AIR CARRIER OWNERSHIP AND CONTROL REVISITED

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ABSTRACT

As the airline industry is in the midst of an economic crisis, air carrier ownership and control rules that have governed international air transport relations for the last fifty years have become subject to increased revision. Those rules impede the free flow of capital and airline consolidation across borders. Airlines have limited opportunities to structure their operations to serve global markets. Most importantly, the rules restrict the strategic choices available to ailing airlines and impede the restructuring of the industry. Particularly in the European Union, where liberalization is limited by restrictive ownership requirements included in bilateral agreements with third countries, airline consolidation and rationalisation through mergers and acquisitions is badly needed.

Impetus for liberalization emanates from the recent judgments of the European Court of Justice in the "Open Skies", which created the opportunity to revisit the entire ownership and control framework on a global scale. The Fifth ICAO Worldwide Air Transport Conference (ATConf/5) provided States with a forum to discuss and bring about change. Finally, the industry itself is pushing towards the liberalization of ownership restrictions that prevent it from operating like any other industry sector.

This thesis provides a review of the recent developments in the field of air carrier ownership and control. The focus is on a critical analysis of the outcome of ATConf/5. In particular, it will examine the significance of ATConf/5 for the development of ownership and control issues in air transport relations between the EU and third States and ultimately for the restructuring of the EU airline industry.

RESUME

A une époque de crise profonde pour l'industrie aéronautique, les règles gouvernant la propriété et le contrôle des compagnies aériennes et s'appliquant aux relations internationales en matière d'aviation depuis cinquante ans sont soumises à une révision croissante. Ces règles font obstacle au libre transfert de capital et à la consolidation entre compagnies par delà les frontières, limitant ainsi les possibilités pour les compagnies aériennes de structurer leurs opérations afin de servir les marchés globaux. Plus important encore est le fait que ces règles restreignent les choix stratégiques des compagnies qui souffrent le plus de la crise, empêchant par là même l'industrie aéronautique de se restructurer. La consolidation et la rationalisation à travers des fusions et acquisitions entre compagnies aériennes est particulièrement urgente au sein de l'Union Européenne, où la libéralisation est limitée par des accords bilatéraux restrictifs avec des Etats tiers.

Le jugement de la Cour Européenne de Justice en matière d'accords de "Ciel Ouvert" constitue un pas vers la libéralisation. Ce jugement a créé l'occasion de réviser, de manière globale, le système des règles concernant la propriété et le contrôle des compagnies aériennes. La Cinquième Conférence Mondiale de Transport Aérien de l'OACI (ATConf/5) a fourni aux Etats un forum, où ils ont pu discuter et provoquer le changement. Finalement, l'industrie aéronautique elle-même a entrepris de renforcer la poursuite de la libéralisation des règles qui l'empêchaient de fonctionner de la même façon que les autres secteurs industriels.

Cette thèse fournit un examen des développements récents en matière de propriété et de contrôle. Une attention particulière sera accordée à l'analyse critique des résultats de l'ATConf/5. Plus particulièrement, cette thèse examine l'impact de l'ATConf/5 sur les relations internationales de L'Union Européenne avec les pays tiers ainsi que la restructuration de l'industrie aéronautique Européenne.

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LIST OF ABBREVIATIONS

A.A.S.L.	Annals of Air and Space Law
AA	American Airlines
AF	Air France
Air & Space L.	Air and Space Law
Air & Space Law.	Air and Space Lawyer
Airline Bus.	Airline Business
Am.U.L.Rev.	American University Law Review
AMJCL	American Journal of Comparative Law
AOC	Air Operator's Certificate
APEC	Asia-Pacific Economic Cooperation
ASA	Air Services Agreement
ATConf/5	Fifth Worldwide ICAO Air Transport Conference
ATRP	Air Transport Regulation Panel
BA	British Airways
BWIA	British West Indies Airways
CAB	Civil Aeronautics Board
CARICOM	Caribbean Economic Community
Case W. Res. J. Int'l L.	Case Western Reserve Journal of International Law
CRS	Computer Reservation System
CX	Cathay Pacific
Doc.	Document
DOT	Department of Transportation
e.g.	*exempli gratia*
ECAC	European Civil Aviation Conference
ECJ	European Court of Justice
ECR	European Community Report
Emory Int'l L. Rev.	Emory International Law Review
EU	European Union

GAO	General Accounting Office
i.e.	*id est*
IASTA	International Air Services Transit Agreement
IATA	International Air Transport Association
ICAO	International Civil Aviation Organization
ICAO J.	ICAO Journal
Inv. Dealers' Dig.	Investment Dealers Digest
J. Air L.& Com.	Journal of Air Law and Commerce
KLM	Koninklijke Luchvaart Maatschapij N.V. – KLM Dutch Airlines
L.N.T.S.	League of Nations Treaty Series
LH	Lufthansa
LuftVG	Luftverkehrsgesetz – German Federal Aviation Act
NW	Northwest Airlines
NZ	Air New Zealand
OAA	Open Aviation Area
OECD	Organization for Economic Co-operation and Development
PIASA	Pacific Island Air Service Agremeement
QF	Quantas
SARS	Severe Acute Respiratory Syndrome
SAS	Scandinavian Airlines Systems
SEPI	Sociedad Estatal de Participaciones Industriales
Syracuse L. R.	Syracuse Law Review
TCAA	Transatlantic Common Aviation Area
Transp. L. J.	Transportation Law Journal
U.N.T.S	United Nations Treaty Series
UK	United Kingdom
US	United States
ZLW	Zeitschrift für Luft- und Weltraumrecht

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INTRODUCTION

"By its nature international air transport is a global business, yet there is not a single global airline".[1] "What is so special about air transport that it requires to be treated so differently from most other businesses?"[2] These and similar statements were made during the Seminar prior to the International Civil Aviation Organization (ICAO) Fifth Worldwide Air Transport Conference (ATConf/5) both of which took place in Montreal in March 2003.

International trade has been significantly liberalized during recent decades yet aviation, though a key element of the global trade infrastructure, has not completely followed this process.[3] In the telecommunications and financial services industries, barriers to the free trade of goods and services caused by government regulation have been reduced. The door has been opened to the development of a global market economy. By reducing restrictions on foreign ownership, markets have been opened up to foreign investment. Cross-border mergers and acquisitions have become common in most trade infrastructures.

In contrast, the airline industry, in many ways the enabler of globalization itself, is still forced to operate within the straitjacket of highly restrictive ownership rules, which are deeply entrenched in air transport relations among States.[4] The restrictions are two-fold.

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[1] Barry Humphreys, Humphreys, Barry, "Liberalized Airline Ownership and Control" (Paper presented to the Seminar prior to the 5th ICAO Worldwide Air Transport Conference, "Aviation in Transition: Challenges & Opportunities of Liberalization", ICAO, Montreal, 22-23 March 2003) [unpublished].
[2] *Ibid.*
[3] Richard Janda, "Has Europe Kickstarted the Global Liberalization of Airline Ownership and Control?" (2003) *Business Briefing, Aviation Strategies: Challenges & Opportunities of Liberalization* (World Markets Research Centre Ltd, March 2003) 46.
[4] The Brattle Group, *The Economic Impact of an EU-US Open Aviation Area* (Report by the US Consultancy, the Brattle Group, commissioned by the European Commission and published in December 2002) at 1-1, online: European Union http://europa.eu.int/comm/transport/air/international/doc/brattle_aviation_liberalisation_report.pdf (date accessed: 30 July 2003).

First, they are found in almost all bilateral air services agreements (ASAs) concluded since the 1940s. The so-called "nationality clauses" in these agreements require any State designating an airline to ensure that the airline is "owned and controlled" by that State or its citizens. Conversely, the State receiving the designation may refuse to accept the designation if its authorities conclude that ownership and control of the airline is not vested in the designating State or its nationals.[5] The primary aim of States in using this criterion has been to limit the economic benefits of ASAs to the contracting parties.

Second, domestic aviation laws of the vast majority of States restrict foreign investment in their airlines, again requiring that airlines be "substantially owned and effectively controlled" by their nationals. States thus ensure that the airline industry remains "national".

Expressed in these ownership rules, the protectionist attitude of States limits the available sources of investment for airlines and prevents them from merging with, acquiring, or being acquired by foreign airlines. This is at odds with the increasingly liberalized and competitive environment in which airlines today operate, and why Giovanni Bisignani identifies the national ownership rules as one of the "three pillars of stagnation".[6]

Air carrier ownership and control was high on the agenda of ATConf/5, which had as its theme "Challenges and Opportunities of Liberalization", which took place in Montreal from 24 to 27 March 2003. When the international community came together in Montreal, European Union (EU) Member States had not only an economic but also a

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[5] See, as an example, *Air Transport Agreement Between the Federal Republic of Germany and the US of America Current version of the Agreement of 7 July 1955, as amended by Protocols between the US of America and the Federal Republic of Germany, of April 25, 1989, of May 23, 1996 and of October 10, 2000, to Amend the Air Transport Agreement of July 7, 1955*, 275 UNTS 3, U.S.T. 527, TIAS No. 3536, German Law Gazette 1956, II-403, reprinted in Dieter Bartkowski, John Byerly, "Forty Years of U.S.-German Aviation Relations" (1997), 46:1 ZLW 3 at 35, online: Luftrecht-online http://www.luftrecht-online.de/index-1.htm (date accessed: 14 September 2003) [US-German ASA].

[6] Giovanni Bisignani, "Seeking a New Way" (Paper presented to the Seminar prior to the 5th ICAO Worldwide Air Transport Conference, "Aviation in Transition: Challenges & Opportunities of Liberalization", ICAO, Montreal, 22-23 March 2003) [unpublished].

specific judicial interest in achieving the relaxation of ownership and control rules on a global basis. In November 2002, the European Court Justice (ECJ) had issued its judgments in the "Open Skies" cases,[7] which effectively force the renegotiation of the ownership and control clauses in a host of critical ASAs, notably those between the US and EU Member States.[8] The Conference thus provided EU Member States with a forum in which to promote both their Community interests and a systematic revision of the entire ownership and control framework.

The main objective of this study is to scrutinize the results of ATConf/5 with respect to airline ownership and control. The thesis will focus on the potential implications of the outcome of ATConf/5 on the restructuring of the European airline industry. It will analyze whether the results of ATConf/5 converges with the interests of the EU, and whether it is now any easier for EU airlines to organize their equity arrangements as other industries may do.

Chapter 1 will set out the background and the conceptual issues relevant for an understanding of the requirement for air carrier ownership and control. It will review the origin of this requirement and give an overview of the various forms of the restrictions in air transport regulation. The second chapter will demonstrate the urgent need for liberalization of the ownership and control rules, since those rules are at odds with an increasingly global and liberalized market place. In addition, there is a special need for the EU to liberalize the rules for the designation and authorization of EU air carriers in air transport relations with third countries. Chapter 3 will analyze how air carrier ownership

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[7] See ECJ, *Commission of the European Communities v Kingdom of Denmark, C-467/98*, [2002] E.C.R. I-09519; *Federal Republic of Austria*, C-475/98, [2002] E.C.R. I-09797; *Federal Republic of Germany*, C-476/98, [2002] E.C.R. I-09855; *Grand Duchy of Luxembourg*, C-472/98, [2002] E.C.R. I-09741; *Kingdom of Belgium*, C-471/98, [2002] E.C.R. I-09681; *Kingdom of Sweden*, C-468/98, [2002] E.C.R. I-09575; *Republic of Finland*, C-469/98, [2002] E.C.R. I-09627; *United Kingdom of Great Britain and North Ireland*, C-466/98, [2002] E.C.R. I-09427, [Judgments in the "Open Skies" cases]. The major aviation issues involved and the Court's reasoning and conclusions in these judgments are substantially identical. These cases were brought by the Commission against seven Member States for having concluded liberal ASAs with the US (open skies agreements) and the UK, which had amended its ASA with the US in 1995. Due to the high similarity between these judgments, future citations will refer only to the judgment ECJ, *Commission of the European Communities v Kingdom of Denmark, C-467/98*, [2002] E.C.R. I-09519 [*Commission v. Denmark* (C-476/98)].

[8] Richard Janda, *supra* note 3 at 46.

and control was addressed at the ATConf/5. This thesis will point out the reasons for the increased willingness of States to reach agreement on the issue. It will examine the discussions, present the outcome and give a preliminary assessment as to the result of ATConf/5. Finally, a last chapter will be dedicated to an analysis of the practical implications of the Conference. This will focus on the EU airline industry. It will address the question whether the outcome of ATConf/5 has any significance for the restructuring of the EU airline industry. In order to answer this question, this thesis will review the development of ownership and control issues in air transport relations between the EU and the US and other third States. It will then give an outlook as to whether ATConf/5 will advance those relations and thereby lead to a situation where EU airlines have full access to the world capital markets and are free to merge to, acquire, or be acquired by foreign airlines.

CHAPTER 1: AIR CARRIER OWNERSHIP AND CONTROL CRITERIA EXPLAINED

1.1 The Origin of Air Carrier Ownership and Control Requirements

The requirement that airlines be "substantially owned and effectively controlled" by a State or its nationals is rooted in post-World War II international air transport regulation.[9] It made its first appearance in 1944 during the Chicago Conference. However, the main instrument arising from that Conference, the Convention on International Civil Aviation[10] (Chicago Convention), which still today forms the basis of the regulation of international civil aviation, does *not* lie at the origin of ownership and control clauses.[11]

At the Chicago Conference, the United States (US) suggested a multilateral treaty to govern international civil aviation. Included was a recognition of the commercial freedom of airlines. This approach was based on a *laissez-faire*, free-market philosophy, which promoted relatively unrestricted operating rights for all airlines on international routes.[12] The United Kingdom (UK), however, opposed this liberal approach. Concerned that its post-war aviation industry "needed a period of recovery",[13] and fearing US strong aviation power, the British advocated an international regime based on strict regulation of air transport by governments.[14] Ultimately, the fundamentally divergent economic and political interests of the two leading powers deterred the Chicago Convention from

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[9] Peter P.C. Haanappel, "Airline Ownership and Control and some related Matters" (2001) 26:2 Air & Space L. 90 [Haanappel, "Airline Ownership and Control"].

[10] *Convention on International Civil Aviation*, 7 December 1944, 15 U.N.T.S. 295, ICAO Doc. 7300/6 [Chicago Convention].

[11] Haanappel, "Airline Ownership and Control", *supra* note 9 at 90, points out that the Chicago Convention deals with the nationality of aircraft, not of airlines; see also Isabelle Lelieur, *Law and Policy of Substantial Ownership and Effective Control of Airlines – Prospects for Change* (Aldershot: Ashgate, 2003) at 2; Lelieur emphasizes that "the *Chicago Convention* is, at best, neutral with regard to ownership criteria, since it also expressly permits operations involving joint and coordinated efforts among airlines to provide international services".

[12] Seth Warner, "Liberalize Open Skies: Foreign Investment And Cabotage Restrictions Keep Noncitizens In Second Class" (1993) 43 Am. U. L. Rev. 277 at 283.

[13] Bruce Stockfish, "Opening Closed Skies: The Prospects for Further Liberalization of Trade in International Air Transport Services" (1992), 57 J. Air L. & Com. 599 at 603.

[14] See Ved P. Nanda, "Substantial Ownership and Control of International Airlines in the US" (2002) 50 AMJCL 377 at 359.

creating a single system of economic regulation of international air transport.[15] Instead of achieving a liberal exchange of traffic rights, the Chicago Convention reaffirmed the principle originally articulated at the Convention of the Regulation of Aerial Navigation[16] (Paris Convention) that nations have sovereignty over the airspace above their territory.[17]

Despite the very liberal approach expressed in the demand for unlimited traffic rights at the Chicago Conference, the US, supported in this regard by the British delegation,[18] *did* try to prevent foreign ownership or control of national carriers.[19] This was opposed by several smaller countries because of their dependence on foreign capital and technical assistance for the provision of national air services.[20] Ultimately, the Chicago Conference decided not to incorporate any provision on the nationality or ownership of airlines into the Chicago Convention.[21]

Instead, the Chicago Conference agreed to expressly include multilateral ownership and control clauses in two subsidiary agreements, namely the International Air Services Transit Agreement[22] (IASTA) and the International Air Transport Agreement[23] (Transport Agreement). The IASTA provides for a multilateral exchange of overflight rights and stops for non-traffic purposes (first and second freedoms)[24] for scheduled

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[15] Haanappel, "Airline Ownership and Control", *supra* note 9 at 90.
[16] *Convention of the Regulation of Aerial Navigation*, 13 October 1919, 11 L.N.T.S. 173.
[17] Article 1 of the Chicago Convention, *supra* note 10, states that "the contracting States recognize that every State has complete and exclusive sovereignty over the airspace above its territory"; Article 6 of the Chicago Convention, *supra* note 10, states that "no scheduled international air service may be operated over or into the territory of a contracting State, except with a special permission or other authorization of that State, and in accordance with the terms of such a permission or authorization".
[18] Joseph Z. Gertler, "Nationality of Airlines: Is it a Janus with Two (or more) Faces?" (1994) 19:1 A.A.S.L. 211 at 237.
[19] Howard E. Kass, "Cabotage And Control: Bringing 1938 U.S. Aviation Policy Into The Jet Age" (1994) 26 Case W. Res. J. Int'l L. 143 at 150.
[20] Gertler, *supra* note 18 at 238; the El Salvador delegation proposed that the proportion of ownership and effective control to be vested in the nationals of a State should be left to internal policies and legislation of that State. This would have meant in practice that wherever the national criteria would be satisfied, no other State could deny the rights under the Convention based on the nationality criteria.
[21] Constantine G. Alexandrakis, "Foreign Investment in U.S. Airlines: Restrictive Law is Ripe for Change?" (1994) 4 U. Miami Bus. L. J. 71 at 75.
[22] *International Air Services Transit Agreement*, 84 U.N.T.S. 389, Article I (5).
[23] *International Air Transport Agreement*, 171 U.N.T.S. 387, Article I (6).
[24] The so-called first and second freedoms, included in the IASTA are the rights for an airline to:
1. fly over the territory of another State without landing (first freedom);

international air services. It has attracted support from 119 States, [25] a majority of States participating in air transport. In the Transport Agreement, States exchange, in addition, three commercial traffic rights.[26] This latter agreement is the result of the vehement pressure, particularly by the US, for liberal economic regulation of aviation. Yet the international support for this so-called "Five Freedoms Agreement" is very modest, with none of the major aviation States, and in total only some 20 States, being party to the agreement.[27]

In identical phrasing, Article I (5) of the IASTA and Article I (6) of the Transport Agreement lay down that:

> Each contracting State reserves the right to withhold or revoke a certificate or permit to an air transport enterprise of another State in any case where it is not satisfied that substantial ownership and effective control are vested in nationals of a Contracting State [...].

Similar language was included in the "Standard Form Bilateral Agreement" recommended by the Chicago Conference.[28] None of the treaties agreed upon at Chicago, however, provide for a definition of the terms of "substantial ownership" and "effective control".

There were two main justifications for the "substantial ownership and effective control" requirement. When the Conference convened in 1944, World War II was still being fought and the primary concern of the participating States was their national

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2. land in another State for technical reasons, such as refuelling or maintenance, without offering any commercial service to or from that point (second freedom).

[25] Figure up to date as of 21 May 2003, online: Juris International http://www.jurisint.org/pub/01/en/182.htm (date accessed: 21 May 2003).

[26] The "Five Freedoms of the Air" are the freedoms in the IASTA plus the three following, commercial rights for an airline to:

1. carry traffic from its State of registry to another State (third freedom);
2. carry traffic from another State to its own State of registry (fourth freedom);
3. carry traffic between two States outside its State of registry provided the flight originates or terminates in its own State (fifth freedom).

[27] Figure up to date as of 21 May 2003, online: Juris International http://www.jurisint.org/pub/01/en/208.htm (date accessed: 21 May 2003).

[28] See US, Department of State, *Proceedings of the International Civil Aviation Conference Vol. I* (Washington, D.C.: U.S. Government Printing Office, 1948) (Publication 2820) at 556.

security. [29] "Politically, the international legal instruments, opened for signature by the Chicago Conference of 1944, were adopted at a time when only 'allied' and 'neutral' States were invited to participate in the Conference, with the intention to keep 'enemy' States and their airlines outside the framework of 'Chicago'."[30] "Commercially, it would seem to have made good sense to limit the benefits of multilateral grants of traffic rights to the 'corporate citizens', the airlines of contracting States and not to extend them to the airlines of non-contracting States."[31] The ownership and control requirement was thus conceived as a means to safeguard national security by keeping money from "enemy" States out of national airlines. Contracting States thereby made sure that no traffic rights would ever fall into "enemy" hands.

The IASTA and the Transport Agreement are the only international agreements that include the ownership and control provisions.[32] Despite this limited incorporation into international law, these provisions have found their way into virtually all subsequent international air transport relations. Repeated incorporation in major bilateral ASAs, rather than prescription by international law, has perpetuated the use of the requirement.[33]

1.2 Application of the Air Carrier Ownership and Control Requirements

The application of the "substantial ownership and effective control" requirement is two-fold. At the international level, States regulate air carrier ownership primarily by a discretionary criteria contained in virtually every ASA (*external aspect*).[34] At the national level, laws restrict the maximum permitted foreign ownership of national air carriers (*internal aspect*). Both aspects are closely connected. Domestic restrictions ensure that the designated air carrier remains "national" and complies with the external requirement.

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[29] Alexandrakis, *supra* note 21 at 74.
[30] Haanappel, "Airline Ownership and Control", *supra* note 9 at 92.
[31] *Ibid.* at 93.
[32] *Ibid.* at 92.
[33] Lelieur, *supra* note 11 at 3.
[34] Yu-Chun Chang, George Williams, "Changing the Rules – Amending the Nationality Clauses in Air Services Agreements" (2001) 7 Journal of Air Transport Management 207 at 208 [Chang, Williams "Changing the Rules"].

1.2.1 Air Carrier Ownership and Control as a Standard Requirement in ASAs (The External Aspect)

1.2.1.1 The Appearance of the Requirement in ASAs

The failure of the Chicago Conference to bring about a multilateral approach, as well as the concept of sovereignty incorporated into the Chicago Convention,[35] precipitated the development of a bilateral system in which ASAs regulate air traffic rights and determine international airline routes, frequency, and capacity.[36]

The first such bilateral agreement was entered into by the US and the UK in 1946 (Bermuda I).[37] Based on the Standard Form Bilateral Agreement, as well as on the IASTA and the Transport Agreement, it provided for an ownership and control clause.[38] Bermuda I granted to each Contracting State the right to revoke the exercise of traffic rights by a carrier, where it was not "satisfied that substantial ownership and effective control of such carrier are vested in nationals of *either* Contracting State".[39] Bermuda I subsequently became the prototype for all future ASAs.[40] Bermuda II, which replaced Bermuda I in 1977,[41] narrowed further the ownership and control clause, by stipulating an even more restrictive clause, according to which substantial ownership and effective control must be vested only in nationals "of the *other* Contracting State".[42]

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[35] Chicago Convention, *supra* note 10 at Articles 1 and 6.
[36] Angela Edwards, "Foreign Investment In The U.S. Airline Industry: Friend Or Foe?" (1995) 9 Emory Int'l L. Rev. 595 at 599.
[37] *Agreement Between the Government of the US of America and the Government of the United Kingdom Related to Air Services Between their Respective Territories*, 11 February 1946, U.S.-U.K.; 60 Stat. 1499 [Bermuda I].
[38] Haanappel, "Airline Ownership and Control", *supra* note 9 at 93.
[39] Bermuda I, *supra* note 37 [emphasis added]; the nationality clause is stated in Article 6 of the Appendix to Bermuda I.
[40] Stockfish, *supra* note 13 at 609.
[41] *Agreement Between the Government of the Kingdom of Great Britain and Northern Ireland and the Government of the United States of America Concerning Air Services*, 23 July 1977, 28 U.S.T. 5367 [Bermuda II].
[42] Bermuda II, *supra* note 41 at Article 6 [emphasis added]; see also Haanappel, "Airline Ownership and Control", *supra* note at 93.

This formulation of the ownership and control requirement survived the "open skies initiative", launched by the US in the early 1990s. The initiative was at first directed towards EU countries.[43] By entering into bilateral open skies agreements, the US intended to promote free competition in the international air transport market. In exchange for as much market access as possible for its carriers, the US offers foreign air carriers full access to all US international airports.[44] Even though the open skies initiative marked a shift towards liberalization, it fell short of liberalizing the ownership and control requirement. Thus, even today, almost all ASAs contain provisions along the following lines:[45]

> 1. Each contracting party shall have the right to designate as many airlines as it wishes to conduct international air transportation in accordance with this Agreement and to withdraw or alter such designations. Such designations shall be transmitted to the other contracting party in writing through diplomatic channels, and shall identify which type of air service specified in the Route Schedule the airline is authorized to conduct.
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> 2. On receipt of such a designation, and of applications from the designated airline, in the form and manner prescribed for operating authorizations and technical permissions, the other contracting party shall grant appropriate authorizations and permissions with minimal procedural delay... And

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[43] The first open skies agreement was signed between the Netherlands and the US in 1992; today, the US has entered into some 59 open skies agreements.

[44] See US, Department of Transportation, *Order in the Matter of defining "Open Skies"*, DOT Order No 92-8-13, Docket No. 48130 (5 August 1992) at 8; the DOT defines Open Skies as follows:

- Open entry on all routes;
- Unrestricted capacity and frequency on all routes;
- Unrestricted route and traffic rights, including no restrictions as to intermediate and beyond points;
- Pricing flexibility;
- Liberal charter arrangements;
- Liberal cargo regime;
- Ability to convert earnings and remit in hard currency promptly and without restriction;
- Open code-sharing opportunities,
- Self-handling provisions;
- Pro-competitive provisions on commercial opportunities, user charges, fair competition, and intermodal rights; and
- Explicit commitment to non-discriminatory operation of and access to computer reservation systems.

[45] See as an example US-German ASA, *supra* note 5.

> 3. Either contracting party may revoke, suspend, or limit the operating authorizations or technical permissions of an airline designated by the other contracting party where *substantial ownership and effective control of that airline are not vested in the other contracting party, the other contracting party's nationals (which may include natural or legal persons), or both*; ...[46]

Due to their perpetual use in ASAs such clauses are commonly referred to as the "standard" or "traditional" ownership and control clauses.

1.2.1.2 Why are Air Carrier Ownership and Control Rules Still the Standard Today?

The question now is why are today's bilaterals still as restrictive as they were 50 years ago, and why are States so reluctant to change the traditional rules?

Rather than the security interests that played a central role in the creation of the restrictions,[47] economic interests now dominate the motives for the continued existence nowadays. In its discussion paper presented at ATConf/5, the ICAO Secretariat identified the primary reason for the perpetual use of the traditional ownership criterion in ASAs: "The national ownership and control criterion [...] provides a convenient link between the carrier and the designating State". [48] In fact, international air transport is governed by the idea of "equal exchange of economic benefits".[49] States exchange mostly equivalent commercial rights in order to receive reciprocal access to their respective aviation markets. To preserve a "balance of benefits", it is important to identify the airlines of the contracting States that may operate the agreed routes, in order to determine the capacity that may be provided, and to specify the rights that may be exercised by those airlines.[50] By virtue of a "tie" between the air carrier using the rights and the State to which these rights pertain, States are able to know and control *who* ultimately profits from the

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[46] See, *e.g.*, US-German ASA, *supra* note 5 at Articles 3 and 4 [emphasis added].
[47] See Chapter 1.1.
[48] ICAO, Working Paper (*Worldwide Air Transport Conference: Challenges and Opportunities of Liberalization*) No. ATConf/5-WP/7 (21 October 2002) at 1 [ICAO, Working Paper, ATConf/5-WP/7].
[49] Henri A. Wassenbergh, "Aspects of the Exchange of International Air Transportation Rights" The Hague (16 April 1981) [unpublished] [Wassenbergh, "Exchange of International Air Transportation Rights"].
[50] Lelieur, *supra* note 11 at 20.

exchange of commercial rights. This allows States to implement the "balance of benefits" policy.

Additionally, the link between air carrier and designating State is important, since States want to prevent a situation where benefits in the form of market access given to an airline of State A end up in the hands of airline B, especially if State B does not offer reciprocal benefits.[51] For instance, the US has a restrictive bilateral agreement with the UK and a liberal one with Germany. Now, the UK, through BA, should not be able to profit from Luftansa's (LH) free market access into the US simply by acquiring ownership and control of LH. Otherwise, BA would get a "free ride", *i.e.*, backdoor access to the US market without giving US carriers reciprocal market access into the British market. By means of the nationality clause, a State can ensure that only those carriers with a "legitimate tie" to the co-contracting party benefit from the traffic rights granted.[52] More importantly, it allows the State to prevent a non-party State, through its carrier, from indirectly gaining an unreciprocated benefit and thus from destroying the concept of equal exchange of commercial rights.[53]

By being permitted to refuse to authorize air services by airlines owned or controlled by certain other States, States have a "bargaining chip",[54] which allows them to trade access to their market against concessions of the same value.[55] Behind this approach lies the view of governments that aviation, including its commercial aspects, forms part of the relations between States. Governments fear that an uncontrolled exchange of

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[51] See H. Peter van Fenema, "Ownership Restrictions: Consequences and Steps to be Taken" (1998) 23:2 Air & Space L. 63 [van Fenema, "Consequences and Steps to be Taken"].

[52] IATA, Government and Industry Affairs Department, *Report of the Ownership and Control Think Tank World Aviation Regulatory Monitor*, IATA doc. Prepared by H. Peter van Fenema (7 September 2000) at 12 [IATA Think Tank].

[53] Wassenbergh, "Exchange of International Air Transportation Rights", *supra* note 49 at 1; IATA Think Tank, *ibid.* at 12.

[54] van Fenema, "Consequences and Steps to be Taken", *supra* note 51 at 64; van Fenema states that the use of ownership and control requirements in ASAs is primarily a matter of aeropolitical expediency, not of law or principle.

[55] Holderbach, Hans, *The Air Transport Relations between the European Union and the U.S.*, (LL.M Thesis, McGill University, Institute of Air and Space Law 1998) at 100 [unpublished].

commercial rights may negatively influence the overall bilateral relationship between the granting and the recipient State.[56]

Moreover, States consider a national airline as an object of national prestige, a demonstration of national sovereign identity that needs to be protected.[57] National ownership and control rules in ASAs have the effect of preserving their respective airlines,[58] since, by virtue of the clause, governments are prevented from designating a foreign airline to operate to the territory of the bilateral partner State. Thus national airlines are protected from competing carriers based in third countries.[59]

Finally, nationality clauses not only prevent carriers of *other* States from using a State's traffic rights, but they also allow a State to ensure that its *own* national carrier does not use the rights of a foreign State to serve its own territory.[60] The concern is that a national air carrier establishes itself in a third State, or that national equity is used to fund the set up of an airline in a third State, which would then operate under the third State's traffic rights to serve the first State. Such a situation causes several concerns.

First, if the own air carriers were permitted to operate under the traffic rights of a third State, national equity could be used to fund the set up of an airline in a third State, instead of in the home country. This raises the danger of a flight of capital to third States that have, *e.g.,* more beneficial tax regulations. Rather than serving the national economy, third States would then benefit from the airline, through the promotion of trade and

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[56] IATA Think Tank, *supra* note 52 at 12.

[57] Henri A. Wassenbergh, "Future Regulation to allow Multi-national Arrangements between Air Carriers (Cross-border Alliances), putting an End to Air Carrier Nationalism" (1995) 20:3 Air & Space Law 164 [Wassengergh, "Putting an End to Air Carrier Nationalism"].

[58] Yu-Chun Chang, George Williams, "Prospects for Changing Airline Ownership Rules" (2002) 67 J. Air L. & Com. 233; also Wassenbergh in "Putting an End to Air Carrier Nationalism", *ibid* at 164, who stresses the paradox existing between the claim of states of their legitimate share of action and profits, on the one hand, and the fact that the only way for many states to be able to obtain such share, will be the participation of its national airline in a multi-national alliance, on the other hand.

[59] Chang, George, "Changing the Rules", *supra* note 34 at 208; see also Rigas Doganis, "Relaxing Airline Ownership and Investment Rules" (1996) 21:6 Air & Space L. 267 at 268 [Doganis, "Relaxing Airline Ownership and Investment Rules"]; Doganis points out that ownership rules afford protection for an economic activity which is vital to most economies.

[60] See for a description of the motives behind national ownership and control used in bilateral agreements ICAO, *Manual on the Regulation of International Air Transport*, ICAO Doc. 9626, provisional second edition (1996) at c. 4.4.

tourism as well as tax income. Likewise, it could not be guaranteed that the airline would assure services to, from and within the home country.

Second, and more importantly, the concern is that the ability of an airline to be designated by a third State to serve the home territory would allow for the creation of "flags of convenience" in air transport. This term has its origin in maritime law, and refers to the ability of ship-owners to register their vessel in any State, regardless of the ship-owners' nationality. This fact often induces owners to register their vessel in a State that has less onerous restrictions on safety and social matters, such as certification and labour.[61] Concerns prevail that the liberalization of those requirements for air carriers might create a situation where airlines are permitted to "flag out" their aircraft to countries that offer lower-cost safety and labour standards.[62] This would allow the carrier to compete with national airlines established in the home country under more onerous safety and social restrictions and gradually deteriorate safety and security standards as well as labour interests. It is argued that only ownership and control criteria create the link between the carrier and the designating State that clearly identifies the State responsible for safety and security[63] as well as social and labour matters.

It is evident that with those economic, safety and social justifications in mind, States are generally reluctant to depart from the use of the standard clause in their respective ASAs.

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[61] Sean McGonigle, *Comparative regulation of air transport in the Asia-Pacific Region*, (LL.M Thesis, McGill University, Institute of Air and Space Law 2003) at 48 [unpublished].
[62] ITF, Working Paper (*Worldwide Air Transport Conference and Challenges and Opportunities of Liberalization*, ATConf/5-WP/75 (3 March 2003) at 2 [ITF, Working Paper, ATConf/5-WP/75].
[63] ICAO, Working Paper, ATConf/5-WP/7, *supra* note 48 at 2.

1.2.2 Selected Regulations Restricting Foreign Investment (The Internal Aspect)

As airline ownership restrictions became prevalent in ASAs, they also gradually found their way into domestic laws.[64]

The existence of those domestic ownership and control laws can be explained in two ways. First, virtually all ASAs contain ownership and control clauses, yet there is no agreed meaning of the terms "substantial ownership" and "effective control" in international law.[65] National laws are therefore necessary to translate the "nationality" provisions in ASAs into a domestic requirement, in order to guarantee compliance with the bilateral clause.[66] Domestic restrictions on foreign investment are thus the result of the *external* aspect.[67] Second, national laws on foreign investment express the wish of sovereign States to possess a national air carrier.[68] A national airline is considered a State asset for it serves important national interests such as the assurance of military transportation in case of emergency; promotion of trade and tourism; and provision of employment.[69] Not least, a national air carrier is a symbol of sovereignty and as such an expression of national pride and prestige.[70] States fear that foreign airlines would be less concerned with these national public welfare aspects.[71]

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[64] Lelieur, *supra* note 11 at 3.
[65] See Chapter 1.1.
[66] H. Peter van Fenema, "Substantial Ownership and Effective Control as Airpolitical Criteria" (1992) in Masson-Zwaan & Mendes de Leon, Pablo, eds., *Air and Space Law: De Lege Ferenda* (Deventer: 1992) 27 at 28 [van Fenema "Substantial Ownership and Effective Control as Airpolitical Criteria"]. On the one hand, States want to ensure that their own designated airlines comply with the bilateral clause, in order to prevent a foreign country challenging traffic rights. On the other hand, the State challenging the nationality of an airline designated by another State regularly relies on its domestic laws on foreign investment, in order to determine whether the designated airline is owned and controlled by the nationals of that other State. Thus, the bilateral clause makes domestic provisions on the nationality or the designated airline necessary. See also Nanda, *supra* note 14 at 377.
[67] IATA Think Tank, *supra* note 52 at 27.
[68] *Ibid.*
[69] See also the results of ICAO, *Questionnaire on State's Policies and Practices Concerning Air Carrier Ownership and Control,* Attachment to State letter SC 5/2-01/50; see also H. Peter van Fenema, "National Ownership and Control Provisions Remain Major Obstacles to Airline Mergers" (2002) 57:9 ICAO Journal 7 at 8 [van Fenema, "National Ownership and Control Provisions Remain Major Obstacles to Airline Mergers"].
[70] van Fenema, *ibid.*
[71] Stockfish, *supra* note 13 at 612.

