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DOT's Regulation of "Unfair or Deceptive Practices": Reform Is Urgently Needed

By Robert W. Kneisley

In the fall of 2017, Southwest Airlines was locked in an intense battle for the patronage of California air travelers. The stakes were high: California is the nation's largest air travel market, generating 134 million domestic passengers annually, more than a quarter of the total U.S. market.¹ While the Golden State has long been an airline battleground, Alaska Airlines' acquisition of Virgin America in 2016 greatly raised the stakes. Alaska Airlines had made no secret of the competitive purpose behind the transaction, stating that the Virgin America acquisition "will position us . . . with an unparalleled

ability to serve West Coast travelers,"² and even claiming on a call with analysts that "Virgin gives us California."³ Soon after the closing of the Virgin acquisition, Alaska Airlines launched an unprecedented expansion of California service, entering 24 new markets and adding 46 daily flights. As one headline stated, "Alaska Airlines Wants to Replace Southwest as California's Go-To Airline."⁴

Southwest, long California's largest airline, reacted quickly by reducing fares and adding dozens of new flights of its own. Both carriers also initiated aggressive

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Aircraft Lenders Should Provide Financing (Not Advice)

By Edward Gross and Erich Dylus



It may seem intuitively obvious that when a bank or leasing company finances a customer's acquisition of an aircraft, it is strictly engaging in the business of financing (which presumably is its area of business focus and expertise). A reasonable customer, absent representations to the contrary, would not assume that its lender or lessor will also provide business risk, tax,

structural, or other advice or assurances. Yet, in a recently decided case, a lender's arguably ambiguous statements prompted a customer to sue, claiming that the lender breached a duty by failing to protect the customer from a tax liability that resulted in the aircraft's seizure by a foreign government. Although the bank prevailed against the customer in litigation, the case serves as a cautionary tale for lenders and lessors about the need to disclaim any role or duty to provide ancillary advice or assurances to their customers

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Chair's Message

I hope everyone had a good summer with some family, fun, and relaxing. Now we forge ahead to finish up the year. This has been a busy and innovative year for the Forum on Air & Space Law. Our practice committees (Space Law; Consumer Protection; Drones; General, Business and Charter Aviation; and Aviation and Space Finance) are very active, with regular calls and conferences, and will be holding break-out sessions during the Annual Conference in Chicago in September. If you haven't yet joined one, consider it. If you don't find a committee that focuses on your niche in aviation or space, consider creating one. We'd be happy to help.

This year is the fortieth anniversary of the Airline Deregulation Act (ADA). This edition of *The Air & Space Lawyer* includes some articles about the ADA, which dovetails nicely into the theme of the Annual Conference in Chicago. We also have articles on aircraft/equipment finance and on-orbit satellite servicing standards. There's always a little something for everyone in *The Air & Space Lawyer*. We hope you enjoy it.

This edition is arriving just as the Forum's Annual Conference takes place. We look forward to a fascinating program as well as the opportunity to catch up with old friends and make new ones from across the spectrum of the aviation and space law bar. Our keynote speakers include Fred Smith, Chairman and CEO of FedEx Corp., and Robert Rivkin, currently Deputy Mayor of Chicago and formerly DOT General Counsel and Senior Vice President at Delta Air Lines. Recognizing the anniversary of the ADA, the conference agenda, through a series of panels, will consider the results of deregulation, while also examining regulation in the Trump era and beyond. Conference sessions will also cover many other topics, including airports, cybersecurity, distribution, labor, and commercial space, in addition to the practice committee break-out sessions I mentioned. Great thanks and congratulations go to our Conference Program co-chairs Bob Span and Steve Taylor and their Program Committee for conceiving and organizing a first-rate program.

Finally, I want to follow up on the changes to the ABA's membership model, which I've mentioned in prior messages. In August the House of Delegates and Board of Governors approved a New Membership Model that includes a reduction in annual dues commencing in September 2019; complimentary "opt-in" membership to the Divisions on Law Practice and Solo, Small Firm and General Practice; and curated content, both general information and CLE, available to all for no charge. The process of getting to this plan was quite detailed, involving many people who donated their time and ideas. The Section Officers Conference (comprising the top leadership of each Section, Division, and Forum) was instrumental in working with the ABA on the final benefits package. I daresay a lot of us were reminded how much better we are when we work together for a common goal. Keep your eyes open for developments and information from the ABA.

Andrea Brantner
Chair, Forum on Air & Space Law



Editor's Column

This issue of *The Air & Space Lawyer* arrives as we gather in Chicago for the Forum on Air & Space Law's Annual Conference. Chicago, of course, is a city that enjoys special significance in the history of our industry as the place where civil aviation's foundational international treaty, the Chicago Convention, was established. This year, however, we are recognizing a milestone regarding another key legal instrument: the fortieth anniversary of enactment of the Airline Deregulation Act (ADA). The ADA is more than just another piece of legislation: it was intended to fundamentally change the balance between government regulation and market forces for the U.S. airline industry. Over the past four decades, the industry has undergone huge changes: once-great airlines such as TWA and Pan Am have disappeared, while others have reorganized under bankruptcy protection. All five of the largest U.S. passenger airlines as currently constituted are the product of mergers. Today, technology drives not just airline operations, but also marketing and sales, as never before. In legal and policy circles, a fascinating debate continues as to whether the government is honoring the ADA's intent and striking the correct regulatory balance, with some (particularly airline lawyers) arguing that the DOT's economic regulation is overreaching and not producing optimal results for consumers, while others (including some consumer advocates) argue that consumers' interests require more extensive and aggressive regulation.

Our first cover article is by an author who is one of the leading proponents of the first view. Bob Kneisley, Associate General Counsel of Southwest Airlines, argues that the DOT has overreached in its economic regulation of the airline industry, stretching its post-deregulation statutory mandate beyond its intended limits. Bob contends that excessively formalistic DOT micro-regulation has actually harmed consumers, depriving them of the benefit of innovative airline products and offers that do not comport with the DOT's regulatory compliance requirements.

This issue also includes a second article on a topic relating to the ADA. Alex Simpson and Claire McKenna of the DOT focus on the ADA's preemption provision. They examine Congress's 1994 recodification of the ADA, which, although not intended to effect any material change, substantively amended the Act's preemption and definitions provisions. This has created a continuing dilemma for litigants and courts in interpreting the

crucial question of the scope of ADA preemption.

Our next article strikes a note of caution for aircraft lenders and lessors: be careful to expressly limit the scope of representations or advice you provide your clients. The authors, Edward Gross and Erich Dylus of Vedder Price, focus on a recent case in which an aircraft purchased in the United States and registered with the FAA was seized by the Brazilian government for failure to pay import taxes. Thereafter, the owner/borrower stopped making payments on the loan, which led to litigation over the outstanding amount. During the litigation, the borrower alleged negligent misrepresentation by the lender bank: that the bank had impliedly advised the borrower that registering the aircraft with the FAA would avoid the need to pay Brazilian import taxes even though the aircraft was hangared and operating in Brazil. Although the court sided with the lender on the negligent misrepresentation issue, the authors caution lenders and lessors to strictly limit their representations, particularly when dealing with businesses and high net worth customers.

For our final article, we venture into space to examine the legal framework (or lack thereof) governing on-orbit satellite servicing activities. Authors Danielle Miller and Elsbeth Magilton cast a spotlight on a rapidly developing trend in the satellite industry: to repair and upgrade satellites while remaining operational in space rather than incurring the far greater costs and inconvenience of replacing them. On-orbit satellite servicing is an expensive and risky commercial proposition, but the authors argue that the government is increasing those risks and thereby undermining these activities by its failure to establish a coherent and well-organized regulatory scheme. They describe the regulatory status quo as a patchwork of overlapping regulatory mandates involving multiple government agencies. They argue that Congress needs to legislate to address the problem with input from expert stakeholders.

As always, please contact me with comments on *The Air & Space Lawyer* and article suggestions at dheffernan@cozen.com.

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Editor-in-Chief

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On-Orbit Satellite Servicing Standards Are a Necessity for the Private Space Industry

By Danielle Miller and Elsbeth Magilton



It is axiomatic that failure to regulate is de facto regulation. Without appropriate structure and predictability, it is difficult to build a new and innovative industry that requires significant private investment. Investors are skeptical

of high-risk endeavors that lack consistent government oversight because (in addition to the commercial risks involved) government may react to events in unpredictable ways. The private space industry epitomizes these concerns, particularly with regard to market readiness for on-orbit satellite servicing.

The technology for on-orbit satellite servicing has existed for several years, but organizations have hesitated to develop it because satellite servicing is highly risky, both operationally and as a business venture. However, experts contend that the time for on-orbit servicing to fully come to market has arrived and that the risks are worth it.¹ Among the many remarkable emerging space industry projects, satellite servicing may seem relatively mundane. Yet, on-orbit servicing is fundamental to future space projects. Therefore, as a high-risk proposition, the satellite industry requires regulatory support for these new and highly critical projects.

This article first describes on-orbit servicing and the technology's potential, including how on-orbit servicing is critical to the continued growth of the space industry. We also address how the technology is currently regulated by the federal government. Next, we argue that the current regulatory scheme is insufficient, and explain why it should be changed to provide servicers legal certainty—and why that matters to their business. The article concludes by addressing why a clear and structured set of rules for governmental licensure or approval of on-orbit space activities is essential to the industry's development.

What Is On-Orbit Satellite Servicing?

On-orbit servicing generally refers to a space-based vehicle that approaches and docks (or attaches itself

to) a satellite, then assumes control of the satellite's maneuvering and positioning (or "stationkeeping").² The National Aeronautics and Space Administration (NASA) has been using robotic tools for this purpose on the International Space Station and for the Hubble Space Telescope for several years,³ including running trials of inspection and cryogen replenishment of nearby satellites.⁴ Companies intend to use this technology for similar reasons: to extend the life of existing space systems by repairing, retooling, and refueling satellites while the satellite remains in orbit. Most recently, Orbital ATK, before its acquisition by Northrop Grumman Innovation Systems, unveiled its latest version of a satellite servicing vehicle, aimed at developing a new version of the company's "Mission Extension Vehicle." The project is called the "Mission Robotic Vehicle and Mission Extension Pods" and would handle maintenance for geostationary satellites nearing the end of their fuel life. The Mission Extension Vehicle could extend the life of a satellite by five years.⁵ This technology will relieve companies of the need to replace billion-dollar projects in space, thereby achieving a giant leap forward in the financial sustainability of new-space ventures.

Why On-Orbit Servicing Is Vital to Future Space Projects

As the main potential customer for satellite servicers, satellite operators with assets in geostationary orbit are keenly interested in the ability to repair their aging assets. Launching and placing a satellite in geostationary orbit, approximately 22,236 miles above Earth's surface, is an extraordinarily expensive proposition.⁶ These satellites are often very large and expensive to launch, particularly given the additional weight of robust anti-radiation shielding. Replacing a satellite due to instrument failure—even a small instrument—would cost millions if not billions of dollars. Even if nothing fails and the satellite simply runs out of fuel at the expected end of life, the cost of replacing the satellite rather than refueling is prohibitive. If a company were able to repair or refuel the satellite, replacement and launch costs could be avoided, particularly if the satellite then remains in orbit for longer than originally anticipated. Satellites could even be periodically upgraded to take

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advantage of technological improvements (e.g., a new camera unit).

