

Policy Shortfalls

What may not be covered in your aircraft hull and liability policy.

By Thomas H. Chappell

Diminution of value is a consequential loss

The typical “all risk” aircraft hull and liability policy does not really mean “all risk”. In fact, all aircraft insurance policies, no matter how broad, contain numerous terms, conditions, and exclusions which limit coverage. Although there is no standardized wording in the aviation insurance industry, there are several common threads. One is that no aircraft physical damage policy (hull policy) will pay for loss of value to the aircraft due to damage caused by an accident. Loss of hull value that is the result of damage history is referred to as diminution of value.

In short, diminution of value is not covered by an aircraft hull insurance policy.

Can such coverage be purchased? Some years ago, one of the insurance companies offered a diminution of value endorsement, but only for high valued aircraft. The coverage was expensive and few endorsements were sold. As a result, I have not seen this coverage offered in quite some time.

If your aircraft is damaged by someone else, they would be responsible for the consequential loss. It would be expected that such a loss would be covered by the appropriate liability policy of the negligent party. The trick is to prove exactly what the reduction in value actually is.

Conversion by a permissive user

Sound familiar? I have written about this short topic several times in the past. Yet, when I mention the subject of conversion, I continue to get blank looks. Let’s touch on the subject again.

If you loan, rent, lease, or consign your aircraft, you could be setting yourself up for an uncovered loss. The fact is, if anyone is allowed to operate your aircraft with your permission and never returns your plane, your insurance carrier may not consider this to be a theft. It may be conversion by a permissive user and, depending upon the specific wording in your aircraft hull policy, may be excluded.

The following wording was taken from the USAIG All-Clear 360 policy.

“Embezzlement. We won’t cover loss or damage to your aircraft caused when someone with a legal right to possess the aircraft embezzles or converts it under a

lease, rental agreement, conditional sale, mortgage or other legal agreement governing the use, sale or lease of property.”

The U.S. Specialty Insurance Company (USSIC) policy uses slightly more restrictive wording that tends to be more traditional.

“We will not pay for physical loss of or damage to your aircraft if anyone to whom you relinquish possession of the aircraft embezzles, converts, or secretes the aircraft.” The underwriter expects that you will use good judgment when allowing others to use your aircraft. I guess there is no substitute for good management practices.

How can such a loss be covered? Only in the case of an employee pilot can such insurance be purchased. This is referred to as “Employee Dishonesty” coverage. In most cases, such coverage is readily available from your insurance agent (not from an aviation underwriter) and is not very expensive. There is a catch. You knew there had to be one, right? Most companies require that coverage be purchased on all your employees not just one select employee or position.

If you own a company that has a large number of employees, employee dishonesty coverage may already be a part of your insurance package. You may just need to increase the coverage limit to accommodate the value of the aircraft.

What about covering permissive users that are not employees? Can coverage be purchased? I know of no way to cover fraud or embezzlement. Good management may be the only recourse. The next time you throw someone the keys to your plane, be sure they are trustworthy.

Products Liability

So you are just an aircraft owner. You are not a dealer. You just hire a pilot or fly the plane yourself. You have all your maintenance done professionally by the most respected shops. Your whole purpose in owning an aircraft is to go from point A to point B. You are a good citizen, pay your bills and taxes (lots of taxes) and ride in or fly your aircraft.

But you want a newer, bigger, faster, airplane. Well you know the picture. So, you sell your aircraft and buy a new one.

The unthinkable occurs. Your old aircraft crashes and the lawsuits start to fly. Everyone is named in the suit. The aircraft manufacturer (if the aircraft is less than 18 years old), the maintenance facilities that maintained your old aircraft, the aircraft dealer that sold your old aircraft, and you, all get the opportunity to defend yourselves in court. Why? The claimant’s attorneys are looking for deep pockets. The more “pockets” the attorneys can draw into the fray, the better their chances of upping the legal awards. It is all about the money, not who is right and who is wrong. You could be involved simply because

you owned the aircraft. You do not have to be negligent to be accused. This exposure is referred to as “products liability incidental to the sale of aircraft”.

Can this exposure be insured? Yes it can with many companies, but only if you qualify for the best policies. Policies such as Global Aerospace’s “Broad Horizon” policy, AIG’s “Gold Medallion”, Starr’s “Elite”, and others provide incidental products liability. Some companies don’t automatically include incidental products liability in their basic policy form but will endorse it to their policy upon request. (Note, not all underwriter’s offer this coverage to every insured and most agents do not offer it unless asked by the client.)

