Is the industry ‘declining in relevance’ or embracing new market niches?

“Broadly speaking across the marketplace, we as insurers have actually been declining in relevance.” That was the opening salvo from XL Group CEO Michael McGavick, as part of his “state of the industry” presentation at last month’s Aviation Insurance Association (AIA) Conference in Miami, Fla. According to several speakers at the conference, the aviation insurance industry continues to be plagued with high competition, low premium revenues, rising claims costs and a continuously changing risk management landscape. While the words “irrelevant,” “unprofitable” and “unsustainable” were bandied about, there were also positive messages, especially around the blossoming commercial UAS market.

McGavick defended his somewhat tongue-in-cheek comment about decreasing relevance by pointing out that while the insurance industry is “superb at insuring physical things,” nowadays there are fewer physical items to insure. “If you look at what’s making the world more valuable these days, it isn’t necessarily physical things,” said McGavick, citing the time functions on cellphones, which are driving down sales of wristwatches. “Much of the world’s economy has shifted to intangible assets, such as software code, ideas and reputations. We as insurers have had a tough time with that transition.” Self-insurance is also dimming the industry’s relevance as many corporations forgo traditional insurance in favor of keeping funds—and their corporate best practices—to themselves.

To remain relevant, the insurance industry must “race ahead and match the rate of change that our clients are experiencing and be relevant to the things that create value to them today,” said McGavick. As an example, he explained that XL Caitlin is “now partnered with the largest artificial intelligence transportation organization in the world, trying to figure out the new liability theories that will allow this technology to come forward. Because we know that if the liability theory doesn’t move, the whole technology could be sitting on the sidelines instead of being used by mankind.”

McGavick listed five factors currently driving the insurance sector: clients facing greater global exposure; data mined with new analytic tools; consolidation in the broker community; pension funds providing alternative capital sources for re-insurance; and regulation making capital more inefficient to use. He says these five drivers, combined with low premium rates, point to future consolidation in the industry.

“This is a really difficult time in the pricing cycle,” McGavick said. “The rates currently being charged for risk are not sustainable. In this environment, the only way to grow is consolidation.”

While the macro view of the industry may be that of an industry struggling to stay relevant, for business aircraft owners and operators the insurance broker is far from irrelevant. Maintaining a close relationship with your insurance broker can be a good source of information on industry best practices that can help lower rates and losses.

“The [insurance] broker’s role is to help the helicopter community,” said Larry Mattiello, director of aviation for Aviation Specialty Underwriters in Addison, Texas. “The broker has been recognized by the FAA, NTSB, HAI [Helicopter Association International], and IHST [International Helicopter Safety Team] as the resource who is closer to the helicopter end user than any other person or entity in our society.”

Mattiello emphasized the importance of ensuring that the broker knows the type and value of all equipment that could be attached to the aircraft and the cost of installing any permanent equipment. For example, specialized mission-specific interiors for EMS aircraft significantly add to the value of the aircraft, and the installation and equipment costs should be factored in
When the broker goes to the underwriter for the coverage and the quote, failing to do so may result in an underinsured aircraft that can leave the operator financially short in the event of a loss. Helicopter operators in particular need to be sure that external equipment such as cameras are covered, possibly in an addendum.

“Hull insurance typically covers just the aircraft itself,” said Mattiello. “If you have a ten-percent deductible on a helicopter used in the motion picture industry, and you have a $500,000 camera attached that’s owned by someone else, that camera may become a self-insured item that nobody is going to be happy about [if there is a loss]. Someone must pay for that camera, and it’s usually going to be the operator.”

**Claims Issues: Limits Too High or Not High Enough?**

It’s not just aircraft that are often underinsured. During a panel discussion titled “Current issues in aviation claims resolution,” Michael McGrory, partner in SmithAmundsen’s Aerospace group in Chicago, described a common problem with claims involving automobiles damaging aircraft when driving up to the airplane at a general aviation airport. “Some drivers are not familiar with parts of the airplane that might be close to the ground, and collisions often ensue. The auto carrier often doesn’t have nearly enough limit to pay for damage to the business jet. This will be a simple liability; you ran into a fixed object. But try to get them to settle when the general insurance adjusters find out how much it costs for an engine cowl. They just don’t believe it. So litigation goes on. It’s unfortunate because usually these claims should be settled quickly but very often they’re not.”

Overinsured aircraft can also create difficult claims. According to Michael Peterson, senior vice president and national director of claims at Willis Aerospace Americas, the underwriter’s desire to repair the aircraft rather than pay out the agreed value can lead to problems. “The initial reaction of the insurers is that they’re looking at paying out a lot of money, so they look for ways to repair the aircraft,” Peterson said. “And it can get challenging dealing with their expert in this area versus experts hired by the policy holder. A lot of these aircraft are subject to financial arrangements that essentially require the policy holder to insure the aircraft for more than market value. So there’s a legitimate basis for it, but from the claims side it’s a big challenge.”