Domestic ownership and control clauses consist mainly of two elements: "Substantial" or "majority ownership", a *de jure* condition, which generally relates to a certain percentage of equity; and "effective control", a *de facto* criteria, which requires an assessment as to who actually holds the "power to direct the internal and external policy of the corporation".[72] Administrations commonly consider "effective control" as the dominant criterion in deciding the admissibility of foreign investment in a national airline, with "substantial ownership" merely being a preliminary condition.[73]

1.2.2.1 The "Citizenship" Requirement in US Law and Policy

US restrictions on foreign ownership of air carriers already existed before the bilateral treaty system adopted those rules. They originate from the political thinking of the 1920s.[74] As civil aviation gained ground and flourished, concerns were raised in Congress as to aircraft availability in case of national emergency.[75] In order to meet this military concern, Congress intervened in air transport through the development of citizenship requirements for airlines, in the Air Commerce Act of 1926.[76] According to this Act, an aircraft could be registered in the US only if owned by "US citizens".[77] The Act set forth the conditions for meeting this citizenship requirement.[78] First, US citizens must maintain 51% of the voting stock. Second, at least two-thirds of the carrier's board members must be US citizens.

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[72] Lelieur, *supra* note 11 at 3-4; see also van Fenema, "Substantial Ownership and Effective Control as Airpolitical Criteria", *supra* note 66 at 29; van Fenema defines "effective" control as "the power, direct or indirect, actual or legal, to set the policy of an undertaking and to direct or manage the execution thereof. It is more than voting control and may be construed on the basis of a relationship that involves close financial links and other ties which might provide rights and powers over the way in which the company conducts its affairs. This includes members on the company's Board of Directors, Chairman, CEO etc.".
[73] Haanappel, "Airline Ownership and Control", *supra* note 9 at 94.
[74] Alexandrakis, *supra* note 21 at 73.
[75] Warner, *supra* note 12 at 305.
[76] *US Air Commerce Act,* Pub. L. No. 69-254, §§ 1-14, 44 Stat. 568 (1926).
[77] *Ibid.* at ch. 344, § 3 (a), 44 Stat. 568, 569.
[78] *Ibid.* at ch. 344, § 9 (a), 44 Stat. 537.

After the Great Depression of the 1930s, the rationale behind US citizenship requirements shifted from military concerns to economic protectionism.[79] Heavy reliance on government intervention and protection from foreign competition replaced the promotion of free trade.[80] Protectionism added to the national security concerns as a motivation for even more restrictive regulations. The Civil Aeronautics Act of 1938,[81] increased from 51% to 75% the amount of an airline's voting stock that must be in US hands for the carrier to be able to qualify as a US operator.[82]

As the underlying principle of the 1938 Act remains valid today, this citizenship requirement survived virtually unchanged and was incorporated into the Federal Aviation Act of 1958,[83] which provides the foundation for the current law on foreign investment in the US. Pursuant to the Act, the Secretary of Transportation may issue a certificate of public convenience and necessity to a "citizen of the US".[84] The Act defines a citizen of the US as:

> (a) an individual who is a citizen of the US or of one of its possessions, or
>
> (b) a partnership of which each member is such an individual,
>
> (c) or a corporation or association created or organized under the laws of the US or any State, Territory, or possession of the US, of which *the President and at least two-third or more of the board of directors and other managing officers thereof are such individuals and in which at least 75% of the voting interest is owned or controlled by persons that are citizens of the US or one of its possessions.*[85]

In interpreting the term "citizen", the Department of Transportation (DOT) and the preceding economic regulatory agency, the Civil Aeronautics Board (CAB), have

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[79] Kirsten Böhmann, „The Ownership and Control Requirement in U.S. and European Union Air Law and U.S. maritime Law – Policy; Consideration; Comparison" (2001) 66 J. Air L. & Com. 233 at 697.
[80] David T. Arlington, "Liberalization of Restrictions of Foreign Ownership in U.S. Air Carriers: The US must take the First Step in Aviation Globalization" (1993) 59 J. Air L. & Com. 133 at 141.
[81] *US Civil Aeronautics Act*, Pub. L. No. 75-706, 52 Stat. 973 (1938).
[82] *Ibid.* at § 1 (13); see also Alexandrakis, *supra* note 21 at 73.
[83] *Federal Aviation Act*, Pub.L. No. 85-726, 72 Stat. 731 (1958); today the citizenship requirement is regulated in the *Airline Deregulation Act*, Pub. L; No. 95-904, § 102 (7), (10), 92 Stat. 1705 (codified as amended at 49 U.S.C. § 1301-1552 (1988 & Supp. III 1991)).
[84] 49 U.S.C. § 41102 (2003).
[85] 49 U.S.C. § 1301 (16) [emphasis added].

consistently employed a strict two-fold approach.[86] Not only must an airline satisfy the requisite percentages of US voting interest, but also, as a cumulative and decisive condition, the air carrier must *actually* be controlled by US nationals in order for the airline to qualify as a "citizen of the US";[87] a requirement which has *not* been defined by the Act. The lack of clear definition leads to a situation in which US policy with respect to the interpretation of the term "control" has been based on a "case-by-case basis".[88] There has been room for interpretation, varying in relation to the international and national aeropolitical goals of the administration at the time, and reflecting over the years the evolution of realities in international business.[89]

In some early decisions[90] the DOT used a very restrictive interpretation of the ownership and control requirements.[91] Taken together, the cases have developed into a regime that holds tightly to the statutory 25% threshold.[92] Beyond the percentage of voting stock, however, the DOT has concentrated on the question whether the foreign investor could actually exercise control in any given form. This ranges from control through equity ownership (voting and non-voting)[93] to control through personal relationships.[94] As a result, the DOT could decide that a carrier, even though satisfying

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[86] Lelieur, *supra* note 11 at 35; see also John T. Steward, "US Citizenship Requirements of the Federal Aviation Act – A Misty Moor of Legalisms or the Rampart of Protectionism" (1990) 55 Air L. & Com. 685 at 703-704.

[87] US, Civil Aeronautics Board, *Order in the Matter of Willye Peter Daetwyler, d/b/a Interamerican Airfreight Co., for Amendment of its Foreign permit Pursuant to Section 402 (f) of the FAA of 1958*, Docket No. 118, 119 (1971).

[88] US, Department of Transportation, *Order in the Matter of the Acquisition of Northwest Airlines by Wings Holdings, Inc.*, Consent Order, DOT Order 89-9-51, Docket No. 46371 (29 September 1989) at 4-5 [*Northwest I*].

[89] For details see Lelieur, *supra* note 11 at 35.

[90] US, Department of Transportation, *Order in the Matter of Page Avjet Corporation, Citizenship,* DOT Order 83-7-5, Docket No. 40905, 102 C.A.B. 488 (1 July 1983) [*Page Avjet Corporation*]; US, Department of Transportation, *Order in the Matter of Application of Intera Arctic Services, Inc., for a Foreign Aircraft Permit under Part 375 of the Department's Regulations*, DOT Order 87-8-43, Docket No. 44723 (18 August 1987) [*Intera Arctic Services*]; US, Department of Transportation, *Order in the Case of Application of Transpacific Enterprises, inc. and America West Airlines, inc. for a waiver from the notice requirement of 14 C.F.R. 303 57 (a),* DOT Order 87-8-31, Docket No. 44973 (13 August 1987).

[91] For a detailed description of the case law with respect to the citizenship requirement in the Federal Aviation Act see Arlington, *supra* note 80 at 144-152.

[92] Nanda, *supra* note 14 at 366.

[93] See *Page Avjet Corporation, supra* note 90 at 492.

[94] Böhmann, *supra* note 79 at 698; see, as an example, *Intera Arctic Services*, *supra* note 90 at 8.

the letter of the law, failed to qualify for US citizenship if foreign nationals exercised actual control over the airline *e.g.* through nonvoting ownership.

In September 1989, the DOT yet again demonstrated its "intolerance for foreign control of US air carriers".[95] At that time, KLM Royal Dutch Airlines (KLM) sought to make a major investment in the then-failing Northwest Airlines (NW) through its subsidiary Wings Holding, Inc. (Wings), a company created for the purpose of purchasing NW.[96] Despite the fact that KLM planned to own only 5% of the voting interest in NW, the DOT decided that KLM would exercise actual control over the carrier.[97] The major concern arose out of KLM's ownership of 56.74% of the equity in Wings. The DOT concluded that the combination of a high level of equity interest with a weak voting stock would enhance KLM's incentive to participate in the business of NW in a significant way, in order to protect its large investment.[98] In addition, the right of KLM to name one person to the Wings twelve-member board of directors and to appoint a three member financial advisory committee to advise NW on management and financial affairs would grant KLM a "de facto position of control".[99]

Two years later, however, the DOT tempered its stringent interpretation of the citizenship requirement, at least as it relates to equity ownership.[100] In 1991, Wings proposed to modify the 1989 Consent Order for the same NW/KLM transaction.[101] It sought DOT approval for an increase in its voting shares to 10% and a total non-voting equity up to 49%. It also asked to permit KLM to designate three members on the Wing's

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[95] Arlington, *supra* note 80 at 153.
[96] *Northwest I, supra* note 88.
[97] See *ibid.* at 4-5; in its consent order, the DOT, stated that in order to determine whether a US carrier maintains its citizenship status, it would consider "whether a foreign interest may be in a position to exercise actual control over the airline, i.e., whether it will have a substantial ability to influence the carrier's activities". "[The analysis] has always necessarily been on a case-by case basis, as there are myriad potential avenues of control. The control standard is a de facto-one".
[98] *Ibid.* at 6.
[99] *Ibid.* at 7; after Northwest and Wings had agreed to take steps that substantially eliminated the foreign control concerns of the DOT, latter was able to allow Wings and Northwest to restructure.
[100] Arlington, *supra* note 80 at 156.
[101] US, Department of Transportation, *Order in the Matter of the Acquisition of Northwest Airlines by Wings Holdings, Inc.*, Order Modifying Conditions, DOT Order 91-1-41., Docket No. 46371 (14 January 1991) [*Northwest II*].

board, which had been increased from twelve to fifteen. In 1992, the DOT surprisingly approved the request. In doing so, the DOT announced a shift towards liberalization of its foreign investment policy, [102] stating that while it would maintain the rule of 25% maximum voting shares and actual control in US citizens, it would now allow foreign equity investment up to 49%, including both voting and non-voting stock.[103]

The relaxation of the DOT's foreign investment policy has to be situated in the context of the changed aeropolitical goals of the US at the time. Starting in 1989, the US pursued an open skies agreement with the Netherlands (the home of KLM), which was concluded in September 1992. The promotion of liberalized air transport relations with the Netherlands and the formation of new economic partnerships, rather than protection from foreign influence in national airlines, was the driving force behind the decision to approve the investment in NW.[104] Looking closely at the aviation relationship between the US and the Netherlands the DOT decided partly in light of this situation, "there was justification to allow KLM to invest heavily through both money and directors in the business of Northwest".[105]

Similarly, the British Airways/USAir case involved considerations of international air transport policy pursued by the US. In July 1992, British Airways (BA) and USAir had signed and announced an agreement calling for a major investment by BA in USAir. Under this agreement, BA would have 21% of the voting stock as well as representation on the USAir board.[106] Eventually the two entities would have merged with a single brand name.[107] In contrast to the favourable influence that the ongoing US – Netherlands Open Skies negotiations had on the NW/Wings DOT decision, the failing bilateral negotiations between the US and the UK negatively influenced the willingness of the DOT to approve

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[102] Nanda, *supra* note 14 at 369.
[103] *Northwest II*, *supra* note 101 at 9.
[104] Lelieur, *supra* note 11 at 37.
[105] Arlington, *supra* note 80 at 159.
[106] Thomas D. Grant, "Foreign Takeovers of US Airlines: Free Trade Process, Problems, and Progress" (1994) 31 Harv. J. on Legis. 63 at 115.
[107] For a detailed description of the USAir/British Airways proposal see Grant, *ibid* at 115-119.

the BA/USAir deal.[108] The DOT rejected the deal, since BA would have gained greater market access in the US, while barriers to entry into the UK market would have remained in place,[109] as negotiations over additional access to London's Heathrow Airport had failed. In March 1993, a second BA proposal was accepted by the DOT.[110] On this occasion, the DOT considered that "the approval of the USAir/BA transaction might increase the likelihood of a US – UK Open Skies agreement; though in the end no agreement was reached."[111]

The cases demonstrate that US policy on foreign investment often goes beyond the literal application of law. Considerations of general national as well as international air policy play an important role. For investors this means facing a high degree of uncertainty making it difficult to plan strategic actions.

Compliance with the ownership and control requirements of the Federal Aviation Act is complicated by the fact that a carrier is required to "continue to comply with the statutory requirements".[112] The air carrier thus needs to trace the ownership structures of the company at all times. It is obvious that this task is extremely difficult to fulfill in the case of publicly traded companies, where ownership of the air carrier might be widely spread amongst shareholders of different nationalities. In order to ensure compliance with the obligations of the Act, the DOT requires air carriers to notify the DOT of any "substantial change" that it proposes to undergo in operations, ownership, or management.[113] The term of "substantial change" is subject to interpretation by the DOT. According to the DOT, a substantial change in ownership is defined as "[t]he acquisition by a new shareholder or the accumulation by an existing shareholder of beneficial control

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[108] Nanda, *supra* note 14 at 370.
[109] Böhmann, *supra* note 79 at 703.
[110] The second deal included an investment by British Airways of $300 million for a 19.9% stake in USAir and excluded the common branding proposed in the first deal. This time, the DOT approved the transaction under the condition that every further British Airways investment would be subject to DOT approval.
[111] Lelieur, *supra* note 11 at 38.
[112] Federal Aviation Act, *supra* note 83 at 49 U.S.C. §41110 (e).
[113] Böhmann, *supra* note 79 at 704.

of 10% or more of the outstanding voting stock."[114] Another mechanism to keep track of the ownership structure of US publicly traded air carriers can be found in the Securities Exchange Act of 1934.[115] According to the Act, "any person who is directly or indirectly the beneficial owner of more than 5% of any security is required to send to the issuer of the security and to file with the Securities Exchange Commission a statement describing the person's identity, residence, and citizenship."[116]

Initiated by a study presented in 1992 by the General Accounting Office (GAO),[117] and endorsed by the "National Commission to Ensure a Strong Competitive Airline Industry",[118] there was a movement for the amendment of the Federal Aviation Act to allow up to 49% foreign ownership in US airlines.[119] At the time, however, the concerns of the proponents of the current statutory regime prevailed.[120] Foreign ownership of US airlines is currently back on the table. The DOT itself proposed raising the ceiling to 49% of voting equity,[121] bringing the US requirements into line with the EU, which allows non-EU investment in EU carriers up to 49% of both voting and non-voting equity.[122] The proposal is timely, considering the moves by the European Commission towards reforms in the aviation sector, with the aim of opening negotiations with the US on the eventual creation of an open aviation area between the EU and the US.[123] Support in favour of an amendment of the Federal Aviation Act is broad; the constituency includes many US airlines. In fact, there are good chances that Congress will actually approve an amendment to foreign ownership restrictions. Given the persistence

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[114] *Ibid.*
[115] *Securities Exchange Act,* 15 U.S.C. §§ 78 (g) (1) ff. (1994).
[116] See Böhmann, *supra* note 79 at 704.
[117] General Accounting Office, *Airline Competition – Impact of Changing Foreign Investment and Control Limits on U.S. Airlines*, GAO/RCED-93-7 (9 December 1992).
[118] The National Commission to Ensure a Strong Competitive Airline Industry, *Change, Challenge, and Competition: a Report to the President and Congress submitted on 19 August 1993,* Washington, D.C.: U.S. Government Printing Office (1993).
[119] Gertler, *supra* note 18 at 218.
[120] For a detailed discussion of the concerns see Edwards, *supra* note 36 at 624 ff..
[121] Kevin Done, "US reform may help restructure loss-making aviation sector" *Financial Times* (23 May 2003); Caroline Daniel, "Ownership rule changes do not a profit make" *Financial Times* (29 May 2003).
[122] See EC, *Council Regulation (EEC) No 2407/92 of 23 July 1992 on licensing of air carriers*, [1992] O.J. L. 240/1 at article 4 (2); see also EC, *Commission Decision of 19 July 1995 on a procedure relating to the application of Council Regulation (EEC) No 2407/92 (Swissair/Sabena)*, [1995] O.J. L. 239/19 at para. 10.
[123] Done, *supra* note 121.

of the "control" requirement in DOT citizenship review procedures, this change would, however, "be unlikely to spur any sizeable new foreign investment in the US airlines industry."[124]

1.2.2.2 The "Community Carrier" Concept in EU Legislation

While the EU approach to the air carrier ownership and control requirement is "less obscure and less protectionist than US policy",[125] EU legislation itself regulates a complex situation. In fact, EU legislation pertaining to the licensing of air carriers applies to the entire Community, a construct that comprises sovereign States. Strictly speaking, EU legislation thus regulates international, and not national, air transport.

Traditionally, every EU Member State had statutes dealing with the granting and the maintaining of operating licences for air carriers.[126] As in the US, EU Member States protected their national airline by imposing restrictions on the percentage of foreign ownership permitted. Furthermore, air transport relations among EU Member States were governed by bilateral agreements that included traditional ownership and control provisions. Neither of these restrictions now exists between Member States.[127]

The removal of foreign ownership restrictions within the EU was achieved through the gradual liberalization of the internal EU transport market by means of three "Packages" of regulations (in 1987, 1990 and 1992).[128] The liberalization of the EU

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[124] Brian F. Havel, "White Paper – A New Approach to Foreign Ownership of National Airlines" (2003) at 25, online: DePaul University, www.law.depaul.edu/bhavel (date accessed: 30 September 2003).
[125] Lelieur, *supra* note 11 at 40.
[126] Hans-Henning Mühlke, "Die Genehmigung deutscher Luftfahrtunternehmen unter Anwendung der entsprechenden Verordnung (EWG) 2407/92" (1995) 44:2 ZLW 147 at 148. In Germany, before the coming into force of Council Regulation 2407/92, the granting and the maintaining of operating licences of air carriers was dealt with in *Luftverkehrsgesetz*, 27 March 1999, German Law Gazette I-550 (1999) (codified as amended by Article 1 of the Act of 21 August 2002, German Law Gazette I-3355 (2002)).
[127] Wassenbergh, Henri A., "Common Market, Open Skies and Politics – A Bald Eagle's-Eye View of Today's Air Transport Regulation" (2000) 25:4-5 Air & Space L. 174 at 177 [Wassenbergh, "Common Market, Open Skies and Politics"].
[128] The "First Package" consisted of EC, *Council Regulation (EEC) 3975/87 of 14 December 1978 laying down the procedures for the application of the rules on competition to undertakings in the air transport sector*, [1987] O.J. L. 374/1; EC, *Council Regulation (EEC) 3976/87 of 14 December 1978 on the application of Article 85 (3) of the Treaty to certain categories of agreements and concerted practices in the air transport sector*, [1987] O.J. L. 374/9, both setting for the procedures for applying the EC antitrust

market was completed with the introduction of the "Third Package" of measures, which were adopted in 1992 and applied as from January 1993.[129] The "Third Package" mainly consists of two Council Regulations, Regulation 2407/92 on "Licensing of Air Carriers"[130] and Regulation 2408/92 on "Access for Community Air Carriers to Intra Community Air Routes".[131] The "Third Package" effectively created for the first time an almost completely open aviation market within the EU, "regardless of the bilateral agreements between the Member States".[132] In 1997, it even led to the freedom to provide cabotage, *i.e.* the right for an airline of one Member State to operate a route within another Member State.

As part of the "Third Package", Council Regulation 2407/92 replaced the national statutes applicable in this field with the concept of "Community Carrier". A "Community Carrier" is defined as "an air carrier with a valid operating license granted by a Member State in accordance with the [Council Regulation on the Licensing of Air Carriers]".[133] Article 4 lays down the harmonized conditions a "Community Carrier" has to satisfy in

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rules to the aviation industry; EC, *Council Directive No 87/601/EEC of 14 December 1987 on fares for scheduled air services between Member States*, [1987] O.J. L. 374/12; the "Second Package" included EC, *Council Regulation (EEC) No 2342/90 of 24 July 1990 on fares for scheduled air services*, [1990] O.J. L. 217/1; EC, *Council Regulation (EEC) No 2343/90 of 24 July 1990 on access for air carriers to scheduled intra-Community air service routes and on the sharing of passenger capacity between air carriers on scheduled air services between Member States*, [1990] O.J. L.217/8; EC, *Council Regulation (EEC) No 2344/90 of 24 July 1990 amending Regulation (EEC) No 3976/87 on the application of article 85 (3) of the treaty to certain categories of agreements and concerted practices in the air transport sector*, [1990] O.J. L. 217/15; finally, the "Third Package" consists of EC, *Council Regulation (EEC) No 2407/92, supra* note 122; EC, *Council Regulation (EEC) No 2408/92 of 24 July 1990 on access for Community air carriers to intra-Community air r*outes, [1992] O.J. L. 240/8; EC, *Council Regulation (EEC) 2409/92 23 July 1992 on fares and rates for air services,* [1992] O.J. L. 240/15; EC, *Council Regulation (EEC) 2411/92 of 23 July 1992 amending Regulation (EEC) No 3976/87 on the application of Article 85 (3) of the Treaty to certain categories of agreements and concerted practices in the air transport sector*, [1992] O.J. L. 240/19; See also EC, Commission, *Overview of air transport,* online: European Union http://www.europa.eu.int/comm/transport/air/index_en.htm (date accessed 10 June 2003).

[129] Böhmann, *supra* note 79 at 718.

[130] EC, *Council Regulation (EEC) No 2407/92*, *supra* note 122.

[131] EC, *Council Regulation (EEC) No 2408/92*, *supra* note 128.

[132] *Ibid.*

[133] See EC, *Council Regulation (EEC) No 2343/90*, *supra* note 128; see also IATA Think Tank, *supra* note 52 at 18.

order to be granted an operating license from its *national* licensing authority.[134] Pursuant to this provision:

> 1. No undertaking shall be granted an operating license by a Member State unless:
>   a) Its principal place of business and, if any, its registered office are located in that Member State;
>   b) and its main occupation is air transport in isolation or combined with any other commercial operation of aircraft or repair and maintenance of aircraft.
> 2. Without prejudice to agreements and conventions to which the Community is a contracting party, *the undertaking shall be owned and continue to be owned directly or through majority ownership by Member States and/or nationals of Member States. It shall at all times be effectively controlled by such States or such nationals. ...*
> 3. Any undertaking which directly or indirectly participates in a controlling shareholding in an air carrier shall meet the requirement of paragraph 2.[135]

The specific character of Regulation 2407/92 lies in the fact that it does not distinguish between citizens of single States but between "EU nationals" on the one and "non-EU nationals" on the other hand. The Regulation applies between and among the 15 Member States plus Norway, Iceland, Liechtenstein[136] and Switzerland.[137] Between and among those parties, restrictions pertaining to foreign ownership in national air carriers have been eliminated. EU air carriers may now be owned and controlled by any Community citizen and enjoy the right of establishment throughout the Union.[138] In relation to non-EU nationals, however, restrictions on foreign investment are still applicable. By restricting non-EU ownership in EU air carriers, third countries are

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[134] The national authorities remain in charge of granting operating licenses, as the Regulation did not establish a central European Authority to perform these tasks; See Mühlke, *supra* note 126 at 148; see also Böhmann, *supra* note 79 at 719.

[135] EC, *Council Regulation (EEC) No 2407/92, supra* note 122 at Article 4 [emphasis added].

[136] The latter countries are subject to the above Community legislation by virtue of the EEA Agreement of 1994, see EC, *Decision of the EEA Joint Committee No 7/94 of 21 March 1994 amending Protocol 47 and certain Annexes to the EEA Agreement*, [1994] O.J. L.160/1.

[137] Switzerland is subject to the above EU legislation by virtue of the EU – Switzerland agreement, an aviation-specific association agreement whereby Switzerland takes over the provisions of the EU internal air transport market. It was signed on 21 June 1999 and entered into force on 1 June 2002; see Lelieur, *supra* note 11 at 42.

[138] Peter P.C. Haanappel, "Airline Challenges: Mergers, Take-Overs, Alliances and Franchises" (1995) 20:1 A.A.S.L. 179 at 181 [Haanappel, "Mergers, Take-overs, Alliances and Franchises"].

prevented from unilaterally taking advantage of the Community's liberalized international air services market.[139]

Similar to US law, Regulation 2407/92 requires that the carrier applying for an operating licence is owned and controlled by a Member State or nationals of a Member State.[140] Unlike US law, however, "the European Regulation is 'less obscure' than the US legislation to the extent that the notions of 'ownership' and 'control' have been clearly defined."[141]

With respect to the ownership requirement, the Regulation uses the term "majority ownership". The Commission interpreted this notion in its review of the "merger" of Sabena and Swissair' in 1995. [142] It approved the deal, concluding that "majority ownership" meant an ownership of more than 50% of the capital of an air carrier.[143] Thus, an air carrier may qualify for the grant of an operating licence, provided not more than 49.5% of the capital of the carrier is held by non-EU nationals.[144] The Commission further held that it is not relevant whether the shares of the "majority owner" are held by a single EU national or by a dispersed group of shareholders, so long as they are EU nationals and their interests add up to a majority.[145] Moreover, "ownership" of an air carrier may refer to the participation in the corporation in terms of capital and not in terms of voting rights.[146]

In contrast to the US legislation, the Regulation provides for a definition of the term of "effective control". According to Article 2 (g) of Regulation 2407/92:

> ...'[E]ffective control' means a relationship constituted by rights, contracts or any other means which, either separately or jointly and having regard to the considerations of fact or law involved,

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[139] Böhmann, *supra* note 79 at 720.
[140] EU, Council Regulation 2407/92, *supra* note 122 at 1.
[141] Lelieur, *supra* note 11 at 41.
[142] See *Swissair/Sabena*, *supra* note 122 at para. 10; see also Böhmann, *supra* note 79 at 720-721.
[143] For a detailed discussion of the *Swissair/Sabena* case, see P. Stepen Dempsey, "Competition in the Air: European Union Regulation of Commercial Aviation" (2001) 66 J. Air L. & Com. 979 at 1053.
[144] See Rigas Doganis, "Relaxing Airline Ownership and Investment Rules", *supra* note 59 at 268.
[145] See *Swissair/Sabena*, *supra* note 122 at para. 11; see also Böhmann, *supra* note 79 at 720-721.
[146] *Swissair/Sabena*, *ibid.*

> confer the possibility of directly or indirectly exercising a decisive influence on an undertaking, in particular by:
>
> (1) the right to use all or part of the assets of an undertaking;
> (2) rights or contracts which confer a decisive influence on the composition, voting or decisions of the bodies of an undertaking or otherwise confer a decisive influence on the running of the business of the undertaking.

In the Sabena/Swissair case, the Commission applied the definition of "effective control". In order to examine whether Swissair would exercise effective control over the Belgian carrier, the Commission analyzed the composition and powers of the Swiss-Belgian management board, the procedure for the appointment of its chairman, the powers of the CEO and of the Belgian shareholders and the extent of the Swiss veto rights.[147] There are thus relatively unambiguous guidelines as to who effectively controls an EU air carrier.

Similar to US law, the EU Regulation burdens air carriers with the task of strictly monitoring the ownership structures of the company. Pursuant to Article 4 (5) of the Regulation, a carrier holding a Community air carrier license shall at all times be able to demonstrate to the Member State responsible for the operating license that it is "majority owned" and "effectively controlled" by EU nationals. It is evident that meeting such a request is extremely difficult in an age of privatization. Today, most carriers in the EU are publicly traded companies. Due to the free transferability of shares, ownership structures may change very quickly among shareholders. The traceability of ownership is even more complicated by the fact that that the identity of shareholders is usually unknown. It is therefore difficult for carriers to continuously ascertain that they fulfill the ownership requirements.[148] National legislators had to step in, in order to facilitate compliance with the Regulation.

In order to guarantee the compliance of Lufthansa (LH) with the requirements of the Regulation after the complete privatization of the carrier in 1997, the German

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[147] IATA Think Tank, *supra* note 52 at 16.
[148] Böhmann, *supra* note 79 at 724.

legislature introduced the Aviation Compliance Documenting Act (ACDA).[149] According to this Act, shares in German listed airlines must be registered shares with restricted transferability,[150] instead of anonymous bearer shares.[151] Moreover, the shareholders are required to give information to the company regarding their nationality. The air carrier is provided with graded devices that allow it to ensure compliance with the ownership requirement. It allows the air carrier to re-acquire its own shares[152] and to increase the capital stock of the company by issuing additional shares, while excluding the right of certain shareholders to buy newly issued shares. Most importantly, the carrier can deny its shareholder the right to transfer its shares and, as a means of last resort, request its shareholder to dispose of its shares.[153]

A comparison between US and EU law and policy on foreign ownership and control leads to the conclusion that there are many similarities between the two systems. However, compared to US law, the EU Regulation provides clearer provisions that leave less room for varying interpretations by administrations. Clarity is reinforced by the fact that, due to the primacy of EU laws over national legislation of Member States, the latter are bound by this Regulation.[154] Thus, the national licensing authorities are not allowed to impose stricter requirements than EU legislation and decisions lay down.[155]

A major difference between the two systems lies in the fact that the US departs from a single-States nationality approach, whereas the EU takes into account a multi-State nationality. EU legislation thus allows for multi-national EU ownership of air carriers. However, as will be demonstrated later,[156] restrictive air transport relations

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[149] *Luftverkehrsnachweissicherungsgesetz*, 5 June 1997, German Law Gazette I-1322 (1997); see Böhmann, *ibid.* at 725.
[150] *Luftverkehrsnachweissicherungsgesetz*, *ibid.* at Article 2 (1).
[151] *Ibid.* at article 3; see also Lufthansa, „Informationsschrift über den Entwurf für ein Luftverkehrsnachweissicherunsgesetz sowie zur vorgesehenen Änderung der Aktienart" (Paper issued at the Lufthansa general assembly, Cologne, 26 June 1997) at 2.
[152] *Luftverkehrsnachweissicherungsgesetz*, *ibid* at Article 4 (1).
[153] *Ibid.* at Articles 4 and 5; Böhmann, *supra* note 79 at 725.
[154] Lelieur, *supra* note 11 at 6.
[155] Mühlke, *supra* note 126 at 158; This primacy of the EU Regulation over Member States' aviation regulation is reflected in *Luftverkehrsgesetz*, *supra* note 126 at § 20 (4).
[156] See *infra* Chapter 2.2.2.2.

maintained by Member States with third States prevent EU international air carriers from taking advantage of this liberal approach.

1.2.2.3 Australia's Liberal Approach

After having described the laws of two of the major players in international air transport,[157] it is now interesting to outline one example of domestic regulation from "the rest of the world". Australian ownership and control legislation provides a good example of a liberalized approach as to foreign investment in national airlines.

The Australian Government considerably relaxed its laws on foreign investment in 1999. It thereby applied two different sets of rules depending on whether foreign investment in domestic or international air carriers is concerned.[158] Under the new foreign acquisition regulations, foreigners are allowed to own up to 100% of domestic airlines,[159] thereby granting the right of establishment in Australia.[160] For Australian international air carriers, the ceiling on foreign investment has been raised to 49%.[161] This latter limitation has been maintained in order to guarantee compliance with the traditional ownership requirement imposed by ASAs in place.

The complete opening up of the domestic market to foreign investment "shows an evolution in thinking which is still an exception" in national air transport regulation.[162]

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[157] Air traffic between and in the aviation markets of the US and the EU account for around 60% of the global total air traffic; see IATA, World Air Transport Statistics (2001), online IATA: http://www.iata.org/air/productsandservices/wats.htm?BreadCrumb=%2FChannels%2Fair%2Fairports%5Finformation (date accessed: 20 June 2003).

[158] See "Australian Government to Ease Foreign Ownership restrictions" *Aviation Daily* (19 August 1999) 3; under former regulations, foreign individual ownership of an international carrier was restricted to 25% and company ownership up to a total of 35%. Individual ownership of a domestic carrier was restricted to 25% and total foreign company ownership to 40%. See Jackie Gallacher, "Australian Ownership Rules Criticized" *Airline Business* (1 August 2003) 26.

[159] Chang, Williams, "Changing the Rules", *supra* note 34 at 211; see also Gallacher *ibid* 26; note, however, that the Australian government can still block a purchase of a domestic airline if it is "contrary to the national interest".

[160] Joan M. Feldman, "Drip, Drip, Drip" *Air Transport World* (1 March 2001) 42.

[161] *Air Navigation Act* (1920), §11 A; § 11 A deals with foreign shareholding in Australian international airlines, online: Australian Government, Department of Transport and Regional Services http://www.austlii.edu.au/au/legis/cth/consol_act/ana1920148/s11a.html (date accessed: 22 June 2003).

[162] IATA Think Tank, *supra* note 52 at 24.

The relaxed rules with respect to foreign investment in Australian airlines have set the basis for enhanced merger and acquisition activities between Australian and foreign air carriers. The change enabled Air New Zealand (NZ) to purchase 100% of Ansett Australia[163] and 49% of Ansett International. Furthermore, BA, Qantas's (QF) "oneworld" alliance partner, owns 25% of QF's shares.[164] Finally, UK-based Sir Richard Branson was able to establish Virgin Blue, which operates domestically in Australia.[165]

Even in comparison to EU legislation, which allows for the free flow of capital between EU Member States, but restricts foreign investments by non-EU nationals, Australian law is extremely progressive. What is more, by means of a clear division between domestic and international airlines, Australian law creates a situation of certainty for foreigners investing in Australian domestic airlines and thereby increases the incentive for cross-border flow of capital.

