Lessor, Financier, and Manufacturer Perspectives on the New Third-Party Liability Conventions

By Jeffrey Wool

In the previous edition of this publication, my learned colleagues Sean Gates and George Leloudas reviewed, from the perspective of the air transport and insurance industries, the proposed new third-party liability conventions adopted at the International Conference on Air Law in Montreal in April and May 2009.[1] This article provides a lessor, financier, and manufacturer perspective on the new conventions, primarily the Convention on Compensation for Damage to Third Parties, Resulting from Acts of Unlawful Interference Involving Aircraft (the UIC). This anodyne abbreviation veils the actual subject matter of this convention: terrorism, and the unique legal challenges that pertain to terrorism. The article also assesses the Convention on Compensation for Damage Caused by Aircraft to Third Parties (covering general risks, thus referred to as "the GRC")—that is, damages from ordinary course operational incidents.

Impact of September 11th

Work leading to the UIC began as a consequence of, and immediately following, the events of September 11, 2001. A prompt and direct result of 9/11 was the withdrawal of aviation insurance cover and the halt of air transport. To permit the resumption of air transport, government-supported war risk insurance was needed to address contractual, risk management, and corporate governance issues. Such government support was viewed as a stop-gap measure. It was clear across the air transport sector that a more lasting solution to risk management in the terrorism context was required, and that such solution needed to be global in nature. To that end, within weeks of 9/11, the Aviation Working Group (working with the International Coordinating Committee of Aerospace Industries Associations) and IATA submitted to ICAO a proposed draft convention limiting liability. ICAO's focus was multipronged: in the short term, governments were requested to provide national war risk insurance or guarantees; in the medium term, work was intensified on a global war risk insurance program;[2] and in the longer term, a treaty would be developed.

Perceptions tend to change over time. The fortunate absence of major aviation terrorist events since 9/11 has led some to lose sight of the general principles and ideas that animated thinking and discussion at that time. Should another major terrorist event occur, these principles and ideas undoubtedly would resurface, but law and policy should not depend on the success or failure of terrorists. Rather, the following principles should remain paramount.

First, aviation terrorism is an act against governments. Like others harmed by terrorism, aviation industry participants are victims as well. To the extent that airlines are asked to compensate other victims, this approach stems more from an interest in efficiency than from the application of accepted legal principles of fault. Policies underlying strict liability are stretched beyond reasonable recognition in the terrorism context. Similar arguments apply to negligence-based liability, given that terrorist acts by definition involve intervening criminal conduct designed to maximize damage of which it is the proximate cause. This principle will be called the "industry-as-victim principle."

Second, following from the industry-as-victim principle, any allocation of legal risk to airlines for acts of terrorism must be limited by the amount of insurance available on a commercially reasonable basis. Anything else would undercut the efficiency basis for liability, and, thus, would be inappropriately punitive. This linking of liability and insurance, a necessity in this context, was taken as a given after 9/11. As time has passed, however, some have lapsed back into unhelpful formal distinctions—such as liability is one thing, insurance is another. No government would have acted differently than the United States when it retroactively limited 9/11 liability to the amount of insurance in place at that time.[3] This principle will be called the "insurance liability cap principle."

Third, as this article's focus reflects, 9/11 materially and adversely impacted the entire industry, not only the airlines. Insurance was withdrawn for other industry participants, which raised the same risk management and corporate governance issues faced by airlines. Customary indemnities given by airlines were weakened, given the latter's insurance problems. These developments adversely affected the airlines

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(uninsured direct exposure) and the indemnitees (uninsured credit exposure). One need look no further than the range of 9/11 defendants to observe the risks of protracted litigation and potential liability faced by the entire industry. A corollary of multiparty litigation, common in the aviation industry, is that limiting the liability of one party directly impacts the potential exposure of other parties.[4] The aviation industry is integrated, with overall air transport dependent on the working of the entire system. This principle will be called the "integrated industry principle."