One area where some aircraft operators and other airport tenants may find themselves underinsured is in environmental insurance. According to Edwin Baez, vice president of Berkley Specialty Underwriting Managers Environmental division, the exceedingly high cost of environmental cleanup and remediation has prompted many airports to add environmental insurance stipulations to contractual agreements.

“We’re seeing more requirements for purchasing environmental insurance even for something like a hangar, which most people would see as low risk,” Baez said. “If you set foot on an airport, you’ll need to carry environmental insurance…and name [the airport] as additional insured. That’s becoming commonplace.”

Baez cited several aviation activities with environmental exposures, including fueling, de-icing, aerial chemical application, aircraft repair and painting, part manufacturing, and fuel transportation and storage. Fuel storage tanks—both above ground and subterranean—can incur significant environmental costs in the event of an accidental release.

“Cleanup and remediation of underground storage tanks can cost up to $1 million per tank,” said Baez. “If you’re in a difficult state like California, Florida or Texas, and you contaminate drinking wells, it could go way beyond $1 million.”

Baez said that most airport owner and operator general liability policies include broad pollution exclusions, which is why separate environmental insurance is required. FBOs typically need three types of liability coverage: site-specific pollution, contractor’s pollution liability and coverage for tankage, including financial responsibility. These cover first-party losses for onsite and offsite cleanup, third-party claims of bodily injury and property damage, emergency response costs, business interruption costs and more. Because aviation doesn’t have the best track record and some environmental insurance carriers are still intimidated by aviation operations, many entities are requiring the purchase of environmental insurance in performance contracts, lease agreements and in financial real estate transactions, mergers and acquisitions.

Corporations that own aircraft should review their liability policies to ensure that the corporation and all pertinent individuals are named insureds. According to Jonathan Morse of The Morse Law Group, the language used in various policies can differ, and can actually result in the corporation not being covered at all.

“Different insurers will have different language in the policy,” Morse said. “Read the policy to find out if the individual is covered as well as the corporation, and whether the corporation is really covered at all. Suggested language for corporate-insured aircraft should name the insured as: ‘[name of the corporation or LLC] and all of its officers, directors, shareholders, members and employees, past and present.’”

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AIRCRAFT INSURANCE

FAA Enforcement Actions and Compliance Philosophy

In an effort to improve aviation safety through the open sharing of apparent violations and a collaborative approach to solving problems, the FAA encourages airmen and other certificate holders to disclose voluntarily any regulation violations they have incurred through the Voluntary Disclosure Report Program (VDRP) or Aviation Safety Action Program (ASAP), depending on the certificate and the FAR Part under which they are operating. But attorney Paul Lange warned that while participating in one of the federal voluntary disclosure programs after a known regulation violation can help certificate holders avoid hefty penalties and enhance safety, there may be severe unintended enforcement and litigation-related consequences.

“[The FAA is seemingly unaware that there are other things out there like civil litigation],” Lange said. “It [says] that you are protected under Part 193 because it thinks the world is limited to FAA enforcement.”

Lange said that certificate holders—who have as little as 24 hours to report a violation after it occurs to be given the full protection of either program—must be careful about the admissions they make. Not only can the FAA revoke protection under certain circumstances, but the information gathered through these programs can be used by other federal or state agencies or by plaintiff’s legal counsel. The VDRP, for example, requires at least oral notification of violation within 24 hours, written notification through the web-based system within 72 hours, and a full report within 10 days that describes the apparent violation, immediate action taken and that the non-compliance has ceased.

“That sounds like an awful lot of admissions to me,” Lange said. “They ask what regulation you have violated. They ask you in a variety of ways what you did wrong. That’s a plaintiff’s lawyer’s dream.” Lange noted that while the FAA may extend the time to file the written report past the 10 days, you’ll need to provide reasons why the extension is needed and those “admissions tend to be harmful.”

Participating in voluntary disclosure programs has become expected (or a standard of care in legal prose), and not using one can be used against the certificate holder or his company in tort litigation. But on the positive side, Safety Management Systems (SMS) have also become a standard of care, and companies that implement SMS, especially if they are not required to, are seen during litigation to be demonstrating a higher regard for safe practices.

“If you use the FAA’s own definition of the SMS components, it establishes senior management’s commitment to continually improve safety,” said Lange. “The safety promotion portion talks about other actions to create a positive safety culture. This is not a bad thing to have in front of a tort jury, or when arguing to an FAA lawyer on an enforcement case. When you’ve got an SMS in place, you can argue that you have management commitment to continually improve safety and create a positive safety culture, notwithstanding what may or may not have gone wrong.”

