Arbitration Clauses in Aviation Insurance Contracts: Are They Fit for Purpose?

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This article investigates whether the use of arbitration is a sufficiently appropriate forum to adjudicate disputes arising out of a number of important and unresolved issues that have arisen in the field of aviation insurance, particularly from the perspective of an aircraft financier.

1 THE CURRENT PRACTICE

If a dispute arises with respect to an aviation insurance policy in the United Kingdom, more often than not the following clause is to be found: 'This policy shall be construed in accordance with English Law and any dispute or difference between the insured and the insurer shall be submitted to arbitration in London in accordance with the statutory provisions for arbitration for the time being in force.' Indeed, as Margo on Aviation Insurance states, such arbitration clauses are 'ubiquitous' in the aviation insurance market.

The current rules governing written arbitration agreements are, as a matter of English law, governed by the Arbitration Act 1996 (the 'Act'). The Act covers those arbitrations commenced on or after 31 January 1997, irrespective of when the underlying agreement was signed. The Act leaves much of the actual

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procedure of the arbitration to the parties, and if agreement cannot be reached then this is left to the arbitration panel or tribunal provided for in the arbitration agreement.

Importantly, arbitration proceedings are normally held in private, and the rulings are also confidential and as a result do not create judicial precedent, unless they are brought to court for enforcement or confirmation when they at least become a public document. The Act provides rights of challenge of an award to the Courts on grounds that the tribunal lacks substantive jurisdiction, on a ‘serious irregularity’ having occurred, or on the basis that the award was wrong in law. It is often difficult to challenge an award in practice where the parties are bound by the decision by agreeing to mandatory arbitration in the first place, and an experienced tribunal will often ensure that the decision and law was applied to the specific facts of the case, to try and limit the grounds of appeal based on the misapplication of the law.

It was not always the case that arbitration has governed aviation coverage disputes as a matter of course. In the past, recourse to the Courts was more common where a dispute arose between the parties. Some believe that the turning point was the hearing in 1974 of the American Airlines Inc. v. Hope cases, which arose out of the attack by Israeli forces on Beirut Airport in December 1968, where a number of aircraft on the ground were destroyed in Operation ‘Gift’.

The various hearings, which eventually went to the House of Lords (now our Supreme Court), involved a claim by two parties who each held an interest by way of security for the finance of two Lockheed Coronado aircraft owned by Lebanese International Airways, which were destroyed on the ground by the Israeli forces. There were a number of issues considered by the Courts, but the dispute centred on the issue that, prior to a separate war risk market being in existence, coverage in this instance for war risks was to be at ‘an additional premium to be agreed by the leading underwriter’ – there was no attempt to reach agreement and therefore litigation followed.

The judge at first instance, Mr Justice Mocatta, was unimpressed by the operation of the aviation insurance market and in his judgment stated: ‘I have found the many vexing problems arising out of these issues extremely difficult to resolve, mainly due to the highly obscure and often inconsistent language used in

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5 Arbitration Act 1996 s. 67.
the insurance documents, with the state of documents described later in his judgment as ‘bewildering’.

Various insurance underwriters were cross-examined at length during the trial as to underwriting practice, which I am told they found an uncomfortable experience which they did not wish to repeat. As a result of this experience, a number of a leading insurers became strong advocates of the secrecy that arbitration offered to govern future disputes.

However, the reading of the decision at all three instances demonstrates admirably why Court action has its benefits, where a number of important issues with respect to the meaning of policy were analysed in open court and which considered issues such as whether liability arising out of ‘unprovoked incidents arising during normal course of assured’s operations’ was incorporated into the slip, the meaning of ‘as expiring’ and whether the clause as to liability for incidents occurring ‘over Arab-Israeli territory’ was applicable.