In addition to saving companies billions of dollars in launch costs, fixing rather than replacing satellites will help to solve a host of other issues. Space is extremely overcrowded. As a practical matter, there is a limited amount of area in the immediate vicinity to Earth that is usable due to Earth's gravity and orbit. In the 1950s, this was not an issue because only two nations (the United States and the Soviet Union) were space-capable, and they placed less than 50 satellites into orbit combined. However, today there are over 60 nations (with over 1,600 active satellites) competing for room in low Earth and geostationary orbits.⁷ The number of space-faring nations is growing steadily, and experts estimate that the number of satellites in orbit will grow exponentially in the next few years.⁸ The competition for usable orbital slots is becoming fierce, and latecomers to the space race are unsure whether there will be room for their use of space in the coming years.

Moreover, while states argue over where they can park their satellites in this congested arena, there is another pressing concern. Space debris, or the leftovers from old space missions, including launching equipment, broken satellites, or tiny pieces that have fallen off space objects, is a critical issue in the free and fair use of outer space. Recently, U.S. Strategic Command (USSTRATCOM), the U.S. government entity that was charged with tracking space objects until that responsibility transferred to the U.S. Department of Commerce in June 2018 under Space Policy Directive-3 (SPD-3),⁹ estimated that there are 23,000 human-made objects larger than a softball in orbit. USSTRATCOM also estimates there are 650,000 softball-to-dime-sized objects, and 170 million bits of tiny debris (like flecks of paint and fragments of bolts or screws).¹⁰ If those pieces of debris, traveling at over 17,000 mph, collide with another space object, it can cause catastrophic failure in important space systems. This problem causes the International Space Station to change course several times per year to avoid larger pieces of debris that threaten the safety of the astronauts or the station. The debris largely comes from old or derelict satellites breaking down and often breaking apart. Those satellites and pieces of debris are also likely to strike other pieces of debris, with the collision creating more debris and perpetuating the problem.

In sum, the ability to repair satellites nearing the end of their life (or to move defunct and inoperable satellites into graveyard or disintegration orbits) would mean less congestion and debris in space—a more sustainable space environment. The current regulatory uncertainty relating to on-orbit servicing, however, is an obstacle to achieving this objective.

The Current Status of Satellite Servicing Regulation

Counterintuitively, market actors are not necessarily averse to regulation of their activities. Appropriate

regulation can provide organizations certainty that their activities are lawful and not vulnerable to arbitrary government intervention. For instance, in an area of utmost concern for lawyers, government regulation can assign liability to various actors, a critically important factor for high-risk ventures like satellite servicing. Satellite servicers would prefer to know whether they can be adequately indemnified against potential harm done to the serviced asset (in this context, a robot attached to a satellite traveling at 17,000 mph) before they commence the servicing. The U.S. government currently indemnifies launch companies against losses over a statutorily established liability cap in the event of a catastrophic occurrence during launch.¹¹ However, the current U.S. regulatory framework leaves unaddressed similar issues in the field of on-orbit servicing. In fact, on-orbit activities are not subject to comprehensive regulation following launch and before reentry. Rather, a patchwork of regulations governs some, but not all, space activities. Multiple government agencies have overlapping (even competing) regulatory authority, which frustrates industry and raises national security concerns.

The problem begins with the current U.S. approach to implementing its obligations under the 1967 Treaty on Principles Governing the Activities of States in the Exploration and Use of Outer Space, including the Moon and Other Celestial Bodies (Outer Space Treaty).¹² The Outer Space Treaty requires that states authorize and supervise their space activities and those of their nationals. Pursuant to this requirement, the United States currently oversees space activity through a number of government entities with differing yet overlapping areas of responsibility. The Department of Commerce's National Oceanic and Atmospheric Administration (NOAA) governs remote sensing satellites, the Federal Communications Commission (FCC) regulates the use of communication spectrum, and the Federal Aviation Administration (FAA) oversees the launch and reentry process. The Department of Defense (DOD) is also heavily involved in the process, conducting security reviews of proposed payloads and sensing equipment.

Although every satellite in space uses spectrum and thus to some extent is subject to FCC regulation, the U.S. government's lack of regulation of actual satellite operations following launch and before reentry is a glaring omission. While NOAA currently requires approval of any satellite carrying a camera that is

On-orbit activities are not subject to comprehensive regulation following launch and before reentry.

technically capable of sensing the planet (even if not intended for that purpose), that mandate will eventually become unsustainable as the number of satellites in space grows exponentially. Eventually NOAA, should it retain this authority, may have to focus on those systems that intend to take images of the planet, and leave other actors alone. Satellite servicers, while almost certainly carrying cameras of some variety necessary to perform their function, would not be primarily tasked with sensing the planet. Thus, no particular U.S. government entity would regulate their operations. This lack of regulation and oversight poses a serious problem for potential satellite servicing entities.

Important international law considerations also apply. Under article VI of the Outer Space Treaty, states are responsible for the actions of their nationals in space and must authorize and supervise those actions. Therefore, in the event of an issue between two operators, their governments must become involved.¹³ The 1972 Convention on the International Liability for Damage Caused by Space Objects (Space Liability Convention),¹⁴ unlike the Outer Space Treaty, provides for resolution of disputes arising from the use of space and issues caused by space assets on Earth. Such disputes are subject to diplomatic negotiations, adjudication by a commission assembled by the parties, or ultimately adjudication by the International Court of Justice.¹⁵ Without knowing what activities the U.S. government considers acceptable, operators cannot be certain whether their government will defend them against the capricious (or valid) claims of foreign operators. Moreover, a consensus is emerging that the lack of U.S. regulation of on-orbit activities is a fundamental breach of the U.S. obligation to authorize and supervise the behavior of its nationals in space. Failure to uphold our international obligations could lead to international reprisals, including sanctions and other penalties imposed by other states whose industries are harmed by the U.S. government's failure to comply with its obligations under these space treaties.

This legal uncertainty makes it difficult for companies to develop on-orbit servicing, which is critically important for the sustainability of the space environment and the space industry's growth. Industry cannot determine what capabilities they may include in their designs and whether the government may subsequently intervene and declare their activities illegal, thereby wasting the investment of time and resources already incurred. Investors are uncertain whether the potentially substantial profits from such a venture could be erased by uncompensated losses from a single accident. They are hesitating to invest the billions of dollars necessary to fund the development of servicing systems in such a high-risk environment. Thus, regulation is essential, sooner rather than later.

Ongoing Development of a Regulatory Framework

The United States, through industry, academic, and government initiatives, is taking steps to address problems arising from the patchwork regulatory framework governing space activities. Section 108 of the U.S. Commercial Space Launch Competitiveness Act of 2015 mandates the executive branch to address the on-orbit authority issue by requiring the director of the White House Office of Science and Technology Policy to "assess current, and proposed near-term, commercial non-governmental activities conducted in space," and to "identify appropriate authorization and supervision authorities."¹⁶ In April 2016, the Obama White House released a report, as required by the Act, which identified on-orbit activities as a category of activity covered by the Act and suggested an oversight framework called "Mission Authorization."¹⁷ The report did not, however, propose any agency to create such regulation.

A new policy President Trump signed on May 24, 2018, calls for the implementation of a series of regulatory reforms to support commercial space, all recommended by the recently reinstated National Space Council earlier in 2018. Space Policy Directive-2 (SPD-2) aims to streamline launch, reentry, and remote sensing regulations, and calls for the creation of a "one-stop shopping" office for commercial space and for reviews of radiofrequency and export control policy.¹⁸ The Secretary of Commerce has been assigned the task of creating this "one-stop shop." It remains to be seen whether this approach will succeed in adapting the current patchwork of regulations, with its glaring omission of on-orbit activities, into a more comprehensive and workable framework. Regardless of the Department of Commerce's approach, Congress must legislate to enable the Department of Commerce to proceed. The Department of Commerce is also working toward this goal during a period of significant transition in space organization, as exemplified by President Trump's announced "space force" and other proposed national security-focused restructuring initiatives.¹⁹

Think tanks, academics, and other government agencies also support the call for congressionally authorized standards for on-orbit servicing. The Defense Advanced Research Projects Agency (DARPA) has created a public-private consortium to address the safe operation of robotics in space. The Consortium for Execution of Rendezvous and Servicing Operations (CONFERS) aims to "[c]reate an industry/government consortium to develop technical standards for safe on-orbit rendezvous and servicing operations."²⁰ According to Todd Master, Tactical Technology Office Program Manager at DARPA, CONFERS will

leverage best practices from government and industry to research, develop, and publish non-binding, consensus-derived technical and safety standards that servicing providers and clients for on-orbit servicing operations would adopt.

In doing so, the program would provide a clear technical basis for definitions and expectations of responsible behavior in outer space. The standards would be broad enough to allow individual companies to pursue their own implementations of these standards to suit their individual businesses, while assuring that the implementations adhere to best practices for operational safety.²¹

This project integrates research, academic and industry expertise, and government experience, while protecting commercial participants' financial and strategic interests. The goal is to provide investors, insurers, and potential customers with the confidence to engage in this new sector—which is exactly what a new regulatory framework must do. These standards may provide critical guidance to Congress and the Department of Commerce as they begin drafting and implementing new laws and regulations.

Conclusion

As with any unregulated activity, there is much debate and discussion over how best to regulate on-orbit activities. The alternative potential approaches range from a light-touch general authorization regime to more specific and detailed regulation. Regardless of differing views on the optimal approach to regulation, there is broad consensus about the need for congressional action regarding on-orbit servicing. First and foremost, legislation would promote U.S. compliance with its obligations to “authorize and supervise” outer space activities under article VI of the Outer Space Treaty. It also could ensure that national security concerns are addressed in a predictable and clear manner. This would inform industry operators about how security reviews and DOD interactions would be conducted, thereby providing greater certainty.

A clear and structured set of rules for licensure or approval of on-orbit space activities is essential. Without certainty, companies' operations will be constrained by ambiguity as to the legality of their activities. All stakeholders, including industry, think tanks, and academics, must play a role in influencing the structure and content of future of on-orbit satellite servicing legislation and regulation—and it cannot happen soon enough.

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No Good Deed Goes Unpunished: The Recodification of the Airline Deregulation Act’s Preemption Provision

By Alexander Simpson and Claire McKenna



The Airline Deregulation Act (ADA)¹ was enacted in 1978, amending the Federal Aviation Act of 1958.² Since then, courts and academics have spilled abundant ink about various aspects of the ADA, including the scope of its preemptive effect.