Beyond implementing and updating an SMS, companies can avoid FAA enforcement actions by measuring accountability against policies and procedures, recognizing risk factors and using periodic third-party audits. But it also helps if you don’t advertise violations of the Federal Aviation Regulations on your website, which is largely how SkyPan International incurred a $1.9 million penalty for unauthorized unmanned aerial systems flights in New York and Chicago class B airspace.

While SkyPan’s initial response to the FAA says that the company “has been conducting aerial photography...for 27 years in full compliance with published FAA regulations,” the FAA used images from the company’s website and documentation subpoenaed from SkyPan’s insurance company to determine that 65 unauthorized UAS flights occurred between March 2012 and December 2014, and 43 flights were in restricted New York class B airspace without ATC permission. Because SkyPan purchased insurance on a per-flight basis, its insurance carrier had detailed information about each flight, including the date and location flown.

“The basic takeaway to consider,” said Donald Mark of Minnesota law firm Fafinski Mark and Johnson during his discussion of the FAA v SkyPan International case, “is that there’s no indication that anybody at the FAA caught SkyPan in the act. All of these illegal flights had been previously recorded, and the information was gathered under subpoena from either Skypan directly or the insurance carrier that had referenced all of the flights flown. So it’s interesting that the FAA is able to recreate violations even if you’re not caught in the act.”

FAA Administrator Michael Huerta chose not to comment on the SkyPan case during a Q&A session after his remarks addressing the AIA conference, but he responded to a question about the “disconnect between FAA senior management and the FSDOs (Flight Standards District Office)” regarding the FAA’s new “compliance philosophy” as spelled out in FAA Order 8000.373 effective June 26, 2015.

“It’s very much a work in progress,” said Huerta, referring to applying the new philosophy. “Different FSDOs, CMOs [certificate management office], and MIDOs [manufacturing inspection district office], are at different places. The principal concern from an ASI [aviation safety inspector] or regional counsel is that if we are asking them to exercise judgment, which is effectively what the...
compliance philosophy is all about, what if they get it wrong? They want to be assured that the agency will stand behind whatever decision they make.”

Huerta indicated that some ASIs are having difficulty switching from an enforcement stance to a collaborative mindset focused on helping the industry achieve compliance. “This is an important cultural change because you’re taking a world that was black and white, and you’re turning it into interpreting different shades of gray. And that is much harder for people to work through. I feel good about the progress we’re making. I don’t believe you flip a switch and suddenly everyone will change overnight, but it’s something we’re committed to and we’re tackling it one on one with conversations with employees.”

Huerta also commented on the upcoming FAA Reauthorization bills making their way through the U.S. House of Representatives and the U.S. Senate, stating that the agency would like two things from the final bill: flexibility and stability. “There are a lot of things that get in the way of our ability to allocate resources or redefine business processes,” said Huerta. “We’d like to have more flexibility to set priorities. The second thing is stability. During my tenure at the agency, we have been through 25 short-term extensions, two shutdowns and a sequester. That wouldn’t meet anyone’s definition of stability. So what we would really like to have is a long-term authorization that would give us the stability to carry out the work that we’re supposed to do.”

**UAS Operations Present Both Risk and Opportunity**

While the booming unmanned aircraft system (UAS) population had already gained the aviation insurance industry’s attention a few years ago, UAS and the impact on risk management was a hot topic at this year’s AIA conference. The sheer numbers of UAS being sold represent both risk and opportunity. The FAA estimates approximately 2.5 million UAS will be sold this year. Of these, approximately 600,000 will be for commercial use, with the remainder flown by hobbyists. Some 435,000 recreational UAS operators have already registered an average of 1.5 drones each on the FAA Small UAS Aircraft Registry. (See AIN January 2016, page 6.) While some hobbyists are joining the Academy of Model Aeronautics (AMA), which provides education on regulations and procedures to new UAS pilots and liability coverage under its $2.5 million general liability insurance program, those who do not may remain unaware of registration requirements, airspace restrictions and even operational safety procedures (such as always flying with a spotter and keeping the UAS within line of sight).

“There are essentially two sides to the UAS manufacturing industry,” said James Van Meter, aviation practice leader for UAS at Allianz Global Corporate & Specialty, who is himself a fixed-wing pilot and UAS operator. “Some of them view themselves as airmen and maintain that airmen will always be the ones operating this equipment. The others are roboticists, who feel they can make the technology so good that anyone can operate it... It will be interesting to see in the next few years which party wins out. As aviation insurers, we feel that to operate UAS safely, operators need to be airmen and they need to approach the operations like pilots.”

