



# Traps for The unwary:

by Phillip J. Kolczynski **Business Flying and the "Compensation or Hire" Rule**

The FAA "Compensation or Hire" rule prohibits a pilot who is not a commercial pilot -- and not operating under the FAA's commercial operating rules -- from carrying passengers or cargo for compensation or hire. In other words, if compensation is paid for a flight carrying passengers or cargo, the flight must be conducted under Part 135, or comparable Federal Aviation Regulations (FARs).

To understand the legal risks created by the Compensation or Hire Rule, one must do more than read FAR 61.113 (formerly 61.118), which is the rule that the FAA cites when they charge a pilot with a compensation or hire violation. To avoid compensation or hire violations, a pilot must be familiar with the definition of a "Commercial Operator," in FAR §1.1. He must understand the privileges afforded to a Commercial Pilot or Airline Transport Pilot. The pilot must also know the rules applicable to Commercial Operators, and the types of permissible business flying, e.g., FAR 119.1 & 91.501. Many business-flying exceptions are not listed in FAR 61.113. This rule simply provides the basic compensation or hire requirement and lists some exceptions in subsections (b) through (g). To really stay out of trouble, a pilot or aircraft owner must understand the distinctions between commercial, business and private flying. The purpose of this article is to reveal traps for the unwary pilot, aircraft owner and aircraft company.

This article is divided into several sections:

- [Business Pilots Work In The Twilight Zone Between Private And Commercial Flying](#)
- [Business Flying = Private Carriage for Hire](#)
- [Dissecting the Basic Compensation or Hire Rule -- FAR 61.113](#)
- [Five Traps for the Unwary Private Pilot](#)
- [Consequences Of Violating The "Compensation Or Hire" Rule For Pilots](#)
- [Consequences of Violating the "Compensation or Hire" Rule for Aircraft Owners](#)
- [Traps for the Unwary Charter Operator or Aircraft Management Company](#)
- [Traps for Corporations: The Aircraft-Ownership or Flight-Department Company](#)
- [A Trap for the Unwary Executive-Pilot-Owner of an Aircraft Sole-Asset Company](#)

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## **Business Pilots Work In The Twilight Zone Between Private And Commercial Flying**

Commercial operations are those involving some form of compensation. Private flying involves no compensation unless specifically authorized by certain FARs. Commercial flying -- because it involves the carriage of passengers for hire -- must be done under the especially strict guidelines of certain FARs. Private flying can be done under Part 91, the General Operating and Flight Rules.

The FAA distinguishes commercial operations as involving either private Carriage for Hire ("Non Common Carriage"), or "Common Carriage." These terms are partially defined in FAR 119.3. Common Carriage is the holding out to the public of transportation for hire; for example, the airlines and charter operators. The strictest operating and maintenance rules apply to common carriage. The commercial operator who is involved in common carriage must have a special Air Carriers Operating Certificate to operate under Parts 125, 135, 137, 121 or 129. Private Carriage is just that: private flying in which the pilot needs only a private pilots license. A private pilot flies under basic operating rules and can carry passengers as long as the passengers do not pay any form of compensation for the flight or the aircraft.

Pilots who fly for business or are employed by businesses operate in a twilight zone known as Private Carriage for Hire. They work under rules that allow flights where the flying is "incidental" to the primary business of the company for whom the pilot is flying (see FARs 61.113(b) and 91.501).

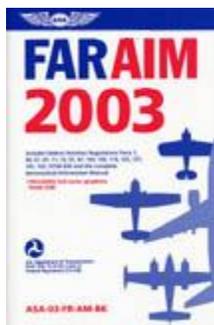
### **Business Flying = Private Carriage for Hire**

Private Carriage for Hire is any business-related flying for hire that does not involve advertising or holding out to the public. It is done under special exceptions to the general operating rules of Part 91. No special certificate is required, although special ratings may be required depending on type of aircraft. Most business pilots have more than a private pilot's certificate.