The above principles underlie the U.S. government's post-9/11 legislation, the FAA war risk insurance program, and the statutory limits placed on liability. They also formed the conceptual basis for ICAO's Globaltime compensation scheme, which contemplated the provision of funds—to all industry participants—to address liabilities, including in the case of further restrictions of commercial insurance. They should animate the solutions adopted by the international community in these conventions.

Lessors, financiers, and manufacturers

In the case of lessors and financiers, 9/11 raised basic risk considerations, particularly in jurisdictions where such parties could be exposed to strict liability (relatively few) or the prospect of complex and protracted litigation. The fundamental point, which must guide policy regarding these parties, is that the economics and structure of the aviation industry simply do not support any third-party (or passenger) liability against lessors or financiers. These entities merely provide a financial service: the provision of credit. Airlines have operational responsibility. Governments have regulatory responsibility. This reality is reflected in many—though regrettably not all—jurisdictions. Law and policy support this reality, as reflected in U.S. federal law, as properly interpreted.[5]

In the case of manufacturers, three threshold points apply. First, governments, in approving an aircraft's design, have ultimate responsibility for antiterrorism features. It follows that manufacturers should have no liability for the consequences of such governmental decisions. Manufacturers are bound by these governmental determinations, which have been made in light of a wide range of policy considerations—such as policy preferences on preventing terrorists, passenger safety, available technology, cost, and military and technology transfer issues. One example of such a determination is whether antimissile technologies should be included on an aircraft, a matter beyond the control of manufacturers. Another example is the nature and extent of cockpit security. Second, the insurance liability cap principle applies to manufacturers. Clearly, the same policies applicable to airlines apply in favor of limiting manufacturers' product liability in the terrorism context to available insurance. Third, in accord with the integrated industry principle, limiting airlines' liability increases risks to manufacturers, the other party customarily involved in aviation accident litigation.

The UIC: Key provisions

At a conceptual level, the UIC represents a breakthrough in air law. For the first time, a major international air law instrument recognizes and advances the integrated industry principle. Previous air law instruments have equated airlines with the industry as a whole. The liability of others was beyond the scope of such instruments, meaning that they were left to applicable law.[6] One could argue in principle or in context about the merits of such an approach, and the complexity and thus the procedural implications of any other approach. But no reasonable argument can be made that ignoring the integrated industry principle is sound law and policy, while limiting liability for airlines. Such an approach contains a zero-sum game element: other industry participants potentially face greater exposure, as they become comparatively more attractive as litigation targets. ICAO and the states at the diplomatic conference deserve credit for this breakthrough.

The means by which the integrated industry principle was followed was through the exclusive remedy provision. Given its importance, the text is set out in full as follows:

> *Article 29—Exclusive remedy*
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> 1. Without prejudice to the question as to who are the persons who have the right to bring suit and what are their respective rights, any action for compensation for damage to a third party due to an act of unlawful interference, however founded, whether under this Convention or in tort or otherwise, can only be brought against the operator and, if need be, against the International Fund and subject to the conditions and limits of liability set out in this Convention. No claim by a third party shall lie against any other person for compensation for such damage.
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> 2. Paragraph 1 shall not apply to an action against a person who has committed, organized or financed an act of unlawful interference.

This provision, while superficially similar to parallel clauses in other air law instruments, is in fact quite new.[7] It channels liability to the operators. It prevents actions by third-party victims against others. Based on the last sentence in Article 29(1), such actions must be immediately dismissed (to the extent there is jurisdiction in the first place). Channeling was inspired by other international instruments (outside of aviation) addressing low and unknown probability but high magnitude liability exposure, which present insuring difficulties.[8] In the present context, channeling provides a sound and economically efficient approach; it assigns liability to those best able to insure and collectivize the risk. It limits the exposure to the assigned party, taking into account insurance available on a commercially reasonable basis.

This channeling concept is based on the UIC's general approach of advancing compensation objectives, rather than assigning blame through liability rules, as traditionally formulated and justified.[9] The "compensation versus liability" question is the prism through which the UIC is best understood. Compensation generally prevailed: the UIC seeks to provide victims with compensation, and does so in a functional manner. The basic elements are strict liability of the airline up to a capped amount, with further claims made against an International Fund,[10] financed by passenger and cargo-based contributions. The airlines, supported by the wider industry, sought a "hard" or "unbreakable" cap through procedures designed to provide a certified safe harbor as a quid pro quo for liability, which they do not deserve in the terrorism context (per the industry-as-victim principle).[11] That hard cap was regrettably diluted.

