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# The Evolution of Global Airlines: The Role of Airline Mergers, Franchises and Alliances in the Re-Development of International Air Transport Regulation

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# ABSTRACT/RÉSUMÉ

Air transport is by its very nature one of the most international of economic activities. However, until fairly recently, its regulatory framework has been premised on an overriding nationalism developed and maintained on the basis of the following: substantial ownership and effective control provisions found in national legislation and most bilateral air transport agreements; restrictions on cabotage found in national legislation, most bilateral air transport agreements and Article 7 of the Chicago Convention; and the related national restrictions on the right of establishment applicable to national carriers.

However, as the international component of the air transport industry has grown in importance, the tenets underlying this restrictive regulatory system are increasingly coming into question. This thesis examines the development of international airline co-operation and integration, namely by way of mergers, franchises and alliances, in the face of the existing regulatory obstacles. It examines the legal impediments to, the form of, and the costs and benefits of each of these integrative methods and their various derivatives. Finally, it traces the regulatory responses to these integrative activities, and explores the possibility and methodology of creating a truly global airline, both in form and in function.

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L'industrie du transport aérien, de par sa nature même, se veut l'une des activités économiques les plus internationales. Cependent, jusqu'à très récemment, sa structure réglementaire reposait sur un nationalisme prédominant développé et entretenu sur la base des principes suivants: les clauses de propriété substantielle et contrôle effectif retrouvées dans les législations nationales ainsi que dans la plupart des accords bilatéraux de transport aérien; les restrictions sur le cabotage rencontrées dans la législation nationale, dans la plupart des accords bilatéraux de transport aérien de même que dans l'article 7 de la Convention de Chicago; et les restrictions nationales correspondantes sur le droit d'établissement des transporteurs nationaux.

Cependant, à mesure que la composante internationale de l'industrie du transport aérien a crû en importance, les postulats sous-tendant cette structure réglementaire restrictive sont de plus en plus remis en question. La présente thèse examine le développement chez les lignes aériennes internationales de la coopération et de l'intégration par les voies de fusions, franchises et alliances à la lumière des présents obstacles réglementaires. Elle traite également des problèmes légaux relativement à la forme, aux coûts et aux bénéfices de chacune de ces méthodes d'intégration ainsi qu'à leurs différentes variantes. Finalement, elle énonce la réponse réglementaire à ces initiatives d'intégration et explore la possibilité de même que la méthodologie de la création d'une véritable ligne aérienne globale, tant au niveau de la forme qu'au niveau de son fonctionnement.

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This thesis is dedicated to my parents, whose sacrifices and support have made the pursuit of my studies and this thesis possible.

Many people have made a contribution to the final creation of this work. Foremost among them is professor Peter Haanappel, whose own dedication to excellence initially drew me to choose him as my thesis supervisor and inspired me to strive to produce what I hope is a work of quality. His high standards dissuaded me from the inevitable and frequent temptation to take short cuts. His succinct advice helped me to focus on the matter at hand, while his intimate knowledge of the industry and belief in my abilities gave me the confidence to pursue my studies in an evolving area of the law.

I have always dreamt of a profession which would somehow allow me to combine my interests in law, economics and international relations, but really had no idea how to go about finding it. Now, through my experience at the Institute, I know I have found it. The first day at the Institute, Dr. Michael Milde advised us that the Institute was like a "bowl of fruit", meaning that the richness of our experience here was directly related to our willingness to pick and choose what we wanted to get out of the experience. I have taken that advice to heart and it has served me well.

Finally, I would like to thank all of my wonderful classmates, whose backgrounds, intelligence and camaraderie made this an unforgettable and cherished experience. Caroline Haney deserves special mention here as she so graciously translated my abstract on very short notice.

# INTRODUCTION

Despite the fact that air transport derives much of its glamour and prestige from its perceived international character, its regulation is still characterized by an overarching nationalism. Many students and practitioners of aviation law are attracted to the field because it seems to combine law and commerce within an international scope. However, if they are interested in pursuing the international and commercial aspects of the industry, they soon realize that most of their time and energy will be devoted to overcoming or buttressing,[1] international and national legal constraints.

In the past few years, governmental fiscal restraints have lead to an increasing trend towards the privatization of airlines. In most other industries, privatization is seen as the converse of nationalization. However in aviation, privatization is just the first step in the process of de-nationalization of the industry. The second step in the process must eventually be the dismantling of the various national regulatory structures which limit international participation. Like it or not, aviation legislators, executives and commentators must admit that recent regulatory and economic developments in the aviation world have and will continue to exert pressure towards the creation of a regulatory framework which would not hinder the development of global or multinational airlines.

This study is intended as an examination of the national and international legal constraints which serve to limit the development of global airlines and the various attempts

[1] Depending on their personal point of view and that of their employer.

to overcome them. It is divided into three parts. Part I examines the internationalization of the industry in Chapter 1, while Chapter 2 canvasses the international and national legal constraints on multinationalization, namely in the form of national ownership and control provisions. Attempts to overcome these restrictions are canvassed in Part II, namely by way of mergers and takeovers, covered in Chapter 3, franchises, covered in Chapter 4, and airline alliances which are covered in Chapter 5. Part III of the thesis examines some of recent developments in the international industry which have contributed to creating the pressure for reforms and their role in shaping the future legal and economic framework within which the industry will either prosper or fail. This new regulatory framework will in turn either nurture or inhibit the development of global airlines.

In many ways, this study is directed at readers who are diametrically opposed to the emergence of global airlines. Although they are still quite numerous, their economic clout and the related ability to foster or hinder reforms is steadily diminishing. Given this fact and the limited resources they can devote to aviation, they cannot afford the luxury of misjudging the future developments in the regulation of the industry. They, above all others, including those who wish to create the global airlines, must be at the forefront of understanding and harnessing these developments. Only by following that course will they manage to minimize the possible negative effects they bring and maximize the potential returns they may create.

# PART I

## 1. THE INTERNATIONALIZATION OF THE AIRLINE INDUSTRY

The commercial airline industry in total is estimated to carry 1.25 billion passengers and 22 million tons of cargo, employ 22 million workers (3 million directly, 7 million indirectly, and 12 million induced), and account for one trillion dollars a year in economic production ($250 billion directly, $250 billion indirectly, and $500 billion induced).[2] Since 1919, when the first scheduled international service commenced between Paris and Brussels,[3] the international component of the industry has played a prominent role in its development. However, the last few years have seen this international component of airline operations emerge as the driving force behind the industry's growth and expansion.[4]

### 1.1 THE CHANGING FACE OF THE INDUSTRY

By all accounts, the air transport industry has experienced its most turbulent period in the last five years. This period has been characterized by huge losses,[5] bankruptcies in

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[2] *Economic Benefits Study Revisited*, ICAO Rev. (Feb. 1994), at 19.

[3] See Shearman, P., Air Transport (London: Pittman, 1992).

[4] Total passenger traffic between the United States and foreign destinations increased by 134% from 1980 to 1993 (from 39.5 million passengers to 92.6 million passengers), while IATA estimates that this number will increase to 226 million passengers by 2010, See *INTERNATIONAL AVIATION: Airline Alliances Produce Benefits, but Effect on Competition is Uncertain*, United States General Accounting Office, GAO-RCED-95-99 (April 1995), at 10 [hereinafter *GAO Alliance Report*]; In the United States, the growth in international traffic is a relatively new phenomenon which still only accounts for approximately 30% of total operations. In regions not as geographically or demographically blessed as the United States, growth on the basis of the internal market has been limited and international traffic has always been at the core of airline operations. In the European Union, the Comité des Sages estimated that operations to non-European countries accounted for more than 50% of airline activities, and in some cases more than 70%, See The Comité des Sages For Air Transport, *EXPANDING HORIZONS: A report by the Comité des Sages For Air Transport to the European Commission - January 1994*, (1994) XXIX-II European Transport Law 136, at 179 [hereinafter *Comité des Sages Report*].

[5] In the four year period ending in 1994, the world's airlines lost a cumulative $15 billion , See Jeanniot, P., *The Balancing Act*, IATA Rev., (Mar./Apr. 1994); This lackluster financial performance was in large part responsible

the United States, and billions of State aids being funneled into still unprofitable European carriers. Overall, this poor performance has been attributed to the recession which occurred in most Western countries, rising fuel costs resulting from the Gulf War, the industry's high labour costs and to the industry's own overoptimistic projections of growth. In the United States, these developments have either been seen as a necessary restructuring or as the direct result of the deregulation of the industry.[6] However, 1995 seems to have witnessed a turnaround in the industry, with many carriers posting profits.[7]

The financial and regulatory changes which have taken place in the industry have also lead to a profound change in the way the industry is structured. In terms of operational strategy, and particularly in the United States, hubbing has become the dominant route strategy. However, its popularity may have peaked, as the continuing success of Southwest Airlines and its linear system have lead to a series of new copy-cat services, both by incumbent players and new entrants.[8] In the United States, where

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for the setting up of the National Commission to Ensure a Strong, Competitive Airline Industry in the United States, and the Comité des Sages in the European Union..

[6] For a detailed denunciation of deregulation, See Dempsey, P.S., *Airlines in Turbulence: Strategies for Survival*, (1995) XXIII Transportation Law Journal 15.

[7] The industry has seen record profits in 1995, leading to expanded hiring and increased aircraft orders, See Prasso, S., *U.S. Airline Industry on Wings of Recovery*, Canadian Press Newswire (9 February 1996); Even ailing USAir posted a profit, after sustaining losses totaling $3 billion in the last five years, See Usborne, D., *Beleaguered Airlines Emerge From $13bn Hell in the Heavens*, The Independent, Business (22 January 1996), at 16; In Europe, after almost collapsing four years ago, a privatized Lufthansa is now making a serious challenge at British Airways' market supremacy, See Lorenz, A., *BA Faces a Dogfight with Lean Lufthansa*, Sunday Times, Business (14 January 1996), at 1; However, this recovery is somewhat selective. The strong North American airlines are posting profits while the weaker ones continue to fight for survival. In Europe, the northern based carriers are leading the way while the southern carriers, which still have not been weaned from State aids, continue to show lackluster results. The European Commission has recently approved yet another bail-out totaling £440 million for the struggling Spanish carrier Iberia, See Pennington, N., *Every Cloud Has a State Airline*, The Times, Business (1 February 1996), at 1; In Asia, generally home to some of the most profitable carriers, profits continue but at a slower pace, See Whitaker, R. & Odell, M., *The Year Ahead*, Airline Business (February 1995), at 24; The Asian carriers, used to the highest profit margins in the industry, are now starting to experience lower yields and rising cost levels, See Cameron, D., *Asia Taxed by Growth*, Airline Business (February 1993), at 30.

[8] The incumbents like Continental, USAir, and United have set up what have been described as "airlines within airlines" offering short-haul low-fare service to compete with Southwest, while ValuJet is the most notable new

deregulation was instituted in 1978, a spate of takeovers, mergers and bankruptcies have left the industry more concentrated than ever.

Due to the fact that the European Union had and still continues to have a much higher degree of governmental control of airlines, and commenced its deregulatory process much later and at a more gradual pace, it has not experienced this tendency towards concentration to the same extent. However, given the full implementation of the Third Package of Liberalization Measures (including the ending of restrictions on cabotage in 1997) and the newfound profitability of some carriers, the trend towards mergers and takeovers in the European Union should accelerate. This development, in conjunction with the continuing competitive pressure to enlarge the airlines' scope and networks so as to improve market access and efficiency, has and will continue to influence airlines to internationalize their corporate structures. Where that is not feasible by way of mergers or takeovers, it will be done through strategic alliances and transborder franchises, where possible.

These developments are laying the groundwork for a world airline industry composed of three groups of carriers. The traditional "flag" carriers will continue to exist but will be overshadowed or integrated into an industry structure composed of the following: global airlines with a world-wide presence; feeder carriers working in conjunction with the global airlines on routes to and from the latter's hubs; and "niche"

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entrant in this category. In Europe, this trend has been lead by Lufthansa, See Jennings, M., *Altered Images*, Airline Business (February 1995), at 34.

carriers operating on routes with special characteristics, either in a scheduled or non-scheduled mode.[9]

Global airlines could be constructed solely through mergers and takeovers, resulting in one corporate entity having multinational operations.[10] However, given the traditional ownership and control constraints, mergers and takeovers are limited to a national, or in the case of the EU, a regional scope. As a result, global airlines are more likely to come about through co-operation with another airline or airlines, either in a strategic alliance or through a franchise. A strategic alliance is characterized by an attempt by the participating airlines to create a joint product through various forms of inter-airline cooperation. An airline franchise is essentially a subsidiary corporate entity, either wholly or partially owned by a larger airline. It offers a product substantially similar to the parent airline, often using its airline designator code and parts of its fleet.[11] Franchise carriers almost always serve as feeder carriers for the parent/global airline's core network.

Carriers in a strategic alliance may also be viewed as feeder carriers in certain circumstances. Where the alliance is between an aspiring global airline and a weaker airline, the smaller airline can be characterized as a feeder airline for the global airline's hub operations. This is particularly the case where the global airline takes an equity position in the weaker airline. In effect, the smaller airline serves a role similar to that

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[9] See Haanappel, P.P.C., *Airline Challenges: Mergers, Take-overs, Alliances and Franchises*, (1995) XX-I Annals of Air and Space Law [AASL] 179, at 180.

[10] For the possible scope of global airlines' operations, See Gialloreto, L., *Air Everything*, Airline Business (March 1993), at 34.

[11] See Haanappel, P.P.C., *supra* note 9.

played by a franchised airline, but to a lesser extent. However, where the alliance is between two aspiring global airlines, the relationship is more symbiotic and is the result of route network complimentarity.

Niche carriers usually operate in geographical point-to-point markets. They are often seasonal in nature and cater to specific market segments delineated by region, price, purpose or national origin.[12]

## 1.2 THE IMPEDIMENTS TO INTERNATIONALIZATION

In many cases, international alliances are the second best solution for airlines wishing to become global players. Although mergers, takeovers and franchises may be the preferred and most commercially viable route to the establishment of a global airline, this course of action faces three regulatory hurdles: the rule in national legislation and in most bilateral air transport agreements that carriers must be substantially owned and effectively controlled by national interests (except in and among the EU Member States); the restrictions on the exercise of cabotage rights found in national legislation, most bilateral agreements (except in and among EU Member States) and in Article 7 of the Chicago Convention,[13] and the related rule found in the legislation of most States (except in and among the EU Member States) limiting the right of establishment to national carriers.[14] In effect, airlines wishing to internationalize their operations must forego the merger and takeover route and consign themselves to strategic alliances, thereby keeping intact their

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[12] Ibid.

[13] *Convention on International Civil Aviation*, 7 December 1994, 15 UNTS 295, ICAO Doc. 7300/6 [hereinafter *Chicago Convention*].

[14] See Haanappel, P.P.C., *supra* note 9, at 181.

national identities. Even within the European Union, where the national rules to this effect have been replaced by EU-wide legislation allowing for ownership and control by nationals of any Member State, the right of establishment in any Member State and full cabotage freedom by 1997, the fact that these regulations only have internal effect (*i.e.* only on routes within the Union) has limited the applicability of mergers and takeovers, as the nationality, establishment and cabotage restrictions still apply to and from the EU.

However, the easing of these restrictions within the European Union has allowed for the establishment of several transborder franchise airlines. The most notable examples of this phenomenon are Deutsche BA of Germany and TAT European Airlines, both partially owned by British Airways (BA).[15]

[15] Transborder franchises will be fully canvassed in chapter 4.

# 2. RESTRICTIONS ON GLOBALIZATION

As mentioned earlier, airlines wanting to globalize their operations face three significant regulatory hurdles, namely: national ownership and control provisions found in national legislation and in most bilateral agreements, restrictions on cabotage found in national legislation, most bilateral agreements and in Article 7 of the Chicago Convention, and the limitation on the right of establishment to national carriers, found in national legislation. The following chapter will focus on the first regulatory hurdle, as it forms the basis of the existing restrictions. The cabotage and right of establishment restrictions are related to and in some ways flow from the national ownership and control provisions. As such, they are secondary hindrances which will also be examined, but briefly.

## 2.1 THE DEVELOPMENT OF NATIONAL OWNERSHIP AND CONTROL REQUIREMENTS

Given the novelty of air transport and the uncertainty over its future development, it is not surprising that early regulators focused on the nationality of "aircraft" rather than that of "airlines". The issue of the nationality of aircraft was seen as being closely connected to the principle of sovereignty over airspace. As the principle of sovereignty over airspace was accepted as the basis of international regulation of air transport, it followed that different treatment should be accorded to national and foreign aircraft.[16]

[16] The first definite statement that aircraft required nationality was made in 1901 by P. Fauchille, who linked aircraft nationality and the right of States to control flights in their airspace as an exercise of their right of self-preservation, See Fauchille, P., *Le domaine aérien et le régime juridique des* aérostats, (1901) VIII Rev. Gen. D.I.P. 414; In 1902, in a report to the *Institut de droit international*, he clarified this statement and defined States' rights as the prevention of spying, customs, sanitation and defence, See Fauchille, P., *Régime juridique des* aérostats, (1902) XIX Ann. inst. dr. int. 19, at 86; For an analysis of the early debate on the sovereignty over airspace and the nationality of aircraft, See Honig, J.P., The Legal Status of Aircraft (The Hague: Martinus Nijhoff, 1956).

### 2.1.1 From Paris to Chicago

#### 2.1.1.1 The Multilateral Approach

Despite protests from some participants, the principle of aircraft nationality in international aviation regulation received broad acceptance at the first formal diplomatic international air navigation conference in Paris, in 1910.[17] This principle was decisively endorsed in 1919 by the Aeronautical Commission for the Regulation of Aerial Navigation, meeting in Paris and more commonly known as the Paris Convention.[18] As had been the case from the earliest deliberations on the subject, the issue of the nationality of aircraft was linked to the sovereignty over airspace, which was accepted as the guiding principle of international regulation and was entrenched in Article 1 of the Convention.

The nationality of civil aircraft was addressed in Articles 6 through 10, and Articles 15 and 25 of the Convention. Under these provisions, aircraft had the nationality of the State where they were registered, and registration could only take place in a State if the aircraft was fully owned by its nationals. Given the requirement for full national control, aircraft could not be registered in more than one State. The State of registry was obligated to ensure that every aircraft on its registry (carrying its nationality mark) shall, wherever it may be, comply with the regulations governing the conduct of air traffic (Annex C to the Convention).

In the case of aircraft owned by corporate entities, the Convention required that the president of the company and at least two-thirds of its directors be nationals of the

[17] See Honig, J.P., Ibid., at 44.

[18] *Convention Relating to the Regulation of Aerial Navigation*, 13 October 1919, 11 UNTS 173 [hereinafter *Paris Convention*].

country in question. The 1929 Amendments to the Convention abolished these specific provisions on the nationality of aircraft, thereby leaving the contracting States to determine the conditions under which the registration of aircraft could be effected.

The Paris Convention also addressed operational rights, through Articles 2,5,15 and 16. Article 2 gave the aircraft of one contracting State the right of innocent passage into and through the airspace of other contracting States. However, aircraft of non-contracting States only enjoyed such a right by "a special and temporary authorization".[19] Article 15 gave the aircraft of every contracting State the right of overflight, but its fourth paragraph empowered States to make the establishment and operation of scheduled international air services, whether with or without landing in their respective territory, subject to their prior authorization. Article 16 of the Convention gave the contracting States the right to reserve the commercial transportation of passengers and goods between points within their territories to their national aircraft.

The result of these provisions was that the regulation of the nationality of aircraft which initially only had operational considerations, began to take on commercial implications. At the same time, the transfer of the regulation of nationality from the Convention to the States seemingly allowed for a more flexible international regime in regards to the nationality of aircraft. Although it still required States to enact specific national laws and regulations governing nationality, it seemed to leave open the possibility for certain States, or groups of States, to adopt less stringent nationality requirements. However, in practice, the principle that the nationality of the owner determined the

[19] The text of this article was subsequently amended in 1922 and 1929, thereby removing its exclusivity.

nationality of the aircraft which had originally been laid down in the Convention remained in force, but now on the basis of national legislation. This basic philosophy in regards to the nationality of aircraft and sovereignty over airspace was followed at the Pan American Convention on Commercial Aviation, signed in Havana on 15 February 1928.[20]

### 2.1.1.2 The Introduction of Bilateral Agreements

The emergence of bilateral agreements covering air transport on regular or scheduled routes soon saw the development of a distinction being made in granting access to airspace to foreign aircraft as opposed to air transport companies of the other Party to the agreement who wanted to operate routes.[21] As an example,[22] under Article III of the 1938 Agreement Between Canada and the United States Relating to Air Navigation,[23] each Party granted to the aircraft of the other Party, "duly registered" by that Party, "liberty of passage" above its territory. The establishment and operation by "an enterprise of one of the Parties of a regular air route or service to, over or away from the territory of

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[20] Noted by Gertler, J.Z., *Nationality of Airlines: Is it a Janus with Two (or more) Faces?*, (1994) XIX-I AASL 211, at 231; The Convention was ratified by twelve American States. For a complete text, See Matte, N.M., Traité de droit aérien-aéronautique (Paris: Pédone, 1964) at 667-672; It should be noted that the United States did not sign the Paris Convention, but was a party to the Havana Convention. The Convention focused specifically on the nationality of aircraft. Its main provisions included the following:

> Art. VII - aircraft have the nationality of the State of registration; Art. VIII - the registration of aircraft shall be done in accordance with the law of each contracting State; Art. VII - the certificate of registration shall include the full name, nationality and domicile of the owner; Art. IV - each contracting State had the right of innocent passage over other contracting States' territories; Art. XII - the aircraft of each contracting State had the freedom to engage in air commerce with the other contracting States without being subject to the licensing system of the other States; Art. XXI - each contracting State's aircraft had the right to discharge passengers and cargo at one point in the territory of the other State and proceed to another point in the same territory for the same purpose, while also being allowed to take on passengers destined for a third country; Art. XXII - each State had the right to reserve cabotage to its own aircraft.

[21] See Gertler, J.Z., Ibid., at 231.

[22] Ibid., at 232.

[23] *Exchange of Notes Recording an Agreement between Canada and the United States of America Relating to Air Navigation, 28 July 1938, Can. T.S. 1938 No. 8.*

the other Party, with or without a stop" were made subject "to the consent of such other Party". Article IV, paragraph (b) authorized the transport of passengers and the import/export of goods into and out of the territory of the other Party in aircraft of either Party. In regards to cabotage, Article VIII, paragraph (b) stated that air commerce "may, in the territory of either Party, be reserved exclusively to its own aircraft."

This Agreement, like most bilateral agreements of that time, determined the nationality of an aircraft by its registration ("duly" executed), without prescribing any such formal linkage for an airline which wanted to operate scheduled air transport services. Scheduled operations required a separate authorization, or as in some other agreements, a separate bilateral agreement on that subject. The general assumption behind this structure was that the Party in question would have a wide degree of discretion on the acceptability of the airline proposed by the other Party.

Some bilateral agreements specifically addressed possible problems which may arise in regards to "nationality", whether in relation to national aircraft or national airlines.[24] In regards to the nationality of aircraft, bilateral air transport agreements did not diverge much from the Paris and Havana Conventions, retaining the criterion of nationality. The nationality of aircraft owned by corporations was usually settled by the

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[24] For example, Article 15 of the 1928 Convention between France and Spain Relating to Air Navigation states:

> Whenever question (s) of nationality arise in carrying out the present Convention, it is agreed that every aircraft possesses the nationality of the State in whose territory it is duly registered.
>
> No aircraft shall be registered in either of the two States unless it is owned entirely by nationals of such State. If the owner is a company, such company, whatever be its form, must fulfill all the requirements prescribed by French or Spanish law respectively in order to be considered as possessing French or Spanish nationality as the case may be.

See the text reproduced in Vlasic, I.A. & Bradley, M.A., The Public International Law of Air Transport, Material and Documents (Montréal: McGill University, 1974) at 40.

laws and regulations of the State where the aircraft were registered. On the other hand, with regards to the nationality of airlines, some agreements allowed each Party to "scrutinize the conditions of nationality"[25] used by the other Party for its airlines. This period also saw the introduction of the concept of designation of specific airlines within the agreement which could exercise the rights under the agreement. The introduction of this now familiar method of controlling access to domestic scheduled markets made the acceptability of certain competitors from the other Party the subject of bilateral bargaining for the first time.

#### 2.1.1.3 Early Multinational Airlines

The preceding review of the early regulatory environment, with its emphasis on national control of aircraft and airlines, is in some ways misleading because it seems to suggest that the creation of multinational airlines was made impossible from the start. In fact, several multinational airlines operated prior to the 1944 Chicago Convention. These multinational airlines usually operated with equity shares held by several governments. Among them were: the Compagnie Franco-Roumaine de Navigation Aérienne (CIDNA) which was set up in 1920 as a French corporation but with equity shares held by the governments of Austria, Czechoslovakia, Hungary and Romania; Deruluft, a jointly owned German-Russian airline which operated between 1921 and 1937, again with sizable investments from the two governments; Tasman Empire Airways Limited which was established in 1940 by the governments of Britain, Australia and New Zealand.[26] In Latin

[25] Language used in the 1936 Air Agreement between Italy and Greece, See Lissitzyn, O.J., International Air Transport and National Policy (New York: Council on Foreign Relations, 1942), at 40.

[26] See Imam, A.H., Transnational Cooperation in Air Transport: Towards the Establishment of International Airlines (LL.M. Thesis, McGill University, Institute of Air and Space Law, 1966), at 29-33 [unpublished].

America, German co-operative projects with the respective governments resulted in the creation of Lloyd Aereo Boliviano in Bolivia, in 1924, and Varig in Brazil, in 1927.[27] It has been suggested that the fact that these "non-national" or multinational airlines were to a large degree owned and/or controlled by their respective governments contributed to their acceptance by the States concerned.[28]

Non-national control of airlines also sometimes took the form of outright foreign ownership of "national" airlines, in some ways a precursor to the modern-day transborder franchise airline. In 1941, Pan American Airways had wholly owned subsidiary airlines in Brazil, Mexico and Cuba. It also held significant equity positions in airlines in China, Guatemala and Colombia.[29] SEDTA was owned by German interests and was based and operated in Ecuador.[30]

### 2.1.2 The Chicago Convention

In regards to the nationality of aircraft, the Chicago Convention followed the principles set down by the amended Paris Convention. It contains numerous provisions on the nationality of aircraft[31] and related matters,[32] and devotes an Annex to international standards regarding aircraft nationality and registration marks.[33] In essence, it retained the

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[27] See Lissitzyn, O.J., *supra* note 25, at 338-339.

[28] See Gertler, J.Z., *supra* note 20, at 233.

