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Leasing and Structured Finance Update

AIRCRAFT LIABILITY ISSUES REVISITED POST 9-11

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Your employer and client, the leasing company, comes to its legal department with a draft term sheet for the synthetic lease of a corporate aircraft with an acquisition cost of $40 million. The term sheet includes all risk liability insurance in the amount of $100 million. Your comments are required as per usual but there is a new and timely note. You are requested to comment and advise on lessor's exposure for personal injury and property damage claims occasioned by hijacking and destruction of the aircraft.

BACKGROUND. Most aircraft in your portfolio have the benefit of an endorsement to the all risk policy providing coverage from "war risk and allied perils" but each such endorsement allows the insurance company to terminate coverage at any time with seven days notice. Your leasing company is now in receipt of such notice for every aircraft in its portfolio.

RETURN TO FUNDAMENTALS. You understand that if the first level of response and defense to such exposure is through insurance, there can be no adequate answer. It is time to confirm that the law of more than two generations in the leasing industry today protects a finance lessor[1] under most circumstances from strict liability and vicarious liability for personal injury and property damage caused by aircraft in its portfolio.

You recall the general rule under federal law that protects a finance lessor from strict liability for personal injury and property damage caused by an aircraft in its lease portfolio which it does not control or operate and this federal rule preempts state legislation to the contrary. You also recall the general rule under state law that the owner lessor of an airplane is not liable for injuries to third parties or their property caused solely by the negligence of its lessee or bailee in the operation of the airplane[2] when the lessee or bailee is operating the airplane for its own benefit and not on behalf of the owner,[3] and that this rule extends to the intentional reckless actions of third parties otherwise in control of the operation of the airplane without the consent of lessor. The owner of an airplane operated by a lessee or bailee is responsible for owner's own negligence and has been held liable for injuries to third persons caused by such negligence,[4] and there can be exposure and liability for a lessor in knowingly entrusting an airplane to one who is inexperienced or incompetent. It is time to confirm the specifics of the federal legislation and the extent that it preempts state law to the contrary.

FEDERAL LAW

Your research confirms Section 44112 of the Federal Aviation Act (the "Act") which provides: "A lessor, owner, or secured party is liable for personal injury, death, or property loss or damage on land or water **only** when a civil aircraft, aircraft engine, or propeller is in the **actual possession or control** of the lessor, owner, or secured party, and the personal injury, death, or property loss or damage occurs because of (1) the aircraft, engine, or propeller; or (2) the flight of, or an object falling from, the aircraft, engine, or propeller."[5]

Section 44112 of the Act defines "lessor" to mean "a person leasing for at least 30 days a civil aircraft, aircraft engine or propeller".

Section 44112 of the Act may be viewed as a two-edged sword. On one hand, it may create liability for the lessor who engages in short-term leasing, meaning leases with a term of less than 30 days. On the other hand, Section 44112 of the Act is a shield that protects lessors from liability to third parties unless they enter into leases with terms less than 30 days or are in actual possession or control of the aircraft.

PREEMPTION OF STATE LAW CLAIMS

You remember some older preemption cases and your research confirms the case law in this area. A number of federal courts have considered whether Section 44112 of the Act preempts state law otherwise imposing strict liability on owners and secured parties of aircraft for injury to person or property caused by an aircraft outside of the operational control of lessor or secured party. In *Matei v. Cessna Aircraft Co.*, 35 F.3d 1142 (7th Cir. 1994) the Seventh Circuit Court of Appeals considered but did not decide the application of Section 44112's predecessor (Section 1404) and affirmed summary judgment for the owner/lessor where the evidence showed that the lessee had exclusive possession and control of the aircraft at the time of the accident. The district court in *Matei*, however, was specific in finding that the applicable state law, as applied to the owner/lessor, was preempted by Section 44112's predecessor (Section 1404). Specifically, the district court in *Matei* held that: "[t]his provision [Section 1404] preempts any contrary state law." The only federal appellate decision to address the issue of preemption in this context concluded in *dicta* that: "[t]his provision appears *clearly* and forthrightly to preempt any contrary state law. . . " *Rogers v. Ray Gardner Flying Service, Inc.*, 435 F. 2d at 1394. In fact, you can find no federal decision denying preemption by Section 44112 of the Act on this question.[6]