Grasping the full picture on liability for lessors, financiers, and manufacturers requires a summary of Articles 24, 25, 26, and 27 of the UIC. Articles 24 and 25 establish rights of recourse in favor of the operator (airline) and the International Fund against "any other person." There are no express substantive or procedural standards governing that right, meaning that such is determined under applicable law. This point was confirmed on the record, following a statement and direct question by the Aviation Working Group. There could be no other sensible interpretation, particularly given that a "person" is defined in Article 1(g) to include a state.

Articles 26 and 27 restrict any right of recourse under applicable law. Article 27 contains two direct and complete restrictions. First, no right of recourse shall lie "against an owner, lessor, or financier retaining title to holding security in an aircraft," where such is not the operator (meaning the airline controlling or making use of the aircraft (see Article 1(f)). This is a wide restriction, which, in a stroke, sweeps aside concepts of strict liability and assertions of negligence. It realistically reflects and promotes the basic structure and economics of the aircraft leasing and financing industry. Second, Article 27 prevents recourse "against a manufacturer if that manufacturer proves that it has complied with the mandatory requirements in respect of the design of the aircraft, its engines or components." This provision is intended to address, and reject, potential claims such as whether antimissile technology is included on an aircraft and the design of cockpit security. The concept of "design" should be read broadly. Manufacturers, which will carry the burden of proof for this exclusion, are well advised to ensure that any design requirements related to antiterrorism are fully and clearly documented.

Article 26(1) further restricts any right of recourse under applicable law "to the extent the person against whom recourse is sought could have been covered [by] insurance available on a commercially reasonable basis." The word "commercially" was added to the pre-diplomatic conference text. That addition indicates that the provision is linked to standard business decision making; it should not require a higher level of cover than is customary. Efforts were made to provide more objectivity, including through an amendable schedule set out by the Conference of the Parties. States, however, did not agree. Thus, a court would determine the amount of insurance available on a commercially reasonable basis. This provision reflects the insurance liability cap principle—with only one modification. Article 26(2) states that, in an otherwise permissible recourse claim by the International Fund (but not by the operator), the insurance cap does not apply where the person against whom recourse is sought has acted "recklessly and with knowledge that damage would probably occur." While this standard for breaking the cap is relatively high, the clause is misguided. It could potentially be invoked in claims against a manufacturer for nondesign issues. As the clause is limited to action by the International Fund, a collective decision would be required regarding any such "reckless" conduct. To some degree, this procedural step will minimize the risk of speculative and strategic assertions.

A final point on Article 29(2). That clause removes the exclusion for financiers in respect of a person, inter alia, who "financed *an act* of unlawful interference" (i.e., terrorism) (emphasis added). This provision should be interpreted narrowly. The entity must have financed the actual terrorist act. Changes were made from a prior, interim draft that could have been read as casting a wider net, to include the general financing of terrorism. The final, narrower text reflects that the UIC is not the proper place to address broader questions relating to the financing of terrorism.

Assessment

Turning to the assessment of the UIC as applied to lessors, financiers, and manufacturers, one may draw several conclusions. Lessors and financiers are fully protected from direct claims by third parties and recourse claims by the operator/airline or the International Fund. Likewise, such protections apply equally to manufacturers as regards matters relating to approved antiterrorist design, provided they carry the burden of proof on its mandatory character. In the case of normal product liability claims against a manufacturer (e.g., improper performance of its manufacturing of the governmentally approved design), recourse, but not direct, claims are permitted. Applicable law determines the standards for any such recourse claim, but such recourse is capped by the amount of insurance available to manufacturers on a commercially reasonable basis. The only exception to that cap applies in the case of recourse by the International Fund, where a determination must first be made that a manufacturer acted recklessly and with knowledge that damage would probably occur.

