against your client. The recovery waiver should be contained in the charter contract. If the charter company does not own its aircraft, but manages aircraft owned by others, the recovery waiver needs to come from the owners themselves. Since it can be unwieldy for every owner to provide a recovery waiver to every charter customer, one option is for the charter company be the agent of the owners for the purpose of issuing recovery waivers.

For fractional owners, the recovery waiver should be in the management agreement or dry lease agreement. Again, bear in mind that the waivers need to come from the aircraft owners, not just the program manager. If this is too cumbersome, one option is to get the program manager to warrant that its repurchase price will exclude diminution in value. This will reduce the likelihood that an owner will have a loss – and thus reduce the incentive for an owner to sue your client.

If there is a recovery waiver from the owner, there should a subrogation waiver from the insurer. When an insurer pays a hull claim, the insurer has the right to subrogate: the insurer may step into the shoes of the aircraft owner in order to recover from the person who damaged the aircraft. If the insurer pays a $250k claim for damage caused by your client's errant car, the insurer may recover that $250k in a negligence action against your client. A waiver of subrogation is an agreement by the insurer that it will not pursue your client to recover the losses it has paid.

A typical subrogation waiver reads as follows: "To the same extent as the aircraft owner waives his rights of recovery against the charter customer, we the insurer waive our rights to subrogate against the charter customer." Note, and this is critically important, the subrogation waiver is meaningless if the aircraft owner has not already waived his rights against your client via a recovery waiver. If your client does not have a recovery waiver, the insurer, despite its subrogation waiver, retains its right to assert a claim against your client for the loss. The subrogation waiver is worthless absent the recovery waiver. The recovery waiver is the true Holy Grail. If you remember only one facet of this insurance article, it should be: **the subrogation waiver is worthless absent the recovery waiver.**

A side point to round out this subject: an aircraft owner may be in peril if he waives his recovery rights without his insurer's permission. If the owner has waived his recovery rights, the insurer, when it steps into the shoes of the owner to subrogate, has nothing to recover: the recovery rights were erased by the owner's waiver. If the owner has waived recovery rights without the insurer's permission, the insurer may recover from the owner for the loss the insurer will incur due to the owner impairing the insurer's ability to recover through the subrogation. In our scenario of a $250k hull loss caused by your client's negligence, the insurer would owe the owner $250k for the loss and have a claim against the owner for $250k for the owner improperly waiving his recovery rights. Netting this out, the insurer doesn't pay for the loss and the owner eats the loss.

To flesh this out further, your client is technically protected if he has a recovery waiver, but does not have a subrogation waiver. In these circumstances, the owner cannot collect from your client due to the recovery waiver; the insurer cannot collect from your client due to the recovery waiver (there is nothing to collect when the insurer steps into the owner's shoes). The absence of a subrogation waiver legally harms only the owner, and not your client. However, I still recommend that you get a subrogation waiver for your client. When the aircraft owner realizes that his recovery waiver, in the absence of a subrogation waiver, may cause him to eat the loss, the owner will have an incentive to dispute the recovery waiver. If your client has a subrogation waiver, the insurer will pay the owner's loss and the owner is unlikely to challenge your client's recovery waiver.

Breach of Warranty

Insurance policies have many conditions that must be met in order for the insurance to cover a loss. The most important conditions include aircraft use, pilot qualifications, and territory. If there is an accident while the aircraft is flown by unapproved pilots, while the aircraft is engaged in an unapproved use, or while the aircraft is outside of the approved territory, the insurer may deny coverage. For a charter customer, it is impractical to verify that the charter company is complying with all of the policy conditions. The fractional owner faces a similar problem, exacerbated by the fact that his aircraft may be operated by thousands of other fractional owners in the fractional program.

The solution is to get a breach of warranty from the insurer. If your client has a breach of warranty, the insurer will provide coverage to your client despite the policy being otherwise breached or invalidated by some unapproved activity. For example, if the fractional program breaches a policy condition by using unapproved pilots, the fractional owner will remain covered if he has a breach of warranty (though the fractional company will not be covered). For a fractional owner, it is imperative to have the breach of warranty encompass acts and neglects not only of the fractional program manager, but of all of the other fractional owners, since they may be operating your client's airplane (via the dry lease exchange agreement under FAR 91 Subpart K).

If an insurer denies a request for a breach of warranty, it indicates that the insurer lacks confidence in the charter company or fractional program. A denial indicates that the insurer perceives a non-trivial risk that its insured will violate a policy condition. This is a caution flag that should prompt you to explore whether your client should have a flying relationship with this operator.

Notice of Cancellation

This section is simple and quick. Make sure that the notice of cancellation gets mailed to your client at his address, not to the address of the charter company or fractional program. Also, bear in mind that "notice of cancellation" is short for "notice of cancellation *by the insurer*." It does not provide notice that the policy has been cancelled at the request of the "Named Insured," nor that the policy has expired, nor that the policy has been materially changed. These are all real risks. If, for example, an insurer is threatening a cash-strapped company with cancellation, the operator, by initiating a request for cancellation, can avoid your client receiving a cancellation notice.