1.2.3 Deviations and Exceptions from the Standard Clauses

Over the years, a number of deviations and exceptions to the use of traditional ownership and control provisions have developed. In fact, in certain cases ownership rules have been by-passed by specific provisions in ASAs, simply ignored by governments or progressively replaced by broadened or liberalized designation rules.[166]

The oldest deviation from the standard ownership and control provision has been the creation of airlines with multi-national ownership. The pioneer in this field is Scandinavian Airlines System (SAS), a "joint operating organization" combining the airlines of Norway, Sweden and Denmark, which are substantially owned and effectively controlled by the nationals of the countries concerned.[167] Strictly speaking, such an airline with multi-national ownership does not comply with the traditional ownership and control

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[163] Chang, Williams, "Changing the Rules", *supra* note 34 at 211.
[164] IATA Think Tank, *supra* note 52 at 24.
[165] Dave Knibb, "Virgin moves on Australia" *Airline Bus.* (1 January 2000) 11.
[166] Rigas Doganis, "Liberalization: Past Experience and Future Steps" (Paper presented at the Seminar prior to the 5 the ICAO Worldwide Air Transport Conference, 22 March 2003) [unpublished][Doganis, "Past Experience and Future Steps"].
[167] IATA Think Tank, *supra* note 52 at 20.

requirement. Nevertheless, thanks to the use of a specific negotiating practice, third countries have accepted this deviation and have abstained from challenging the airline's traffic rights.[168] In fact, each of the three countries enters into individual bilateral agreements with third States containing designation clauses, in which all three States are entitled to designate SAS as their "national" carrier.[169] At the same time, even though the bilateral agreements are entered into separately by each of the three governments, the negotiations are conducted contemporaneously between the three States on the one and the third country on the other side.[170] Other similar examples of multi-national airlines include Air Enrique[171] and Gulf Air.[172]

ICAO has initiated another deviation from the traditional ownership and control clause. The 24th Session of the ICAO Assembly in 1983 adopted Resolution A24-12 (now incorporated in A33-19),[173] which introduced the concept of "Community of Interest" in respect of airline designation. This concept urges Contracting States to accept the designation by one developing State of an airline "substantially owned and effectively controlled by another State within the same regional economic grouping".[174] BWIA International Airlines is an important example of a designated "community of interest airline". Several members of the Caribbean Economic Community (CARICOM), such as Barbados and Saint Lucia, designated BWIA to operate services under their respective bilateral agreements with third countries, even though it is substantially owned and effectively controlled by the Government of Trinidad and Tobago. The designation of this

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[168] van Fenema, "Substantial Ownership and Effective Control as Airpolitical Criteria", *supra* note 66 at 37.
[169] Doganis, "Relaxing Airline Ownership and Investment Rules", *supra* note 59 at 267.
[170] Haanappel, "Airline Ownership and Control", *supra* note 9 at 95.
[171] Air Afrique was created in 1961 between eleven African states (Benin, Burkina Faso, Congo, Centrafrique, Cote d'Ivoire, Chad, Togo, Mali, Mauritania, Niger, and Senegal).
[172] Gulf Air was created in 1950 between four Persian Peninsula Partner States (Bahrain, Oman, Qatar and Abu Dhabi.
[173] ICAO, Assembly Resolution A33-19, *Consolidated statement of continuing ICAO policies in the air transport field* (2001), online: ICAO http://www.icao.int/icao/en/res/a33_19.htm (date accessed: 12 May 2003).
[174] See IATA Think Tank, *supra* note 52 at 22.

"community of interest airline" has been accepted by the US, the UK and Canada as well as Germany.[175]

Moreover, some countries have been exempted by their bilateral negotiating partners from the use of the traditional ownership and control requirements.[176] For instance, Hong Kong, the former British colony, was authorized by a number of nations to redefine the criteria for designation and to use the "incorporation and principal place of business" standard.[177] This was necessary, in order for Hong Kong to effectively designate its airline, Cathy Pacific (CX). CX is incorporated and has its principal place of business in Hong Kong, but is owned and controlled by the British Swore Group.[178] Hong Kong, due to its present status as a Special Administrative Region of China, is still allowed to conclude bilaterals using the above clause.[179]

Important deviations from the traditional ownership and control clause can also be found in an increasing number of regional or plurilateral agreements. In particular, multilateral open skies agreements often contain broadened criteria for the designation and authorization of airlines operating under the agreement.

The EU is notable for such a multilateral open skies area with liberalized ownership and control requirements. As seen earlier, the EU created a common internal aviation market.[180] Even though cross-border traffic is involved, air transport relations among the Member States are no longer regulated by bilateral agreements. Traditional ownership and control restrictions have been replaced by the concept of a "Community Carrier". Inside this common area, air carriers that qualify as "Community Carriers" can operate freely.

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[175] Lelieur, *supra* note 11 at 52.
[176] IATA Think Tank, *supra* note 52 at 23.
[177] van Fenema, "National Ownership and Control Provisions Remain Major Obstacles to Airline Mergers", *supra* note 69 at 9.
[178] Haanappel, "Airline Ownership and Control", *supra* note 9 at 95.
[179] IATA Think Tank, *supra* note 52 at 24.
[180] See Chapter 1.2.2.2.

Another approach for liberalized ownership and control clauses applicable to the parties of a multilateral ASA is found in the Asia-Pacific Economic Cooperation (APEC) "Multilateral Agreement on the Liberalization of International Air Transportation" (APEC Agreement).[181] The APEC Agreement was entered into by the US and four like-minded APEC partners (Brunei, Chile, New Zealand, and Singapore) in November 2000.[182] In its provision on the designation and authorization of air carriers,[183] the Agreement eliminates the traditional criterion of "substantial ownership" and replaces it by an "incorporation and principal place of business" test. Thus, the traditional criterion is loosened, since the ownership of the airline no longer needs to be vested in nationals of the designating party. [184] However, the Agreement does maintain the "effective control" test. In doing so, "it still leaves open the possibility that, even if a carrier is substantially owned by its own nationals, it is controlled effectively from abroad and therefore not available for designation".[185] For that reason, the above clause does not facilitate mergers and acquisitions among airlines of different nationality. It is hardly likely that one airline would make a major investment in a foreign airline, without being able to exercise control of that airline. Nevertheless, the APEC Agreement "does introduce, in a multilateral setting, an interesting change of approach vis-à-vis the traditional ownership and control

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[181] *Multilateral Agreement on the Liberalization of International Air Transportation*; online: State Department http://www.state.gov/www/issues/economic/tra/001115_apec_opskies.html. (date accessed: 08 July 2003) [APEC Agreement].

[182] The APEC Agreement was signed on 1 May 2001 and entered into force on 21 December 2001; for further information on the Agreement consult online: Maliat, http://www.maliat.govt.nz (date accessed: 08 July 2003). On 21 December 2001, Peru deposited its Instrument of Accession to the Multilateral and the agreement entered into force as between Peru and all Parties on 17 May 2002; On 4 July 2002, Samoa, a non-APEC country, deposited its Instrument of Accession to the Multilateral and it entered into force as between Samoa and all Parties on 10 October 2002.

[183] Article 3 (2) on the designation and the authorization of air carriers of the APEC Agreement provides that:

"...each Party shall grant appropriate authorizations and permissions with minimum procedural delay, provided that:

(a) effective control of that airline is vested in the designating Party, its nationals, or both;
(b) the airline is incorporated in and has its principal place of business in the territory of the Party designating the airline;..."

[184] John Kiser, "The Multilateral Agreement on the Liberalization of International Air Transportation", (Paper presented at the Seminar prior to the 5 the ICAO Worldwide Air Transport Conference, 22 March 2003) [unpublished].

[185] Janda, Richard, *supra* note 3 at 47.

requirement which will put some pressure on the requirements that still remain in place".[186]

A more complete liberalization of the standard clause is included in the Pacific Island Air Service Agreement (PIASA), which was agreed upon in October 2002 and will be presented for signing and ratification in 2003. By entering into this Agreement, the governments of several Pacific Island States, as well as of Australia and New Zealand, have attempted to liberalize their air services arrangements. The eventual aim is to establish a single aviation market among many of the island States of the Pacific.[187] The PIASA provides for a two-phased transition to what is effectively a "community ownership and control regime".[188] Where a State has no flag carrier, the PIASA permits that a State to designate another State's airline, provided the place of residence and principal place of business of that carrier is located within the territory of the designating party.[189]

"These formulas all deviate from the traditional clauses, but they also have one other thing in common, which is that they only work inwardly."[190] Having been agreed upon bilaterally, plurilaterally or multilaterally, third parties to the agreements have no obligation whatsoever to accept the formula used. For instance, if a Singaporean made a major investment in a Peruvian carrier (Singaporean substantial ownership), the Peruvian entity would be able to freely operate inside the APEC area. Having agreed upon a liberalized standard for the designation, no Party to the APEC Agreement could deny the air carrier the right to fly from Peru to any Party's territory, as long as the carrier is incorporated and has its principal place of business in Peru and remains under effective Peruvian control. However, under the traditional ownership criteria, third States are still

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[186] IATA Think Tank, *supra* note 52 at 22.
[187] For a detailed description of the PIASA, see Peter Harbison, "Island Countries turn to Multilateralism to improve air Services across vast Region" (2002) 57 ICAO Journal 16; see also Sean McGonigle, *Comparative regulation of air transport in the Asia-Pacific Region*, (LL.M Thesis, McGill University, Institute of Air and Space Law 2003) [unpublished];
[188] Harbison, *ibid* at 18; see for further information online: Forumsec http://www.pecc.net/airtransportpapers/Guild.ppt (date accessed: 14 May 2003).
[189] Peter Harbison, *supra* note 187 at 18.
[190] van Fenema, "National Ownership and Control Provisions Remain Major Obstacles to Airline Mergers", *supra* note 69 at 9.

free to reject the designation of an air carrier that does not comply with the standard clause. Alternatively the third State could attach aeropolitical, financial or other conditions to the acceptance of the model.[191] This threat of aeropolitical counter-demands from other States may put the whole transaction at risk and prevent airlines from taking advantage of merger and acquisition opportunities.[192]

This example demonstrates that "[c]ountries are caught in a kind of prisoner's dilemma under this system."[193] In fact, every initiative by a State or a group of States to liberalize the traditional ownership and control requirements might compromise the access of those States' airlines to international routes to other countries.[194] As long as the alternative criterion is not universally accepted, departures from the standard clause will be risky. States will remain cautious in making exceptions to the use of the traditional ownership and control clauses and the requirement of "substantial ownership and effective control" will continue to constitute the standard.

What is more, even if liberalized criteria for the designation of air carriers became the standard, national restrictions on foreign investment would still stand in the way of cross-border mergers and acquisitions. Deviations from the traditional ownership approach can, thus, only succeed, if States, as in the case of Australia,[195] change their national laws to follow the international process of liberalization.

While in the above-mentioned cases States have used variations from the standard clause in their ASAs with other States or have liberalized their national legislations, in

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[191] *Ibid.*; see also Nick Ionides, "APEC Moves Towards Multilateral Open Skies" *Airline Bus.* (1 January 2001) 24.
[192] Holderbach, *supra* note 55 at 110; a similar comment has been made by Ulrich Schulte-Strathaus, Secretary General of the Association of European Airlines (AEA), during a personal interview, Brussels, 19 June 2003 [Schulte-Strathaus, Interview].
[193] Havel, *supra* note 124 at 6.
[194] *Ibid.*
[195] Other examples of liberalized national ownership laws can be found in New Zealand, Peru, Chile; for details, see Lelieur, *supra* note 11 at 52-53.

some other instances, airlines themselves have departed from complying with the clause thereby confronting other States with the violation of the provisions included in ASAs.[196]

When the Argentine air carrier, Aerolineas Argentinas, was privatized in 1990, it was taken over by the Spanish State-owned Iberia. Today, Iberia and its parent company Sociedad Estatal de Participaciones Industriales (SEPI)[197] are the major investors in Aerolineas Argentinas, at one time owning more than 60% of the air carrier.[198] Permissible under Argentine law, which allows foreign airlines or other investors to own 70% or more of an Argentine airline, this situation is not in line with the requirements of the US-Argentina bilateral agreements. [199] Even though in the eyes of the US, Aerolineas Argentinas had lost its Argentinean nationality under the bilateral agreement and was in fact controlled by Spain, the US abstained from challenging the traffic rights.[200] After having received a relatively modest expansion of traffic rights to the benefit of US airlines operating to Argentina, the US declared it would refrain from invoking the nationality clause.[201]

Similarly, in the case of Swissair/Sabena, the US did not consider the invocation of the nationality clauses contained in the bilaterals with Switzerland and Belgium, even though SAirGroup, the parent of Swissair, held 49.5% of Sabena and announced an agreement with the Belgian Government to raise its stake to 85%.[202] This behaviour may have been influenced by the fact that both Switzerland and Belgium are parties to open skies bilateral agreements with the US.[203] Such an agreement offers virtually unlimited operational and commercial opportunities to carriers to both negotiating partners. Invoking the nationality clause in such circumstances would not have changed any commercial opportunities of either side.

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[196] IATA Think Tank, *supra* note 52 at 24.
[197] The Spanish government has transferred most of Iberia-held shares to its holding company, Sociedad Estatal de Participaciones Industriales (SEPI), Iberia's parent company.
[198] van Fenema, "Consequences and Steps to be Taken" *supra* note 51 at 65.
[199] IATA Think Tank, *supra* note 52 at 25.
[200] Böhmann *supra* note 79 at 709.
[201] Lelieur, *supra* note 11 at 54.
[202] *Ibid.*
[203] IATA Think Tank, *supra* note 52 at 26.

While these examples demonstrate that States are more and more ready to make exceptions to the standard requirement, it has to be understood that departures and exceptions on a case-by-case basis do not create "the kind of predictability that an airline or government strategist would feel comfortable with when considering whether to be an active or a passive participate in a take-over."[204]

1.3 Concluding Remarks

The aim of this chapter has been to set out the background and conceptual issues underlying the perpetual use of the "substantial ownership and effective control" criterion in international air transport. While exceptions and deviations from the standard clause are not new, and prove that the nationality rule is not "sacrosanct",[205] those departures have not effectively been able to supplant the traditional principle. The requirement remains the dominant criterion,[206] a worldwide standard[207] that continues to cause uncertainty.

We will now turn to why there is need for change of this worldwide standard. What is the motivation behind the increasing number of initiatives to revisit the traditional criterion, and why was "air carrier ownership and control" so high on the agenda of ATConf/5?

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[204] IATA Think Tank, *supra* note 52 at 27.
[205] Doganis, "Past Experience and Future Steps", *supra* note 166 at 9.
[206] Lelieur, *supra* note 11 at 52.
[207] Holderbach, *supra* note 55 at 110.

CHAPTER 2: THE NEED FOR CHANGE

The traditional ownership and control criterion for airline designation and authorization had been widely accepted during the time when most national carriers were owned by the designating State or its nationals.[208] However, the situation has changed significantly as a result of liberalization. In an increasingly global and liberalized business environment, ownership and control provisions constitute an odd relic of State protectionism that impedes further liberalization and the restructuring of the airline industry. This effect is specifically apparent in the case of the EU air transport market. Here, however, the issue of ownership and control liberalization encompasses simple economic aspirations. Europe has a legal obligation to seek change.

2.1 Air Carrier Ownership and Control Requirements are at Odds in an Increasingly Global and Liberalized Business Environment

"There has always been a fundamental contradiction in the airline industry": The activities of international airlines, by their very nature, cross national boundaries, and do so more rapidly and frequently than any other means of transport;[209] however, the carriers themselves are almost invariably national rather than multinational companies.[210]

This situation slightly began to change following the deregulation of the US industry from 1978, [211] the privatization trend that took off in the 1980s and finally the deregulation of the airline industry in the EU from 1997.[212] Now, "the same forward momentum that built behind deregulation and privatization is slowly pushing towards

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[208] ICAO, Working Paper, ATConf/5-WP/7 *supra* note 48 at para. 3.1.
[209] Haanappel, Peter P.C., "Airline Challenges: Mergers, Take-Overs, Alliances and Franchises" (1995) 20:1 A.A.S.L. 179.
[210] As has been seen under Chapter 1.2.3, there are only some exceptions to the rule, as e.g. SAS, Gulf Air, Air Afrique.
[211] *Airline Deregulation Act*, Pub.L. No 95-504, 92 Stat. 1705 (1978) (codified as amended at 49 U.S.C. app. §§ 1301-1542 (1988 & Supp. III 1991)); for an overview over deregulation of the US airline industry, see Edwards, *supra* note 36 at 605; Stockfish, *supra* note 13 at 413-427.
[212] See Scott M. Gawlicki, "Virtual Mergers: With traditional mergers difficult to pull off, airlines are finding creative ways to consolidate" *Investment Dealers Digest* (31 January 2000).

globalization of the aviation industry."[213] The traditional requirement that an airline must be substantially owned and effectively controlled by national interests, however, hinders the trend towards further globalization. As will be demonstrated, these rules exclude airlines from full access to foreign capital markets and from merging with, acquiring, or being acquired by, foreign airlines. As a result, "the aviation industry lags in adapting to globalization even as it drives other sectors to globalize".[214]

2.1.1 Ownership and Control Requirements Deny Airlines full Access to Capital Markets - Yet most airlines are grossly undercapitalised

"Aviation is not immune to the world economic downturn, but is particularly susceptible to it."[215] Indeed, since the end of 1999, a drop in passenger traffic caused by the weak economy has hit airlines on all continents hard.[216] The terrorist attack on 11 September 2001 has triggered another sharp drop in passenger numbers, highlighting the existing structural flaws in the aviation industry.[217] The fear of new terrorism related to the Iraq war as well as the Severe Acute Respiratory Syndrome (SARS) outbreak has kept demand for travel near record lows, and has thereby further intensified air carrier's difficulties in 2003. Moreover, major carriers have also found it difficult to raise prices because of competition from low-fare carriers on many of their routes.[218]

The past three years have been characterized as the worst crises in the history of aviation.[219] The results posted by the world's major flag carriers are disastrous. According to IATA, the accumulated net loss of IATA members on international scheduled routes

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[213] Chris Thornton, "Who's Afraid of Mergers?: Foreign Ownership Rules have long Dogged the Airline Industry. There is now a Chance for Change" *Airline Bus.* (1 September 1999) 9.
[214] The Brattle Group Report, *supra* note 4 at I-1.
[215] UK, H.L., Select Committee on the European Union, *"Open Skies" or Open Markets? The Effect of the European Court of Justice (ECJ) Judgments on Aviation Relations Between the European Union (EU) and the United States of America (USA)* Session 3 (2002), 17th Report at 14 (8 April 2003) [UK, H.L.].
[216] For an overview of the financial performance of the airline industry especially in Asia, Europe and North America before the events of 11 September 2001, see Rigas Doganis, *The Airline Business in the Twenty-first Century*, (New York: Routledge, 2001) at c. 1.2. [Doganis, *The Airline Business*].
[217] UK, H.L., *supra* note 215 at 14.
[218] Doganis, *The Airline Business, supra* note 216 at c. 1.2.
[219] Caroline Daniel, Kevin Done and Rahul Jacob, "The 1991 Gulf war led to the collapse of three big carriers. This war could be even worse" *Financial Times* (26 March 2003); see also Bisignani, *supra* note 6 at 1.

stands at US$14.1 billion.[220] Overall, the airline industry has lost US$31 billion over the last two years.[221] Two major US carriers, US Airways[222] and United Airlines[223], filed for Chapter 11 bankruptcy protection; American Airlines has been able to avert bankruptcy only after labour unions made major concessions;[224] and many US airlines only operate profitably through direct State aids and government loan guarantees.[225] Air Canada is under bankruptcy protection.[226] In Europe, where the flag carriers of Belgium and Switzerland have failed, the situation is not much better.[227] Even some Asian airlines, although back on course at the beginning of 2003,[228] have seen major losses due to the SARS outbreak in spring 2003.[229]

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[220] IATA, *World Air Transport Statistics* (2003), online: IATA, http://www.iata.org/air/productsandservices/wats.htm (date accessed: 16 July 2003).

[221] Bisignani, *supra* note 6 at 1; Lord Marshall of Knightsbridge, "Air Transport in the 21rst Century: the Reinvention of an Industry", (33rst ISC Symposium, St. Gallen, 23 May 2003) online; ISC, http://www.isc-symposium.org/ISC/abstract_Marshall.pdf (date accessed: 18 July 2003). At the time of writing, the Airline has already emerged from bankruptcy.

[222] US Airways, the 6th biggest Airline in the US, has filed for bankruptcy on 11 August 2003, see "AU Airways files for bankruptcy" *BBC News* (22 August 2002), online: BBC, http://news.bbc.co.uk/2/hi/business/2187519.stm (date accessed: 10 July 2003); "US Airways Reorganization", online: USAirways, http://www.usairways.com/reorganization/ (date accessed: 16 July 2003). In the meantime, the Airline has emerged from reorganization.

[223] United Airlines, the world's second largest carrier, filed for Chapter 11 bankruptcy protection on 9 December 2002, becoming the largest airline and the 6th largest US corporation to seek bankruptcy protection, see "United Airlines files for Bankruptcy" *BBC News* (9 December 2002), online: BBC http://news.bbc.co.uk/2/hi/business/2556225.stm (date accessed: 16 July 2003).

[224] Angela Brown, "American Airlines Averts Bankruptcy", *The Globe and Mail* (17 April 2003).

[225] Delta Air Lines Inc., Northwest Airlines Corp. and Continental Airlines Inc. were able to returned to profit after two years of losses only by means of government security aid, see "Security aid lifts airlines" *The Globe and Mail* (18 July 2003); see also Edward H. Phillips, "Continental Back in the Black" *Aviation Wk & Space Tech.* (21 July 2003) 34.

[226] Air Canada filed for bankruptcy protection under CCAA on 1 April 2003.

[227] The Association of European Airlines (AEA) reports that overall traffic for its members was down by 4.6% on 2001, and still some 6.7% lower than in 2000. However, capacity fell by a sharper 8.8% last year, which helped load factors to climb to 73.7% for the year. Of the major carriers, only Air France appears to have added substantial capacity in 2002 and this was a modest 1.7%. Alitalia was down nearly 18% and British Airways also slashed 8.8% off its seats as traffic fell away. Swiss also shows up as a heavy loser compared with its *predecessor* Swissair, which had gone bust by the end of November 2001; see "The Struggle to Recover" *Airline Bus.* (1 March 2003), 75.

[228] "The Struggle to Recover", *ibid.*

[229] Singapore Airlines, consistently one of the most profitable airlines in the world, has been losing between $3 million and $4 million a week because of SARS travel bans and now has to face major cutbacks and layoffs, see "Singapore Airlines to Lay Off 1,000", *Pacific Business News* (23 June 2003) online: PacificBusinessNews, http://pacific.bizjournals.com/pacific/stories/2003/06/23/daily9.html (date accessed: 16 July 2003).

This demonstrates that more than ever before, the world's undercapitalized and indebted air carriers are in need of capital. The traditional ownership and control requirement, however, limits the extent to which airlines can seek capital from the international markets. This did not pose a major problem at the time when most airlines of the world were still government owned or at least funded.[230] Yet, after many years of providing funding to their inefficient airlines, more and more governments do not have sufficient resources to step in again, often because other priorities such as education, health care and other infrastructural needs take precedence. Additionally, national laws frequently impose restrictions on State aid in favour of certain national industry. Airlines thus have to turn towards the private sector for financing. The existing regulatory framework then puts these airlines into a predicament. Few individual investors might have sufficient capital to invest and there will be few industrial companies with spare funds to invest in a somewhat risky enterprise, such as an airline.[231] Carriers may, therefore, find it difficult to get financing from domestic investors. The only candidate for saving the airline may be a foreigner, eventually a foreign airline. Yet the foreign investor's willingness to invest in the ailing airline will often be thwarted by the uncertainties that stem from the requirement that stipulates that an airline must be substantially owned and effectively controlled by nationals. The major economic value of an international airline consists in its rights to operate to international destinations. It is therefore in the interest of the investor to ensure compliance of the carrier with nationality clauses included in ASAs. In order to guarantee that bilateral partners do not make use of their option to challenge the nationality of the carrier and to withdraw the traffic rights, the foreign investor will have to abstain from taking a majority stake in the airline. Additionally, he will not be able to take decisions affecting the future of the airline or exercise managerial control. Under such conditions, the foreign investor might simply decide to withdraw from the deal.[232] Foreign investors' interest in providing major funding for the ailing airline is further frustrated by the high degree of uncertainty that

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[230] As an interesting exception, US air carriers have always been owned by private entities.
[231] Chang, Williams, "Changing the Rules", *supra* note 34 at 209.
[232] See also Paul V. Mifsud, "Airline Concentration and Cross-Border Arrangements" (1992) in Henri A. Wassenbergh ed., *External Aviation Relations of the European Community,* (Deventer: 1992) 11 at 14.

stems from the bilateral clause. Governments interpret the terms of "substantial ownership" and "effective control" in different and unpredictable ways;[233] and the bilateral clause allows a third country the options simply "not to be convinced" that the carrier is substantially owned and effectively controlled by nationals.[234] As a consequence, most foreign investments in the airline industry have been made only in a limited scale, instead of taking a majority stake in the airline.[235]

The scenario described above shows that ownership and control rules restrict the "cash-strapped airlines"[236] in their access to the world capital markets. Unlike other industries, a free flow of capital remains largely unknown to the airline industry.[237] There is a need to liberalize the "substantial ownership and effective control" requirement. Certainly, access to foreign capital on its own will not return airlines to profitability. Nonetheless, it will be one measure to facilitate the reorganization of the airline industry.

2.1.2 Ownership and Control Requirements Limit Cross-border Mergers and Acquisitions

Besides reorganization through capital investment, restructuring via mergers, acquisitions and takeovers is one of the key drivers of change in most industries.[238] It is also the

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[233] See, *e.g.*, US law and policy on foreign ownership and control, *supra* Chapter 1.2.2.1.
[234] IATA Think Tank, *supra* note 52 at 14.
[235] Ruwantissa Abeyratne, "Legislative Responses Aimed at Managing Economic Crises in Aviation – The Liberalization Approach", (Aviation Management Education and Research conference, Montreal 21 July 2003), 2003 Conference Proceedings at 9 [Abeyratne, "The Liberalization Approach"]; Equity investments between foreign airlines have remained within the respective thresholds of mostly 25% or 49% of permitted foreign ownership; for an overview of major equity investments between foreign airlines see P. Stephen Dempsey, "Carving the World into Fiefdoms: The Anticompetitive Future of International Aviation" (2002) at 28 [forthcoming in Vol. XXVII A.A.S.L. (2002)].
[236] Expression used by Cheong Choong Kong, Former Deputy Chairman and CEO, Singapore Airlines in "Managing a Global Airline in Singapore" (Speech to Singapore Institute of International Affairs, 15 July 2003, Singapore), online: SIIA, http://www.siiaonline.org/article/Managing%20Global%20Airline.pdf (date accessed 20 September 2003).
[237] Joan M. Feldman, *supra* note 160 at 42.
[238] The Brattle Group Report, *supra* note 4 at I-10. Wilhelm Pompl, *Luftverkehr: Eine ökonomische und politische Einführung*, (Berlin: Springer, 3rd ed. 1998) at 115; Pompl distinguishes between three types of concentration: two or more air carriers give up their independence and create a new company (merger); integration of one air carrier in a holding company, whereby the integrated carrier disappears from the market (takeover); one carrier acquires a majority stake in another air carrier, while both companies continue to exist (acquisition).

natural economic evolution in the airline industry.[239] Indeed, following US deregulation, the privatization trend and finally the deregulation of the EU aviation market, the airline industry "appears poised to begin an ongoing, long-term move toward consolidation",[240] concentration and the creation of a few global mega-carriers.[241] The mid-1980s were the peak years for mergers, acquisitions and alliances within the US domestic airline industry.[242] In the EU, air carriers began to implement a growth strategy a decade later. [243] It can be presumed that more and more air carriers will try to enlarge their scope and networks through mergers, takeovers, strategic alliances as well as airline franchises.[244]

Both, airline mergers and alliances give airlines the chance to lower costs and enhance demand by rationalizing the combined networks and expanding the scope of seamless services. Mergers and acquisitions, or operational integration under a single holding company, allow airlines to pursue "growth strategies designed to hold and expand the existing market shares, gain access to new markets, achieve unit cost reduction, shield themselves against fierce competition and increase the scale of operations in order to attain a critical market position."[245] Airline alliances, on the other hand, permit airlines to expand their global reach and attain many of the cost-saving synergies of a merger, without actually bringing two or more airlines together.[246] Airlines continue to provide point-to-point service by integrating different global networks, while keeping their

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[239] Gawlicki, *supra* note 212.
[240] *Ibid.*
[241] Doganis, "Relaxing Airline Ownership and Investment Rules", *supra* note 59 at 267.
[242] See Doganis, *The Airline Business*, *supra* note 216 at c.. 4.1; in 1984, 15 US air carriers accounted for 90% of the domestic market. In 1989, however, the same share was held by only eight US airlines. Some carriers disappeared or were taken over after filing for bankruptcy (e.g. Braniff, Pacific Express and Northeastern). Other carriers vanished due to outright mergers (e.g. Delta took over Western, TWA acquired Ozark, and Continental, Texas and Eastern merged into one company). On the domestic European markets, a similar trend can be observed.
[243] The delay is due to the fact that liberalization of the European airline industry only commenced in the mid 1980s; see Colin Baker, "Joining: Consolidation in the European travel sector" *Airline Bus.* (1 September 2000) 107.
[244] Haanappel, "Mergers, Take-overs, Alliances and Franchises", *supra* note 138 at 180.
[245] Abeyratne, "The Liberalization Approach", *supra* note 235 at 8; see also Paul Stephen Dempsey, "Airlines in Turbulence: Strategies for Survival" (1995) 23:15 Transp. L. J. 15 at 59; and Doganis, *The Airline Business*, *supra* note 216 at c. 4.4., who identifies four different beneficial impacts on costs: Higher traffic volumes due to increased market power; emergence of cost economies between the alliance partners; the major partner airline can benefit from the smaller partner's lower operating costs; and scope for cost reduction through joint purchasing.
[246] Gawlicki, *supra* note 212.

separate identities intact.[247] Since the "whole purpose of a merger is to take the rationalization process further, closing down less efficient facilities, and reorganizing the product lines in a consistent way",[248] a merger or fully-fledged acquisition gives airlines the opportunity to reach economies of scale to a greater extent than does an alliance.

While the net of alliances between airlines of different nationality becomes increasingly dense, the world's international aviation industry has, until now, failed to consolidate through mergers and acquisition. As any transnational merger, acquisition and takeover leads to the loss of nationality of one of the carriers concerned, the consolidated entity faces a possible challenge to its nationality by bilateral partners.[249] Certainly, nationality clauses have simply permissive character, and the bilateral partner is by no means obliged to challenge the carrier's nationality. As demonstrates, *e.g.*, the case of Aerolineas Argentinas, waivers to the nationality restrictions have been granted in the past.[250] However, "*ad hoc* escapes from the ownership and control restrictions" are not likely to create the regulatory certainty and predictability needed for airlines to assume that they can engage in cross-border deals without concern about losing traffic rights.[251] Traditional ownership and control rules thus practically preclude the creation of multinational airlines through mergers and acquisitions.[252]

Faced with this hurdle, airlines of different nationalities are practically forced to enter into strategic alliances rather than to merge.[253] Despite the benefits that airline

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[247] *Ibid.*

[248] Chang, Yu-Chun, *The Influence of Airline Ownership Rules on Aviation Policies and Carrier Strategies, The Air Transport Relations between the European Union and the US,* (PhD Thesis, Cranfield University, Air Transport Group, College of Aeronautics 2002) at 242 [unpublished] [Chang, *Influence of Airline Ownership Rules*].

[249] See Klaus Keller, *Regulatory Aspects of Airline Alliances – A Case Study of Star Alliance,* (LL.M Thesis, McGill University, Institute of Air and Space Law 2000) [unpublished] at 21.

[250] See *e.g.* Aerolineas Argentinas, *supra* Chapter 1.2.3.

[251] Havel, *supra* note 124 at 13.

[252] As Haanappel, "Mergers, Take-overs, Alliances and Franchises, *supra* note 138, points out that the nationality clause is only one of three regulatory hurdles. Other hurdles are the following: the rule in national legislation, in bilateral agreements and in Article 7 of the Chicago Convention, which forbids of puts restrictions on the exercise of cabotage rights; and the related rule in the legislation of many states to the effect that the right of establishment is limited to national air carriers.

[253] See Paul Stephen Dempsey, "Intercarrier Agreements and Alliances – The Competitive Challenge" (2003) *Business Briefing, Aviation Strategies: Challenges & Opportunities of Liberalization* (World

alliances provide,[254] the use of these arrangements has only created temporary breathing space for some airlines.[255] In fact, alliances are often considered as "the second best solution", a poor surrogate to permanent restructuring.[256] This is mainly due to the instability inherent in the global alliance group.[257] An "airline alliance is in essence a cooperative arrangement between independent airlines, joining forces where they can without taking irrevocable steps or otherwise sacrificing their chances of survival or substantially reducing their options in case they become alliance-free again".[258] Many airlines may prefer the loose alliance model to the complete integration of two airlines by a merger. Conversely, other airlines may consider that the creation of alliances falls short of providing real solutions to their problems. Alliance partners constantly have to reach agreement with one another on issues such as the methods to increase revenue, reduce cost, provide "seamless connections" and raise quality. While being part of the alliance team, each airline has to function as an independent company. This is a "commercially anomalous existence that leads to frequent withdrawals or even dissolution."[259] Since the link between the partners is relatively weak, it is difficult for carriers to plan their strategies, take far-reaching restructuring measures or control the performance of other

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Markets Research Centre Ltd, March 2003) 54.; according to Dempsey, four factors appear to be motivating the creation of airline alliances: 1. the desire to achieve greater economies of scale, scope and density; 2. the desire to reduce costs by consolidating redundant operations; 3. the need to reduce the level of competition wherever possible as markets are liberalized; and 4. the desire to avoid the nationality rules that prohibit multinational ownership and cabotage.

[254] See *Ibid.* at 56-57; Dempsey enumerates the benefits of airline alliances. These benefits are, *inter alia*: an ability to provide more capacity and enter new markets without having to make large capital expenditures; an ability to generate thousands of new 'online' city pair combinations; the ability to extend the reach and scope of their frequent-flier programmes; the ability to capture market share from non-aligned competitors; the ablilty to fix prices with competitors in dominant markets; the ability to reduce competitive capacity in key markets to improve yields; a reduction in the costs of equipment and services; a reduction in airport handling and operations, selling and ticket costs as a result of economies of scale; an ability to pool costs and revenue to share risks and rewards.

[255] van Fenema, "National Ownership and Control Provisions Remain Major Obstacles to Airline Mergers", *supra* note 70 at 8.

[256] See Keller, *supra* note 249 at 100.

[257] Haanappel, "Airline Ownership and Control", *supra* note 9 at 97

[258] IATA Think Tank, *supra* note 52 at 31.