[29] See Wynn, W.E., Civil Air Transport (London: Hutchinson's Scientific and Technical Publications, 1945), at 52-53.

[30] See Lissitzyn, O.J., *supra* note 25, at 165.

[31] Chapter III, "Nationality of Aircraft", Articles 17-21.

[32] Art. 12 - rules of the air, Art. 29 - documents carried in aircraft, Art. 31 - aircraft radio equipment, Art. 32 - licenses of personnel, Art. 33 - recognition of certificates and licenses, etc..

[33] Annex 7 to the Chicago Convention, International Standards, *Aircraft Nationality and Registration Marks*, 4th. ed. 1981.

regime whereby aircraft have the nationality of the State of registry, and in principle may only be registered in one State. However, the Chicago Convention itself does not address the issue of the nationality of the owners of aircraft.

By addressing the nationality of aircraft, the Chicago Convention imposed various responsibilities on the State of registry in regards to the operational performance of its aircraft. Given this obligation, the State responsible would obviously wish to maintain sufficient controls over the aircraft on its register, including imposing appropriate conditions for registration. As the State's obligations in this regard continue throughout the time the aircraft remains on its register and performs international flights, and as the State cannot realistically be expected to perform the detailed and continuing oversight of aircraft on its register, a large part of this responsibility must necessarily devolve to the owners of the aircraft. This devolution of responsibility justifies conditions being imposed on the owners to ensure their ability to meet the required operational standards for their aircraft.

However, there is no link between the owner's nationality and his ability to meet the operational criteria. Nevertheless, from the perspective of government technical regulatory bodies, it is easier to exercise the necessary controls over entities whose nationality is clearly established. Since the Convention does not address the nationality of the owners and since no alternative internationally accepted method of establishing owner nationality existed, while aircraft were clearly given the nationality of their State of registry, the easiest and most logical solution at the time seemed to be the extension of nationality criteria to owners. As a result, the notion of nationality of aircraft has been

exercising an indirect influence on who can actually operate the flights, and therefore on the nationality of air carriers as well.[34]

### 2.1.3 The Adoption of Substantial Ownership and Effective Control Requirements

Although the nationality of airlines was not addressed in the Chicago Convention itself, the abovementioned regulatory linkage and the decisive influence of the United States and the United Kingdom at the Convention ensured that substantial national ownership and effective control became the norm for the industry, through the adoption of subsequent documents. The United States had proposed that the Chicago Convention include a proviso that any State would have a right to withhold permission to fly across its territory to any foreign airline in which substantial ownership or control is not vested in nationals of a State Party to the Convention.[35] The stated reasoning behind this proposal was that the United States felt that it was important to know with whom they were dealing with at all times. In particular, it did not want former or present enemy States (*i.e.* Germany and its Axis allies) forming airlines based in other countries and utilizing rights granted to them. The security concerns at the time were obvious, but the United States also did not want to see a repeat of the extensive German penetration of the Latin American market prior to World War II and was in effect protecting the turf for its own carriers.[36] This line of reasoning was to a large extent shared by the United Kingdom.

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[34] For a more detailed analysis of this subject, See Gertler, J.Z., *Nationality of Airlines: A Hidden Force in the International Air Regulation Equation*, (1982) 48-1 Journal of Air Law & Commerce [JALC] 60, at 66-70.

[35] Art. 5(a) of the draft Convention on Air Navigation, proposed by the United States, See United States 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.

[36] For the German penetration of the Latin American Market, See **2.1.1.3 Early Multinational Airlines**, at 14.

It is interesting to note that El Salvador, a Latin American country, expressed a dissenting opinion on this issue. It had argued that smaller countries required a functioning air transport system, which required recourse to foreign capital and technical know-how. Therefore, it proposed that the degree of national ownership and control be left to the national regulations of each country. In effect, this would have meant that once an airline satisfied national ownership and control criteria (whatever they may be), other States could not deny it the exercise of the rights under the Convention on the basis of its nationality. However, El Salvador seems to have been alone on this point, as its formal proposal failed for want of a second.[37]

#### 2.1.3.1 The IATA[38] and IASTA[39] Agreements

As stated earlier, the Chicago Convention did not include any provisions on national ownership and effective control. Rather, they were incorporated into two separate agreements, the International Air Transport Agreement and the International Air Services Transit Agreement. The two agreements use identical language in this regard. Each contracting State has a discretionary power to withhold or revoke authorizations granted to airlines of another State if it is not satisfied that "substantial ownership and effective control are vested in nationals of **a contracting State** ...".[40]

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[37] See Gertler, J.Z., *supra* note 20, at 238, f.n. 77.

[38] *International Air Transport Agreement*, signed on 7 December 1944, 171 U.N.T.S. 387 [hereinafter *IATA Agreement*].

[39] *International Air Services Transit Agreement*, signed on 7 December 1944, 184 U.N.T.S. 389, ICAO Doc. 7500 [hereinafter *IASTA Agreement*].

[40] IATA Agreement Art. I, para. 6; IASTA Agreement Art. I, para. 5.

### 2.1.3.2 Incorporation Into Bilateral Agreements

The future development of substantial national ownership and effective control as a *de rigueur* requirement in international aviation also received impetus from the inclusion of basically the same language in the standard bilateral agreement for provisional air routes, also adopted at Chicago. The only modification being that substantial ownership and effective control were to be vested in "nationals of **a Party of this (the bilateral) Agreement**".[41] The effect of this slight change in wording from the IATA and IASTA Agreements was that whereas in the latter case ownership and control must be vested in **any Party to the Agreements (IATA and IASTA)**, the Chicago standard agreement required that ownership and control be vested in nationals of **either party to the bilateral agreement**, thereby narrowing the scope of ownership possibilities.

Following the Chicago Conference, the narrower Chicago standard wording was incorporated into bilateral air service agreements, most notably the Bermuda I Agreement between the United States and the United Kingdom,[42] which served as a model for subsequent agreements. It should be noted that the use of such provisions in bilateral agreements left a State free to impose conditions on a foreign airline, aside from allowing it to withhold or revoke authorizations. Over time, references to ownership and control by nationals of either contracting Party were replaced by the requirement of ownership and control by nationals of the **Party designating the airline** in question.[43]

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[41] See United States Department of State, *supra* note 35, at 127-129.

[42] *Agreement Between the United Kingdom and the United States*, 11 February 1946, 3 UNTS 253 [hereinafter *Bermuda I*].

[43] The 1947 bilateral agreement between Chile and the United Kingdom made the substantial ownership and control rule a unilateral one, requiring designation. An example of the language used in such a provision may be found in the *Air Transport Agreement Between the Government of Canada and the Government of the United States of*

### 2.1.4 The Chicago Legacy

Despite the widespread subsequent adoption of the requirement of substantial national ownership and control, it is debatable whether this development can be attributed solely to the Chicago Conference. As stated earlier, the provision was not incorporated into the Chicago Convention, but in the IASTA and IATA Agreements and in the Chicago standard form of bilateral. Even there it was not intended as an absolute rule but as a discretionary power given to States and was only made applicable to scheduled services. Nonscheduled services were made subject to the less restrictive regime of Article 5 of the Chicago Convention, under which nonscheduled rights were made available to aircraft of other contracting States irrespective of their nationality or ownership.[44]

Most tellingly, the Chicago Conference concurrently adopted several provisions allowing for joint operating organizations and pooling.[45] Although there have not been many, a few such joint operating ventures involving the participation of several countries have been operating international services without conflicts with the Chicago system. They include: SAS,[46] Air Afrique,[47] Gulf Air[48] and the former East African Airways.[49]

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America, signed on 17 January 1966, Can. T.S. 1966 No. 2, Art.VI, para. (a): "Each contracting Party reserves the right to withhold, revoke, or impose conditions on the authorization granted to an airline designated by the other contracting Party in accordance with Art. V:

3. in any case it is not satisfied that substantial ownership and effective control of that airline are vested in the Contracting Party designating the airline or in nationals of that Contracting Party";

Example noted by Gertler, J.Z., *supra* note 20, at 239.

[44] This assertion is debatable as nonscheduled traffic, although seemingly less fettered by the Chicago Convention, is still subject to State permission. It is unlikely that a large capacity almost regular unscheduled service by a carrier not substantially owned and controlled by nationals of the other Party would receive such permission. If so, it would be very restrictive as to capacity, and as always, subject to withdrawal.

[45] *Chicago Convention*, *supra* note 13, Articles 77-79.

[46] The Scandinavian Airline System is a consortium of Swedish, Danish and Norwegian airlines, which was established pursuant to an agreement signed on 1 October 1950. The shares in the consortium are held 3/7 by Swedish interests and 2/7 each by Danish and Norwegian interests, with the planes proportionally registered in the respective countries.

National regulatory bodies' natural predilection towards certainty in regards to aircraft ownership and airline ownership and control[50] and the resulting bilateral framework premised on the same certainty, were challenged by the trend towards the leasing of aircraft which emerged in the 1970s.[51] As a result, in 1980, the 23rd Session of the ICAO Assembly adopted a Protocol for the amendment of the Chicago Convention in the form of proposed Article 83*bis*.[52] The proposed Article 83*bis*, which has so far received 83 of the 98 ratifications needed to come into force, would apply when an aircraft registered in a contracting State is operated under lease, charter or interchange by a foreign operator. It would allow the State of registry to transfer all or part of its functions and duties to the operator's State of business or residence.[53] However, its impact on the issue of the nationality of airlines is rather limited.

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[47] Established in March 1961 as a joint corporation of 11 African States. Now 80.2% owned by ten States (Benin, Burkina Faso, Central African Republic, Chad, the Congo, the Ivory Coast, Mali, Mauritania, Niger and Senegal) and 19.48% by SPAO (Société de participation en Afrique et dans l'Ocean Indien). As Air Afrique was not a consortium of companies, like SAS, but rather a multinational company ICAO adopted Art. 18 of the *Convention on Offences and Certain Other Acts Committed on Board Aircraft*, which allowed for the designation of any one State as the State of registry in cases where aircraft are not registered in any one State, in cases pertaining to this Convention, signed at Tokyo on 14 September 1963, (1993) XVIII-II AASL 169 , ICAO Doc. 8364; Although it must be kept in mind that this approach was formulated for the particular purposes of that Convention, it has been suggested that it is a workable compromise for situations where joint operating agencies run airlines without a specific apportionment of aircraft among the participants, See Milde, M., *Nationality and Registration of Aircraft Operated by Joint Air Transport Operating Organizations or International Operating Agencies*, (1985) X AASL 133, at 144.

[48] Established in March 1950 as a joint corporation with shares held by four Gulf States (Bahrain, Oman, Qatar and the United Arab Emirates).

[49] Ceased operations after several years.

[50] See **2.1.2. The Chicago Convention**, at 15.

[51] At the beginning of the 1980s, approximately 6% of the world's jet fleet was on operational lease. By 1991, this figure had reached 20% and is projected to rise to 36% by the end of the decade. This trend does vary from region to region, with 40% of the US airline fleet on lease and 25% of the European fleet on lease, See Bureau of Transport and Communications Economics, International Aviation: Trends and Issues (Report 86) (Canberra: Australian Government Publishing Service, 1994), at 389 [hereinafter *BTCE Report*].

[52] *Protocol relating to an amendment to the Convention on International Civil Aviation*, signed at Montréal on 6 October 1980, (1993) XVIII-II AASL 149, ICAO Doc. 9318.

[53] See Fitzgerald, G.F., *The Lease, Charter and Interchange of Aircraft in International Operations - Article 83bis of the Chicago Convention on International Civil Aviation*, (1981) VI AASL 64.

In 1983, the 24th Session of the of the ICAO Assembly adopted a resolution exhorting States to accept that, within regional economic groupings, a developing State or States may designate for operation of air services an airline of another member State of the group, provided that ownership and control remains within the group.[54] Several States, including Canada, have adopted this approach in their bilateral agreements with some of the Caribbean countries.[55]

However, notwithstanding the fact that the Chicago Conference was not an unequivocal endorsement of national ownership and control, the fact that the Chicago standard agreement was not a very attractive agreement to many States and was superseded by the Bermuda I agreements, and the fact that the IATA Agreement was soon rendered irrelevant,[56] the national ownership and control provisions found throughout the aviation world today remain the legacy of the Chicago Conference.

### 2.1.5 The Link Between Governments and Airlines

As mentioned earlier, there were serious and quite practical considerations in ascribing nationality to aircraft. Facility in regards to fulfilling the national regulatory obligations in regards to aircraft soon saw the extension of nationality to airlines. The introduction and crystallization of the bilateral air transport agreement system narrowed the issue of airline nationality to one of designation.

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[54] ICAO, *Practical Measures to Provide an Enhanced Opportunity for Developing States with Community of Interest to Operate International Air Transport Services*, Assembly Resolution A24-12, ICAO Doc. 9509, at III-6.

[55] See Gertler, J.Z., *supra* note 20, at 240.

[56] The Agreement was a liberal arrangement exchanging the five freedoms of the air, therefore unattractive to most States, resulting in very few ratifications of the Agreement.

However, although these developments are logically and temporally linked, the link between airlines and nationality was really cemented by governmental involvement in the industry. The respective governments were in essence guarantors of the operational safety of their aircraft. As international flights could only occur under international agreements with other countries, governments were by necessity given the role of managing the development of the initial structure of air transport right exchanges. Given the fact that most of these developments were occurring right after World War II, when security was still foremost in most countries' minds, the fact that governments are inherently conservative in matters of international relations, and the fact that aviation's true potential was just being realized, it is not surprising that there was a convergence of governmental interests in creating an international air transport system premised on creating, requiring and protecting national airlines.

Over time, the number of enumerated justifications for linking airlines to States increased to include: participation in air traffic, earning hard currency, garnering national prestige, supporting the national tourism industry, supporting the national aircraft and maintenance industries, providing high technology employment, providing links to ethnic groups abroad, and providing a strategic reserve of aircraft for military use. These considerations lead to the establishment of mostly government owned airlines throughout the world,[57] the "flag" carriers, who divvied up the world air transport market between them.

[57] Except in the United States.

## 2.2 NATIONAL LEGISLATION

The international regulatory order for the exchange of traffic rights which developed after the Chicago Conference, predicated on the concept of nationality of airlines, necessitated the parallel enactment of national legislation to the same effect. Although the history of this type of legislation pre-dates the Chicago Convention, arising from the same concerns which influenced the development of the early multilateral framework,[58] this examination will only focus on the modern legislation governing air carrier citizenship and establishment found in the United States, Canada and the European Union.[59]

### 2.2.1 The United States

In the United States, the establishment and operation of air carriers is governed by the *Federal Aviation Act of 1958*, as amended in 1988.[60] Under the Act, no air carrier may engage in air transportation without a valid certificate issued by the Department of Transportation.[61] It requires that a United States air carrier[62] be a citizen of the United States and defines "citizen" as follows:

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[58] See **2.1 THE DEVELOPMENT OF NATIONAL OWNERSHIP AND CONTROL REQUIREMENTS**, at 9-14.

[59] The earliest American legislation containing a limitation on foreign ownership of U.S. carriers can be found in the *Air Commerce Act of 1926*. It defined a citizen of the United States as an individual who is a U.S. citizen, a partnership composed only of U.S. citizens, or a corporation that was organized in the United States and that fulfilled two further requirements: 1) two-thirds of its board of directors had to be U.S. citizens, and 2) U.S. citizens had to own fifty-one percent of its voting stock, Ch. 344, Pub. L. No. 69-254, 44 Stat. 568 (1926) (formerly 49 U.S.C. §§ 171-84 (west 1951) (repealed in 1958); For a detailed examination of the history of American legislation, See Stewart, J.T. Jr., *United States Citizenship Requirements of the Federal Aviation Act - A Misty Moor of Legalisms or the Rampart of Protectionism*, (1990) 55 JALC 685.

[60] Pub. L. No. 85-726, 72 Stat. 737 (1958), currently codified in 49 U.S.C. §§ 1301 *et seq.*.

[61] 49 U.S.C. § 1371 (1988).

[62] "Air carrier" is defined as "any citizen of the United States who undertakes whether directly or indirectly or by a lease or any other arrangement, to engage in air transportation", 49 U.S.C. § 1301(3) (1988).

(a) an individual who is a citizen of the United States or one of its possessions, or

(b) a partnership of which each member is such an individual, or

(c) a corporation or association created or organized under the laws of the United States or of any State, territory, or possession of the United States, of which the presidents and two thirds or more of the board of directors and other managing officers thereof are such individuals and in which at least 75 per centum of the voting interest is owned or controlled by persons who are citizens of the United States or one of its possessions.[63]

### 2.2.2 Canada

Although this thesis will focus on the United States and the European Union, Canada's legislation will be examined here because its wording opens up the possibility of significant foreign equity participation in Canadian airlines. In Canada, the establishment and operation of air transport services is governed by the *National Transportation Act of 1987*.[64] Like the United States, Canada requires a license for the operation of air services, which can only be held by "Canadians".[65] A "Canadian" is defined as follows:

> "Canadian" means a Canadian citizen or a permanent resident within the meaning of the *Immigration Act, 1976*, a government in Canada or an agent thereof or any other person or entity that is controlled in fact by Canadians and of which at least seventy-five percent, or such lesser percentage as the Governor in Council may by regulation specify, of the voting interests are owned and controlled by Canadians, as defined in the *National Transportation Act, 1987*.[66]

Although the wording of this requirement appears very similar to the requirements in the United States, the use of the word "Canadian" instead of "citizen" and the inclusion of the phrase "or a permanent resident within the meaning of the *Immigration Act, 1976*"

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[63] 49 U.S.C. § 1301(16) (1988).

[64] R.S.C., 1985 c.28 (3rd supp.).

[65] R.S.C., 1985 c.28, s. 72 for domestic service, s. 89 for scheduled international service.

[66] R.S.C., 1985 c.28, s. 67(1)

suggests that it may be possible for foreign citizens to set up an air carrier in Canada. Although this has not been attempted yet, interesting possibilities come to mind when this definition is viewed in light of the fact that "permanent resident" under the new *Immigration Act*,[67] enacted in 1993, includes landed immigrants to Canada.

Under the Investor Immigrant Program, qualified applicants are given landed immigrant status in Canada if they invest a set sum of money in a Canadian business. This program has proven very successful in attracting Asian immigrants, particularly those from Hong Kong. Many of these immigrants have made very large investments in Canadian real estate and businesses,[68] yet continue to operate their Asian businesses and live part of the time in their country of origin, with the security of a Canadian passport. Participants in the program are always looking for investment opportunities in order to qualify. On the other hand, investors and operators of air transport services are always looking for ways to penetrate foreign markets. Why not kill two birds with one stone?

Given the wording of the legislation, it would seem possible to set up a Canadian airline fully owned by foreign nationals. This would not be a practical solution for existing airlines, given their ownership and corporate structure (the airline can't immigrate), but it does seem like an attractive option for someone, or a group, to set up an airline. The most logical option would be to set up a charter airline, initially operating between Canada and the investor's home region. Given that personal relationships play a large role in Asian business and governance, a Canadian airline owned by a prominent Asian, or a

[67] Immigration Act, 1976-77 c.52, s. 7 (as amended in 1993).

[68] Vancouver's newfound prosperity is largely a result of such investments.

prominent group, would also most likely find it less arduous to obtain the necessary approvals for operation to that region.[69]

### 2.2.3 The European Union

The European Union is an interesting subject in this regard because it has done away with traditional national ownership and control requirements within its Member States, through the enactment of Council Regulation 2407/92[70] introduced in the Third Phase of Liberalization Measures.[71] The Regulation continued the practice of Member States licensing air carriers but mandated that it be done in accordance with harmonized, non-discriminatory, and Community-wide criteria. In place of national ownership and control requirements, the EU instituted Community criteria. The applicant must be:

> ... owned and continued to be owned directly or indirectly or through a majority of ownership by Member States and/or nationals of Member States. It shall at all times be effectively controlled by such states or such nationals.[72]

In addition, Member States may no longer give preferential licensing treatment to their "flag" carriers, nor may they limit the number of licenses granted. In effect, it means that citizens of any Member State may establish airlines in any other Community State, as has been done by British Airways in Germany and France.[73]

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[69] For a detailed description of the Canadian requirements for operating an airline, See Transport Canada Aviation, *Canadian Commercial Air Services Operations Certification Requirements and General Information (TP8880E)* (Ottawa: Canada Communication Group, 1993).

[70] EU, *On Licensing of Air Carriers*, of 23 July 1992, O.J. L240/1.

[71] For a general review of the Third Phase of Liberalization, See Haanappel, P.P.C., *Recent European Air Transport Developments*, (1992) XVII-II AASL 217.

[72] Art. 4, para. 2.

[73] The insistence on national Community ownership, as opposed to establishment, of air undertakings has been questioned by some commentators as being contrary to the EU rules on establishment. Under Article 58 of the Treaty of Rome, the right of establishment is conferred on "companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within

## 2.3 CABOTAGE RESTRICTIONS

The last major hurdle to establishing multinational airlines comes by way of the restrictions on the exercise of cabotage rights found in Article 7 of the Chicago Convention, most bilateral agreements and in the national legislation of most States. Cabotage is the right to carry traffic between two points in a foreign territory. There are two types of cabotage. The first type is called consecutive cabotage, and gives the right to carry traffic between points in a foreign territory, but only in conjunction with the exercise of third or fourth freedom traffic rights (carriage to or from the country of registration). It is also referred to as the eighth traffic freedom right. The second type is called stand-alone cabotage, which allows for such carriage without it being linked to a third or fourth freedom traffic right, and is also referred to as the ninth traffic freedom right.

Given the aforementioned discussion of the nationalist imperative in international aviation, it is not surprising that cabotage is considered the jewel in the aviation crown of most nations.[74] As such, it is the most sensitive and protected aspect of the aviation traffic market, both nationally and internationally. Such traffic is almost exclusively reserved for the domestic air carriers, both in domestic legislation and in bilateral air transport agreements. On a multilateral basis, it is dealt with in Article 7 of the Chicago Convention, which specifically prohibits States from entering into agreements which grant

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the Community", See Balfour, J., *Flying the Flag - the Role of Nationalism in Air Transport*, paper delivered at the Annual Conference of the European Air Law Association, 9 November 1990; As in other jurisdictions, air carrier nationality is linked to the nationality of aircraft. Articles 8 and 10 of the *licensing* regulation have changed the requirement that aircraft used by a Member State's carriers be registered in the Member State to a requirement that such aircraft be registered in the national register or within the Community, See Ricketts, R. & Balfour, J., *Aircraft Use, Registration and Leasing in the EC*, (1993) XVIII-I Air & Space Law 25.

[74] Although , as we shall see later, its importance is probably over-exaggerated for most national markets, particularly in light of the latest trends in the development of air transport traffic and relations.

cabotage rights on an exclusive basis.[75] However, the Article is composed of two sentences which lead to some ambiguity as to its effect.

The first sentence is basically a restatement of the sovereignty principle, but in a commercial way. States may refuse to give permission to **aircraft** of other contracting States for carriage of cabotage traffic. Notwithstanding the Chicago Convention's focus on aircraft rather than on airlines, the reference to aircraft here is generally viewed as a drafting error, and State practice has been to read the sentence as if it reads "airline", thereby avoiding any problems which may arise with leased aircraft. As such, it does not create a major obstacle to the operation of cabotage routes by multinational airlines.[76]

The second sentence, however, is the real stumbling block to such operations, as it prohibits States from specifically granting cabotage rights on an exclusive basis to any other State or any **airline** of another State. The reference to "specific" granting of the privilege on an "exclusive" basis, leads States to be very wary in granting such rights. They are never included in bilateral agreements, thereby avoiding the "specificity" of the granting, and are conferred on a unilateral permit basis, which can be withdrawn at any

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[75] The text of the Article reads as follows:

> Each contracting State shall have the right to refuse permission to the aircraft of other contracting States to take on in its territory passengers, mail and cargo carried for remuneration or hire and destined for another point within its territory. Each contracting State undertakes not to enter into any arrangements which specifically grant any such privilege on an exclusive basis to any other State or an airline of any other State, and not to obtain any such exclusive privilege from any other State.

For a detailed analysis of this part of Article 7, See Mendes de Leon, P., Cabotage in Air Transport Regulation (Dordrecht: Martinus Nijhoff, 1992), at 21-37.

[76] The issue arose in relation to SAS, which registers its aircraft among the consortium countries. As such, aircraft registered in Denmark but carrying traffic internally in Sweden would be performing cabotage, and Sweden could not refuse other States the same right. The question was put to ICAO but was never answered, while SAS continues the practice.

time.[77] Article 7 does not state what its contravention would bring. It is assumed that the State granting the right would have to grant it to every other State, a sort of Most Favoured Nation clause for aviation. However, the other States cannot ask for more than that specific route with exactly the same frequency.[78]

### 2.3.1 Cabotage in the European Union

The Third Phase of Liberalization Measures, enacted in 1992, also introduced the concept of cabotage freedom within the Union, by way of Council Regulation 2408/92,[79]albeit with some restrictions until 1997.[80] Since the Member States of the Union continue to exist as separate international legal entities, "States", the granting of cabotage rights to Member States would seem to contravene the second sentence of Article 7, which prohibits the "specific" and "exclusive" granting of such rights. On its face, this arrangement seems to contravene the "exclusivity" principal. However, it has been argued that the "no cabotage privilege" does not extend to regional arrangements such as the European Union,[81] with the SAS agreement[82] being given as a precedent for such a conclusion. It has also been argued that the absence of protest by third countries

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[77] An example of this is the Geneva-Zurich route, where any carrier can apply for the traffic right as long as the Swiss cabotage forms part of an international route and as long as the foreign carrier has traffic rights to both Geneva and Zurich. As a result, the conferral of the right cannot be viewed as neither too specific nor discriminatory. Such service is presently provided by TAP, Finnair and Royal Air Maroc. Example provide by Haanappel, P.P.C., from a lecture given on 20 March 1995, Institute of Air and Space Law, McGill University, Montréal.

[78] For a detailed analysis of this section of Article 7, See Mendes de Leon, P., *supra* note 75, at 37-53.

[79] EU, *On Access for Community Air Carriers to intra-Community air routes*, of 23 July 1992, O.J. L240/8.

[80] Until 1997, such cabotage traffic must be consecutive, cannot comprise more than 50% of capacity, and Member States may continue to regulate domestic traffic but in a way not contrary to the Community's competition rules.