Less analyzed, however, has been the effect on the ADA of the 1994 recodification of title 49 of the U.S. Code.³ More specifically, notwithstanding the recodification law’s assurance that it was “not [to] be construed as making a substantive change in the laws replaced,”⁴ the “changes in phraseology” that were nevertheless made to various aviation laws have posed a dilemma for the aviation bar, prompting one member to remark that the pre-recodification version of title 49 “continues to live on, in what might be described as a ‘shadow’ existence—repealed and unpublished, but nevertheless controlling in the event that the terms of the statutes now enacted in subtitle VII substantively depart from those of their predecessors.”⁵

The changes in phraseology to the ADA’s preemption provision⁶ have proven especially troublesome, such that the U.S. Supreme Court has twice commented on the matter. In *American Airlines, Inc. v. Wolens*,⁷ the Court noted that the ADA’s preemption provision had been changed from laws “relating to rates, routes, or services” of an operator to laws “related to a price, route or service” of an operator, but that this change was intended by Congress to be nonsubstantive. More recently, in *Northwest, Inc. v. Ginsberg*,⁸ the Court observed that the recodification’s omission of “rule” and “standard” from the prohibition of state enforcement of any “law, rule, regulation, standard, or other provision” was nonsubstantive.

Yet few tribunals have examined several ostensibly minor changes in the phraseology of the ADA’s preemption provision and the associated definitions section in the Federal Aviation Act—changes that, in fact, have materially altered how courts evaluate the threshold question of whether the ADA’s preemption

provision applies in the first place. These changes in phraseology have affected how courts analyze (1) the application of the ADA’s preemption provision to *intrastate* operators, and (2) the type of authority—economic or safety—that is required to be held by an operator in order to trigger the ADA’s preemption provision.

The following are the post- and pre-recodification versions of the ADA’s preemption provision, with emphasis on the changes in phraseology that will be discussed below. Post-recodification, the ADA’s preemption provision states, in pertinent part:

[A] State, political subdivision of a State, or political authority of at least 2 States may not enact or enforce a law, regulation, or other provision having the force and effect of law related to a price, route, or service of *an air carrier* that *may provide air transportation under this subpart* [(subpart II of part A of subtitle VII of title 49)].⁹

Whereas pre-recodification, the preemption provision read:

[N]o State or political subdivision thereof and no interstate agency or other political agency of two or more States shall enact or enforce any law, rule, regulation, standard, or other provision having the force and effect of law relating to rates, routes, or services of *any air carrier having authority under [title IV of this Act] to provide air transportation*.¹⁰

Application of the ADA’s Preemption Provision to *Intrastate* Operators

Post-Recodification

Generally, the ADA’s preemption provision applies to an operator holding the necessary licensure from the federal government to fly *interstate*, even if in practice the operator flies purely *intrastate*. Yet the post-recodification version of the ADA’s preemption provision arguably indicates the opposite result:

- The ADA, as recodified, preempts any state requirement “related to a price, route, or service of an air carrier that may provide air transportation under this subpart.”
- 49 U.S.C. section 40102—the definitions section of the Federal Aviation Act of 1958, as

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recodified—defines “air carrier” as “a citizen of the United States undertaking by any means, directly or indirectly, to provide air transportation.”¹¹

- “Air transportation” is defined as “foreign air transportation, interstate air transportation, or the transportation of mail by aircraft.”¹²
- Thus, per the ADA’s plain language and associated definitions, a predicate for ADA preemption is that the operator is an “air carrier,” i.e., a U.S. citizen that “undertak[es] . . . to provide” *foreign, interstate, or mail transportation*.

An operator that “may” provide foreign/interstate/mail air transportation (i.e., has the necessary authority from the federal government to do so) but in practice flies purely *intrastate* passenger carriage arguably has not “undertak[en] to provide” foreign/interstate/mail air transportation. Thus, cases tying the applicability of the ADA’s preemption provision to an intrastate operator satisfying the statutory definition of “air carrier”¹³ have reached a predictable result.

For example, in *SeaAir NY, Inc. v. City of New York*,¹⁴ SeaAir brought suit in federal court, contending that its city permit, which forbade “air tour operations,” was preempted by the ADA. SeaAir, a sightseeing operator, “principally argue[d] that because its planes fly into New Jersey airspace during the course of their flights” from New York, ADA preemption applied:

[I]n order to benefit from federal preemption, SeaAir must establish that its air tours constitute “[i]nterstate air transportation[.]” . . . This is so because if SeaAir does not engage in such transportation, it does not fall under the provision of the Airline Deregulation Act of 1994 that expressly preempts state and local aviation regulations.¹⁵

The court held, however, that SeaAir’s flights were not “interstate air transportation”—and thus the ADA’s preemption provision did not apply—because, while those flights briefly entered New Jersey, they began and ended in New York.

*Med-Trans Corp. v. Benton*¹⁶ reached the opposite result from *SeaAir*, but relied in part on the same analytical framework. In finding a state requirement preempted, the court noted that the case before it was “readily distinguished” from *SeaAir* because “plaintiff does transport patients via air ambulance between North Carolina and South Carolina Plaintiff therefore would satisfy the requirement set out by the Second Circuit that it ‘carry its passengers’ from one state to another.”¹⁷

In contrast, some post-recodification courts have looked past the statutory definition of “air carrier” in order to bring intrastate operators within preemption’s orbit. In *Stout v. Med-Trans Corp.*, the court cursorily acknowledged the statutory definition of “air carrier,” but also

observed that “the text of the preemption provision provides that it applies to ‘an air carrier that *may* provide air transportation.’”¹⁸ The court concluded: “Based on the plain language of the statute, an air ambulance need only have the necessary authority to provide interstate, foreign, or mail transportation to fall within the preemption provision, and it need not provide interstate transportation in the certain instance to trigger preemption.”¹⁹

In *Scarlett v. Air Methods Corp.*, meanwhile, the court found:

The ADA preemption clause is written in broad terms to preempt state regulation of an air carrier that *may* provide interstate air transportation. As such, the air carrier need not *always* or *exclusively* provide interstate air transportation, but need only have the ability or potential to provide air transportation in order for the preemption clause to apply.²⁰

While these courts did not affirmatively state that they intentionally overlooked the statutory definition of “air carrier” in order to (appropriately) accommodate application of the ADA’s preemption provision to an intrastate operator, their analyses indicate just that. U.S. Department of Transportation (DOT) guidance is consistent with the holdings of *Stout* and *Scarlett*:

[A]ny operator with Federal air carrier authority is to be accorded the protections of the Federal preemption provision, regardless of its precise flight operations. Thus no practical niche is carved out for only its intrastate operations. Given our experience, we are of the view that consideration of trying to carve out intrastate service as a mechanism to avoid preemption would neither be a realistic nor productive exercise.²¹

Pre-Recodification

Had the courts above relied instead on the plain language of the pre-recodification versions of the ADA and the Federal Aviation Act’s definitions provision, they might have reached a different result (*SeaAir, Med-Trans*), or reached the same, correct result but without appearing to stray from the statutory definition of “air carrier” (*Stout, Scarlett*) in contravention of the Supreme Court’s position that “[s]tatutory definitions control the meaning of statutory words . . . in the usual case.”²²

In holding that the ADA’s preemption provision applied to *foreign* operators²³—notwithstanding the definition of “air carrier” as being limited to U.S. citizens—the Second and Ninth Circuits, in *In re Air Cargo Shipping Services Antitrust Litigation*²⁴ and *In re Korean Air Lines Co., Ltd., Antitrust Litigation*,²⁵ respectively, remained faithful to the statutory text by emphasizing the caveat in the pre-recodification version of the Federal Aviation Act that its definitions, including that of “air carrier,”

were to apply “unless the context otherwise requires.” While not focusing on that exception, *Lawal v. British Airways, PLC*,²⁶ harmonized its holding with the statutory text by emphasizing the context in which the term appeared. More specifically, because “air carrier” followed “any” and preceded “having authority under title IV of this Act to provide air transportation,” the court “endeavor[ed] to interpret the statutory language according to its natural meaning” rather than in accordance with its defined terms.²⁷

Such reasoning applies equally, as it must, to intrastate operators, in order to ensure Congress’s intent of a uniform system of aviation regulation, free from a patchwork of state laws.²⁸ In other words, context necessitates nonapplication of the statutory definition of “air carrier” in order to provide intrastate operators, which do not “engage to provide”²⁹ interstate/foreign/mail air transportation, with the safe harbor of preemption.³⁰ While we are unaware of any court to have performed this analysis in the intrastate (as opposed to foreign) operator context, the Ninth Circuit may have suggested it when it stated, “[t]he preemption provision preempts states from regulating the *intrastate* activities of any carrier ‘having authority under Title IV’—notably omitting quotation marks around ‘air carrier.’”³¹

Yet the statutory language that led *Lawal* and other courts to a contextual interpretation of “air carrier” no longer exists. As recodified, the ADA’s preemption provision refers to “an” air carrier rather than “any” air carrier, and the Federal Aviation Act’s definitions provision no longer includes the caveat that its definitions apply “unless the context otherwise requires.” Nevertheless, section 1(a) of the recodification law states that the law was “not [to] be construed as making a substantive change in the laws replaced,” and the Supreme Court has acknowledged that, ordinarily, “it will not be inferred that Congress, in revising and consolidating the laws, intended to change their effect.”³² Therefore, post-recodification, it remains proper to interpret “air carrier” broadly and in context, thus inclusive of intrastate operators. In fact, referencing *Lawal*, one court has noted that “use of the term ‘any air carrier’ in the pre-1994 ADA provision is critical, and its import carries over into the interpretation of the provision post-1994.”³³

DOT Economic Authority vs. FAA Safety Authority as the Preemption Trigger

Another overlooked change to the ADA’s preemption provision, promulgated by title 49’s recodification, also has altered judicial analyses. Pre-recodification, the ADA’s preemption provision applied to an operator “having authority under title IV of this Act to provide air transportation,” whereas post-recodification the provision applies to an operator that “may provide air transportation under this subpart.”

Post-Recodification

Since the 1994 recodification of title 49, some courts

have cited FAA safety authority as demonstrating that the operator is authorized to “provide air transportation under this subpart.” *Bailey v. Rocky Mountain Holdings, LLC*;³⁴ *Valley Med Flight, Inc. v. Dwelle*;³⁵ and *EagleMed, LLC v. Wyoming ex rel. Department of Workforce Services*³⁶ are all examples of recent federal district court opinions where the court cited the operator’s safety certification under 14 C.F.R. part 135, in addition to economic authority from the DOT, as evidence that the ADA’s preemption applied.

