BREAKING THE SHACKLES:

FOREIGN OWNERSHIP AND CONTROL IN THE AIRLINE INDUSTRY

By

Wasim Zaidi

Faculty of Law

Institute of Air and Space Law

McGill University, Montreal

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ABSTRACT

Liberalization of the international air transport services is the cornerstone for a growing air transport industry. Since the 1990s, it has progressed at various levels through relaxation of key provisions in about 4000 bilateral services agreements currently in place globally. In 2007, almost 30 per cent of the international traffic moved between States that have embraced liberalization.

The international character of the airline sector facilitated the rapid growth of trade in goods and services over the last sixty years. Yet, paradoxically, it has the most restrictive rules on ownership and control unlike other sectors. This anomalous restriction prevents freedom to invest, considered essential to the functioning of the market, and promotes protectionist policies. As a result, the airline industry has emerged as a conspicuous oddity in a world of widespread trade liberalization.

Liberalization has been well accepted and embraced in other industrial sectors and there is increased activity in international mergers and acquisitions across the globe. Trans-national and cross border investments have increased exponentially. Removal of national restrictions in airline industry is the need of the hour. The recent US-EU 'open skies plus policy' and the potential of the ongoing second stage negotiations resulting in allowing of foreign ownership of the US and the EU airlines will usher in a new era of further liberalization of ownership and control rules.

This thesis seeks to discuss the policies and rationale behind archaic ownership and control requirements and the benefits flowing from a liberal approach. After recommending the opening up of cross border investments in the airline industry, this thesis proposes important steps to be taken to achieve prosperous results for the airline industry.

RESUME

La libéralisation de la règlementation du transport aérien international est la pierre angulaire d'une croissance soutenue pour le secteur. Depuis les années 1990, la libéralisation a progressée à divers niveaux grâce à l'assouplissement des dispositions clés dans plus de 4000 accords bilatéraux de services actuellement en place au niveau mondial. En 2007, près de 30 pour cent du trafic circulant entre les États était régi par des dispositions libéralisées à différents degrés.

Le caractère international du secteur de l'aviation a facilité la croissance rapide du commerce des biens et des services au cours des 50 dernières années. Pourtant, paradoxalement, ce secteur a les règles sur la propriété et le contrôle les plus restrictives. Ces restrictions anormales empêchent la liberté d'investir, considérée comme essentielle au fonctionnement du marché, et contribue à la promotion de politiques protectionnistes. En conséquence, l'industrie du transport aérien est devenu manifestement une curiosité dans un monde dominé par la libéralisation des échanges.

La libéralisation a été bien acceptée et cultivée dans d'autres secteurs industriels et il y a eu une augmentation de l'activité dans les fusions et acquisitions dans le monde entier. Ailleurs, les investissements transnationaux et transfrontaliers ont augmenté de façon exponentielle. La suppression des restrictions nationales dans l'industrie du transport aérien est la nécessité de l'heure. La récente politique des Etats-Unis et de l'Union Européenne dite « ciel ouvert plus » et le succès de la deuxième étape des négociations qui ont permis la propriété étrangère des compagnies aériennes des États-Unis et de l'Union Européenne marquent le début d'une nouvelle ère dans la poursuite d'une libéralisation plus poussée de la propriété et des règles de contrôle.

Cette thèse vise à examiner la raison d'être des règles archaïques de propriété et de contrôle et les avantages découlant d'une approche libérale. Après avoir recommandé l'ouverture des investissements transfrontaliers dans le secteur du transport aérien, cette thèse propose des mesures

importantes à prendre pour atteindre les résultats escomptés et la prospérité pour le secteur du transport aérien.