Chris Proudlove, senior vice president for complex/unmanned risk at Global Aerospace, echoed this sentiment when discussing underwriting UAS policies. “We look at the applicant,” said Proudlove. “A 30-year aviation company that’s diversifying into unmanned aircraft will approach the business of flying the drone with a different mindset from a wedding photographer who is simply using a drone to get a better shot. We look at things like checklists and logbooks, things that are part of the fabric of aviation. Companies that blend the best of technology with solid aviation background seem to do the best job of getting through the startup process and operating safely.”

According to Van Meter and Proudlove, the aviation insurance industry has developed aviation-specific products for UAS operations, including changing the definition of aircraft to account for drones. Nearly every insurance product available for manned aircraft is now available for unmanned aircraft, including up to $1 million hull insurance and up to $300 million liability limit.

“We’ve figured out solutions for how to

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write [insurance policies for] the cameras, the sensors, the launches and the recovery equipment,” said Van Meter. “Someone asked me if we’ve ever actually quoted $300 million [in liability limits]; it’s pretty rare. Most of the [commercial UAS] buyers in this space are in the $50 million [liability limit] range. But those higher limits are available.”

Proudlove indicated that the fledgling UAS community still has some maturing to do when it comes to writing legally binding contracts. “We’ve seen a lot of fairly loose contracts,” Proudlove said. “Decisions [are] being made over a beer and not with legally binding contracts. We had one claim where a $70,000 camera was wrecked. It had been lent by one operator to another and there was no contractual agreement. No one knew who was responsible for it. We figured it out and paid the claim, but it highlighted that there’s a great deal to be done to make sure the proper contracts are being used to support this industry as it grows.”

Lester Forsythe of the Unmanned Safety Institute discussed safe UAS operations, including the need to have a minimum of two adequately trained people operating the UAS (a pilot and a spotter). “One of the biggest UAS operation technology issues is lack of training,” said Forsythe. “Even commercial users that have Section 333 exemptions today, still don’t get professional training or have the aviation mindset. We’re trying to make sure that people understand that we have to treat these things as aircraft.”

Forsythe listed a number of operational considerations that non-aviation UAS operators may not think of, including proximity to an airport, GPS non-availability in certain areas and winds aloft. “If the UAS has operating limitations of 30 mph, and there is a 25 mph wind on the ground, the operator might say it’s OK to launch without realizing that winds aloft are likely stronger. As soon as the UAS gets up a couple of hundred feet, the wind could exceed the UAS’s capability.”

Forsythe also pointed out that the majority of UAS manufacturers are not aircraft manufacturers. “They are using consumer-grade components, not commercial- or military-grade components, so there are going to be failures. You get what you pay for. If you buy a $1,000 drone and use it every day for commercial activity, expect a failure.”

One UAS risk voiced by Richard Morris, attorney at Fowler White Burnett, is that while the FAA limits the majority of UAS operations to a maximum altitude of 400 feet, manned aircraft are reporting seeing UAS at altitudes much higher than 400 feet. Morris tied this statistic to a 2011 study of 71 business aviation accidents featuring loss of control in flight (LOC-I) that found 63 percent of these accidents began at less than 1,000 feet. “These incidents typically occur on takeoff, approach to landing and on go-arounds,” said Morris. “So you can see the potential conflict between lots of drones up to 400 feet and an aircraft trying to land.”

As part of his LOC-I presentation, Morris identified proposed FAR Part 23 changes that could reduce the number of LOC-I incidents overall, including new verbiage in Sections 23.200 and 23.215 requiring warnings to improve pilot awareness of imminent LOC-I.

“The Part 23 rules are part of the FAA’s new approach to performance-based requirements as opposed to prescriptive rules dictating a certain type of compliance,” Morris said. “The performance-based requirements propose requiring warnings to improve pilot awareness of stall margins, angle of attack (AoA) or energy awareness.”

Morris also noted other regulatory changes aimed at reducing LOC-I, among them the new 14 CFR Part 21.8(d) regulation for the approval of non-required AoA systems, and the newly revised 14 CFR Part 60 for flight simulator evaluation and qualification guidelines that include certain upset recognition and recovery procedures that became effective on May 31.

“There’s a question about the cost of [the simulator upgrades], and from what I’ve seen there’s only one simulator that’s compliant with the new requirements,” Morris said. “The FAA estimates that it will cost $80 million for airlines to upgrade these simulators; some wonder whether the [airframe] manufacturers who typically would provide the data from flight-test are going to give that up easily or charge for it. The FAA has recognized that might be an issue and will allow third-party providers to offer more type representative simulators covering a wider range of aircraft. However, the biggest issue with the new simulator capabilities is that there are no instructors who have used them before because they haven’t been required.”

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