In other cases, courts have not considered economic authority at all.³⁷ For example, in *Stout v. Med-Trans*, the court found that “the ADA’s preemption provision is implicated . . . because Defendant Med-Trans is an ‘air carrier’ under the Act.”³⁸ More specifically, because “Med-Trans holds a Part 135 ‘Air Carrier Certificate’ from the Federal Aviation Administration certifying that it is ‘authorized to operate as an air carrier’ . . . it certainly may provide interstate air transportation.”³⁹

Pre-Recodification

In contrast to the generic post-recodification language, the pre-recodification ADA states that preemption applies to an operator having “authority under title IV of this Act to provide air transportation.” To be sure, title IV of the Federal Aviation Act of 1958, as amended, was labeled “Air Carrier Economic Regulation” and provided for *economic* authorization of operators in the form of a certificate of public convenience and necessity or an exemption, such as authorization to operate as an air taxi or commuter operator under 14 C.F.R. part 298. Thus, throughout the 1980s and early 1990s, courts focused exclusively on economic authority from the DOT as the trigger for ADA preemption. For example, in *Hughes Air Corp. v. Public Utilities Commission of State of California*, the Ninth Circuit held that the ADA applied to an operator because it was registered as a commuter operator under part 298.⁴⁰

To be clear, FAA safety authority is, and always has been, separate and distinct from DOT economic authority.⁴¹ In conjunction with 49 U.S.C. section 44705, in order to conduct “common carriage”—i.e., when an operator “‘holds itself out’ to the public, or to a segment of the public, as willing to furnish transportation within the limits of its facilities to any person who wants it”⁴²—an operator requires either an “air carrier certificate” or an “operating certificate,” containing the “operating specification” (e.g., part 121 or part 135) under which the operations must occur.⁴³

Had the *Stout* court and certain other courts reviewed the pre-recodification language, they would have discerned that FAA safety authority is not pertinent to the applicability of the ADA’s preemption provision. While this may ultimately have made no difference, to the extent the operators in those cases possessed both DOT economic and FAA safety authorizations, it would be critical where a purely intrastate

operator that *lacked* DOT economic authority but possessed FAA safety certification under 14 C.F.R. part 135 sought the benefit of ADA preemption.

Conclusion

While well intentioned, the 1994 recodification of title 49 of the U.S. Code made substantive changes to the text of the ADA's preemption provision, and the associated definitions section in the Federal Aviation Act. These changes materially altered the manner in which courts evaluate, as a threshold matter, the applicability of the ADA's preemption provision. Instead of slavishly abiding by the current text, courts must familiarize themselves with the pre-recodification law so as to correctly find the ADA applicable to intrastate operators, with economic authority constituting the appropriate predicate for such a finding. We hope that this article may serve as a lodestar for such future analysis.

Endnotes

1. Pub. L. No. 95-504, 92 Stat. 1705 (1978).
2. Pub. L. No. 85-726, 72 Stat. 731 (1958).
3. The Federal Aviation Act of 1958, as amended, previously resided in an appendix to title 49. Congress reenacted title 49 in 1994 via Pub. L. No. 103-272.
4. Pub. L. No. 103-272, § 6(a), 108 Stat. 745 (1994).
5. Jol A. Silversmith, *"It, Being Dead, Yet Speaketh": The Recodification of the Federal Aviation Act of 1958*, 29 AIR & SPACE LAW., no. 1 (2016), at 8.
6. The ADA's preemption provision, Pub. L. No. 103-272, § 4, added new § 105 to the Federal Aviation Act.
7. 513 U.S. 219, 223 n.1 (1995).
8. 134 S. Ct. 1422, 1429 (2014).
9. 49 U.S.C. § 41713(b)(1) (emphasis added).
10. 49 U.S.C. app. § 1305(a)(1) (emphasis added). As enacted by Congress, the provision stated "title IV of this Act," but that language was changed to "subchapter IV of this chapter," i.e., subchapter IV of chapter 20 of title 49 of the U.S. Code, when originally codified. And as originally enacted, the provision referred to "authority under title IV of this Act to provide *interstate* air transportation," but the Civil Aeronautics Board Sunset Act of 1984, Pub. L. No. 98-443, removed "interstate."
11. 49 U.S.C. § 40102(a)(2).
12. *Id.* § 40102(a)(5).
13. See, e.g., *Schneberger v. Air Evac EMS, Inc.*, No. CIV-16-843-R, 2017 WL 1026012, at *2 (W.D. Okla. Mar. 15, 2017) ("The initial question, then, is whether air ambulance providers such as Air Evac and EagleMed qualify as 'air carriers' under the ADA and thus may invoke the federal-preemption defense at all."); *Med-Trans Corp. v. Benton*, 581 F. Supp. 2d 721, 731 (E.D.N.C. 2008) ("Thus, to benefit from federal preemption under this provision, plaintiff must show it is an air carrier for purposes of the ADA[.]"); *SeaAir NY, Inc. v. City of New York*, No. 99-C6055, 2000 WL 1201379, at *2 (S.D.N.Y. Aug. 23, 2000) ("SeaAir, however, only gets the benefits of such preemption if it is an 'air carrier' under the statute.");
14. 250 F.3d 183 (2d Cir. 2001).
15. *Id.* at 186 & n.1.
16. 581 F. Supp. 2d 721.
17. *Id.* at 732. Interestingly, while *Med-Trans's* reasoning as to this point may be awry, based on other factors it ultimately reached the correct conclusion regarding preemption.
18. No. 17-cv-115-MW-GRJ, slip op. at 5 (N.D. Fla. May 2, 2018).
19. *Id.*; see also *LeMay v. USPS*, 450 F.3d 797, 799 (8th Cir. 2006) (observing "as a general rule of statutory construction, 'may' is permissive, whereas 'shall' is mandatory").
20. No. 16-cv-02723-RBJ, 2018 WL 2322075, at *5 (D. Colo. May 22, 2018).
21. Letter from James R. Dann, Deputy Assistant Gen. Counsel, DOT, to Donald Jansky, Assistant Gen. Counsel, Tex. Dep't of State Health Servs. (Feb. 20, 2007).
22. *Lawson v. Suwannee Fruit & S.S. Co.*, 336 U.S. 198, 201 (1949).
23. Congress had intended as much. The Civil Aeronautics Board Sunset Act of 1984, Pub. L. No. 98-443, 98 Stat. 1703, amended the ADA's preemption provision by removing "interstate" from "having authority under title IV of this Act to provide *interstate* air transportation." One court has explained: "the Sunset Act's deletion of the limiting term 'interstate' from the ADA preemption provision leads us to conclude that Congress intended to expand the ADA's preemptive scope to cover state regulation of 'foreign air carrier[s].'" *In re Korean Air Lines Co., Ltd., Antitrust Litig.*, 642 F.3d 685, 695 (9th Cir. 2011).
24. 697 F.3d 154, 159 (2d Cir. 2012).
25. 567 F. Supp. 2d 1213, 1217 n.4 (C.D. Cal. 2008), *aff'd*, 642 F.3d at 693 n.5.
26. 812 F. Supp. 713 (S.D. Tex. 1992).
27. *Id.* at 718; *accord In re Air Cargo Shipping Servs. Antitrust Litig.*, No. 06-md-1775, 2008 WL 5958061, at *21 (E.D.N.Y. Sept. 26, 2008) ("*Lawal's* interpretation gave meaning to the modifying words before and after 'air carrier.'").
28. See generally *Air Cargo*, 697 F.3d at 160-61; *Korean Air Lines*, 642 F.3d at 694.
29. Recodification did not substantively change the definitions of "air carrier" and "air transportation." Compare 49 U.S.C. § 40102(a)(2), (5), with § 101(3), (10) of the pre-recodification Federal Aviation Act. Thus, to avoid further complication, we refer to the post-recodification definitions in this section.
30. Cf. Arcie Izquierdo Jordan & Kenneth R. Hoffman, *Federal Preemption of State Laws Regulating For-Hire Motor Carriers Transporting Property (Including Baggage) as Part of an Intrastate Air/Truck Shipment*, 19 TRANSP. L.J. 335, 337 (1990) ("An examination of the Aviation Act's definitions of an air carrier and air transportation in conjunction with the licensing requirements of Section 1371 (Subchapter IV) demonstrate that Section 1305(a)(1) applies to any air carrier which undertakes to provide interstate, overseas or foreign air transportation and has either received authority from the Civil Aeronautics Board (CAB) or been exempted from certification requirements.").

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DOT's Regulation of "Unfair or Deceptive Practices"

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new marketing programs to attract customers. For its part, Southwest launched an innovative loyalty promotion specially designed for California residents, the centerpiece of which was offering a Rapid Rewards "Companion Pass" to anyone who signed up for a Southwest credit card and used it for *a single purchase* (for anything, not necessarily air travel). A Companion Pass essentially enables two people to travel together for a year on any number of Southwest flights for little more than the price of a single ticket; the companion flies for free, paying only government taxes and fees. Travel bloggers raved about the California offer: "an insane offer,"⁵ "a shockingly great opportunity,"⁶ and "perhaps the greatest Southwest promotion of all time."⁷

Southwest advertised the Companion Pass offer via e-mails to existing California Rapid Rewards members, with the headline "FLY ONE. GET ONE FREE.* FOR A YEAR. (Seriously)." The asterisk led to a disclosure on the same page that read: "*Does not include taxes and fees from \$5.60 one-way." The promotion proved to be extraordinarily popular with the public, generating tens

The DOT's intervention in the California battle denied air travelers the benefits of vigorous airline competition and innovative marketing.

of thousands of new Rapid Rewards members in less than two months.

DOT's Intervention in the Airline Battle for California—and How It Harmed Consumers

While the airline battle in California was raging, Southwest was surprised to receive a letter from the U.S. Department of Transportation's (DOT's) Office of Aviation Enforcement and Proceedings (Enforcement Office) expressing "concern" about Southwest's Companion Pass promotion, and threatening to levy penalties for Southwest's "apparent violation" of the DOT's full-fare advertising (FFA) rule and 49 U.S.C. section 41712 for having engaged in an "unfair or deceptive trade practice." The letter stated that the DOT believed Southwest's advertisement was "misleading" because it advertised a "fare" as "free" even though passengers were responsible for payment of applicable taxes and fees. The letter added that

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Southwest's use of an asterisk and same-page disclosure alerting customers to the need to pay applicable taxes "does not rectify the misleading statement." The letter also stated (unnecessarily) that "[v]iolation of the Federal aviation statutes and regulations is a serious matter" and warned that "Southwest's potential liability in this matter is therefore substantial."

Immediately after receiving the Enforcement Office letter, Southwest terminated the Companion Pass promotion, well before it was scheduled to end. This was a difficult decision, because there was no evidence that Southwest's offer had misled or confused anyone. Neither Southwest nor the DOT had received any consumer complaints about the offer. On the contrary, it had been extremely well received by the public. Moreover, Southwest had reasonable defenses to the DOT's challenge.⁸ However, given the DOT's threat of "substantial" enforcement penalties, Southwest felt that the prudent course was to end the promotion.

The net result of the DOT's intervention was the abrupt termination of a highly popular and innovative travel offer, thereby depriving thousands of additional Californians of the "insane offer" and "great opportunity" that Southwest had made available for several weeks. The harm to consumers was actually even greater because the DOT's threat of heavy fines served as a deterrent to Southwest against offering similar promotions in other markets, or nationally. Thus, far from "protecting consumers," the DOT's intervention in the California battle served only to deny air travelers the benefits of vigorous airline competition and innovative marketing.

