NEWSSTAND

Eruptions and Disruption But No Indemnification

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This article explains the liability faced by air carriers arising out of the closure of most of Europe's airspace for six days in April 2010, the lack of insurance to cover that loss and the new products being considered to cover such eventualities in future.

Europe is now reflecting on the lessons to be learned from the closure of most of its airspace for almost a week as a result of the eruption of Iceland's Eyjafjallajökull volcano that had been dormant for over 200 years. Whilst many will focus on the role of governments and regulators in closing the airspace, much has also been said and written about the losses suffered by airlines and the lack of available insurance to cover that loss, as well as the losses of hundreds of thousands stranded travellers. The International Air Transport Association's (IATA) estimate of the cost to the worldwide airline industry is US$1.7billion.

Insurance for Stranded Travellers
The usual reaction of a traveller faced with the effects of a natural disaster is to look to their travel insurer to provide indemnity for their losses. However, it is rare that the terms of the insurance are read before the cover is called upon and this results in a mismatch between the expectations of the insured and the cover they have purchased. While the media often paints insurers as the villain, this does not reflect the fact that the insurance was priced to cover the specified perils. There are three matters of which potential claimants should be aware:

- Coverage is triggered under most policies following a delay caused by (a) strike, civil commotion, riot, or (b) mechanical failure or breakdown of the relevant public transport, or (c) weather.
  Under ordinary rules of interpretation, it is unlikely that volcanic ash in the atmosphere would be treated as a weather phenomenon. It may nevertheless be argued that weather is synonymous with atmospheric or meteorological conditions, which should include changes caused by volcanic ash.
- Cover is often excluded where the withdrawal of public transport is by order or recommendation of a regulatory authority or government. Policies with such a provision would bar coverage in this instance. This exclusion is often present in delay and cancellation or curtailment insurance (where a trip is cancelled or curtailed prior to departure).
- The available limits of cover will almost always be insufficient to cover the actual loss incurred and will usually provide a fixed benefit up to a few hundred pounds.

Accordingly, even if the claim is covered, the insurance is likely to provide a partial indemnity only.

The Liability of Air Carriers

The European Union (EU) brought in legislation across Member States in February 2005 providing care and compensation for passengers affected by flight cancellations, delay or denied boarding (EC Regulation 261/2004). The Regulation applies to community carriers, ie carriers licenced in any Member State, and to non-community carriers for cancelled flights from the country of a Member State. There are two elements to the compensation for a cancelled flight: the necessity to provide hotel accommodation, meals, travel to the airport and reimbursements of certain phone or internet costs (referred to as care) and monetary compensation of up to 600 Euros per passenger depending on the length of the flight. The second element of the compensation is subject to an “exceptional circumstances” defence, which almost certainly applied in this instance. The first element applied to all cancelled flights and airlines cannot contract out of it. It is a mandatory provision. Airlines are also obliged to provide written notice of the compensation available to passengers. The results of this provision can be arbitrary. For example, a British Airways passenger stranded in San Francisco receives the benefit of this Regulation. Had the passenger flown on a US carrier, the Regulation would not apply. However, a passenger that had flown on a US carrier to London and then had the return flight cancelled would fall within the Regulation, as the affected flight was to depart from an airport within the EU. Airlines face criminal sanctions if they fail to comply with the Regulation. It is usually the Civil Aviation Authority in the relevant EU country that is tasked with enforcement.

Airline Insurance

Generally, airline liability policies require some form of legal liability to passengers for bodily injury or death and/or property damage. That was absent in this instance and it is very unlikely that the standard airline liability coverages would be triggered.

Many airlines purchase Business Interruption (BI) insurance, but such policies almost always also require some form of property damage to be triggered. Coverage for airline BI was in the spotlight following the attacks of September 11 2001, and the contrasting experiences of United Airlines and US Airways are informative. The US Federal Aviation Administration ordered the closure of Washington’s Reagan National Airport in the immediate aftermath of the World Trade Center attacks, fearing that the US Capitol may be attacked. The airport was closed prior to the attack at the Pentagon. As a result of the closure, both airlines claimed for lost income under their BI policies. United failed to recover under its policy but US Airways did recover. The contrasting outcomes were the result of nuances in their respective wordings. United’s policy was triggered if access to the insured’s property was prohibited by order of a civil authority as a direct result of “damage to adjacent premises”. The US Airways’ policy provided coverage if access to the insured’s property was prohibited by order of a civil authority “as a direct result of a peril insured against”. Understandably, the Federal Appeals Court in the United case did not consider the Pentagon (a building 3 miles away) to be adjacent to United’s property. Conversely, a Virginia State Court concluded that US Airways’ policy did not require actual damage or loss of the insured’s property to invoke coverage but only the risk of actual damage. The closure of the airport was due to the risk of an imminent attack at the airport which housed US Airways’ property.