Although an arbitration clause gives the requisite privacy of dealings, and may help insurers in providing opaque and grey areas allowing for compromise and argument, modern commerce demands certainty and judicial precedent properly argued in open court. In addition, insurers have typically been through the process many times before, know the arbitrators and the likely rulings they will return. In contrast, insured parties are more likely to see arbitration on a one-off basis and will need to rely on their counsel to have the equivalent knowledge, and are thus potentially at a disadvantage. The aviation insurance industry now bears little or no resemblance to the market that existed in the 1960s, with the small and specialist Lloyd’s syndicates now being replaced by large multinational composite insurance companies, which are fully regulated and have far more sophisticated practices and procedures, which are more than capable of standing up to judicial scrutiny.

2 THE ROLE OF AVIATION INSURANCE FOR AVIATION FINANCE

This is particularly relevant with respect to the relationship between the aviation finance community and aviation insurers. In particular, clear guidance is needed in a number of areas where there is still doubt and where clear judicial guidance is desirable on vital issues, such as the area of breach of warranty.

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7 (1972) 1 Lloyd’s Report 256.
8 (1972) 1 Lloyd’s Report 263. In large part this is due to what Shiemann L. J. scathingly referred to as ‘the kebab principle of draughtsmanship’. As he went on to note, echoing Mocatta J’s comments of 25 years previously, ‘to one who has no familiarity with insurance policies it is astonishing that those active in this market are prepared to do business with one another on the basis of documents which are so difficult to understand’. Kuwait Airways Corporation v. Kuwait Insurance Co. (1997) 2 Lloyds Rep 687 at 701.
As aircraft finance was developing, some financiers on some deals were even satisfied with a statement in the financing documents that ‘the operator shall ensure that the aircraft is properly insured at all times’. As more and more aircraft have been financed and as their values have increased, new and varied financing structures have evolved, particularly with the development of leasing. Some financiers and their brokers have become insistent that insurers approve the actual wording of the insurance certificate and the endorsements in each lease or mortgage, often at very short notice, as a prerequisite for funding.

By the late 1980s, the aviation insurers realized the current way of dealing with this issue was totally unsatisfactory and could not be allowed to continue. The situation was exacerbated by the use of word processing which allowed finance documents to become longer and more complex. As a result, in the early 1990s there were a number of meetings of Lloyd’s and London Company underwriters following which, in February 1991, the London Insurance Market introduced a standard form endorsement for financiers and lessors for use in connection with aircraft finance lease transactions. The endorsement, commonly known as the Airline finance/lease contract endorsement, was a development now known by its current designations AVN67B and AVN 67C which has simplified the procedure for arranging or confirming insurance cover in the context of aircraft financing, and has also standardised and clarified the cover provided to financiers by London insurers.

Several improvements were made to the original wording of AVN 67 so that in 1994 AVN 67B came into force and in 2007 AVN 67C was introduced. AVN 67C simplified termination wording and created a notice based system and created greater certainty on timing of termination. It also ensured coverage for lease servicers and managers and ensured financier coverage for crew liability claims. This endorsement has not been widely accepted as it has been viewed by many brokers as not addressing certain issues satisfactorily, and therefore AVN 67B was preferred. There is therefore a proposal for an AVN 67D which will update and address certain of these issues. Now, most financiers only review the endorsement with its completed schedules and the accompanying brokers’ letter of

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10 For an excellent background on this see the Aviation Working Group Memorandum on Aviation Insurance in the context of financing and leasing July 2010 on its website. See further D. J. Peache, Insurance Problems in the Age of Lease Aircraft and two papers presented at the Beaumont Garnault Aviation Conference entitled Panacea or Pandora’s Box by Peter J. C. Viccars & J. A. M. Edmunds.

11 Mango on Aviation Insurance, supra n. 2, para. 28.03.

12 There are a number of commentaries on the difference between the two. See Mango on Aviation Insurance, supra n. 2, paras 28.63–28.87.
undertaking promising to inform the insured of notice of a cancellation or material change.