DOT Bans "Free" Offers; FTC Allows Them

To put this unfortunate incident in a broader context, it is useful to compare the DOT's policy on offers of "free" air travel with the Federal Trade Commission's (FTC's) policy toward offers of free goods or services by non-airline businesses. In 1971, the FTC issued *voluntary* guidance to merchants offering "free" goods or services, specifying numerous conditions and qualifications that had to be met in order to advertise goods or services as "free."⁹ However, after only a few years of experience with that policy, the FTC quickly abandoned it. This decision was explained by Georgetown law professor (and later FTC chairman) Robert Pitofsky:

When the [FTC] acted as a surrogate enforcement arm for competitors, as it often did in ad regulation . . . , it characteristically became entangled in *nit-picking, literalistic disputes over the meaning of words in ads*. During this period, many enforcement complaints against advertisers grew directly out of competitor complaints and appear to have been

primarily intended to protect sellers against competition . . . Many of these cases involved disputes over *relatively inconsequential items of information . . . [including] the definition of “free.”*¹⁰

Professor Pitofsky added:

The [FTC’s] decision to downplay enforcement against alleged fictitious pricing, thereby permitting some exaggeration and ambiguity in price claims, is *consistent with the principle of minimum enforcement where consumers, as opposed to competitors, are unlikely to be seriously injured* and where rigid substantiation requirements might suppress a useful form of competition.¹¹

Yet, more than four decades after the FTC abandoned its own guidelines against advertising “free” merchandise, the DOT continues to aggressively enforce restrictions against using “free” in air fare advertisements.¹² In so doing, the DOT appears unconcerned about “nit-picking, literalistic disputes over the meaning of words in ads.” Perhaps the DOT is unaware of the FTC’s experience with similar issues in a far broader swath of the U.S. economy than just air transportation. In any event, the DOT seems oblivious to “the principle of minimum enforcement where consumers, as opposed to competitors, are unlikely to be seriously injured.” While significant in its own right, this policy difference is just one example of how the DOT’s regulation of *airline* advertising and customer service is much more intrusive and prescriptive than the FTC’s regulation of the same activities in other sectors of the economy—under a *substantially identical* statutory standard.

“Unfair or Deceptive Practices”: The Four Words Behind DOT’s Regulation of Airline Customer Service

The basis for virtually all of the DOT’s consumer-related regulations is 49 U.S.C. section 41712, which authorizes the DOT to “investigate and decide whether an air carrier . . . has been or is engaged in an unfair or deceptive practice or an unfair method of competition in air transportation or the sale of air transportation.” In practice, most of the DOT’s consumer regulations are premised on the “unfair or deceptive practices” portion of the statute—and primarily the “deceptive practices” portion of that phrase. It is ironic, considering how little regulatory authority the DOT possesses over this “deregulated” industry, that the agency has used these four words as a springboard to develop an extensive regulatory regime that controls airlines’ consumer-facing activities in extraordinary detail. Indeed, the DOT’s expansive regulation of airline customer service is far out of proportion to anything Congress could have intended when it freed the airlines from the heavy-handed economic regulation of the Civil Aeronautics Board 40 years ago.¹³

In fact, important limitations on the DOT’s authority are apparent from the face of the statute. First, the DOT is not authorized to regulate “in the public interest,” i.e., to restrict or prohibit any airline practice which it happens to dislike on the grounds that it is adverse to the public interest. Rather, the DOT must find, *based upon relevant evidence*, that a specific action is “an unfair or deceptive practice.” Further, section 41712 specifies that only if the DOT finds, “after notice and an opportunity for a hearing,” that an air carrier “is engaged in an unfair or deceptive practice” may the agency order the air carrier “to stop the practice.” This language reinforces the need for the agency to have specific *evidence* of an “unfair or deceptive practice” before taking action against it.

Moreover, section 41712 must be read in concert with Congress’s directives to the DOT in the Airline Deregulation Act (ADA), which repealed nearly all of the federal government’s economic authority over air carriers and air transportation. In the ADA, Congress instructed the DOT to place “maximum reliance on competitive market forces and on actual and potential competition” to provide “efficiency, innovation, and low prices,” as well as “the variety and quality” of air transportation services.¹⁴ The U.S. Supreme Court has emphasized that Congress intentionally left the DOT with a very limited role in regulating airline customer service matters in order to allow “free-market mechanisms” to flourish.¹⁵ Thus, the DOT should rely primarily on the competitive marketplace to determine customer service matters, and intervene only where there is clear evidence of market failure.

Unfortunately, DOT regulators too often have disregarded these judicial decisions and policy directives. In recent years, the agency has issued a blizzard of highly prescriptive rules, guidance documents, and “frequently asked questions” (FAQs) that specify in extreme detail how air carriers are and are not permitted to communicate with and treat their customers. This intrusive regulatory scheme over airline marketing and customer service not only is at odds with Congress’s directive to “place maximum reliance on competitive market forces,” but it is also out of step with the policies of the FTC and other federal regulatory agencies that govern other sectors of the U.S. economy.

DOT’s Interpretation of “Unfair or Deceptive Practices” Differs Greatly from FTC’s

The language of section 41712 is substantively

The DOT’s regulation of airline advertising and customer service is much more intrusive and prescriptive than the FTC’s regulation of the same activities.

identical to that of section 5 of the Federal Trade Commission Act (FTC Act), 15 U.S.C. section 45, which empowers the FTC to prevent entities from engaging in “unfair or deceptive acts or practices in or affecting commerce.” Section 5 does not apply to airlines, other common carriers, and certain financial institutions, but it applies to nearly all other businesses and lines of commerce in the United States. Section 41712 is closely modeled on section 5 of the FTC Act, and courts have long held that the FTC’s interpretation of section 5 is an authoritative guide for the DOT’s implementation of its section 41712 authority.¹⁶

The FTC’s standard for finding an act or practice “deceptive” under section 5 requires three core findings:

1. The person or business must *intend to mislead consumers* via a false statement, misrepresentation, or material omission. Thus, an innocent misstatement of fact alone would not constitute “deception” under the statute.
2. The practice in question must *actually mislead or be likely to mislead consumers acting reasonably in the circumstances*. It is not sufficient that *any* consumer is deceived, but only those who are acting reasonably.
3. The act or *practice must be “material,”* i.e., such that a reasonable consumer would

act in reliance on it to his or her detriment.¹⁷

In order to establish a violation of section 5, the FTC must have *evidence* sufficient to establish each of these core elements—i.e., that the practice is intended to mislead, and does in fact mislead or is likely to mislead reasonable consumers to their detriment.¹⁸ Importantly, the FTC applies a presumption that market forces inherently constrain the likelihood of deception.¹⁹ Thus, the FTC regards deception to be likely only in instances of market failure, i.e., where a reasonable consumer is unable to obtain and act upon information that would avoid the deception.

The standards discussed above represent a significant tightening of the FTC’s practices under section 5 that occurred during President Reagan’s tenure. As a former FTC commissioner observed, prior to 1984, “proof of actual deception was not necessary. It was enough that the act or practice had the *tendency or capacity to deceive*.”²⁰ In the 1980s, the FTC reined in its standards for finding deception at the behest of President Reagan’s new commissioners, who believed that “the old principles could result in unwarranted

federal government challenges to advertising.”²¹ Hence, the FTC no longer challenges practices that merely have a “tendency or capacity to deceive,” but only those for which there is *evidence of actual deception or the likelihood of deception* of reasonable consumers.

In contrast to the FTC’s deliberate and transparent approach to determining whether a practice is “deceptive,” the DOT has taken a different path. Unlike the FTC, the DOT has not adopted a statement of general policy that clearly articulates the DOT’s interpretation of “unfair or deceptive practices” in air transportation under the ADA. This is a disservice to both regulated parties and the traveling public because it fails to provide appropriate guidance before disputes or questions arise. However, this may change, as the DOT recently issued a notice that it plans to conduct a rulemaking to define “unfair or deceptive practices” under section 41712.²² Such a proceeding would be welcome, but the notice raises questions about the sincerity of the agency’s commitment in this regard.²³

In the absence of an overarching policy statement, the DOT typically resorts to an ad hoc, case-by-case process to determine whether a particular practice is “unfair or deceptive” under section 41712. Significantly, there is no indication that the DOT adheres to the FTC’s three-part standard for finding deception. Indeed, the DOT’s findings that particular practices are “deceptive” often appear to turn on the personal beliefs of agency personnel rather than objective evidence. Thus, the DOT’s process resembles the FTC standard used under section 5 *before* being tightened during the Reagan years, i.e., where evidence of actual deception was unnecessary and it was sufficient that a practice had a “tendency or capacity to deceive.”

This was especially common during the Obama administration, when the DOT issued a torrent of highly prescriptive regulations governing airline marketing and customer service, including three separate multipronged rulemakings titled “Enhancing Airline Passenger Protections.” As Airlines for America (A4A), the U.S. airline trade association, noted, since 2009, the DOT issued 84 completed or pending regulations targeted at or significantly affecting airlines, the majority of which were “significant regulatory actions” as defined by Executive Order 12,866.²⁴

Indeed, the Obama DOT made no secret that interpreting section 41712 in a way to justify greater regulation of the airline industry was a high priority. As the DOT’s then general counsel stated: “[W]e have specifically the power to oversee and take action when we determine that there has been unfair or deceptive practices in the industry. We have, I think in this Administration, been *very aggressive about figuring out ways to do that that really haven’t been done before*.”²⁵ And, the DOT was true to that claim during those years.

The DOT’s adoption of the FFA rule in 2011 is a good example.²⁶ For several decades prior to the

The FTC only challenges practices for which there is evidence of actual deception or the likelihood of deception of reasonable consumers.

issuance of this new rule, airlines were permitted to advertise their base fares so long as applicable government taxes and fees were prominently disclosed so consumers could clearly see the total price of their air travel including taxes before purchase. This policy was consistent with the FTC's rules for price advertising, and reflected the way that nearly all sellers of goods and services across the economy displayed prices. Indeed, the DOT repeatedly touted the public benefits of this practice: "Not only is the separate listing of [government taxes and fees] not deceptive, but we believe that passengers benefit from knowing how much they are paying government entities apart from fares they pay the carriers."²⁷ In 2005, the DOT again reaffirmed the policy, stating that it protects consumers, facilitates price comparisons, and fosters fare competition.²⁸

In 2010, however, early in the Obama administration, the DOT proposed to reverse this decades-long policy, to require that all advertised prices for air transportation must include government taxes and fees. In doing so, the DOT offered *no evidence* that consumers had suffered harm from the existing policy.²⁹ Instead, the DOT *speculated* that consumers may have been confused or deceived by airline pricing, citing postings on a website called the "Regulation Room," an online forum that invited comments on proposed federal regulations. Most of the site's postings did not even relate to airfare advertising, and those that did offered nothing more than speculation that the DOT's previous policy may have confused the public. The DOT conceded that such comments amounted to no more than "feelings" of deception rather than *evidence of actual deception*.³⁰ Yet, in its final rule, the DOT concluded: "[w]e believe that consumers are deceived when presented with fares that do not include numerous required charges."³¹ Although the DOT may have "believed" that consumers were deceived, it presented no credible *evidence* that they actually were deceived.