The Market Response
It is unprecedented for airlines to incur a US$1.7billion loss from a single occurrence and find that there is no insurance to compensate the loss. This has produced a rush to develop a policy that might respond to a similar natural catastrophe in the future at a price that is affordable and provides reasonable coverage.

In this section, we consider the key provisions that might be included in such coverage and how the policy could be structured to make it more affordable.

Scope of Cover
Brokers have offered BI insurance to aviation companies for many years and will be cognisant of the key provisions of such cover. It is nevertheless to be expected that such policies will need to be tailored to the risk posed by volcanic eruptions and other events that prevent an airline flying its planes. The key provisions for such policies are as follows:

- Coverage triggers should not be linked to physical damage but to an event or occurrence resulting in a necessary ban or suspension of flights. The way this is expressed is not necessarily encompassed by force majeure, which may be interpreted as covering events like severe weather or industrial action. Many insurers will not want to cover such perils but instead limit coverage to natural events. Also, the wording should address whether cover is triggered as a result of a prohibition against using airspace or perhaps a lesser standard of the airspace being impaired by closure or the withdrawal of air control services in a region that ordinarily provides such service. This would cover the situation that occurred over Europe, where there was no legal bar to flying but no air traffic control was provided, effectively grounding all commercial flights. One might also consider whether cover should be triggered by the inability to operate from a serviced airfield due to regulatory restrictions, eg avian flu.
- A waiting period after which coverage is triggered, eg 48 hours. This would reflect ISO wording for BI policies.
- A limitation on the period of closure for which cover is available.
- Extra expense coverage – the cost of "caring for" passengers and/or compensating them pursuant to a legal obligation on an air carrier and the cost of operating extra flights to return stranded passengers to their destinations.
- Denied ingress/egress cover.
- An agreed methodology for calculating how the loss is valued, eg a combination of the airline's revenue per passenger mile and revenue per available seat mile.
- Confidential arbitration to resolve disputes within a specified timeframe.

The Use of a Captive or Mutual Insurer
One of the limitations on buying BI insurance as outlined above is the perceived expense of such cover and many in the market believe that the cost of a policy for force majeure-type situations would be prohibitive. An effective method of reducing premium costs is the use of a captive insurer and this model has been employed successfully in other lines of insurance business. However, it is not without difficulties. The advantages of a captive insurance structure are clear. It retains the profit that might be made in a traditional insurance arrangement within the group of companies setting it up and any underwriting surplus can be retained to increase capacity in the

future. Also, it allows investment income to be earned on the premiums paid, the capital payments setting up the captive are tax deductible and if suitably located, the captive will benefit from favourable tax and regulatory regimes. For example, IATA member carriers (and perhaps the Airports Council International) could set up an off-shore captive insurer to cover force majeure and/or natural catastrophes. The captive would offer specified limits of cover which may need to scale depending on claim volumes. The captive is likely to require extensive reinsurance in the early years and that reinsurance may well have a high attachment point. The terms of cover provided by the captive are likely to be broader than those provided under traditional BI policies. Above the captive's policy limits, carriers or airports could buy high level excess cover.

Other benefits of using a captive include:

- a reduced risk of "moral hazard", as there is an obvious incentive on covered parties to minimise their loss.
- it is more likely that the wording used will be sufficiently broad to cover the perils for which cover is sought, but it will need to be acceptable to reinsurers.
- there is less likelihood of disputes over what it is intended to be covered.

As with all types of insurance or reinsurance, there are pitfalls. The captive is a company in its own right and its directors will owe fiduciary duties to it. Accordingly, premiums will need to be commercially priced. There will be substantial start up costs together with the cost of capitalising the captive and installing a professional management team. The financing would need to come from the policyholders. The captive would also be heavily exposed to risk aggregation, whereas commercial insurers are spread over many companies and lines of business.

Reinsurance purchased by the captive would need to be "as original" or "back to back". However, specific words of incorporation would be needed to ensure that jurisdiction and choice of law provisions are the same as between the captive's policy and the reinsurance. The notice and claims co-operation provisions in the reinsurance will need to be adapted to reflect the captive structure. One might also consider including a "conflicts of interpretation" clause and a payment obligation under the reinsurance on the day the captive makes payment. Notwithstanding the pitfalls, captive insurance structures can provide greater flexibility than traditional insurance arrangements.

Insurance is nothing if not responsive to the commercial environment and the challenge posed by the eruption in Iceland has set the global insurance market the challenge of finding a solution. It is only a matter of time until it does so.