[259] Havel, *supra* note 193 at 17.

airlines. In this way, air carriers are prevented from achieving the integration benefits that would flow from the full integration through mergers.[260]

The instability of airline alliances also stems from the fact that States have, in the past, pursued an *ad hoc* approach to the regulatory treatment of airline alliances based on aeropolitical considerations rather than a systematic regulation.[261] For instance, when BA and American Airlines (AA), the two core "oneworld" members, filed for anti-trust immunity, the US and the UK governments denied the necessary regulatory clearances on aeropolitical grounds.[262]

For those reasons many airlines are dissatisfied with the alliance solution.[263] They consider that alliances "are not an instrument of choice but a 'poor man's merger',[264] brought about by an aviation-unique regulatory concept, *i.e.* the 'substantial ownership and effective control' requirement".[265]

It is outside the scope of this thesis to analyze whether consolidation of the airline industry through cross-border mergers, acquisitions and take-overs will really happen once ownership and control rules are liberalized. Airlines of different nationality may, at the end of the day, prefer the loose relationship of an airline alliance to a complete and practically irreversible merger. Cultural discrepancies, differences in training of staff as well as technical diversities, such as the use of different types of aircraft and diverse supplies might make a true cross-border merger extremely costly.[266] Likewise, competition authorities might prevent airlines from merging to multinational mega-

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[260] Michael Whitaker, "Liberalizing U.S. Foreign Ownership Restrictions: Good for Consumers, Airlines and the United States" (Paper presented to the Seminar prior to the 5th ICAO Worldwide Air Transport Conference, "Aviation in Transition: Challenges & Opportunities of Liberalization", ICAO, Montreal, 22-23 March 2003) at 2 [unpublished].
[261] Abeyratne, "The Liberalization Approach", *supra* note 235 at 8.
[262] Haanappel, "Airline Ownership and Control", *supra* note 9 at 97.
[263] Joan M. Feldman, "Holes in the Dike" *Air Transport World* (1 August 2000) 42.
[264] Keller, *supra* note 249 at 100.
[265] IATA Think Tank, *supra* note 52 at 31.
[266] Chang, *The Influence of Airline Ownership Rules on Aviation Policies, supra* note 248 at 180-181; Chang identifies the disadvantages of mergers: Difficulties in post-merger integration; antitrust restrictions; need for capital. Disadvantages of alliances are: Consensual decision-making process takes longer; alliance must remain reversible; partners' goals may be different; alliance cannot force partners to accept any particular solution; partners might be purchased by a rival.

carriers. It is therefore true that airlines would probably enter alliances even if the foreign ownership restrictions were relaxed or removed. This should, however, be no reason for governments to simply ban the opportunity of airlines to choose from a wide array of commercial alternatives. As in any other industry, merging with, acquiring, or being acquired by, foreign airlines may be possible remedies for rationalization and thereby help airlines to return to profitability. All these options should be available to airlines.

2.1.3 Ownership and Control Requirements Distort Airline Markets

Finally, bilateral ownership and control rules have an adverse effect on the airline industry, since they cause distortion of airline markets.

As noted above, market access to foreign countries is granted to airlines by means of ASAs negotiated between governments. Nationality clauses in those ASAs ensure that only airlines nationally owned and controlled by the bilateral partner gain market access. In order to preserve their market access to a certain country, airlines are restricted to strategic deals within their country. They have to seek funding from national investors and can only merge with or acquire other domestic airlines. Now, market distortion results from the significant differences in the size that exist between different domestic markets and the consequently important discrepancies in the scope of action open to airlines in their respective marketplace. For instance, the US is the world's largest air transport market.[267] US airlines, through mergers and acquisitions, have become very large and gained very substantial benefits of scale.[268] With their huge domestic network as a base, they have become very powerful in many international markets, often reinforcing their market power through commercial alliances aimed at building global networks.[269] Conversely, EU, Asian or Latin American airlines, through ownership rules,

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[267] According to the *ICAO Annual Report of the Council 2001*, ICAO Doc 9786, Chapter I, . on a regional basis, some 35% of the total traffic volume (passengers/freight/mail) was carried by North American airlines.

[268] The world's six largest airlines measured with respect to passengers per kilometre American Airlines (75,524,448), United (64,430,461), Delta (61,382,775), Northwest (43,349,848) and Continental (36,305,997); see "Trends – Top 20 Airlines" *Air Transport World* (1 July 2003) 1.

[269] Doganis, *The Airline Business*, *supra* note 216 at 51.

are prevented from building the large "home" base they need to ensure the same benefits as US carriers and so be able to compete with them.

In addition, the traditional ownership and control requirement promotes the creation and maintenance of unprofitable carriers. Since under the bilateral system, States may only designate a nationally owned airline, small States with little traffic potential are discouraged from designating foreign airlines to exploit their traffic rights with third countries.[270] They are left with only two choices: either to set up their own airline, irrespective of the traffic demand; or let the bilateral partner's airline provide the service. Out of fear of dependence on the bilateral partner, as well as out of prestige, States often chose the first option and set up their own national carrier. These carriers, usually government-owned, are in many cases unprofitable for long periods, becoming serious drain on the economy.[271]

Finally, since ownership and control rules deny airlines full access to the world capital markets, airlines have to seek funding from domestic investors[272] who may, however, not easily be found. Airlines are therefore often subsidized with governments encouraged to bail out their national airline.[273] Since different States do not pursue the same policy on government intervention, airlines that do not receive subsidies might be at disadvantage. For instance, while the US Government implemented an important rescue package to ensure the sustainability of US airlines after the events of September 11, 2001, the EU decided to keep the existing legislations and policies regarding state aid, allowing limited support from the Member States to their national air carriers. It is evident that situations like this create market distortions.

There is thus increasing need to liberalize the requirement of "substantial ownership and control" as a criteria for air carrier designation and authorization. This is one of the necessary steps towards a global market place, in which international air

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[270] Doganis, "Relaxing Airline Ownership Rules", *supra* note 144 at 269.
[271] *Ibid.*
[272] See in the case of Air Canada e.g. Virginia Galt, "Air Canada Casts Net for New Investors" *The Globe and Mail* (17 July 2003).
[273] See Doganis, *supra* note 144 at 269; "Security aid lifts airlines" *The Globe and Mail* (18 July 2003).

carriers will have equal opportunities to grow and operate profitably.[274] As will be demonstrated now, the pressure to liberalize those standard provisions weighs particularly heavily on the EU.

2.2 The Specific Need for the EU to Find a Substitute

For the EU, the need to liberalize the standard criterion of "substantial ownership and effective control" in international air transport relations is two-fold. Not only is there an urgent economic necessity to liberalize those rules, but also is there a legal obligation to bring about change. This legal need follows from the recent ruling of the ECJ in the "Open Skies" cases of 5 November 2002. Both needs have their root in the antagonism that exists between internal EU liberalization and restrictive air transport relations with third States.

2.2.1 The Two-Fold Situation: Liberalization versus Protectionism

As was described earlier, the EU air traffic market has been completely liberalized by means of the "Three Packages". Regulation 2407/92 has significantly relaxed the ownership requirements through the creation of the concept of "Community Carrier". *Internally*, *i.e.*, between the Parties to the liberalized EU air traffic market, "the traditional substantial ownership and effective control clause has become inoperative, and any challenges to an airline's traffic rights within the 'internal aviation market' would have to be based on evidence that the airline concerned does not qualify as a Community air carrier."[275] As in one big domestic market, EU air carriers may now be owned and controlled by any Community citizen.

While the *internal* EU market has been liberalized, relationships between individual Member States and third States, *i.e., external* relations, remain governed by a net of bilateral agreements including conventional ownership and control rules. The intra-EU legislation on licensing of air carriers has not and could not amend the bilateral

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[274] Wassenbergh, "Putting an End to Air Carrier Nationalism", *supra* note 57 at 166.
[275] IATA Think Tank, *supra* note 52 at 19.

agreements between EU Member States and third States.[276] In relation to those States, the nationality of the individual designating Member State thus remains the decisive criterion for the designation and authorization of air carriers.

Only exceptionally have some Member States entered into ASAs that take into account the Community ownership. For instance, the provision on designation and authorization in the bilateral agreement between Germany and Brunei grants Brunei the right to challenge a carrier designated by Germany, if the carrier is not able to demonstrate that it is substantially owned and effectively controlled by *EU nationals.*[277] Generally, however, Member States have been reluctant to push third States to accept the concept of "Community Carrier" in their respective ASAs.

As a result, EU air carriers have to comply with two different sets of criteria. In order to be granted an operating license from the national licensing authority, it suffices that the carrier is substantially owned and effectively controlled by EU-nationals. Member States are not allowed to discriminate to the advantage of their "own" national airlines.[278] Second, in order to be effectively designated to operate "internationally", *i.e.*, to a destination outside the EU, proof of being in European hands will not satisfy a third country who continues to have the right to insist that the airline is substantially owned and effectively controlled by the designating Member State or its nationals. In case of non-compliance with the traditional nationality clause, the non-EU State is entitled to withhold or revoke an operating permit. [279]

This two-fold situation significantly reduces the benefits associated with the liberalization of the internal EU air transport market. This situation also led the

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[276] *Ibid.*

[277] See the *Air Transport Agreement between the Federal Republic of Germany and Brunei Darussalam,* German Federal Gazette (BGBl.) 1994, II-3670, Art. 3 (4); the last provision refers to Council Regulation 2407/92, art. 4 (5), supra note 94, which requires a carrier holding a Community air carrier license to be at all times able to demonstrate to the Member State responsible for the operating license that it meets the requirements of Art.4 (2).

[278] *Ibid.*

[279] See generally for the problem of disparity between internal and external relations EC, Commission, *The European Airline Industry: From Single Market to World-Wide Challenges,* online: European Union http://europa.eu.int/comm/transport/air/rules/doc/com_1999_182en.pdf (date accessed: 16 July 2003).

Commission to take legal action against EU Member States that continuously entered into conventional ASAs with third States.

2.2.2 *The Economic Need: Nationality Clauses are a Barrier to the Badly Needed Restructuring of the EU Airline Industry*

The antagonism between restrictive external air transport relations of Member States and complete internal EU liberalization causes a peculiar situation. Where the free flow of cross-border economic action is specifically encouraged, the "air transport industry suffers from chronic under-capitalization and excessive fragmentation, it is heavily in debt and has permanent cash-flow problems."[280]

2.2.2.1 *The State of the EU Airline Industry Demonstrates its Urgent Need for Restructuring*

The EU airline industry has been hit hard for the last three years. Indeed, it seems that due to the peculiarity of the EU aviation market, its air carriers have been especially vulnerable to crisis. According to the Association of European Airlines (AEA), European scheduled airlines had four consecutive years of losses and another year of losses is expected for 2003.[281] In 2001, AEA member airlines experienced the highest loss ever in their history, with a total financial loss of US$3.02 billion and an overall traffic loss of 5.4%.[282] In 2002, the total financial loss of European scheduled airlines was still at US$0.89 billion with a passenger traffic loss of US$ 4.8 billion.[283]

This disastrous financial situation is aggravated by a disproportionate fragmentation of the market. In contrast to US airlines, which have been able to

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[280] EC, Commission, *Communication from the Commission to the European Parliament and the Council on the Repercussions of the Terrorist Attacks in the United States on the Air Transport Industry*, COM(2001) 574 final, (10 October 2001), at paras. 5 and 7.

[281] Schulte-Strathaus, "State of the European Airline Industry", (ECAC Trennial Session, Strasbourg, 8 July 2003) online: AEA, http://www.aea.be/sms/datafiles/ecac_soi.ppt (date accessed: 4 July 2003)

[282] AEA, *Yearbook 2002*, I-5, online: http://www.aea.be/sms/datafiles/yearbook02.pdf (date accessed 21 July 2003).

[283] AEA, *Yearbook 2003*, I-3, online: http://www.aea.be/sms/datafiles/yearbook03.pdf (date accessed: 22 July 2003).

consolidate and thereby become very powerful in international markets, no European international airline has merged since 1993.[284] As a consequence, in a market that comprises 15 Member States, a total of 125 airlines operating passenger services on their own account are fighting for a share of the pie.[285]

The devastating economic performance of EU airlines demonstrates that restructuring of the EU airline industry is badly needed. As will be shown in the following, the current regulatory framework considerably limits the industries' opportunities for restructuring and to return to profitability.

2.2.2.2 The Two-Fold Situation Impedes the Restructuring of the EU Airline Industry

In a market that has been completely liberalized, the airline industry should have many options for restructuring. "Community Carriers" should have free access to the EU capital markets, should be free to merge with, acquire, and be acquired by, other Community carriers. Yet, this is not the case. Nationality clauses in ASAs with third States outside the EU "still haunts the EU liberalization plan."[286]

2.2.2.2.1 EU Airlines have Limited Options to Seek Funding within the EU

The need of EU international carriers to comply with two different sets of criteria considerably limits the freedom of EU airlines to seek capital investment within the EU. This limiting effect can best be understood by taking a close look at the earlier mentioned German legislation regulating the traceability of shareholder nationality, the ACDA.[287]

The ACDA was enacted for two reasons. Besides the intention to ensure compliance of air carriers with the EU Regulation, the ACDA was also motivated by the need for EU air carriers to conform to the requirements imposed by ASAs.[288] The Act provides the air carrier with graded rights that allow him to enforce compliance with both

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[284] Lelieur, *supra* note 11 at 19.
[285] AEA, Yearbook 2002, *supra* note282.
[286] Havel, *supra* note 193 at 20.
[287] See *supra* Chapter 1.2.2.2.
[288] *Luftverkehrsnachweissicherungsgesetz, supra* note 149 at Article 1.

criteria. Those rights are applicable as soon as 40% of the issued shares are the hands of such shareholders whose ownership might conflict with either of the two criteria.[289] Let us imagine that LH is in need of capital. No German investor has sufficient funds to make a major investment in the airline. Now, a British national is willing to save the airline and takes an equity stake of 53% in LH. Under the EU Regulation, the British national is permitted to engage in such a majority investment in the EU carrier, LH. However, the ASAs between Germany and third States, such as the US, still require LH to be owned and controlled by *German* nationals. Compliance of LH with the nationality clauses is thus endangered. In order to maintain LH's traffic rights to the US, LH would have to enforce the restoration of the German nationality of LH by requiring the British investor to dispose of a significant part of its shares.[290] LH would then be restricted to seek capital mainly in Germany.

This example demonstrates that, even though the EU air transport market has been liberalized and legislative barriers to cross-border investments have been removed, ailing EU airlines still have very few options for fresh capitalization.[291]

2.2.2.2.2 EU Airlines are not free to Engage in Pan-EU Mergers and Acquisitions

Similarly, the maintenance of the traditional nationality clauses in bilateral air transport relations between Member States and third States prevent the EU airline industry from restructuring through consolidation. While the liberalization of the EU market enables airlines mainly operating within the internal market to consolidate, EU international

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[289] *Ibid.* at Article 4.
[290] *Ibid.* at Article 5.
[291] It should be added that the German-US Agreement contains a provision on German or US ownership interest in *carriers of third countries*: by virtue of Article 3 (3) each party waives the right to challenge the nationality of the carrier of the third country as long as the German or US ownership interest in that third country carrier is less than 50%, and provided the third country has an Open Skies agreement with the US and with Germany and permits such investment. Thus, if a German investor were to acquire a 49% stake in KLM, the US would have no right to challenge the nationality of KLM under the US-Netherlands agreement. The benefit of this clause, however, remains limited for two reasons. First, the clause still limits the investment in KLM to 50%. A majority investment in the carrier by the German investor thus remains excluded. Second, the traditional nationality clause is still part of the German-US agreement. Hence, in the example given above, LH is still not permitted to seek major funding from the British investor without endangering its traffic rights to operate to the US. For details see Böhmann, *supra* note 79 at 710.

airlines are still prevented from merging with, acquiring, and being acquired by, other EU airlines. While EU airlines would not lose their status as "Community Carrier" by merging with one another, they would, however, lose their single-State nationality. This fact endangers the maintenance of traffic rights previously granted by third countries.

This was the main reason for the failure of several merger negotiations between KLM and BA in the past.[292] It was envisioned that BA would acquire 51% of KLM, thereby gaining control over the Dutch carrier. Thus, the merged carrier would not have been a nationally controlled Dutch airline. As a consequence, third States may have challenged the nationality of the merged carrier under their respective ASAs with the Netherlands. The carrier would certainly not have been permitted to operate international air services from and to Amsterdam under the ASAs between the UK and non-EU States. International air services under traditional ASAs all have to start and terminate in the country designation.[293] As only the UK could designate the UK-controlled carrier, all international traffic would therefore have to be directed through the UK. KLM would be reduced to a regional hub air carrier for short-haul services. Services at the already congested Heathrow airport would be considerably increased;[294] a result that would certainly not satisfy the needs of either carrier.

The concerns might not have been so great with regard to those bilateral partners of the UK and the Netherlands that are in a weaker negotiating position. Some small States, with relatively unattractive markets, would most probably have accepted the

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[292] BA and KLM already envisioned a merger as soon as at the beginning of the 1990s. Thereinafter, it has been repeatedly reported that the question of a merger between those two European carriers is back on the table; see e.g. Feldman, *supra* note 263.

[293] Wassenbergh, Henri A., "Policy Statements on International Air Transport" (2000) 25:6 Air & Space L. 291 at 295; Wassenbergh also points out that "in more recent bilateral air agreements the agreed services on the specified routes may be operated if they at least include a stop in the home country of the designated air carriers". This, however, would only change the situation in so far, as the merged carrier would have to fly

[294] See for a detailed description of all possible consequences of a BA/KLM merger Wassenbergh, *ibid.* at 296.

designation of the merged carrier, fearing that otherwise they might lose access to the very attractive UK market as an aeropolitical counter-reaction.[295]

There is no doubt that the US, however, in line with its consistent air policy, would only accept direct Amsterdam-US air services by the merged air carrier under the Netherlands-US agreement, if the UK also concluded a liberal ASA with the US. Conversely, if both parties to the merger involve nations that have open skies agreements with the US, it is likely that the US would accept the designation of the merged entity. Both parties to the merger having been granted very liberal access rights to the US, the balance of benefits does not risk being distorted.

These examples demonstrate that, while nationality clauses in ASAs concluded between Member States and third States are only permissive, it very much depends on the quality of the bilateral relationship between the bilateral partners whether traffic rights will be withdrawn.[296] "That prospect of possible challenges and possible negotiations creates uncertainties which is something merger-planning airlines try to avoid."[297] EU carriers are thus impeded from taking advantage of the opportunities offered by the liberalization of the internal EU market.

Some authors argue that consolidation will not give the EU airline industry any relief.[298] It is pointed out that "the large North American airlines in the worst financial shape are the ones that recently merged or the ones that spent years attempting to and no sensible observers have seen mergers as a solution to the current US industry crises."[299] Moreover, as in any other industry, the consolidation of carriers will induce increased scrutiny by competition authorities that might prevent consolidation. Others, conversely,

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[295] van Fenema stresses the fact that bilateral air transport relations, in practice, are very much a function of negotiating position and power, IATA Think Tank, *supra* note 52 at 14.
[296] IATA Think Tank, *ibid.* at 17.
[297] H. Peter van Fenema, "Airline ownership and control: long and short term approaches to a trade barrier" (Annual Conference of the European Air Law Association, Zurich, 9 November 2001) [unpublished].
[298] See, *e.g.*, Hubert Horan, "The EU-US Open Access Area: How to realize the radical vision" *Aviation Strategy* (1 July 2003) 2 at 9.
[299] *Ibid.*

predict a major overhaul and restructuring of the industry.[300] "The result will be fewer, but more efficient airlines; and, particularly in Europe, the disappearance of several national carriers."[301] In fact, it can be argued that EU airlines might have learnt about the techniques of merging from the US experience from the mistakes made by US carriers.[302] They might have understood that air carriers will not be able to return to profitability simply by joining forces and by consolidating. A merger between airlines will only produce industry restructuring benefits, if other difficulties inherent to the airline industry, such as overcapacity, are combated at the same time. In order for the EU airline industry to return to profitability, it is, however, essential that airlines be given *all* the strategic opportunities other industries are provided with. That includes the possibility to restructure through mergers, acquisitions and takeovers. Whether such a restructuring will indeed take place, once regulatory barriers are removed, and whether it will bring the desired relief, cannot be predicted with certainty.[303]

2.2.2.2.3 Market Distortion is Perpetuated

Finally, the current regulatory regime has the effect of limiting competition between EU carriers on routes to third States and of giving third States' carriers a competitive advantage over EU carriers.[304] The effect is particularly strong in relation to the US. This can be explained with the imbalanced market access opportunities that EU and US carriers enjoy in their respective markets.

Open skies agreements concluded by the US with most Member States allow the national carriers or the Parties to operate between any points in the contracting Member State and any points in the US. The dense net of such open skies agreements enables US carriers to fly from any airport in the US to a wide array of airports in the EU. Conversely, Community Carriers are restricted to operating international services to the US from

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[300] Philip Butterworth-Hayes, "Ailing Airlines Face More Competition, Consolidation and Cost Cutting" *The Wall Street Journal Europe – Aerospace* (16 June 2003) 5.
[301] *Ibid.*; see also "A way out of the wilderness" *The Economist* (3 May 2003) 61.
[302] "Elusive Cost Savings" *Aviation Strategy* (June 2000) 4.
[303] *Ibid.* at 5; this article enumerates possible cost savings from airline merging.
[304] The Brattle Group, *supra* note 4 at 1-9.

points within their respective home country.[305] This is due to two aspects. First, open skies agreements do not provide for the right of passenger carriers to operate from a foreign country to another point outside their home country (seventh freedom).[306] Second, the US does not recognize the EU internal market as a domestic market, and adheres to the concept of nationality of single Member States. Recognizing the "Community Carrier" concept would mean giving EU carriers the chance to receive seventh freedom rights through the backdoor. These restrictions have the effect of giving US carriers the opportunity to offer a greater choice of routes than EU carriers are able to offer. This gives US airlines a competitive advantage. At the same time, this regulatory system limits competition among EU carriers on transatlantic routes, since EU carriers cannot compete with other Community carriers on these routes.

Instead of freely operating within and out of the liberalized EU market, its carriers are still bound by national barriers. Due to the bilateral ownership and control provisions, EU carriers cannot operate between and within the EU and third States as freely as third country carriers can in the EU. While one major aim of the liberalization of the EU air transport market was the elimination of market distortions, the result, in fact, is further distortion.

2.2.3 The Legal Need: The Judgments of the ECJ in the "Open Skies" Cases

In view to complement the progress taking place in the internal EU market, the Commission, the executive body of the Community and the guardian of the Treaty, had since the early 1990s,[307] and particularly after the completion of the internal aviation market in 1992,[308] repeatedly requested a mandate from the Council of Ministers (the Council) to replace agreements between Member States and third States with a single agreement. This request was reinforced as the US approached EU Member States in order

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[305] Open skies agreements with the US do not grant European carriers seventh freedom rights, i.e. the right to operate services from a third country without any connection to the home country.
[306] Seventh freedom rights for cargo carriers are provided for in some few cases.
[307] EC, Commission, *Communication from the Commission to the Council on Community Relations with Third Countries in Aviation Matters,* COM(90) 17 final, (23 February 1990).
[308] EC, Commission, *Communication from the Commission to the Council on Air Transport Relations with Third Countries in Aviation Matters,* COM(92) 434 final, (21 October 1992).

to negotiate and conclude liberal open skies agreements. The Commission was concerned that such agreements would obstruct any common Community approach for an arrangement with the US.[309] In 1992, the Commission therefore specifically urged the Member States not to enter into new agreements with the US. Nonetheless, several Member States did conclude such agreements;[310] and the Council showed itself reluctant to grant the Commission a negotiating mandate.

In 1996, the Council granted the Commission a limited mandate to negotiate with the US on competition rules, ownership and control of air carriers; CRS; code sharing; dispute resolution; leasing and environmental clauses.[311] Market access, capacity, carrier designations and pricing were, however, expressly excluded from the mandate. Despite calls by the Commission to have full competence, Member States refused to give up their negotiating powers. As negotiations were carried out, the Commission's concerns materialized, since the US was not willing to reach a partial agreement *e.g.* on ownership and control without negotiating market access at the same time.[312]

Considering that the situation was not sustainable in the long run, the Commission took infringement procedures in 1995[313] and in December 1998 brought actions under Article 169 Treaty of the European Community (EC Treaty) (now Article 226 EC Treaty) against seven Member States that had signed Open Skies agreements with the US.[314] The Commission alleged that, in negotiating and concluding such agreements, Member States

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[309] Rene Fennes, "The European Court of Justice Decision on Bilateral Agreements – The Future of Relations" (2003) 17-WTR Air & Space Law. 1 at 15.

[310] The first Open Skies agreement was entered into with the Netherlands in July 1992; Germany, Finland, Denmark, Belgium, Austria, Luxembourg and Sweden followed the example during the early 1990s. Later, other European Member States, such as France, Portugal and Italy entered into Open Skies agreements as well.

[311] *Commission v. Denmark* (C-467/98), *supra* note 7 at para. 19.

[312] Frederik Sørensen, Wilko van Weert and Angela Cheng-Jui Lu, "ECJ Ruling on Open Skies Agreements v. Future International Air Transport" (2003) 18:1 Air & Space L. 3 at 7 [Sørensen et al., "ECJ Ruling"].

[313] The Commission in 1994 asked Member States not to enter into negotiation s with the US without first arriving at an agreed position with the Commission. This request was repeated in early 1995, and was then followed in mid-1995 with formal notice to Member States, claiming that they were infringing the Commission's competence. All the Member States concerned filed replies protesting the Commission action.

[314] At the time that the Commission brought action, the following seven countries had signed Open Skies agreements with the US: Austria, Belgium, Denmark, Finland, Germany, Luxembourg, Sweden.

breached Community law with respect to competence and ownership and control clauses.[315] An action was also brought against the UK, but only as regards the latter aspect.[316] On 05 November 2002, the ECJ rendered the judgments in the so-called "Open Skies" cases.[317]

2.2.3.1 The Findings of the ECJ

One of the two main issues of the cases was whether Member States were entitled to negotiate and conclude agreements with the US.[318] The Commission alleged that the Community had exclusive competence to negotiate and conclude ASAs. It based this claim on two alternative arguments.

First, the Commission considered that such an exclusive competence of the Community was necessary in order to attain Community objectives.[319] The Commission argued that the agreements with the US undermined the benefits of the "Third Package" of liberalization measures by causing discrimination, distortions of competition and the destabilization of the internal Community market.[320] According to the Commission "American carriers could operate in the Community without being subject to all the Community obligations, traffic would be drawn towards one Member State to the detriment of the others, and the equilibrium sought by the establishment of common rules

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[315] John Balfour, "Airline Ownership and Control – The Position in the European Community" (2003) *Business Briefing, Aviation Strategies: Challenges & Opportunities of Liberalization* (World Markets Research Centre Ltd, March 2003) 65 at 66 [Balfour, "Airline Ownership and Control"].

[316] Since the efforts of the United States to enter into an Open Skies agreement with the UK had failed, the Commission's action could only be based on the argument that the nationality clause included in the agreement infringed Community law. Subsequent proceedings were initiated against the other Member States that had entered into open skies agreements with the US (France, Italy, Portugal), but these cases have not yet been heard by the Court.

[317] See *Commission v. Denmark* (C-467/98), *supra* note 7.

[318] Since Bermuda II between the US and the UK was no Open Skies agreement, this argument was only directed against the following states: Austria, Belgium, Denmark, Finland, Germany, Luxemburg, Sweden.

[319] ECJ, *Opinion given pursuant to Article 228 (1) of the EEC Treaty, Opinion 1/76*, [1977] E.C.R. 741 at 759; see *Commission v. Denmark* (C-467/98) supra note 7 at para 45.

[320] *Commission v. Denmark* (C-467/98), *ibid.* at para 47; Balfour, "Airline Ownership and Control", *supra* note 315 at 66; for a detailed description of the conditions of the AETR test see also Torsten Stein, "Code Sharing und Open Skies – Herausforderungen für die Europäische Wettbewerbs- und Luftfahrtpolitik" (2001), 50:2 ZLW 135 at 148.

would be broken."[321] Therefore, exclusive Community action in relation to non-Member States was necessary. Second, the Commission claimed that the Community had exclusive competence as a result of the ECJ judgment in the *AETR* case.[322] This case held that, to the extent that agreements with third countries affected the operation of Community legislation, competence for negotiating and concluding such agreements shifted from the Member States to the Community.[323] The Commission alleged that, since the Community has adopted a complete set of common rules designed to liberalize the internal market in the air transport sector,[324] the signing of ASAs between Member States and the US was liable to have an adverse effect on the functioning of the internal market covered by the common rules.[325]

The ECJ rejected the Commission's argument that the bilateral agreements inherently violated European legislation by limiting the benefits of the "Third Package".[326] Conversely, it stated that the Council was able to adopt the "Third Package", without it being necessary to conclude an ASA with the US at the same time. The ECJ did, however, assert that the Community had established a complete set of Community rules in the field of air transport. It concluded that, to the extent that internal jurisdiction is vested in the Community, this jurisdiction is projected externally.[327] Applying the *AETR* test, the ECJ identified some specific provisions in ASAs that fall within the scope of, and have an adverse effect on, those Community rules. Specifically, the Court

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[321] *Commission v. Denmark* (C-467/98), *supra* note 7 at para 67.
[322] ECJ, *Commission of the European Communities v. Council of the European Communities,* C-22/70, [1971] E.C.R. 263; for a detailed description of the conditions of the AETR test see also Stein, *supra* note 320 at 148 ff.
[323] Balfour, "Airline Ownership and Control", *supra* note 315 at 68.
[324] *Commission v. Denmark* (C-467/98), *supra* note 7 at para. 66.
[325] See *ibid.* at para 65; see also Sørensen et al., "ECJ Ruling", *supra* note 312 at 9. For a more detailed presentation of the Commission's arguments see Allan I. Mendelsohn, "The European Court of Justice Decisison on Bilateral Agreements – Ownership and Control" (2003) 17-WTR Air & Space Law. 1 at 23 [Mendelsohn, "The European Court of Justice Decision"]; see also John Balfour, "A Question of Competence: The Battle for Control of European Aviation Agreements with the United States" (2001) 16-SUM Air & Space Law. 7 at 8.
[326] *Commission v. Denmark* (C-467/98), *supra* note 7 at paras. 54 to 64; see also Mendelsohn, *ibid.* at 24.
[327] Armand de Mestral, "The Consequences of the European Court of Justice's 'Open Skies' Decisions" (2003) *Business Briefing, Aviation Strategies: Challenges & Opportunities of Liberalization* (World Markets Research Centre Ltd, March 2003) 23 at 24; see also Thomas D. Grant, "An End to 'Divide and Conquer'? EU may Move Towards More United Approach in negotiating 'Open Skies' Agreements with USA" (2002) 67 Journal of Air L. & Com. 1057 at 1068.

addressed those provisions that dealt with intra-European fares,[328] computer reservation systems (CRS)[329] and the allocation of airport slots.[330] Yet, the Court found the necessary "effect" (and thus an infringement of Community law) only with respect to fares and CRS.[331] More importantly, the Court held that the Commission lacked competence over the major bilateral issues of routes and traffic rights.[332] This means that the judgments, despite the Commission's efforts, do not confer on the Commission the long-sought mandate to negotiate major bilateral aviation issues on behalf of the Community States with the US.

For current purposes, the more interesting part of the judgments is, whether the so-called "nationality clauses", used in the Open Skies agreements and Bermuda II, infringe the right of establishment granted by the EC Treaty to individuals and companies. The Commission submitted that the nationality clauses were contrary to the right of establishment laid down in Article 43 EC Treaty.[333] Pursuant to Article 43 EC Treaty, freedom of establishment includes the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms within the meaning of the second paragraph of Article 48[334] EC Treaty. This should be the same under the law and conditions laid down for its own nationals by the Member State in which establishment is effected. Articles 43 and 48 EC Treaty thus guarantee

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[328] The EU legislation in the field of intra-European fares is EC, Regulation 2409/92, OJ No L240/15, 24 August 1992, Article 1 (3). Joachim Bentzien, "Die Urteile des EuGH vom 5. November 2002 betreffend die Zuständigkeiten der EG für Luftverkehrsabkommen mit Drittstaaten" (2003) 52:2 ZLW 153 at 157-158, submits that the decision of the ECJ with respect to intra-European fares is legally not founded. Bentzien argues that Article 1 (3) of Regulation 2409/92 does not imply a prohibition for airlines from third States to offer fares that are lower than intra-European fares, but rather a protection clause in favour of EU airlines. Addressees of the Regulation are EU airlines and *not* carriers from third countries. Therefore, he argues, an exclusive Community competence in this matter could not have been established.

[329] The Community legislation in the field of CRS is EC, Regulation 2299/89, OJ No L220/1, 29 July 1989, as amended, which applies to non-EU nationals where they use or offer for use a CRS in the EU.

[330] The Community legislation in the field of airport slots is EC, Regulation 95/93, OJ No L14/1, 22 January 1993, which applies to non-EU carriers as well as EU carriers.

[331] The Court found that, in fact, none of the open skies agreements dealt with the matter of slots.

[332] Allan I. Mendelsohn, "The United States, the European Union, and the Ownership and Control of Airlines", *Issues in Aviation Law and Policy* (ICC, 2003) ¶ 25,151 [Mendelsohn, "The United States, the European Union"].

[333] *Consolidated Version of the Treaty Establishing the European Community,* [2002] O.J. C325/40, [EC Treaty]; ex Article 53 EC Treaty.

[334] Ex Article 58 EC Treaty

national treatment to nationals, companies or firms of Member States when they are established in the territory of any other Member State. The Commission argued that the terms "law" and "conditions" in Article 43 EC Treaty also cover the rights and obligations arising from international agreements entered into by Member States with third countries.[335] The nationality clauses were examples of such rights and obligations. They limited the Member States' right to designate airlines, and allowed the US to reject the designation of any airline that was not owned and controlled by the party to the agreement.[336] Therefore, the Commission argued that the nationality clauses infringed the freedom of establishment of airlines.

The Court agreed with the Commission and ruled that the nationality clauses improperly limit the right of establishment guaranteed by the Treaty of Rome.[337] It stated that any provision in which a Member State agrees to allow the US to veto services by an airline owned or controlled by citizens of a second Member State represents discrimination by the first Member State against the second.[338] For instance, under the ASA between the US and Germany, the US is entitled to reject the designation by Germany of Air France (AF) to operate under the US-German agreement. Conversely, the US has to accept the designation of LH by Germany. Thus, AF is precluded from the benefits of the ASA between the US and Germany, while those benefits are assured to LH. Consequently, the Court found that Community airlines suffer discrimination, which prevents them from benefiting from the treatment that the host Member State accords to

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[335] *Commission v. Denmark* (C-467/98), *supra* note 7 at para. 114.

[336] *Ibid.* at para. 113; but see Henri Wassenbergh, "A Mandate to the European Commission to Negotiate Air Agreements with Non-EU States: International Law versus EU Law" (2003) 28:3 Air & Space L. 139; Wassenbergh criticizes the ruling by the ECJ. According to him, by concluding that Member States may not discriminate between EU undertakings on the basis of nationality even in respect of activities outside the EU, the ECJ has exceeded its competence. "Neither can nor does EU law oblige Member States to treat Community air carriers in the same way as the national air carrier(s) *vis-à-vis* non-EU third countries."

[337] Bentzien, *supra* note 328 at 173 argues that, "from the point view of international public air law this judgement may be less convincing because the freedom of establishment according to Article 52 EEC-Treaty does not include and does not grant the freedoms of air. Even in the EEC-Treaty these two different legal areas are separated in tow different chapters and so far as the traffic rights are concerned the reservation clause of Article 84 para 2 EEC-Treaty applicable. The decision of the Court does not make this distinction and does not prove the special character or the legal nature of the classic standard provision in bilateral air transport agreements concluded since more than fifty years."

[338] *Commission v. Denmark* (C-467/98), *supra* note 7 at para 131.

its own nationals.[339] Community carriers are effectively discouraged from establishing themselves outside their own Member State.[340] The Court therefore concluded that by awarding the US the potential right to discriminate between Community carriers Member States had breached their obligations under the EC Treaty.[341]

2.2.3.2 Implications

The reaction to the judgments was mixed, and in fact both parties, Member States as well as the Commission, claimed victory. While the ECJ decided that the Commission has exclusive jurisdiction to negotiate certain limited air transport matters with foreign States, it upheld the Member States' competence to negotiate and conclude ASAs in general. In fact, compared to the large range of issues included in ASAs, the scope of the Community's exclusive competence is rather limited and not central for the functioning of those agreements.[342] Much to the disappointment of the Commission, the ECJ did not – and indeed could not – confer a full and exclusive competence to conduct negotiations with third States.[343] Such competence was still dependent on a mandate from the Council.