Moreover, the DOT relied on a seriously flawed cost-benefit analysis to justify the new rule. The DOT claimed that the new advertising policy would generate "net monetized benefits" of \$22 million over 10 years.³² This conclusion was highly questionable at best,³³ but in any event was essentially meaningless—because \$22 million in benefits, when divided by the DOT's own estimate of 2.4 billion affected airline passengers over the same 10 years, amounted to *only 0.9 cents per person*.³⁴ Although the DOT did not mention this calculation in the proceeding, such a profound change in federal policy should never have been premised on claimed "benefits" of *less than a penny per passenger*.³⁵

Beyond that—and to come full circle—the deeply flawed FFA rule was the basis for the DOT's issuance of its guidance on the marketing and sale of "free" air transportation, the asserted authority on which the Enforcement Office challenged Southwest's California

Companion Pass promotion. The DOT's "free" guidance is independently flawed for reasons noted earlier, but the important point is that if the DOT had adhered to the FTC's interpretation of "deceptive practices," the DOT would have had no basis to adopt the FFA rule or its "free" guidance in the first instance. Instead, the only way the DOT was able to justify these sweeping policy changes was by consciously *ignoring* the FTC's contrary interpretation of the identical governing law.

DOT's Highly Prescriptive Regulation of Airline Customer Service Is Out of Step with Federal Regulation of Other Forms of Transportation

The DOT's "very, very aggressive" interpretation of section 41712 during the Obama administration resulted in an extensive compilation of rules, guidance documents, and FAQs that prescribe in extreme detail how airlines may advertise their services to, communicate with, and otherwise interact with members of the public. This intrusive regulatory control is inconsistent with the FTC's oversight of customer service in other sectors of the economy under an identical statutory mandate. Moreover, the DOT's highly prescriptive rules and guidance documents are also out of step with federal regulation of other modes of travel and transportation, including Amtrak and other passenger rail lines, interstate bus lines, cruise lines, hotels, and transit systems. These transportation and travel entities are variously subject to oversight by numerous federal agencies: the FTC, Surface Transportation Board (STB), Federal Railroad Administration (FRA), Federal Motor Carrier Safety Administration (FMCSA), Federal Maritime Commission (FMC), and Federal Transit Administration (FTA), among others. Yet none of these regulatory agencies has a "full-price advertising rule," prohibits use of the word "free" in advertisements, prescribes the content of websites, or otherwise replicates the many prescriptive rules, standards, and guidance requirements that the DOT imposes uniquely on *airline* customer service in order to eradicate alleged "unfair or deceptive practices."

The DOT has never publicly acknowledged this glaring regulatory disparity, much less attempted to explain or defend it. This is odd, as there is no apparent reason why the federal government should single out airline marketing and customer service for micromanagement while paying little to no attention to such matters by

The DOT's process for finding deception often turns on whether the practice has a tendency or capacity to deceive.

other forms of transportation or businesses in other lines of commerce.

Conclusion

While the DOT often claims that it uses its regulatory and enforcement powers under section 41712 to “protect consumers,” a substantial number of the DOT’s regulatory actions have been founded on an improper interpretation of its legal authority, particularly during the Obama administration. Moreover, experience has shown that many of the DOT’s regulatory activities during that period stifled publicly beneficial airline competition and innovation, increased the cost of air travel, and placed unnecessary restrictions on normal

interactions between air carriers and their customers—all to the detriment of consumers.

Until now, there has been no serious public discussion of this unfortunate situation, and much less have any significant corrective measures been taken. Hopefully this will change in the Trump administration, given its professed commitment to meaningful regulatory reform. The opening of a “Regulatory Review” docket is a welcome development, but no significant changes to the DOT’s regulatory regime have yet been implemented. A good start would be for the DOT to conform its interpretation of “unfair or deceptive practices”

to the standards applied by the FTC to other sectors of the economy. There should also be a serious, de novo review of rules, actions, and guidance documents that were premised on the “very, very aggressive” legal interpretation employed by the previous administration. Existing DOT rules and other actions that are found not to meet the FTC’s standards for unfair or deceptive practices should be promptly rescinded or scaled back.

DOT personnel are earnest and professional, and can no doubt apply the same kinds of standards as the FTC, but they must be directed to do so by senior DOT leaders who are committed to serious reform.³⁶ These measures would go a long way toward ensuring that the DOT does in fact place “maximum reliance on competitive market forces” to best achieve “efficiency, innovation, and low prices” as well as the “variety and quality” of airline services, as Congress intended.

Endnotes

1. U.S. DEP’T OF TRANSP., ORIGIN AND DESTINATION SURVEY (2017), <https://www.bts.gov/topics/airlines-and-airports/origin-and-destination-survey-data>.

2. Alaska Airlines, Investor Presentation (Nov. 28, 2016), <http://investor.alaskaair.com/static-files/2c06b879-10db-4544-92f6-22b647e0ec49>.

3. Transcript of ALK - Q2 2016 Alaska Air Group Inc Earnings Call (July 21, 2016), <http://investor.alaskaair.com/static-files/2611b3f7-929f-44b4-ad4a-219c6f6d1d52>.

4. Hugo Martin, *Alaska Airlines Wants to Replace Southwest Airlines as California’s Go-To Airline*, L.A. TIMES, May 15, 2016, <http://www.latimes.com/business/la-fi-alaska-southwest-20160515-snap-story.html>.

5. Summer Hull, *Open to All California Residents: Southwest Companion Pass with One Purchase on New Card!*, POINTS GUY (Oct. 19, 2017), <https://thepointsguy.com/2017/10/open-to-all-california-residents-earn-southwest-companion-pass-with-just-one-purchase-on-new-card/>.

6. Mark Lamb, *Free Southwest Companion Pass for CA Residents*, POINTS TO NEVERLAND (Oct. 24, 2017), <https://pointstoneverland.com/free-southwest-companion-pass-for-ca-residents/>.

7. Claire Tsosie, *Limited Time: California-Only Southwest Companion Pass Deal*, NERDWALLET (NOV. 15, 2017), <https://www.nerdwallet.com/blog/credit-cards/limited-time-california-only-southwest-companion-pass-deal/>.

8. Aside from the lack of any consumer harm, the advertisement in question offered a credit card, not any specific air transportation, and was thus outside the DOT’s jurisdiction.

9. Guide Concerning Use of the Word “Free” and Similar Representations, 36 Fed. Reg. 21,517 (Nov. 10, 1971).

10. Robert Pitofsky, *Beyond Nader: Consumer Protection and the Regulation of Advertising*, 90 HARV. L. REV. 661, 673–74 (1977) (emphasis added).

11. *Id.* (emphasis added).

12. U.S. Dep’t of Transp., Guidance on the Use of the Term “Free” in Air Fare Advertisements and Disclosure of Consumer Costs in Award Travel (May 17, 2012), https://cms.dot.gov/sites/dot.gov/files/docs/Use_of_the_word_free_in_fare_advertisements_0.pdf. However, as this is only a guidance document, it is not independently enforceable. See Memorandum from the U.S. Attorney Gen. on Prohibition on Improper Guidance Documents (Nov. 16, 2017), <https://www.justice.gov/opa/press-release/file/1012271/download>.

13. For a more thorough discussion of these issues, see David Heffernan, *Department of Transportation’s “Aggressive” Approach to Consumer Protection Regulation and Enforcement*, 80 J. AIR L. & COM. 347 (2015).

14. 49 U.S.C. § 40101(a)(6), (12).

15. See *Am. Airlines, Inc. v. Wolens*, 513 U.S. 219, 228 (1995) (observing that the ADA was intended to “leave largely to the airlines themselves . . . the selection and design of marketing mechanisms appropriate to the furnishing of transportation services”); see also *Delta Air Lines, Inc. v. Civil Aeronautics Bd.*, 674 F.2d 1, 3 (D.C. Cir. 1982) (noting that the ADA “replaced the old form of regulation with a new economic regime that relied heavily on free-market mechanisms”).

16. *Am. Airlines, Inc. v. N. Am. Airlines, Inc.*, 351 U.S. 79, 82 (1956); *United Air Lines, Inc. v. Civil Aeronautics Bd.*, 766 F.2d 1107, 1111–12 (7th Cir. 1985).

Existing DOT rules that are found not to meet the FTC’s standards for unfair or deceptive practices should be rescinded or scaled back.

17. See *In re Cliffdale Assocs., Inc.*, 103 F.T.C. 110, 174 (1984); FTC Policy Statement on Deception (Oct. 14, 1983), https://www.ftc.gov/system/files/documents/public_statements/410531/831014deceptionstmt.pdf.

18. See *Cliffdale*, 103 F.T.C. at 174.

19. *Id.* at 181 (finding that “market incentives place strong constraints on the likelihood of deception”).

20. J. Thomas Rosch, FTC Comm’r, Deceptive and Unfair Acts and Practices Principles: Evolution and Convergence 2 (May 18, 2007) (emphasis added) (citing *Aronberg v. FTC*, 132 F.2d 165, 167 (7th Cir. 1942)), https://www.ftc.gov/sites/default/files/documents/public_statements/deceptive-and-unfair-acts-and-practices-principles-evolution-and-convergence/070518evolutionandconvergence_0.pdf.

21. *Id.* at 5.

22. Department Regulatory and Deregulatory Agenda; Semiannual Summary, 83 Fed. Reg. 27,162 (June 11, 2018).

23. First, the notice gives no date for starting the proceeding. Second, the notice implies that the DOT already adheres to the FTC’s statutory interpretations; e.g., it states that “the Department has found a practice to be deceptive if it misleads or is likely to mislead a consumer acting reasonably . . . with respect to a material issue.” But that is untrue, as demonstrated above. One wonders if this could be an effort to rewrite the history of the DOT’s activities under section 41712.

24. Comments of Airlines for America, Part One: Proposals for Fundamental Reform of DOT Economic Regulation and Enforcement, Docket No. DOT-OST-2017-0069, at 12 (Dec. 1, 2017).

25. Transcript of First Meeting of Advisory Committee

on Aviation Consumer Protection 14–15 (June 28, 2012) (opening statement of Robert Rivkin, DOT Gen. Counsel) (emphasis added), <https://www.transportation.gov/sites/dot.gov/files/docs/resources/individuals/aviation-consumer-protection/286126/acacp-1st-meeting-transcript.pdf>.

26. See generally Supplemental Comments of Airlines for America Regarding 14 CFR §399.84 – the “Full Fare Advertising Rule,” Docket No. DOT-OST-2017-0069 (Mar. 15, 2018) [hereinafter A4A Supplemental Comments].

27. Request of Air Transp. Ass’n of Am., DOT Order No. 85-12-68, at 8 (Dec. 24, 1985).

28. Price Advertising, 70 Fed. Reg. 73,960 (Dec. 14, 2005).

29. See A4A Supplemental Comments, *supra* note 26, at 6–9.

30. *Id.* at 9.

31. Enhancing Airline Passenger Protections, 76 Fed. Reg. 23,110, 23,143 (Apr. 25, 2011).

32. A4A Supplemental Comments, *supra* note 26, at 10.

33. A4A asserted that a proper analysis would show the proposed rule would *cost* the public \$24 million. *Id.* at 11.

34. *Id.*

35. As the Office of Information and Regulatory Affairs (OIRA) stated in its 2018 Regulatory Priorities, “Unless specifically required by law, agencies should regulate only when the benefits *substantially outweigh* the costs” Introduction to the Unified Agenda of Federal Regulatory and Deregulatory Actions—Fall 2017, 83 Fed. Reg. 1664, 1670 (Jan. 12, 2018) (emphasis added).