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TABLE OF ABBREVIATIONS

ABA	**American Bar Association**
A.A.S.L	**Annals of Air and Space Law**
AF	**Air France**
Air & Space L.	**Air and Space Law**
Airline Bus.	**Airline Business**
Am.U.L.Rev.	**American University Law Review**
ALPA	**Airline Pilots Association**
AOC	**Air Operator's Certificate**
APEC	**Asia-Pacific Economic Cooperation**
ATRP	**Air Transport Regulation Panel**
ASA	**Air Service Agreement**
ATConf/5	**5th Worldwide Air Transport Conference**
BA	**British Airways**
BWIA	**British West Indian Airways**
Case W. Res. J. Int'l L.	**Case Western Reserve Journal of International Law**
CRAF	**Civil Reserve Air Fleet**
CAB	**Civil Aeronautics Board**
CARICOM	**Caribbean Economic Community**
CRS	**Computer Reservation System**
DOD	**Department of Defense**
DOT	**Department of Justice**
Doc.	**Document**
ECAC	**European Civil Aviation Conference**
ECJ	**European Court of Justice**
EEA	**European Economic Area**
Emory Int'l L. Rev.	**Emory International Law Review**
EU	**European Union**
FAA	**Federal Aviation Administration**
FDI	**Foreign Direct Investment**
GAO	**General Accounting Office**

GATT	**General Agreement on Tariffs and Trade**
GATS	**General Agreement on Trade in Services**
IASTA	**International Air Services Transit Agreement**
IATA	**International Air Transport Association**
ICAO	**International Civil Aviation Organization**
ICAO J.	**ICAO Journal**
Inv. Dealers' Dig.	**Investment Dealers Digest**
JAA	**Joint Aviation Authorities**
KLM	**Koninklijke Luchvaart Maatschapij N.V.**
L.N.T.S.	**League of Nations Treaty Series**
M&A	**Mergers and Acquisitions**
MFN	**Most Favored Nation**
OECD	**Organization of Economic Cooperation and Development**
NW	**Northwest airlines**
OAA	**Open Aviation Area**
SARS	**Severe Acute Respiratory Syndrome**
SARPS	**Standards and Recommended Practices**
TCAA	**Transatlantic Common Aviation Area**
Transp. L. J.	**Transport Law Journal**
U.N.T.S.	**United Nations Treaty Series**
US	**United States**
UK	**United Kingdom**
USOAP	**Universal Security Oversight Audit Programme**

Wall St. J.	**Wall Street Journal**
WTO	**World Trade Organization**

INTRODUCTION

Globalization and liberalization have changed the business world and brought about a paradigm shift in the conduct of business. All kinds of business pursuits have benefited from it. Shipping, telecommunications and banking are just some of the many industries experiencing increased commercial activity both domestically and internationally. Flow of capital from one country to another, buying and selling of enterprises and mergers and acquisitions of corporations by foreign companies[1] are just some of the beneficial examples of a liberalized framework being in place.

Like any other business, civil aviation which is one of the most international of industries, is also involved in the process of gradual liberalization and globalization. Unfortunately the aviation market has failed to fully enjoy the fruits of liberalization. Despite its inherent international character, airline industry is paradoxically bound by some of the most restrictive rules on national ownership and control. These ownership and control requirements are linked to nationality and thus originated the concept of 'flag carriers'. Exchange of traffic rights was tied to nationality of airlines and has been the norm since the late 1940s.[2]

Substantive ownership and effective control[3] restrictions are firmly entrenched in national laws and further strengthened by archaic rules and regulations driven by protectionist policies. In dealing with airline designation and authorization under their bilateral air service agreements, States generally retain the right to withhold, revoke, or impose conditions on the operating permission that a foreign air carrier needs in order to operate the agreed services if the carrier is not "substantially owned and effectively controlled" by the designating State or its nationals[4].

[1] Land Rover and Jaguar were recently acquired by Tata, an Indian conglomerate in early 2008. Both Land Rover and Jaguar were car brands owned by Ford, a US automobile company; See "*Tata acquires Jaguar, Land Rover for $2.30 bn"* (26th March, 2008). <http://www.timesofindia.com>

[2] P.P.C Haanappel, "Airline Ownership and Control and Some Related Matters" (2001) 26-2 Air & Space L. 90 at 90.

[3] The two criteria are together also referred to and understood as "traditional criterion" later on in the text and have the same meaning.

[4] Standard 'Nationality clause' mentioned in the Bilateral Air Services Agreements signed by States.