The key feature of the endorsement is that it provides a ‘stand-alone’ provision, which financiers do not have to read but can simply check to ensure that the correct documents are listed, along with the right Contract Parties. Insurers no longer have to review the relevant finance documents, and except as expressly stated in AVN 67B, financiers are ‘subject’ to the terms and conditions etc. of the policy. The endorsement contains the all-important breach of warranty and severability of interests protection for the financier, and insurers shall give brokers 30 days’ notice of cancellation or material alteration and 7 days’ notice for hull war. The endorsement covers both hull and liability and a separate endorsement exists for war coverage.

2.1 Breach of Warranty

As I mention above, one of the key features of the AVN67B endorsement is the breach of warranty clause, which provides as follows:

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 nondisclosure) of any person or party that 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.

The reason for this feature of AVN 67B is that, as a general principle of English law, if an insured breaches a warranty in the policy the insurer is automatically discharged from liability under the policy from that date of breach. The purpose of a breach of warranty clause is to protect the ‘innocent’ financier from having its cover voided or repudiated by insurers in the event of the primary insured breaching certain of the warranties in the insurance policy, even if not related to the loss. There had been previous attempts by the market to address this issue in the past, but without total success.

The introduction of the Insurance Act 2015, which received Royal Assent on the 12 February 2015 and came into force on the 12 August 2016, has brought some further changes in this area. The Act abolishes ‘basis of contract’ clauses, which provide that any inaccuracy in a statement by a party provides sufficient ground to invalidate the insurance, even where the inaccuracy is minor or

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13 See Clause 3.2 of AVN 67B.
14 See the discussions in the AWG memorandum referred to in n. 11 above.
16 Insurance Act 2015 s. 9.
unrelated to the actual loss. Therefore, it is now not possible for insurers to avoid payment entirely in the event of a breach of warranty, thus providing some further protection for both the insured party, and any Additional Insureds.

The fundamental question that arises under English Law, and where clear judicial interpretation is so badly needed, is the precise legal effect of the breach of warranty cover in the light of the endorsement and whether or not the coverage is merely an extension of the original policy and does not create a separate insurance contract in favour of the financier.

The wording in AVN 67B clearly regards itself as independent from the main contract. Clause 2.1 provides ‘Subject to the provisions of this Endorsement, the Insurance shall operate in all respects as if a separate Policy had been issued hereunder.’ In addition, there is reference in the preamble to a separate premium being payable. As far as this last issue is concerned, this raises additional questions which I will discuss below.

There has been much debate on this issue. According to Margo on Aviation Insurance, ‘The precise legal effect of breach of warranty cover has not been clearly established. Courts in some jurisdictions have held that breach of warranty cover is merely an extension of the original policy and does not create a separate contract in favour of the financiers.’ The authors then cite a New Zealand case and a Mississippi case in support and various other cases where a contrary view was upheld.

If it were the case that coverage was merely an extension of the previous policy, notwithstanding the wording in AVN 67B to the contrary, then this would present a serious and real issue for financiers. If the insured and the financer are held to be insured under the same contract of insurance, the insurers could rely on pre-inception misrepresentations and non-disclosures by the insured to deny coverage to both the insured and its financiers.

In considering this issue, the financing community should take comfort from Clause 2.1 of AVN 67B referred to above and the law as to contractual interpretation, albeit in a different context, as spelt out by Lord Clarke in Rainy Sky v. Kookmin Bank (2012) 1 Lloyd’s Rep. 34, at paragraph 23:

the ultimate aim of interpreting a provision in a contract, especially a commercial contract, is to determine what the parties meant by the language used, which involves ascertaining what a reasonable person would have understood the parties to have meant. As Lord Hoffmann made clear in the first of the principles he summarised in the Investors Compensation Scheme case [1998] 1 WLR 896 at page 912H, the relevant reasonable person

18 As indeed insurers attempted to argue comparatively recently in a case in the Cayman Islands (Cessna Finance Corporation v. Allianz Global Risks US Insurance Company FSD 72 of 2014), which was settled before the issue could be subjected to judicial scrutiny.
is one who has all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract.\textsuperscript{19}