Earlier this year the United States District Court, S.D. Indiana, reviewed this issue in its opinion *In re: Lawrence W. Inlow Accident Litigation*, February 7, 2001.[7] You skimmed this case in the springtime but it has new significance today. Mr. Inlow was fatally injured by a helicopter rotor blade after he disembarked from the helicopter. The helicopter itself had been acquired by GECC from Aerospatiale Helicopter Corporation for lease to Conseco Investment Holding Company which, in turn, subleased the helicopter to Conseco, Inc. Summary judgment was granted and the case dismissed against the lessor relying upon federal preemption under Section 44112 of the Act. The Court noted that Section 44112 was enacted in 1948 to facilitate the financing of aircraft and continued:

"The plain language of Section 44112 establishes that it preempts state common law claims against covered lessors. The statute provides that a 'lessor' . . . is liable for personal injury, death, or property loss or damage . . . only when a civil aircraft, aircraft engine or propeller is in the actual possession or control of the lessor. . . the word 'only' could have effect only if the statute preempts claims against lessors arising under state law."[8]

The *Inlow* Court went on to note that if there were any doubts of the meaning of the word "only" in Section 44112(b) the legislative history of the original provision should put such doubt to rest. The Court concluded that the House Report in 1948 shows that Section 44112(b) was a direct response to the Uniform Aeronautics Act which was then in force in at least ten states including Indiana.[9] Those state laws as they existed in 1948 declared the "owner" of every aircraft "absolutely liable" for injuries caused by the flight of the aircraft, regardless of the owner's degree of control over a lessee. The Court in the *Inlow* case concluded with reference to Section 44112(b) that the "statutory provision was plainly intended and plainly written to preempt such state statutes and parallel common law claims." And further, the Court reasoned:

"The application of the statute does not call for any inquiry into whether the lessor's role in financing a transaction was necessary, convenient or anything else. The issues under the statute are whether there was a lease for more than 30 days and whether the lessor had actual possession or control of the aircraft."[10]

With this requirement that a lessor must be in actual possession or control of the aircraft at the time of the accident, the Court reasoned that Section 44112 "prevents the imposition of liability on lessors that are not engaged in some concrete fashion in the operation of the aircraft."[11]

Your research also discloses that prior to June of 1948 some courts had construed certain provisions of the Uniform Aeronautics Act and the rules and regulations promulgated thereunder as creating vicarious liability on the part an owner of an aircraft. Specifically, the Uniform Aeronautics Act defines "operation of an aircraft" to include owning an aircraft. Further, the Uniform Aeronautics Act statutorily prohibits operating an aircraft in violation of the rules promulgate under the Uniform Aeronautics Act. And finally the rules promulgate under the Uniform Aeronautics Act require that each aircraft be operated in a manner which is not reckless or careless. By weaving these three provision together, some courts had found owners vicariously liable when the aircraft operator was careless or reckless.

With this body of law clearly in mind, the Report from the House of Representatives which accompanied the 1948 amendment to the Civil Aeronautics Act of 1938 and introduced Section 44112[12] referred to the Uniform Aeronautics Act in the following statement of objective:

"Provisions of present Federal and State law might be construed to impose upon persons who are owners of aircraft for security purposes only, or who are lessors of aircraft, liability for damages caused by the operation of such aircraft even though they have no control over the operation of the aircraft. This bill would remove this doubt by providing clearly that such persons have no liability under such circumstances."[13]

The Report went on to comment regarding the then current status and effect of the Uniform Aeronautics Act noting that it would impose liability "upon any person registered as owner, even though he holds title only as security under a mortgage or other similar security instrument or as lessor under an equipment trust. . . . An owner in possession or control of aircraft, either personally or through an agent, should be liable for damages caused. A security owner not in possession or control of the aircraft, however, should not be liable for such damages. . ."[14]

CURRENT STATE LAWS

What then is the status of any state law seeking to impose strict liability or vicarious liability upon an owner or lessor of aircraft? You review the existing law of all 50 state jurisdictions plus the District of Columbia, Puerto Rico, Guam and the Virgin Islands for statutory law that might (i) impose strict liability against the owner of an aircraft, registered or otherwise, under a true lease or a synthetic lease or against a lender holding a security interest in the aircraft causing the personal injury or property damage; or (ii) create vicarious liability against the owner or lessor of an aircraft, registered or otherwise, for the negligent actions of the operator of the aircraft.