Business pilots cannot fly an aircraft for compensation or hire unless it is incidental to the business of the company they fly for. Generally, business pilots involved in flying small airplanes are subject to the restrictions of FAR 61.113. In addition, certain pilots are allowed to fly relatively small aircraft, for compensation or hire, if they do so in one of the specialized operations permitted by FAR 119.1(e). These specialized operations do not require compliance with Part 135, but they usually involve some form of compensation or hire. They include: student instruction, certain airport-proximate sightseeing flights, ferry or training flights, crop dusting, bird chasing, banner towing, aerial photography, fire fighting, helicopter-construction operations, pipeline patrol, sightseeing in hot-air balloons, local-airport parachute-jump flights, and certain airport-proximate helicopter operations.

Pilots can fly large aircraft and large turbojet multi-engine aircraft for compensation or hire, if they and comply with FAR 91.501. Some small aircraft can be operated under FAR 91.501, pursuant to Exemption No. 1637, issued to the National Business Aircraft Association (NBAA), on September 26, 1984. The provisions of 91.501 cause confusion for some pilots and I will discuss traps for the unwary in 91.501 in several sections later in this article.

### **Dissecting the Basic Compensation or Hire Rule -- FAR 61.113**



FAR 61.113 is entitled "Private Pilot Privileges and Limitations: Pilot in Command." The title is a little misleading because the rule says little about privileges; it mainly covers the basic provisions restricting flights for "compensation or hire."

In pertinent part, FAR 61.113 provides:

*(a) Except as provided in paragraphs (b) through (g) of this section, no person who holds a private pilot certificate may act as pilot in command of an aircraft that is carrying passengers or property for compensation or hire; nor may that person, for compensation or hire, act as pilot in command of an aircraft.*

*(b) A private pilot may, for compensation or hire, act as a pilot in command of an aircraft in connection with any business or employment if:*

(1) The flight is only incidental to that business or employment; and

(2) The aircraft does not carry passengers for compensation or hire.

The following exceptions are listed in this rule:

(c) A private pilot may not pay less than the pro rata share of the operating expenses of a flight with passengers, provided the expenses involve only fuel, oil, airport expenditures, or rental fees;

(d) Allows passenger carrying during charitable airlifts;

(e) Allows search and location reimbursements (apparently you can get compensation for locating but not rescuing);

(f) Allows a private pilot with 200 hours to demonstrate aircraft to buyers;

(g) Allows pilots to tow a glider in compliance with FAR 61.69.

### Five Traps for the Unwary Private Pilot



**First Trap:** Subsection (a) of the rule is poorly worded. What the FAA is trying to say is that the rule applies in two situations: 1) When the pilot is personally getting compensation or is personally for hire; and 2) When the pilot does not receive compensation personally but the aircraft is being flown to generate compensation or the aircraft is offered for hire. This is a trap for the unwary pilot who works under "blinders," oblivious to the fact that the people he works for are running a compensation or hire operation. Note that the FAA could investigate a civil penalty action against the employer who doesn't hold a certificate from the FAA, but it is much easier to simply violate the pilot who holds a certificate.

**Second Trap:** A private pilot can fly in connection with business or employment as long as the flying is "only incidental" to that business or employment. This is important! It is the foundation for more than one "Trap for the Unwary," discussed in this article. The FAA considers "only incidental" to apply to the traditional corporate flying situations. For example, a company manufactures "widgets" as their primary business. They have a corporate flight department, in-house, with private pilots (or better) who fly company employees and customers and guests on "widget" business. The employees, customers, and guests cannot be charged for the flights. The flying is "only incidental" to the widget business and is perfectly proper under Part 91.

What if the company has -- as its sole or primary purpose -- the ownership and operation of the aircraft, typically an aircraft holding company? This can be a trap for the unwary pilot who flies the aircraft for the company. He could be violating the compensation or hire rules, unless the flying fits into one of the exceptions, discussed above in FAR Part 91.501 or FAR 119.3.

Now change the example such that the company has a primary widget business and the flying is "only incidental," but the company is charging the passengers for the flights on the company plane. One must distinguish between traditional business travel entertaining involving customers who award contracts to the entertainer, versus the use of a company to -- in effect -- collect fares for transportation. This could be a trap for the unwary pilot and needs to be analyzed by an aviation lawyer to determine if the company is in violation for collecting a disguised airfare.