The principal implications of the judgments flow from the findings of the Court on the nationality clauses.

While only directly related to the open skies agreements of Member States with the US, the judgments' ramifications are much broader. They can be seen to apply to all ASAs between Member States and third States, open skies or not.[344] As virtually every ASA in entered into by Member States with third States include nationality clauses,

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[339] *Ibid.*
[340] Fennes, *supra* note 309 at 16.
[341] *Ibid.*
[342] Carl Otto Lenz, Nina Niejahr, "The European Court of Justice and European Air Transport Law (continued)" (2003) 38:2 European Transport Law 157 at 163; the authors state that "[t]he core of any ASA, market access and pricing on routes to third countries, remains in the hand of the Member States. Whether the Community is competent to negotiate nationally clauses is unclear. The Court only found the existing nationality clauses incompatible with Community law, but refrained from deciding whether the competence to rectify that incompatibility lies with the Member States or with the Community."
[343] Mendelsohn, "The United States, the European Union", *supra* note 332 at ¶ 25,151.
[344] Note that the UK was also included in the legal action even though its agreement with the Unites States does not follow the open skies format; see Fennes, *supra* note 309 at 16.

around 1,500 agreements are concerned.[345] In an even wider context, the judgment may well have created a unique occasion "for [S]tates all over the world to join together and to adopt an approach that would multilaterally liberalize the entrenched ownership requirement and, at the same time, fully, or at least largely meet the requirements of the ECJ decision."[346] This is why many authors praised the decisions in the "Open Skies" cases as a "severe challenge to the culture of ASAs",[347] and "likely to reshape international aviation and aeropolitics in ways that cannot be foreseen".[348]

Furthermore, it has to be observed that it was the ruling of the Court on nationality clauses, rather than its findings regarding the question of Community competence, which pushed Member States to finally grant the Commission the long sought mandate on 5 June 2003.

As a direct consequence of the judgements, Member States had two options: either negotiate with their bilateral partners, in order to replace the traditional nationality clauses by a designation clause that satisfies EC law;[349] or support the proposal of the Commission for a mandate to remove the infringements through a Community approach to ownership and control.[350] In the view of the Commission, the second option was the only possible course of action open to the Member States. In its Communication, released shortly after the decisions in November 2002,[351] the Commission asked Member States to terminate their bilateral agreements with the US.[352] According to the Commission, the termination of the agreements would be the only possible way to comply with the judgments. The Commission also requested the Member States to refrain from making international aviation commitments of any kind before having clarified their compatibility

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[345] De Mestral, *supra* note 327 at 24.
[346] Mendelsohn, "The European Court of Justice Decision", *supra* note 325 at 22.
[347] "Bilaterals in the Dock" *Airline Bus.* (1 December 2002) 26.
[348] Perry Flint, "The Devil is in the Detail" *Air Transport World* (1 December 2002) 5.
[349] Balfour, *supra* note 315 at 68.
[350] Fennes, *supra* note 309 at 17.
[351] EC, Commission, *Communication from the Commission on the Consequences of the Court Judgment of 5 November 2002 for European Air Transport Policy,* COM(2002) 649 final, (19 November 2002) at paras. 56-62 [COM (2002) 649 final].
[352] *Ibid.* at para. 67.

with Community law.[353] Finally, the Council was urged to agree to a negotiating mandate for the replacement of existing bilaterals with the US by an agreement at Community level.[354]

This Communication revealed the Commission's actual intention behind its legal action. It provoked the impression that the Commission sued the Member States in order to finally receive the long awaited mandate to negotiate on behalf of the whole Community. As will be shown, this is a political rather than a practical reason.[355]

In fact, no Member State's airline has ever applied for and been refused designation by another Member State to operate on a third country route from that State;[356] and it is not very likely that such a situation will appear in the near future.[357] Why should, for instance, AF operate flights from Frankfurt to New York, if that means competing with LH, an "already entrenched competitor airline holding prime slots and gates in Frankfurt."[358]

Moreover, it is noteworthy that the nationality clauses used in ASAs are only permissive. The US is, therefore, in no way obliged to refuse the designation of an airline that is not majority owned and controlled by the bilateral partner. On this basis, the US has occasionally waived the nationality restrictions, in particular where a change in the ownership and control composition of a foreign airline did not affect US aviation policy or interests. Most remarkably, in the "Cargo Lion" decision[359] the DOT accepted a Luxembourg-designated cargo airline, Cargo Lion, in which no Luxemburg national had

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[353] *Ibid.* at para. 69.
[354] *Ibid.* at para 70.
[355] McGonigle, *supra* note 187 at 23; see also Bentzien, *supra* note 328 at 170.
[356] *Ibid.*
[357] See Thomas Kropp, quoted in Cathy Buyck, "The EU's 'historic judgment'", *Air Transport World* (1 January 2003) 36. See also Flint, *supra* note 348 at 5, who points out that it is not very likely that European airlines will fly out of each other's hubs in order to operate to the US. "That strategy didn't work for airlines operating inside the US in the late 1980s; there is no reason to assume it will be any more effective in Europe today".
[358] McGonigle, *supra* note 187 at 24.
[359] US, Department of Transportation, *Application of Translux International Airlines SA d/b/a Cargo Lion for Exemptions under49 USC Section 40109*, DOT Order 96-4-37, Docket No. 50362 (18 April 1996); Department of Transportation, *Application of Translux International Airlines SA d/b/a Cargo Lion for Exemptions under 49 USC Section 40109*, DOT Docket OST 98-4329 (1998).

any ownership interest.[360] The carrier was 49% German owned and 41% Swiss owned; UK and Canadian nationals held each 5%. The basis for the grant of the license was that a majority of its owners were nationals of States (in this case Germany and Switzerland) that had open skies agreements with the US.[361]

Finally, the Commission did not base its legal action upon a concrete case of refused designation of a Community carrier. Therefore, it may be the Commission used the legal action and the judgments more as a political than a practical means, to force Member States to denounce all current bilaterals that contain nationality clauses, and thus to secure its mandate to renegotiate all of these bilaterals.[362]

Member States reacted with general reluctance to accept the above-mentioned interpretation of the judgments.[363] In their view, the judgments of the ECJ do require Member States to remedy the infringements of EC law brought about by the nationality clauses, but "the judgments do not go so far as to preclude Member States from negotiating bilateral agreements, provided these comply with relevant provisions of Community law".[364]

On 26 February, the Commission submitted a recommendation to the Council for authority to open Community negotiations with all bilateral partners on the ownership and control of airlines.[365] Compared to the Communication submitted in November, the Commission adopted a less rigorous approach in this communiqué. The Commission proposed that the Council consent to a mandate that would be restricted to the renegotiation of the issue of ownership and control and other matters of Community competence. Member States would remain free to maintain and negotiate their own

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[360] Havel, *supra* note 193 at14.
[361] See Mendelsohn, "The United States, the European Union", *supra* note 332 at ¶ 25,151.
[362] Mendelsohn, "The European Court of Justice Decision", *supra* note 325 at 22.
[363] UK, H.L., *supra* note 215 at 16.
[364] See *e.g.* written evidence by the Government of the United Kingdom, cited in UK, H.L., *ibid.* at 17.
[365] EC, Commission, *Communication from the Commission on Relations between the Community and Third Countries in the Field of Air Transport, Proposal for a European Parliament and Council Regulation on the negotiation and implementation of air service agreements between Member States and third countries,* COM(2003) 94 final, (26 February 2003) [COM(2003) 94 final].

agreements with third countries on matters of national competence.[366] Moreover, a mandate should only be granted after the parties agreed on a revised definition of the beneficiaries, which would then be used by the Commission in negotiations to override the relevant clauses in existing agreements.[367]

Despite this less radical approach, Member States remained hesitant to grant the mandate, but they realized that the ruling of the Court with respect to nationality clauses did not leave them much room for individual action.[368]

Legally, Member States presumably remained able to renegotiate their bilateral agreements with third States in order to bring the existing ownership articles into line with the ECJ judgments. Renegotiation would have been in line with the expressed willingness of the US to replace the offending clauses, at least with open skies partners.[369] Member States seem, however, to have realized that the Court's judgements as regards nationality clauses eliminated the main reason for retaining to the power to negotiate and conclude ASAs.

As a direct consequence of the judgments, all Community carriers have the right to establish themselves in each other's territory, with the right to claim international market access under the same conditions as nationally registered carriers.[370] Member States are no longer entitled to limit the benefits of their agreements with third States to

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[366] *Ibid.* at para. 45.
[367] *Ibid.*
[368] See written evidence submitted by the Bundesministerium für Verkehr, Bau, und Wohnungswesen (BMVBW) to the Selected Committee on the European Union, UK, H.L., *supra* note 215 at 16; in the body of the evidence the BMVBW states: "as regards infringements which are founded in commitments affecting the Treaty (article 43) it appears to be difficult, although not impossible, to bilaterally agree with the other contracting party on adequate remedial action. In this respect a common approach by all Member States concerned appears to be indispensable in order to ensure conformity with the Treaty. In our view, consent by the European Commission is also required in addition to agreement by the other contracting party".
[369] Jeffrey Shane, "The US Official Comments on EU 'Open Skies' ruling" (Speech at the American Bar association forum in Florida, 8 November 2002, online: The United States Mission to the European Union, www.useu.be/Categories/Transportation/Nov0602USEUOpenSkies.html (date accessed: 24 July 2003) [Shane, "The US Official Comments"]; so also Balfour, who stresses, however, that it is unthinkable that the US would e.g. agree to allow British Airways to take advantage of the US/German open skies agreement in order to operate freely between Germany and the US; see Balfour, "Airline Ownership and Control", *supra* note 315 at 69.
[370] Fennes, *supra* note 309 at 18.

their national airline. Thus, if *e.g.* Germany renegotiated the nationality clause its ASA with the US, the result would be a clause that opens up the benefits of that agreement to all other EU airlines that seek establishment in Germany and designation under the US-German agreement (the so-called "Community Clause"). Germany would, thus, have to share its negotiated achievements with all other Member States.[371] Under these circumstances, there would, in fact, be nothing to be gained by Germany entering into its own ASA with the US. The finding of the ECJ as regards ownership and control thus has a huge potential to affect the current system of bilateral agreements concluded by Member States.[372]

Nor is the only difficulty that a Member State would be obliged to negotiate on behalf of all Community carriers and share all its benefits with latter. For some Member States, it would be extremely difficult to make their bilateral partners agree on a Community Clause, without facing major counter-demands. For the negotiating partner, this would mean permitting all air carriers established in the Member State to profit from the traffic rights exchanged with one single State. This would run counter to the entrenched principle of "balance of benefits". Not many States would likely accept such a designation clause without raising aeropolitical counter-demands. For instance, it would be practically unthinkable for the US to agree to allow BA to take advantage of the US-German open skies agreement, in order to operate freely between Germany and the US, while the UK does not agree on opening up Heathrow for US carriers.[373]

An interesting example of the weak negotiating position in which Member States find themselves was the negotiation of a new ASA between the British and the Chinese

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[371] As a consequence of the judgments, Member States have to set up administrative, non-discriminatory rules for the distribution of the benefits received from a bilateral agreement. However, the right of establishment does not give an unqualified right to operate, but rather the right to operate on the same conditions as those applied to local nationals. See also Balfour, "Airline Ownership and Control", *supra* note 315 at 69; Balfour points out that if a Member State operates a restrictive policy on designation, it may continue to apply such restrictive policy, providing there is no discrimination on grounds of nationality. Balfour, however, also submits that it is even possible that a Member State remains entitled to maintain a monopoly for extra-EC services in favour of its national carrier.

[372] Fennes, *supra* note 309 at 18.

[373] See Balfour, "Airline Ownership and Control", *supra* note 315 at 69; see also Daniel Michaels, "EU is ready to negotiate open skies pact with US", *Wall Street Journal* (5 June 2003).

Governments. It was clear to the British Government that the new ASA would have to include a Community Clause.[374] The Chinese were, however, not interested in signing a deal which would have been open to all Member States and which would mean major competition from EU airlines. The only way to restrict the threat of competition would have been for China to limit access to its territory by more restrictions on capacity and frequency.[375] In the end, the UK withdrew from the negotiations.[376] This example shows that the situation after the Open Skies Judgments in practice means a "dead end" for Member States' negotiations with third States. It could be hoped that the bargaining power of the EU, negotiating as one single block, would be enhanced compared to the bargaining power of the individual Member State.[377] It was therefore in Member States' interest to pass to the Commission the competence to negotiate such agreements. From an aeropolitical point of view, Member States did not have much choice but to agree to authorize the Commission to negotiate with third States on behalf of the whole Community.[378]

On 5 June 2003, the Council finally agreed on a package of measures that passes responsibility for conducting key air transport negotiations to the Commission.[379] The package consists of three parts.

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[374] Emma Blake, "France's Air Pact With China Tests New EU Aviation Laws", *Dow Jones Business News* (27 February 2003).

[375] See Balfour, "Airline Ownership and Control", *supra* note 315 at 69; Balfour notes that if the bilateral agreement is a restrictive agreement, with capacity and frequencies strictly controlled, then the nationality of the airline from the other end providing those frequencies might not matter very much in practice;

[376] In contrast to this, *France* signed an ASA including the traditional ownership and control clause in an apparent breach of EU law. The deal, signed in January 2003, gives stat-controlled carrier AF an exclusive new route into Canton, China; see Blake, *supra* note 374.

[377] See COM (2002) 649 final at para 41; the Commission advocates that through a unified approach, "the Community would be able to defend its interests, argue its case and promote its vision for global aviation in a more effective way". Instead of many small sized countries, the US would face an even bigger market and an economically strong partner, The Community could officially offer the US something that has already been granted in reality now, i.e. the access to the European market as a whole, including the right to fly from one destination in Europe to another. Having offered this, the Community hopes to be in a position to demand concessions from the US, such as seventh freedom operations and cabotage.

[378] See also written evidence by BMVBW, *supra* note 368.

[379] EC, Commission Press Release IP/03/806, "New Era for Air Transport: Loyola de Palacio Welcomes the Mandate Given to the European Commission for Negotiating an Open Aviation Area with the US", 05 June 2003 [Commission Press Release IP/03/806].

a) A Council decision on authorizing the Commission to open negotiations with the United States in the field of air transport.

b) A Council decision authorizing the Commission to open negotiations with third countries on the replacement of certain provisions in existing bilateral agreements with a Community agreement.

c) A proposal for a Regulation of the European parliament and of the Council on the negotiation and implementation of air service agreements between member States and third countries.[380]

By approving this package, Member States granted the Commission the mandate to negotiate in two different fields. First, the Commission is authorized to open up negotiations with the US in the field of air transport. Second, Member States authorize the Commission to open negotiations with third countries on the replacement of certain provisions in existing bilateral agreements with a Community agreement. This so-called "horizontal mandate" will allow the Commission to pursue negotiations to seek the amendment of the nationality rules with any country, allowing for a series of targeted negotiations with important partners.[381] The mandate is historic, since the Council decided that, for the first time in the history of civil aviation, sovereign States are no longer entitled to conclude some of their ASAs.[382] The likewise revolutionary third part of the package consists of a proposal that will be submitted to the European Parliament. It implies that Member States remain competent to negotiate in fields that are of exclusive Community competence, as long as the interests of all the carriers established in the EU are taken into account.[383] A system established at EU level will ensure proper coordination and remove discrimination between different EU airlines. This part of the package is revolutionary under EU law because it allows for the conclusion of "illegal"

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[380] See EC, Council of the European Union Press Release Nr. 9686/03 (Press 146), 2515th Council meeting – Transport, Telecommunications and Energy (Luxembourg, 5 June 2003) at 19, online: European Union, http://ue.eu.int/Newsroom/newmain.asp?BID=103&LANG=1 (date accessed: 18 July 2003).

[381] European Commission Press Release IP/03/806, *supra* note 379.

[382] Schulte-Strathaus, Inverview, *supra* note 192.

[383] This specificity has also been stressed by Ludolf van Hasselt; Head of Unit, Directorate General for Energy and Transport, European Commission during a personal interview, Brussels, 19 June 2003 [van Hasselt, Interview]. Van Hasselt gave the example of LH seeking designation under the bilateral agreement between France and a third state: The French government will have to treat Air France and LH, an airline with an establishment in France, exactly the same. If France negotiates with another country, all the carriers from other Member States will have to be invited. If they have to distribute traffic rights following the negotiations, they will have to treat all Community Carriers the same. They are not allowed to give preferential treatment to any carrier.

agreements under certain circumstances.[384] It recognizes that, particularly on the question of ownership and control and the designation of air carriers, it may not be possible to convince a third country to accept the Community Clause.[385] The proposal anticipates such a case by stipulating that the agreement can, nevertheless, be concluded where important Community interests are at stake.[386]

The mandate granted on 5 June 2003 constitutes a compromise between Member States and the Commission. Instead of completely handing over their negotiating power to the Commission, Member States have successfully defended their position. It is an opportunity to reshape the external aviation relations with non-EU countries "in the spirit of close cooperation of the Community institutions involved in the field of international civil aviation".[387] It is to be noted, however, that, when the international community came together in Montreal in March 2003; most of the Member States had so far not clearly whether or not they would vote for a negotiating mandate in Council.[388]

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[384] The illegality could emerge, if e.g. the agreement does not include the Community Clause and thereby discriminates against other Community carriers.

[385] van Hasselt, Interview, *supra* note 383.

[386] See COM(2003) 94 final, Article 4 para 3 of the Draft Regulation; van Hasselt, Interview, *ibid.*

[387] Expression used by Dr. Thilo Schmidt, Deputy Director General of the German Civil Aviation Authority – BMVBW, covering letter to BMVBW written evidence, cited in UK, H.L., *supra* note 215 at 16. In the letter he writes: "in my view, the ECJ's judgments form a solid basis to shape the external aviation relations with non-EU cuntries in the spirit of close cooperation of the Community instituations involved in the field of international civil aviation".

[388] While the international community gathered in Montreal, the European Ministers of Transport met in Brussels on 27/28 March 2003 in order to discuss, *inter alia*, the question whether the Commission should be granted the negotiating mandate. See EC, Council of the European Union Press Release Nr. 7686/03 (Press 90) 2499th Council meeting – Transport, Telecommunications and Energy, (Brussels 27-28 March 2003) at 22, online: European Union, http://ue.eu.int/Newsroom/newmain.asp?BID=103&LANG=1 (date accessed: 22 September 2003) It emerged that "most Member States were willing to give the Commission a mandate but only in return for greater certainty over future arrangements for the negotiation and implementation of bilateral agreements in the light of the recent judgment o f the European Court of Justice." See UK, H.L., *supra* note 215 at 16. In fact, delegates of the European Commission at the ICAO 5th Air Transport Conference seemed to be optimistic as to the result of the negotiations held between the Council and the Commission in the matter.

2.3 Concluding Remarks

This chapter has demonstrated that there is urgent need for liberalization of ownership and control provisions. While these provisions affect the entire airline industry, the regulatory barriers to consolidation hit the EU airline industry particularly hard. As a result of the ECJ ruling, there are prospects for relief. When the international community came together at ATConf/5, it was clear that the nationality clauses in around 1,500 agreements conflicted with Community law. Either Member States themselves, or the Commission on their behalf, would have to find a substitute to the infringing clauses. Member States and the European Commission therefore had a major interest in presenting their situation to the international community and encouraging liberalization. The implications of the ECJ judgments create an opportunity to revisit the entire ownership and control framework systematically and on a global scale. In fact, ATConf/5 provided a timely opportunity for States to bring about change.

CHAPTER 3: AIR CARRIER OWNERSHIP AND CONTROL DISCUSSED AT ATCONF/5

3.1 The Increased Willingness of States to Liberalize Air Carrier Ownership and Control

The issue of air carrier ownership and control was high on the agenda of ATConf/5.[389] Particularly the need to find alternatives to the criteria for the designation and authorization of carriers was considered as one of the key issues to be dealt with at the Conference.

It was not the first time that an ICAO Worldwide Air Transport Conference had addressed the issue of air carrier ownership and control. In 1994, at the Fourth Worldwide ICAO Air Transport Conference (ATConf/4), it was one of the main subjects discussed. The achievements of ATConf/4 in this respect were, however, very modest. Most states had expressed reservations about extensive change.[390] Accordingly, ATConf/4 restricted itself to considering the "option of broadening the ownership and control criteria to one or more States parties to an agreement" and to extending the "community of interest" concept to all States part of a pre-defined group.[391]

In 2003, the approach of States with respect to the liberalization of ownership and control was different. The international community was far from being at one on to the extent and form of liberalization. States generally agreed, however, that this Conference would have to bring about more significant change than in the past. Proof of this attitude

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[389] Before this Conference, four other similar Conferences had been held by ICAO in 1977, 1980, 1985 and 1994. Those Conferences had mainly dealt with coordination and harmonization of policy for the regulation of capacity, tariffs and non-scheduled air transport; See Abeyratne, Ruwantissa, "The Worldwide Air Transport Conference of ICAO and its Regulatory and Economic Impact" (2003) 28:4/5 Air & Space L. 218 [Abeyratne, "The Worldwide Air Transport Conference of ICAO"].

[390] ICAO, *Report of the World Wide Air Transport Conference on International Air Transport Regulation: Present and Future*, ICAO Doc. 9644 (1995) at para. 2.3.5.3. [ICAO Doc. 9644].

[391] *Ibid* at para.. 2.3.6.1. It is interesting to observe that the results of ATConf/4 and the implementation of its Recommendation were subject of fourteen Council meetings in the aftermath of ATConf/4. In contrast to that, Council Members agreed on the adoption of the Conclusions and Recommendations issued by ATConf/5 during the first Council meeting concerned with that issue.

is the fact that ATConf/5 concluded that "there is widespread support by States for liberalization of provisions governing air carrier designation and authorization".[392]

The growing willingness of States to liberalize the criteria for designation can be traced to increasing liberalization of air transport at the regional level. Since 1994, a large number of regional and plurilateral agreements have introduced broadened criteria. Two examples are APEC and the PIASA, which have already been dealt with above.[393] On the African Continent, air transport market access has widely been liberalized through the implementation of the Yamoussoukro Decision[394] and several sub-regional arrangements, such as within COMESA.[395] Another example of regional liberalization is the Australia-New Zealand Single Aviation Market (SAM). In 1996, Australia and New Zealand entered into this agreement, which, *inter alia*, introduced a single ownership and control criterion, under which a SAM carrier could be owned and controlled by nationals of both

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[392] ICAO, *Report of the Worldwide Air Transport Conference: Challenges and Opportunities of Liberalization* , ICAO Doc. 9819 (2003) at para. 5, 6 [ICAO Doc. 9819]; see also ICAO, Consolidated Conclusions, Model Clauses, Recommendations and Declaration (*Worldwide Air Transport Conference: Challenges and Opportunities of Liberalization*) (31 March 03) at para. 2.1., online: ICAO, http://www.icao.int/icao/en/atb/ATConf5/docs/ATConf5_conclusions_en.pdf (date accessed: 7 August 2003).

[393] See Chapter 1.2.3.

[394] The Yamoussoukro Declaration was adopted in October 1988. In this declaration, African States agreed on a new civil aviation policy. It was, however, not before November 1999 that it was agreed by the African Ministers to actually implement the Declaration. After intensive discussions, the Ministers adopted a Decision relating to the Implementation of the Yamoussoukro Declaration concerning the Liberalization of Access to Air Transport Markets in Africa. The Decision was subsequently endorsed by the Assembly of Heads of State and Government of the African Economic Community in July 2000. The framework provides for a continent-wide aviation agreement to liberalize the African skies with the aim of reaching full liberalization by the year 2002. The main thrust of the Decision is to liberalize gradually scheduled and non-scheduled intra African air transport services in order to facilitate access to air transport markets in Africa; see United Nations Economic Commission for Africa, *The road forward for the implementation of the Yamoussoukro Decision*, online: UNECA, http://www.uneca.org/itca/yamoussoukro/Liberalisation%20in%20Africa-eng.doc (date accessed 19 August 2003).

[395] In May 1999, COMESA introduced the 'COMESA Regulations for the implementation of Liberalization of air Transport Services'. As part of the liberalization program, COMESA introduced new conditions as to market access and introduced the concept of COMESA air carriers. Of particular note is the widening of the ownership and control of air carriers from the narrow National/State ownership to the broader COMESA ownership i.e. ownership by any combination of COMESA member States Governments and/or its citizens or private institutions. Another important aspect is the relaxation of intra-COMESA cross-border investments by States and/or COMESA citizens/private institutions in air transport services; see Amos Marawa, 'The COMESA Air Transport Liberalization Experience' (Seminar prior to the 5th ICAO Worldwide Air Transport Conference, "Aviation in Transition: Challenges & Opportunities of Liberalization", ICAO, Montreal, 22-23 March 2003), online: ICAO, http://www.icao.int/icao/en/atb/atconf5/Seminar/Marawa.pdf (date accessed: 19 August 2003).

nations.[396] Finally, since 1994, air transport has been completely liberalized amongst the Member States of the EU. In fact, only few months before AT/Conf5 took place, the ECJ issued its judgments in the "Open Skies" cases. In view of the necessity to renegotiate ASAs with third States, EU Member States as well as the Commission, had a great interest in agreeing on some kind of liberalized approach to air carrier ownership and control.

Additionally, it has to be realized that the Conference was held against the backdrop of an economic slowdown. Airlines, especially in developing countries, have growing difficulty obtaining capital from their domestic markets.[397] This leads many States to realize that there is a great necessity for wider access to foreign capital, which increasingly supersedes the concern about losing control over the national airline.[398]

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[396] The Agreement came into effect in November 1996. In order to operate services in the SAM, carriers must meet the following criteria: at least 50% ownership and effective board control by Australian and/or New Zealand nationals, at least two-thirds of the Board members are Australian and/or New Zealand nationals, the Chairperson of the Board is an Australian or New Zealand national, the airline's head office is in Australia or New Zealand, and the airline's operational base is in Australia or New Zealand; see *Australia-New Zealand Single Aviation Arrangements* (1 November 1996), online: Australian Department of Foreign Affairs and Trade, http://www.dfat.gov.au/geo/new_zealand/sam.pdf (date accessed: 19 August 2003). For details concerning the SAM, see Jeffrey Goh, *The Single Aviation Market of Australia and New Zealand* (London: Cavendish Publishing Limited, 2001) at 48 ff.

[397] This fact has also been revealed by the result of a Survey of States' Policies and Practices on Air Carrier Ownership and Control conducted by the ICAO Secretariat in 2002; see ICAO, Working Paper (*Result of the Survey of States' policies and practices concerning air carrier ownership and control*) No. AT-WP/1933 (2 April 2002); for a detailed evaluation of the result of the survey, see Lelieur, *supra* note 33 at 146.

[398] At ATConf/4, African states noted that air carriers of developing countries needed external investment, but that it would be damaging if this led to loss of national control; see ICAO Doc. 9644, *supra* note 390 at para. 2.3.2. At ATConf/5, African states reviewed their position taken in AtConf/4. They pointed out that most African States have limited resources and are not able to establish and sustain competitive airlines from their own resources. They recognized that strictness in ownership and control will not help individual States or Regional Economic Groupings to achieve the required transformation of their economies using air transportation as the vehicle to achieve their objectives. Therefore they supported the liberalization of ownership and control provisions, see 53 African States, Working Paper (*Worldwide Air Transport Conference: Challenges and Opportunities of Liberalization*), No. ATConf/5-WP/80 (4 March 2003).

3.2 Discussion on Air Carrier Ownership and Control at ATConf/5

The opinions expressed at ATConf/5 with respect to agenda item 2.1. on air carrier ownership and control varied widely. While some delegations supported a substantial broadening in the near term of the provisions, others advocated a more gradual reduction of specified proportions of national ownership, which would limit change for the time being to certain types of operations, application within certain geographic regions, or simply case-by-case considerations.[399] In contrast to the 1994 Conference, where delegations presented their situation, but were not ready to depart from their position, the discussion at ATConf/5 was based on the will to find a compromise between the different approaches.

The discussion was built around the balanced approach adopted by the ICAO Secretariat in its Working Paper submitted to the Conference.[400] The Working Paper stressed that there are risks, as well as benefits attached to the liberalization of air carrier ownership and control. Any approach would have to accommodate those who wish to liberalize, as well as those who want to retain the traditional requirement for their own carriers.[401] It would be crucial to bring about a regime under which States that do not wish to liberalize do not inhibit others from doing so.[402] Based on the proposal developed by the ICAO Air Transport Regulation Panel (ATRP)[403] and previous work by ICAO as well as by other organizations such as the European Civil Aviation Conference (ECAC),[404] the Organization of Economic Co-operation and Development (OECD),[405]

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[399] ICAO Doc. 9819, *supra* note 392 at para. 2.1.3.1. a).
[400] ICAO, Working Paper, ATConf/5-WP/7, *supra* note 48.
[401] *Ibid.* at para. 3.6.
[402] *Ibid.*
[403] See ICAO, *Report of the Tenth Meeting of the Air Transport Regulation Panel*, ICAO Doc. ATRP/10 (17 May).
[404] ECAC, *Report on Task Force on Ownership and Control Issues, First Meeting*, ECAC Doc. OWNCO/1 (24 December 1998). ECAC endorses the ATRP proposal of establishing a "strong link". According to ECAC, a strong link can be ensured by requiring both the following elements: that a carrier's principal place of business be in the country which designates it; and that a carrier holds an Air Operator's Certificate from the country designating it. As a negative element, the ECAC proposal includes a provision, according to which a State would be enabled to withdraw a foreign airline's permit if there were grounds to suspect that the safety of its operations fell short of international standards.
[405] OECD, Directorate for Science, Technology, and Industry – Devision of Transport, *Liberalization of Air Cargo Transport,* Doc. No. DSTI/DOT(2002)1/REV1 (May 2002) at 16, online: OECD,

International Air Transport Association (IATA)[406] and APEC,[407] the Working Paper proposed a new optional criterion based on "principal place of business" and "effective regulatory control" by the designating States.[408] The proposed conclusions and recommendation for action by States and ICAO were designed to facilitate the application of more flexible arrangements by States wishing to liberalize, while at the same time protecting the position of all States. Safety and security would not only have to be maintained but enhanced.[409]

Air carrier representatives, such as IATA and the International Air Carrier Association (IACA), adopted a more progressive, even radical approach in favour of liberalization.[410] IATA proposed to distinguish between commercial control (conferred by ownership and regulatory control and exercised by licensing authorities) and economic control, advocating dispensing entirely with the necessity for the economic connection.[411] Regulatory control of safety and security would remain the only link between the

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http://www.oecd.org/dataoecd/44/2/2086192.pdf (date accessed: 22 September 2003); in its report, the OECD proposed to depart entirely from the ownership and control requirement and to rely on alternative provisions to ensure the integrity of regulatory oversight arrangements. Such alternative provision would simply require that a designated air carrier is incorporated and has its principal place of business in the territory of the Contracting Party that designates it; moreover, it would be required that the designated air carrier be appropriately licensed by the Contracting Party that designates it, and that the designating Party is maintaining and administering adequate safety and security standards.

[406] IATA, Policy Paper, *Airline Views on Liberalizing Ownership and Control*, online: IATA, http://www.iata.org/WHIP/_Files/WgId_0205/IACOCFinal2_English.pdf (date accessed: 22 September 2003). For details concerning the IATA proposal see *infra* note 410.

[407] See *supra* Chapter 1.2.3.

[408] ICAO, Working Paper, ATConf/5-WP/7, *supra* note 48 at para. 4.1; The model clause is set out at para. 4.6.; The Secretariat proposed that 'evidence of principal place of business includes such factors as: the airline is established and incorporated in the territory of the designating Party in accordance with relevant national laws and regulations, has a substantial amount of its operations and capital investment in physical facilities in the territory of the designating Party, pays income tax, registers and bases its aircraft there, and employs a significant number of nationals in managerial, technical and operational positions.' The Secretariat proposed that 'evidence of effective regulatory control includes but is not limited to the airline holds a valid operating licence or permit issued by the licensing authority such as an Air Operator Certificate (AOC), meets the criteria of the designating Party for the operation of international air services, such as proof of financial health, ability to meet public interest requirement, obligations for assurance of service: and the designating Party has and maintains safety and security oversight programmes in compliance with ICAO standards'

[409] *Ibid.* at paras 6-7.

[410] IATA, Working Paper (*Worldwide Air Transport Conference: Challenges and Opportunities of Liberalization*) No. ATConf/5-WP/26 (3 December 2002) [IATA, Working Paper No. ATConf/5-WP/26]; IACA, Working Paper (*Worldwide Air Transport Conference: Challenges and Opportunities of Liberalization*) No. ATConf/5-WP/33 (17 January 2003).

[411] IATA, *ibid.* at para 4.1.

designating State and the airline. On the other hand, labour representatives, such as IFALPA and ITF, strongly opposed the broadening of ownership and control requirements. They pointed out that the proposed changes did not address labour and social implications.[412] Airline ownership and control provisions had to be preserved in order to safeguard against the use of "flags of convenience", which would undermine labour and social standards.[413]

The risk of emergence of "flags of convenience" was raised throughout the Conference. Both delegations that strongly supported liberalization, as well as those that were more cautious, agreed on the paramount importance of safety and security. It was repeatedly stressed that liberalization should, in no way, compromise safety and security. A predominant concern of delegations was that under a new regime the responsibility and lines of authority for safety and security oversight might not remain clear.[414]

Many delegations took the view that the proposal made by the ICAO Secretariat created the necessary link between carrier and designating State and strengthened regulatory control by the designating party, including aviation safety and security. Others, however, were more cautious. Several delegations considered their concerns as regards safety and security as a reason to advocate the maintenance of the current regime.[415]

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[412] ITF, Working Paper, ATConf/5-WP/75, *supra* note 62; IFALPA, Information Paper (*Worldwide Air Transport Conference: Challenges and Opportunities of Liberalization*) No. ATConf/5-WP/34 (25 February 2003)

[413] It its working paper, ITF vigorously refuted the arguments that were brought forward by proponents of liberalization of airline ownership and control. The model clause proposed by the ICAO Secretariat would not create the link necessary to prevent the emergence of 'flags of convenience'. Broadening the ownership and control criterion would risk opening the airline sector to social dumping, safety dumping, security dumping and reduced oversight; see ITF, *supra* note 412 at para. 2.

[414] See *e.g.* US, Working Paper (*Worldwide Air Transport Conference: Challenges and Opportunities of Liberalization*) No. ATConf/5-WP/96 (11 March 2003).

[415] See *e.g.* Members of LACAC, Working Paper (*Worldwide Air Transport Conference: Challenges and Opportunities of Liberalization*) No. ATConf/5-WP/99 (24 March 2003), who expressed their view that no solution acceptable to the majority of States has yet been found. Special attention should be paid to concerns such as, *inter alia*, the potential emergence of 'flags of convenience' and the deterioration of safety and security standards. Pakistan, Working Paper (*Worldwide Air Transport Conference: Challenges and Opportunities of Liberalization*) No. ATConf/5-WP/57 (12 March 2003), who believed that excessive change could lead to 'flags of convenience' and therefore supported the preservation of the national ownership and control criteria as applied in ASA on a case-by-case basis. Republic of Korea Working Paper (*Worldwide Air Transport Conference: Challenges and Opportunities of Liberalization*) No.