[81] See Weber, L., *The European Union and the Chicago Convention of 1994, (1994) XIX-III Air & Space Law 179, at 182.*

[82] See *supra* note 75.

should be viewed as acquiescence, thereby creating a new rule of international law.[83] However, considering the still unsettled state of Community application of its regulations, it is difficult to accept the argument that a silence lasting little more than two years somehow demonstrates acquiescence, thereby leading to the creation of a new rule of customary law.[84] However, the passage of time and the continued implementation of the Community's internal air transport market liberalization, without protest by third countries,[85] will give such an argument more credence.[86]

## 2.4 THE NEED FOR REFORM

The existing linkage between aviation, nationality and government clearly puts air transport policy within the political sphere. Above all else, it is a struggle for power,[87] utilizing the law as its sword and shield. Since the early developments in the regulation of air transport, that power was perceived to be most easily achieved and preserved through the identification of airlines with governments. In some respects, for some countries and during the nascent period of international air transport, that was probably the case. The general framework engendered by the Chicago Convention, with its emphasis on this national identification, nevertheless created an environment within which States could

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[83] See Weber, L., *supra* note 81.

[84] The duration of a practice is one of the determinants in the recognition of rules of customary international law. However, in aerospace matters, rules of customary law have emerged from relatively short periods of practice, See Brownlie, I., Principles of Public International Law (4th ed.) (Oxford: Clarendon, 1990), at 5.

[85] Third countries are unlikely to protest, as they risk losing the fifth freedom rights they enjoy presently. These rights are far more lucrative than any possible cabotage rights in the Member States, as it is extremely difficult to compete against an established national carrier on its domestic routes.

[86] For a detailed analysis of the impact of EU liberalization on cabotage, See Mendes de Leon, P., *supra* note 75, at 135-180.

[87] See Wassenbergh, H.A., Aspects of Air Law and Civil Air Policy in the Seventies (The Hague: Martinus Nijhoff, 1970).

negotiate the exchange of economic rights of access with each other. In retrospect and given the novelty of the industry, the legal/regulatory "technology"[88] of bilateral negotiations, with its resulting emphasis on governmental identification with airlines, served the industry well up until the changes which started to occur in the industry in the late 1970s. In fact, it served as an impetus for its initial stage of growth, as it in a certain sense "monetized"[89] the exchange of international air traffic rights.

The industry's further growth occurred in stages following revolutionary and sequential developments in the following fields: aviation technology (from the 1950s to the early 1970s - the introduction of jet engines for civilian transport and the development of larger and more efficient planes culminating in the 747), management technology (from the 1970s to the 1990s - frequent flyer schemes, yield management systems, organizational restructuring, quality and customer service improvements), and information technology (from the 1970s to the 1990s - computerized reservation systems).[90]

However, it is not expected that the industry will experience any revolutionary developments in the enumerated fields in the foreseeable future, with the hypersonic plane projected to be first on line in about ten years. Given the fact that the hypersonic plane will be used almost exclusively on international routes (with the possible exception of certain routes within the United States and a few other countries), its viability and impact on the industry will be constrained by the same regulatory framework which limits today's

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[88] Term used by Gialloretto, L., *International Air Transport Regulation and Airline Efficiency*, (1995) XX-I AASL 459, at 459.

[89] By introducing uniformity and a modicum of clarity to air traffic rights, thereby facilitating their exchange.

[90] See Gialloretto, L., supra note 88, at 460.

technology. Therefore, the most logical, practical and possible method of increasing efficiency and profitability presently and into the foreseeable future appears to be a revamping of the regulatory mechanism, including a rethinking and revision of the nationality criteria.

# PART II

## 3. MERGERS AND TAKEOVERS[91]

In jurisdictions where the deregulation of air transport has occurred, thereby allowing the industry to develop according to economic rather than regulatory criteria, a trend towards consolidation emerged as the driving force behind the industry's re-organization. However, as was outlined in the previous chapter, national ownership and control requirements have ensured that mergers and takeovers remained almost exclusively a national phenomenon. This national trend towards consolidation of the industry has been particularly evident in the United States. In the fifteen year period between the introduction of deregulation in 1978 and 1992, the eight largest American carriers had absorbed the operations of thirty-one domestic carriers[92] and had increased their control of the domestic market from 80% to 90%.[93] The ensuing collapse of PAN AM and the restructuring and downsizing of TWA have further decreased the number of major market participants, but have increased their market power to the point where the industry is now controlled by an oligopoly of six carriers.

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[91] Mergers and takeovers essentially describe the same process, as they both result in one corporate entity. However, they differ in the way that goal is achieved. Mergers occur when two airlines, usually of comparable size, join their separate corporate entities and operations into one. Takeovers occur in situations where an airline absorbs the operations of another airline, usually but not necessarily, smaller in size. Takeovers can either be consensual or hostile, while mergers are generally the result of negotiated agreements.

[92] See the chart in Dempsey, P.S., *Airline Deregulation in the United States: Competition, Concentration, and Market Darwinism*, (1992) XVII-II AASL 199, at 212.

[93] Ibid., at 218.

These developments have been paralleled in Canada. In 1984, when the process of deregulation first commenced, Air Canada controlled 53% of the domestic market, with CP Air, the regional carriers and local carriers splitting the rest of the market amongst themselves. By 1990, Air Canada and PWA (the successor airline to CP Air and now named Canadian Airlines) controlled 98% of the Canadian market.[94]

The process of consolidation , partly through mergers, has also occurred within the European Union, but to a lesser extent. The most notable examples of this are British Caledonian's merger with British Airways in 1987, and the takeover of Air Inter and Union de Transport Aeriens (UTA) by Air France in 1990.[95] However, as in other regions, this has mostly been a national phenomenon owing to national ownership and control restrictions. The introduction of Community ownership and control criteria as of 1993 opened the door to multinational mergers and takeovers within the Union.

## 3.1 THE DRIVE TOWARDS CONCENTRATION

Alfred E. Kahn, the architect of American deregulation, was the main proponent of the contestability theory of the airline market and premised much of the dismantling of the regulatory mechanism on this belief.[96] Under this theory, the U.S. airline market was perceived to be contestable, that is, lacking significant barriers to entry and without economies of scale or scope.[97] However, the ensuing consolidation of the industry proved

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[94] See Petsikas, G., *Competition in the Canadian Airline Industry: A Contradiction in Terms?*, (1990) XV AASL 207, at 207-211.

[95] See *BTCE Report*, *supra* note 51, at 250.

[96] See Kahn, A.E., *The Theory and Application of Regulation*, (1986) 55 Antitrust Law Journal 177.

[97] Economies of scale refer to increasing returns with increasing size and production runs. In the case of airlines, it would refer to increasing returns with increasing passenger carriage capacity. Economies of scope refer to increasing returns with increasing variety of services provided. In terms of airlines, the scope would increase with

that not to be the case, with several factors influencing the eventual development of an oligopolistic market structure.

### 3.1.1 The Airlines' Need For Size and Scope

Economies of scale do exist to a certain extent in the airline industry, but their impact is not very significant.[98] Nevertheless, even though economies of scale flatten out beyond a small firm size, carriers have sought merger partners who could provide them with nationwide geographic coverage and traffic density,[99] thereby allowing them to increase the variety or scope of the services they offer. These include: increased city-pair services, more attractive frequent flyer programs, more efficient use of computer reservation systems, discriminatory pricing, and utilization of hub-and-spoke systems. Therefore, although economies of scale are not very significant in themselves for airlines, they are necessary to extract the more important economies of scope.[100]

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the introduction of computer reservation systems, hub-and-spoke systems and frequent flyer programs. For a detailed analysis of economies of scale and scope and their impact on the contestability of a market, See Baumol, W., Panzar, J. & Willig, R., Contestable Markets and the Theory of Industry Structure (New York: Harcourt Brace Jovanovich, 1982).

[98] The O.E.C.D. found that while some evidence of the existence of economies of scale does exist in air transport, they do not appear very significant at the overall firm level, See O.E.C.D., Deregulation and Airline Competition (Paris: O.E.C.D., 1988), at 22.

[99] See Brueckner, J.K. & Spiller, P.T., *Economies of Traffic Density in the Deregulated Airline Industry*, (1994) XXXVII Journal of Law and Economics 379.

[100] The premises underlying the deregulatory drive and the resulting industry consolidation have been heavily criticized by some commentators. The premises themselves are viewed as false, in light of the fact that barriers to entry do seem to exist in the market, particularly in the form of hub-and-spoke and computer reservation systems. The post-deregulation industry structure is seen as a betrayal of the promises made about deregulation, See Brenner, M., *Airline Deregulation -- A Case Study in Public Policy Failure*, (1988) 16 Transport Law Journal 179; Also, See the rejoinder by Kahn, A.E., *Airline Deregulation-A Mixed Bag, But A Clear Success Nevertheless*, (1988) 16 Transportation Law Journal 229.

### 3.1.2 The Hub-and-Spoke System

The development of hub-and-spoke systems allowed airlines to generate higher traffic density and frequency on major routes. It also resulted in enhanced marketing opportunities by virtue of the increased number of possible city-pair markets which could be served, thus producing significant networking economies. The efficient utilization of such a system required that traffic be funneled to the hub from the outlying regions, which could best be accomplished by controlling the regional carriers. On the other hand, the increasing dominance of hubs by single carriers acted as an artificial barrier to operation and entry for independent regional carriers.[101] Even without equity control of existing regional carriers, the dominant carrier at a hub controlled access to gates, which were rarely sold but leased, thereby ensuring that the regional carriers' operations slowly became dependent on the dominant carrier's good-will. The dominant carriers' need for funneling and the regional carriers' growing reliance on the dominant carriers acted as a push-pull mechanism towards mergers and takeovers.

### 3.1.3 Computer Reservation Systems (CRS)

Airlines sell over 80% of their tickets through travel agents, 95% of whom use one of the airline-owned computer reservation systems, with the Sabre (owned by American) and Apollo (owned by United) systems being the dominant players in the market. Ownership of CRS is intimately related to the size and scope of an airline's operations and confers tremendous competitive advantages. Above cost booking fees charged to user

[101] Prior to deregulation, while Atlanta (for Delta) and Pittsburgh (for Allegheny, now USAir) were moderately concentrated, no airline dominated more than 50% of the market (measured by gates, passengers, or takeoffs and landings) at any major American airport. Today, 60% of the market (and in some cases 90%), at 17 major airports is controlled by dominant airlines, See Dempsey, P.S., *supra* note 6, at 35.

airlines increased the marketing costs of smaller incumbent carriers, while acting as a barrier to entry for new entrants.

More importantly, the huge profit margins generated by such systems allowed the operating (larger) airlines to cross-subsidize their airline operations, affording them the opportunity to instigate and withstand longer and more frequent price wars.[102] Screen and system bias also allowed the system-owning airline to increase ticket sales at the expense of user airlines. Travel agent commission overrides induced some travel agents to present biased information to consumers and captured agency loyalty. Contractual provisions between CRS operators and travel agents created exclusive dealing arrangements by making it very difficult and expensive for agents to change systems.[103]

### 3.1.4 Frequent Flyer Programs

New entrants and smaller incumbent carriers also face having to overcome the brand loyalty created through frequent flyer bonus programs. Large airlines have an advantage over small airlines in that they cover more potential destinations, thus making their bonus awards easier to earn and making them more attractive to travelers. New entrants and smaller incumbents can only match this capability by having comparable size

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[102] In 1986, Sabre accounted for half of American Airline's profits. Its CRS delivered a profit margin of 100% while its airline operations only had a 3-4% rate of return. These profits were generated at a time when the industry was in a great deal of flux, allowing American to be the price leader knowing that its CRS profits were isolated from this intense competition, See Bruneau, J.M., *Concentration Within the U.S. Airline Industry: A "Natural Phenomenon" or an "Ordinary" Monopoly/Oligopoly Resulting From the Behaviour of Competitors?*, (1992) XVII-II AASL 123, at 136.

[103] Through the inclusion of liquidated damages, minimum use and roll-over clauses. However, not all commentators view the development and concentration of CRS as inherently negative. D.J. Boudreaux and J. Ellig have argued that although there may be some anti-competitive aspects to CRS, most notably display bias, the reality of the market not having access to perfect information meant that CRS with all their imperfections performed a useful function. They maintain that display bias reduces search costs, while long-term operator/agent contracts protect the investments made in the systems, See *Beneficent Bias: The Case Against Regulating Airline Computerized Reservation Systems*, (1992) 57 Journal of Air Law & Commerce (JALC) 567.

and scope as the larger airlines (virtually an impossibility) or by offering awards after significantly fewer flights, thereby increasing their percentage of non-revenue generating traffic. This point was made in support of the USAir-Piedmont merger.[104]

## 3.2 MERGER AS THE OPTIMAL SOLUTION

The cumulative effect of all of the above developments was to make merger the optimal solution for both major carriers and smaller incumbents. Given the traditionally low profit margins of airlines, profit and revenue growth could most efficiently be increased by harnessing economies of scope and traffic densities, which could only be extracted through economies of scale, meaning airlines had to grow. Given the capital intensiveness of the industry, the heavy debt loads of most major airlines and the industry's traditional overcapacity, internally generated growth was a second best solution in many cases. Although economies of size and scope, the hub-and-spoke system, CRS and frequent flyer programs had the effect of serving as barriers to entry, that was not their primary objective.

If one views aircraft as a $30 million to $180 million factory producing consumer goods,[105] in this air carriage, the fact that such a factory can easily be leased for a fraction of its actual cost does not mean that everyone should have the right or the means to run such a factory. One cannot argue that the industry has always had a tendency towards

[104] Noted by Bruneau, J.M., *supra* note 102, at 139; Piedmont Acquisition Case, D.O.T., Docket 44719, (22 May 1987), Exhibit JA-T-1, at 16-17.

[105] A metaphor suggested by Dempsey, P.S., *supra* note 6, at 38.

overcapacity,[106] while at the same time lamenting the lack of new entrants, who would presumably add to that capacity.

Regional or smaller carriers are often portrayed as victims of mergers, but that is not necessarily the case. The airline industry can in some ways be compared to the pharmaceutical industry. Smaller laboratories which have a marketable product often do not have the resources to test, distribute and market their products. They can resist joining forces with larger companies, but they can rarely hope to extract the maximal returns possible from their investments. However, by giving up some of their control and in return gaining access to larger resources and systems, they can reap a larger return. In terms of airlines, it depends on how scale and scope are viewed. If they are seen as inherently negative, one has no choice but to conclude that mergers are also negative in their effects. In a perfect world, every airline would have access to the same financing sources and at the same rates, while magically being able to create instant and world-wide networks and marketing. Unfortunately, that is not the case. Smaller airlines must pay a price to access these resources and the potential returns they bring, and that price is control.

## 3.3 AIRLINE MERGERS IN THE UNITED STATES & EUROPE

It must be kept in mind that the foregoing discussion on the stimuli driving consolidation within national airline industries, in themselves, are not limited by national boundaries. Economies of scope and traffic density make no distinction as to a passenger's nationality, point of origin or destination, nor do they have differing effects on

[106] Ibid., at 23.

airlines of different nationalities. The drive towards a critical mass and the scope that it gives in conjunction with the ever increasing importance of the international component of airline operations, have in fact made mergers and takeovers between airlines of different nationalities an imperative. Mergers within national boundaries have basically run their course, with most of the weaker airlines already having merged or collapsed. Further consolidation must take place, but if it is artificially limited by national ownership and control criteria, it can only produce a more anti-competitive marketplace deleterious to the consumer.

When it comes to buttressing weaker airlines, national regulators are left with four choices: re-regulate (which is highly unlikely), allow them to collapse, allow mergers with national carriers (leading to more market concentration), or let a foreign airline assume control of their operations, thereby breaking with sacrosanct national ownership and control criteria but preserving a semblance of a competitive national market. However, as we shall see in the following sections, mergers between airlines of different nationalities find it almost impossible to overcome national ownership and control criteria. Although a particular transaction may seem to pass the strict requirements of national citizenship in the jurisdiction in question, the actual interpretation of the law makes it almost impossible for foreigners to assume control.

The following analysis will focus on the United States and the European Union for two reasons. One, their markets are by far the largest integrated aviation markets in the world. Two, the United States, with its fully privatized market and early deregulation, and the European Union, still in the process of integrating its collection of what were

essentially national aviation markets, provide the most interesting and dynamic subjects for the study of the evolution of aviation law.

### 3.3.1 The United States

#### 3.3.1.1 The "Numbers" Test

As mentioned earlier, under section 101(16) of the *Federal Aviation Act*, a U.S. carrier must be a "citizen" of the United States to engage in air transportation.[107] That is, U.S. citizens must own 75% of the airline's voting stock and two-thirds of the members of the airline's board of directors or other managing officers must be U.S. citizens. In interpreting the citizenship requirement, the Civil Aeronautics Board (CAB) and the Department of Transportation (DOT) have been very strict, only deviating from the 25% foreign ownership maximum in two cases.[108]

#### 3.3.1.2 The "Control" Test

However, in addition to this technical or numerical test, a second functional test is applied in takeover or merger cases involving U.S. airlines as targets. This second test, termed the "control" test, is couched in section 408 of the Act which deals with consolidations, mergers, and acquisitions of U.S. aeronautical companies by anyone, including foreign corporations.[109] Section 408(a)(4) effectively prohibits a foreign carrier from gaining control of a U.S. air carrier. It makes it unlawful "for any foreign carrier or

[107] See 2.2.1 The United States, at 25.

[108] The 49% stake held by KLM in Northwest, which shall be examined in the following sections, and the 27% Air Canada stake in Continental.

[109] 49 U.S.C.S. § 1378.

person controlling a foreign carrier to acquire control, in any manner whatsoever, of any citizen of the U.S. substantially engaged in the business of aeronautics".

As "control" is not defined in the Act, the interpretation of its meaning has been left to the CAB and the DOT. It has been found in cases where either the management structure, creditor relationships, indirect partnerships, stock options or other financial mechanisms have suggested a modicum of "control".[110] However, section 408(f) of the Act which applies to transactions under section 408(a)(4) makes a statutory presumption of "control" where "any person owning beneficially 10 per centum or more of the voting securities or capital ... of an air carrier shall be presumed to be in control of such air carrier unless the Board/DOT finds otherwise".

As a result of this section, a proposed merger with a foreign airline must pass both tests to meet with DOT's approval. If the proposal calls for a foreign equity holding of more than 25%, it is dismissed immediately. If it comes under this threshold, the proposal must still pass the presumptive "control" threshold of 10%. However, as we shall in the review of some of the decisions on this issue, a 10% equity holding is not necessarily the minimum threshold for the purposes of section 408(a)(4).

[110] The cases leading to these findings will be canvassed in the following section.

### 3.3.1.3 Merger Cases

The actual control test was first enunciated and applied by the CAB in a 1940 decision.[111] Since that decision, the test has been restated and applied many times over the years by both the CAB and the DOT.

## A. Strict Interpretation of "Control"

1. ***Willye Peter Daetwyler, D.B.A. Interamerican Airfreight Co., Foreign Permit***[112] - Daetwyler, a Swiss citizen, held 25% of the stock of Interamerican Airfreight, but was found to exercise actual control over the enterprise because he had close personal relationships with many of the other stockholders, some of whom were employees of other companies owned by him.

2. ***Premiere Airlines, Fitness Investigation***[113] - An administrative law judge found that Mr. Cicippio, who had borrowed $2.5 million from his Saudi Arabian employer to invest in the airline, was under the control of the employer as a result of the loan. The CAB stayed its decision and approved the application after Premiere re-organized, stripping Mr. Cicippio of control. He had resigned from the board of directors and management, his voting interest had been transferred to an independent voting trustee, a

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[111] Uraba Medellin and Cent. Airways Inc., Certificate of Public Convenience and Necessity, 2 C.A.B. 334, 337 (1940), where the Cab stated, at 337 [emphasis added]:

> [t]he apparent general intent of the statute is to ensure that air carriers receiving economic support from the United States and seeking certificates of public convenience and necessity, under section 401 of the Act shall be citizens of the United States **in fact**, in purpose and in management. The shadow of substantial foreign influence may not exist.

[112] 58 C.A.B. 118 (1971).

[113] C.A.B. Order No. 82-5-11 (5 May 1982).

new senior financial officer had replaced him, and Premiere promised to pursue equity capital from other sources.

3. ***Key Airlines Inc., Fitness Investigation***[114] - The Board came to the conclusion that the presence of even one foreign partner in a controlling partnership, no matter how small his interest (5%), will prevent the application from coming within the definition of Section 101(16). The Board emphasized that the statute is not satisfied merely by numerical standards, but that it required that the carrier be controlled by U.S. citizens. Here, it found debt to be one form of foreign control.

4. ***Re Page Avjet***[115] - Page Avjet was ordered to stop operations because even though the foreign equity-holder held less than 10% of the stock, which was non-voting, they could nevertheless influence many of Page Avjet's crucial decisions by virtue of their right to block any consolidation, merger or acquisition, and its power to dissolve the company. The CAB approved a re-organization whereby the stock was split into two classes, with the foreign holder limited to the non-voting class. CAB found that this ownership structure sufficiently "insulated" the U.S. citizen officers and directors. This finding sparked much interest because it seemed to signal a loosening of the strict interpretation of the Act in that the CAB approved the plan despite the fact that Page retained the right to be bought out under certain conditions, which left it with a great deal of leverage over the airline.

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[114] C.A.B. Docket 41526, Order 84-4-83 (23 April 1984).

[115] C.A.B. Order No. 83-7-5 (July 1, 1983); C.A.B. Order No. 84-8-12 (2 August 1984).

5. ***Re Intera Arctic Services***[116] - Intera patterned its ownership structure on the plan approved for Page Avjet., whereby IT, a foreign corporation, held 25% of the non-voting class of stock and also retained the right to a buy-out. In rejecting the application, the DOT stated that *Page Avjet* represented the extreme outer limits of the interpretation of the citizenship requirements. It found that in the case at hand the foreign entity held 25% of the stock (a much larger stake than the 9% held by Page), thus a resulting buy-out would have a greater impact on the American shareholders. More importantly, it found that two key directors and management officials, although U.S. citizens, were also officers of the foreign corporation, thus leading to a conclusion of foreign influence and control.

6. ***Re Acquisition of Northwest Airlines, Inc.***[117] - KLM had initially planned to take a 56.74% holding in Wings Holdings Inc., a company created for the purpose of purchasing Northwest Airlines. Under the initial agreement, KLM was to own less than 5% of the voting stock in Northwest. However, the DOT argued that notwithstanding the small share of voting stock held by the foreign entity, the large share of equity held by a foreign citizen, even when in the form of non-voting stock, posed citizenship problems, particularly in light of the fact that there were other ties to the foreign entity. It also concluded that due to KLM's lack of voting stock, it would have a strong incentive to participate in the management of Northwest in order to protect its investment. Furthermore, the DOT found that KLM had *de facto* control of Northwest due its power to name one person to Wings' twelve-member board of directors[118] and its right to

[116] D.O.T. Order No. 87-8-43 (18 August 1987).

[117] D.O.T. Order No. 89-9-51 (29 September 1989).

[118] There were also no restrictions on the board member's participation in Northwest's decision-making.

organize a three member committee which would advise Northwest on financial matters.[119] Thus, the DOT concluded that KLM was likely to use these methods to control Northwest in order to protect its $400 million investment.

In light of these findings, the proposal was restructured in a way to substantially eliminate the foreign control concerns of the DOT. KLM's share of Wings' equity was to be reduced to no more than 25% within six months of the consent order. Until that time, a voting trust would hold any of KLM's interest exceeding that percentage. KLM's ability to create a financial advisory committee was eliminated and the participation of its member of the board of directors was limited. Northwest further undertook to report to the DOT on any agreements or change in ownership status which might affect the airline's citizenship status.

7. ***Re Discovery Airways Inc.***[120] - The Discovery board of directors consisted of seven members, four of whom were alleged to be foreign citizens or under the control of foreign citizens. The vice-chairman of the board of directors, who was also the board's representative to Discovery's management, was an Italian citizen. The DOT saw him as essentially serving the function of president and had him removed from the liaison position. The other three board members in question were all U.S. citizens, but one a Mr. Ho, was also the president of a wholly owned subsidiary of a Japanese company. The DOT felt that he was essentially under the control of a foreign entity, thus it ordered that he be removed from the board of directors and that his voting stock be placed in voting

[119] There were also no limits on the authority and scope of the advisory committee's advice.

[120] D.O.T. Order No. 89-12-41 (21 December 1989).

trust. The remaining two members of the board in question were also ordered removed because of their connections to Mr. Ho and the Japanese company.

As can be seen from these decisions, the DOT and its predecessor, the CAB, have consistently and strictly interpreted the citizenship requirements of the Federal Aviation Act. They have looked beyond *de jure* control to elements such as present and past personal and financial relationships between U.S. citizens and foreign corporations, to find *de facto* foreign control of U.S. airlines and reject the applications.

## B. Apparent Liberalization of the Citizenship Criteria

1. ***Re Acquisition of Northwest Airlines Inc. (Northwest II)***[121] - Two years after the DOT's initial consent order, Northwest filed another petition asking the DOT to modify the order. Specifically it asked that: the requirement limiting KLM's equity in Wings to 25% be terminated; KLM be permitted to hold 49% of the total equity; and 10.5% of the voting interest in Wings be held free of the voting trust (with any excess over 49% still to be held in trust); KLM be allowed to designate three members of the board of directors in an enlarged board of 15 members; and that the financial reporting conditions be removed. The DOT, for the first time stated that after a re-evaluation of the relationship between voting equity and non-voting equity, it would now allow up to 49% total foreign equity investment in a U.S. carrier. Although it pledged to continue to examine all methods of foreign control over U.S. carriers, the DOT would no longer construe foreign equity investments up to this limit, taken alone, as indicative of foreign control. Furthermore, it stated that this new approach was not limited to the Northwest/KLM application but

[121] D.O.T. Order No. 91-1-41 (23 January 1991).

would be applied in all foreign merger situations. The DOT noted that although KLM would have three members on the board of directors, their influence would be off-set by the other twelve members. To guard against these foreign appointed directors exercising a disproportionate influence, they were barred from serving as Chairman of the board and could not hold a disproportionate number of positions on important corporate committees.

This decision was seen as the dawning of a new era in the United States' approach to foreign equity investments in its airlines. It seemed to signal a policy shift towards an approach which examined the re-structuring of the American airline industry in the light of developments in the international industry as a whole. The DOT itself stated that its decision was partly based on its "reassessment of the complexities of today's corporate and financial environment".[122] This decision came at a time when the United States and the Netherlands were finalizing their "open skies" agreement. The DOT looked closely at this agreement and used it as a basis for its decision to allow KLM to invest and participate in Northwest's operations both through equity and its appointed members of the board of directors.