**Third Trap:** A private pilot may share in the operating expenses of the flight with the passengers. Note that the FAA says the pilot "... may not pay less than his pro-rata share." A trap for the unwary exists when a pilot pays

less than his share. Thus there is a potential violation where the arrangements call for the pilot to contribute his piloting services and the passengers simply pay for the plane, the fuel, oil and airport expenses. The pilot must pay not less than his pro-rata share of the flight expenses -- he cannot simply contribute his services as his share, then have the passengers cover the trip expenses, unless his services are objectively valued and added to the total trip costs and he pays his pro-rata share.

**Fourth Trap:** A trap for the unwary lies when the pilot wants the passengers to pay more than the fuel & oil for that flight, the aircraft rental and the airport expenses (landing fees, tie down for the trip, etc.). Let's say the pilot wants the passengers to split a portion of the annual maintenance, some of his insurance costs, a portion of his annual hangar rent, or any other fixed cost of aircraft ownership. The rule does not allow the sharing of fixed ownership or long-term operating costs, just "the operating expenses of a flight." If maintenance is needed to complete the flight, it may be an operating expense of the flight; but any maintenance expense included in the passengers' tab and not directly related to the flight can be challenged by the FAA.

Be aware that the term "compensation" is interpreted very broadly by the FAA. I sometimes think that the FAA is trying to outdo the IRS, an agency that wants to tax income in "any form." The FAA does not care if the pilot actually makes a profit or has a profit motive. If the pilot gains any economic advantage from the flight beyond the permissible sharing, he is getting more than his pro-rata share.

An exchange of services could constitute compensation. Judge Patrick Geraghty of the NTSB, who currently hears enforcement cases in the western United States, has explained that compensation can exist "without an exchange of greenbacks or dollar bills or anything else if there is a quid pro quo" that benefits the operator.

Understanding the FAA's interpretation of compensation leads to the question of whether a pilot can simply volunteer his airplane and his piloting services to transport passengers to where they want to go, as long as the pilot pays no less than his pro-rata share of the flight expenses. Let's say that -- out of love of flying, and/or a desire to build hours of experience -- the pilot may be willing to pay his share of the passengers' trip. He/she may reason that this is a lot better than paying the whole amount for that amount of flight time. What if the pilot does collect money from the passengers but only their pro-rata share? FAA legal interpretations have been issued declaring that this arrangement may involve impermissible "compensation or hire." The problem is that a violation can occur if the pilot is getting an economic advantage beyond the sharing, because he is not involved in a trip for a "common purpose."

**Fifth Trap:** The "common purpose" requirement is a *hidden* trap for the unwary private pilot. The traps I mentioned so far have not been hidden -- you just had to read the rule carefully. This one is a real sleeper. The Administrative law judges of the NTSB -- who hear FAA enforcement cases against pilots -- have come up with a "test" to determine if a private pilot is getting a permissible sharing from a pro-rata sharing arrangement or impermissible compensation.

The Administrative Law Judges of the NTSB use the common-purpose test that is not in FAR 61.113 or any of the FARs. The Judges will look beyond the calculation of pro-rata share for evidence of whether the pilot and the passengers were engaged in a trip for a "common purpose" [Administrator v. Carter, Order EA-3730, Docket SE12735, NTSB Decisions (1992)]. Under the "common purpose" test, if the pilot and passenger(s) are embarked on a flight for the same reasons, then they can share expenses under 61.113 (c), because they have a "common purpose." If the passengers want to go from point A, to point B, and the pilot is simply the driver or has other interests for making the flight, there is no common purpose. If he takes any compensation or economic benefit for the trip, he may be violating 61.113. The pilot in this example is, in effect, running a charter operation and should comply with FAR 119 & 135.