Indemnifications

Indemnifications are more of a contract topic than an insurance topic, but I squeeze this in because the indemnifications section of your client's charter contract or fractional contract may be home to more insurance mischief than any other section. For example, several seemingly reputable operators have adopted indemnification clauses that make their customers responsible for losses that exceed insurance limits – as well as for losses that are not insured. This indemnification language can be so murky that the reader will have no inkling that the language's purpose is to make the customer the backstop insurer. These provisions are all the more galling because it is the charter companies and fractional programs that select their insurance coverage and limits. If a company feels its coverage is inadequate, the company should improve its insurance program rather than offload the risk to its unsuspecting customers. If you encounter an indemnification that makes your client the backstop insurer and the operator refuses to amend that section, have your client take his business elsewhere. There are plenty of charter operators and fractional programs that do not engage in this subterfuge.

Excess Insurance

Excess policies have many wonderful attributes. The policy limits provide coverage that can be your client's – not coverage that is shared amongst the charter company or fractional program, the aircraft owners, and the crew. I have even tailored excess policies so that the limits benefit the purchaser alone – not his guests, nor passengers, nor crew, nor anyone else. Another attribute of excess policies is that they provide a level of coverage in the event that the underlying primary policy does not respond – whether due to cancellation by the charter company or due to your client's failure to get a breach of warranty. Further, an excess policy puts your client in control of the limits. Your client can match the excess limits to his assessment of the exposure – rather than being bound by whatever limits the charter company or fractional program deems adequate.

When selecting an excess policy, avoid policies that have a stacking clause. A stacking clause reduces your client's liability limit by the amount of the limit of any underlying coverage or excess coverage written by your client's same insurer. For example, if your client has a $100 million excess policy written by ABC Insurance and that policy has a stacking clause, and if your charter company has a $75 million policy written by ABC, then your client's $100 million excess policy is reduced to $25 million. Premiums for policies with stacking clauses are not significantly cheaper, so there is almost no economically rational scenario that supports buying an excess policy with a stacking clause.

Beware of excess policies that require a scheduled underlying policy. If a scheduled underlying policy is required, it indicates several unfavorable possibilities: your client's excess policy is void if the underlying policy disappears; your client's excess policy does not respond if the underlying policy fails to respond – whether that failure is due to a policy breach or due to the insolvency of the insurer; and your client's excess policy is void if there is an endorsement or change to the underlying policy. The requirement for an underlying policy is a red flag.

Encourage your client to buy war coverage with his excess policy. The charter company's policy or fractional company's policy probably has a sublimit for third party war liability (claims from people on the ground or for property damage on the ground). Even if your client's operator has a policy with limits of $300 million, that policy probably contains a third party war sublimit of $100 million or $150 million. It is always comforting to increase a sublimit – and that is an excellent function for an excess policy.

It is relatively simple to buy a non-owned or an excess policy to cover charter customers. The exposure is well understood by the insurers and they have policies specifically crafted to provide this coverage.

Fractional Excess

Buying an excess policy to cover fractional owners can be incredibly complicated. There are only two insurers whose policies I like, and those are not necessarily the insurers who excel at providing coverage for fractional programs. Fractional excess policies need to cover the fractional owner for his use of his aircraft, co-owners' use of his aircraft, other fractional customers' use of his aircraft, the fractional program's use of his aircraft, his use of other fractional aircraft, his use of charter aircraft provided by his fractional program, and his use of charter aircraft that he arranges himself. It is exceedingly difficult to procure an excess policy broad enough to encompass the exposures.

For those of you who have not descended into the netherworld of fractional excess policies, this may seem bizarre: I have seen a policy that does not cover the fractional owner for his own aircraft – even though his aircraft and N# were listed on the Declarations page. I have also seen policies that cover the owner's aircraft, but do not cover any of the other aircraft that a fractional owner invariably uses. If your client is contemplating buying a fractional excess policy, or if he already has such a policy, it behooves you to review the policy in painstaking detail. Do not trust that the underwriter understands the nuances of fractional exposures.

Closing

If you have a client who is a charter customer or fractional owner, he is far removed from his operator's insurance process. At the operator's insurance meetings, there is no one present who is focused on covering the needs of your client. Compounding the problem, relatively few charter customers and fractional owners engage an attorney to protect their interests. The paucity of representation begets a paucity of reviews of operators' policies on behalf of charter customers and fractional owners. The paucity of reviews means that you may be the first reviewer – and a plethora of errors await you. It falls upon your broad shoulders to ensure that your client has adequate insurance coverage for his aviation activities. To fulfill your responsibilities to your client, it is imperative that you painstakingly perform the most-dreaded task in all of aviation: reading the insurance policy.

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