This whole issue was considered in a Memorandum on Aviation Insurance in the context of Financing and Leasing prepared on behalf of the Aviation Working Group in July 2010.\textsuperscript{20} The Memorandum charts the history of the endorsement wording and provides an excellent analysis of the implications if there were a duty on the part of financiers to disclose to insurers prior to obtaining cover, such matters as any departure from standard practice in aviation finance, any ‘unusual’ provisions in the finance documents and the way in which the finance party’s security was structured. It concludes that this would be totally impractical and would defeat the whole purpose of the endorsement and make finance considerably more difficult. Again, the Insurance Act 2015 has had some impact on this area, as it abolishes the old ‘Duty of Disclosure’, replacing it with a ‘duty of fair presentation’. This requires the insured party to disclose all material circumstances which it knows or ought to know, make these disclosures in a clear manner and ensure that all material representations are correct.\textsuperscript{21}

However, this vital issue has not yet been judicially considered and, as the position stands, it would be heard by a panel of arbitrators without a binding precedent.

2.2 Territorial limits

An ancillary issue also arises with regard to breach of warranty coverage: whether or not the operation of the insured aircraft outside the territorial or geographical limits of the policy constitutes a breach of warranty and therefore whether or not coverage is prejudiced. Although most policies are written on a worldwide basis, this can still be a particular issue on war risk coverage or for certain regional or corporate jet operators where there are often geographical limitations in the policy.

Again, and helpfully, this is also considered at length in Margo.\textsuperscript{22} There are some cases in the United States where it was held that, with respect to a financier on whose behalf a breach of warranty coverage has been effected, such financier is entitled to recover under the policy where the insured’s aircraft was operated beyond the territorial limits of the policy. The situation in England is far less clear

\textsuperscript{19} Although for judicial resistance at the highest level to the increasing tendency towards ‘commercial’ interpretation of contractual wording, see Lord Sumption’s speech on the subject of contractual interpretation, given as the Harris Society Annual Lecture at Keble College on 8 May 2017,

https://www.supremecourt.uk/docs/speech-170508.pdf

\textsuperscript{20} See supra n. 11.

\textsuperscript{21} Insurance Act 2015 s. 3.

\textsuperscript{22} Margo on Aviation Insurance, supra n. 2, ss 28.23 & 28.24.
and although there is no clear case law on this exact point, logic would dictate that there is no cover if there was an operation outside limits: as with many other aspects of coverage, there is no warranty that the aircraft will only be operated within the territorial limits, and thus operation outside those limits would not constitute a breach of warranty per se, it would merely give rise to a situation where cover is suspended (or more accurately, the insurance is non-responsive) for the duration of the operation outside the territorial limits. Thus, as a matter of English law, in circumstances where the underlying policy is merely suspended or non-responsive, a question may be raised by an insurer as to whether a financier has recourse under AVN67B or C.

2.3 WHAT DOES ‘KNOWINGLY CONDONED’ MEAN?

Even the breach of warranty wording contained within the wording of AVN67B needs further clarification. The current wording is highlighted above and is subject to the important proviso that coverage is only available ‘if the Contract Party has not caused, contributed to or knowingly condoned the said act or omission’. Questions have then arisen, in particular to what ‘knowingly condoned’ means. To take a few of the main examples: whether this is an objective or a subjective test; whether actual knowledge (as opposed to constructive or ‘blind eye’ knowledge) is required; what level of employee might count for the purposes of requisite ‘knowledge’; whether ‘condoning’ requires something more positive than mere silent lack of objection etc. Here again, judicial clarification would be helpful. It should also be noted that any questions of interpretation would be resolved using the usual rules of construction, meaning that ambiguities would be construed against the drafting party, in this case the insurer.