2. ***British Airways/USAir*** - Under the original agreement, British Airways was to invest $750 million in USAir and was to hold a 44% share of the overall equity. Of the total investment, $520 million was to go towards the purchase of a class of convertible shares, whose conversion to common shares would have given BA a 21% share of the total voting stock. The rest of the investment was to be in the form of another class of

[122] Ibid., at 7.

convertible stock, which was also convertible into common voting stock making up 23% of the total voting stock.[123]

The most controversial aspect of the agreement was the enlargement of USAir's board of directors from 13 to 16 members. BA was to appoint four members to the new board, while up to two other directors would have been "interlocking independent directors" who would serve on both BA's and USAir's boards. Furthermore, many key decisions of the new board of directors would have to be made by a super majority, made up of 80% of the board's members.[124]

The BA/USAir proposal was aimed at integrating and coordinating the activities of the two airlines within a period of five years. Areas planned to be integrated included: brand, sales, planning and inventory control, network planning, advertising and promotion, frequent flyer programs, ground handling, cargo operations, catering, information management, training, financial reporting systems, financing of capital equipment, facilities, purchasing, engineering, and quality assurance.

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[123] No conversion of either class of stock was to take place within the first four years. After five years, USAir had the right to require the conversion of all of the preferred shares into either common voting stock or common non-voting stock, according to the regulatory framework in place at that time, See USAir Corporate Communications Department, *USAir, British Airways to Invest $750 Million in USAir, First Step in Creation of World's Largest Airline Alliance*, News Release (21 July 1992).

[124] Such decisions included any operating or budget plan, other annual capital expenditures over $10 million, any investments exceeding $10 million, the appointment or dismissal of any senior USAir executive, the purchase or sale of routes, and any material marketing agreements or joint ventures.

Although BA's possible total 44% stake in the equity of USAir fell within the 49% guideline set in *Northwest II*, and its 25% representation on the board of directors fell within the 33% limit set out in the *Federal Aviation Act*, the agreement eventually failed when it became clear that it would not receive DOT's approval. This approval was not forthcoming because of a confluence of factors which made support of the proposal untenable politically.

The United States was just in the process of renegotiating its bilateral agreement with the UK and was having difficulties getting the British negotiators to agree to a liberalized air traffic rights regime, which the U.S. hoped to eventually lead to an "open skies" agreement similar to the one signed with the Netherlands.[125] U.S. carriers were interested in concessions which would grant them greater access to the highly valuable slots at London-Heathrow airport and expanded fifth freedom rights for European destinations. As a result, BA and USAir found themselves facing an unusual coalition of major carriers including American, Delta, United and Federal Express, who were intent on exerting political pressure to use the approval of the proposal as a bargaining chip in the ongoing bilateral agreement negotiations with the U.K.. Approval of the proposal would have meant that BA would have full access to both the U.K. and U.S. markets, thereby negating any incentive the British government may have had to grant the concessions desired by the Americans.

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[125] On March 31, 1992, former Secretary of Transportation, Andrew Card, announced the DOT's "open skies" initiative, which was aimed at European countries under which the U.S. would offer to negotiate "open skies" agreements with any European country that was willing to grant U.S. carriers unrestricted access to their respective airline markets. "Open skies" is defined in *Re Defining Open Skies*, D.O.T. Order No. 92-8-13 (August 5, 1992) where it states:

The proposed agreement faced other objections which also lead to its failure. BA's stake in USAir fell within the letter of the law as to the 21% foreign voting equity holdings (of the 25% limit), 25% representation on the board of directors (of the 33% allowed), and as to the 44% total foreign equity holding (of the 49% allowed under DOT's stated policy). However, the requirement of super majority board approval of almost all critical business decisions failed to pass the actual "control" test. The coalition of U.S. carriers opposing the deal had argued that such an arrangement would mean that BA had *de facto* control of USAir, contrary to the *Federal Aviation Act*.[126]

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These are the basic elements which will constitute our definition of "OPEN SKIES" for purposes of the Secretary's initiative:

(1) Open entry on all routes;

(2) Unrestricted Capacity and frequency on all routes;

(3) Unrestricted route and traffic rights, that is the right to operate service between any point in the European country, including no restrictions as to intermediate and beyond points, change of gauge, routing flexibility, co-terminalization, or the right to carry Fifth Freedom Traffic;

(4) Double-disapproval pricing in Third and Fourth Freedom Markets and (1) in intra-EC markets: price matching rights in third-country markets, (2) in non-EC markets: price leadership in third-country markets to the extent that the Third and Fourth Freedom carriers in those markets have it;

(5) Liberal charter agreement (the least restrictive charter regulations of the two governments would apply, regardless of the origin of the flight);

(6) Liberal cargo regime (criteria as comprehensive as those defined for the combination carriers);

(7) Conversion and remittance arrangement (carriers would be able to convert earnings and remit in hard currency promptly and without restriction);

(8) Open code-sharing opportunities;

(9) Self-handling provisions (right of a carrier to perform/control its airport functions going to support its operations);

(10) Procompetitive provisions on commercial opportunities, user charges, fair competition and intermodal rights; and

(11) Explicit commitment for nondiscriminatory operation of and access for computer reservation systems.

[126] The deal also raised some other issues, which although somewhat valid, did not seem to play a large role in the DOT's disposition towards the proposal. National security was trotted out as a reason to reject the proposal because USAir would effectively be under the control of a foreign entity leading to concerns that USAir's aircraft

At the time, DOT seemed to give much credence to these arguments, but BA's withdrawal of the application meant that DOT never had to make a decision on the matter. Given the fact that the same concerns arose in the Northwest case, where the DOT seemed to make a concerted effort to allow the parties to come up with a workable compromise, there is no reason to believe that the same could not have been done in this case. As opposed to the Northwest/KLM application where the U.S./Netherlands "open skies" agreement had served as a catalyst towards compromise, the lack of progress in the U.S./U.K. bilateral negotiations served as an impetus towards disapproval of the agreement.[127]

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would be unavailable for duty under the Civil Reserve Air Fleet (CRAF) program. The job security of USAir employees was also brought into question and was a legitimate concern in light of the huge job losses in the industry and the general diminution of job security. As labour costs make up a large proportion of the total input costs in the industry, consolidation was paralleled by intense labour strife and a re-evaluation of management-employee relations. This battle between management and labour resulted in financial hemorrhaging which further weakened or destroyed vulnerable airlines, eventually contributing to the cycle of bankruptcies, mergers and takeovers, See Northrup, H.R., *The Failure of the Teamsters' Union to Win Railroad-Type Labor Protection for Mergers or* Deregulation, (1995) 22 Transportation Law Journal 365, Schoder, L., *Flying the Unfriendly Skies: The Effect of Airline Deregulation on Labour* Relations, (1994) 22 Transportation Law Journal 105, and Walls, J., *Airline Mergers, Acquisitions and Bankruptcies: Will the Collective Bargaining Agreement Survive?*, (1991) 56 JALC 847.

The proposal gained some support from local cities served by USAir, which saw a rejuvenated USAir pumping more money into their economies. The final issued raised by the proposal concerned the benefits which would accrue to consumers with the strengthening of another market participant. However, proponents of the deal forecast a large consumer windfall, while opponents saw any benefits as merely short-term. For a more detailed analysis of these issues, See Arlington, D.T., *Liberalization of Restrictions on Foreign Ownership in U.S. Air Carriers: The United States Must Take the First Step in Aviation Globalization*, (1993) 59 JALC 133, at 161-173.

[127] See Arlington, D.T., Ibid., at 178-186.

In January 1993, BA revised its proposal and offered to pay $300 million for an initial 19.9% voting share (rising to 21.8% with approval from USAir's shareholders) and three seats on the USAir board. The revised bid included a further phased investment of $200 million in the first three years and an additional $250 million in the following two years. This brought the total investment to $750 million, equal to the original bid's investment, but with a total 32.4% equity stake, subject to the agreement of the DOT. The *de facto* veto over critical board of directors' decisions was not incorporated into this agreement.[128]

#### 3.3.1.4 Anti-Trust and Public Interest Test

The previous discussion is somewhat misleading in that it has ignored the anti-trust and public interest tests which form a vital part of the foreign equity participation review in the United States. As this dissertation is focused on national ownership and control provisions and their detrimental impact on the development of global airlines, it has focused on the "numbers" and "control" tests as they are specifically applicable to mergers and equity participations by foreign airlines. However, the "anti-trust" and "public interest" tests are applicable to any mergers or takeovers, whether involving foreign entities or not.

[128] See *BTCE Report*, *supra* note 51, at 258.

Prior to the implementation of the *Airline Deregulation Act of 1978*,[129] mergers and acquisitions in the airline industry enjoyed anti-trust immunity, as the industry was viewed and regulated as a public utility. However, the *Deregulation Act* instituted a regulatory environment premised on the belief that the industry was primarily competitive, necessitating that the CAB/DOT be given an additional task which was, "The prevention of unfair, deceptive, predatory, or anti-competitive practices in air transportation and the avoidance of (a) unreasonable industry concentration, excessive market domination, and monopoly power; and (b) other conditions that would tend to allow one or more air carriers unreasonably to increase prices, reduce services or exclude competition ...".[130]

From that point on, immunity from anti-trust provisions would only be granted on a case by case basis and only if it is found to be in the public interest, meaning that mergers and acquisitions in the airline industry were to be evaluated by the same anti-trust standards as applied to other industries.[131] In 1989, the Department of Justice (DOJ) took over responsibility for approving airline mergers from the DOT. The DOT still retains the right to challenge any merger approved by the DOJ, though in practice, such challenges are unlikely. However, it has retained the power to grant anti-trust immunity for international aviation agreements.

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[129] Pub. L. No. 95-504, 92 Stat. 1705 (1978), codified in various sections of 49 U.S.C.S..

[130] 49 U.S.C.S. § 1302(a)(7).

[131] See North Central-Southern Case, C.A.B. Order No. 79-6-7 (1979), which was one of the first major post-deregulation merger cases. The CAB set an early precedent in ruling that a section 408 approval will not be accompanied by anti-trust immunity under section 414 (49 U.S.C.S. § 1384).

American anti-trust laws are enunciated in the *Sherman Act*[132] and the *Clayton Act*.[133] Section 1 of the *Sherman Act* makes monopolies that unreasonably restrain trade illegal.[134] Although there has been significant litigation under the *Sherman Act* in regards to other industries, it has seldom been invoked in regards to practices in the airline industry.[135] However, most litigation in regards to anti-trust matters in the airline industry has occurred under the *Clayton Act*, which was passed in 1914 to supplement the provisions of the *Sherman Act*. It includes the following provisions: section 2 includes what is commonly known as the *Robinson-Patman Act*, which addresses the problem of price discrimination, section 3 prohibits tying arrangements, section 7 prohibits certain types of mergers, section 8 prohibits certain types of corporate interlocks, section 4 provides for a private cause of action in federal court,[136] while section 16 provides for injunctive relief.

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[132] 15 U.S.C.S. §§ 1-7 (1988).

[133] 15 U.S.C.S. § 15, 26 (1988).

[134] Section 1 specifically provides that:

> Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal. Every person who shall make any contract or engage in any combination or conspiracy hereby declared to be illegal shall be deemed guilty of a felony, and, on condition thereof, shall be punished by fine not exceeding $10,000,000 if a corporation, or, if any other person, $350,000, or by imprisonment not exceeding three years, or by both said punishments, in the discretion of the court.

[135] In Illinois Corporate Travel Inc. v. American Airlines Inc., 889 F.2d 751, 753 (7th Cir. 1989), *cert, denied*, 495 U.S. 919 (1990), an agreement whereby an airline which made hotel and rental car reservations through its reservation and ticketing service, in direct competition with its agents, was found not to be illegal *per se*. The court held that illegality depended on whether the agreement reduced supply from the consumers' perspective, which it only thought possible through an agreement among carriers; In International Travel Arrangers Inc. v. Western Airlines Inc., 623 f.2d 1255, 1268 (8th Circ.), *cert. denied*, 449 U.S. 1063 (1980), an airline's campaign to prevent travel group charters from competing with its scheduled services was found to be a violation of section 1 of the Act as it was found to be using false, misleading, and deceptive advertising.

[136] Although this thesis does not permit a thorough analysis of American anti-trust laws and their impact on the airline industry, it should be noted that although private anti-trust litigation is permitted under section 4 of the Act, it is prohibitively expensive and faces substantive procedural hurdles. However, it has been suggested that private anti-trust compliance programs, financed by levies on the airlines, could off-set some of the anti-competitive

Various criteria have been used to evaluate the anti-trust effects of airline mergers, among them being the elimination of direct or horizontal competition, the elimination of potential competition in the "relevant markets", and the "contestable markets" theory.[137] The "public interest" aspect of anti-trust analysis of mergers and acquisitions in the United States is not absolutely clear. Section 102 of the Declaration of Policy enumerates some of the elements in the following:

> ... the availability of a variety of adequate, economic, official and low-price services by air carriers and foreign air carriers, the placement of maximum reliance on competitive market forces and on actual and potential competition and the development and maintenance of a sound regulatory environment which is responsive to the needs of the public ... the domestic and foreign commerce of the United States, the United States Postal Service and the national defense ...[138]

In *Daetwyler*, the CAB equated Congressional policy with the public interest.[139] In *Pan-American World Airways, National Acquisition Case*, the Board concluded that section 408 included both a "public interest" test and a separate "anti-trust" test.[140] However, the scope of this thesis does not permit an exhaustive analysis of the cases which have enunciated and applied these tests. In cases involving foreign equity

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actions of the airlines without having to resort to re-regulation, See Hunt, A., *Assault on the Airline Industry: Private Antitrust Litigation and the Problem of Settlement*, (1994) 59 JALC 983.

[137] The DOJ has outlined a series of criteria for determining market concentration, among them: firm finances (unhealthy firms may have less oligopoly power); barriers to foreigners (foreign firms will not have oligopoly power if limited by quotas); ease of entry (in contestable markets concentration may not be a problem); nature of the product (product-specific considerations must be taken into account); homogeneity (if the product is undifferentiated, cartelization is easier); substitutes (if no good substitutes exist, concentration is a greater problem); merging firms (if merging firms are similar, a merger is more anti-competitive); buyer market (if terms of sale are public knowledge, cartelization is easier); fringe firms (if small firms cannot expand, concentration is a bigger problem); and efficiencies (mergers that produce efficiencies may be treated leniently), See U.S. Department of Justice and Federal Trade Commission, *Horizontal Merger Guidelines*, (1992); A 1994 addition to the guidelines specifically addresses mergers involving international companies, See U.S. Department of Justice, *Antitrust Enforcement Guidelines for International Operations*, (1994).

[138] 49 U.S.C.S. § 1302.

[139] See *supra* note 112, at 121.

[140] C.A.B. Order No. 79-9-163 (1979).

participation in American airlines, the issue of citizenship has overshadowed the anti-trust and public interest considerations. Given the previous discussion on the difficulty of overcoming the citizenship hurdle, it is not surprising that the majority of such cases have been stymied by the "numbers" and " control" tests, thereby not necessitating an "anti-trust" and "public interest" examination. However, two cases which have dealt with this aspect of merger control in the United States will be briefly examined here.

1. ***Texas Air Corp. (TAC), Acquisition of Eastern Airlines***[141] - The DOT identified possible anti-trust ramifications with respect to the Washington/New York and the New York/Boston shuttle markets. It rescinded its initial disapproval of the transaction only when Texas Air agreed to transfer enough additional slots to Pan Am, enabling it to compete effectively in these markets. Although not a case involving equity participation by a foreign airline, this decision illustrates the competition considerations involved with mergers within the United States, which are also applicable to foreign airline acquisitions.[142]

2. ***United States v. USAir Group Inc.***[143] - This decision concerned the modified proposal by British Airways to acquire equity in USAir.[144] The proposed Final Judgement required USAir to sell its authority to serve London from the Philadelphia, Baltimore/Washington and Charlotte gateways, within 45 days of BA/USAir's

[141] D.O.T. Order No. 86-8-77 (1986) & Order No. 86-10-2 (1986).

[142] Anti-trust issues were also raised in the sale of air routes from London to U.S. cities by TWA to American Airlines. The DOT refused to permit transfer of the Baltimore/London and Philadelphia/London routes because of perceived anti-competitive effects. The Department of Justice indicated its intent to challenge the transaction if the route transfer were to be approved by the DOT, See DOJ Press Release (25 April 1991).

[143] Proposed Final Judgement and Competitive Impact Statement, 58 Fed. Reg. 16,698 (30 March 1993).

[144] See 2. ***British Airways/USAir***, at 49-54.

commencement of joint operations from those gateways. Had USAir not acquiesced to this order and sold its rights, the DOT had authority to assign them to other American carriers.

However, it should be noted that since the DOT assumed jurisdiction over airline mergers, acquisitions, and consolidations on 31 December 1984, it has approved every airline merger submitted to it.[145] This is in spite of the fact that it is generally agreed that airlines in the United States are operating in a monopolistic/oligopolistic manner,[146] leading to frequent charges of anti-competitive behaviour and practices.[147]

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[145] See Hunt, A., *supra* note 136, at 1011.

[146] See Peteraf, M.A. & Reed, R., *Pricing and Performance in Monopoly Airline Markets*, (1994) XXXVII Journal of Law and Economics 193, Lanik, J.C., *Stopping the Tailspin: Use of Oligopolistic and Oligopsonistic Power to Produce Profits in the Airline Industry*, (1995) 22 Transportation Law Journal 509, and Cooper, R.E., *Communication and Cooperation Among Competitors: The Case of the Airline Industry*, (1993) 61 Antitrust Law Journal 549.

[147] Charges of predatory pricing are often leveled at the industry, leading to some litigation. However, under U.S. law, predatory pricing is extremely difficult to prove. This fact results in a very high cost of litigating such cases, often without gaining the desired decision, See Clouatre, M.T., *The Legacy of Continental Airlines v. American Airlines: A Re-Evaluation of Predatory Pricing Theory in the Airline Industry*, (1995) 60 JALC 869, and Gesell, L.E. & Farris, M.T., *Antitrust Irrelevance in Air Transportation and the Re-Defining of Price Discrimination*, (1991) 57 JALC 173.

### 3.3.2 The European Union

The European Union[148] provides an interesting contrast to the United States by virtue of its structure, its regulatory goals and its regulatory mechanisms. First of all, it is a Union of sovereign States, under which both national and Community laws apply, to varying degrees. Secondly, the development of all aspects of Community law has been premised on the goal of achieving integration. Thirdly, it develops, filters and implements its regulatory approaches to various aspects of the Union's activities through a mixture of national (through the European Council and the national governments), administrative (through the European Commission), and judicial (through the European Court of Justice) inputs.

As was stated earlier, the implementation of the Licensing Provision in the Third Package of liberalization measures substituted Community ownership criteria in place of the existing national ownership requirements.[149] From 1 January 1993, any citizen of the Community had the right to establish and operate an airline in any one of the Community's Member States, provided that they held 51% of the airline's equity. Whereas the objective of American policy towards mergers in the airline sector was the maintenance of control by United States' citizens and the protection of a competitive marketplace, the objective of merger control generally, and within the airline sector, was the promotion of integration within the Community.[150]

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[148] The entry into force of the Maastricht Treaty, which came into effect on 1 January 1994, changed the name of the European Community to "European Union". Here, Union and Community will be used interchangeably, See *Treaty on European Union*, 7 February 1992, 1 CMLR 719.

[149] See **2.2.3 The European Union**, at 27.

[150] For an analysis of the foundations of EU competition laws, See Gerber, D.J., *The Transformation of European Community Competition Law?*, (1994) 35 Harvard Law Journal 97; For a comparison with the foundations

As a result, whereas American regulators concentrated on stymieing foreign penetration of their air transport market, Community regulators focused on merging formerly foreign airlines (owned by nationals of its various Member States) into an integrated market. The dearth of mergers with truly foreign airlines (non-EU citizens) and the spate of mergers and acquisitions within the EU meant that most of the Community's time and effort was spent in constructing competition, or anti-trust, regulatory mechanisms.

#### 3.3.2.1 Articles 85 and 86

At its inception, the Treaty of Rome[151] lacked any merger provisions. Although its authors tried to introduce merger restrictions in the final text, there was a lack of political consensus on common policies, criteria, and procedures.[152] As a result, the European Commission based its merger practice on the general competition provisions found in Articles 85 and 86. Article 85 prohibits agreements, decisions and concerted practices which have as their object or effect the prevention, restriction or distortion of competition within the common market. Article 86 forbids any abuse of a dominant position within the common market, and like Article 86, applies in cases where trade between Member States may be affected.

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underlying anti-trust laws in the United States, See Frerct, P.-H., *The European Union Regulation on "Concentrations" and United States Merger Laws*, (1994) 2 Tulane Journal of International and Comparative Law 143, at 144-145.

[151] *Treaty Establishing the European Economic Community*, 25 March 1957, 298 UNTS 11 [hereinafter *Treaty of Rome*].

[152] See Schwartz, E., *Politics as Usual: The History of European Merger Control*, (1993) 18 Yale Journal of International Law 607, at 613.

1. ***Phillip Morris***[153] - Although the case did not involve airline mergers, it is significant for its interpretation of Article 85(1). It concerned an arrangement whereby Phillip Morris acquired a minority interest in a competitor, Rothmans International. The European Court of Justice (ECJ) concluded that insofar as the acquisition of a minority interest served as an instrument for influencing the commercial conduct of the companies in question, with the result that competition was restricted or distorted, Article 85(1) was applicable. However, it is not clear whether Article 85 applies to a total takeover or merger, as the Court's reference to the "conduct of the companies in question" seemed to imply that the corporations must stay separate entities for the Article to apply. Also, the Article seems to ignore the possibility of corporate restructurings, as it only allows exemptions from its application for a limited duration, and deems all such transactions void under Article 85(2) if such exemptions are not granted.[154]

2. ***Continental Can***[155] - As for Article 86, in a case concerning the acquisition by one company of a controlling interest in a competitor, the ECJ established that it was an abuse of a dominant position to seek to strengthen that position by means of a concentration, thus falling within the scope of Article 86 in certain circumstances. However, it also found that those circumstances are only likely to exist where an undertaking already in a dominant position "strengthens that dominant position so that the degree of control achieved substantially obstructs competition, *i.e.* so that the only undertakings left in the

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[153] Cases 142 and 156/84, *BAT and Reynolds v. Commission*, (1988) 4 CMLR 24.

[154] See Balfour, J., *Airline mergers and acquisitions: what controls does EEC law provide?*, (1990) XV-5/6 Air Law 237, at 239.

[155] Case 6/72, *Europemballage Corpn and Continental Can Inc. v. Commission*, (1973) CMLR 199.

market are those which are dependent on the dominant undertaking with regard to their market behaviour. Although the application of Article 86 is clearer, this interpretation means that it cannot apply unless the investing company already has a dominant position in the relevant market.

3. ***British Airways/British Caledonian Merger***[156] - Despite the inadequacies of these two Articles, the Commission succeeded in applying them to an airline merger, albeit a national one. Although a formal decision was never taken, the Commission managed to extract certain undertakings from British Airways in connection with its takeover of British Caledonian. Under the agreement, British Airways agreed to refrain from applying for licenses for certain routes, to limit its share of slots at Gatwick airport, and to certain other measures which facilitated the operations of competing airlines. Although the Commission never publicly released the legal basis of any action it might have taken had such an agreement not been reached, it could only have had recourse to Articles 85 and 86.

Given the lack of clarity in the ECJ's previous interpretations of these two Articles, as to their applicability to total takeovers, British Airways may have been successful in arguing that they were inapplicable to its proposal. However, as it wanted to complete the transaction as quickly as possible, the concessions it was forced to give up seemed minor compared to the time, effort and cost it would have had to expend to fight the Commission.[157]

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[156] No decision was made. They reached a negotiated agreement with the Commission and the takeover proceeded in 1987.

[157] See Balfour, J., *supra* note 154, at 240.

### 3.3.2.2 The Merger Control Regulation[158]

The questions regarding the applicability and scope of Articles 85 and 86 were largely rendered moot by the coming into force of the Merger Control Regulation on 21 September 1990, which established a clear legal basis under which the Commission could intervene in respect of concentrations. The regulation provides that concentrations within its scope must be notified to the Commission,[159] which will appraise them for their compatibility with the common market.[160] Concentrations already implemented, but found to be incompatible, may be set aside or be permitted to proceed only if modified.[161] The regulation gives the Commission wide powers of investigation,[162] along with a power to impose significant fines for failure to notify or to supply correct information, and for implementation of a concentration incompatible with the common market.[163] Concentrations within the scope of the regulation are subject to exclusive control of the Commission, although it may refer concentrations which may threaten a national market to Member States' competition authorities.[164]

Concentrations are defined so as to include both total mergers and acquisitions of corporations under which rights, contracts or other means "confer the possibility of

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[158] Council Regulation 4064/89, *On the control of concentrations between undertakings*, of 21 December 1989, (1990) O.J. L257/14 [corrected text].

[159] Article 4; The procedural rules were further clarified by the Commission, See EC Commission, *Commission Regulation on the notifications, time limits and hearings provided for in Council Regulation 4064/89 on the control of concentrations between undertakings*, (1995) 4 CMLR 190.

[160] Article 2.

[161] Article 8.

[162] Articles 11-13.

[163] Articles 14-15.

[164] Article 9; For a general analysis of the regulation, See Jones, C., & Gonzàlez-Diaz, E., The EEC Merger Regulation (London: Sweet & Maxwell, 1992).

exercising decisive influence" on the other undertaking,[165] but exclude joint ventures between undertakings which remain independent, and which are co-operative in nature.[166] The regulation only applies to concentrations "with a Community dimension", which is found if the concentration satisfies three tests, namely:

> (1) the aggregate world-wide turnover of all the undertakings concerned must be more than 5 billion ECU; and
>
> (2) the aggregate Community-wide turnover of each of at least two of the undertakings must be more than 250 million ECU; and
>
> (3) all of the undertakings concerned must not achieve more than two-thirds of their aggregate Community-wide turnover within one and the same Member State.[167]

The first criterion means that only concentrations involving at least one major undertaking (airline) will be covered, to meet the required combined turnover.[168] The second also narrows the regulation's applicability by requiring that each of the participating undertakings have a turnover level rarely reached by airlines other than national airlines. The third criterion does the same by applying only to concentrations which have a substantial effect on Community trade and not over those whose effects are primarily focused on the respective national market. As the regulation defines "services" as services provided to undertakings or consumers in the Community or Member States, as the case may be, and as almost all routes flown by airlines either begin or end in their home State, most airlines are likely to achieve at least half of their turnover in their home

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[165] Article 3(3)-(4); The Commission later clarified the notion of "concentration", See EC Commission, *Commission Notice of 31 December 1994 on the notion of a concentration under the Merger Control (Antitrust) Regulation 1989*, (1995) 4 CMLR 235.

[166] Article 3(2).

[167] Article 1.