The traditional criterion, as mentioned earlier, has been in use since the 1940s and provides for a convenient link between the carrier and the designating State by which parties to the agreement can:

a) implement a "balance of benefit" policy for the airlines involved;

b) prevent a non-party State through its carrier from gaining, indirectly, an unreciprocated benefit; and

c) identify those who are responsible for safety and security matters.

The traditional provision, coupled with the view that the air carrier had important strategic, economic, and developmental roles, encouraged the growth of national, primarily state-owned air carriers.

Earlier, ownership and control provisions arguably mattered less; airlines were generally state-owned and less commercially focused with common pooling agreements, revenue and capacity sharing. Due to increased privatization of airlines and globalization of the industry more generally, ownership and control restrictions now create major problems for airlines which seek to access foreign capital or expand operations internationally. An imperfect solution to the problem has been found in airline alliance which enables them to skirt foreign ownership and cabotage[5] issues.

Genesis of "substantial ownership" and "effective control"

To understand the origin of ownership and control one has to go back in time at the beginning of the 20th century when civil aviation was in a nascent stage and governments all over the world were getting together to lay down governing principles for the civil aviation industry. The Convention relating to the Regulation of Aerial Navigation (also called the Paris Convention of 1919)[6] addressed safety and navigation and also laid down the basic legal framework for international aviation in the 20th century. The first article of the Paris Convention recognized that each State enjoyed "complete and exclusive sovereignty over the airspace above its territory".[7]

[5] Cabotage is defined as the carriage of traffic between two points which are both located within the territory of one State; *See* Pablo Mendes, *Cabotage in Air Transport Regulation* (Dordrecht, Martinus, Nijhoff Publishers, 1992) xi.

[6] Convention Relating to the Regulation of Aerial Navigation, signed Oct.13, 1919, 11 L.N.T.S 173.

[7] See Lord McNair, *The Law of the Air* 3rd ed. (London: Stevens & Sons. 1964) 407.

With the taste of war fresh in their mouths, the delegates of Paris were not ready to embrace the tradition of Hugo Grotius and his notion of "freedom of the seas"- unconstrained use of the oceans by vessels flying the flags of any nation and owned by citizens of any country.[8] In recognizing the exclusivity of national territorial rights, the world community rejected the older concept of international maritime law which allowed unencumbered commercial use of the oceans during peacetime by vessels flying the flag of any nation and *owned and controlled by citizens of any country* to visit the ports of any nonbelligerent State and participate in international trade and commerce.[9] Hence during those days, national security and national defense was an important consideration for repudiating "freedom of the seas". This furthered the need to impose ownership and control restrictions on airlines.

The Paris Convention repudiated the notion of the freedom of air and jealously guarded the new notion of air sovereignty for nations that were more worried about planes flying over their territory than by ships.[10]The Paris Convention stressed on nationality through many of its articles, such as nationality of aircraft (Art. 6),[11] national airspace (Art. 1) and Article 7[12] and governments took the cue. However, the Paris Convention's requirement that aircraft be effectively owned and controlled by nationals of the registering State *did not* make its way into the Chicago Convention.[13] The issue of whether aircraft or airline ownership was tied to nationality was left to the national law. But since cabotage rights normally were conferred only to airlines owned by nationals of the State of registration and often nationality was a domestic law prerequisite of registry, the result would be the same in much of the world.

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[8] Paul Dempsey & Lisa Helling, "*Oil Pollution by Ocean Vessel: Legal Regime of Flags of Convenience, Multilateral Conventions and Coastal States*" (1980) 10 Den. J. Int'l L. & Pol'y 37.

[9] Andreas Lowenfeld, *Aviation Law: Cases and Materials* (New York: M. Bender, 1972).

[10] Anthony Sampson, *Empires of the Sky: The Politics, Contests and Cartels of World Airline* (London; Toronto: Hodder & Stoughton, 1984) 18.

[11] "Aircraft possesses the nationality of the State on the register of which they are registered".

[12] "No aircraft shall be entered on the register of the contracting States unless it belongs *wholly* to the nationals of such State."; *Supra* note 6.

