

Spring 2022 | Aviation Finance Briefing Note

Society of Actuaries in Ireland Banking & Aviation Finance Committee

Leased Aircraft in a time of War

Russia recently passed a law which will allow Russian airlines to place aircraft leased from foreign aviation lessors on Russia's aircraft register. The law does not instruct airlines to re-register their leased aircraft on the Russian aircraft register.

Under the Convention on International Civil Aviation¹, at any time, an aircraft can only be registered with the civil aviation authority of one jurisdiction. The civil aviation authority of the jurisdiction of registration of an aircraft is responsible for the issue and withdrawal of airworthiness certificates for aircraft on its register.

Aircraft leased to Russian airlines are generally registered with the civil aviation authority of Ireland or the civil aviation authority of Bermuda. One reason for this approach to the registration of leased aircraft operating in Russia may be the inability under Russian local law to recognise and record certain preferred security.

Presumably the aim of the recently passed law from a Russian perspective is to permit the registration of the leased aircraft on the Russian civil aviation register and so that the Russian civil aviation authority can grant aircraft airworthiness certificates to Russian airlines so that they can at least fly routes within Russia. The EU and the US on the one hand and Russia on the other hand have mutually blocked access to each other's airspace.

However, adding an aircraft which is registered with the civil aviation authority of Ireland or Bermuda to the Russian civil aviation authority register appears to be at variance with the Chicago Convention, which does not permit the registration of an aircraft on more than one civil aviation register at any one time.

It has been reported² that the civil aviation authority of Ireland and that of Bermuda were suspending the airworthiness certificates of certain aircraft leased to Russian airlines as they were unable to verify the airworthiness of those aircraft.

¹ Also known as the Chicago Convention.

² <https://www.reuters.com/world/putin-signs-law-registering-leased-planes-airlines-property-tass-2022-03-14/>

Under a typical aircraft lease agreement, it would be an event of default for an airline to register the aircraft on the civil aviation register of a different jurisdiction to that specified by the lessor without the permission of the lessor and without deregistering it from its current civil aviation registry.

Russian airlines are therefore faced with a dilemma. If the airworthiness certificates are withdrawn by the Irish or Bermudan civil aviation authorities, their aircraft ought to be in effect grounded. If Russian airlines place the aircraft on the register of Russian civil aviation authority, they run the risk of damaging relationships with major global aircraft lessors by in effect expropriating the aircraft.

According to [ft.com](https://www.ft.com)³, Rolls-Royce, Safran and GE Aviation have paused the provision of support services and Airbus and Boeing have suspended the supply of spare parts and other services to Russian airlines. Without spare parts of the correct specifications and support services, it is difficult to see how all of the leased aircraft in Russia can remain flying for any extended period of time.

Following the introduction of EU and US sanctions on Russia, aircraft lessors around the world had until March 28 to repossess 500 or more aircraft, estimated to be worth something of the order of US\$10 to US\$13 billion, which are leased to Russian airlines. It has been reported⁴ that Russian airlines have in general been unresponsive to requests to return leased aircraft. It is at times like this that the importance of the size of the security deposit given by the airline to the aircraft lessor and the maintenance reserves collected by the lessor, either in cash or in the form of letters of credit, become relevant in at least providing some mitigation of any potential losses.

EU Regulation 2022/328, which is directly effective throughout EU Member States and came into force on 26 February 2022, prohibits the leasing of aircraft to Russian entities. Table 1 below examines some possible implications of EU Regulation 2022/328 for a number of aviation insurance clauses.

The recently passed Russian law permitting the placing of leased aircraft on the Russian civil aviation register could be viewed as facilitating an appropriation of leased aircraft by the Russian government. From the perspective of an aviation leasing company with 'war risk' aviation insurance, this facilitation or intent may give rise to an insurance claim under the policy which is designed to indemnify

³ <https://www.ft.com/content/9a24a4b3-a3fa-4a37-b783-cbe393461473>

⁴ <https://www.reuters.com/business/aerospace-defense/air-lease-says-russian-law-leased-aircraft-help-with-insurance-claims-2022-03-16>

aircraft lessors against the expropriation of or damage to an aircraft as a result of war.

Compared with other insurance markets, aviation insurance has a relatively small premium and customer base and the potential loss that a single airline may cause is very large. To limit their exposure to any one airline, insurers therefore tend not to cover the entire exposure of a single airline; rather, many insurers take a small proportion of the exposure of a single airline.