The UIC significantly improves the position of lessors, financiers, and manufacturers regarding design claims—arguably their greatest risk in this context. While imperfect, the manufacturers' position regarding normal product liability is generally improved, when measured against current law in most jurisdictions.

Lessors, financiers, and manufacturers will naturally take into account the position of their airline customers in determining the extent to which they actively support the UIC. There are some concerns in this regard, most notably the softening of the airlines' liability cap. That softening raises questions about adherence to the industry-as-victim principle. The airlines, individually and collectively, must determine their own positions on the UIC. They will likely weigh its terms against their position under current law, while taking into account the payment of passenger and cargo contributions to the International Fund. The airline industry will note other aspects, both positive and negative, in assessing the UIC. On the positive side, Article 18(3) contains a reasonably helpful "drop-down" provision accessing the International Fund, and reducing liability, where insurance is wholly or partially unavailable. On the negative side, a state can declare at time of ratification that the UIC does not apply to domestic flights, which contravened the position of the airline industry (noting that 9/11 involved domestic flights).

General Risks Convention (GRC)

Throughout the development and negotiation of the texts, most state delegations and industry representatives felt that a treaty on third-party liability for general risks was neither necessary nor desirable. Current law is not seen as problematic. Insurance is available at reasonable rates to cover general risks. Legal systems are sharply divided between fault and strict liability regimes, thus making wide acceptance of a harmonized system unlikely. The outdated Rome Convention of 1952, with low limits of airline liability, lacks contemporary relevance, and thus need not be directly superseded by a modernized instrument (*compare* the Warsaw system and the Montreal Convention of 1999). Nonetheless, certain groups of states pressed for adoption of the GRC, principally contending that it will help modernize their national laws. Although this arguably is not the soundest basis for an international convention of this type, overall political considerations resulted in the proposed GRC.

The GRC text is favorable from a lessor and financier perspective. Article 13, following the wording in the UIC, states that "neither the owner, lessor or financier retaining title or holding security in an aircraft, not being an operator, nor their servants or agents, shall be liable for damages under this Convention or the law of any State Party relating to third party damage." This is fortified by Article 11, which prevents recourse by an operator against these entities and persons. Taken together, the GRC provisions, like the UIC, reflect and advance the basic structure and economics of the leasing and financing industry.

From a manufacturer perspective, the GRC is more complex and its merits are more debatable. The starting point is Article 4, in which the airlines are granted a soft cap limiting the amount for which they are strictly liable (Article 4(1)). Article 4(3) provides that cap is breakable on simple negligence. The threshold issue for manufacturers is whether their overall risk has increased or remains roughly the same, measured against current law.[12] The argument for the former is that the airlines have a cap, making the manufacturers more attractive litigation targets by comparison. The argument for the latter is that airlines are strictly liable up to the cap, which may increase their comparative attractiveness as a litigation target. Moreover, the cap is easily breakable, thus not protective in practical terms. A final consideration is that, through Article 12(2), certain limits on types of recoverable damages in favor of the airlines (e.g., preventing punitive damages) also apply in favor of manufacturers.

The future of the UIC and GRC

The entry into force prospects for the UIC are unclear, given the significant differences of opinion on the approach followed by, and details of, that convention. The prospects for the GRC are equally uncertain, in view of basic questions about its necessity and utility. Each of these instruments requires 35 ratifications to enter into force. In the case of the UIC, those ratifications must be from countries with sufficiently high levels of traffic to ensure the capitalization of the International Fund. In practical terms, that means that the UIC needs to be ratified by either the United States or most European Community member states. While little time has passed since adoption of these texts, there is currently no apparent rush toward ratification. Yet circumstances may change, producing different ratification dynamics.

The UIC addresses a critical topic for the air transport sector. Recalling the lessons of 9/11 and the resulting core principles outlined above, all interested parties should consider whether, on balance, the UIC provides a better and more lasting framework than current law to address aviation terror compensation and liability. A strong argument can be made that it does. The UIC also represents a breakthrough in air law: for the first time, the integrated industry principle was followed. Air law should embrace this broader conception of the range of interested parties.