[168] For a clarification of "undertaking", See EC Commission, *Commission notice of 31 December 1994 on the notion of undertakings concerned under the Merger Control (Antitrust) Regulation 1989*, (1995) 4 CMLR 247.

State,[169] thus taking any concentrations they may be involved in out of the regulation's scope.[170]

If a concentration falls within the scope of the regulation, it can only be prevented or modified if it is incompatible with the common market. A concentration is incompatible with the common market if it "creates or strengthens a dominant position as a result of which effective competition would be significantly impeded in the common market or in a substantial part of it".[171] Although the concept of "dominant position" is a carry-over from Article 86, thus implying a parallel interpretation, under the regulation the Commission is required to take into account a series of criteria in its analysis. They include: the need to preserve and develop effective competition within the market, the market power of the undertakings in question, barriers to entry, and any possible effects on suppliers and consumers. At the same time, the Commission is to make its appraisal in light of the goal of strengthening the Community's economic and social cohesion. However, a concentration is presumed to be compatible with the common market where the market share of the undertakings in question does not exceed 25% of the common market or a substantial part of it.[172]

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[169] The definition of services also leaves open the question whether the sale of tickets in the Member State falls within its scope. If it does, the sale of a ticket for travel between the home State and a destination outside the Community (for example, a London-Miami ticket bought in London) would be counted in the airline's turnover both within the Community and the Member State. This would not usually be a problem because the regulation will not apply only in cases where each of the undertakings achieves more than two-thirds of its Community-wide turnover within the same Member State, See Balfour, J., *supra* note 154, at 242.

[170] The Commission further clarified the scope and calculation of "turnover", See EC Commission, *Commission notice of 31 December 1994 on the calculation of turnover under the Merger Control (Antitrust) Regulation 1989*, (195) 4 CMLR 262.

[171] Article 2(1).

[172] It should also be noted that "dominance" for the purposes of an Article 86 analysis must be shown to exist in a particular market, necessitating the identification of the product market and the geographical market, See Balfour, J., *supra* note 154, at 243-245; Also See Rodger, B.J., *Market Integration and the Development of European*

Joint ventures are classified as either "concentrative" or "co-operative", with important procedural consequences flowing from this classification. Concentrations are found where there is a lasting structural change in the nature of competition. Co-operative joint ventures are ones where there is no such lasting change, but are merely agreements between the parties to co-ordinate their competitive behaviour. The Merger Control Regulation is applicable to concentrative joint ventures but not to co-operative joint ventures, which remain subject to Articles 85 and 86. However, concentrative joint ventures which do not have the necessary "Community dimension" do not fall within the scope of the Merger Control Regulation, but are subject to national merger controls.[173]

The creation of a joint venture which functions as a separate entity for a lasting period, without the co-ordination of competitive behaviour between the undertakings involved, or between them and the joint venture, does fall within the scope of the regulation.[174] In a recent clarification on the distinction, the Commission indicated that the continued presence of the participating corporations in markets upstream or downstream

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*Competition Policy to Meet New Demands: A study of the Control of Oligopolistic Markets and the Concept of a Collective Dominant Position Under Article 86 of the EC Treaty*, (1994) 2 Legal Issues of European Integration 1, and Fine, F.L., *The Substantive Test of the EEC Merger Control Regulation: The First Two Years*, (1993) 61 Antitrust Law Journal 699.

[173] See Ruppelt, H.-J., *National Merger Control for International Airlines*, in Dagtoglou, P.D., Montag, F. & Balfour, J.M. (eds.), European Air Law Association Volume 4: Third Annual Conference, (Proceedings of a European Air Law Association Conference, held on 15 November 1991, in Berlin), (Deventer: Kluwer, 1992), at 43, and Elland, W., *The Merger Control Regulation and Its Effect on National Merger Controls and the Residual Application of Articles 85 and 86*, in Dagtoglou, P.D. & Soames, T (eds.), European Air Law Association: Airline Mergers and Cooperation, (Proceedings of a European Air Law Association Conference, held on 27 July 1990, in London), (Deventer: Kluwer, 1991), at 49; Also, See Alford, R.P., *Subsidiarity and Competition: Decentralized Enforcement of EU Competition Laws*, (1994) 27 Cornell International Law Journal 271.

[174] See Soames, T., *Joint Ventures and Cooperation Agreements in the Air Transport Sector*, in Dagtoglou, P.D. & Soames, T., (eds.), Ibid., at 71.

from those where the joint venture is to operate will no longer necessarily be perceived as implying that the joint venture is not a concentrative one but a co-operative one.[175]

It should also be kept in mind that European Union competition laws also have extra-territorial effects, stemming from the ECJ's decisions in the *Wood Pulp Case*[176] and the *Ahmed Saeed Case*.[177] Given the fact the merger laws in the United States also have extra-territorial effects, the European Union and the United States attempted to co-ordinate their anti-trust enforcement policies by entering into the 1991 United States-European Union Agreement on the Application of their Competition Laws.[178]

### 3.3.2.3 The Residual Effect of Articles 85 and 86

The implementation of the Merger Control Regulation has modified the effect of Articles 85 and 86. Through its revocation of the regulation which was adopted in 1987, which implemented Articles 85 and 86 in relation to international air transport between

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[175] See EC Commission, *Commission notice of 31 December 1994 on the distinction between concentrative and co-operative joint ventures under the Merger Control (Antitrust) Regulation 1989*, (1995) 4 CMLR 227; However, co-operative joint ventures relating to air transport are still subject to the procedural rules of Regulation 3475/87, (1987) O.J. 374/1, and of Regulation 17/62, (1959-62) O.J. Spec. Ed. 87; For activities ancillary to air transport, See Adkins, B., Air Transport and E.C. Competition Law (London: Sweet & Maxwell 1994), at 44-62.

[176] Joined Cases 89, 104, 114, 116, 117, 125-129/85, *Ahlstrom Osakeyhtio et al. v. the Commission*, (1988) 4 CMLR 901, where the Court held that regardless of the place of formation of anti-competitive agreements and regardless of the participants' citizenship, if the agreements are to be implemented and their effects felt within the Community, Article 85 of the *Treaty of Rome* applied, notwithstanding the fact that none of the appellants were Community citizens.

[177] Case 66/86, *Ahmed Saeed Flugreisen et al. v. Zentrale zur Bekampfung Unlauteren Wettbewerbs e.V.*, (1990) 4 CMLR 102, where the Court found that notwithstanding the absence of implementing legislation, Article 86 applied to the entire air transport sector, including extra-Community air transport.

[178] (1991) 4 CMLR 823; Following a judgement of the ECJ, Case C-327/91, (1994) 5 CMLR 517, in which it held that the Commission was not competent to conclude the Agreement, the Council and the Commission approved an amended Agreement by Decision 95/145/EC/ECSC of 10 April 1995, See *Amendments to the Agreement*, (1995) 4 CMLR 677; Also, See Barbot, L.A., *Tracing the Extraterritorial Application and Enforcement of European Union Competition Policy Concerning Transnational Mergers*, (1994) 2 Tulane Journal of International & Comparative Law 253.

Member States,[179] Article 85(1) ceased to be directly effective in respect of concentrations, both generally and in the air transport sector. However, as per the ECJ's ruling in the *Ahmed Saeed* case, Article 86 is directly effective and does not require the adoption of implementing legislation to be enforceable in national courts. As a result, third parties or the unwilling targets in a hostile takeover could rely on Article 86 to obtain injunctive relief to prevent the acquisition from proceeding. Furthermore, even if an acquisition has taken place, Article 86's absolute prohibition of abuses of a dominant position, with no possibility of an exemption, means that a national court could order a divestment.[180] However, the Commission has indicated that it will not itself invoke Article 86 against concentrations.[181]

#### 3.3.2.4 Merger Cases Since the Regulation

As we have seen, the structure and wording of the Merger Control Regulation raises certain issues which have been examined in several decisions since its implementation. Since the Regulation is fairly new, each of the cases decided by the Commission has considered several of the issues raised by it. Therefore, the following review will examine these decisions on an issue by issue basis, rather than on a case by case basis.

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[179] Council Regulation 3975/87, (1987) O.J. L374/1.

[180] See Levitt, M., *Article 88, the Merger Control Regulation and the English Courts: British Airways/Dan-Air*, (1993) 2 ECLR 73.

[181] EC Commission, *Accompanying Statements entered in the Minutes of the E.C. Council*, (1990) 4 CMLR 314; Sir Leon Brittan indicated that the Commission will only use this residual power in cases where there is a clear case of dominance, which cannot be dealt with by national competition authorities; For a general discussion of the residual effect of Articles 85 and 86, See Elland, W, *supra* note 173.

1. **Community Dimension** - In *Delta Air Lines/Pan Am*,[182] a case concerning Delta's purchase of Pan Am's routes into London and its hub in Frankfurt, the Commission considered three possible tests for determining whether an undertaking had the necessary Community turnover to fall within the scope of the Regulation. The three possibilities were:

> (1) attributing revenues from transatlantic fares to the country of destination, which is to be treated as the final destination point outside the home country of the airline (thus, revenues from a New York/Paris/New York flight by a U.S. carrier would be allocated to France); or
>
> (2) the cross-border nature of the services provided would be taken into account and so revenues would be divided 50:50 between the country of origin and the final destination; or
>
> (3) revenues would be attributed to the Member State in which the ticket sale took place.

As the transaction surpassed the 250 million ECU threshold under all three tests, the Commission left the question open.

In *Air France/Sabena*,[183] the same result was reached by either test, but although the Commission left the question open again, it expressed a preference for the second test. However, this preference was not reiterated in *British Airways/TAT*,[184] where the Commission considered all three possibilities again, without preferring any one as all three methods came to the same result.

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[182] Case IV/M.130, Decision of 13 September 1991.

[183] Case IV/M.157, Decision of 5 October 1992.

[184] Case IV/M.259, Decision of 27 November 1992; TAT is an example of a foreign franchise airline, which shall be canvassed in the following chapter.

2. **Concentrative and Co-operative Joint Ventures** - In *Air France/Sabena*, the Commission found that Air France's minority acquisition of 37.58% of Sabena's voting stock constituted a concentrative joint venture. Although Air France only held a minority stake and could nominate five of the fourteen members of the board of directors, joint control was found on the basis of the fact that all major decisions relating to the company's operation had to be approved by a super majority (75%) of the shareholders.

In terms of co-ordination of competitive behaviour between the parties and the joint venture, the Commission found that the creation of a new joint venture entity was illusory in this case, as the Belgian State which held the majority stake in Sabena could not be considered an actual or potential competitor as the only air transport activities it participated in were carried out by Sabena. Notwithstanding the fact that the Commission found that Air France had the means at its disposal to control the joint venture, it concluded that this would not compromise the powers of the Belgian State to control Sabena jointly with Air France.

In *British Airways/TAT*, although British Airways acquired a minority shareholding of 49.9% in TAT EA, the Commission found that TAT EA was jointly controlled by British Airways and TAT SA. Again, this finding was based on the Commission's view that British Airways' degree of control was atypical of a minority shareholder. Specifically, the Commission pointed to the following: British Airways could nominate four members of the nine member board of directors, major decisions required the approval of at least one TAT and one British Airways director, and TAT EA's business plan for the following three years had been agreed in advance between BA and TAT SA.

In terms of co-ordination of competitive behaviour between the parties and the joint venture, the Commission found that TAT EA's operations were distinct from those of TAT SA's and British Airways'. It concluded that TAT SA had withdrawn from the markets where TAT EA was to be active, by transferring its operations to TAT EA. In regards to British Airways, it found that although both British Airways and TAT EA provided repair and maintenance services, they were directed at different product and geographical markets. Finally, in light of the fact that the main reason for the link-up with British Airways was to give TAT EA access to the resources and networks of a large international airline, the Commission concluded that British Airways would have a substantial and growing influence over TAT EA. As a result, the acquisition by BA of joint control of TAT EA did not have as its object the co-ordination of the competitive behaviour of an independent undertaking.

3. **Compatibility With the Common Market/Abuse of a Dominant Position** - In *Delta Airlines/Pan Am*, the Commission considered market shares in both the narrow market definition of single routes, comprising a distinct market, and the wider market definition, comprising a bundle of routes. By both measures, the combined market share fell at or below the 25% threshold of market share. Although the transaction would leave Delta having the largest share of the wider market, the strong market presence of American Airlines, BA and TWA (at 10%), and Lufthansa, United Airlines, Air France and KLM (at 4-7%), would ensure that the concentration would not result in the creation or strengthening of a dominant position.

In *British Airways/TAT*, although BA held between 28% of the total slots at Gatwick airport and 38% of those at Heathrow, and was the only airline able to operate from both these airports, the Commission concluded that the concentration would not result in the creation or strengthening of a dominant position. This conclusion was based on its finding that a certain degree of competition would remain in the market, in light of the presence of Air France and other existing or future competitors, which were expected to enter the market after the full liberalization of the Union's air transport policy and market. In order to ensure the availability of slots for these potential new entrants, the Commission extracted undertakings from the parties involved to make slots available at Gatwick.

In *Air France/Sabena*, the Commission found that the concentration would result in a total monopoly on the three European routes in question: Brussels-Lyon, Brussels-Nice and Brussels-Paris. In light of the fact that even the Union's liberalization process was only likely to increase competition in the long term, the Commission obtained undertakings from both parties and the Belgian and French governments. These undertakings included: on inter-Union routes - withdrawal by one of the parties from some routes in favour of competing carriers, promises not to increase frequencies, and interlining agreements with new entrants; on extra-Union routes - multidesignation on some routes in favour of competing national airlines, and promises to favour new entrants for new route rights and slots; and generally - time and number limitations on the slots at Zaventem airport.[185]

[185] For a more detailed examination of these cases, See Adkins, B., *supra* note 175, at 116-130; For an examination of the trends in the Commission's approach to assessing impediments to competition, See Downes, T.A. &

### 3.3.3 Comparison of the Two Merger Control Approaches

In comparing the approach of the European Union towards mergers in the air transport sector to that of the United States, it must be kept in mind that the two international entities are at different stages of historical, political and economic development. This fact had and will continue to have a profound effect on the development and structure of their respective airline industries. The United States' size, unified market, long-term prosperity and tradition of private ownership have allowed its carriers to develop into some of the largest and most competitive in the world. In addition, its industry underwent the process of consolidation much sooner than its European counter-part. Thus, its focus in merger matters has been on protecting competition and keeping foreign participants out of its market.

Although the European Union shares these concerns, it must try to deal with them at the same time that it is trying to integrate its disparate national industries, which have a long history of public ownership and protectionist policies. Given the fact that the Commission has not opposed any airline mergers to date, and has obtained undertakings in the cases where competition concerns have arisen, it should be viewed as a *de facto* manager and promoter of airline mergers, as it necessarily must be if the Union's airline industry is to compete. It will be interesting to watch how its approach changes when it is

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MacDougall, D.S, *Significantly Impeding Effective Competition: Substantive Appraisal Under the Merger* Regulation, (June 1994) European Law Review 286; For a summary of the developments in EU Competition regulation in 1994, See Art, J.-Y. & Van Liedekerke, *Developments in EC Competition Law in 1994 - An Overview*, (1995) 32 CMLR 921; For an examination of the use of undertakings/settlements in European Union air transport and their comparison to settlements in the United States, See Bergmann, H., *Settlements in EC Merger Control Proceedings: A Summary of EC Enforcement Practice and a Comparison with the United States*, (1993) 62 Antitrust Law Journal 47, at 79-83.

faced with more merger proposals involving truly foreign airlines, as they are surely to follow this stage of the industry's re-alignment.[186]

[186] For a comparison of the approaches to competition policy in the United States and the European Union, See Stoeppelwerth, A.M., *Bearding the Giants: The Intersection of Deregulation and Competition Policy in the United States and Europe*, (1994) 2 Legal Issues of European Integration 27.

# 4. AIRLINE FRANCHISES

By this point in the thesis, it should be obvious to the reader that the development of the international airline industry has been somewhat particular. The restrictions on globalization, inherent in the bilateral system built on the framework of the Chicago Convention, the resulting national restrictions on ownership and control, and the restrictions on cabotage,[187] have resulted in an industry structure which does not resemble the norms established for most international industries. Even mergers and takeovers, which in any other industry simply result in the creation of one corporate entity, are complicated by the over-riding national ownership and control criteria.

As a result, it is presently impossible to talk about true mergers and takeovers in the international airline industry. As we have seen in the previous discussion, even mergers within the European Union, which has as its goal the integration of its internal aviation market, have never taken the form of majority foreign control. The process is somewhat akin to a conjuring act. The merging airlines try to integrate as much as possible, while striving to create and maintain the illusion of distinctness as to ownership and control, while the national regulatory bodies spend considerable time and energy trying to pierce this veil of illusion, where it exists, and conjuring it up where it doesn't. Overall, the resulting entity exhibits a schizophrenic personality. Its character and behaviour runs a continuum between full integration and slight association.

[187] See 2. **RESTRICTIONS ON GLOBALIZATION**, at 9-33.

In many ways, airline franchises function as the only true merged entities in the international aviation sector. They are essentially subsidiary corporate entities, either wholly or partially owned by larger airlines, which offer a product substantially similar to the parent airline, often using its airline designator code and part of its fleet.[188] With respect to the nationality of ownership, franchises can either be of a national or international character. National franchises are a very common phenomenon in most mature aviation markets, meaning those that have at least undergone a semblance of deregulation. The franchising of regional carriers has played a vital role in the consolidation of the national markets in the United States and the European Union. The major carriers' need for size and scope,[189] and the development of the hub-and-spoke system,[190] computer reservation systems[191] and frequent flyer programs[192] have effectively created a convergence of interests towards integration, both for the major and regional carriers.

## 4.1 NATIONAL FRANCHISING

Airlines now functioning as franchises were previously independent regional carriers, servicing markets which were usually unprofitable for the major carriers to serve. The abovementioned developments in the industry as a whole made it imperative that major carriers funnel as much regional traffic as possible into their service networks, while

[188] See Haanappel, P.P.C., *supra* note 9.

[189] See **3.1.1 The Airlines' Need for Size and Scope**, at 36.

[190] See **3.1.2 The Hub-and-Spoke System**, at 37.

[191] See **3.1.3 Computer Reservation Systems (CRS)**, at 37.

[192] See **3.1.4 Frequent Flyer Programs**, at 38.

the regional carriers' limited resources made it difficult for them to grow internally.[193] In order to address these concerns, the concept of franchising, familiar in the fast food industry, was introduced in the aviation industry in the early eighties in the United States and has since become a buzzword in European aviation.[194]

As an example, CityFlyer Express was founded in 1991 from the remnants of Air Europe. Flying out of Gatwick airport, it was originally just a marketing ally of British Airways, carrying approximately 250,000 passengers per year. In 1993, it became British Airways first franchise partner. Although it remains a private company, distinct from BA, it has traded in its old livery and commercial independence for BA's flight codes, CRS, sales promotion and frequent flyer programs, which have helped it to more than double its ridership. In return, it feeds British Airways' international network with passengers from destinations such as Jersey, which because of the its cost base BA could not afford to serve.

In addition, BA earns extra revenues from services such as ground handling and from franchise fees paid by CityFlyer,[195] while being able to consolidate its dominant position in the market.[196] The positive outcome of this first foray into the franchise market convinced BA to pursue an aggressive franchising strategy throughout its home market.

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[193] See **3.2 MERGER AS THE OPTIMAL SOLUTION**, at 39.

[194] In 1994, it was estimated that 35% of the American airline industry operated under franchise, See Clayton, N., *Loganair buyout hits trouble*, Sunday Times, Business (10 July 1994).

[195] In 1995, BA was expected to earn £30 million from the "feed traffic" generated by its franchised carriers, See Keenan, S., *BA's Irish breakthrough*, The Times, Features (20 July 1995).

[196] See Harrison, M., *Franchise Plan to tighten BA's grip*, The Independent, Business & City Page (21 July 1993), at 25.

By 1995, it had six franchise airlines flying from or within the U.K. in BA colours.[197] Their franchise fees contributed £20 million to its coffers, and added 54 airports to its network.[198]

### 4.1.1 Impact on Competition

Most of the criticism of the concept of airline franchising in national markets has centered on the possible anti-competitive aspects of such schemes.[199] Opponents of the consolidation of the industry see franchising as a nefarious tactic by which fledgling airlines are swallowed up by the dominant players in the market, while being forced to pay for such a fate through royalties. However, given the prohibitive costs of internally optimizing regional carrier returns[200] and the robust post-franchising performance of airlines such as CityFlyer, it is probably more correct to view the ability to enter such an arrangement as a privilege rather than a curse.

Franchising is a two-way street and should be perceived as an element of the industry's burgeoning trend towards outsourcing. Instead of protecting its market share by entering the regional carrier's market and engaging in predatory pricing, thereby destroying or severely weakening the regional carrier and gaining a market which it cannot profitably or adequately serve, the franchiser airline piggy-backs on the regional carrier's twin competitive advantages, namely its size and its intimate knowledge of the niche

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[197] Loganair, Manx Europe, GB Airways, Brymon Airways, CityFlyer Express and Maersk Air (which is also a foreign franchise, which shall be canvassed in the next section), See Keenan, S., *supra* note 195.

[198] Ibid.

[199] See Harrison, M., *supra* note 196.

[200] See **3.2 MERGER AS THE OPTIMAL SOLUTION**, at 39.

market it serves. In return, the franchisee airline coat-tails on the major carrier's twin competitive advantages, namely its size and its scope.

## 4.2 INTERNATIONAL FRANCHISING

International or transborder franchising is a relatively new phenomenon, so far limited to the European Union. The implementation of the Licensing Regulation[201] as part of the Third Package of liberalization measures in January 1993, meant that the Community's airlines could be owned and controlled by citizens of any Member State and enjoyed the right of establishment[202] throughout the Union. This change in regulation enabled British Airways to purchase a 49.9% stake in TAT EA of France, and to establish Deutsche BA in Germany, in which BA has a 49% stake with the remainder held by subsidiaries of German companies.[203]

International airline franchises share all of the advantages found with national franchises. However, they are essentially created to access the respective domestic markets and international routes from those markets, where permitted. As TAT EA and Deutsche BA are now respectively classified as French and German carriers, notwithstanding BA's holdings, they are allowed to perform domestic air services within those two countries and international carriage within the Union. In addition, several non-EU countries have waived the substantial national ownership and effective control

[201] Council Regulation 2407/92, See *supra* note 70.

[202] Granted under chapter 2 of the *Treaty of* Rome, See Bermann, G.A., Goebel, R.J., Davey, W.J., & Fox, E.M., Cases and Materials on European Community Law (St. Paul: West, 1993), at 542-583.

[203] See *BTCE Report*, *supra* note 51, at 256.

provisions with respect to Deutsche BA, thereby permitting it to exercise the route rights granted to Germany in agreements with Russia, Switzerland and Turkey.[204]

Other European carriers have started copying this foreign franchise concept, but in varying forms. Danish Maersk Air offers a franchised product in the U.K. on behalf of BA, through a U.K. subsidiary. The British Virgin Atlantic Airlines offers its franchised product through Cityjet, an Irish airline flying mostly on the Dublin-London route, and South East European Airlines, a Greek airline flying the London-Athens route. However, this franchising concept differs in that Virgin has not made a financial investment in these airlines, limiting its involvement to marketing .[205]

### 4.2.1 Franchises and National Ownership and Control Provisions

Notwithstanding the relative attractiveness of foreign airline franchises, their existence and structure is premised on the loosening of traditional substantial ownership and control provisions found in national legislation and most bilateral agreements, and restrictions on cabotage found in the Chicago Convention. Until now, such a loosening has only occurred within the European Union, thus limiting the applicability of international franchises to that region. Also, it should be kept in mind that notwithstanding the fact that substantial ownership and effective control provisions in bilateral agreements are permissive in nature, they are rarely waived as in the case of Deutsche BA. Countries which are aviation powers are unlikely to take such a course of

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[204] These waivers are possible because of the permissive rather than obligatory language used in the bilateral ownership and control clauses, See Haanappel, P.P.C., *supra* note 9, at 181, f.n. 4.

[205] See Richardson, D., *Foreign Suitors woo Branson's scarlet lady*, The Independent, Business Travel Special Report (27 April 1994), at 16.

action without getting something very substantial in return, such as some form of an "open skies" agreement or at least an increase in the route rights for their carriers.

This problem is exacerbated by the fact that under Community law, the franchised airlines licensed in the Member States have the right to national treatment by those States, thus are within their rights to request the granting of equal access to the third country routes negotiated by the Member State. In the short term, it is expected that Member States will refuse to grant access to those routes to the franchised airlines. In the long term, third countries will have to concede the replacement of nationality clauses with Community clauses in future bilateral agreements.[206]

[206] See Weber, L., *The European Union and the Chicago Convention of 1994*, (1994) 19-3 Air & Space Law 179, at 183.

# 5. AIRLINE ALLIANCES

Alliances are the weakest, but most prevalent, form of corporate concentration in the airline industry. In the case of mergers, the resulting single commercial unit offers products and services which are distinct from the ones previously offered by the pre-merger airlines. In the case of takeovers, the target airline undergoes a process of assimilation whereby the combined entity usually ends up offering the products and services of the dominant carrier. On the other hand, airline franchises and alliances result in two or more corporate units co-operating to create a joint product. In the case of franchises, the process usually, but not always, involves a sizable degree of equity participation by the dominant carrier[207] and a certain degree of loss of identity for the franchisee airline. Although airline alliances may also involve equity participation by one airline in another, they do not result in the subsumption of either of the participants' identities, but rather in the co-operative creation of a joint product.

## 5.1 THE DRIVE TOWARDS ALLIANCE-BUILDING

As we have seen, although airline mergers, takeovers and franchises may lead to the optimal structuring and utilization of the industry's assets, in practice, the regulatory hurdles premised on nationality criteria have limited their applicability to airlines of the same nationality.[208] The motivation behind the creation of airline alliances is the same as

[207] See **4.2 INTERNATIONAL FRANCHISING**, at 80.

[208] With the exception of trans-border franchises within the European Union, Ibid.

that found behind the trend towards mergers and takeovers within national, or in the case of the EU, regional markets.[209]

Airlines have generally entered into alliances with foreign partners in order to funnel traffic to their international and domestic flights with passengers entering their home market from destinations which they do not themselves serve. This lack of service to and from particular destinations is either due to the unprofitability of the routes in question, bilateral constraints, or the restrictions on cabotage, which have a particularly profound effect on the American market. In the case of the United States, the main motivation for domestic airlines entering into alliances is the desire to feed their domestic traffic to partner airlines which serve international markets they do not, while the foreign airlines seek to feed the international traffic they bring into the United States' gateway cities to the American domestic destinations which they themselves cannot serve. Thus, alliance-building serves as a further method of increasing market access and optimizing economies of scope and network density, in this case internationally.