Proponents of liberalization emphasized the economic benefits of broadening the criteria. Such broader criteria would widen access to capital markets, reduce air carrier's dependence on government financial support, and allow airlines to build more extensive networks through mergers and acquisitions, improve the health of the industry as well as increase efficiency and competition in international air transport markets.[416] In particular, some developing nations articulated their support for a liberalized approach for air carrier designation and authorization. They outlined the difficult financial situation their airlines are facing, and stressed the need for foreign investment.[417] It was pointed out that the "Community of Interest" principle could only partially rectify those difficulties, since it expands the pool from which capital can be drawn to only other developing nations in similar economic situation.[418] In contrast to this progressive approach, a number of delegations repeatedly pointed out that liberalized ownership and control rules might endanger the existence of their national airline. The assurance of services was also a matter of concern for many of these developing States.[419]

Concerns were also raised as to the risk of increased appearance of "free riders" (i.e. where an airline of a third party uses bilateral traffic rights that its government does not have), industry concentration that could result in anti-competitive actions against smaller airlines, possible flight of foreign capital, which could lead to less stable operation and national emergency requirements.[420]

ATConf/5-WP/101 (24 March 2003), who pointed out that, although the principal place of business criterion includes safeguards to prevent concerns about safety and security, there will still be concerns with third party 'free rider' situation if applied in bilateral agreements. During the discussion, Japan raised the argument that the ICAO Secretariat's proposal remains ambiguous with respect to a clear responsibility for safety and security.

[416] ICAO Doc. 9819, *supra* note 392 at para. 2.1.2.1. For a more detailed description of the advantages of air carrier ownership and control liberalization, see *supra* Chapter 2.

[417] See Barbados, Working Paper (*Worldwide Air Transport Conference: Challenges and Opportunities of Liberalization*) No. ATConf/5-WP/48 (4 February 2003); 53 African States, *supra* note 398.

[418] Barbados, *ibid.* at para. 2.5. In contrast to this, the delegation of ACAC asked for the floor, in order to point out that lack of capital is *not* the reason for the financial difficulty of airlines.

[419] Conversely, some small island States without a national airline, such as Maldives, favoured a broadened criteria as means for attracting service by foreign airlines of for attracting service by foreign airlines or for attracting capital if they should decide to establish an airline in future.

[420] ICAO Doc. 9819, *supra* note 392 at para. 2.1.2.1. For a more detailed description of the risks, see *supra* Chapter 1.2.1.2.

A number of delegations expressed support for retaining the traditional ownership and control criteria, particularly in bilateral ASAs. Based on the traditional thinking of reciprocity, those delegations stressed the need to take into account the disparities in economies, markets and competitiveness of airlines between the partners to the agreement.[421] Considering that some States had already agreed on alternative ownership and control provisions, or had even waived those criteria, some delegations did not see any need for agreeing on common alternative criteria. Support for gradual liberalization of air carrier ownership and control at the regional level was, however, stronger.[422]

Repeatedly, certain delegations made it clear that they were not (yet) ready to liberalize. They emphasized that liberalization should not be seen as an objective, but rather as a process open for every State as an option at their own choice.[423] A solution that would dictate one single approach was not acceptable to them.

These delegations could, however, be reassured once it appeared that "flexibility" would be the underlying principle in any new approach to liberalization. Fearing that the Conference might fail to bring about any reform, EU Member States as well as the US in particular continually stressed "flexibility" in their interventions.[424]

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[421] E.g. Republic of Korea, *supra* note 415, who believed that national ownership and control criteria are more appropriate for the bilateral air transport framework, while the principal place of business criterion could be applied more appropriately in regional frameworks. With respect to the principal place of business criterion, there were still concerns with a third party 'free rider ' situation if a member State in a region concluded a bilateral containing this criterion with a State outside of the region.

[422] See e.g. ACAC, Working Paper (*Worldwide Air Transport Conference: Challenges and Opportunities of Liberalization*) No. ATConf/5-WP/65 (14 March 2003); Korea *supra* note 415.

[423] In particular, the delegations of Russia, Argentina, Japan, Brazil, Chile and Saudi Arabia expressed this concern.

[424] See EU, ECAC and their Member States, Working Paper (*Worldwide Air Transport Conference: Challenges and Opportunities of Liberalization*) No. ATConf/5-WP/84 (10 March 2003), who considered that the economic situation of many airlines, the need to make international financial resources more accessible for aviation, and the wish of the air transport industry to have the same commercial freedom enjoyed by other sectors of the economy could be met by three key principles: 1) States should accommodate any other State that wishes to liberalize its ownership and control restrictions unilaterally or as part of a group of like-minded States; 2) with appropriate assurances on safety, consideration should be given to designation of airlines based in a third country; and 3) ICAO Member States should develop a common approach to liberalizing ownership and control requirements while ensuring high standards in aviation safety. During the Discussion on air carrier ownership and control, the term of 'flexibility' was first stressed by the delegation of UK. The UK exposed that air carriers are in need for investment, but that States could not be forced to accept investment from other States. Therefore, there should be a flexible approach towards the application of ownership and control. Flexibility should, however, not be prescribed,

There were on the one hand those wanting substantially to broaden provisions governing air carrier designation and authorization; on the other hand, those more cautious with respect to liberalization. Under a flexible approach, more progressive States would respect the concerns of those not wanting to liberalize in the near term.[425] In return, more cautious States should allow the flexibility sought by others. In this regard it should be noted that EU Member States certainly had in mind that a flexible approach would facilitate the acceptance by other States of the "European Community Carrier".

3.3 The Outcome of ATConf/5

In contrast to ATConf/4, which failed to bring about any concrete reform on the issue of air carrier ownership and control,[426] the deliberations at ATConf/5 resulted in a *Declaration of Global Principles for the Liberalization of International Air Transport* (the Declaration), a number of Conclusions, a Model Clause on designation and authorization based on "principal place of business" and "effective regulatory control" and a Recommendation on the liberalization of air carrier ownership and control.

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but should evolve. Also India pointed out that the proposed model clause would have the function of option. In an intervention, the Chairman of ATConf/5 welcomed this flexible approach by the US and India. He observed that States felt concerns, but that it was crucial that a common solution would be found and that there would be some reform. He then underlined the need for flexibility. A global perspective would have to be taken in order to add a formula that allows for a mixed system of criteria without sticking to one single formula. The US delegation stated that 'flexibility' is the right emphasis. It would be essential that we look at ownership and control in the most flexible way. States would not be obliged to change their national ownership rules. However, if another State designates an air carrier that does not comply with the traditional ownership rules, this designation should not be refused or withdrawn.

425 It was interesting to observe that also the European Commission made a very consensus-seeking intervention. The Commission expressed its appreciation for the objections made by other States (specifically Japan and Brazil) against liberalized criteria for the designation of air carriers. This intervention has to be situated within the background of upcoming renegotiations of ASAs with third States. By intervening in this manner, it can be presumed that the Commission sought to reassure third States that renegotiations would meet the concerns of other States. The Commission certainly intended to give an example of flexibility. Giving due regard to the concerns of other States, the Commission could better expect from third States the acceptance of a 'Community Clause'

426 ATConf/5 only resulted in very vague Conclusions, without giving any concrete basis for adjustment and liberalization; ATConf/5 did not agree on any model clause nor did it recommend any action; see ICAO Doc. 9644, *supra* note 390 at para. 2.3.6.

The culmination of the Conference certainly lay in the Declaration, approved by ovation.[427] With respect to air carrier ownership and control, the Declaration unequivocally pronounces that "States should give consideration to accommodating other States in their efforts to move towards expanded transborder ownership and control of air carriers, and/or towards designation of air carriers based on principal place of business, provided that clear responsibility and control of regulatory safety and security oversight is maintained".[428]

Similar aspects form part of the Conclusions, which reflect the discussion held at ATConf/5.[429] They emphasize widespread support for liberalization.[430] At the same time, they stress the need for a flexible approach to liberalization. States should approach liberalization at their own pace, taking both the benefits and risks into account, while at the same time accommodating the approaches of others.[431] The Conclusions put emphasis on the paramount importance of safety and security in any liberalized arrangements.[432]

Besides these two documents, ATConf/5 agreed on two written documents that are intended as examples for concrete State action, namely an ICAO Model Clause and Recommendations.[433]

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[427] ICAO Doc. 9819, *supra* note 392 at 59; see also Abeyratne, "The Worldwide Air Transport Conference of ICAO", *supra* note 389 at 221.

[428] *Ibid.* at 61. Formally, Conference Declarations are of lower status than Conference Recommendations, once the Recommendations have been reported to and adopted by the ICAO Council. Yet, in the eyes of States the Declaration, being something adopted by a large number of States and organizations at the Conference, would appear to be of greater importance and significance and have greater weight than the Recommendation.

[429] It has to be noted that Conclusions do not have the status of Recommendations. However, the trend in recent years has been for Conferences to give close attention to and put special emphasis on its Conclusions. In the case of the Conclusions of ATConf/5, they have been sent out to States for their consideration and for follow-up action as necessary.

[430] ICAO Doc. 9819, *supra* note 392 at 59.

[431] *Ibid.* at para. 2.1.3.1. c).

[432] See ICAO, Working Paper (*Results of the Worldwide Air Transport Conference*) No. C-WP/12040 (17 April 2003) at para 3.3 [ICAO, Working Paper, C-WP/12040].

[433] It is significant that ATConf/5 brought about two important written documents for State action, whereas ATCon/4 only resulted in some Conclusions.

3.3.1 The ICAO Model Clause

The Conference adopted the regulatory arrangement that had been proposed by the ICAO Secretariat based on "principal place of business" and "effective regulatory control" (Model Clause).[434] The Model Clause distinguishes between economic and regulatory control. On the economic side, it replaces the traditional ownership requirement with the concept of "principal place of business". On the regulatory side, it underlines the responsibility of the designating State for the exercise of regulatory control over the designated air carrier by requiring "effective regulatory control".[435] Integral notes are attached to the Model Clause. They enumerate the criteria to evidence the links between the air carrier and the designating State.[436] For instance, evidence of "principal place of business" is predicated, *inter alia,* upon establishment and incorporation of the airline in the designating State, or the substantiality of the amount of operations and capital investment in that State.[437] Evidence of "effective regulatory control" is predicated upon, *inter alia,* the fact that the airline holds a valid operating licence or permit such as an Air Operator Certificate (AOC), or the fact that the designating Party has and maintains safety and security oversight programmes in compliance with ICAO standards. The Conference agreed that this Model Clause should be used as an optional criterion for market access in addition to the ICAO endorsed options for Community of Interest. The Model Clause was regarded as "a means to facilitate and contribute to the pursuit of the general goal of progressive regulatory liberalization", and as "a catalyst for broader liberalization".[438] It was stressed, however, that the use of the arrangement by a State would not necessitate that States change their existing laws or regulations pertaining to national ownership and control for its own carriers.[439] Interestingly, the use of the ICAO Model Clause is only proposed "without prejudice to the specifities of regional

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[434] See ICAO Doc. 9819 *supra* note 392 at para. 2.1.3.2. The Model Clause can be viewed at ICAO, Consolidated Conclusions, Model Clauses, Recommendations and Declaration, online: ICAO http://www.icao.int/icao/en/atb/ATConf5/documentation.htm (date accessed 08 August 2003).
[435] ICAO Doc. 9819 *ibid.*
[436] For a more detailed description of the integral notes see *supra* note 408.
[437] See ICAO Doc. 9819 *supra* note 392 at para. 2.1.3.2.
[438] *ibid.* at para 2.1.4.
[439] *Ibid.*

agreements".[440] This clarification has been introduced on request and in the interest of delegations that are party to regional arrangements. In fact, this provision complies with the needs of EU Member States and the Commission. It leaves room to take the steps necessary to bring international air transport relations in line with the ECJ judgments in the "Open Skies" cases.

3.3.2 The Recommendations

The Recommendation reflects many of the Conclusions and particularly emphasises the flexible yet discretionary approach to liberalization.[441]

The Conference recommended that, in the absence of liberal designation and authorization provisions in an ASA, "air carrier designation and authorization for market access should be liberalized at each State's pace and discretion progressively, flexibly and with effective regulatory control in particular regarding safety and security."[442] Also recommended was the new proposed alternative criterion of the Secretariat mentioned above, particularly to be applied to instances "where States addressed the issue of air carrier designation and authorization in their international air transport relationships, where they could use it as an option at their discretion in a flexible manner."[443]

The Conference also proposed "States may at their discretion take positive approaches (including coordinated action) to facilitate liberalization by accepting designated foreign air carriers that might not meet the traditional national ownership and control criteria or the criteria of principle place of business and effective regulatory control."[444] It is interesting to observe that this recommendation was only included into the Recommendations on the initiative of the UK delegation and as a result of an extremely controversial debate.[445] The disregard of such stipulation would have meant

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[440] *Ibid.* at para. 2.1.3.2.
[441] ICAO, Working Paper, C-WP/12040, *supra* note 432 at para. 3.3.3.
[442] ICAO Doc. 9819, *supra* note 392 at para. 2.1.4.
[443] Ruwantissa Abeyratne, "The Worldwide Air Transport Conference of ICAO", *supra* note 389 at 227.
[444] ICAO Doc. 9819, *supra* note 389 at para. 2.1.4.
[445] During the discussion of the Draft Report on Agenda Items 2 and 2.1, ICAO, Working Paper (*Worldwide Air Transport Conference: Challenges and Opportunities of Liberalization*) No. ATConf/5

omitting one pivotal result of the discussions held at ATConf/5 on air carrier ownership and control; one key element on which the international community had agreed upon would not have been recommended as an action by States. It is also important to observe that the inclusion of this point into the Recommendation was crucial to the EU Member States. This provision sets an example for a more liberal acceptance of alternative designation criteria. It will hopefully facilitate the approval by third States of the designation of "European Community Carriers", where this concept will not be integrated into the ASA.

Three options for action were recommended for States wishing to liberalize the conditions under which they accept designation of a foreign air carrier in cases where that air carrier does not meet the ownership and control provisions of the relevant air services agreements. States could make individual statements of policy for accepting designations of foreign air carriers; joint statements of common policy; or binding legal instruments, provided in all cases that these policies are developed in accordance with the principles of non-discrimination and non-exclusive participation.[446]

WP/105 (26 March 2003) at para 2.1.4, the UK asked for the floor in order to file the following amendment to the Recommendations to be introduced between recommendation a) and b): "States should accommodate the designation by other States of airlines *not* substantially owned and effectively controlled by the nationals of the designating States even when they have decided to maintain traditional nationality-based ownership and control rules for the designation of their own airlines. This will allow all States to determine at their own pace of liberalization, while not preventing States that wish to liberalize from doing so". This proposition caused very controversial reactions and an extensive debate. While some States agreed with the proposal and supported the fact that its inclusion in the Recommendations would simply mean clarification of what has been discussed, other delegations argued that the UK was reopening a debate at a point where it was too late. This debate was first terminated by the chairman, who agreed that the UK was not entitled to reopen the debate. After reprehension by the President of the Council, the chairman reopened the discussion. In the meantime, the New Zealand delegation had filed a proposal for an alternative recommendation, which was finally adopted without further discussion; see proposal related to WP/105 presented by New Zealand, Working Paper (*Worldwide Air Transport Conference: Challenges and Opportunities of Liberalization*) No. ATConf/5 WP/114 (27 March 2003); This procedure demonstrates that, despite the fact that there seemed to be vast agreement on the flexible approach during the discussion, the consensus is still relatively weak and might be destroyed easily.

[446] The Recommendation in this point differs from the proposal made by the Secretariat insofar as it introduces the words "whenever possible". This wording was included on the initiative of the delegations of France and Switzerland, who argued that the unrestricted recommendation of 'non-discrimination' and "non-exclusive participation" would imply a connotation of most favoured nation principle (MFN), which is in discordance with the principle of reciprocity in ASAs.

Among the actions recommended by the Conference is a requirement that "the State designating the air carrier provides or ensures the provision of adequate oversight of safety and security for the designated air carrier, in accordance with standards established by ICAO."[447]

The Recommendation proposed an information system with States notifying ICAO of their policies, positions and practices on designation and air carrier ownership and control criteria, ICAO making such information available to others.[448] It was also suggested that ICAO assist States, or groups of States, requesting development and further refinement of the Model Clause and continues to monitor developments as required.[449]

3.4 A Preliminary Assessment of the Outcome of ATConf/5

The Conference did not produce any binding document, nor did it agree on revolutionary change in the field of air carrier ownership and control. The international community did agree on compromise-oriented Conclusions and Recommendations, a very flexible approach that leaves room for liberalization as well as the maintenance of the traditional system. The question therefore arises whether ATConf/5 stayed behind what it could possibly have achieved.

The outcome of ATConf/5 has to be assessed in the light of its projected goal, as well as the surrounding circumstances in which the Conference took place. The main objective was "to develop a framework for the progressive liberalization of international air transport with safeguards to ensure fair competition, safety and security, and including measures to ensure the effective and sustained participation of developing countries."[450] The aim of ICAO was not to take any decision that would be binding on ICAO Member

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[447] See Abeyratne, "The Worldwide Air Transport Conference of ICAO", *supra* note 389 at 227.
[448] ICAO, Working Paper, C-WP/12040, *supra* note 432 at para. 3.3.
[449] See ICAO Doc. 9819, *supra* note 389 at para. 2.1.3.
[450] Assad Kotaite, "Address by the President of the Council of the International Civil Aviation Organization (ICAO)" (Address at the Opening Session of the Fifth Worldwide Air Transport Conference) online: ICAO http://www.icao.int/icao/en/atb/ATConf5/documentation.htm (date accessed: 7 August 2003).

States or that would predefine the path to be followed; in fact, the Conference did not have any constitutional power to take binding decisions.[451] Rather, "ICAO intended to offer a global forum for ICAO Member States and other concerned parties to examine issues and policy options in the field of air transport regulation and promote a better understanding of the concept and the impact of full liberalization."[452] What is more, ATConf/5 had to reconcile various approaches and opinions of participants from 145 Contracting States of ICAO and 26 observer organizations.[453] A major challenge to the Conference was the task of finding a common denominator between those States and delegations advocating far reaching liberalization and those averse to excessive broadening of the criteria for the designation and authorization of air carriers.

An assessment of the outcome of ATConf/5 has to address two aspects. First, does the result successfully facilitate the liberalization of air carrier ownership and control criteria? Second, does the outcome effectively address potential concerns, in particular the potential deterioration of safety and security standards?

3.4.1 Does the Result go Far Enough? Does it Facilitate the Liberalization of Air Carrier Ownership and Control?

The result of ATConf/5 takes into account two different scenarios. On the one hand, the Conference agreed on the draft Model Clause, which is intended to serve as an alternative criterion for air carrier designation and authorization. On the other hand, the Conference proposed a flexible approach towards liberalization in cases where States do not make use of the Model Clause in their respective ASAs.

Under the Model Clause, the traditional ownership requirement is no longer a condition for designation. Yet, an economic link with the designating State is still required, to ensure that the airline serves the designating country. Thus, in order to be effectively designated, it suffices that the air carrier has its principle place of business in

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[451] Note that the Air Transport Conference is not a body recognized by the Chicago Convention as part of ICAO and therefore not provided with constitutional power.
[452] Lelieur, *supra* note 11 at 147.
[453] ICAO Doc. 9819, *supra* note 392 at 2, 4.

the designating State and that the *same* State exercises "effective regulatory control" over the airline, no matter who owns the company. If e.g. State A and C entered into an ASA including the ICAO Model Clause, an air carrier based in State A and under effective regulatory control of the government of A can be designated to operate under this ASA, even though it is substantially owned by citizens of State B. C would *not* be permitted to refuse the designation of the airline on the basis of the carrier's nationality. Thus, under the Model Clause, foreign investors are given the legitimate right to exercise control over the undertaking in proportion to the committed funds. This way, investors are finally given some kind of certainty, which might enhance their willingness to invest in a foreign airline. This would provide air carriers with wider access to capital markets. Likewise, it allows for the designation of a merged carrier. Hence, the Model Clause significantly liberalizes the traditional criteria of "substantial ownership and effective control". It helps to create a more favourable environment, in which airlines can conduct their business according to the market conditions and their commercial needs.[454]

ATConf/5 did, however, not go so far as to provide for completely liberalized air transport relations. The shortcoming of the Model Clause lies in the maintenance of the economic link between the air carrier and the designating Sate. The following example will show that under this new approach, airlines still remain restricted in their options to operate. Assume Airline A of State A and Airline B of State B merge into one entity, operating as a single carrier, under one single brand name. This merged carrier (let us call it AB) has its principal place of business in State A and holds an Air Operator's Certificate (AOC) from State A. Now, AB would like to take advantage of the combined networks of A and B by operating from both State A and State B to a third destination, C. A and C have included the Model Clause in the respective ASA; so have B and C. Therefore, A could successfully designate AB to operate from A to C. However, even under the new approach, AB could *not* be designated to operate from B to C, since the carrier is economically linked only to State A. Thus, even under the new approach a

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[454] So also ICAO, Working Paper, ATConf/5-WP7, *supra* note 400 at para 4.4.

carrier can only operate from one single State, namely that State to which it maintains an *economic* as well as a *regulatory* link.

As this scenario demonstrates, the Model Clause still restricts the benefits of a merger between two airlines that would like to broaden and integrate their networks. The only way to bypass this constraint is to separate the carrier artificially, by setting up a subsidiary in another State and submitting this subsidiary to the regulatory control of that second State. Hence, the Model Clause does not facilitate complete cross-border marketing integration, and even less the creation of a true multi-national carrier.[455]

Such facilitation could have been achieved, had ATConf/5 agreed on a clause that completely scraps the economic link. The Conference did not, however, approve the IATA proposal that suggested leaving regulatory control of safety and security as the only connection between the designating State and the airline.[456] The IATA proposal argues that an airline should be allowed to fly anywhere, as long as its operating license is valid and recognized by the receiving State.[457] Under this approach, still taking the above described scenario, C would recognize the operating authorization of AB as the designated carrier of A, to serve C from *anywhere* in the world as long as it remains licensed by A. AB could completely integrate the two networks and operate as one single, multinational carrier. This proposal envisages completely liberalized international air transport, where airlines, like any other business, can operate freely.

Given the positions stated at the Conference, such a far-reaching approach, even if economically reasonable and desirable, would have provoked fervid objections by most delegations. In fact, if the only designation criterion were regulatory control, the bilateral agreement under which the airline is designated would cease to influence who benefits

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[455] Compare also Horan, *supra* note 299 at 4.
[456] As noted earlier, such a complete abolition of the economic connection had been proposed by IATA, see IATA, Working Paper, ATConf/5-WP/26, *supra* note 410. Such far going approach is only provided for in the Template Air Service Agreement (TASA) as a model clause for fully liberalized air transport relations; see *Template Air Services Agreements for Bilateral, Regional or Plurilateral Liberalization*, ICAO, Working Paper (*Worldwide Air Transport Conference: Challenges and Opportunities of Liberalization*) No. ATConf/5-WP 17 (27 January 2003) at A-10, B-14 [TASA].
[457] See IATA, Working Paper, ATConf/5-WP/26, *supra* note 410 at para. 4.1. b).

from operations.[458] Under this approach, for instance, a carrier that remains under the effective regulatory control of Germany, but has its principal place of business in the US or is owned by US citizens, could be designated by Germany to operate under the Germany-Japan ASA. The only way to prevent the designation of the US carrier would be to allege that the German Government did not exercise regulatory control over the carrier. Under that ASA, Japan would have no ability to make sure that the benefits of the ASA remain tied to Germany, or that no third State takes an unreciprocated advantage of the granted benefits. In such a scenario, this might permit the US carrier to get a "free ride" to Japan. At the same time, for Germany, it would mean sharing the benefits of the negotiated rights with the US. If that is the case, the German Government might conclude that there is only limited economic benefit for Germany to negotiate and exchange commercial rights with Japan. The example demonstrates that the abolition of the economic link would break the traditional concept of reciprocal exchange of economic benefits.[459] It would have been extremely optimistic to hope that the international community present at ATConf/5 would do away with this concept, which is enshrined in international air transport regulation.[460]

It is regrettable that the Model Clause does not provide incentives for States to liberalize air transport on a wide and multilateral scale. Rather, it perpetuates the traditional bilateral system.[461] ATConf/5 simply proposes that States consider the use of the Model Clause.[462] This implies a choice in favour of a system whereby governments take the role of negotiating commercial rights on a bilateral or plurilateral basis. As has

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[458] ICAO, *Report of the Air Transport Regulation Panel Working Group on Air Carrier Ownership and Control*, ICAO Doc. ATRP/10/WG (16 September 2002) at 12.

[459] In contrast to that, the ICAO model clause expressively takes into account the concept of reciprocity; see ICAO, Working Paper, ATConf/-WP/7, *supra* note 400 at para. 4.5.

[460] The Conference discussed an overhaul of the bilateral system under the issue of Market Access. In this context, ATConf/5 concluded that 'the basic GATS principle of most favoured nation (MFN) treatment to traffic rights remains a complex and difficult issue', and that 'while multilateralism in commercial rights to the greatest extent possible continues to be an objective of the Organization, conditions are not ripe at this stage for a global multilateral agreement for the exchange of traffic rights. States should continue to pursue liberalization in this regard at their own choice and own pace, using bilateral, regional and/or multilateral avenues as appropriate'; see ICAO Doc.9819, *supra* note 389 at para. 2.2.3.1. d) and e).

[461] It should be noted, though, that ATConf/5 concluded that States may choose to liberalize air carrier ownership and control on a unilateral, bilateral, regional, plurilateral or multilateral basis; see ICAO Doc. 9819, *supra* note 389 at para. 2.1.3.1. h).

[462] *Ibid.* at para. 2.1.3.2.

been demonstrated earlier,[463] such a segmental liberalization carries risks. Nothing guarantees that third States that adhere to more restrictive criteria will not undermine the benefits of the liberalized criteria used by others. The effectiveness of the clause thus considerably depends on the number of States that utilise it in their respective ASAs.[464] However, the "inherent inflexibility of the [bilateral] system in not being able to facilitate accord among a large number of involved States"[465] will make it difficult, if not impossible, to achieve a broad and universal application of the Model Clause.[466]

It might therefore seem justified to conclude that by agreeing on the Model Clause, ATConf/5 did not achieve more than creating one additional alternative criterion to the traditional clause without providing for a comprehensive solution.

Such a conclusion would, however, mean ignoring one major achievement of the Conference. By adopting the concept of "flexibility", ATConf/5 provides an example that might help overcome the conflict between different approaches to ownership and control. The result encourages more cautious States to accept the designation of air carriers that do not comply with the traditional criteria, irrespective of their own rules as to air carrier designation. In the end, this means a departure from the strict thinking of "reciprocity". The adoption of this flexible approach might impel States to deviate more often and more deliberately from the traditional clause. If used by States in the future, the flexibility promoted by the Conference might, indeed, pave the way for enhanced gradual liberalization of international air transport. It is desirable that such liberalization takes

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[463] See Chapter 1.2.3; Chapter 2.2.1.
[464] See also Janda, *supra* note 3 at 47.
[465] Abeyratne, Ruwantissa, "Liberalization of Trade in Air Transport Services" (2003) 4:4 Journal of World Investment 639 at 640 [Abeyratne, "Liberalization in Trade"].
[466] Janda, *supra* note 3 at 47, goes one step further. He points out that, even if commonality to ownership and control rules is achieved in most major bilaterals, significantly different grants of traffic rights as between different bilaterals would produce incoherence in the operation of a liberalized ownership and control regime. He gives the example of Canada and US, both agreeing on the inclusion of the Model Clause in their ASAs with the EU. The US would, however, receive a more favourable grant of rights (*e.g.* on 5th freedom routes) than Canada. Under such conditions, a foreign ownership stake in a Canadian carrier would be less attractive than one in a US carrier simply because of the grant of rights. Canadian carriers would be brought to invest in US carriers and to move their principal place of business to the US for entirely artificial reasons. Janda concludes, "the very regime designed to free the flow of capital – liberalized ownership and control – would constrain and distort the flow of capital because of its presence within the bilateral system."

place on a plurilateral or even multilateral basis, as was proposed by the Conference.[467] ICAO's role as a Registrar, administering information on the attitudes of States will be an important medium to facilitate any such evolution towards liberalization. By the means of the registry, the risk related to trans-border transactions will be more calculable. Hereby, ICAO will help increasing the badly needed certainty.

As has been seen,[468] States have already made exceptions in earlier instances in order to accommodate liberal approaches by other States and air carriers. In this respect the results of the Conference are not revolutionary. It also has to be kept in mind that neither the Model Clause nor the recommendation of "flexibility" has any binding force. In fact, it remains up to each State as to what extent it will make use of the options. In this sense, one could argue that ATConf/5 simply endorses what States had been doing prior to the Conference and would do in future anyway.[469] It is a significant, however, that States at AtConf/5 for the first time declared openly, and at an international forum that they are willing to look favourably at those who want to move faster towards liberalization of air carrier ownership and control. It is also the first time that States confirmed such willingness in a written document. The endorsement of such modern approach by ICAO definitely contributes to a change in the traditional way of thinking.

3.4.2 Does the Result go too far? Does it Create Sufficient Safeguards against Risks Attached to Liberalization?

When evaluating the result of ATConf/5, one has to consider whether the new approach creates sufficient safeguards against the potential risks attached to liberalization. It is essential that liberalization does not jeopardize safety and security standards, that social concerns are sufficiently taken into consideration and that economic concerns are met.

On the economic side, the result of ATConf/5 remains very balanced. On the one hand, the economic link is broadened and cross-border mergers and acquisitions are

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[467] ICAO Doc. 9819 at para. 2.1.3.1 h).
[468] See e.g. the example of Aerolineas Argentinas, *supra* Chapter 1.2.3.
[469] Such provocative reflection has also been made by Abeyratne, "The Worldwide Air Transport Conference of ICAO", *supra* note 443 at 224.

facilitated. On the other hand, the Model Clause has not entirely abolished the economic link. The authorizing State can, therefore, still exercise control over the beneficiary of granted traffic rights. As has been explained earlier, the concept of balance of benefits can still be pursued. This allows States to bar "free riders" access to their markets.

The result of ATConf/5 facilitates access to international capital markets. Presumably, particularly in the developing world, airlines will take advantage of this new option. This will enhance the sustainability of some carriers. Where airlines profit from increased capital, services will be assured. At the same time, as a result of liberalized criteria for designation and authorization, some other carriers will disappear from the market. The result of the Conference does not prevent this evolution. Until today, however, it has to be realized that the airline industry has been treated unlike most other industries. In order for the entire industry to recover, States have to give up their protective attitude. Under the liberalized approach adopted by ATConf/5, the market, and not governments, will be able to regulate the airline industry. The optional character of the Conclusions and Recommendations leaves it up to States whether to face the risk, and let the market regulate itself or to pursue the traditional way of protecting the national airline. The result of ATConf/5 does not limit those States that would like to take advantage of the benefits offered by liberalized ownership and control. At the same time, it allows States to adhere to the traditional approach.

The Conference attached great importance to safety and security, as well as to social standards. This aspect is reflected in the concluding documents issued by ATConf/5. In fact, the Conclusions as well as the Recommendations, repeatedly stress the importance of safety and security and the need to properly address the economic and social impacts of liberalization.[470] Moreover, the documents emphasize that other potential risks associated with foreign investment have to be taken fully into account.[471]

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[470] ICAO Doc. 9819, *supra* note 389 at para. 2.1.3.1. e) and para. 2.1.4. a).
[471] *Ibid.* at para. 2.1.3.1. e).

The underlying principle is the need to establish clear lines of responsibility and accountability for safety and security in liberalized arrangements.[472]

It now remains to be analyzed whether the Model Clause establishes clear lines of responsibility. As seen earlier, the Model Clause preserves the link between the air carrier and the designating State. When compared to the traditional ownership and control clause, this element reinforces the obligation on the part of the designating State to maintain effective regulatory control over the airline it designates. Under the traditional approach, the term "effective control" mainly refers to economic control over the carrier.[473] In contrast to this, the Model Clause envisions control primarily through licensing, which can include both economic and operational elements.[474] According to the annotations to the Model Clause, such effective regulatory control specifically includes that the designating Party has and maintains safety and security oversight programmes in compliance with ICAO standards.[475] Therefore, in comparison to the traditional concept, the new Model Clause strengthens the responsibility of the designating State for safety and security oversight.

By establishing an economic as well as a regulatory link between the air carrier and the designating State, the Model Clause clearly identifies which party the responsibility for safety and security oversight falls upon. As noted earlier, under the proposed arrangement, it is not possible for a State to designate a carrier that has its principal place of business in another State. As a principle, a State can only designate a carrier to operate from and to that same State. Under this system, air carriers are not encouraged to "cherry pick" the State with the cheapest safety, security and social costs as a State of designation, *i.e.* to establish a "flag of convenience". If they did so, the carriers would be limited to operations from, to or via that State.

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[472] See *ibid.* at para. 2.1.3.1. and para. 4.2.3.1., 4.6.
[473] See under Chapter 1.2.2.
[474] See integral notes, ICAO Doc. 9819, *supra* note 389 at para. 2.1.3.1. (i)
[475] *Ibid.*

Moreover, the Model Clause retains the discretionary right of the receiving State to refuse the authorization of a designated carrier, should there be any doubt as to the fulfillment of regulatory duties by the designating State. The continued availability of this right, coupled with strengthened regulatory controls including those required of the designating party, provides the means a receiving party needs to address potential concerns such as safety and security aspects including potential emergence of "flags of convenience".[476]

3.5 Concluding Remarks

The outcome of ATConf/5 constitutes a significant step towards liberalization. This chapter has shown that States seem willing to move away from deadlocked standards and the traditional way of thinking. The outcome of the Conference establishes the basis for the liberalization of designation criteria, while creating sufficient safeguards against the risks attached to liberalization. It now remains to be seen whether States take the result of ATConf/5 seriously and adhere to what they there endorsed. Taking the example of the EU, the final chapter will examine whether the positive atmosphere created by the Conference will have any practical implications on future relations and the evolution of the airline industry.

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[476] ICAO Working Paper No. ATConf/5-WP7, *supra* note 48 at para. 4.4.

CHAPTER 4: THE SIGNIFICANCE OF THE OUTCOME OF ATCONF/5 FOR THE RESTRUCTURING OF THE EU AIRLINE INDUSTRY

The previous chapters have shown that the European airline industry needs restructuring and that ownership and control rules constitute an impediment to reorganization through cross-border mergers, takeovers and foreign investment. Because of the ECJ decision in the "Open Skies" cases, existing nationality clauses in ASAs with third States will have to be renegotiated. In removing barriers to consolidation, the EU will have to rely on the flexibility of other governments. ATConf/5 created an atmosphere where States were urged to accommodate liberal approaches adopted by others, even when they themselves adhere to rules that are more restrictive. It has, however, been demonstrated that the documents issued by ATConf/5 are simply advisory in character. They cannot be used directly by Member States or the Commission to enforce the acceptance of the "Community Carrier" concept. This chapter considers, whether the outcome of ATConf/5 will nevertheless facilitate the task of renegotiating nationality clauses, thereby removing regulatory barriers to airline reorganization. In order to answer this question, this chapter will review the development of ownership and control issues in air transport relations between the EU and third States, and assess whether ATConf/5 will advance those relations. If so, it may be concluded that the outcome of ATConf/5 has some significance for the restructuring of the European airline industry.

4.1 The Significance of the Outcome of ATConf/5 for the Liberalization of Ownership and Control Requirements in EU – US Air Transport Relations

The ruling of the ECJ in the "Open Skies" cases was primarily concerned with the air transport relations between EU Member States and the US. It is, therefore, essential first to consider the potential impact that ATConf/5 might have on the development of ownership and control issues in EU - US air transport relations, before addressing other EU-third party relations.