Feel better? Not so fast. Most policies written today in the general aviation insurance industry are written on an occurrence policy form. If an accident occurs, the policy in force at the time of the loss is the one that pays. (Not the policy in force at the time your aircraft is sold.) This means, as long as your old aircraft is operational, you have an exposure and may want to maintain coverage for incidental products liability. If at some point you no longer own an aircraft and no longer purchase aircraft insurance, you will have no products liability coverage.

When premiums become fully earned

If your policy is canceled prior to normal policy expiration, should you expect a return of your unearned premium? It depends upon the situation.

If the policy is canceled at the insurance company’s request you will expect to receive the unearned premium on a prorated basis. This means the company will return 1/365th of the premium for each day remaining on the policy.

If the policy is canceled at the insured’s request, the insurance company could impose a short rate penalty returning only a portion of the unearned premium. This penalty is not a flat percentage. A standard short rate table is used to calculate premium returns. The cancellation penalty decreases as the policy nears maturity. For the purpose of “dirty math” you can use a rule of thumb of a 10% premium penalty.

This is not the end of the cancellation story. Most aircraft hull policies stipulate that in the event of a total or constructive total loss, the hull portion of the premium becomes fully earned. You will receive a prorated return of the unearned liability premium, but not the hull premium. Obviously, if the loss occurs early in the policy period, the actual amount of the hull premium that would be forfeited would be greater.

The cost of hull insurance can be quite expensive on high valued aircraft or those used for more hazardous missions such as aerial applications. In these situations, some (not all) underwriters will offer the insured the opportunity to purchase “premium insurance”. This is an endorsement that removes the fully earned hull premium requirement.

There are no absolutes in the insurance industry. A true Lloyd’s policy form may require that both the hull and liability premium is fully earned in the event a loss exceeds the

amount of the premium earned at the time of the loss. This makes the value of premium insurance greater.

Also note, not all underwriters will offer the opportunity to purchase premium insurance. This varies by company and can be quite expensive depending upon the individual insurance company's philosophy.

Worker's Compensation or Aircraft Liability

The age old debate of the employment status of your pilot(s) may be decided in court after a bodily injury claim occurs. Is the pilot an independent contractor (contract pilot) or an employee?

It has long been a standard in the general aviation industry that many pilots who "moonlight" hold themselves out to be independent contractors. The aircraft owners are not expected to withhold taxes or to provide employee benefits or workers compensation.

This situation is bothersome, however. Just agreeing that a pilot is an independent contractor does not make it so. What if a loss occurs and the pilot is injured or killed. Will he or his family expect to receive compensation for his injuries? Will he remember after the loss that he was a contract pilot and no benefits were offered?

This is certainly a gray area at best. The Internal Revenue Service and the individual states publish a list of tests that will determine whether the worker is an employee or an independent contractor. The state workers compensation laws are very specific as to who is an employee and who is an independent contractor. I would strongly encourage anyone who owns an aircraft to research this topic. You can then plan for the worst case scenario.

One surefire way to solve the problem is to declare the pilot to be an employee. Agree in the compensation negotiations that the aircraft owner will withhold taxes and Social Security (just reduce the daily pilots salary a bit) and provide workers compensation insurance. Usually, aircraft are owned by a shell LLC or corporation with no other employees. This eliminates any discrimination of benefits that might occur with larger employee groups.

Won't this be expensive? Workers compensation is calculated as a rate on each \$100 of payroll. Each state establishes their rate structure. A general aviation pilot rate is usually 5% to 6% of the pilot payroll. Full-time or part-time, it is all the same.

So, we have a solution? Yes, on the insurance side we do. What about the FAA? If our shell corporation provides both the aircraft and the pilot to the parent company who ultimately pays the expenses, isn't this considered part 135 charter use?

Some of my more astute clients have set up a separate LLC as an aircraft management firm. The aircraft is owned in a shell LLC and the crew is employed by a separate LLC that provides aircraft management and pilot services exclusively to the owner. The two

check rule may be applicable and could avoid a conflict with the FAA. Oh, don't forget to name the pilot services LLC as a second named insured or as an additional insured with a waiver of subrogation on your aircraft insurance policy.

Now, we don't have to speculate on what would happen if a contract pilot is injured or how a court would rule. We have spent a bit of extra money and taken ourselves out of harms way and helped the pilot in the process. Workers compensation is the sole remedy for employee injuries in most jurisdictions. And the pilot, as an employee, will be protected for liability losses under the aircraft hull and liability policy.

See it does pay to read the "fine print". →