**Miscellaneous Traps:** Situations that can -- depending on the circumstances -- involve violations of the compensation or hire rule, include:

- Pilots being paid a fixed amount for flights with passengers to avoid the hassle of calculating the pro-rata share, particularly if the amounts paid to the pilot exceed the pro-rata share of the flights;
- Pilots who provide "fly-in" package deals to people fishing, golfers, skiers, scuba divers, etc. The operation of the aircraft may not be considered "only incidental" to another business. Indeed, it may very well be considered the primary business, one involving charter air-transportation with recreation at the destination;
- A pilot who transports club passengers who are members of the same club as the pilot. The pilot does not receive compensation from the passengers, but the club they all belong to, receives the compensation. The aircraft is being used for compensation or hire;
- A private pilot who is building his flight experience, flies cargo to gain flight time and he receives no money from the shipper. A cargo charter occurs, where a pilot flies to a destination chosen by the cargo shipper, that is not a destination the pilot was going to for his own purposes.

### **Consequences Of Violating The "Compensation Or Hire" Rule For Pilots**

The most apparent consequence of a violation is the likelihood of an FAA enforcement action. FAA Order 2150 is the legal guide that covers the Compliance and Enforcement program. This Order provides that FAA attorneys can impose a sanction of a 180-day suspension of a pilot's certificates or impose revocation of his certificate. These are the recommended sanctions for a *single* violation of the compensation or hire rule.

### **Consequences of Violating the "Compensation or Hire" Rule for Aircraft Owners**

Pilots are not the only ones who need to guard against violations of the compensation or hire rule. CEOs, business managers and aircraft owners need to understand that a pilot-certificate enforcement action may not be the worst consequence if there is an accident, while the aircraft is operated violating the compensation or hire rule. Frequently, the violation does not occur because the pilot in command lacks a commercial pilot certificate. The violation arises because the aircraft is operated under Part 91, but the flight can be shown to be one for compensation or hire. Thus, the flight was a commercial operation. As such, it should have been conducted under the stricter requirements of Part 135, etc. The requirements of Part 135 are extensive and involve both operations and maintenance. When a pilot operates an aircraft for a business -- purportedly under Part 91 -- but violates the compensation or hire rule, he may also have violated one or more of the safety provisions of Part 135.

Violations of safety rules of Part 135, if in any way causally related to the accident, can have dire consequences for the pilot's employer. Violations of the safety requirements of Part 135 may constitute negligence per se. Odds are that, if pilot error was a contributing cause to the accident, a 135 violation may be causally related to the crash. The likelihood that the employer company will avoid liability in any post-accident litigation is greatly reduced.

Many business aircraft operations are insured. Most aviation liability insurance policies have provisions about violations of the FARs. These provisions may exclude coverage for accidents involving violations of the FARs, where the violation is causally related. Even worse, a non-commercial aviation liability policy may not require proof of an FAA violation but may exclude coverage for any flight for which compensation is "charged," or words to that effect. Check your policy!

## Traps for the Unwary Charter Operator or Aircraft Management Company



On-demand charter operators and aircraft management companies can fall victim to the "compensation and hire" rule, even though they are certificated for operations under Part 135. This can happen when they manage or operate mixed-use aircraft. In this context, mixed-use aircraft are those operated under Part 135 on some flights and Part 91 on other flights.

Many on-demand charter operators have fleets made up of mixed-use aircraft. Owners lease their personal or corporate business class aircraft to charter operators with a management agreement and lease between the owner and operator. The charter operator puts the aircraft on its Air Carrier Operators Certificate, maintains the aircraft under Part 135 standards, and conducts charter flights with the aircraft. On occasion, the charter company can use the aircraft for Part 91 flights such as training, positioning, ferrying or maintenance test flights.

The owner of the leased aircraft can -- upon proper notice -- reserve the flight for his own Part 91 personal use or for corporate use, often under FAR 91.501. Frequently, the owner's pilot may fly the aircraft for the owner under Part 91 on some flights. He may be allowed to work for the charter operator flying Part 135 charter flights the rest of the time. Or vice versa: The charter company's pilots may be permitted to conduct Part 91 personal or corporate flights for the owner, when not flying charter. This flexibility can be beneficial for both parties.