It appears that seven jurisdictions have adopted legislation substantially comparable to Section 44112 of the Act thereby shielding a lessor or secured party not in operational control of the aircraft from strict liability in tort. You note that there are an additional thirty-five jurisdictions that have no statutory law imposing strict liability or vicarious liability upon an aircraft owner or secured party. Finally, you identify twelve jurisdictions which purport to create by statute strict liability or vicarious liability on an owner of an aircraft. It appears that ten of the jurisdictions in this last category have statutory law predating the 1948 amendment to the Act, which statutory laws remains today substantially similar to Section 4 of the Uniform Aeronautics Act which was intended to be superseded and preempted by the 1948 amendment. You conclude that on their face these provisions are still good law in each such jurisdiction, but when applied to lessors who lease for more than thirty days and who do not have actual possession or operational control of the aircraft, these provisions should have no force or effect as they are preempted by the 1948 amendment to the Act. A chart providing a summary of such state law is attached hereto.

California and Minnesota are the two jurisdictions with statutory provisions which post-date the 1948 amendment. California adopted its provision in 1953. In 1969, however, your research discloses that the California Attorney General issued an opinion interpreting the state statute in light of the 1948 federal statutory amendment. The California Attorney General stated that: "[t]he term 'owner' as used in . . [the California statutory provision creating strict liability on the part of an aircraft owner] does not include the holder of a security interest who is not in possession of the aircraft" or "lessors under a lease executed as part of a plan to finance the purchase of aircraft."

The second jurisdiction, Minnesota, adopted a vicarious liability statutory provision in 1976. In particular, Section 360.0216 of the Minnesota Statutes provides as follows:

> "When an aircraft is operated within the airspace above this state or upon the ground surface or waters of this state by a person other that the owner, with the consent of the owner, express or implied, the operator shall in case of accident be deemed the agent of the owner of the aircraft in its operation."

Under the terms of this statutory provision, if the operator of the aircraft is negligent then such negligence by statute is imputed to the owner. As applied to lessors who lease for more than thirty days and who do not have actual possession or control of the aircraft, this provision should be in your opinion preempted by the 1948 amendment to the Act.

HIJACKING AND WAR PERIL COVERAGE

You have concluded and your memorandum comments reflect that the first answer for a finance lessor to this issue is in the immunity to liability provided by Section 44112 of the Act and its preemption of all state law to the contrary. But you must also comment on the apparent plan to proceed with all risk coverage only and without war risk and allied peril coverage.

Your research discloses that in *Pan American World Airways, Inc. v. Aetna Casualty & Surety Company*, 505 F.2d 989 (2d Circuit 1974), the Second Circuit Court of Appeals had held that where members of a political activist group from Jordan hijacked an aircraft over London and destroyed the aircraft on the ground while in Egypt, the resulting loss to the aircraft was not due to war within the meaning of the term as used in the exclusionary clauses of the "all risks" policies covering the aircraft at that time.

You are also aware of the decision of the United States District Court in *Holiday Inns, Inc. v. Aetna Insurance Company*, 571 F. Supp. 1460 (S.D.N.Y. 1983), quoting extensively and approvingly from the Pan American case cited above, declined to apply the war risks exclusion to a claim for damage to a hotel that was shelled during the battles in Beirut, Lebanon.

But reliance upon all risk coverage to protect your lessee against the risk of hijacking is misplaced and you know that you cannot rely on the narrow holdings in these earlier cases today. In the Pan American case, the court resolved ambiguity in the policy terms against the all risk insurer but specifically noted that various exclusionary terms then in use or being considered for use would have excluded the loss had they been employed. When the all risk insurers failed in 1974 to exclude "political risks" in words descriptive of current world events, the court concluded that they acted at their own peril. You know that such ambiguity is not likely to be the case today. You always prefer a closing procedure that includes the receipt of the full insurance policy but you know that such procedure is frequently the subject of objection and that lessees often prefer to deliver only a broker's certificate. Absent a full review of the policy disclosing the terms of hijacking coverage which you do not now anticipate, you have no basis to conclude that an all risk policy will provide coverage against hijacking.

You conclude and your memorandum reflects that a decision to allow lessee to self-insure for war risk is solely a credit decision impacting the lessee, its cash flow and reserves and does not expose a lessor or secured party not in possession or control of the aircraft or engaged in short-term leasing to potential liability.

54 JURISDICTION SEARCH OF AIRCRAFT LIABILITY STATUTES
October 19, 2001

By: Andrew P. Sutor, IV

Jurisdictions with no statute expressly imposing strict liability/vicarious liability on an owner of an aircraft:(35 of 51)

Alabama	Alaska	Arizona
Colorado	Connecticut	District Of Columbia
Florida	Georgia	Guam
Illinois(1)	Indiana	Iowa
Kansas	Kentucky	Louisiana
Maine	Massachusetts	Mississippi
Missouri	Montana	Nebraska
New Mexico	North Carolina	Oklahoma
Ohio	Oregon	Puerto Rico
Rhode Island	Texas	Utah
Virgin Islands	Virginia	Washington
West Virginia	Wyoming	