## 5.2 CLASSIFICATION OF AIRLINE ALLIANCES

Airlines have a long history of co-operating with each other, mainly by way of interlining.[210] However, airline alliances are a wider and deeper form of co-operation involving all or some of the following instruments: joint ventures, code-sharing agreements, blocked space agreements, franchises, general sales agency agreements,

[209] See **3.1 THE DRIVE TOWARDS CONCENTRATION**, at 35, and **3.2 MERGER AS THE OPTIMAL SOLUTION**, at 39.

[210] Under an interline agreement, passengers are carried by one airline on behalf of another. The carriers involved are required to honour tickets issued by other carriers involved in the agreement, but the identities of the carriers remain intact.

marketing agreements, joint frequent flyer programs, joint ground handling, joint purchasing and insurance, hub scheduling co-ordination, wet leasing, management contracts, etc..[211]

Although all airline alliances are entered into with the purpose of creating a joint product, they differ in the degree of integration intended and in their geographic scope. On the continuum of integration, "strategic" alliances represent the highest and widest form of co-operation, as they are structured in a way so as to emulate a merger or takeover.[212] In terms of scope, "strategic" alliances are those whose various forms of inter-airline co-operation cover the whole or major part of the route networks of the participating carriers, thereby linking their respective service networks. In terms of the degree of integration, "strategic" alliances are those whose participating carriers attempt to offer a joint or seamless product to the consumer, almost always involving the extensive use of codesharing. The best examples of this are the Northwest/KLM, USAir/British Airways, and United/Lufthansa alliances.[213]

On the other hand, non-strategic alliances (basically all other alliances) do not attempt to create a seamless product and have a narrower geographic scope. They may

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[211] The most significant forms of co-operation will be canvassed in later sections of this chapter.

[212] Distinction suggested by Haanappel, P.P.C., *supra* note 9, at 183.

[213] SAS and Lufthansa also announced the creation of a new alliance combining routes, sales and airport services in May, 1995. The proposal still requires the approval of the European Commission. Notwithstanding the new alliance, Lufthansa intends to maintain its links with United, See *SAS, Lufthansa join forces to become Europe's largest*, Canadian Press Newswire (11 May 1995); The "European Equity Alliance", involving Austrian Airlines, SAS and Swissair (formerly including Finnair), and the "Global Excellence Alliance", involving Delta Air Lines, Singapore Airlines and Swissair are other examples of "strategic" alliances. However, they differ from the abovementioned "strategic" alliances in that they involve three partners, small cross-equity holdings, and limited integration. The "European Quality Alliance" though is soon to lose SAS as a partner, given its new alliance with Lufthansa, See **5.5.1.4 The Proposed Lufthansa/SAS Joint Venture**, at 110.

take the form of "regional" alliances which also involve codesharing between airlines, but on a limited number of routes to and from a specific region. As an example, United Airlines' alliance with Ansett Australia allows it to code-share on Ansett flights within Australia and connect those flights with its own flights between Australia and the United States.[214] "Point-specific" alliances have an even narrower scope in that they only involve code-sharing on flights between a limited number of cities. These types of alliances usually involve one airline purchasing blocks of seats on another airline's flights and reselling them as its own.[215]

The last major characteristic which distinguishes between different forms of alliances is the presence or absence of equity participation by alliance participants in the equity of their partners. Although minority equity participation cannot be considered a *conditio sine qua non* for the strategic nature of an alliance, it is often an indication of the strength and duration of the commitment towards integration, thus an important element in classifying an alliance as "strategic".[216] The Northwest/KLM and USAir/BA alliances illustrate this point. Both cases were examined in the merger section of this thesis because both KLM and BA wished to in effect merge with Northwest and USAir respectively, which required the acquisition of a large portion of the two American airlines' equity. However, as they were blocked from doing so to the extent they wished, their "strategic"

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[214] Other examples of "regional" alliances are (as of Dec. 31, 1994): American/British Midland, American/Gulf Air, Continental/Alitalia, United/British Midland, and United/National Airlines Chile, See *GAO Alliance Report*, *supra* note 4, Appendix II, at 66.

[215] Referred to as a blocked-space agreement. For examples of "point-specific" alliances, See Ibid.

[216] See Haanappel, P.P.C., *supra* note 9, at 184.

alliances became attempts at creating *de facto* merged airlines, with their respective equity participations playing both a symbolic and a functional role.

Their large investments symbolized their commitment to the alliance, thereby strengthening both the investor and invested-in airline's confidence to implement expensive, extensive and long-term restructuring, while at the same time serving as a source of finance for those adjustments. Although minority equity participation is not required for an alliance to be classified as a "strategic" alliance, nor is it a guarantee of success, it is nevertheless an important element in assessing the strength and scope of an alliance.

## 5.3 METHODS OF INTEGRATION

### 5.3.1 Codesharing

Codesharing is by far the most important method of accessing unserved or under-served foreign destinations. It is the affixing of one airline's designator code on the flights of another airline, on the basis of a mutual agreement.[217] Since consumers prefer to book connecting flights on the same airline,[218] codesharing is used to show connecting flights as occurring on one airline, in order to have them listed as "on-line" (same airline) rather than "interline" (two airlines) on CRS. In addition, airlines prefer to have their connecting

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[217] There seems to be some disagreement on the proper definition of codesharing. This is the definition given by the U.S. DOT, See Haanappel, P.P.C., *supra* note 9, at 184, *GAO Alliance Report*, *supra* note 4, at 13, and Gellman Research Associates, *A Study of International Code Sharing*, (Report prepared for the Office of Aviation and International Economics, Office of the Secretary of Transportation, DOT) (December 1994), at 6 [hereinafter *GRA Codesharing Report*].

[218] Studies have shown that this preference is premised on the belief that same carrier connections involve shorter distances between terminal gates making transfers easier, and are less likely to result in lost luggage, See Carlton, D.W., Landes, W.M., & Posner, R.A., *Benefits and Costs of Airline Mergers: A Case Study*, (Spring 1990) Bell Journal of Economics, at 68.

flights listed as "on-line" because some CRS list such flights ahead of "interline" flights and travel agents tend to book customers on flights listed higher on the CRS screen.[219] However, as we shall see later, this on-line preference is disappearing from computer reservation systems in favour of elapsed travel time.

#### 5.3.1.1 Forms and Advantages of Codesharing

Both airline alliances and franchises make extensive use of codesharing. In franchising there is only one form of codesharing, with the franchisee airline simply using the franchiser's designator code. In an alliance, the participating airlines will take advantage of the fact that there are several ways of listing a flight in order to assign an alliance partner's designator code to their flights in addition to their own. For example, a flight may be listed as flight XX/YY 123, with a single flight number and airline XX usually operating the flight. The flight may also be listed twice, using different designator codes but the same flight number, as in XX 123 and YY 123, without making it clear as to who is actually operating the flight. In addition, the flight may also be listed twice but with slightly different flight numbers, as in XX 123 and YY 4123, with airline XX most often doing the actual flying.[220]

Codesharing can also be characterized by the type of flight operations to which it is applied. Specifically, it may be used on gateway-to-gateway operations or on behind-gateway operations that connect at the gateways. Gateway-to-gateway operations connect principal origin and destination cities for international travelers. Codesharing on

[219] See Boudreaux, D.J. & Ellig, J., *supra* note 103.

[220] Examples provided by Haanappel, P.P.C., *supra* note 9, at 187.

these flights allows the participating airlines to show a greater frequency of flights to these destinations than they actually operate, thereby increasing the perceived market service on those particular routes.

An even greater advantage to airlines comes from codesharing on behind-gateway operations, as codesharing on these flights allows them to appear to adequately serve markets which they themselves do not serve at all or serve infrequently. As an example, Northwest's alliance with KLM allows it to list KLM flights beyond Amsterdam as its own, thereby allowing it to market services to over 30 cities in Europe and the Middle East, when it actually flies to only 4 cities in those regions.[221] A somewhat similar example, but one which deals with behind-gateway cabotage service, is provided by British Airways arrangement with USAir. Under their alliance, British Airways is allowed to market service to 52 cities within the United States beyond its approved American gateways, to which it actually does not fly.[222]

#### 5.3.1.2 Issues Raised by Codesharing

### A. Underlying Route Rights

Aside from these commercial considerations, the development of codesharing on international flights was in many ways an attempt to overcome the regulatory hurdles on foreign participation in national aviation markets (both domestic and international) based on national legislation, bilateral air transport agreements and restrictions on cabotage.[223]

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[221] See *GAO Alliance Report*, *supra* note 4, at 15.

[222] Ibid., at 18.

[223] See **2. RESTRICTIONS ON GLOBALIZATION**, at 9-33.

As national governments were averse to granting further route rights to foreign airlines, particularly in regards to fifth freedom rights and cabotage within the United States, airlines wanting to increase their penetration of those markets resorted to codesharing, which most national regulatory bodies saw as less threatening.

Codesharing first appeared on international markets in 1985. At the time, the DOT stated that it would permit the practice in U.S. international markets without approval proceedings as long as the international carrier had underlying route rights for the cities involved. Under this policy, American and Qantas started codesharing on American's trans-continental flights, as Qantas already had route rights to the major east coast gateways involved. This policy changed in late 1987 when United Airlines and BA proposed codesharing on United flights in the Chicago-Seattle market, as an extension of BA's London-Chicago service. The DOT informed United that it would need authorization for the proposed codesharing, despite the fact that BA already held the rights to the London-Chicago-Seattle route.

Although the DOT eventually granted an exemption to United, it announced that all subsequent codesharing agreements would require DOT approval, which would not be granted unless the agreement passed a "public interest" test. The "public interest" test was based on the extent to which the proposal was covered by the United States' bilateral agreements, the extent to which the foreign country granted reciprocal rights to U.S. airlines, and the perceived benefits to the U.S..[224]

[224] D.O.T. Order No. 88-3-38, See Hadrovic, C., *Airline Globalization: A Canadian Perspective*, (1990) 19 Transportation Law Journal 193, at 197-198.

Codesharing became an issue in bilateral negotiations in 1991, when the U.S. and U.K. were renegotiating certain aspects of the Bermuda II agreement, specifically the succession of other American carriers to the route rights held by PAN AM and TWA to Heathrow. In exchange for allowing American and United access to Heathrow, the British gained the right for any British carrier to codeshare to any U.S. city, provided there was a competing U.S. carrier providing service from the U.K. to the U.S. city in question. The agreement in effect opened the door for BA to serve almost every major U.S. airport by codesharing with one of the major American carriers.

In 1992, the United States announced its "open skies" initiative, which included open codesharing opportunities.[225] As a result of the "open skies" agreement signed between the U.S. and Netherlands, KLM was able to obtain the most extensive U.S. codesharing rights of any carrier in the world, allowing the KLM/Northwest alliance to dominate in certain markets. This development lead Lufthansa to challenge Northwest's codeshare operations beyond Amsterdam into Germany, which for the first time made codesharing a dominant issue in the ensuing bilateral negotiations with Germany.[226] The two countries eventually signed an interim four year agreement in October 1993, which includes a two year capacity freeze with small increases in the last two years of the agreement. This agreement covers both the number of actual flights and the number of codeshared flights. It also gave Germany access to more American gateways, thereby

[225] See supra f.n. 125.

[226] See Jennings, M., *The Code War*, (1994) Airline Business: The Skies in 1994 12, at 13.

making the simultaneously announced United/Lufthansa codesharing agreement more valuable.[227]

On 1 November 1994, the DOT unveiled a new aviation policy statement,[228] in which it stated that it was favourably disposed toward codesharing as long as the foreign countries involved provided U.S. carriers with liberal access to its markets. As part of its overall policy of pursuing liberal bilateral agreements, which at the present time is mainly directed at small European countries,[229] it would include unlimited codesharing behind the gateways of both countries in any "open skies" agreements reached. For countries not prepared to agree to such liberal bilateral agreements, the DOT is prepared to use codesharing as a bargaining chip. Applications to codeshare will be approved or disapproved in light of the following criteria: pricing and service options available to consumers, access to international markets for individual cities, effects on the U.S. airline industry (including whether or not the U.S. carrier does the long-haul flying), and the U.S. policy goal of liberalizing international air transport markets. These criteria are broad enough and subjective enough to guarantee that codesharing remains a critical aero-political issue in future bilateral negotiations.

Thus, although codesharing got its start as an attempt to side-step the morass of negotiated-for route rights, its tremendous impact has made it an object of the same

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[227] See Jennings, M., & Odell, M., *Lufthansa in Wolf Pact*, Airline Business (November 1993), at 13.

[228] D.O.T., *U.S. International Aviation Policy Statement*, (1 November 1994).

[229] The offer was made to Norway, Sweden, Denmark, Belgium, Finland, Switzerland, Austria, Luxembourg, and Iceland, as an attempt to isolate the larger European countries and force them to accept similar agreements, See Racic., M.A., *Opinion 1/94 of the European Court of Justice and Its Implications for European External Aviation Relations*, (1995) XX-II AASL 291, at 316.

bilateral process it was designed to avoid. The requirement of double route authority (codeshared and actual) has been criticized on the basis that traditional interlining, which shares some of the attributes of codesharing, does not require such double authority. However, the sheer importance of the practice to the industry has ensured that it is dealt with in bilateral agreements, thereby somewhat complicating its development, but ensuring clarity where such agreements have been reached.[230]

## B. Consumer Protection

Codesharing has obvious benefits for consumers in terms of the creation of non-stop services which could not be supported by single carriers,[231] one-stop check-in, better connections, and consistency of service. However, it may also give rise to confusion for consumers at check-in, in consulting airport flight monitors, at boarding gates, and during the collection of checked baggage.[232] In addition, some commentators view codesharing as glorified "interlining" and criticize the marketing of such flights as "on-line" as misleading to the consumer.

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[230] See Haanappel, P.P.C., *supra* note 9, at 188, f.n. 22.

[231] As an example, Austrian Airlines (OS), Delta Airlines (DL) and Swissair (SR) started a codeshared Vienna-Geneva-Washington D.C. service in late 1994. The flight was operated by Austrian Airlines, with blocked space agreements between the participating carriers. The flight between Vienna and Washington carried OS and DL designator codes, the OS and SR codes between Vienna and Geneva, and SR and DL codes between Geneva and Washington. Without this arrangement, the Geneva-Washington market could not support non-stop service by any one of the participating carriers, See Haanappel, Ibid., at 187, f.n. 18.

[232] British Airways partly based its decision not to codeshare out of Washington National Airport on the basis of their concern about consumer confusion at check-in. BA does not fly out of that particular airport, therefore airport authorities would not permit it to place its own signs on the roadways leading up to the terminal. As a result, BA feared that passengers would drive up with BA tickets and not understand that they should head for the USAir gates and check-in counters, See *GRA Codesharing Report*, *supra* note 217, at 60.

Internationally, ICAO has established a "Code of Conduct" for the regulation and operation of CRS.[233] It addresses the abovementioned concerns by exhorting CRS vendors to design their display algorithm to ensure that no carrier obtains an unfair advantage through the misrepresentation of services. ICAO's discussion of its "Code of Conduct" does acknowledge that codesharing connections vary, from almost "on-line", where one partner owns the other, to "interline". However, as its Member States cannot yet agree on whether codesharing engenders misrepresentation, it has been unsuccessful in developing specific guidelines for a world-wide code.

In the United States, the DOT regulates the use of CRS and requires that "systems shall not use any factors directly or indirectly relating to carrier identity in constructing the display of connecting flights in an integrated display".[234] Although this requirement does not specifically mention codesharing, its wording appears to have implications for codesharing in that carriers could not be discriminated against on the basis of their codesharing. The Notice of Proposed Rulemaking (NPRM) of the DOT with respect to the Disclosure of Codesharing Arrangements and Long-Term Wet Leases is designed to address some of these concerns.[235] It would strengthen the current requirement that airlines and travel agents making reservations on a codeshared flight tell passengers beforehand which airline will actually be operating the flight. In addition, the proposed rules would require travel agents in the United States and ticket agents for U.S. and

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[233] International Civil Aviation Organization, *Policy and Guidance Material on the Regulation of International Air Transport*, 1992), at 31-34.

[234] 14 C.F.R § 255.4(c).

[235] 14 C.F.R. § 257, Docket Nos. 49702 & 48710; Notice 94-11; RIN 2105-AC 10.

foreign airlines to provide written notice at the time of sale naming the airline that will operate the flight for tickets sold in the United States

In Europe, the E.C. "Code of Conduct" on CRS,[236] based on the ECAC "Code of Conduct", addresses codesharing concerns in terms of screen bias, while ECAC has created a Working Group to study the implications of codesharing. It has been suggested that it should be possible to improve the coding system by the creation of an industry standard to combine individual designator codes in a transparent fashion so as to indicate flights operated by an alliance.[237]

## C. Other

It should also be mentioned that codesharing raises other issues which may have an impact on its development and future regulation. Codesharing is viewed with some trepidation by airline labour unions, particularly those in the United States. Their concerns center on codesharing's potential to replace fifth freedom operations by U.S. carriers, primarily in Europe. The Airline Pilots Association is worried about the continuing trend of replacing American-run fifth freedom feeder traffic with traffic transported by European codesharing partners. If the European codesharing partners eventually encroach on the gateway-to-gateway routes, which are the largest source of employment in the American international air transport sector, the impact on U.S. labour could be more severe. In

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[236] Regulation 2299/89 (1989) O.J. L200/1, as amended by Regulation 3089/93 (1993) O.J. L278/1.

[237] See Haanappel, P.P.C., *supra* note 9, at 188; Also See Venit, J.S. & Kallaugher, J.J., *Computerized Reservation Systems*, in Dagtoglou, P.D., Dutheil de la Rochère, J. & Balfour, J.M., European Air Law Association Volume 6: Fifth Annual Conference, (Proceedings of the European Air Law Association's fifth conference, held on 5 November 1993, in Paris), (Deventer: Kluwer, 1994), at 69; IATA's Legal Advisory Group also identified a number of codesharing issues and suggested regulatory approaches to them, focusing on the need for transparency in any future responses to be adopted, See Weber, L., *Legal Activities of the International Air Transport Association (IATA) 1993-1994*, (1995) XX-1 Air & Space Law 32, at 33.

addition, although codesharing has obvious benefits for hub airports, its expanded use may have detrimental effects on non-hub airports.[238]

### 5.3.2 The Spectrum of Integrating Activities

Codesharing should be viewed as the foundation of alliance-building. However, absent any other types of supplementary integration instruments, "naked" codesharing, which simply involves putting one airline's code on another's flight, is no different in practice than connecting interline services. Therefore, most codesharing agreements are more complex than an agreement to simply swap two-character codes on CRS displays.

As we have seen, strategic alliances emulate mergers, both in the scope and depth of their integrating activities. They may further be divided into three models: the "marketing agreement/codesharing" model, the "merger" model, and the "investor" model. The "marketing agreement/codesharing" model is best exemplified by the United/Lufthansa alliance. It usually involves joint marketing/sales, shared facilities, schedule co-ordination, blocked-space agreements and frequent flyer program links. Although such an alliance cannot truly be viewed as a merger emulation, the coverage of the co-ordinating measures over two such large airline networks puts it somewhere in between a mere alliance and a merger emulation, but much closer to the latter. The "merger" model is best exemplified by the KLM/Northwest alliance. It utilizes all of the above integrating instruments, but goes further in creating true joint operations by also incorporating: revenue pooling, fares and inventory control, joint marketing and sales, network planning, standard service contracts, and shared marketing data. In effect

[238] See *GRA Codesharing Report*, *supra* note 217, at 60-62;

creating a seamless product, or as close to a seamless product as present regulatory and market conditions allow.

The "investor" model is best exemplified by the BA/USAir alliance, which although also employing the purchase of a large equity stake like the "merger" model, is differentiated by two characteristics. The first is the fact that it involves the integration of a dominant and a subordinate carrier, necessarily affecting the direction of integrating activities. The second is the fact that the extent of its integrating activities is limited by national ownership and control provisions and competition regulations, which were overcome by the KLM/Northwest alliance by virtue of the "open skies" agreement signed between the United States and the Netherlands.[239]

## 5.4 THE REGULATION OF ALLIANCES

Although airline mergers face almost insurmountable national ownership and effective control requirements, which even if overcome or side-stepped, lead to rigorous competition and anti-trust examinations by regulators in both the United States and Europe, the process in some ways has advantages over the one to which airline alliances are subjected. Despite the complexity, length and eventual cost of gaining merger approval, the participating airlines at least have the comfort of knowing that the arduous process is a one-time affair. In merger examinations, regulators either approve or disapprove the merger. Although conditions may be attached to an approval, the decision

[239] See **B. Apparent Liberalization of the Citizenship Criteria**, at 48-54.

is definitive, allowing the participating airlines to concentrate their time and resources on making the merger work.[240]

In contrast, airline alliances face having to overcome lower regulatory hurdles, particularly when they involve complementary route networks, but with the knowledge that more hurdles may be thrown their way at any time. Regulators usually follow a two step approach in analyzing airline alliances. The first step involves ascertaining which elements of the alliance require competition law approval and which do not, the second involves an examination and approval/disapproval of the potentially anti-competitive elements.

### 5.4.1 The United States

In the United States, blocked space arrangements and codesharing agreements, usually the essential components of alliance building, require approval by the DOT. According to the DOT's 1994 Policy Statement, such approval will be freely given to arrangements involving airlines from countries agreeing to liberalized "open skies" agreements. However, agreements involving airlines from other countries are subject to a case by case review according to several fairly subjective criteria.[241] When approval is granted, it is given for a set duration, making it subject to re-examination, which leaves it open to the vagaries of international aero-political developments and often spurious challenges by competitors.[242]

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[240] See **3.3 AIRLINE MERGERS IN THE UNITED STATES AND EUROPE**, at 40-75.

[241] See *supra*, at 92.

[242] See **5.5.1.2 BA/USAir**, at 106-108.

Even when DOT approves such arrangements, they are still subject to anti-trust reviews by the Department of Justice.[243] However, the American Secretary of Transportation has the authority to grant anti-trust immunity to agreements in foreign air transportation. The immunity may be granted if an agreement is in the public interest and is necessary to permit implementation of an approved co-operative agreement. If it is found that such a co-operative agreement will substantially reduce or eliminate competition, it may only be approved if: (1) the agreement is necessary to meet a serious transportation need or to achieve important public benefits, including international comity and foreign policy considerations, and (2) that transportation need or those public benefits cannot be achieved by reasonably available alternatives that are less anti-competitive. However, immunity does not extend to joint ventures involving the sharing of costs and/or revenues, both for domestic and international air transport.

So far, only the KLM/Northwest alliance has requested and received such immunity. Heavily influenced by the signing of the "open skies" bilateral agreement between the United States and the Netherlands,[244] the decision to grant immunity was based on the finding that the agreement was in the public interest and that it was unlikely that the parties would proceed with the alliance without immunity, for fear of legal challenges by competitors.

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[243] See **3.3.1.4 Anti-Trust and Public Interest Test**, at 54-59.

[244] See ***Re Acquisition of Northwest Airlines Inc. (Northwest II)***, at 48-49.

### 5.4.2 The European Union

Within the European Union, Article 85(3) provides for exemption from the prohibition found in Article 85(1) of agreements which restrict or distort competition and affect trade between the Union's Member States.[245] The exemption applies to both individual agreements and categories of agreements which meet the criteria set out in Article 85(3), that is if the agreement:

> ... contributes to improving the production or distribution of goods; or to promoting technical or economic progress, while allowing consumers a fair share of the resulting benefit, and which does not: (1) impose on the undertakings concerned restrictions which are not indispensable to the attainment of those objectives; or (2) afford such undertakings the possibility of eliminating competition in respect of a substantial part of the products in question.

Block exemptions are generally issued in the form of Commission Regulations, acting under powers delegated by the Council, in the form of an Enabling Regulation. If an agreement, decision or concerted practice falls within the scope of a block exemption, it will automatically be exempt from the prohibition in Article 85(1), without the need for notification of the Commission. Regulation 3975/87[246] establishes the procedure for the application of the competition rules to the air transport sector,[247] while the Enabling Regulation 3976/87[248] establishes the application of Article 85(3) to certain categories of agreements and concerted practices in the air transport sector.[249] Under the provisions of

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[245] See **3.3.2.1 Articles 85 and 86**, at 61-64, and **3.3.2.3 The Residual Effect of Articles 85 and 86**, at 68-69.

[246] EU, *Council Regulation 3975/87 on the Application of Competition Rules to Undertakings in the Air Transport Sector*, of 14 December 1987, (1987) O.J. L374/1.

[247] See Adkins, B., *supra* note 175, at 46-59.

[248] EU, *Council Regulation 3976/87 on the Application of Article 85(3) to Certain Categories of Agreements and Concerted Practices in the Air Transport Sector*, of 14 December 1987, (1987) O.J. L374/9.

[249] See Adkins, B., *supra* note 175, at 63-67.

Regulation 3976/87, the Commission has adopted three block exemptions[250] covering the following areas of airline activities: joint planning and co-ordination of schedules, joint operations, consultations on passenger and cargo tariff rates on scheduled air services and slot allocation at airports; activities relating to computer reservation systems; and ground handling services (now expired).[251] However, both the block exemptions from the competition rules and the individual exemptions have a limited duration.

Thus, under EU competition law, joint promotion and advertising, joint ground handling services, joint frequent flyer programs and interlining generally do not require Commission approval. Unlike the United States, the EU does not require the approval of blocked space agreements and codesharing agreements, unless they are combined with an agreement or concerted practice to set or reduce capacity on specific air routes.[252] Joint planning and co-ordination of schedules, and tariff consultations are allowed under the abovementioned block exemptions, subject to certain conditions.

However, given the fairly narrow scope of the block exemptions, they do not generally apply to joint ventures or joint operations, which must usually receive an individual exemption from the competition rules. All such integrative practices, even if approved under individual or block exemptions, are still subject to Article 86 if they result

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[250] Initially on the basis of three Regulations, Commission Regulation 1617/93, (1993) O.J. L155/18, Commission Regulation 83/91, (1991) O.J. L10/9, and Commission Regulation 82/91, (1991) O.J. L10/7 respectively. The block exemptions have been amended with the further implementation of EU liberalization measures. However, the scope of this paper does not permit a further examination of these developments, See Adkins, B., Ibid., at 65-74.

[251] See Dussart-Lefret, C., & Federlin, C., *Ground Handling Services and EC Competition Rules*, (1994) XIX-2 Air & Space Law 50.