[13] *Convention on International Civil Aviation,* 7 December 1944, 15 U.N.T.S 295, ICAO Doc. 7300/6 [Hereinafter referred to as *Chicago Convention*]; The Chicago Convention sets up the institutional and legal framework for post-war international civil aviation. It also constituted the International Civil Aviation Organization (ICAO).

Thus traditional criterion was in place as early as the 1920s although they found legal manifestation after 1944.[14] These restrictions were a natural by-product of the aforementioned State sovereignty over its airspace. Several factors have dictated the need to impose ownership and control requirements on airlines by governments since the two World Wars began. One of the most compelling needs to let ownership and control stay in the hands of nationals of the State was to let them enjoy the fruits of sovereignty. In this perspective, traffic rights form part of the natural resources of sovereign States. States negotiating for traffic rights wished to see their own nationals benefit from the commercialization of these resources. Herein were sown the seeds of interpretation of ownership and control by States which found manifestation and were given shape later on through the IASTA and Bermuda agreement which will be discussed later on.[15] In addition to the Paris Convention, similar conventions were signed in Madrid[16] in 1926 and Havana[17] in 1928 and in substance, they reiterated the same principles.[18]

From the beginning of civil aviation, States have played an active role in the growth and development of their airlines, which were seen by some as symbols of national aspirations and pride, prestige and global penetration. Most governments recognize the important role that their air carriers play in facilitating communications, trade and tourism, and national pride, as they "show the flag" around the world.[19] It should be noted that before the Chicago Convention was adopted, ownership and control requirements mattered less as airlines were generally State-owned and less commercially focused.[20]

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[14] The *US Air Commerce Act* of 1926 required air carriers to maintain 51% voting stock by US nationals and also a two-thirds US citizen presence on the Board of Directors.

[15] *Agreement Between the Government of the United States and the Government of the United Kingdom Related to Air Services Between their Respective Territories*, 11 February 1946, U.S-U.K., 60 Stat. 1499.

[16] *Iberio-American Convention relating to Aerial Navigation,* 1926.

[17] *Convention on Commercial Aviation*, 1928.

[18] John Cobb Cooper, "*Backgrounds of International Public Air Law"* (1967) 1 Yearbook of Air and Space Law 3 at 21-22.

[19] Oliver Lissitzyn, *International Air Transport and National Policy* (New York, Council on Foreign Relations, 1942) 18-19.

[20] *Ibid.* at 2.

Definition of "substantial ownership" and "effective control"

Despite their constant use since the early 20th century and finding expression in the IASTA,[21] "substantial ownership" and "effective control" have never been defined in any of the modern international treaties concerned with air law. Moreover as "national ownership and control" are not part of international treaty law or customary law but rather a product of State practice, they have never been the subject of a universal legal definition, although recent attempts have made definitions clearer. Let us take a closer look at what they mean and imply.

Definition of "Substantial Ownership"

In order to understand what "substantial ownership" means within the airline community, let us dissect the component words and understand what they ordinarily mean before focusing on the airline industry. Substantial is defined as "of considerable size or value". Ownership is explained as "dominion, possession, proprietary rights, proprietorship, right of possession, title".[22] Hence we can interpret it to mean the possession and/or right of possession, dominion an ownership of a considerable size and value. Ownership in an airline is generally understood to mean the ownership of voting shares of the stock. 'Substantial' would imply the ownership of 50% and/or more shares of the stock.[23] In other words, the question of what constitutes 'substantial' has in domestic laws been answered by staying on the safe side of more than 50% of ownership of company shares. Ownership can be through private or a public entity. It can be safely concluded now that "majority ownership is substantial ownership".[24]

The airlines were state-owned earlier and so ownership mattered less but with the wave of privatization over the last 20 years, ownership has taken on a more private shape. Private ownership and alien stakeholders have more holdings in a typical airline company nowadays. Airlines seek to invest in

[21] *International Air Services Transit Agreement*, 7 December1944, 84 U.N.T.S. 389, 394, ICAO Doc. 7500 [Hereinafter referred to as *IASTA*].