36. See, e.g., Jeff Rosen, *Putting Regulators on a Budget*, NAT’L AFF., Spring 2016, <https://www.nationalaffairs.com/publications/detail/putting-regulators-on-a-budget>.

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31. *Hughes Air Corp. v. Pub. Utilities Comm’n of State of Cal.*, 644 F.2d 1334, 1337 (9th Cir. 1981) (emphasis added).

32. *Finley v. United States*, 490 U.S. 545, 554 (1989) (quoting *Anderson v. Pac. Coast S.S. Co.*, 225 U.S. 187, 199 (1912)).

33. *In re Air Cargo Shipping Servs. Antitrust Litig.*, No. 06-md-1775, 2008 WL 5958061, at *21 (E.D.N.Y. Sept. 26, 2008) (emphasis added).

34. 136 F. Supp. 3d 1376 (S.D. Fla. 2015).

35. 171 F. Supp. 3d 930 (D.N.D. 2016).

36. 227 F. Supp. 3d 1255 (D. Wyo. 2016).

37. See *Schneberger v. Air Evac EMS, Inc.*, No. CIV-16-843-R, 2017 WL 1026012, at *2 (W.D. Okla. Mar. 15, 2017) (finding that because Air Evac and EagleMed had FAA air carrier certificates with part 135 operations specifications permitting service throughout the country, they were “air carriers” under the ADA); *Med Trans Corp. v. Benton*, 581 F. Supp. 2d 721, 732 (E.D.N.C. 2008) (concluding that because

Med Trans actually operated interstate, and held part 135 operations specifications permitting service throughout the country, it was “an air carrier for purposes of the ADA”).

38. No. 17-cv-115-MW-GRJ, slip op. at 8 (N.D. Fla. May 2, 2018).

39. *Id.*

40. 644 F.2d 1334, 1337–38 (9th Cir. 1981); see also *Hiawatha Aviation of Rochester v. Minn. Dep’t of Health*, 389 N.W.2d 507, 509 (Minn. 1986).

41. See *U.S. Air Carriers*, DOT, <https://www.transportation.gov/policy/aviation-policy/licensing/US-carriers> (“[T]he economic authority issued to air carriers by the Department is separate from the safety authority (commonly referred to as Part 135 or Part 121 Operations Specifications) granted to them by the [FAA].”).

42. FAA, ADVISORY CIRCULAR AC 120-12A, PRIVATE CARRIAGE VERSUS COMMON CARRIAGE OF PERSONS OR PROPERTY (Apr. 24, 1986).

43. See generally 14 C.F.R. pt. 119.

Aircraft Lenders

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beyond those specifically memorialized in the loan or lease documentation.

Background

The structures and documents typically used by parties to commercial aircraft finance transactions reflect market practices developed and refined over time among air carriers, manufacturers, lessors, lenders, and investors, and their respective counsel, tax, accounting, and other advisors. Although periodic innovations reflect changes in acquisition and fleet strategies; financing trends; accounting, tax, or legal considerations; or other circumstances, the transaction structures and documents that achieve market acceptance are thereafter replicated for each new transaction of a particular type. Lenders, lessors, and investors in these replicated transactions find it comforting that the structural considerations and enforcement risk and other implications have already been scrutinized and accepted by other sophisticated market participants. This approach provides predictability regarding financing providers' enforcement of their commercial aircraft leases and loans.

Business and general aviation financing, by contrast, is much less commoditized, and the enforcement cases reflect the challenges of extending credit to the broad spectrum of customers in that market. Unlike air carriers and operating lessors, business and general aviation aircraft purchasers, especially high net worth individuals, rely on advice from their various external resources when acquiring these expensive assets. Those resources may include brokers, original equipment manufacturers, lawyers, accountants, pilots, and, in some cases, their social network. The advice sought and provided by these more or less informed sources can include the suitability of a particular aircraft for the customer's needs, balance sheet and privacy matters, liability, and regulatory compliance. However, a typical customer's primary focus tends to be the cost of acquiring, owning, maintaining, financing, and operating an aircraft.

Most of these economic considerations either are a function of prevailing market circumstances or may be

managed by practical means. Among the cost variables that business and general aviation customers may find most compelling and seek to manage structurally are related tax implications. Although tax considerations for U.S. customers could include how to optimize any unique income tax benefits available to aircraft owners, both domestic and non-U.S. customers are likely to seek advice as to how they might minimize any related taxes, duties, import or other governmental charges, or impositions payable in each pertinent jurisdiction. These considerations are also meaningful in commercial aircraft transactions, but in most cases, parties to those transactions rely on precedent structures and documents that are assumed to be consistent with advice provided by sophisticated tax counsel and a common aversion to reputational risk. The soundness of the structural engineering intended to achieve the customer's tax purposes in certain business and general aviation transactions may not be as reliable as with commercial aviation due to the uniqueness of the circumstances of the spectrum of business and general aviation customers and the lack of an industry vetting process.

Unreliable tax advice in these transactions could lead to harsh economic circumstances, including fines, penalties, liens, or even seizure of aircraft. When leased or financed aircraft are seized, the lessor or lender must endure the related consequences. But these financing providers expect to be protected from and not accountable for the consequences of the customer's tax-related transaction structuring.

The Neto Case

In a recent case, *1st Source Bank v. Neto*,¹ a high net worth individual customer living in Brazil believed that he was exempt from import taxes because of the structural aspects of his acquisition and ownership of an aircraft. The structure did not achieve the customer's import tax avoidance purposes, and the Brazilian government ultimately seized the aircraft. The aircraft had been financed, and when the lender pursued the loan balance, the guarantor argued that he should not have to pay because he claimed to have relied in part on the lender's expertise and implied advice regarding the tax structure. As discussed below, the lender ultimately prevailed, but the case serves as a caution to lenders, lessors, and other financing providers to refrain from providing structural advice to their customers beyond financing.

The ultimate customer and guarantor in this case, Joaquim Neto (a Brazilian citizen), used a noncitizen trust (NCT) to purchase a Dassault Falcon 2000 aircraft and register it with the U.S. Federal Aviation Administration (FAA),² although he planned to

Unreliable tax advice could lead to harsh economic circumstances, including seizure of aircraft.

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The Forum on Air & Space Law continues to be the one-stop shop for aviation and space practitioners. The Forum has established two new committees to better serve the aviation community, and we want you to be a part of these exciting opportunities. The first committee will be focused on general, business, and charter aviation and will be chaired by **Christa M. Hinckley**, LeClair Ryan, Dallas, Texas. The second committee will be focused on aviation and space financing and will be chaired by **Marc D. Latman**, Smith, Gambrell & Russell, New York, New York. The committees' names and their vision statements are:

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primarily hangar and operate the aircraft in Brazil.³ Neto entered into a grantor trust agreement in 2009 with Wells Fargo, as owner trustee, for the purpose of establishing the NCT. As trustor, Neto directed the owner trustee to purchase the aircraft and register it with the FAA in that capacity. In 2011, Neto sought financing for the aircraft from 1st Source Bank, and after countersigning a letter of intent (LOI) from the bank offering to make a \$6 million loan, he directed the owner trustee to enter into a loan and security agreement and other loan documents evidencing the obligation to repay the loan and pledge of the aircraft as collateral to secure that repayment. Neto guaranteed the loan obligations by entering into a guarantee in favor of the bank.

Unfortunately for Neto, the Brazilian government confiscated the aircraft in 2012 while it investigated Neto's alleged import tax evasion. Neto asserted that he failed to pay any such taxes because he believed that no import taxes would be imposed despite his hangaring and operating the aircraft in Brazil. Neto continued making the loan payments for several months after the confiscation, but stopped paying in September 2014. The bank accelerated the loan balance and sought to enforce its repossession, collection, and other remedies under the loan documents.

The bank was unable to foreclose on the aircraft while in the custody of the Brazilian government, so it pursued a casualty claim as loss payee under the insurance policy required under the loan documents. The insurer settled the bank's claim and remitted the loss proceeds to the bank in the agreed amount, which was less than the outstanding loan balance. The bank then sued the owner trustee, as borrower, and Neto, as guarantor, to collect the deficiency amount. Neto and Wells Fargo asserted affirmative defenses to the bank's demands, alleging that it impaired the collateral and failed to mitigate its damages. The bases for these asserted defenses were that the bank did not adequately attempt to obtain the aircraft's release from the Brazilian government, and that it failed to mitigate its damages by accepting less than 100 percent of the loan balance due when settling its casualty policy claim. Of particular interest, Neto also counterclaimed for negligent misrepresentation, alleging that the bank, in extending the loan, had impliedly advised Neto that registering the aircraft with the FAA pursuant to the NCT would allow Neto and the owner

trustee to avoid paying Brazilian import taxes despite hangaring and operating the aircraft in Brazil.

The court granted summary judgment in favor of the bank for both the recovery of the loan deficiency and other related payment obligations, and against Neto's counterclaim that the bank had negligently misrepresented the Brazilian import tax implications.

The Lender Was Not Accountable for Alleged Structural Advice

The *Neto* case is especially noteworthy because the customer asked the court to hold the bank accountable for damages relating to certain structural aspects of the transaction. The bank had to rebut Neto's counterclaim that it negligently misrepresented the tax avoidance benefits of the NCT registration, and he relied on the bank's advice because it held itself out as an experienced aircraft lender. The sole basis for Neto's misrepresentation claim was the bank's statement in the LOI, which read as follows: "[w]e believe these terms meet your desires as well as fall within our agreed upon credit requirements and applicable U.S. and Brazilian laws."⁴

The court dismissed Neto's negligent misrepresentation counterclaim. It held that despite the bank's admitted "knowledge of aircraft financing and banking, and that it offers aircraft financing through its Aviation Division of its Specialty Finance Group,"⁵ Neto had not relied on structural advice by the bank, as evidenced by Neto's having created the aircraft trust prior to seeking the loan or even consulting the bank. Therefore, the bank's statement in the LOI and related loan terms could not be construed as implicit advice that the aircraft's FAA registration pursuant to an already established NCT could achieve Neto's import tax avoidance purposes. The court observed that Neto's counsel advised him that the NCT structure for the aircraft's ownership was legally compliant "prior to [the bank's] provision of financing services."⁶ The court also noted that the lender was unaware of Neto's intentions regarding the cross-border and nonbusiness operation of the aircraft,⁷ which was the Brazilian government's justification for its seizure,⁸ and the resulting seizure frustrated the bank's ability to foreclose on the aircraft.

The Customer's Other Claims and Defenses

Neto raised other defenses to the bank's deficiency claim, in each instance alleging that the bank had breached responsibilities under the loan agreements and related documents or under commercial law applicable to secured parties.