[252] For a more detailed analysis of EU codesharing regulatory practices and their comparison to those in the United States, See de Groot, J.E.C., *Codesharing: United States' Policies and the Lessons for Europe*, (1994) XIX-2 Air & Space Law 62.

in an abuse of a dominant position.[253] It should also be kept in mind that the specific integrative practices discussed above also have an impact on other air transport issues and practices, such as slot allocation, which must be addressed by regulators.[254]

## 5.5 ALLIANCE BENEFITS

### 5.5.1 Participating Carriers

The three strategic alliances between American carriers and foreign airlines are all producing the intended large increases in the number of passengers traveling on their networks. This is due to the broad nature of their codesharing arrangements and the great degree of integration already achieved by the carriers in scheduling, operations, advertising, and frequent flyer programs. However, the benefits accruing to the particular airlines in question vary in relation to the details of each of the agreements. They will be analyzed here in order from most integration achieved to least.

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[253] See **3.3.2.1 Articles 85 and 86**, at 61-63, and **3.3.2.3 The Residual Effect of Articles 85 and 86**, at 68-69; The Commission's decision in the *British Midland v. Aer Lingus* case raises the possibility that there may be a "duty to codeshare", analogous to the "duty to interline", See EU, *Commission Decision 92/213 of February 1992 Relating to a Procedure Pursuant to Articles 85 and 86 of the EEC Treaty*, (1992) O.J. L96/34. However, the existence of such a duty under EU competition law has been questioned on the basis of the fact that the decision was not appealed to the European Court of Justice and the inappropriateness of extending such a duty from interlining, which is an industry-wide practice, to alliance building, which is by its very nature a selective activity, See Haanappel, P.P.C., *supra* note 9, at 192, and Dutheil de la Rochère, J., *Control of Competition as a Tool of Civil Aviation Policy*, in Dagtoglou, P.D., Dutheil de la Rochère & Balfour, J.M., supra note 237, at 39; For a general survey of the application of EU competition laws to co-operative practices by airlines, See van Houtte, *Community Competition Law in the Air Transport Sector (I) & (II)*, (1993) XVIII-2 Air & Space Law 61 & (1993) XVIII-6 Air & Space Law 275, respectively.

[254] The European Union's Code of Conduct allows slot exchanges between carriers, but not unilateral transfers of slots. This may limit the transfer of a slot from one alliance partner to another, in cases where the transferee partner actually operates the flight but the transferor partner does not receive a slot in return, See Haanappel, P.P.C., supra note 9, at 189; Also See Crans, B.J.H. & Cras S.P., *EC Aviation Scene: 2. Slot* Allocation, (1994) XIX-1 Air & Space Law 31, and Haanappel, P.P.C., *Airport Slots and Market Access: Some Basic Notions and Solutions*, (1994) XIX-4/5 Air & Space Law 198; For an analysis of the issues raised by slot allocation and possible regulatory responses, See Janda, R., *Auctioning Airport Slots: Airline Oligopoly, Hubs and Spokes, and Traffic Congestion*, (1993) XVIII-I AASL 153.

#### 5.5.1.1 KLM/Northwest

Northwest's and KLM's riderships have increased dramatically since the creation and implementation of the present alliance. Northwest has reported that for the year ended June 1994, over 353,000 passengers traveled on Northwest alliance flights, compared to 164,450 passengers traveling on connecting Northwest and KLM interline flights in 1991. In addition to this increase of almost 200,000 passengers on Northwest aircraft, KLM estimated that during this same period approximately 150,000 passengers traveled on codeshared flights using only KLM aircraft.

Although some of this increase can be attributed to the improved economic conditions in the United States and Europe since 1991, the alliance has been the key factor in this traffic growth. Prior to the alliance, Northwest did not serve the 30 overseas cities that they now serve by codesharing with KLM. Therefore, traffic funneled from those cities to Amsterdam by KLM, and then carried by Northwest from Amsterdam to the United States is additional traffic directly attributable to the codesharing arrangement.[255]

This increase in ridership in conjunction with the fact that the partners (1) divide the resulting revenues according to an agreed prorated formula that accounts for the miles each airline flies, and (2) both fly numerous long-haul routes as part of the alliance, has had a significant impact on both airlines' financial performances. It has been estimated that in 1994, the alliance produced between $125 million and $175 million in added revenues for Northwest, which represents about one-third of Northwest's $455 million in

[255] As an example, Northwest noted that it would require several planes and an investment of several million dollars to serve Oslo from its Minneapolis hub. However, the codesharing arrangement allows for 30 additional passengers per day to fly from Oslo to Amsterdam on KLM and connect to Northwest flights for the United States, with minor additional investments, See *GAO Alliance Report*, *supra* note 4, at 27-31.

transatlantic passenger revenues, and about 5% of its $3 billion in total international passenger revenues. These added revenues helped Northwest post a company record $830 million operating profit in 1994, as opposed to a loss of $60.1 million in 1991 and $141.7 million in 1990. In the same period, KLM was estimated to have earned approximately $100 million in added revenues as a result of the alliance, making up 18% of KLM's transatlantic passenger revenues and 3% of its overall international passenger revenues.[256]

The alliance's success can be attributed to the broad scope of its codesharing network and the high degree of integration which the airlines have achieved. In terms of the scope of their network, they have structured their operations so as to take advantage of Northwest's hubs in Boston, Detroit and Minneapolis, and KLM's hub in Amsterdam, enabling them to link Northwest's domestic service from 88 American cities with KLM's services to 30 cities in Europe and the Middle East. By KLM/Northwest's own admission, their high level of integration has been made possible by the anti-trust immunity granted to them by the DOT, allowing them to co-ordinate their activities without fear of legal challenges by competitors. This has allowed them to take several steps towards integration which would be impossible without immunity, such as: jointly developing fares for routes served by the alliance,[257] creating a joint identity by operating under the same service mark, and offering common incentives to their sales forces who market both

[256] All data obtained from the *GAO Alliance Report*, Ibid.

[257] See Cooper, R.E., *Communication and Cooperation Among Competitors: The Case of the Airline Industry*, (1993) 61 Antitrust Law Journal 549.

airlines.[258] However, DOT and DOJ officials have stated that the high degree of integration achieved by the alliance would not violate anti-trust laws even without immunity, as the two airlines were not significant competitors on most routes.[259]

Perhaps the strongest endorsement for the efficacy of the KLM/Northwest alliance comes from the complaints voiced by the alliance's American and foreign competitors. Analysis of KLM/Northwest's market share on flights between 34 U.S. cities and 30 European and Middle Eastern cities shows that it climbed from 1.2% in 1991 to 3.3% in 1994.[260] Continental Airlines has claimed that it lost $1 million in revenues in 1994 from the traffic diverted to the alliance on routes between the United States and Europe. Similar concerns have also been raised by several foreign airlines. However, even if Continental's claimed revenue loss was accurate, it is a minuscule portion of its overall transatlantic passenger revenues. Given this fact and the fact that the alliance's other detractors failed to produce any data supporting their claims,[261] the KLM/Northwest alliance must be viewed as a win-win situation for KLM, Northwest, the United States and the Netherlands.

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[258] Northwest and KLM have also integrated in other areas, including: the creation of marketing products such as World Business Class (which are common to both KLM and Northwest flights);the use of the same branding for airplane exteriors and interiors, uniforms, vehicles and stationary, and identical seat pitch (thereby reducing purchasing costs and emphasizing the integrated service to the passengers); and produced common advertising emphasizing their integration.

[259] See *GAO Alliance Report, supra* note 4, at 30.

[260] Ibid., at 31.

[261] Ibid.

#### 5.5.1.2 BA/USAir

Unlike KLM and Northwest who codeshare on each other's routes, the BA/USAir alliance, which began in May 1993, only involves codesharing by BA on USAir's flights within the United States, while USAir does not list BA's flights as its own. As British Airways operates all of the long-haul flights to Europe, it gets to keep most of the revenue generated by the codesharing agreement. This codesharing revenue and the 7% dividend paid quarterly by USAir to BA is the return on its investment in the ailing airline. USAir benefited from the initial cash infusion, which was critical at the time, and continues to gain revenue under the agreement from several sources, including: the codesharing agreement, increased interline traffic due to its frequent flyer links with BA, and the "wet leasing" of three of its aircraft to BA for transatlantic operations.[262]

In the eleven month period following the commencement of codesharing, 14,300 passengers traveled on these domestic BA/USAir flights. In the following nine month period, this number had grown to 47,749 passengers.[263] Given the fact that their codesharing agreement covers 52 cities in the United States, most of which BA did not previously serve, or served through interlining agreements, most of the increase in traffic can be attributed to the co-ordination and integration between the airlines. In addition, British Airways experienced a 60% increase in its interline traffic with USAir from U.S. cities other than the 52 covered by the codesharing agreement. Overall, BA is estimated to have generated $100 million in revenues from the alliance between April 1994 and

[262] The USAir planes fly BA's colours, with USAir crews, on BA flights between London and Baltimore, Charlotte and Pittsburgh.

[263] All data obtained from *GAO Alliance Report*, *supra* note 4, at 32-36.

March 1995. This is broken down to $45 million from the codeshare traffic and $55 million from a combination of the increased interline traffic, linked frequent flyer programs, and cost savings. This is equivalent to 5% of BA's total revenues on traffic to and from the United States, and 1% of its total international revenues.

On the other hand, USAir is estimated to have earned approximately $20 million in total from the alliance in 1994. This is broken down to $8 million from the codeshared traffic, and $12 million from the increase in interline traffic and the "wet lease" arrangements. However, the returns to both airlines are expected to increase as the airlines speed up the integration of their operations and marketing, which has been hampered by the temporary nature of the DOT's approval of the codesharing agreement and its occasional threats to disapprove the agreement.

Overall, this uncertainty over the DOT's approval, the "one-way" flow of increased benefits, and the continuing financial troubles at USAir have resulted in less integration than that found with the KLM/Northwest alliance, and therefore smaller benefits. In terms of the alliance's effects on other carriers, the BA/USAir arrangement seems to have been more detrimental to other airlines than the KLM/Northwest alliance. Much of the traffic generated by the alliance, which now flies USAir from the interior of the U.S. and BA to points outside, was originally handled by other U.S. carriers and interlined with U.S. or British carriers to points outside the United States, or was carried by the same U.S. airline throughout, including on-line service by USAir.

In summation, the BA/USAir alliance is a win-win situation for both BA, in terms of it receiving the bulk of the increased revenue, and USAir, which was rescued from

collapse and shares in some of the added revenues. However, it is not clear whether the aggregate effect on the U.S. airline industry is positive or negative.

#### 5.5.1.3 United/Lufthansa

The United/Lufthansa alliance is both the most recent and least integrative of the three major alliances. This "marketing alliance/codesharing" strategic alliance was implemented in June 1994. Under their agreement, Lufthansa codeshares on United's flights between Lufthansa's hub in Frankfurt and 25 interior cities in the United States, via United's hubs at Chicago O'Hare and Washington Dulles airports. In addition, Lufthansa codeshares on United's flights between Lufthansa's 10 U.S. gateway cities and the 25 U.S. interior cities. In return, United codeshares on Lufthansa's flights between Frankfurt and 30 European and Middle Eastern cities, in addition to codesharing on Lufthansa's flights between Frankfurt and its 10 U.S. gateways. Given the recent forging of an alliance between Lufthansa and SAS, SAS is expected to sever its codesharing agreement with Continental Airlines and join the United/Lufthansa alliance, thereby making it one of the broadest alliances in the industry.[264]

United has estimated that the alliance has increased its traffic by approximately 600 passengers per day, increasing the airline's total traffic by 219,000 passengers in the alliance's first year of operation. Much of this increase comes from traffic generated on flights between the United States and the 30 foreign cities (flown to by Lufthansa), which United did not previously serve. With increasing integration, the additional traffic

[264] See Canadian Press Newswire, *supra* note 213 and **5.5.1.4 The Proposed Lufthansa/SAS Joint Venture**, at 110.

generated by the alliance, which had exceeded the airlines' expectations, was soon expected to reach 1,000 passengers per day.[265]

Most of the traffic generated by the alliance was assumed to be diverted from other airlines serving those markets, although competition between the United/Lufthansa, KLM/Northwest and BA/USAir alliances was likely to be generating some new traffic, drawn by the competitive pricing and increased frequency on those routes. Competing airlines have claimed a loss of traffic to the alliance, but have not provided any data backing up their claims. However, the impact of the alliance is expected to be weaker than that produced by the KLM/Northwest alliance as the absence of anti-trust immunity for the alliance's operations restricts the scope of their integrative operations. The anti-trust immunity is unlikely to come in the future as the two airlines are competitors in several city-pair markets.

In assessing the overall impact of the alliance, it should be kept in mind that the United/Lufthansa alliance differs in one important respect from the KLM/Northwest and BA/USAir alliances. Whereas the latter two alliances involved one partner who was in acute need of both the financial strength and the expanded network of its eventual foreign partner, creating a situation which basically dictated that the faltering airlines either integrate or risk collapse, the United/Lufthansa alliance is the integration of two willing, somewhat equal and stable partners.[266] Overall, it has produced benefits for both its

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[265] All data obtained from *GAO Alliance Report*, *supra* note 4, at 36-38.

[266] Although Lufthansa was still undergoing restructuring, its situation cannot be compared to that faced by USAir and Northwest.

partners, while creating no sizable or obvious negative impacts for the airline industry in Germany and the United States.

#### 5.5.1.4 The Proposed Lufthansa/SAS Joint Venture

As mentioned earlier, Lufthansa and SAS have announced their intention to form an alliance,[267] which if approved would also qualify as a strategic alliance on the basis of the extent of the integrative steps to be taken. Under the proposal, the two partners would create a regional joint venture which would serve as their exclusive vehicle for operating scheduled air transport services between Germany and Scandinavia. On a world-wide basis, they intend to establish an integrated air transport network involving the co-ordination of the following aspects of their operations: codesharing, network planning, pricing policy, yield management and budgeting, and marketing and sales. If the alliance is approved by the EU Commission, it is expected to generate extensive savings and traffic growth.[268]

#### 5.5.1.5 Regional Alliances

Regional alliances are by their vary nature more limited in geographic scope, thereby limiting the level of integration possible. However, as with strategic alliances, their success in large part depends on integrating the operations of the participating carriers to the highest degree possible. An example of a relatively integrated regional alliance is the one between United and Ansett Australia, which was implemented in

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[267] See *supra*, at f.n. 213.

[268] Lufthansa and SAS have submitted an application outlining their proposed joint venture to the Commission which has not taken its decision yet, See Notice of the EC Commission, *Re The Agreement Between Deutsche Lufthansa AG and Scandinavian Airlines System SAS (Case IV/35.545)*, of 7 June 1995, (1995) O.J. C141/9.

September 1992, and whose partners have worked hard at developing and marketing the alliance. It is estimated that United carries about 120 passengers per day (translating to 43,000 passengers per year) on flights from its gateways in the United States to Ansett's hub in Sydney, who then fly on Ansett's codeshared flights to 8 cities in the Australian interior, which United did not previously serve. The alliance generates approximately $14 million in additional revenue for United, which although it makes up only 1% of United's overall trans-pacific passenger revenues, nevertheless is important given the thin profit margins in the industry.[269]

Similar positive results have also come from United's regional alliance with British Midland, which commenced in April 1992. The alliance has increased the number of passengers flying United from the United States to Heathrow by approximately 30,000. In the 14 month period preceding the alliance, British Midland flew an average 151 passengers per month on an interline basis with United from Heathrow to 5 Northern European cities. Since the implementation of the codesharing agreement, BM has flown approximately 2,072 United passengers per month (about 25,000 passengers per year) to the same destinations. This increase in traffic has come largely at the expense of British Midland's main rival, British Airways.[270] However, it should be kept in mind that regional alliances do not always produce similar benefits. Ansett had previously been allied with Northwest, however, the limited co-ordination and integration they achieved eventually lead to the alliance's dissolution.

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[269] All data obtained from the *GAO Alliance Report*, *supra* note 213, at 38-39.

[270] Ibid., at 39-41.

### 5.5.1.6 Point-Specific Alliances

Most point-specific alliances involve codesharing and blocked-space arrangements between the airlines, whereby one carrier buys a block of seats on another airline's flights and markets them as its own. However, such alliances have had a checkered history in terms of success. Roughly one-third of the 50 point-specific alliances approved by the DOT in the period preceding 31 December 1994 have been terminated by the participating airlines, because they failed to produce the traffic and revenues expected. The blocked-space agreement between American Airlines and Cathay Pacific on Cathay Pacific's flights between Los Angeles and Hong Kong, which was terminated in 1992, illustrates some of the pitfalls of such limited arrangements. American had entered the arrangement because it thought it too expensive to fly the route itself. However, although the route attracted the expected number of passengers, American found it a money-losing venture because it had to match Cathay Pacific's low prices.

Delta airlines has one of the most extensive networks of point-specific alliances, covering blocked-space agreements with nine airlines.[271] In all cases, the agreements have been entered into because it is too expensive for Delta or the participating airlines to serve those markets themselves. Its arrangement with Swissair, part of its "Global Excellence Alliance" which involves minor cross-equity participation, has been successful largely because the participating airlines have worked closely together to integrate operations and jointly market their products. As an example of such integration, Delta flight attendants

[271] As of 31 December 1994, it had such arrangements with the following airlines: Aeroflot, Aeromexico, Austrian Airlines, Malev Hungarian, Sabena, Singapore Airlines, Swissair, TAP, and Varig, See *GAO Alliance Report*, *supra* note 4, Appendix II, at 66-67.

are present on the blocked-space flights flown by Swissair between New York and Zurich, while both airlines adhere to common quality assurance procedures. However, no figures are available to asses the profitability of this venture. The blocked-space agreement between American Airlines and South African Airways is another example of a successful point-specific alliance. American sold over 16,600 seats on SAA's flights between New York and Johannesburg, in the first two years following the implementation of the agreement in November 1992. Although the venture is said to be profitable for both carriers, no data backing up such claims is available.

In terms of the impact on other industry players, such alliances may produce relatively minor but nevertheless negative effects. A blocked-space arrangement between an American carrier and a smaller country's flag carrier can force other American carriers to exit the market. As an example, TWA claimed that it had to exit the U.S.-Switzerland market because it could not compete with the daily non-stop service provided by the Delta/Swissair alliance. However, given TWA's other problems, this claim may be exaggerated.

"Bare-bones" point-specific alliances, which do not include blocked-space arrangements or joint promotion, but only involve codesharing, produce very minimal benefits for the participating carriers and have a negligible impact on other airlines. An example of such an arrangement is Virgin Atlantic's arrangement with Midwest Express, under which Virgin Atlantic displays Midwest Express' flights between Boston and Milwaukee as its own, so as to link Milwaukee with its flights from London to Boston. In

the first seven months following the start of the arrangement, 203 codeshared passengers traveled from Milwaukee to London (29 per month).[272]

### 5.5.2 Consumers

The greatest benefit accruing to consumers from airline alliances comes in the increased choices available to them in choosing how to get to their destination. As an example, prior to codesharing, a passenger who wanted to fly from Indianapolis to Lyon would have had to interline on several different carriers. Now he can choose to get to his destination by way of three options, by taking either: BA/USAir on an Indianapolis-Pittsburgh-London-Lyon itinerary, KLM/Northwest on an Indianapolis-Pittsburgh-London-Lyon itinerary, or United/Lufthansa on an Indianapolis-Washington D.C.-Frankfurt-Lyon itinerary. Passengers have also benefited from close schedule co-ordination among partners which has resulted in shorter lay-over times between connections and a proliferation of one-stop check-in services.

In addition, alliances have resulted in the extension of international service to many cities which previously had none, or had limited international service. A few American examples of this are: Atlanta - Delta's blocked-space arrangement with Varig resulted in daily non-stop service by Varig to and from Rio de Janeiro and one-stop service to and from Sao Paulo; Washington D.C. - Delta's arrangement with Austrian Airways resulted in direct one-stop service by Austrian to and from Vienna; Cincinnati - Delta's blocked-space agreement with Swissair resulted in non-stop service by Delta to and from Zurich;

[272] All data obtained from *GAO Alliance Report*, *supra* note 4, at 41-43.

and Memphis - the KLM/Northwest alliance resulted in Memphis having non-stop service to Europe for the first time.[273]

However, it is not yet clear whether the development of alliances has resulted in a reduction in fares. In 1994, the DOT created an economic analysis unit to monitor alliances' impact on competition, which should result in a clearer picture of their effect on fares. However, its work will be hampered by the fact that the DOT's traffic data does not distinguish codeshared traffic from other traffic and the fact that the DOT does not have access to information concerning fares charged by foreign airlines. To address these limitations, the DOT started requiring the American airlines involved in strategic alliances, namely Northwest, United and USAir, to file special reports on their codeshare traffic as of 1994.

## 5.6 FACTORS AFFECTING THE SUCCESS OF ALLIANCES

The preceding review of alliances and the benefits derived from them shows a recurring theme when it comes to what makes certain alliances succeed while others fail. The greatest determinant of success in alliance-building is the level of co-ordination and integration aspired to and achieved. As with most endeavours, half-hearted or superficial efforts at creating global networks usually produce mediocre results or fail completely. As

[273] In March 1989, eight cities in the United States (Denver, Dallas/Fort Worth, Baltimore/Washington, Orlando, Metropolitan Washington, Kansas City, Phoenix and Portland, now grown to 30 member cities) formed a lobby group known as the U.S. Airports for Better International Air Service (USA-BIAS). The group's efforts culminated in the DOT's *Original Cities Program*, D.O.T. Order No. 90-6-20 (1990), and the *1991 Amendments*, D.O.T. Order No. 91-11-26 (1991), which set the criteria allowing for increased access to foreign carriers to cities not receiving adequate international air transport services. Since the inception of the program, nine member cities have gained services to seventeen international destinations, which is estimated to have created 83,000 jobs and generated $3.8 billion per year in economic activity. For a general description of the program and a detailed city-by-city analysis of its impact, See Fiore, D.R., *Expanding International Air Service Opportunities to More U.S. Cities*, (1994) 22 Transportation Law Journal 327.

has already been explained, there is a spectrum of airline co-operation, covering the following progressive stages: (1) interlining, (2) schedule co-ordination and joint promotions, (3) marketing agreements, blocked-space agreements and codesharing, (4) revenue pooling, sharing of fare and marketing data, and the creation of a seamless product (emulated merger, with or without equity participation), and (5) actual merger.

Although one would expect that the most rational approach to building global alliances would entail taking graduated steps along this spectrum, airline experience has shown that that is not necessarily the case. Airlines who have wished to minimize their risks have sometimes opted for a trial stage of minimal integration and have usually been disappointed with the results, therefore further eroding their willingness to attempt greater degrees of integration. Successful alliances appear to require a "critical mass" of integrating activities, covering as broad a range of airline activities as possible, a sort of "critical scope" of activities.

This "critical scope" of activities also includes geographical scope in terms of the integrative activities being implemented across the participating airlines' full networks. In turn, the integration of the airlines' full networks is easier to achieve and more productive when the networks are complimentary, rather than overlapping, in terms of market coverage. The integration of complimentary networks brings several advantages, among them being: an increase in market coverage for both participating airlines; fewer anti-competitive effects, therefore raising fewer regulatory concerns and leading to a more co-operative relationship with regulatory authorities; and fewer redundancies requiring

rationalization, thereby resulting in a more co-operative relationship with both the affected labour unions and regulatory agencies.

However, the implementation of integrative activities with the requisite mass and scope requires a high degree of confidence among the participating partners, as it is a long-term, expensive and potentially destabilizing (if it fails) process. Although sizable equity or cross-equity holdings do not guarantee the eventual success of alliances, they must be viewed as one of the greatest confidence-building measures available to the partners. In addition, in alliance situations involving a weaker airline, they may be required in order to finance the integrative process to the extent required and allowed by competition law.

# PART III

## 6. THE EVOLUTION OF GLOBAL AIRLINES

The preceding discussion on alliances, focusing on strategic alliances, brings us full circle. The strategic character of an alliance is defined by its attempts to emulate a merger. Some successful strategic alliances may almost be characterized as *de facto* merged airlines in terms of function, however existing national ownership and control provisions ensure that *de jure* global airlines, both in form and in function, cannot presently exist. Although the distinction between *de jure* and *de facto* global airlines may appear minor at first sight, it is vitally important for both the short-term and long-term developmental structure of global airlines.

The current trend of creating airlines which almost function as global airlines, but which are not structured and do not look like global airlines, carries on the long tradition of skewed development in the international airline industry. Airlines operate internationally, but must have national ownership. Passengers and industries are encouraged to travel and trade, but their options to do so are severely and deliberately restricted. The airline industry utilizes prohibitively expensive and usually high technology equipment and systems, yet every insolvent and underdeveloped country must have its own airline. Airlines can generate tremendous profits, both direct and indirect, yet they almost consistently produce prohibitive losses and drain public coffers.

The fact that airlines must continue not to look like global airlines, while making every effort to act like one, is important because it detracts them from the task at hand, which is the creation of an efficient, secure, globe-spanning, and profitable transportation company. The necessity of keeping up the appearance of a "national" global airline is time and resource consuming, both of which are better spent in actually creating and running such an airline. In the long term, the uncertainty which this sort of regulatory system engenders stunts and skews the development of airlines, as the carriers in question lack the confidence to take the bold technological, organizational, and financial steps required to create the airline of the future. The success of the airlines of the future will be predicated on their efficiency, financial strength and access to global markets.[274] Regulation will dictate if, when, and how this can occur. It can either continue to inhibit these developments, or it can play the leading role in directing and nurturing them.

## 6.1 LOOSENING THE RESTRICTIONS ON GLOBALIZATION

### 6.1.1 Rethinking the Concepts Underlying the Regulatory Regime

Although there were serious and practical reasons for ascribing nationality to aircraft, the extension of the same requirement to airlines was a result of a confluence of factors, none of which necessarily mandated the development of the present restrictive national and international regulatory regime. The link between governments and airlines, although temporally and somewhat logically linked to the particularities of air transportation and its initial development, was premised on the novelty of aviation and

[274] See Bock, A., *How to Restore the Airline Industry to Its Full Upright Position: An Analysis of the National Commission to Ensure a Strong, Competitive Airline Industry Report*, (1994) 59 JALC 663.

convenience. Regulators follow a fairly simple philosophy - when in doubt, ban or restrict. At the time, international air transport presented both an immense potential and a myriad of threats, neither of which were clearly ascertainable. As a result, the immediate regulatory instinct was to control access in terms of where, by whom, how often and how much.