[22] Collins English Dictionary and Thesaurus (ed. 1993) 814.

[23] See EC, Commission Decision of 19 July 1995 on a procedure relating to the application of Council Regulation (EEC No. 2407/92 (Swissair/Sabena), [1995] O.J.L. 239/19.

[24] IATA, Government and Industry Affairs Department, *Report of the Ownership and Control Think Tank World Aviation Regulatory Monito*r, IATA doc. Prepared by P. van Fenema (7th Sept. 2000) [Hereinafter referred as IATA Doc].

other domestic and international airline companies and build up a sizeable stake with reasonable reciprocation. However national laws prevent ownership beyond a certain percentage. To ensure compliance with the 'nationality clause' provision, most national civil aviation acts contain articles which translate the above into a national requirement though with many variations.

Definition of "Effective Control": Effective would ordinarily be defined as "1. productive of or capable of producing a result; 2. in effect, operative; 3. actual rather than theoretical." Control[25] is defined as "1. to command, direct or rule; 2. to check, limit or restrain; 3. to regulate (financial affairs); 4. power to direct: *under control*".

As for "effective control" the relevant IATA study[26] observes that, more often than for substantial ownership, effective control is subject to practice rather than to legislation. Where there is legislation, the law is usually clear enough to express that all or a percentage of the Board members or the Chairman or CEO have to be nationals and/or residents of the country concerned. For example, in the U.S, the Civil Aeronautics Act of 1938[27] provides that in order for an airline to be considered a national flag carrier, US citizens must: 1) hold at least 75% of the voting stock of the airline;[28] 2) hold not less than 51% of the airlines non-voting equity; and 3) in all important respects, effectively "control" the airline.[29] As the IATA study revealed, there may also be requirements for the head office or principal place of business to be located in the country of which the airline is a national.

Effective control may be described as the power, direct or indirect, actual or legal, to set (short term or long term) policy and direct or manage the

[25] Collins English Dictionary and Thesaurus (ed. 1993) 239.
[26] APAG study on National Ownership and Effective Control of Airlines, supplementary documentation for APAG/29, (Montreal; 24 Sept, 1991) 7; APAG stands for IATA's Aeropolitical Advisory Group.
[27] David Arlington, "*Liberalization of Restrictions on Foreign Ownership in U.S Carriers"* (1993) 59 J. Air. L & Com 133 at 142. [Hereinafter called US Doc]
[28] 49 U.S.C. Section 1301(16) (1988); The Air Commerce Act 1926 imposed a 51 per cent ownership of the airlines by US citizens for it to be deemed a US-flag carrier.
[29] Isabelle Lelieur, *Law and Policy of Substantial Ownership and Effective Control of Airlines* (Aldershot: Ashgate, 2003) 46-50; Angela Edwards, "*Foreign Investment in the U.S Airline Industry: Friend or Foe?"* (1995) 9 Emory Int'l L. Review 595, 604. [Hereinafter Edwards Doc]

execution thereof. It is more than voting control, and may be construed on the basis of a relationship which involves close financial links and other ties which might provide rights and powers over the way in which the company conducts its affairs.[30] It is much more subtle and trickier in nature than ownership.

Effective control requirements find legal manifestation in several countries. Let us discuss the elaborate legal provisions in the in US Federal Aviation Act of 1958, which makes it unlawful "for any foreign carrier or persons controlling a foreign carrier to acquire control in any manner whatsoever of any citizens of the United States substantially engaged in the business of aeronautics."[31] Historically, a presumption of control existed where ownership exceeded 10% of the airline.[32] Securities and Exchange Commission reporting requirements are triggered by the acquisition of 5% of the voting stock. In reality, ownership of substantially lesser percentages of widely held corporations can result in "effective control" (although we shall see that the DOT[33] current view is that foreign control of US air carriers never exists).

In the United States, the *Securities Exchange Act* of 1934 defines "control" as follows:

> "The term "control" means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise."[34]

EU Regulation 2407 / 92[35] defines "control" more clearly than the US legislation and actually defines "effective control" and does not leave it

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[30] H. Peter Van Fenema, *"Substantial Ownership and Effective Control as Airpolitical Criteria"*
(1999) Essays to Wassenbergh 27.