The owner may direct that his corporate pilot transport passengers who are employees, guests, clients or customers on the corporate aircraft under Part 91. This can be done as long as the transport is incidental to that company's business and the passengers are not charged for the flight. These same passengers, who have become accustomed to the airplane and its pilots, may on other occasions, choose to travel as charter customers of the charter operator.

The "compensation or hire" problem can arise when a charter operator discovers -- after a flight -- that the pilot(s) and/or aircraft were not qualified to fly under Part 135. Similarly, the subject flight may have been permissible under Part 91, but not under Part 135, due to weather minima, runway length or other requirements. **Trap for the Unwary:** There is a strong temptation to characterize the flight as a Part 91 flight, and simply not charge the passengers. Whether such "born again" Part 91 flights are permissible may depend on many factors. Even if the passengers are not charged, the passengers may have been acquired by the advertising or by the "holding out for hire" by the charter operator. Thus, common carriage may have occurred and the compensation or hire rule may have been violated.

Any charter operator, faced with this problem, should immediately contact an aviation attorney experienced with Part 135 operations for advice. Certainly, they should do so before making any written entry in a record, log, or report. There may be proper ways to avoid a potential violation. Relief may be available through a timely disclosure in return for enforcement amnesty, under the FAA's Voluntary Disclosure Reporting Program. The FAA adopted this program for holders of an Air Carrier Operators Certificate in 1998. However, while this program can be very useful, there are potential traps for the unwary in the voluntary disclosure program, which should be discussed under the attorney-client privilege before a decision is made.

## Traps for Corporations: The Aircraft-Ownership or Flight-Department Company

A very subtle trap for the unwary involves the common practice of forming a corporation or Limited Liability Company (LLC) to own and operate an aircraft in order to carry employees or clients of an affiliated company. Frequently, companies and executives are advised by tax specialists, asset protection consultants or business

advisors to form a separate legal entity -- typically, a corporation or LLC -- to own an aircraft. The separate aircraft ownership company is supposed to act as a buffer against liability to protect the main company or the executive(s). It often makes arrangements to transport passengers for the main company. The same situation can occur where an owner or executive in a company forms a separate aircraft ownership company and uses the aircraft for main company business flights.

The FAA calls these Aircraft Ownership/Holding Companies "Sole Purpose Transport Companies" or "Flight Department Companies." They are frequently violating the "compensation or hire" rule. Usually, some form of compensation is paid to the aircraft ownership company for passenger carriage; this is where the violation occurs.

The FAA permits corporations to have in-house flight departments that transport employees, clients, contractors etc. They can do so as long as the transportation is "incidental" to the business of the corporation. According to FAR 91.501(b)(5), "incidental" means not the primary business of the company.

The FAA allows carriage of passengers for an affiliated company, such as a parent corporation or subsidiary corporation. The carriage must be within the scope of the main company's business or incidental to the business of the main company. *And*, the passengers cannot be charged for the flight. The FAA does not extend this permission to separate companies, whose sole or primary purpose is the ownership and operation of an aircraft. The FAA considers this a transport company, i.e., a charter operation. Such flying is not incidental to business; transportation by air is *the* business of such aircraft ownership companies. Thus, an aircraft-ownership company whose sole or primary purpose is the ownership and operation of an aircraft risks a compensation or hire violation when it transports the passengers of an affiliated company and accepts compensation for the carriage.

If an aircraft ownership company uses its aircraft to transport the employees, clients, contractors, etc., of another company, even an affiliated one, under Part 91, it cannot receive any compensation from the passengers or the other company. The flights are in violation of the "compensation or hire rule and must be conducted under Part 135 [e.g., FAA General Counsel Legal Interpretation 1989-22 (August 8, 1989)].

Having exposed this trap for the unwary, I must point out that there are many companies and aircraft owners who own aircraft this way. They own aircraft in corporations or LLCs, with no other primary business purpose. They are theoretically violating the FAA legal interpretation prohibiting Flight Department companies. They are able to do so because the FAA has not been aggressive in conducting enforcement actions; but just because most have gotten away with it doesn't mean that all should do it. As discussed earlier, there can be more serious consequences if there is an accident on a compensation or hire flight conducted under Part 91.