2.4 IS A SEPARATE ASSIGNMENT OF INSURANCES NEEDED?

Another issue arising out of AVN 67B is whether or not a separate assignment of insurances is necessary to give effect to the loss payable clause, or can a financier rely on the current wording in AVN 67B? A loss payable clause is the clause in an insurance policy which specifies that, in the event of a loss, the proceeds of the policy will be paid to the entity named in the clause. A question of debate between lawyers practicing in our field is whether or not a separate assignment is really necessary. With an assignment, the notice given to the insurers states the identity of the loss payee. In contrast, Clause 1.1 of the endorsement provides that ‘settlement shall be made to the order of the Contract Party(ies)’ which are listed, and insurers
often argue that separate notice under an assignment is unnecessary as the Contract Parties and the Contracts are listed in the Schedule identifying the terms used in the endorsement.

2.5 **Third party rights exclusion**

Aviation policies almost invariably contain provisions excluding the operation of the Contract (Rights of Third Parties) Act 1999 (such as the AVN 72 Contract (Rights of Third Parties) Act 1999 exclusion clause) so that they maintain privity of contract and all that flows from that. The question therefore arises as to the capacity in which, for example, the lessor’s interests are protected under the policy. If the lessor is a contract party (i.e. is insured in its own right and regarded as a party to the agreement) then, obviously the lessor, as a Contract Party has the right to enforce the agreement.

If it is not a party to the insurance contract but merely an intended beneficiary (classically where they were added as a mere loss payee), then privity could preclude a lessor from seeking to enforce the policy and it would have to rely on the lessee to do so, in circumstances where the lessee may have no interest or may not even be in a position to do so, for example by reason of insolvency.

I am aware that certain of these vital issues have been the subject of arbitration, but as such no precedent or clear judicial ruling is available to help the financing community and this shall continue to be the case until the market practice and the wording in the policies change.

2.6 **Other aviation areas not involving financiers where judicial interpretation is needed**

It is not only in the field of aircraft finance that there are unresolved issues with respect to aviation insurance, and in these instances where the insured or operator has a particular concern judicial clarification would again be helpful.

Examples of these are as follows:

2.6[a] *When Is an Aircraft a Total Loss When It Disappears?*

According to AVN 1C, which forms the basis of most aviation policies and which came into force in 1998, ‘The insurer will at their option pay for, replace or repair, accidental loss of or damage to the Aircraft described in the Schedule from the risks covered, including disappearance, if the Aircraft is unreported for 60 days after the commencement of the Flight.’
A different approach has been adopted in the 2014 revision AVN 1D which, in Clause 15 in the definition of a ‘Total Loss’, includes the disappearance of the Aircraft if it cannot be located 30 days after the commencement of the flight, or the date of the reported theft.

This whole approach has been thrown into focus following the terrible events of Malaysian Airways flight MH370 from Kuala Lumpur to Beijing where 239 people are still missing from the flight on 8 March 2014.

2.6[b]  Non-payment of Premium: Whither Coverage?

The premium is the amount paid by the insured for the insurance and is normally paid to the broker who deducts his commission and passes it to the insurer. What happens if the premium is not paid but coverage is in place?

A number of policies contain the premium payment clause, AVN 6A which gives insurers the right to terminate coverage on no less than 30 days' notice to the broker in the event of non-payment of a premium instalment when due. It also makes any outstanding instalments of premium payable ‘forthwith’ in the event that there is a claim which exceeds the instalments paid to date. This ties in with the format of a broker’s letter of undertaking and the wording given in AVN 67B and AVN 67C. If these are not in place, can cover be terminated immediately and if not, when does it cease?

In addition, a further question can arise regarding the payment of an Additional Premium under AVN 67B, a concept which was introduced to thwart any arguments based on lack of consideration in forming the contact in the first place and which is briefly referred to above. This Additional Premium is a fixed amount of USD100, the theory being that this payment would allow the contract to be enforceable as a stand-alone contract, even in the event of non-payment of the standard premium. However, in practice, the Additional Premium is not allocated to a particular instalment of the standard premium, raising a question as to if and when it has been paid. Clearly it can be inferred that, where no premium has been paid, the Additional Premium is outstanding as well, but in the case where some payment has been made, how might this be allocated towards the Additional Premium, and therefore, does the contract stand?