4.1.1 Ownership and Control Issues as Envisioned by the EU Before and During ATConf/5

Before ATConf/5, EU policy regarding ownership and control with the US was based on the concept of a Transatlantic Common Aviation Area (TCAA). The creation of a TCAA was first proposed by the Association of European Airlines (AEA),[477] and later adopted by the Council as a key objective for the Community. It was finally endorsed and promoted by the Commission.[478] The proposed TCAA contains virtually all of the features of the US model open skies agreement, but goes considerably beyond that.[479] It is intended to take liberalization further by creating a common transatlantic market, after the example of the EU common air transport market. The core features of the TCAA proposal are: a) the freedom to provide services; b) airline ownership and the right of establishment; c) competition policy; and d) leasing of aircraft.[480]

Since the ECJ judgments in the "Open Skies" cases, the Commission has reinforced its promotion of this project, indicating it will be negotiated by the Commission itself on behalf of the Member States. Under the name "Open Aviation Area" (OAA), but comprising the same elements as the TCAA, the Commission intends to combine the deregulated US domestic market with the liberalised EU single market. According to the Commission, the OAA would amount to a veritable free trade area in air transport, encompassing not just transatlantic operations but operations within the EU and the US as well. For present purposes two features of the proposed OAA are especially

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[477] Initial views on such a new regulatory framework between the EU and the US were put forward by the AEA in a 1995 policy paper on EU external aviation relations. A more detailed proposal, which laid out the proposed elements of a TCAA was developed by the AEA in 1999. See AEA, *Towards a Transatlantic Common Aviation Area – AEA Policy Statement* (September 1999) [AEA, TCAA policy paper].

[478] See EC, Commission, *White Paper- European transport policy for 2010: Time to Decide, 12 September 2001,* online: European Commission, http://europa.eu.int/comm/energy_transport/en/lb_en.html (date accessed: 24 September 2003); under Part IV "Managing the Globalisation of Transport", one section is devoted to "the urgent need for an external dimension to air transport": Here, the Commission explains the need for a TCAA type agreement with its main partners (US, Japan, Russia, etc.) based on the principles of free access to traffic rights, equal conditions of competition, safety, environmental protection and the elimination of property rights.

[479] Ulrich Schulte-Strathaus, "Common Aviation Areas: The Next Step Towards International Air Liberalization" (2001) 16-SUM Air & Space Law. 4 [Schulte-Strathaus, "Common Aviation Areas"].

[480] See AEA, TCAA policy paper, *supra* note 477 at 2.

important: "There would be *no restrictions on ownership and control of US airlines by European investors* (including European airlines), and *no restrictions on ownership and control of European airlines by US investors* (including US airlines)."[481] Likewise, "EU investors or airlines would have the right of establishment in the US and US investors or airlines would have the right of establishment in the EU."[482] Concerning market entry and access, it is contemplated that carriers may operate between any two points in the OAA. This is the case even if that service does not include a point in the carrier's homeland (*i.e.,* a Seventh Freedom service), or, indeed, is operated solely between two points in an OAA member country (*i.e.,* cabotage service).[483]

EU policy on ownership and control issues implies a free trade approach. Instead of simply liberalizing ownership and control provisions on a bilateral basis, the proposal intends to completely do away with all restrictions. Within the area, nationality clauses for designation would no longer have a role to play, since this area would be treated as one single market. In order to operate, it would suffice to be granted an operating license. The historic concept, by which governments regulate international competition, would be completely abandoned within the area and replaced by a framework where airlines could be organized on a multinational basis.[484] As a *consequence* of this envisioned free trade approach, a UK citizen could freely invest in a carrier operating and based in the US, just as a US investor could do the same with regard to a carrier operating within the UK.[485]

It is interesting to observe that the proposal envisions only a selective elimination of restrictions on foreign ownership and control of national airlines.[486] Indeed, while those restrictions would be entirely lifted for the benefit of EU and US carriers, they would still apply to all *foreign* investors and airlines. This implies that there would have to be an "OAA nationality", which would be decisive for the determination of the beneficiaries of the OAA. In order to draw a line between beneficiaries and non-

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[481] The Brattle Group, *supra* note 4 at 1-13.
[482] *Ibid.*
[483] Schulte-Strathaus, "Common Aviation Areas", *supra* note 479 at 4.
[484] Horan, *supra* note 299 at 2.
[485] *Ibid.*
[486] The Brattle Group, *supra* note 4 at 1-13.

beneficiaries of the OAA, the proposal requires the air carrier to be "majority owned or controlled" by "OAA nationals". Only if the carrier complies with these criteria would it be granted an operating licence, allowing it to enter the OAA market and conduct air transport within the area. Services operated to a point outside the area, or by a carrier from a nation outside the area, would continue to be governed by traditional ASAs.[487] The choice of the criterion of "ownership and control" relies on the arguments considered by the AEA in its policy paper on the TCAA. Besides the "substantial ownership and control" criterion, the AEA also examined a criterion based on "place of incorporation" and "principal place of business".[488] The choice was, however, made in favour of the first option. Only by applying this more restrictive alternative could the open area be protected against free-riders.[489] Moreover, it was hoped that by restricting the right of establishment to nationals of Parties to the open area, third States would be encouraged to join the agreement.[490] This would progressively extend the concept of open access to other countries and regions.

The proposal for a common or open aviation area between the EU and the US has received approval from the industry.[491] European airlines see some benefit in enlarging the internal EU market over the Atlantic. The Brattle Group, which has been commissioned by the Commission to estimate the economic value of open access, estimated 5bn Euros of direct consumer benefits. In this total, Brattle claims that the major benefit of open access (3bn Euro) would result from massive productivity gains.[492]

When the international community came together in Montreal, the Commission certainly still had the negotiation of an OAA in mind. As a precondition for such a negotiation, the Commission had to be granted the negotiating mandate, which,

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[487] *Ibid.*
[488] AEA, TCAA policy paper, *supra* note 477 at 9. According to the AEA, applying within the TCAA the more flexible approach would mean that third country nationals, including third country airlines, could set up airlines in TCAA countries who would then be allowed to operate freely within the TCAA, without any assurance that TCAA nationals/airlines would be treated similarly elsewhere.
[489] *Ibid.*
[490] *Ibid.*
[491] BA and Virgin Atlantic have expressly endorsed the project; see the UK, H.L., *supra* note 215 at 17-18; Lufthansa has also expressed its support; see Buyck, *supra* note 357.
[492] The Brattle Group, *supra* note 4 at 1-13.

when ATConf/5 took place, had not yet been agreed upon by the EU Council. As long as the question of partition of competences between the Member States and the Community was not clarified, neither Member States nor the Commission could do more than endorse the term "flexibility". The adoption of this term would facilitate the pursuit of either a Community approach or negotiations by individual Member States.

4.1.2 Ownership and Control Issues as Envisioned by the US Before and During ATConf/5

The enthusiastic promotion of the free trade approach by the Commission was not reflected by the US counterpart either before or during ATConf/5.

As a first reaction to the ECJ decisions, the US government expressed its willingness to modify its ASAs with each EU Member State individually. On the issue of the infringing nationality clauses, it was stressed "the US from time to time has waived its objections under such clauses in the interests of ensuring fuller participation in the aviation market by certain trading partners and to encourage competition".[493] In order to underline this position, reference was made to the earlier-mentioned "Cargo Lion" decision.[494] As if to prove that the US had a liberal approach to the ownership and control issue and that it was not too concerned by the EU requirement to amend the nationality clauses, the US stressed its departure from the conventional approach to airline nationality in the APEC Agreement.[495]

The US then made an offer (specifically to those EU Member States that have signed open skies agreements with it) that it would substitute the offending nationality clauses. The system proposed by the US would "allow multi-EU ownership of any EU designated airline, provided that the airline "has its principal place of business" in the designating State and that the designating State "maintains effective regulatory control"

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[493] Jeffrey Shane, "The US Official Comments", *supra* note 369.
[494] See *e.g.* Mendelsohn, "The United States, the European Union", *supra* note 332 at ¶ 25,151.
[495] The agreement expressly prohibits any signatory country from objecting to operations by any airline that has its principle place of business in the country from which its flights originate on the grounds that it is not owned by citizens of that country.

over the airline, including issuance of a valid operating license or permit such as an Air Operator's Certificate.[496] This proposal would thus have waived all traditional ownership requirements, and substituted an "effective regulatory control" approach for the vague "effective control" test in the APEC agreement.[497]

The US proposal to enter into negotiations with Member States on an individual basis was rebuffed by the Commission in a letter to Member States, in which they were warned to reject such a "minimalist proposal".[498] According to the Commission, such a proposal would not take into account the requirements established by the ECJ. It would "fail to recognize the fundamental rights contained in the Treaty and the implications of past jurisprudence of the Court of Justice in the field of establishment."[499]

This statement is certainly right if the designation clause requires, as the clause proposed by the US did, that the designated air carrier has its principle place of business *in the designating country*. Under such a clause, an air carrier needs to have *one principal* place of business in the designating Member State.[500] Even if the carrier has several places of business in different Member States, it could only be designated by the one Member State in which it has its *principal* place of business to operate from that States to the US.

According to the ECJ, conversely, all Community carriers have the right under Article 43 of the EC Treaty to establish themselves in each other's territory with the right to claim international market access under the same conditions as nationally registered carriers.[501] At the same time, referring to earlier jurisprudence,[502] the ECJ underlined that it is enough for a Community company to set up a branch or an agency in a Member State

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[496] Mendelsohn, "The United States, the European Union", *supra* note 332 at ¶ 25,151.
[497] *Ibid.*
[498] See letter by François Lamoureux, director general of the Commission's transport and energy department, cited in Daniel Dombay, "Brussels escalates dispute on 'open skies'" *Financial Times* (31 January 2003).
[499] *Ibid.; see* also Mendelsohn, "The United States, the European Union", *supra* note 332 at ¶ 25,151.
[500] See ICAO Doc. 9819, *supra* note 392 at para. 2.1.3.2.
[501] ECJ, *Commission of the European Communities v Kingdom of Denmark* (C467/98) at para. 131.
[502] See ECJ, *Compagnie du Saint-Gobain, Zwiegniederlassung Deutschland v. Finanzamt Aachen Innenstadt*, C-307/97, [1999] E.C.R. I-6161 at para. 35.

in order to benefit from the right of national treatment.[503] It thus suffices that an air carrier has some sort of established presence in a Member State, such as a business, sales office or subsidiary, in order to be able to claim national treatment and thus to operate from that Member State to a third country.[504]

The difference between the two approaches lies in the term of "*principal* place of business". Two examples will illustrate this difference. LH, a German carrier, established and incorporated in Germany with the substantial amount of its operations there, has a sales office in Paris. Under the requirement established by the ECJ, LH would have to be treated equal to AF in the designation to operate *e.g.* to the US, since LH has *a* place of business in France. Under the Model Clause, however, LH could not be treated in the same way as AF, since LH does not have its *principal* place of business in Paris, but simply a sales office. LH could only be designated by Germany to fly from points in Germany to points in the US. As this comparison shows, the proposal of the US is significantly more restrictive than the view of the ECJ.[505] It does not sufficiently take into account the right of establishment. As has been demonstrated earlier, under such a system, EU carriers would still be prevented from creating a true multi-national carrier and from completely integrating the two companies.[506]

The US proposal can, however, easily be brought in line with the ECJ ruling, simply by adapting it to the specificities of the EU air transport market. One could, *e.g.*, take into consideration the negotiation of a designation clause, according to which each Contracting Party shall have the right to refuse to grant the operating authorizations in any case where that Party is not satisfied that the said airline has its principal place of business *in the Community* (any one of its Member States), and that said airline is under effective regulatory control of *any* Member State. Under such a clause, LH could be designated by any Member State, or in the case of a Community approach by the Commission, to operate from that Member State *e.g.* to the US. LH would be allowed to

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[503] Rene Fennes, *supra* note 309 at 18.
[504] *Ibid.*
[505] See UK, H.L., *supra* note 215 at 26.
[506] See *supra,* Chatper 3.4.1.

claim this right simply because LH has its principle place of business in one Member State of the EU.

Such a clause would sufficiently take into account the concept of "Community Carrier".[507] In fact, under this clause, the conditions for the designation and authorization of an air carrier would even be broader than what requires the ECJ ruling. A Community Carrier would not even be required to have an establishment in the Member State from which it would like to operate to the third State.

The Commission's argument that a designation and authorization clause based on "principal place of business" is not in line with the ECJ judgments can thus be easily refuted. For the Commission, the substitution of the infringing nationality clauses by such a clause would, however, mean accepting a solution that is limited to the mere conclusion of an ASA based on the traditional approach of government regulated international air transport. Such an approach would fall far short of what it is trying to achieve, namely the agreement of an OAA. Having this in mind, the Commission argued that a satisfactory outcome for European interests could only be achieved if the Commission were to be mandated by the Member States to enter into Community negotiations with the US.[508]

The US generally welcomed opening discussions with the Commission on liberalizing air services between the EU and the US. The US attitude as regards the extent to which air services between the EU and the US would be liberalized, however, differed quite substantially from the one expressed by the Commission. According to the US approach, the general concept of government regulated international air transport would

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[507] As an example, the UK Government has recently, with some success, attempted to persuade bilateral partners to accept a designation clause similar to the Model Clause. According to this clause, "each Contracting Party shall have the right to refuse to grant the operating authorizations in any case where that Party is not satisfied that the said airline is:

a) *incorporated* and has its *principal place of business* in the territory of a Member State of the European Union or of an European Free Trade Association State party to the Agreement on the European Economic Area; and
b) Holds a current Air Operator's Certificate issued by the aeronautical authority of a Member State of the European Union or of an European Free Trade Association State party to the Agreement on the European Economic Area." [emphasis added]. See UK, H.L., *supra* note 215 at 20.

[508] Letter by Lamoureux, *supra* note 498.

remain in place. Rather than the negotiation of a veritable free trade zone encompassing the open skies model, the US would envision the combination of bilateral opens skies agreements into one multilateral open skies agreement between the US and the EU. The US would agree on the renegotiation of the designation clause so as to accept the designation of "Community Carriers", and might even consent to granting EU carriers seventh freedom rights, thereby allowing EU airlines to fly from any point in the EU to the US. The main difference to the approach preferred by the Commission lies in the fact that such an EU - US open skies agreement would only liberalize ownership and control criteria for the designation and authorization of air carriers, without going so far as to eliminate national restrictions on foreign investment.

An attempt by the US Government "to test uncharted waters beyond its own model of open skies"[509], by opening up a multinational aviation area freed of all restrictions on foreign ownership would require consent in Congress on the amendment of US legislation. In particular, changes to the Civil Reserve Air Fleet (CRAF) and Fly America requirements, along with the dilution of cabotage restrictions would face strong political opposition.[510]

First, an elimination of ownership restrictions would raise concerns as to America's military readiness. Under the CRAF programme, US commercial air carriers pledge to provide military air-lift in a defence emergency in exchange for exclusive access to US Government peacetime business.[511] Department of Defence (DOD) officials fear that allowing foreign investors to acquire US air carriers would jeopardise the military's dependable access to this emergency capability.[512]

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[509] Schulte-Strathaus, "Common Aviation Areas", *supra* note 479 at 5.
[510] For a critical discussion in particular of the US justifications for maintaining national restrictions on foreign ownership, see Lelieur, *supra* note 11 at 54 ff.; Edwards, *supra* note 36 at 624 ff.
[511] The Brattle Group, *supra* note 4 at 1-7.
[512] *Ibid.* The DOD's concerns rest on three assumptions:
- US air carriers are more dependable than foreign air carriers;
- if a foreign entity bought a US air carrier it would operate as a foreign carrier;
- if the US Government changed its statutory policy to allow foreign ownership of US carriers it would open itself up to problematic transactions.

Another critical element of the proposal of the Commission is the fact that the abolition of ownership requirements would defeat the "Fly America" plan. Under this plan, any movement of passengers or cargo, including that of contractors, in anyway connected with US Government affairs has to take place on US airlines or on non-US airlines that have code-sharing agreements with US airlines. The cumulative impact of the "Fly America" policy is to reserve for US airlines a significant share of trans-Atlantic traffic.[513] Now, if foreign airlines were allowed to establish themselves in the US, and to invest or to take over US carriers, the benefits of these government contracts could no longer be preserved for US carriers.

Finally, removing restrictions on foreign ownership would allow foreigners to establish themselves in the US, by setting up an airline in the US or by buying a national airline. This would allow them to penetrate and to operate within the internal air transport market through their national subsidiaries.[514] The US domestic air transport market has until now been restricted to US carriers by cabotage rules. Giving foreign airlines the chance to penetrate and to operate freely within the domestic air transport market raises national security concern. At the same time, the prospect of having non-US airlines participate in the US domestic market has raised concerns with US carriers as well as organized labour. While US airlines are afraid of the new competitive pressure that calls into question their long-term viability,[515] organized labour is concerned that the elimination of ownership restrictions could facilitate the substitution of less expensive workers for more expensive domestic workers.[516]

The US delegation present at ATConf/5 abstained from making clear statements concerning the issue of ownership and control in air transport relations with the EU. Addressing the issue in a concrete manner before even knowing who would be the negotiating partner would have meant crossing the bridge before they came to it. It is,

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[513] UK, H.L., *supra* note 215 at 27.
[514] Lelieur, *supra* note 11 at 78.
[515] Shane, Jeffrey, "Airlines and National Security in the United States", (Separate Comments presented to the American Bar Association, "Cross-Border Investment in International Airlines: Presenting the Issues", 2000).
[516] The Brattle Group, *supra* note 4 at 8-1.; Edwards, *supra* note 36 at 626-628

therefore, necessary to interpret the general statements made by the US very thoroughly. Such an interpretation might give some information as to whether the US is willing to accommodate the EU position in the matter of ownership and control.

In its main intervention, the US delegate specifically stressed the need for flexibility, underlining that it remains an internal policy choice of each country as to how to deal with ownership and control.[517] Whatever path a country chooses, it should, however, keep the importance of a healthy air transport system in mind. The question should be whether ownership and control rules impede the flow of capital and, therefore, interfere with the development of a healthy air transport system. [518] The delegate then gave the example of the APEC Agreement as a positive example for liberalization. The US stressed that the APEC Agreement does not change national rules on ownership and control. Under the Agreement, each State is free to decide individually on the rules applicable to the designation process of its own air carriers. Once a State has designated an airline, the partner State is not allowed to refuse or withdraw the designation of the carrier for reasons solely based on the ownership of the designated air carrier. Finally, the delegate stressed the need of the airline industry for the free flow of capital, acknowledging that nationality rules, even those of the US, are an impediment to the free flow of capital and, therefore, a great concern.[519]

The intervention comprises at least three important aspects. First, by stressing the term "flexibility", one can deduce US willingness to accept liberal approaches to ownership and control by other States. For the EU this is valuable information, if not new. The US reiterates its earlier position, namely that it is prepared to agree on a substitute to nationality clauses that takes into account the concept of "Community Carrier". On the other hand, one can assume that by stressing the term "flexibility", the US is not simply pursuing altruistic goals. This assumption is reinforced by the fact that the delegate made particular reference to ownership and control rules as an internal policy choice. By underlining that it should be up to each State how to deal with the issue, the delegate

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[517] Personal notes taken at ATConf/5, Montreal, 25 March 2003.
[518] *Ibid.*
[519] *Ibid.*

justified the strict approach adopted by US laws on foreign investment. It also shows that the US is not likely to completely eliminate those rules.

Secondly, by giving the example of the APEC Agreement, the US seems to have intended to give proof of its liberal attitude. However, it also gives rise to the presumption that the US Government is willing to go as far as proposing an agreement similar to the APEC Agreement in future negotiations with the EU counterpart, but not further.

Finally, the last part of the statement made by the US delegate gives the hope that US national laws on foreign ownership might, if not eliminated, at least be amended. It has been stated earlier that the DOT has proposed to raise the limits on foreign ownership in US airlines from 25% to 49%, and that this proposal is currently under serious discussion.[520] The delegation clearly recognized that restrictions on foreign ownership impede the free flow of capital and that, for the sake of a healthy airline industry, it might be necessary to increase the amount of permitted foreign capital in US airlines. One may therefore conclude that there is some prospect for an amendment of US laws. At the same time, an overly optimistic attitude would be premature. In fact, one has to keep in mind that the delegation present at ATConf/5 was certainly composed of officials of the DOT itself.

The statements made by the US delegation at ATConf/5 reinforce the position already adopted by the US before the Conference. One can therefore summarize the US approach on ownership and control as follows: "The US would like to keep their designated air carriers owned and controlled by US citizens but does not insist on the nationality of foreign designated air carriers."[521] The US is thus open to endorse liberal approaches by others to the traditional criterion for designation and authorization of air carriers. However, "no formula ought to require a state (such as the United States) to alter

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[520] See *supra* Chapter 1.2.2.1.

[521] Henri Wassenbergh, "Towards Global Economic Regulation of International Air Transportation Through Interregional Bilateralism" (2001) 24 AASL 237 at 247.

its internal laws that govern ownership of its own airlines, no matter how willing that state is to accept multinational ownership of other airlines".[522]

4.1.3 The Outcome of ATConf/5

After having examined EU and US policy on ownership an control as it presented itself before and during ATConf/5, it remains to examine whether and in which way the outcome of ATConf/5 may influence the development of air transportations relations between the two in future.

The question first arises whether the outcome of ATConf/5 has any significance for the US position, as regards the recognition of the concept of "Community Carrier". Ostensibly, the outcome of ATConf/5 encourages States to liberalize the standard ownership clauses for the designation of air carriers. It encourages every departure from the restrictive approaches adopted in ASAs, but also advises States not to invoke traditional nationality clauses still in place where the air carrier designated by the partner State does not comply with the traditional ownership requirements. Now, what does this outcome add to the US policy and practice? In fact, not much. As has been described earlier, the US has declared its willingness to renegotiate infringing nationality clauses in order to accommodate the requirements established by the ECJ. The US is willing to take a flexible approach by authorizing the designation of air carriers that do not comply with the traditional standard clause. This flexible approach has even been manifested in earlier US practice (see "Cargo Lion"). When comparing the US position with the Conclusions and the Recommendation issued by ATConf/5, one has to come to the conclusion that the US position is already largely covered by the outcome of the Conference.[523] By advising an attitude of "flexibility", the outcome of ATConf/5 does not go further than what has already been implemented in US policy and practice as regards the recognition of the "Community Carrier".

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[522] Mendelsohn, "The European Court of Justice Decision", *supra* note 325 at 322.
[523] See ICAO Doc. 9819, *supra* note 392 at para 2.1.3.1. c), f), g); para 2.1.4. a), b), c).

The Model Clause as recommended by ATConf/5 is not new to US practice. When the US proposed to Member States to replace the infringing nationality clauses with a designation and authorization clause based on "principle place of business" and "effective regulatory control", the US used a formulation that was later endorsed as Model Clause by ATConf/5. Presumably, that this was no coincidence. The ICAO Secretariat had submitted its working paper in which it proposed the exact same clause, in October 2002, some time before the US made the offer to the Member States. This demonstrates that the US is not indifferent to developments taking place at ICAO. At the same time this fact might reassure the EU side that an agreement with the US on the accommodation of "Community Carriers" might soon be reached. Such an agreement could be based on a clause providing that each Party shall grant operating authorization, provided that the designated airline has its *principal place of business* in the *Community* (any one of its Member States) and that the airline is under the *effective regulatory control* of *any* Member State. Under such a clause, the economic link, if not completely scrapped, would at least extend to a plurality of designating States. This would be a big step forward in the direction of removal of regulatory barriers to cross-border mergers and acquisitions, at least among EU airlines.

Even though the outcome of ATConf/5 does not give the US any impulse to further liberalize its position as regards the recognition of "Community Carriers", the US position has been influenced by proposals made at the level of ICAO and endorsed by ATConf/5. The outcome of ATConf/5 has some, if also rather limited, significance for the US position as regards the recognition of the concept of "Community Carrier".

The second point that has to be addressed is the question whether the result of the Conference has any significance for the US position on the issue of the negotiation of an OAA. It will be argued that ATConf/5 does not encourage the US to adopt a more open attitude on this subject. This point can be illustrated by two arguments.

First, ATConf/5 essentially recommends the liberalization of criteria pertaining to air carrier designation and authorization for market access. The Model Clause is intended to serve as a concrete example of such liberalized criteria to be used in ASAs. This

recommendation implies the adherence to the historical concept whereby national governments have the role of designating national companies and negotiating with other national governments for the exchange of commercial rights.[524] The US clearly intends to maintain this concept. This is, however, not what the Commission has in mind when promoting the conclusion of an OAA. As has been explained earlier, the proposal for an OAA goes further than the simple liberalization of rules for designation and authorization in the existing bilateral system. It implies the complete abolition of these rules and a departure from the traditional system of air carrier designation.

Second, the debate at ATConf/5 was primarily concerned with the external aspect of the ownership and control issue. As an international conference, ATConf/5 was not in a position to address the internal aspect of the issue. Therefore, the Conclusions emphasise that no liberalized arrangement used at the international level should require a State to change "its existing laws or regulations pertaining to national ownership and control for its own carriers".[525] At another point, the Conclusions stress that flexibility is needed in order "to enable all States to follow the approach of their own choice at their own pace."[526] The outcome of ATConf/5 therefore does not put any pressure on the US to abolish or even change its laws on foreign investment in US airlines. On the contrary, the US can rely on the outcome of ATConf/5 in order to justify its position.

The outcome of ATConf/5 does not go so far as to expressively promote a concept similar to the OAA. Instead of bringing the US and the EU closer together in their position, and instead of backing up the promotion of an OAA, the result of the Conference has, in fact, strengthened the US position.

In conclusion, one can say that the outcome of ATConf/5 has very limited significance for the liberalization of air transport relations between the US and the EU. The outcome of ATConf/5 does not portend more than has already been practiced by the US in relation to the EU, nor does it encourage the US to completely eliminate its

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[524] Horan, *supra* note 299 at 5.
[525] ICAO Doc. 9819, *supra* note 392 at ICAO at para. 2.1.3.1. f).
[526] *Ibid.* at para. 2.1.3.1. c)

national restrictions on foreign ownership. ATConf/5 did thus not give fresh impetus to the question of removal of barriers to consolidation amongst EU airlines and between EU and US airlines. It will now be seen whether the Commission's mandate to open negotiations with the US gives such momentum.

4.1.4 The Commission's Mandate to Open Negotiations with the US in the field of Air Transport

On 5 June 2003, EU Member States' transport ministers finally agreed to grant the Commission the long-sought mandate to open negotiations with the US in the field of air transport. This step finally solves the question of partition of competences between Member States and the Community as regards aviation relations with the US. It is now clear that the Commission, on behalf of the Community and its Member States, will be able to directly negotiate an agreement with the US.[527] The Parties can finally focus on the possible content of the agreement. The mandate granted to the Commission covers a wide-range of issues. The negotiations will include all the arrangements governing air transport between and within the EU and US. This will include the rules governing market access (routes, capacity, frequency) for cargo and passengers; how fares are set; how to ensure effective application of competition rules; and how to ensure maintenance of high standards of airline safety and aviation security.[528]

As has been described earlier, the positions of the EU and the US especially on the issue of ownership and control differed widely; and the outcome of ATConf/5 did not encourage the US to change its position. It is therefore questionable whether the EU and the US will find common ground, now that the Commission has been granted the negotiating mandate and that the two parties can finally address the questions in a concrete way. Second, the question arises as to what impact an agreement between the

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[527] It has been clarified that any agreement reached with the US will be conceived as a single agreement applicable to the whole Community. The Commission will be assisted, during the negotiations, by a Special Committee designated by the Council. Moreover the Commission will regularly inform the Council on the progress of the negotiations.

[528] See EU, Council Press Release Nr. 9686/03 (Press 146), *supra* note 380.

EU and the US would have on the removal of barriers to cross-border mergers, takeovers and investments, and in the end on the restructuring of the EU airline industry.

4.1.4.1 Can the EU and the US Find a Common Ground?

Following the grant of the negotiating mandate to the Commission, the EU and the US agreed on opening negotiations in early autumn 2003 towards an overall agreement on air transport liberalization.[529] In line with its long time position, the Commission announced that it will propose the establishment of an OAA, whereby the US and the EU will reciprocally open up their markets and investment rules.[530] This implies that the Commission will aim for the complete elimination of ownership restrictions within the area, so that an EU carrier could own up to 100% of an US carrier, or *vice versa*.

If the Commission were to try to push for a full-fledged approach from the beginning of the negotiations without taking into account the political and legal difficulties in the US, it will certainly be difficult to achieve an agreement anytime soon.[531] An alternative would be to focus on priorities and accept a phased approach. The Commission has already acknowledged that "there is an immediate priority – in light of the decisions of the European Court of Justice, the existing agreements need to be brought into conformity with Community law".[532] It is therefore conceivable that the Commission will first concentrate on the ownership and control issue, in order to replace the existing nationality clauses with an EU-clause. Such a clause could, *e.g.*, be based on the ICAO

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[529] EC, Commission Press Release IP/03/897, "European Union and The United States of America Agree on Opening Negotiations on Open Aviation Area", 25 June 2003, online: European Union, http://www.europa.eu.int/rapid/cgi/rapcgi.ksh?p_action.gettxt=gt&doc=IP/03/897|0|RAPID&lg=EN&display (date accessed: 1 October 2003) [Commission Press Release IP/03/897]. See also "Autumn Date For EU-US Aviation Talks" (26 June 2003) *AIRwise News* (30 June 2003), online: Airwise News, http://news.airwise.com/stories/2003/06/1056623.html. (date accessed: 2 July 2003). Both sides acknowledge the relatively short timeframe, during which major achievements might possibly be reached. While the Commission is going to change in June 2004, presidential elections in the US will start in Summer 2004. Therefore, it is hoped to conclude an agreement between Easter and Summer 2004.

[530] On the issue of ownership and control, the Commission announced that the negotiations will address opening up each side's internal market to the airlines of the other side through the removal of the special restrictions which currently apply to foreign ownership and control of airlines in the US and EU.

[531] Frederik Sørensen, "The future of 'wide open skies'" (2003), 146 E-communiqué, online: ACI Europe, http://www.aci-europe.org/default.asp?url=http://www.aci-europe.org/ecommunique/archive.asp (date accessed: 01 October 2003).

[532] Commission Press Release, IP/03/897 *supra* note 529.

Model Clause concept, whereby the US would accept the designation of an air carrier with its principal place of business in the Community.[533] In order to guarantee compliance with the ECJ ruling, it is, however, likely that the Commission will propose a clause referring to "establishment" and "licensed in accordance with EU law".[534] As described earlier, the US has at several instances affirmed that it is willing to come to an agreement on the accommodation of the concept of "Community Carrier"; and no matter the exact wording of the replacing provision, the US would not be required to go much further than what it signed with its APEC partners. Having the statements of the US delegation at ATConf/5 in mind, it seems realistic that the US and the EU will soon find a common ground as regards the substitution of the nationality clauses by an EU-clause.

It will be considerably more difficult to convince the US to accept the conclusion of an OAA, under which the US would be required to completely remove its national restrictions on foreign ownership of US airlines. As has been stated earlier, there are strong voices in the US that invoke concerns as regards the CRAF and "Fly America" program, as well as concerns related to security, labour and increased competition for US airlines.[535] It will therefore take enormous political effort to change the laws on ownership restrictions. On the other hand, it is recognized more and more that the concerns are not insurmountable.[536] Voices, even within the US, that refute the traditional justifications for national restrictions are becoming louder.[537] Alternatives for guaranteeing sufficient civil airlift capacity for national security purposes are available.[538] For the Commission, however, it will not suffice to argue that solutions to the concerns can be found. Instead, the burden to present concrete answers will fall almost exclusively

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[533] See proposal made *supra* Chapter 4.2.1.
[534] See also Fennes, *supra* note 309 at 16.
[535] See *supra,* Chapter 4.2.1.
[536] Schulte-Strathaus, *supra* note 479 at 22.
[537] See e.g. Whitaker, *supra* note 260. See a detailed critical analysis of the justifications in Lelieur, *supra* note 11 at 59 ff; see also The Brattle Group, *supra* note 4 at 7-1 ff., 8-1 ff., 9-1 ff.
[538] Schulte-Strathaus, *supra* note 479 at 22; according to Whitaker, *supra* note 260 at 4 "[A]ny concerns that a foreign-owned airline in the United States would not be accountable to the U.S. government should be allayed by the fact that the United States would require that any U.S. airline be licensed in the United States, regardless of its ownership".

on the European side.[539] The Commission will have to propose a package that develops compatible solutions for all the outstanding issues on the table, even those that are not directly related to ownership and control. The Commission will have to convince the US that an OAA entails far-reaching economic benefits for US air carriers that are able to outweigh other concerns.

In relation to the US, the fact that the Commission now represents fifteen Member States does not considerably increase the negotiating position of the EU side. In fact, the Commission is asking for the opening up of the US market for EU carriers. The equivalent for such a demand would be opening up the EU market for US carriers. Now, this offer would not be overly compelling for the US side. First, having difficulty to sustain, it is doubtable whether US carriers would be interested in establishing themselves in the EU or in acquiring an EU airline. Second, through the net of bilateral open skies agreements, including beyond fifth freedom rights with virtually all Member States, US carriers already now have access to nearly the entire EU market. Practically speaking, an OAA would not offer more market access to US carriers. An additional benefit, in terms of market access, would only flow from such an agreement where it provided increased access for US air carriers to London Heathrow.[540] Additionally, difficulties will also lie within the EU. Considering that Member States like the UK, Greece, Ireland and Spain presently do not have open skies agreements with the US, asking them to embrace a far-reaching liberal approach will require them to make a big step forward.[541]

It is, however, not inconceivable that the US might be on the verge of accepting an opening in this area, in order to transform air transport into a normal economic activity, to provide capital to US airlines and in order to encourage needed consolidation of the industry.[542] In fact, some US airlines have expressed their support for opening up ownership restrictions. They argue that government protection of national airlines has not

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[539] Horan, *supra* note 299 at 10.
[540] Britain presently only allows two US airlines, American and United, to fly into Heathrow. The US Government has repeatedly insisted that Heathrow be opened to other US airlines.
[541] See Daniel Michaels, "EU is ready to negotiate open skies pact with U.S." *The Wall Street Journal* (5 June 2003).
[542] Sørensen, *supra* note 531.

prevented the airline industry from facing deep financial crises. Removing the foreign ownership cap would help "to address carrier's chronic need for investment."[543] Additional pressure for an agreement on an OAA might loom once there is concrete example of an EU - US merger project. In that case, regulators would be forced to remove regulatory barriers in order to make this merger happen.

The US Government also has a political interest in an aviation agreement between the EU and US. If the EU and the US achieve agreement on a novel approach to aviation, there is a good chance that it will become the model for civil aviation in future.[544] This would permit the US, as in the case of the open skies initiative, to reshape civil aviation with the ultimate objective of creating a worldwide aviation regime on the basis of the EU - US agreement.

It is realistic that the two aviation powers will soon come to a common ground on the conclusion of a multilateral agreement that will, *inter alia,* replace nationality clauses with a "Community Clause". In that case, the EU and the US would conclude a liberal multilateral treaty similar to the APEC Agreement, which would bring existing ASAs into line with the ECJ ruling. Whether, in the end, it will be possible for the Commission to convince the US Government to completely remove its national restrictions on foreign investment, and to negotiate a real open area encompassing the concept of open skies agreements, is still questionable. This will be even more difficult considering that the Commission will not be able to draw upon the results of ATConf/5 to back up its proposal, but will rather have to convince the US to take a step further than what has been endorsed by the Conference. Certainly such a far-reaching agreement will not be concluded anytime soon.[545] Equally certainly, it will not be concluded because the Commission wishes it, but because the US is convinced that its airline industry will benefit from it.