Aviation underwriters have moved quickly to manage their risk exposure on aircraft leased to Russian airlines by a combination of measures, including amending policies to exclude any future losses on aircraft in Russia and withdrawing from providing cover for aircraft operated in Russia.

Aviation war risk insurance policies permit the insurer to give notice of cancellation of elements of the cover and it was reported that a number of international insurers were availing of such clauses in aviation war risk insurance policies.

Aviation insurance policies are generally written on a 'losses occurring' basis. The insurer will only admit claims for losses which occurred during the period of insurance. Thus, the time at which a loss occurred will be critical and may be the subject of litigation in relation to claims arising from the lessee's failure to return an aircraft.

A host of issues arise in relation to aviation war risk insurance.

- In relation to cancellation notices:
 - Were they issued in the period between sanctions being imposed and the expropriation of the aircraft?
 - Can the insurer issue a notice to cancel or diminish cover while the insured peril is in progress?
- Does the imposition of sanctions mean that insurers don't have to honour claims?

The claims process is likely to be very difficult and lengthy. Ultimately, claims will have to be settled in the courts.

Aviation war risk insurance policies have annual aggregate limits on the amount of the pay-out for any one insured event. One aviation insurance broker estimated that, in the case where the aircraft cannot be recovered by lessors, the global aviation insurance market could suffer a loss of the order of US\$5 billion, which would be bigger than the loss suffered following 9/11.

However, aviation all-risks policies operate on an “each and every loss” basis without an aggregate limit. In view of the absence of an aggregate limit on aviation all-risk policies, some aircraft lessors may decide to make an all-risks claim to recoup potential losses.

Table 1
Possible Implications of EU Regulation 2022/328 for Aviation Insurance

Aviation Policy or Clause or Endorsement	Comment
AVN 111 (Sanctions & Embargo)	From 26 February 2022, the coverage provided by EU-based insurers ceased. While AVN 111 does not bring about a cancellation of the policy, an insurer whose coverage is required to cease under AVN 111 may give 30 days’ notice of the cancellation of its share of cover under the policy.
AVN 67B (Airline finance/lease contract endorsement)	It is legally untested as to whether continuing coverage under AVN 67B creates a separate policy for the lessor or depends on the underlying policy still being in place. AVN 67B provides that 7 days’ notice of cancellation or alteration of the policy in favour of the insurer can be given in respect of war risks. If the lessor terminates the lease this should cause the cover under AVN 67B to cease. AVN 67B does not exclude claims for theft of the aircraft by the insured.
AVN 67C (Airline finance/lease contract endorsement (hull war))	AVN 67C excludes claims for theft of the aircraft by the insured. Therefore, if the lessee withheld the aircraft in circumstances where the state in which it operates had no role, it is difficult see how a valid claim for constructive total loss could be argued.
AVN 52E covers war liability	Under AVN 52E, war risk liability cover is automatically terminated if the insured aircraft is requisitioned for use or title.
LSW 555D is a separate hull ⁵ war insurance policy. Subject to certain exclusions, LSW 555D covers <i>‘confiscation, nationalization, seizure, restraint, detention, appropriation, requisition for title or use by or under the order of any government (whether civil, military or de facto) or public or local authority.’</i>	LSW 555D may exclude confiscation by a state. Assuming it does not exclude confiscation by a state, if the Russian state were to prevent the return of an aircraft to a lessor, a valid claim for loss may arise under this clause.
Contingent Cover is used by lessors to insure an aircraft where: (i) due to an omission, the insurance that the lessee is required to put in place under the lease is insufficient; (ii) the lessee’s policy fails to provide cover; (iii) the lessee does not comply fully with the insurance requirements of the lease.	Where EU insurers are no longer providing cover, risk may have commenced under contingent policies. A contingent cover policy may contain a clause permitting the insurer to give notice of cancellation.
Possessed Cover is used by lessors to insure aircraft that are: (i) in the process of being repossessed or have been repossessed; (ii) returned after termination of a lease; or (iii) awaiting commencement of a lease.	Where EU insurers are no longer providing cover, risk may have commenced under possessed policies. A possessed cover policy may contain a clause permitting the insurer to give notice of cancellation.
Aggregation Clause	The main hull insurance policy as well as contingent and possessed hull insurance policies are generally written with an aggregate limit. Losses beyond the aggregate limit in a single policy year are effectively not insured.

⁵ Hull insurance covers damage to the aircraft.