2.6[c]  Exclusions for Financial Causes Under the War Risk Policies?

The understanding of war and hijacking risks coverage in the London market is complex. The situation is that, under a general insurance of aircraft hull-only coverage, certain of the war risks excluded under AVN 48B will be written
back. The remainder of the war risks will be insured in the specialist war aviation market.  

The basic write-back policies are contained in several variants, but the most common are LSW 555B, C and D, which are each referred to as the aviation hull war and allied perils policy. Basically, the way these policies work is that these provisions write-back into the policies certain risks which are excluded from the insured’s hull all-risks policy, caused by a number of issues. However, even these policies exclude certain loss, damage or expense, caused by the following:

1) 
   a) War (whether there be a declaration of war or not) between any of the following states: the United Kingdom, the USA, France, the Russian Federation, and the People’s Republic of China, save that if any aircraft is in the air when an outbreak of such war occurs, coverage shall continue until the aircraft has completed its first landing thereafter;
   b) Confiscation, nationalisation, seizure, restraint, detention, appropriation, requisition for title or use by or under the authority of government(s) named in the policy schedule, or any public or local authority under its jurisdiction;
   c) Any debt, failure to provide bond or security or any other financial cause under court order or otherwise;
   d) The repossession or attempted repossession of the aircraft either by any title holder or arising out of any contractual agreement to which any insured protected under the policy may be party; and
   e) Delay, loss of use, or except as specifically provided in the policy any other consequential loss, whether following upon loss of or damage to the aircraft or otherwise.

2) Directly or indirectly arising out of any detonation of any weapon of war employing atomic or nuclear fission and/or fusion, or other like reaction or radioactive force or matter, whether hostile or otherwise.

As one can see from the above, certain items have consequences from financial causes and the question then arises of whether or not these exclusions apply in the context of the lawful exercise of a lien, for example a statutory lien for unpaid Eurocontrol fees24 and landing fees.25 This point needs judicial clarification.

23 Traditionally, and for historical reasons, the Marine Market, although with the agglomeration of insurers the division between markets is becoming less distinct.

24 Civil Aviation Act 1982 s. 73 provided for regulations to be made to enable the CAA (or Secretary of State for Transport) to collect air navigation charges on behalf of Eurocontrol. The Civil Aviation (Eurocontrol) Act 1983 amended the Civil Aviation Act 1982 to provide for the enforcement in the UK of determinations on Eurocontrol charges made by the relevant authorities in other Contracting States.

25 See Civil Aviation Act 1982 s. 88.
2.7 Engines and their fleet transfer

Aircraft engines are normally insured as part of the aircraft on which they are installed. Given their portability and the removal from one aircraft to another, it is possible to effect separate insurance to cover individual engines or a group of engines which are off-wing and treated as spares.

The issue arises where an accident occurs to a leased aircraft and one of the engines was not owned by the lessor but by another lessor, who would like to be recompensed for their loss. The question also arises as to what happens to the so-called ‘orphan’ engine which is off-wing and owned by the airframe lessor, as it is often the case that a ‘Total Loss’ under the financing documents is different from the practice of the insurers.

3 SUMMARY

One of the major benefits cited by practitioners for using arbitration is the perceived help of the 1959 New York Convention on the Recognition and Enforcement of Foreign Arbitrational Awards. It is often the case that with a number of jurisdictions there are difficulties in enforcing a court order without the matter being reheard in the local court and in certain countries, particularly in the Middle East and Russia, it is viewed as easier to enforce an arbitration order using the New York Convention. This article does not discuss the practical merits of utility and timing of using courts against arbitration, other than in respect of the specific areas discussed above. For certain airlines based in certain countries, arbitration may still be the answer. However, this should not be a default provision for the reasons which I set out above in respect of the treatment of aviation insurance disputes.

As one can see there are a number of important issues in the field of aviation insurance where there is a clear need for the benefits and disadvantages of particular wording to be argued in open court and then for judicial interpretation to be provided which gives clear and concise advice going forward, setting a precedent to be followed.

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