Jurisdictions with statutes similar to Section 44112 of FAA Statute:(7 of 54)

Arkansas	New Hampshire	New York	North Dakota
Pennsylvania	South Dakota	Tennessee	

Jurisdictions with statutes imposing strict liability/vicarious liability on an owner of an aircraft. (12 of 54) {[year] = year adopted}

California[1953](2)	Delaware[1935]	Hawaii[1923]
Idaho[1931]	Maryland[1924]	Michigan[1945](4)
Minnesota[1976]	Nevada[1923](3)	New Jersey[1946](3)
South Carolina[1929](3)	Vermont[1923]	Wisconsin[1929]

(1) Case law holding that Section 44112 does not preempt state common law imposing liability. State law was a common law products liability claim. (*Retzler*)

(2) Attorney General Opinion 69-151 (October 9, 1969). The term "Owner" as used in the statute does not include (i) holders of a security interest and (ii) lessors under a lease executed as part of a plan to finance the purchase of the aircraft.

(3) Statute excludes chattel mortgagees and conditional vendors from definition of "owner."

(4) Case law holding that Section 44112 preempts state statutory liability for injuries on the ground -- but not for injuries inside the plane. (*Storie / Sexton*)

[1] The term "finance lessor" as used herein predates the use of the term "finance lease" now included in UCC Article 2A and otherwise used in lease accounting. *Francioni v. Gibsonia Truck Corp.*, 372 A.2d 736, 740 (Pa. 1977). The term "finance lessor" as used herein and in the cases on product liability is in distinction to the "commercial lessor", the classic example of which is a car rental agency.

[2] *Nava v. Truly Nolen Exterminating of Houston, Inc.*, 683 P.2d 296 (Ct. App. 1984) (owner of an airplane was not liable for injuries resulting from an airplane crash during a test flight after a repair and during a bailment for the repair); *McDaniel v. Ritter*, 556 So. 2d 303 (Miss. 1989). Tort liability of one renting or loaning airplane to another, 4 A.L.R. 2d 1306 § 3.

[3] *Rich v. Finley*, 89 N.E.2d 213 (Mass. 1949).

[4] *Matei v. Cessna Aircraft Co.*, 35 F.3d 1142 (7th Cir. 1994) (defective condition of plane); *Southeastern Air Service v. Crowell*, 78 S.E.2d 103 (Ga. 1953) (defective condition of plane).

[5] 49 U.S.C.A. §44112 (West 2001).

[6] There are two state cases to the contrary, denying federal preemption defenses asserted by aircraft lessors. These cases are neither well reasoned nor likely to be controlling on the issue presented: (i) The opinion of the Illinois Court of Appeals in *Retzler v. Pratt & Whitney*, 723 N.E. 2d 345 (Ill. App. 1999) is reviewed and convincingly rejected by the District Court in the *Inlow* case. *Retzler* relied on a Third Circuit decision, *Abdullah v. American Airlines, Inc.*, 18, F.3d 363 (3rd Cir. 1999), analyzing passengers' tort claims against an airline for injuries caused by turbulence. *Retzler* also relied upon the silence of the Seventh Circuit's decision in *Matei* on the preemption issue. (ii) See also *Sexton v. Ryder Truck Rental, Inc.*, 320 N.W. 2d 843 (Mich. 1982) in which the preemption argument is rejected without discussion.

[7] *In Re Lawrence W. Inlow Accident Litigation*, No. IP 99-0830-C H/G, 2001 WL 331625 (S.D. Ind. Feb. 7, 2001).

[8] Id. at *15.

[9] Section 4 of the Uniform Aeronautics Act, as in effect in at least 10 states prior to June of 1948, provided as follows:

> "The owner of every aircraft which is operated over the lands or the waters of this State is absolutely liable for injuries to persons or property on the land or water beneath, caused by the ascent, descent, or flight of the aircraft, or the dropping or falling of any object therefrom, whether such owner was negligent or not, unless the injury is caused in whole or in part by the negligence of the person injured, or of the owner or bailee of the property injured. If the aircraft is leased at the time of the injury to persons or property, both owner and lessee shall be liable, and they may be sued jointly or either or both of them may be sued separately."

Uniform Aeronautics Act §4.

[10] *Inlow*, 2001 WL 331625 at *14.

[11] Id. at *18.

[12] Formerly 49 U.S.C. § 1404.

[13] H.R. Rep. No. 80-2091 (1948), *reprinted in* 1948 U.S.C.C.A.N. 1836.

[14] Id. at 1837.