However, over fifty years have passed since the development of the present regulatory regime. The premises underlying its structure, mainly based on the fear of the unknown, no longer hold true, if they ever did. The link between airlines and governments must be replaced by a wider link between governments and air transportation in general, including all of its derived and ancillary elements and benefits. Air transportation is no longer a fairly simple ticket, board and fly operation, but a complex set of inter-related activities. Although this set of activities is necessarily linked, each is a distinct operation, better and more efficiently performed by some than others. Likewise, air transportation is no longer an independent activity, but is rather an integral part of and channel for the whole spectrum of international trading activities, thereby increasing its importance but also necessitating that it be regulated with a view to maximizing its overall potential. This new reality requires a rethinking and readjustment of national ownership and control provisions, bilaterally negotiated route exchanges, restrictions on cabotage, and competition law application.

### 6.1.2 Multilateral Attempts at Reform

#### 6.1.2.1 ICAO

The Chicago framework was unsuccessful in coming up with a multilateral approach to the economic regulation of international air transport, leaving the field to bilateralism. However, by adopting standard capacity clauses in bilateral agreements, a pseudo-multilateral framework was established which governs the exchange of traffic rights to this day. ICAO, as the multilateral forum for matters involving civil aviation, has found itself under increasing pressure, both from within and without, to involve itself in the economic regulation of air transportation by coming up with a modernized multilateral approach.

However, all attempts at reforming the system through the Chicago framework stumble over the provisions found in Article 44, particularly paragraph (f), of the Convention which states that one of the objectives of ICAO as an organization is to "insure that the rights of contracting States are fully respected and that every contracting State has a fair opportunity to operate international airlines". This provision has until now been seen as the justification for contracting States claiming a legitimate share of international air transportation, guaranteed to them by virtue of the present system based on mutual concessions made by way of national airlines and bilateral route right exchanges.[275]

[275] See Wassenbergh, H., *"Legitimate" Shares of States Under International Air and Space Transportation Regulation*, (1995) XX-I AASL 83.

As part of the follow-up to its 1992 World-Wide Air Transport Colloquium,[276] ICAO established a Group of Experts on Future Regulatory Arrangements (known as GEFRA), to examine future regulatory arrangements for international air transport, which presented its findings at the 1994 ICAO World-Wide Air Transport Conference.[277] Under the proposals submitted to the Conference, Parties would grant each other full market access (including unrestricted route, operational and traffic rights) for use by designated air carriers, with cabotage and seventh freedom right exchanges being optional.[278] In terms of designation, each Party to an air transport agreement would be free to designate any carrier to use the market access granted to it by a second Party, and that second Party would commit itself to permit such an air carrier to do so, provided that the designated carrier:

> (1) is and remains substantially owned and effectively controlled by nationals of any one or more States that are Parties to the agreement, or by any one or more of the Parties themselves; or
>
> (2) has its headquarters, central administration or principal place of business in the territory of the designating Party, regardless of its ownership and control; and in either case
>
> (3) qualifies under the laws and regulations normally applied by the aeronautical authorities of the Party receiving the designation and complies with the laws and regulations of the receiving Party relating to the admission, departure, operation and navigation of aircraft in its territory and those relating to the admission to and departure from its territory of passengers, crew, cargo or mail.[279]

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[276] Held in Montréal from 6-10 April 1992.

[277] Held in Montréal from 23 November to 6 December 1994.

[278] See ICAO, *Fourth Air Transport Conference*, WP/6 (14 April 1994).

[279] See ICAO, *Fourth Air Transport Conference*, WP/8 (20 April 1994).

The proposal also included a "safety net", giving each Party the right to impose a time-limited capacity freeze as an extraordinary measure in response to a rapid and significant decline in that Party's participation in a country-pair market. The broadened criteria would enlarge the scope of a State's right to designate an airline and would remove some of the obstacles for States wishing to liberalize the control criteria for their own carriers. Given the discretionary nature of current bilateral national ownership and control criteria, the broadened criteria could be applied unilaterally or bilaterally.

In addition to the "safety net", which was intended for use in exceptional circumstances, the related ICAO Working Paper No. 10[280] provided for the establishment of two new regulatory arrangements: a "Code of Conduct for Healthy Sustained Competition" and a new dispute resolution mechanism.[281] The two proposed regulatory arrangements would apply continuously (unlike the "safety net") and would jointly replace the entire complex of present regulatory arrangements, which provide for either *a priori* governmental determinations, full or limited *ex post facto* controls, or virtually no control of air carrier pricing and capacity. The proposed "Code of Conduct" would apply to many airline activities now covered by national competition laws, including: (1) price dumping, (2) price predation, (3) inordinately high pricing due to a lack of competition, abuse of a dominant position or collusion, (4) price discrimination, (5) capacity dumping, (6) capacity predation, (7) capacity insufficiency, and (8) capacity discrimination.

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[280] See ICAO, *Fourth Air Transport Conference*, WP/10 (19 April 1994).

[281] For an analysis of the existing aviation dispute resolution mechanisms and the proposed new mechanism, See Diederiks-Verschoor, I., *The Settlement of Aviation Disputes*, (1995) XX-I AASL 335.

However, notwithstanding the generally sound nature of the proposals, they were found unacceptable by the majority of the States attending the Conference, particularly those from the developing and under-developed regions of the world.[282] As a result, the Conference's main achievement was in eliciting and compiling the positions of the various States and regions in attendance. Although ICAO was exhorted to exert a leadership role in the regulation of international civil aviation, it was not given the mechanism to do so and was left to "facilitate" any future regulatory arrangements.[283]

#### 6.1.2.2 The World Trade Organization

In the aftermath of the World-Wide Air Transport Conference, the international air transport world still found itself without a multilateral modernized approach to the economic regulation of air transport, while ICAO found itself increasingly marginalized from any eventual framework which may emerge. Given ICAO's unwillingness to lead, the impetus for applying the GATT approach to international air transport as a "trade in services" has grown.

After seven years of protracted negotiations, the Final Act incorporating the results of the Uruguay Round of Multilateral Trade Negotiations was signed on 15 April 1994.[284] It contains an agreement establishing the World Trade Organization, which is to provide a

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[282] Generally for the positions of the various States and regions attending, See Abeyratne, R.I.R., *The World-Wide Air Transport Conference and Air Traffic Rights - A Commentary*, (1995) XXX-2 European Transport Law 131, at 142-145; For a detailed discussion of the concerns voiced by developing nations, See Poonoosamy, V., *Developing Countries in the Wake of Aeropolitical Changes*, (1994) XIX-II AASL 589.

[283] For a survey of the proposals and the Conference conclusions, See Poonoosamy, V., *The ICAO World-Wide Air Transport Conference - Montreal*, (1995) XXX-2 European Transport Law 115.

[284] *Agreement Establishing the World Trade Organization*, 15 April 1994, 33-5 ILM 1125 [hereinafter *WTO Agreement*].

single institutional framework for the conduct of trade relations among the Member States, in addition to four annexes which contain the substantive provisions of the Agreement.[285] Annex 1B of the Agreement includes the General Agreement on Trade in Services (GATS) distinguishing four ways in which the provision of services may arise: (1) cross-frontier supply of services (*e.g.* international flights, or CRS services provided abroad), (2) consumption abroad (*e.g.* services supplied to tourists abroad), (3) commercial presence (*e.g.* ticket sales through airline offices abroad), and (4) the presence of natural persons abroad (*e.g.* crews on "wet leased" aircraft).[286]

The WTO has broad enforcement powers in regards to its Member States' trade subsidy activities, including: supervising access to national markets, overseeing the "phase-out" of tariffs and quotas in trade agreements, reaching binding dispute settlement decisions, granting compensation, and imposing sanctions. When a State has made market access commitments, it may not derogate from them, unless specifically provided for in its Schedule, by setting quotas on : (1) the number of service suppliers, (2) the total value of service transactions or assets, (3) the total number of service operations or on the total quantity of service output, (4) the number of natural persons that may be employed in a particular service sector, (5) the types of legal entity or joint venture through which a

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[285] For a detailed analysis of the *WTO Agreement* and the GATT system in general, See Petersmann, E.-U., *The Dispute Settlement System of the World Trade Organization and the Evolution of the GATT Dispute Settlement System Since 1948*, (1994) 31-6 CMLR 1157.

[286] See *supra* note 284, Ann. 1B, Article 1(2); See Wassenbergh, H.A., *The Future of International Air Transportation Law*, (1995) XX-II AASL 383, at 406-407; For the European Court of Justice's interpretation of the scope of this definition, See *Re: The Uruguay Round Treaties (Opinion 1/94)*, (1995) 1 CMLR 205, at 316, and Racic, M.A., *supra* note 229.

service supplier may supply a service, or (6) the maximum percentage of foreign shareholding or the total value of individual or aggregate foreign investment.

The framework for the safeguard mechanism and "safety net" proposed at the ICAO Conference is found in Article IX, which prohibits anti-competitive practices, and Article X, which requires multilateral negotiations be held to decide on provisions governing "emergency safeguard measures" within three years of the entry into force of the *WTO Agreement*.[287]

The GATS approach to international economic regulation is based on two principles. The first is the non-discrimination principle, requiring unconditional mandatory MFN treatment and unconditional national treatment. MFN treatment is a general principle which requires that Member States "shall accord services and service suppliers of any other member treatment no less favourable than that provided for under the terms, limitations and conditions agreed and specified in its Schedule".[288] National treatment is a specific principle requiring Member States to provide "no less favourable" treatment to foreign service providers than that provided to domestic providers.[289] The second principle is the prohibition of non-tariff barriers.

Although the immediate application of the Annex is restricted to three aspects of air transport services, namely: (1) aircraft repair and maintenance services; (2) the selling and marketing of air transport services; and (3) computer reservation systems, the wording

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[287] See Janda, R., *Passing the Torch: Why ICAO Should Leave Economic Regulation of International Air Transport to the WTO*, (1995) XX-I AASL 409, at 418.

[288] Article XVI.

[289] Article XVII.

of GATS makes it clear that it applies to air transport services *in toto*. However, as the existing bilateral exchange of route rights framework is premised on discrimination and non-tariff barriers, the GATS approach has been seen by many as unsuitable for air transport services.

The MFN principle in effect transforms bilateralism into multilateralism, since all Member States benefit from any improvement in market access negotiated by any two States. MFN and national treatment are extended to all Parties regardless of reciprocity, whereas the existing bilateral regime is premised on reciprocity. As a result, it is feared that this multilateralizing effect would result in the exportation of liberal air traffic rights regimes by dominant States to States and regions unwilling and/or unable to implement such a uniformly liberalized approach. Given the idiosyncrasies of air transport, which can be accounted for in bilateral agreements, this multilateral approach is viewed as being limited because its scope cannot extend beyond the least common denominator of opinions.[290]

Some commentators have suggested that it is possible to combine the MFN principle and traditional bilateralism, by applying it to the most favourable equal exchange of inbound and outbound access to transborder markets which a country is prepared to make. Thus, a country would identify the most liberal arrangement it would be willing to offer and would have to offer it to all other WTO members on the basis of reciprocity.[291]

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[290] See Wassenbergh, H.A., *World Air Transport Regulatory Reform*, (1994) XIX-1 AASL 491, at 507-508. Also See Abeyratne, R.I.R., *The Economic Relevance of the Chicago Convention: A Retrospective Study*, (1994) XIX-II AASL 3, at 24-38, and Mencik von Zebinsky, A., *The General Agreement on Trade in Services: Its Implications for Air Transport*, (1993) XVIII-II AASL 359, at 392-394.

[291] See Janda, R., *supra* note 287, at 423-426.

However, given the abovementioned reservations, the GATS approach to the economic regulation of air transport is not expected to be adopted in the near future, although it may prove enough of a threat to ICAO to force it to finally make a real attempt at addressing the issue.

### 6.1.3 Regional Attempts at Reform

#### 6.1.3.1 The European Union

As mentioned earlier, national substantial ownership and effective control provisions have been replaced by Community ownership criteria within the European Union.[292] This change has come in conjunction to the creation of a Community-wide internal air transport market, granting access to all intra-Community air transport to carriers of all Member States, with restrictions on cabotage remaining in effect until 1997. Although the change in ownership criteria only has internal effect, with the exception of the few States which have waived this provision in their bilateral agreements with respect to Deutsche BA,[293] it is expected to lead to a proliferation of Community ownership clauses in future bilateral agreements.

This may or may not happen in conjunction with the transfer of the external negotiation mandate from the Member States to the Commission, as requested by the Commission. The European Court of Justice made it clear in *Opinion 1/94* that the Commission cannot proceed without such a mandate.[294] However, although this decision

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[292] See 2.2.3 The European Union, at 27-28.

[293] See 4.2 INTERNATIONAL FRANCHISING, at 80-81.

[294] For a comment on the implications of the decision, See Racic, M.A., *supra* note 229.

resolved the competence issue in regards to external air transport negotiations, the successful transfer of the mandate requires the resolution of several issues, among them: the scope of the *acquis communautaire* (the legal framework of Community harmonization measures), the mechanics of mixed negotiation and conclusion of agreements, and the formulation of an overall external air transport policy.[295]

Since the ECJ's decision, the EU Transport Ministers Council met on 19-20 June 1995. to discuss the Commission's proposal for a mandate to negotiate an air transport agreement with the United States, on behalf of all of the Member States.[296] Although a decision on the matter was not made, the proposal elicited much skepticism as to whether the Commission could define a common interest for such negotiations and as to whether such negotiations would objectively produce the best results for all Member States. A decision on the matter is now expected to follow a review of a report on these issues, which was to be presented to the Council at its December 1995 meeting. In addition, the EU will increasingly concentrate on creating a seamless European aviation market, that is, a European Aviation Area encompassing all of the countries in Europe (ECAC members) with a multilateral framework utilizing harmonized regulatory rules.[297]

However, in terms of the EU's requirement for majority Community ownership and control for its carriers, it should be noted that based on an agreement made on 4 May

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[295] Ibid., at 313-317.

[296] See *Third-state Negotiations Top Agenda at Council on 19 and 20 June*, ITA-Press (1-15 June 1995), at 2.

[297] See Auer, A., *Relations Between the European Union and the Wider Europe*, in ECAC/EU A Competitive European Air Transport Industry in a Global Environment (Proceedings of a conference titled *ECAC/EU Dialogue with European Air Transport Industry*, organized by the International Institute of Air and Space Law in Leiden, held in Noordwijk, from 6-7 July 1995), at 20.

1995, Swissair will increase its holding in Sabena from 49.5% to 62.5%, subject to the right of the Belgian government to buy back control of the carrier. As Switzerland is not a Community Member, this development has been viewed by some commentators as heralding the end of national flag carriers in the regulation of international air transport.[298]

### 6.1.3.2 The Andean Group (GRAN)

Regional liberalization has not been an exclusively European phenomenon. In 1991, the Member States of the Andean Group (GRAN) made up of Bolivia, Colombia, Ecuador, Peru, and Venezuela jointly implemented air transport liberalization policies. Although it is too early to talk of an Andean Aviation Union, the Andean Group has implemented several measures aimed at liberalizing the intra-Andean market. Decision 297, *Integration of Air Transport in the Andean Subregion*, sets forth the criteria for the exchange of the Five Freedoms of the air for scheduled flights operated within the group, while laying down the guidelines under which the Member States are to grant fifth freedom rights to third countries. In addition, it regulates non-scheduled flights (passenger and cargo) within the Group and with other countries.

Decision 320, *Multiple Designation in Air Transport in the Andean Subregion*, defines the conditions for multiple designation under the bilateral air transport agreements between the Member States (not including cabotage), while the complementary Decision 361 sets simplified regulatory criteria for such multiple designations. In terms of competition policy, the Andean Group aims at drafting and implementing legal

[298] See Wassenbergh, H.A., *supra* note 286, at 397; Although this is a bit of an overstatement as it is not the first such case. Iberia of Spain holds majority ownership of Aerolineas Argentinas, See Haanappel, P.P.C., *supra* note 9, at 184, f.n. 10.

mechanisms to identify and prevent practices such as dumping, predatory tariffs, and excessive pricing (either due to an abuse of a dominant position or lack of competition).[299]

### 6.1.4 Bilateral Attempts at Reform

Buoyed by the relative strength of its dominant carriers, and frustrated by the prospects for reform in multilateral settings, the United States set about restructuring the regulatory framework for international air transport on its own. The process was set in motion by the "open skies" agreement with the Netherlands, and has been reinforced by the positive results produced under that agreement. Since then, the United States has made it a deliberate policy to seek out like-minded partners where it can, while making concentrated attempts to coerce those who do not yet share its point of view.

In early 1995, the United States extended the invitation to enter into bilateral "open skies" agreements to nine smaller European States. The proposed agreement would include enhanced market access (with some limitations remaining on the European countries' access and not including cabotage within the United States), unlimited codesharing, full fifth freedom rights, and no restrictions on capacity and pricing. Although the United States did not seem to gain much from the eventual signing of such agreements with the countries in question, particularly as it held many of the fifth freedom rights it would ostensibly gain, the offer was part of its overall strategy of forcing or nurturing (depending on one's point of view) the development of similar bilateral air transport regulatory regimes with the larger European countries.

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[299] See Weber, L., *The Chicago Convention and the Exchange of Traffic Rights in a Regional Context*, (1995) XX-I AASL 123, at 130-132.

On 24 February 1995, the United States signed an "open skies" agreement with Canada.[300] The agreement does not include cabotage, but does grant unrestricted transborder route access (with a three year phase-in period for American access to Vancouver, Toronto and Montréal), multiple designation, national slot allocation treatment at high density U.S. airports, and pricing deregulation (with regulatory intervention allowed in extraordinary situations).[301] In a similar vein, the United States has signed an agreement with Germany with a phased-in period of liberalization measures, culminating in "open skies" as of 1 November 1997.[302]

In terms of national ownership and control provisions, the United States continues to consider the conclusion of "open skies" agreements as a prerequisite to any case by case review of foreign equity participations in its airlines beyond the 25% limit.

## 6.2 CONCLUDING REMARKS: THE CONVERGENCE OF AERO-POLITICAL AND MARKET FORCES

The internationalization of the aviation industry can be viewed in three stages. The first, which can be characterized as politically driven, has historically relied on prestige, security and public interest considerations to shape national and international regulatory policy, resulting in very restrictive arrangements. The second, which can be characterized as micro-economically drive, has concentrated on shaping the nascent regulatory regime to suit the commercial interests of the national airlines. The third stage, which we are just

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[300] *Air Transport Agreement Between the Government of Canada and the Government of the United States of America*, signed on February 24, 1995, (1995) XX-II AASL 460.

[301] For a detailed analysis of the agreement, See Lacy, M.W., *Freedom in the Air: The 1995 Canada - United States Bilateral Air Transport Agreement*, (1995) XX-II AASL 139.

[302] See *supra* at 91.

entering, is characterized by a return to public interest considerations but from a macro-economic viewpoint. At this stage, aviation policy is not viewed in isolation, but is made in consideration of overall national economic imperatives and fiscal constraints. Thus, at a time when more and more governments are facing severe fiscal pressures, they will increasingly be willing to sacrifice or limit national airline interests in order to gain greater overall access to traffic, for the purposes of transport, trade and tourism.

### 6.2.1 The Role of Regionalism

The development of the future national and international regulatory framework will be driven by the twin engines of regionalism and aggressive bilateralism. Notwithstanding assurances to the contrary, regionalism represents a very real threat to smaller countries outside of the existing or developing regional arrangements. Although the European Union has gone to great lengths to try to reassure smaller non-Union countries that they will not have to shoulder the costs of concerted regional liberalization,[303] States outside the EU and the recently implemented and sure to be enhanced U.S.-Canada "open skies" arrangement cannot realistically expect the treatment they have been accorded up until recently to continue.[304] Political considerations will dictate that they retain some access, but economic considerations will increasingly dictate that this access be kept below a route profitability threshold acceptable to the regions' carriers.

States that cannot somehow participate in their own regional arrangements have two choices. Their first choice should be to understand and harness these developments

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[303] See *Comité des Sages Report*, *supra* note 4, at 184.

[304] See Poonoosamy, V., *supra* note 282, and Poonoosamy, V., *Keynote Speech*, in ECAC/EU, *supra* note 297, at 17-18.

by encouraging the development of regional arrangements in which they can participate, while carving out a niche role for themselves, fully integrated into the developing supra-regional structure, somewhat akin to the role now played by feeder regional and franchised carriers. If they choose not to do so, they will find themselves facing the second option by default, that is, a gradual and irreversible squeezing out of the market.

However, it should be noted that although regionalism may seem an unpalatable or even regressive alternative at the present time, it is probably the only means of eventually securing a more rationalized global regulatory approach. Comments made by several of the delegations at the recent 31st Session of the ICAO General Assembly[305] seemed to signal a recognition of the danger of ICAO becoming irrelevant if it does not make a serious attempt at reaching a multilateral approach to economic regulation. Although this does represent a slight shift in attitude, it will probably not be enough to come up with a consensus on a workable multilateral framework.

Given the constraints of reaching a multilateral solution, and given the traditional wariness towards liberalization, regional liberalization is probably the only pragmatic approach to reform. It affords the necessary degree of comfort to allow disparate countries to make real and often risky changes to national aviation policies. This change in attitude has its own momentum which will gradually carry over into eventual multilateral arrangements. Countries which cannot or do not participate in such regional arrangements risk having no meaningful participation in the development of any future multilateral arrangements.

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[305] Held in Montréal from 19 September to 4 October 1995.

### 6.2.2 The Role of Bilateralism

Aggressive and dynamic bilateralism, particularly on the part of the United States, is the second engine driving these developments. Although it was initially viewed as a threat, serving as a dominant impetus for the development of regional frameworks, the maturation of the regional approach has seen this type of bilateralism assume a more complimentary role to regionalism in the re-development of the economic regulation of international air transport. Detractors of a liberalized approach focus much of their criticism on the fact that in many ways, the United States is driving this restructuring through its own "open skies" bilateral initiatives, thereby breaking with international comity based on sacrosanct multilateralism. However, these same detractors seem to have conveniently forgotten the history behind the present multilateral framework. Although the current economic regulation of international air transport has evolved into a *de facto* multilateral framework, it is based on the same type of aggressive bilateral initiative, namely the Bermuda I agreement,[306] which is presently being criticized.

One has to wonder what the consequences of this insistence on developing regulatory initiatives only by way of multilateral consensus would have been had they been as strident, and eventually successful, after the Chicago Conference. If Bermuda I and all its derivatives had been blocked by the same reasoning, would there be a *de facto* multilateral approach to defend? Would air transport be a dominant economic activity, as it is today? Would passengers have more or fewer options in terms of destinations, carriers and frequencies?

[306] See 2.1.4 The Chicago Legacy, at 20-22.

We live in a dynamic world, where political systems, countries and industries, no matter how belligerent, defensive and intransigent, eventually collapse from the weight of their own inefficiencies and injustices, and we are all better for it in the long run. Who would have thought that Singapore, an entity which didn't even exist at the time of the Chicago Conference, would one day become an aviation power?

However, for regionalism and bilateralism to play a truly meaningful and productive role in the creation of a stronger and barrier-free international aviation industry, it must be characterized by a willingness by **all of the participants** to forego some of the advantages which have accrued to them through the historically restrictive approaches to aviation relations. The more liberalized approach to the exchange of route rights, as espoused most vociferously by the United States, requires a certain "leap of faith" from the smaller and weaker participants in the industry. However, such a "leap of faith" requires that all parties to any new arrangements bargain in good faith.

Despite its present dislike of the restrictive approach to the exchange of route rights, the United States has by far been its greatest beneficiary. Its post-war industrial strength and the relative political and economic weakness of its negotiating partners has allowed it to extract concessions which would seem unthinkable at the present time. This situation is best exemplified by the extensive fifth freedom rights it has been able to acquire throughout the world, most notably in Asia and Europe. The utilization of these fifth freedom rights has resulted in the creation of American international hubs on foreign territory. These hubs in effect give the United States the ability to participate in regional aviation in a manner totally unrelated to the relative strength of its carriers in the region.

This development is contrary to the spirit of the agreements through which these rights were acquired. The United States cannot argue against barriers which create international market distortions while at the same time reaping the benefits of regional market distortions. The strategy of insisting on the implementation of the historical arrangements according to the letter of the agreements, while at the same time contravening the spirit of those same agreements is short-sighted. It ignores the present economic and political realities and undermines the confidence of all of the participants, without which the required "leap of faith" is impossible.

Some markets, particularly the Asian one, have experienced tremendous growth in the last few years under the existing restrictive arrangement, both in aggregate traffic and in the relative strength of its carriers. Therefore, they may feel insulated from the maladies affecting other aviation markets. However, this growth has to a great extent been demand driven, so much so that it has been able to overcome the distortions discussed above and any inefficiencies inherent in the region's dominant carriers. However, this situation will not last forever, as the market will eventually mature. When this level demand playing field eventually materializes, Asian carriers will find themselves facing some of the same difficulties experienced by carriers in the developed markets. Unless these developments are taken into account today and the necessary efficiency and regulatory adjustments are made, Asian carriers will in the future find themselves competing against highly efficient American and European carriers in a flat demand market, without the benefit of protectionist national policies. Therefore, it is imperative that they too participate in this regulatory re-development.

### 6.2.3 The Role of Strategic Alliances

If the preceding hypothesis is correct, and regionalism and bilateralism do truly act as the building blocks of a new liberalized regulatory framework, then strategic alliances should be viewed as the cement holding the structure together. Although a good part of this thesis was spent in describing the obstacles that must be overcome in order to create merged airlines, franchises and strategic alliances, it should be kept in mind that they were eventually overcome to varying degrees. The process of making sacrifices and overcoming hardships, although often derided in today's world, serves a cathartic role. Although the concept may seem misplaced here, it should be remembered that air transport is a human activity, aside from its complexity and geographic scope, little different from all other human activities or processes. The fact that airlines found it difficult to globalize sensitized them to the concerns of national governments, international regulators, their passengers and their workers. Given the fact that air transport is an activity which touches law, economics and politics, the skills learned through these tribulations will prove invaluable in building and successfully running a truly global airline.

In international air transport, whether we like it or not, everything is interrelated. Proponents of global airlines very often seem to forget this fact, and hurt their cause by their impatience. They seem to forget that almost all apparently revolutionary political and economic developments are the result of a series of relatively minor, but related events. Viewed from a distance, these events can be seen for what they truly are, the finale of a sequence of gradual changes. In international air transport, strategic alliances are an integral part of this sequence. Now that they have been accepted in varying degrees, they

continue and strengthen the momentum towards the eventual emergence of truly global airlines. As the operations of strategic alliances become more and more integrated with the relevant national industries, they will increasingly be seen as an important part of the domestic airline operations by the national regulators, the labour unions and the passengers. This change in perspective has already been seen in other industries such as automobile manufacturing, where foreign-owned plants are now passionately defended by local politicians and labour leaders, who would have previously been the foreign manufacturers' most strident opponents. The growth in this commonality of interests will eventually result in the **evolution** of global airlines.

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