The bank had to rebut Neto's affirmative defense that the bank impaired the collateral by not adequately attempting to secure the release of the aircraft from Brazilian authorities.⁹ The court rejected the collateral preservation defense, however, noting that it was the owner trustee's responsibility under the terms of the loan documents to "keep the Collateral safe and secure . . . [to] use and operate the Collateral with care and only with

A lender's experience may be useful to the customer, especially as to the cost and time efficiencies associated with a lease or loan transaction.

qualified personnel in the ordinary course of Customer's business and in conformity with all laws and regulations . . . ' and [to] not 'permit [the airplane's] identity to be lost, or otherwise dispose of [the] Collateral or any interest therein.'"¹⁰ The court also noted that the defendants had not alleged that the bank had taken any action that influenced the seizure of the aircraft, and in any event the aircraft's preservation and reclamation was the owner trustee's express responsibility.¹¹ Further, despite this allocation of responsibility to the owner trustee, the court acknowledged the bank's undertaking to preserve its collateral rights by timely notifying the Brazilian government of the security interest after the aircraft's seizure, preventing the government from selling the aircraft¹² and further impairing the bank's collateral remedies.

Neto also alleged that the bank had a duty to mitigate its damages, and failed to satisfy that duty, because the bank settled its insurance claim for less than the full amount of the loan balance.¹³ The court, however, held that the loan documents did not require the bank to mitigate its damages beyond pursuing the insurance settlement and applying the related proceeds against the loan balance, noting "receipt of payment by [the bank] under the Aircraft Policy did not extinguish the debt that Defendants obligated themselves to pay . . . even if [the bank] had obtained a full recovery under the [insurance policy]."¹⁴ Nor did the court find that the bank had any contractual obligation to collect from the insurer before demanding payment of the unpaid loan amounts from Neto pursuant to his unconditional guarantee to make those payments.¹⁵ Instead, the court reasoned that, under Indiana law, there is "no dispute that the unconditional guarantee that [Neto] entered into made him responsible for payment in full of the amounts due, regardless of any settlement."¹⁶ The bank prevailed, as the court deemed the bank's settlement with the insurer for the agreed amount to be commercially reasonable, and in any event determined that the settlement had no impact on Neto's unconditional guarantee to pay the bank upon demand all unpaid loan amounts.

Banks Provide Financing, Not Tax or Structural Advice

In the *Neto* case, the customer was unable to convince the court that the bank provided advice regarding structural devices that the customer should employ to achieve his tax avoidance purposes. Neither the LOI provisions nor the other transaction circumstances cited by the customer as proof of the bank's having provided unreliable tax advice were sufficient to persuade the court that the bank should be held accountable to the customer for the seizure of his aircraft after he failed to pay the required import taxes. The bank's deficiency claim was also supported by what the court deemed to be a commercially reasonable approach to mitigate its damages, as well as the unconditional nature of Neto's guarantee.

Nonetheless, lenders and other financing providers should take note of the arguments Neto raised, especially

his argument that the bank provided structural advice and Neto suffered harm by relying on that advice. Business and general aviation financing providers compete for lending and leasing opportunities, and certain of these lenders and lessors market not only their financing products but also their experience with the various ownership, operational, and other considerations by their customers when acquiring an aircraft. That experience may be useful to the customer, especially as to the cost and time efficiencies associated with approving, documenting, and closing a lease or loan transaction. However, marketing materials, transaction documents, and discussions with customers should be accompanied by a disclaimer of any responsibility regarding tax, accounting, regulatory, or other structural matters. This would be consistent with the proposition that a proposed financing transaction is not intended to achieve any purposes other than the acquisition financing or refinancing of the customer's aircraft. All of these documents and communications should also clearly allocate to the customer the responsibility for seeking and relying on the advice of its lawyers, accountants, and other resources, and not the lender or lessor, as to these other matters.

As noted above, Neto's misrepresentation claim was based on a single statement by the bank in the LOI that it believed the proposed terms "meet your desires as well as fall within our agreed upon credit requirements and applicable U.S. and Brazilian laws."¹⁷ The bank could have avoided any risk that this statement evidenced its having provided structural advice if it had not included this text or any similar assurance regarding the alignment of the proposed terms with the customer's "desires" or that the terms comply with "applicable U.S. and Brazilian laws." Some lessors and lenders address this risk by expressly disclaiming any structural advice, including pursuant to text provided above or near the customer's signature, to the effect that:

BY ITS EXECUTION AND DELIVERY OF THIS PROPOSAL LETTER, CUSTOMER CONFIRMS THAT NEITHER [LESSOR/LENDER] NOR ANY OF ITS AFFILIATES, OR ANY OTHER PERSON PURPORTING TO ACT ON ITS OR THEIR BEHALF, HAS MADE ANY REPRESENTATION WARRANTY, OPINION, ADVICE, OR OTHER ASSURANCE OF THE ACCOUNTING, TAX, COMMERCIAL LAW, OR OTHER CHARACTERIZATION OF THE TRANSACTIONS CONTEMPLATED IN THIS PROPOSAL LETTER.

However, discussions with customers should be accompanied by a disclaimer regarding tax, accounting, regulatory, or other structural matters.

Of course, it is also important for a financing provider to be aware of its customer's purposes and consider the legal and reputational implications. Aside from avoiding claims that they provided or confirmed advice regarding structural matters, lenders and lessors should also be wary of circumstances that may give rise to claims by the customer, the government, or third parties about facilitating harmful, unlawful, or other nefarious conduct. The due diligence practices of most established lessors and lenders should provide meaningful protection from these risks.

We have not identified any other similar reported cases in which a borrower argued that a lender should be held liable for advice given to the borrower. However, other cases involve claims that lenders had and breached some duty to a customer. Certain of these customers alleged that the lenders had and breached some fiduciary duty or duty of care generally related to the loan, including as to disclosures, enforcement, or diligence regarding the property being financed.¹⁸ For example, the court in *Bank of Red Bay v. King* acknowledged the capacity for such a duty, noting:

While the relationship between a bank and its customer has been traditionally viewed by courts as a creditor-debtor relationship which does not impose a fiduciary duty of disclosure on the bank, a fiduciary duty may nevertheless arise when the customer reposes trust in a bank and relies on the bank for financial advice, or in other special circumstances.¹⁹

Several of these opinions were issued by California state and federal courts applying California law. Generally, a financial institution owes no duty of care to a borrower under California law when the institution's involvement in the loan transaction does not exceed the scope of its conventional role as a mere lender of money.²⁰ A financial institution is generally thought to have exceeded the scope of its conventional role as a lender of money when it assumes the ability to exercise control over the enterprise to which it is providing capital.²¹ A financial institution may also be deemed to have a fiduciary duty when it has a substantial interest in the success of a borrower to which it has extended a loan beyond the "immediate purpose of the contract."²² Although the facts of these cases were dissimilar to those of the *Neto* case, they underscore that financing providers may be vulnerable to defenses and counterclaims if their involvement in the transaction extends beyond lending money.

Conclusion

Although commercial aviation lenders and lessors should avoid giving the appearance of providing structural advice to their aircraft finance customers, the risk may be greater when dealing with business and high net worth aviation customers because courts might be more sympathetic to their allegations. The favorable decisions by the court in

the *Neto* case could be attributed to the bank's reasonable approach to the circumstances, the unassailable provisions of the loan documents, and the specious nature of the customer's claims, especially the attempt to blame the bank for the customer's failure to avoid the imposition of the Brazilian import tax by registering his aircraft at the FAA registry. Lenders and lessors that follow these prudent documentation, diligence, and enforcement practices are more likely to achieve their investment purposes and avoid unnecessary enforcement risks, expenses, and delays by avoiding these types of claims.

Endnotes

1. No. 3:15-CV-261-JD, 2018 WL 571941 (N.D. Ind. Jan. 25, 2018).
2. The use of an NCT ownership structure was necessary for FAA registration of the aircraft because Neto was not a U.S. citizen for purposes of 14 C.F.R. § 47.2.
3. *Neto*, 2018 WL 571941, at *1. All parties, including the bank, were advised as to the aircraft's primary usage in Brazil. *Id.*
4. *Id.*
5. *Id.* at *2 n.3.
6. *Id.* at *1.
7. *Id.* at *6.
8. *See id.*
9. *See id.*
10. *Id.* at *2.
11. *Id.* at *4.
12. *Id.*
13. *See id.*
14. *Id.* at *5.
15. *See id.*
16. *Id.*
17. *Id.* at *1.
18. *See, e.g.,* *Alpine Bank v. Hubbell*, 555 F.3d 1097, 1111 (10th Cir. 2009) (applying Colorado law) ("[Borrowers] must establish . . . that '(1) [they] actually reposed a special trust or confidence in the [Bank]; (2) such trust was justifiable; and (3) the [Bank] either invited or ostensibly accepted the trust imposed.'"); *Bank of Red Bay v. King*, 482 So. 2d 274 (Ala. 1985) (applying Alabama law); *Li-Conrad v. Curran*, 50 N.E.3d 573 (Ohio Ct. App. 2016) (ruling that the tort of negligent misrepresentation does not apply to a loan transaction between a bank and its customer because there is no fiduciary-like relationship in which the bank would have a professional duty to give dependable information).
19. 482 So. 2d at 285.
20. *See, e.g.,* *Dougherty v. Bank of Am., N.A.*, 177 F. Supp. 3d 1230 (E.D. Cal. 2016); *Griffin v. Green Tree Servicing, LLC*, 166 F. Supp. 3d 1030, 1048–49 (C.D. Cal. 2015); *Cornejo v. Ocwen Loan Servicing, LLC*, 151 F. Supp. 3d 1102 (E.D. Cal. 2015).
21. *See, e.g.,* *Connor v. Great W. Sav. & Loan Ass'n*, 447 P.2d 609, 616 (Cal. 1968); *Kinner v. World Sav. & Loan Ass'n*, 57 Cal. App. 3d 724, 734 (Ct. App. 1976); *Bradler v. Craig*, 274 Cal. App. 2d 466, 476 (Ct. App. 1969).
22. *Wagner v. Benson*, 101 Cal. App. 3d 27, 34–35 (Ct. App. 1980).

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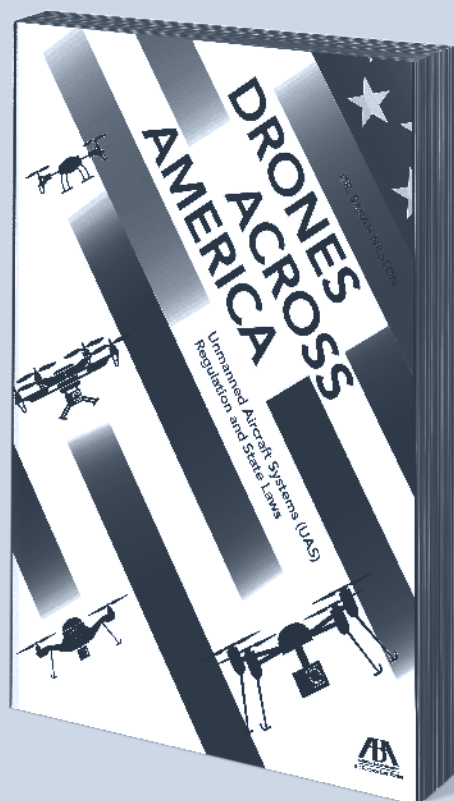
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