### **A Trap for the Unwary Executive-Pilot-Owner of an Aircraft Sole-Asset Company**



The "put the airplane in a separate company" advisors suggest that a company be formed for the sole purpose of owning and operating an aircraft. They believe it can insulate the stockholders against air-crash liability whether it has insurance or not. Some even think that the corporation can insulate a pilot-owner from liability when he is flying.

The liability-avoidance premise is that a corporation's shareholders are not supposed to be liable for the debts of the corporation. The corporate veil is supposed to create an impenetrable barrier between the corporation and the shareholders. Executives may be tempted to take the aircraft out of the main company so that a serious aircraft accident does not jeopardize it.

Similarly, many high-net-worth pilot-owners put their aircraft in a corporation. They hope to insulate their estates against liability if they are a cause of a fatal crash.

The corporate veil defense is designed for standard business debts and for active businesses. There could be a trap for the unwary owner/stockholders of shell corporations who pilot their own corporation's aircraft. They are counting on the corporate veil to protect them from personal liability after a major air crash.

Importantly, the owner-pilot flying the aircraft is the operator. He is usually in operational control. He personally makes the safety of flight decisions, not the shell corporation. He does so under the authority of his FAA pilot certificate, not under some state's corporate charter. Thus, liability for a pilot error crash will primarily result from his failure to prudently exercise operational control. His exposure may not be eliminated by the corporation's ownership of the aircraft. When a pilot-owner has a bad crash, there is a risk -- under some states' laws -- that he will be held personally liable despite the corporate veil, or that the corporate veil might be pierced.

I am not suggesting that active businesses with assets or corporate activities beyond the ownership and operation of an aircraft are at risk. What I am saying is that when a mere shell corporation is formed -- with no business or asset other than an airplane -- the loss of that asset in a crash leaves the corporation undercapitalized. It will be without the financial ability to pay for its liabilities. If it does not have insurance -- or the insurance is woefully inadequate or the coverage is lost by an exclusion -- the corporate veil may be pierced. Some states have "piercing the corporate veil" laws that scrutinize not only the proper construction and use of the corporate entity but also whether it is "equitable" (fair) to provide corporate veil protection to stockholders when the veil is challenged.

Another perspective: What would a trial judge do when the widows and orphans from an air crash cannot get adequate compensatory damages? What if the investigation reveals the company has no assets but the owner(s) have substantial net worth? Will the court apply the law to protect the stockholder-owner-pilot or to compensate the victims?

This trap for the unwary can get worse. What if the owner-pilot's sole-asset company receives compensation, in whatever form, for the carriage of passengers? What if he flies under Part 91, not the stricter safety rules of Part 135? As discussed earlier, Part 135 has such strict operational safety rules that a crash due to operational error usually involves a violation of Part 135. The NTSB tells us that 80-90% of all crashes are due to pilot error. Will the liability insurer -- with million of dollars of exposure -- be tempted to deny coverage after a crash under these circumstances?

If owner-pilots choose to operate under the teeth of this trap for the unwary, they should do so only after seeking specialized legal advice. While some business advisors may think there is corporate veil protection for the pilot-owner of a shell corporation, I suggest that experienced air crash lawyers would disagree. I believe that not many courts will allow the shell entity's corporate veil to protect the owner-pilot's assets against wrongful death judgment creditors when he was flying.

Pilots who fly their own aircraft for business must be very careful about how they structure their ownership and operation. They must be careful of the source of payments for their operating expenses when carrying passengers. They must maintain ample insurance and conduct their operations so that coverage is in place at all times.

The compensation and hire rules can be confusing and a trap for the unwary. If in doubt about the propriety of any operation under the FARs, seek the advice of your friendly FAA FSDO inspector. Many of these people are very knowledgeable and, if they have time and are willing to advise you, there would be no charge for their guidance. Alternatively, consult with an aviation attorney -- the best ones usually work for compensation or hire.

One important consideration: Always be careful when talking to an FAA inspector about a flight you have already conducted. When you talk to an attorney about a flight that has already been conducted, everything you reveal is confidential. Your disclosures are protected by one of the strongest privileges recognized in the law: the attorney client privilege.

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