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[543] Whitaker, *supra* note 260.
[544] van Hasselt Interview, *supra* note 383.
[545] Sørensen, *supra* note 531, estimates that it will take up to 5 years or longer to come to a full scale agreement.

4.1.4.2 The Potential Effects of an EU - US Agreement on the Restructuring of the EU Airline Industry

A general reaction to the Commission's negotiating mandate was that talks with the US would facilitate Community air carriers to arrive at international mergers and acquisitions.[546] It was thought that an agreement between the EU and the US would pave the way for "mergers between European airlines from different countries and between US and European airlines" and the overall "consolidation of the industry".[547] This would allow the fragmented EU airline industry to restructure. It will be argued that such an impact, even if desirable, will not flow from the simple fact that the EU and the US agree on a multilateral agreement, no matter how liberalized it is. Other third States have a big share in the complete removal of barriers to the consolidation of the EU industry through mergers and acquisitions among EU airlines.

Let us first look at the potential implications of an EU - US open skies-type agreement. It should be presumed that such an agreement allows all Community carriers to be designated to operate from any point within the EU to the US. By agreeing on such an agreement, some of the regulatory barriers to cross-border mergers and acquisitions among EU carriers would be removed.[548] EU carriers could merge without fearing the loss of traffic rights to the US. This would, for instance allow KLM and BA to merge since the US would thus no longer be an obstacle to the merger.[549] Likewise, a failing EU carrier could seek capital investment from an investor of another Member State, without placing its traffic rights to the US into danger. Finally, competitive disadvantages of EU carriers compared to US carriers would be eliminated, since EU airlines would no longer

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[546] Henri A. Wassenbergh, "June 5, 2003, a Historic Decision by the EU-Council of Transport Ministers" (2003) 28:4/5 Air & Space L. 214 at 215 [Wassenbergh, "June 5, 2003"]
[547] Loyola de Palacio, "Troubled airlines need an open sky" *Financial Times* (30 June 2003)
[548] "Intra-European Rationalization now conceivable" *Aviation Strategy* (June 2000) 3; this article enumerates potential take-over targets in the European scheduled business.
[549] Wassenbergh, "June 5, 2003", *supra* note 546 at 215.

be bound to operate only from their own country. Similar to US airlines, they would be able to operate between any point in the EU and points in the US.[550]

Nevertheless, an EU - US open skies agreement will not completely remove the barriers to mergers and acquisitions among EU airlines. This is due to the fact that air transport relations to third countries, such as Russia or Japan, would remain governed by the traditional bilateral system including standard nationality clauses. Nothing guarantees that these States abstain from invoking the nationality clauses and thereby effectively prohibit the merged carrier from operating freely out of the Community. These examples show that even following a liberal agreement between the EU and the US, Community Carriers still risk losing their traffic rights to third countries. Resistance from one or more of these States could lead to loss of traffic rights, and therefore put a consolidation effort on hold. One can therefore presume that mergers and takeovers within the EU will remain an exception so long as the vast majority of the bilateral partners of the EU have not accepted the same concept. So long as there is a slight danger that third States may oppose the designation of pan-EU entities, EU airlines will be careful in cross-border deals.[551]

The recently proposed merger of KLM and AF demonstrates this remaining dilemma of EU carriers. KLM and AF have engaged in negotiations for moving toward what amounts to the first merger of two of Europe's leading flag-carriers.[552] This deal seems to anticipate the new opportunities that might flow from an open skies agreement concluded between the EU and the US. It heralds the beginning of a broader wave of consolidation of the EU airline industry. Alitalia has already announced its interest to join the planned AF-KLM merger.[553] The deal, however, demonstrates that marketing opportunities are still limited, even if the US agrees to the liberalization of nationality clauses. In fact, since all the concerned States have got open skies agreements with the

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[550] The Brattle Group, *supra* note 4 at 1-9.
[551] Sørensen, *supra* note 531.
[552] See John Tagliabue, "Air France and KLM edge closer to alliance" *International Herald Tribune* (27 September 2003), online: The IHT Online, http://www.iht.com/cgi-bin/generic.cgi?template=articleprint.tmplh&ArticleId=111506 (date accessed: 01 October 2003).
[553] Tony Barber, "Alitalia sale plan to be reviewed" *Financial Times* (02 October 2003).

US, such a deal would presumably not even have been opposed by the US in the past. Instead of completely merging to one single company with one single brand name and operating from both Member States (France and the Netherlands), the two carriers only intend to pursue a half-hearted solution. "Ideally, the carriers envision the formation of a jointly-owned company with the KLM brand kept alive as a Dutch subsidiary exercising the international traffic rights from the Netherlands".[554] More likely is a looser tie-up. "KLM will join the global SkyTeam alliance of airlines, based around AF and Delta Airlines. Under that umbrella, KLM and AF will pool flights, coordinating schedules and prices as much as is allowed by EU competition authorities."[555] No matter the outcome of the deal, the structure will be very complex. This will be necessary, in order to ensure that KLM's international traffic rights are not jeopardized by third States that continue to maintain traditional nationality clauses in their ASAs with France and the Netherlands.

The same concern applies in the case of the negotiation of an OAA. Such an agreement would remove the barriers to cross-border mergers and acquisitions, as well as to foreign investment within that area. EU airlines could freely merge with airlines from other Member States, as well as with US air carriers, and freely operate within any point in the OAA. Since there would be no restrictions on foreign investment, Lufthansa would be able to acquire a major stake in United Airlines (UA). Virgin Atlantic would be able to set up a carrier in the US and operate within the OAA without any restrictions. However, this OAA would only work inwardly.[556] With respect to all OAA-third States, air transport relations would remain governed by traditional ASAs. Unless these States accept a clause that allows for the designation of an "OAA Carrier", or unless the great majority of States have joined the OAA, they could still challenge the nationality of the merged LH/UA carrier. Certainly, aeropolitical risks could be reduced by the strengths of the EU and the US composing one aviation area.[557] The negotiating position of the EU and the US, coalescing their negotiation authorities and negotiating as one block, would

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[554] "Air France's alliance with KLM reveals a new industry pattern" *The Economist* (20 September 2003) 61.
[555] *Ibid.* at 62.
[556] van Fenema, "National Ownership and Control Provisions Remain Major Obstacles to Airline Mergers", *supra* note 69 at 9.
[557] Holderbach, *supra* note 55 at 117.

be considerably strengthened. However, the renegotiation of designation clauses with every single bilateral partner of the OAA remains necessary. Until this tedious process has been accomplished, carriers will avoid any move that could undermine their traffic rights to countries that are not linked to the OAA. An initial conclusion of an OAA covering the EU/US zone would therefore be "largely symbolic".[558] "No large international air carrier will be able to even entertain ideas about seriously integrating operations or marketing across borders until Open Access agreements cover a significant portion of the global market."[559]

The mandate to open negotiations with the US in the field of air transport granted to the Commission on 5 June 2003 will pave the way for negotiations between the EU and the US on the liberalization of ownership and control provisions. No matter the outcome of the agreement between the two parties, it will be a major step towards the removal of regulatory impediments to mergers, takeovers and acquisitions amongst EU carriers and between EU and US carriers. The main impulse for the liberalization of ownership and control of the EU airline industry will thus flow from the grant of this mandate rather than from the outcome of ATConf/5. An agreement between the EU and the US, even if completely liberalized, will, however, not remove all the barriers to cross-border mergers and acquisitions. Consolidation amongst EU airlines as well as between EU and US airlines will only take place once a critical mass of third States looks at the ownership and control issue in a liberal way. The possibility of restructuring of the EU airline industry through consolidation is thus largely dependent on air transport relations with other EU-third States. For Member States and the Commission, this means that efforts will have to be intensified in order to come to an agreement on ownership and control issues with third States. It has to be hoped that the outcome of ATConf/5 facilitates this task.

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[558] Horan, *supra* note 299 at 5
[559] *Ibid.*

4.2 The Significance of the Outcome of ATConf/5 for the Liberalization of Ownership and Control Requirements in Air Transport Relations of the EU with other Third States

It has been demonstrated that negotiations between the EU and third States on the issue of liberalization of ownership and control are of major importance in order to guarantee a comprehensive removal of regulatory barriers to the restructuring of the EU airline industry. The question to examine now is whether the outcome of ATConf/5 brings liberalization of the antiquated criterion further in air transport relations with other EU-third States.

4.2.1 Ownership and Control Issues Before and During ATConf/5

The recent impulse for an increased effort to liberalize ownership and control clauses in air transport relations between Member States and other EU-third States emanates from the decisions of the ECJ in the "Open Skies" cases. Even though the ruling was given in the context of the eight ASAs with the US, its principle applies to nationality clauses in all ASAs concluded by Member States. The judgments thus force the general review of the nationality clauses in air transport relations with all Member States' negotiating partners. In order to simplify the task of analyzing the development of the issue in air transport relations with those States before, during and, subsequently, in the aftermath of ATConf/5, they will be classified into three groups.

The first group of States is composed of nations that have a developed aviation sector and that pursue a liberal approach towards air carrier ownership and control. States such as Australia, New Zealand and Singapore fall into this category. These States have very liberal national laws on foreign investment in their national airlines.[560] Singapore, for instance, does not place any restrictions on foreign ownership of Singapore

[560] As has been presented earlier, Australia's national laws on foreign investment in national airlines are very liberal. See *supra* Chapter 1.2.2.3; Similarly, New Zealand's ownership rules are relaxed. There are no restrictions on foreign ownership of domestic carriers. Local law limits foreign holdings in a New Zealand international carrier to 49% with one single airline not being allowed to hold more than 25% and total airline participation being limited to 36%, see Chang, Williams, "Changing the Rules", *supra* note 34 at 212.

Airlines.[561] In line with this non-interventionist attitude concerning the internal ownership and control aspect, this group of States generally adopts a liberal attitude as regards air carrier designation and authorization in their international air transport relations.

The second group is composed of States that pursue a rather restrictive policy as regards the issue of air carrier ownership and control, such as Japan, Russia and China. These States allow only a limited amount of foreign ownership in their national airlines.[562] As regards foreign airlines operating into their territories, they adopt a strict attitude having a keen eye on the air carrier's compliance with the traditional criterion of "substantial ownership and effective control". Having a very attractive home market, access to these States is of major interest for EU carriers. This situation places these States into a strong negotiating position regarding the renegotiation of nationality clauses with Member States, which allows them to remain reluctant to make any concessions. China already demonstrated this strong position when it declined to accept the proposal made by the UK Government to replace the nationality clause in the UK-China ASA by a Community Clause.[563]

Third, there are some States with relatively small and unattractive home markets, mostly developing States. Those States comprise in particular some African States or States in the Middle East. Examples are Angola, Uganda, and Lebanon. Those States often do not have a very developed air transport sector and sometimes do not even have a national airline.[564] In their national laws on foreign investment as well as in international

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[561] In Singapore there is no limit at all imposed on foreign ownership of Singapore Airlines' share, neither by an airline nor by an individual or other entity; see IATA Think Tank, *supra* note 52 at 47.

[562] For an overview of the status of maximum foreign ownership restrictions in these countries see Yu-Chang, *The Influence of Airline Ownership Rules on Aviation Policies, supra* note 248at 48; see also IATA Think Tank *supra* note 52 at 43 ff. Foreign holdings in Chinese carriers used to be limited to 35% of the shares and 25% of the voting rights. The *Regulations on Foreign Investment in Civil Aviation Industry*, which came into force on 1 August 2002 not only relaxed the maximum of foreign investment up to 49.99 %, but also eliminated requirements about effective control, such as appointment of the director of the board and general manager by the Chinese side of a joint venture. The Japanese Air Law stipulates that no airline with more than 1/3 foreign ownership and/or control cannot be registered as a Japanese carrier.

[563] See Chapter. 2.2.3.2.

[564] E.g. Uganda, see Ambrose Akandonda, "Safeguards and Sustainability to the Liberalization of Air Transport" (Presentation to the Seminar prior to the 5th ICAO Worldwide Air Transport Conference, "Aviation in Transition: Challenges & Opportunities of Liberalization", ICAO, Montreal, 22-23 March

relations, they often orientate themselves towards standard ownership requirements. However, there are also examples of States that have liberalized ownership and control requirements.[565] Since the national economy of most of these States depends on tourism, attracting air service operations, also from the EU, to their territory is essential to them.

The meeting in Montreal in March 2003 gave EU Member States as well as the Commission Member States the opportunity to present their situation to the international community, to encourage the liberalization of the discriminatory ownership and control clause and to promote approval from the negotiating partners to the needed changes in the respective ASAs.

The first opportunity to draw attention upon the EU situation was given during the Seminar prior to ATConf/5, where decisions of the ECJ in the "Open Skies" cases, as well as the implications that flow from the ruling, were broadly discussed. [566] This permitted the EU to make the international community and all present delegations aware of the developments taking place in the EU and the needs connected with it.

During the discussions held at ATConf/5 on agenda item 2.1. the situation of the EU was dealt with only in a very limited way. Singapore, however, officially addressed the ECJ ruling and called upon ICAO Contracting States to "attempt to openly share their views and concerns, if any, with the view to making at least some mutually acceptable progress."[567] Singapore even proclaimed that it "would be prepared to incorporate an "European Union (EU) community clause" in [...] bilateral ASA with European countries for all EU carriers to utilize the rights under the said ASAs, so long as third-party free riding can be prevented".[568]

2003), online: ICAO, http://www.icao.int/icao/en/atb/atconf5/Seminar/Akandonda.ppt (date accessed: 03 October 2003).

[565] *Ibid.*

[566] Especially Francis Morgan, DG for Energy and Transport, Air Transport Agreements, European Commission; John Balfour, Partner, Beaumont & Son. Giovanni Bisignani applauded the ruling of the ECJ.

[567] Singapore, Working Paper (*Worldwide Air Transport Conference: Challenges and Opportunities of Liberalization*) No. ATConf/5-WP/39 (28 January 2002) at 2.

[568] *Ibid.*

Besides the official discussions taking place at ATConf/5 and the prior seminar, ATConf/5 offered government officials the opportunity to engage into negotiations on an informal basis. ATConf/5 provided a real forum, where EU Member States and the Commission were able to promote the acceptance of the concept of "Community Carrier" through unofficial talks with delegations of other States. For instance, the Commission had on the agenda for the Conference to speak to a number of States that might be interested in entering into liberal agreements with the EU, once the Commission would receive the negotiating mandate.[569] States like Singapore, South Africa, Chile and Australia appeared to be interested in the discussions. The conclusion of liberal agreements with the enumerated States would allow the Commission to set an example for an agreement to be negotiated with the US.[570]

Before and during ATConf/5, the attitude of third States towards the EU interest to liberalize ownership and control criteria was thus diverse. While some States appeared to be reluctant to consider revising nationality clauses in ASAs with Member States, others expressively called upon acceptance of new concepts. Again other States abstained from adopting a strong position on the issue. It will now be analyzed whether the outcome of ATConf/5 positively influences the development of ownership and control issues in air transport relations between the EU and third States.

4.2.2 The Outcome of ATConf/5

The relevance of ATConf/5 for the development of ownership and control issues in EU international air transport relations will be measured in relation to the question, whether the result of ATConf/5 entails an enhanced acceptance of the concept of "Community Carrier" by third States. Going one step further it will be attempted to predict, whether the result of ATConf/5 will provoke more liberal attitudes of States towards concepts beyond the mere liberalization of ownership and control inside the EU market. One should keep in mind that the ideal long-term result would be the removal of impediments to the

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[569] Personal Conversation with Jonathan Aleck, former Representative of Australia to the Council, ICAO.
[570] van Hasselt, Inerview, *supra* note 383.

consolidation of the global airline industry. The analysis will differentiate between the three groups of States.

In advising States to pursue a liberal and flexible approach towards the issue of ownership and control, the result of the ATConf/5 reflects the attitude adopted by Australia, New Zealand and Singapore already before and during ATConf/5.[571] Nevertheless, one should not conclude from that that the outcome of the Conference is meaningless for EU air transport relations with those States. More than confirming the status quo, the result contributes some new impulse that might enhance the speed and the extent to which air carrier ownership and control criteria will be liberalized. First, the recommended Model Clause, applied to the entire Community, provides for an expedient solution that could be used to replace nationality clauses in ASAs with those third States. Second, ATConf/5 gave both sides the chance to exchange their views and to confirm their liberal attitude. It demonstrated that States like Australia, New Zealand and Singapore would react in a flexible way when renegotiating nationality clauses. They would certainly not insist on the inclusion of the Model Clause in ASAs but might agree on even more liberal criteria. This fact facilitates an early agreement on the replacement of nationality clauses in air transport relations with those States. Such an agreement could then serve as a model for aviation relations with other third States.

Australia and Singapore appeared to be particularly interested in going a step further than the mere substitution of nationality clauses on a bilateral basis. The fact that the international community present at ATConf/5 endorsed the flexible approach might encourage the EU to press ahead in relation to this group of States, in order to agree on a liberal multilateral arrangement. This arrangement could be concluded in parallel to an EU - US agreement. The cumulative conclusion of such agreements would presumably have the effect of sending a strong signal to the rest of the aviation community. It would encourage more and more States to join these agreements and would extend the liberalization of air transport relations to other parts of the world.

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[571] ICAO Worldwide Air Transport Conference, "Aviation in Transition: Challenges & Opportunities of Liberalization", Personal Notes, ICAO, Montreal, 22-27 March 2003.

While the outcome of ATConf/5 strengthened the already liberal attitude of the first group of States, the situation as regards air transport relations with the second group of States, such as China, Japan and Russia, is more complex. In fact, the Community present at ATConf/5 had the difficult task of counteracting the restrictive approach adopted by these States before and even during the Conference. Will the Governments of China, Japan and Russia change their restrictive attitude in the aftermath of ATConf/5 and embrace proposals made by their EU counterpart to amend nationality clauses? This question gives reason to a cynical counter-question: why should they? The Conclusions, Recommendations and the Declaration encourage States to liberalize criteria for air carrier designation and authorization. They encourage States to adopt a flexible attitude, to depart from the idea of equal exchange of benefits, in order to accommodate the approaches chosen by others. Nevertheless, they only imply an option. Neither do the documents force States to amend nationality clauses, nor do they force States to accept the designation of foreign air carriers that might not meet the traditional ownership criteria. These States are perfectly entitled to pursue the same restrictive approach they adopted before the Conference.

States, such as China, Japan and Russia should embrace the concept of "Community Carrier" having endorsed the choice in favour of liberalization and flexibility as expressed in the documents issued by the Conference. In negotiations with these States, Member States and the Commission could point at the result of ATConf/5 and use it as an additional argument in favour of their position. However, one has to keep in mind that ATConf/5 was simply a meeting of the international community under the aegis of ICAO and was deprived of any constitutional power. Delegations exchanged their views, made political declarations of their intent and adopted some written documents, which they knew, would not have any binding character.[572] A significantly distinct situation applies, when the delegations of two States meet, in order to negotiate air transport matters on a concrete basis. At that moment, the tangible economic benefit of the national airline is at stake. As long as a State is not in need to make any concessions,

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[572] See Chapter 3.1.

it will realistically not take any steps that will allow Community carriers to increase their economic and competitive advantage to the detriment of its own airlines. "It would indeed be surprising if a State were to advocate and pursue liberalization without reservation purely in order to promote a liberal global air transport industry to the detriment of its own economy and industry."[573]

The analysis in the two previous scenarios seems to give reason to conclude that the outcome of ATConf/5, rather than enhancing liberal approaches, simply supports States in adhering to the position they already pursued before the Conference. This conclusion seems justified as regards those States that already had a determined position before coming to ATConf/5. Many delegations present at ATConf/5, such as States from the third grouping, lacked, however, such a firm attitude with respect to air carrier ownership and control. They did not come to the Conference with the intention to present their point of view but rather to form their opinion. They were able to inform themselves about concepts pursued by other States and regions, such as the EU, and to increase their awareness of the problems related to the use of the traditional criterion of "substantial ownership and effective control". For those States, the Conclusions and Recommendations endorsed by the Conference outline the standards applicable to international air transport relations. In this respect, it is of great significance that ATConf/5, in contrast to ATConf/4, produced written Recommendations in favour of a liberal and flexible approach. A comparison of the documents issued by the two Conferences proves that the standards applicable to international air transport are in transition. The Recommendations issued by ATConf/5 might encourage these States to use the Model Clause as the new standard for the designation and authorization of air carriers and to adopt an overall flexible approach in their international air transport relations. For Member States and the Commission, this implies that the renegotiation of nationality clauses will be considerably facilitated. Not only are those States increasingly aware of the needs of the EU to change traditional concepts for air carrier designation in their relation with third States. Additionally, Member States and the Commission will be

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[573] Abeyratne, Ruwantissa, "Liberalization of Trade in Air Transport Services" (2003) 4:4 Journal of World Investment 639 at 640.

able to use the outcome of ATConf/5 as an argument in favour of a more liberal approach towards the designation of EU carriers. Regional seminars and workshops that will be organized by ICAO as follow-up actions to ATConf/5[574] will give the Commission the chance to recall third States the difficult situation of the EU and the needs that are attached to it. In the end, the result of the Conference might even lead those States to look at an OAA in a flexible way.

The outcome of ATConf/5 brings liberalization of the antiquated criterion of ownership and control further in relation to most third States. However, States that already pursued a restrictive approach as to air carrier designation before ATConf/5 and that do not see any increased economic benefit for their own carriers in the acceptance of the "Community carrier" concept will presumably not change their mind as a result of the Conference. These States remain a threat to airline consolidation. It remains to examine, whether the mandate to enter into negotiations with third States granted to the Commission on 5 June 2003 gives some new impulse to the matter.

4.2.3 The Commission's Horizontal Mandate

The package adopted by the Council on 5 June 2003 comprises two important elements for negotiations with third States. On the one hand, it authorizes the Commission to open negotiations with third States, in order to replace certain provisions in ASAs, which are incompatible with Community law with standard clauses (horizontal mandate).[575] On the basis of this horizontal mandate, the Commission will be able to renegotiate nationality clauses with third States.[576] On the other hand, it includes a draft Regulation authorizing Member States to individually negotiate and implement ASAs with third States.[577]

In renegotiating nationality clauses with third States, the Commission intends to proceed according to a priority list.[578] This list particularly takes into consideration

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[574] ICAO, Working Paper C-WP/12040, *supra* note 432 at para 3.3.4.
[575] See, Council Press Release Nr. 9686/03 (Press 146), *supra* note 380 at 20.
[576] Commission Press Release IP/03/806, *supra* note 379.
[577] COM(2003) 94 final, *supra* note 365.
[578] Council Press Release Nr. 9686/03 (Press 146), *supra* note 380 at 20.

aspects of economic and commercial expectations of the EU airline industry.[579] A number of studies have pointed at a rising economic potential for air transport in the Asian area, including China and the benefits that could arise from that for EU airlines.[580] It is therefore conceivable that the Commission will try to liberalize ownership and control as quickly as possible with those Asian States, such as China, in order to allow EU carriers to benefit from that future growth.

It will be difficult for the Commission to pursue this project in a successful way. China presented itself reluctant accept Member States' proposal to replace the traditional nationality clause with a "Community Clause". Now, the specific character of the horizontal mandate will make it equally difficult for the Commission to convince China to accept the new concept. The horizontal mandate entitles the Commission to negotiate issues of Community competence with third States on the basis of standard clauses. Those standard clauses will be included in an "umbrella agreement" and supersede conflicting provisions in ASAs between Member States and third States, while the rest of the ASA will remain unchanged.[581] While the Commission is entitled to renegotiate nationality clauses with third States, questions that do not fall under Community competence will remain regulated in ASAs concluded by individual Member States with their bilateral partners. The following example will demonstrate the difficulties that arise from the nature of the horizontal mandate.

ASAs concluded between China and individual Member States include nationality clauses, which allow China to establish an equal bilateral exchange of economic benefits with each of the Member States. Now, the Commission proposes the replacement of the nationality clauses in those ASAs by a Community clause pertaining to "establishment in the designating State", "licensing in accordance to applicable law" and "under effective regulatory control of the designating State". Since under such a clause any EU carrier could claim from every Member State to be designated to operate to China, the benefit of the traffic rights would no longer be tied to the air carriers of the negotiating States. The

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[579] Commission Press Release IP/03/806, *supra* note 379..
[580] See, e.g., Chang, *The Influence of Airline Ownership Rules on Aviation Policies, supra* note 248.
[581] Council Press Release Nr. 9686/03 (Press 146), *supra* note 380 at 20.

equal exchange of reciprocal benefits between China and the bilateral Partner State would thus be tormented. Moreover, such a clause would imply the grant of seventh freedom rights for the benefit of EU carriers. While EU airlines could operate from any point in the Community to China, carriers established in China could still only operate on routes that have been negotiated bilaterally with each Member State. The negotiation of such a Community clause thus requires from China to grant Community carriers increased access to its territory without receiving reciprocal economic benefits in exchange. A solution to this problem would be to grant carriers established in China open access to the Community, meaning that the carrier could freely operate from China to any Member State and in between two points within the Community. This is, however, a question of market access, which does not fall within the Community competence. The Commission is not entitled to negotiate such a question on the basis of the horizontal mandate.

As this example shows, the horizontal mandate alone will presumably not lead to a vast acceptance of the concept of "Community Carriers" by third States. Considering the difficulties that may arise from the separate negotiation of designation and authorization on the one hand and market access on the other hand, the Commission has already indicated that it intends to present a proposal for a mandate that would entitle the Commission to negotiate comprehensive agreements with certain States.[582] Member States will certainly be hesitant to hand over such a negotiating mandate to the Commission. This would mean giving up their remaining significant vestige of national jurisdiction in the field of international air transport. However, even without such a full mandate, an arrangement will be significantly facilitated, if the negotiations by means of the horizontal mandate are backed up by a coordinated action by Member States. Member States should be urged to support Community negotiations on the issue of nationality clauses, for instance, by granting third States increased market access in their respective ASAs. Until a full mandate is granted, it is essential that Member States, together with the Commission, develop a pertinent and coordinated policy as to what kind of reciprocal benefits they are willing and able to offer third States exchange for the acceptance or the

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[582] The Commission intends to present mandates for full negotiations with Japan, Russia, China, Singapore, New Zealand, Australia, Morocco and Turkey; van Hasselt Interview, *supra* note 383.

"Community Carrier" concept. If this advise is followed, the horizontal mandate will enhance the prospect for a Community agreement with third States on liberalized rules for the designation and authorization of EU carriers.

4.3 Concluding Remarks

There is some prospect for liberalized relations between the EU and third States. While the liberalization of ownership and control requirements in EU - US relations will likely happen independently of ATConf/5, the outcome of the Conference gives new impetus to the relaxation of the standard provisions, in particular in relation to other third States. The result helps some States in forming a more liberal and flexible opinion of air carrier ownership and control, and strengthens the already liberal attitude of other States. This will facilitate the task of the Commission in the renegotiation of nationality clauses. However, as has been demonstrated, the EU will not be able to completely rely on the outcome of ATConf/5. It will be particularly difficult to convince some less liberal States, which have a strong negotiating position compared to the EU, to accept the "Community Carrier" concept. An agreement with those States is, however, of major importance. Only the acceptance of the liberal designation criteria with all negotiating partners will eliminate the discrepancies between the internal and external EU aviation market. Only then will the EU airline industry be able to take advantage of the benefits of liberalization and profit from restructuring. The new mandate for the Commission to enter into negotiations with third States gives important momentum.

CONCLUSION

The outcome of ATConf/5 demonstrates that the international community increasingly recognizes that ownership and control restrictions are a regulatory impediment to the free flow of capital and to the restructuring of the airline industry through cross-border mergers, acquisitions and takeovers. They constitute are barrier to the healthy development of the airline industry. By recommending the use of a liberal Model Clause for the designation and authorization of air carriers, as well a flexible approach in international air transport relations, ATConf/5 constitutes an important step in the right direction towards the liberalization of ownership and control rules. The Conference illustrates that standards are in transition.

The atmosphere created by ATConf/5 and laid down in the documents endorsed by the Conference is beneficial to the economic and legal needs of the EU. It must adapt its external air transport relations to the realities of the liberalized internal EU market. Only a liberal approach by third States towards the designation of "Community Carriers" will remove the barriers that prevent the EU airline industry restructuring through consolidation.

Regulatory barriers to the restructuring of the EU airline industry might soon partially be removed through an agreement between the EU and the US. A new impulse emanates from the decision of the Council to grant the Commission a mandate to enter into negotiation with the US in air transport matters. It is expected that an agreement will bring EU - US relations in line with the ECJ judgments, providing for the recognition of "Community Carriers". The outcome of ATConf/5 is conducive to such a development. In the longer term, the Parties might even agree on the creation of an open free trade area, which would permit EU carriers to merge with US airlines. By agreeing to such a free trade area, the Parties would go far beyond the mere implementation of the results of the Conference. Covering the most important aviation markets (the EU, the US and the transatlantic market), this might work as catalyst for global liberalization and take ownership and control far beyond what ATConf/5 could possibly have achieved. No matter the degree to which ownership and control are liberalized in the expected EU - US

agreement, it will, however, be a significant step towards the removal of regulatory impediments to mergers, takeovers and acquisitions amongst EU carriers, and perhaps even between EU and US carriers. The economic benefits of these ambitious projects will, however, only be able to materialize if a critical mass of States agrees on the replacement of nationality clauses with liberal designation criteria.

The outcome of ATConf/5 will more significantly influence the liberalization of EU air transport with other third States. It will facilitate the task of the EU in renegotiating traditional nationality clauses in line with the ECJ judgments. However, no third State is bound by the outcome of ATConf/5. Nothing guarantees that all third States will accept the concept of "Community Carrier". In fact, the EU might have to realize that the negotiation practice of States may differ quite substantially from political explanations made at an international conference. It is therefore essential that the Commission does not neglect negotiation with third States in favour of the ambitious negotiations with its most important trading partner, the US. It must rather reinforce its efforts to come to an agreement with third States, and integrate them into the negotiating process.

Recent developments, taking place in particular in the EU airline industry, support the presumption that the ECJ ruling, furthered by the outcome of ATConf/5, has set the pace for a transition of standards away from protectionism towards liberalization. KLM and AF are currently engaged in serious merger negotiations, while Alitalia has already indicated its interest in joining the merger. The projected tie-up of Swiss with BA in the "oneworld" alliance will expand the already dense net of alliances, providing for deep marketing integration. All these developments demonstrate that EU airlines in particular have increased confidence that regulatory impediments to consolidation will soon be removed. It also demonstrates that EU airlines feel significant pressure to use options such as cross-border mergers, acquisitions and take-overs to increase their profitability. However, it also illustrates that EU airlines remain prudent when entering into cross-border deals. They are thus still prevented from maximizing efficiency, through the complete integration of marketing and operating assets in one single company operating under one single brand name. There is need for further change.

While the outcome of ATConf/5 demonstrates the willingness of States to bring about liberalization of air transport relations, it also illustrates that the traditional concept of ownership and control is still deeply ingrained into the thinking of the international aviation community. ATConf/5 has not been able to overhaul the traditional concept, whereby national governments have the role of negotiating traffic rights, and of designating and authorizing the airlines that are permitted to take advantage of economic benefits granted by other national governments. Such a system means that governments try to protect their airline against foreign competition, and have a keen eye on the equal exchange of economic benefits. While the promotion of flexibility in the Recommendations issued by ATConf/5 increases the hope that at least the concept of a strictly equal exchange of reciprocal economic benefits will be abandoned, practice indicates that the contrary is likely. States generally remain reluctant to grant foreign air carriers economic benefits without receiving equal benefits in exchange. As long as this thinking prevails, the departure by a State from the worldwide standard of "substantial ownership and effective control" will remain a risky undertaking.

It will take a lot of time and effort to attain a system of free trade, in which the airline industry has the same commercial opportunities as any other industry, and where airlines from all over the world are free to follow their commercial needs. Equally, it has become apparent that it will take a long time to achieve a system where EU airlines are given the full range of strategic options, including the option to join forces with airlines from all parts of the world. Such a system would require States not only to eliminate ownership and control restrictions in their international air transport relations (the *external* aspect), but also to support the liberalization process taking place at the international level, by lifting their national restrictions on foreign investment (the *internal* aspect). More than once, it was made clear that States are not yet prepared to take this step.

ATConf/5 was not an end in itself. In fact, it marks only the beginning of the road towards the liberalization of "substantial ownership and effective control" criteria. On the basis of the achievements of the Conference, States will now have to take liberalization further. In the near future, the EU, together with its negotiating partners, will be the key

player for determining the speed and the extent to which air transport relations will be liberalized. Simply asking third States to act in line with the outcome of ATConf/5, by adopting a flexible and liberal approach in addressing questions of Community interests, will not enhance liberalization. In fact, it is of major importance that the EU, supported by the US, acts as a precursor to the liberalization of air carrier ownership and control criteria. It must implement, to the furthest extent possible, the outcome of ATConf/5 and take measures that go even beyond the Recommendations of the Conference.

Certainly, the EU has already realized a high degree of liberalization, through the elimination of ownership and control restrictions within the internal EU market. However, this liberalization does not go so far as to completely remove restrictions on foreign investment. The benefits of the internal market remains foreclosed in favour of airlines "owned and controlled" by EU nationals, and third country airlines and investors are still prevented from holding a major interest in an EU airline. Likewise, the proposal for the creation of an OAA with the US envisions considerably liberalized air transport relations with the US. The proposal implies the complete elimination of ownership restrictions within the area. However, the benefits of the open area will be limited to those carriers that are "owned and controlled" by the EU or the US. Third country airlines will be barred from benefiting from the liberalized area.

The EU should consider setting an example for the sake of enhancing global liberalization, by giving third country carriers the chance to benefit from the regional liberalization, even if, at first, EU carriers do not receive reciprocal benefit from those third countries in exchange. Following the example of Australia, restrictions on foreign investment could be lifted at least in relation to "domestic airlines", meaning airlines operating within the EU internal market. In order to be granted an operating license, it would suffice that the carrier is incorporated and has its principal place of business in the EU, and that it is under effective regulatory control of an EU Member State. A similar clause could be included in the proposal for an OAA. It is essential that the US, as the most important aviation nation, support this step.

By opening up restrictions on ownership of EU airlines, third country carriers would be granted the right to invest in EU carriers, and even to set up an airline in the EU. In contrast to what is argued by the EU (and more importantly by the US), opening up the benefits of the area to third countries carriers would not increase the existence of free-riders, nor would it prevent the wished-for "domino effect". In fact, such a liberal attitude would rather set a signal to other parts of the world. It would increase the incentive for other States to grant EU and US airlines reciprocal rights in their markets. This would have the effect of spreading liberalization to other parts of the world and provoke the desired "domino effect". Moreover, by adopting such a liberal approach, the EU would not lose an important bargaining chip in relation to third States, but rather improve the Commission's bargaining situation. Indeed, the Commission will have to ask third States for concessions. Those States will certainly be more willing to accept the designation of "Community Carriers", where the third country carrier can benefit from increased opportunities in the EU market.

By completely removing ownership restrictions, and by abandoning the traditional thinking of equal exchange of economic benefits, the EU would demonstrate its dedication to the liberalization of air transport and to flexibility. This would set the ball rolling for movement away from traditional principles, towards an environment where EU airlines could seek investment from the international capital markets, and merge with carriers from other parts of the world. In the long-term, this would lead to a situation where markets (and not governments) exclusively decide whether or not the airline industry is ripe for restructuring through consolidation.

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