Both the UIC and the GRC provide sensible rules for the treatment of lessors and financiers. These aspects bode well for future legal issues addressed by ICAO and the states that might take ICAO precedent into account in the development of national law.

Endnotes

1. *See* Final Act, International Conference on Air Law, Montreal, Apr. 20 to May 2, 2009, DCCD Doc No. 44. For the final version of the two texts adopted at the Diplomatic Conference, the Convention on Compensation for Damage to Third Parties, Resulting from Acts of Unlawful Interference Involving Aircraft and the Convention on Compensation for Damage Caused by Aircraft to Third Parties, *see* DCCD Doc No. 43 and DCCD Doc No. 42, respectively. No article commenting on the results of the Diplomatic Conference would be complete without commending Mrs. Kate Staples, president of the Conference, for her extraordinary skill and fairness in leading the Conference and Ms. Tan Siew Huay, for her diligence and thoroughness in chairing the Drafting Committee.

2. Press Release, ICAO, ICAO Council Approves Global Aviation War Risk Insurance Scheme (June 14, 2002). While ICAO's Globaltime compensation scheme did not enter into force, the work on it helped lay the foundation for the UIC. In particular, the scheme was farsighted in its treatment of the industry as a whole, its global approach to risk sharing in the terrorism context, and its method for addressing future withdrawal of insurance coverage (the so-called drop-down). Each of these aspects features prominently in the UIC.

3. *See* Air Transportation Safety and System Stabilization Act, Pub. L. No. 107-42, 115 Stat. 230 (2001).

4. *See* R. Litan, *The Case for Government-Supported Terrorism Insurance for U.S. Aerospace Manufacturers* (Nov. 11, 2002) (on file with the author).

5. 49 U.S.C. § 44112 (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 . . .") (emphasis added). The intention of § 44112 was to "remove one of the obstacles to the financing of purchases of aircraft." *See* H.R. Rep. No. 802091 (1948). As a general proposition, federal courts have correctly interpreted this section to preempt liability under state law. *See, e.g.*, *In re* Lawrence W. Inlow Litig., 2001 U.S. Dist. LEXIS 2747 (S.D. Ind. 2001). There have been some misguided state law decisions, *see, e.g.*, *Retzler v. Pratt & Whitney*, 723 N.E.2d (Ill. App. 1999), that need to be addressed at the first opportunity.

6. Most notably in the Convention for the Unification of Certain Rules for International Carriage by Air, 1999 ("MC 99"), *reprinted in* S. Treaty Doc. 106-45, 1999 WL 333292734, and the Convention for the Unification of Certain Rules relating to International Transport by Air, 1929, *reprinted in* note following 49 U.S.C.A. § 40105 (1997).

7. *See, e.g.*, MC 99, art. 29 (basis of claims).

8. Examples include the Convention on Third Party Liability in the Field of Nuclear Energy (1960), the Vienna Convention on Civil Liability for Nuclear Damage (1963), the International Convention on Civil Liability for Oil Pollution Damage (1992), the International Convention on Liability and Compensation for Damage in connection with the Carriage of Hazardous and Noxious Substances by Sea (1996), and the International Convention on Civil Liability for Bunker Oil Pollution Damage (2001).

9. *See* M. Jennison, *Report of the Rapporteur on the Draft Convention on Compensation for Damage Caused by Aircraft to Third Parties, in the Case of Unlawful Interference, ICAO Legal Committee*, 33d Sess., L/C33—WP/3-3 at ¶ 2.2.

10. *See* UIC arts. 8 (constitution and objectives of the Fund), 9–10 (conference of the parties (authority over the Fund)), 11 (secretariat and director of the Fund (management of the Fund)), 12–15 (matters relating to contributions to the Fund), 16 (duties of State Parties in respect of the Fund), and 17–18 (use of funds and compensation by the Fund).

11. *See* Joint Industry Paper, International Conference on Air Law, Montreal, April 20 to May 2, 2009, DCCD Doc No. 10.

12. *See* Aviation Working Group Paper, International Conference on Air Law, Montreal, Apr. 20 to May 2, 2009, DCCD Doc No. 5.