[31] 49 U.S.C Section 1378(a)(4); The authority of the Department of Transportation under this provision was terminated as of January 1, 1989. 49 U.S.C Section 1551(a) (7).

[32] 49 U.S.C Section 1378(f).

[33] The Department of Transportation, a federal agency, was established by an act of Congress on October 15, 1966. The mission of the Department of Transportation, a cabinet-level executive department of the United States government, is to develop and coordinate policies that will provide an efficient and economical national transportation system, with due regard for need, the environment, and the national defense.

[34] *The Securities Exchange Act,* 17 C.F.R Section 240.

[35] EU, *Council Regulation 2407/92.*

subject to the interpretation of an agency such as the DOT[36] in the US. Article 2 (g) of EU Regulation 2407/92 defines effective control as:

> "a relationship constituted by rights, contracts or any other means which, either separately or jointly and having regard to the considerations of fact or law involved, confer the possibility of directly or indirectly exercising a decisive influence on an undertaking, in particular by:
>
> (a) the right to use all or part of the assets of an undertaking;
>
> (b) rights or contracts which confer a decisive influence on the composition, voting or decisions of the bodies of an undertaking or otherwise confer a decisive influence on the running of the business of the undertaking."[37]

Moreover, it is highly unlikely that a foreign investor would be interested in investing substantial capital in an airline he could not effectively control.[38] But in the unlikely event a foreign citizen should be deemed by DOT to have "control" of a U.S airline, it would no longer be deemed a U.S-flag carrier, and hence would be prohibited under the cabotage restrictions from plying domestic trade. Also foreign citizens cannot serve as president, hold more than two-thirds of the seats on the Board of Directors, or more than 25% of voting stock of a US airline.[39] DOT has employed fitness requirements under the Act to monitor foreign control issues.[40] Carriers undertaking significant changes in their operations must provide DOT with information relevant to their citizenship and fitness.[41]

As to control generally, DOT has stated that:

> 'Foreign influence may be concentrated or diffuse. It need not be identified with any particular nationality. It need not show any sinister intent. It need not be continually exercisable on a day-to-day basis. If persons other than U.S citizens. Individually or collectively, can significantly influence the affairs of the US carriers, it is not a US citizen.'[42]

Both in the view of the former US Civil Aeronautics Board[43] and the present day Department of Transportation,[44] the effective control test is the *real* test

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[36] US doc., *supra* note 27 at 143; Department of Transportation is the federal agency to oversee and regulate transportation in U.S. The power of the Civil Aeronautics Board was terminated in by the Airline Deregulation Act of 1978. At the same time, this power was transferred to the DOT.

[37] *Supra* note 35.

[38] Feldman. *What Are the Chances of Foreign Ownership of U.S Airlines?* Air Transport World (Nov, 1987)

[39] 49 U.S.C Section 1301(16).

[40] 49 U.S.C Section 1372 (r).

[41] 14 C.F.R Section 204 (4).

[42] Department of Transportation, *Order in the matter of Intera Arctic Services*, Inc., DOT Order 87-8-43, Docket No. 44,723 (1987).

[43] *Supra* note 27.

[44] US doc., *supra* note 27; With the CAB Sunset Act of 1978, Department of Transport (DOT) was handed over the reins of the Federal Aviation Administration.

of ownership and control and should be applied scrupulously and one might add, both with a measure of suspicion and with respect to any formal or legal structure used and a certain inclination to construe forbidden foreign control unless proof to the contrary can be given. We will understand the abovementioned concept through one of the most important cases addressing foreign control of a US airline. It involved KLM's acquisition of a significant interest in the holding company of Northwest airlines.[45]

In 1989, Wings Holding, Inc., acquired control of Northwest airlines with 81.5% debt and 18.5% equity. Wings debt was $3.1 billion, two-thirds of which were loans provided by Japanese banks. Equity was $705 million, of which Alfred Checchi, Gary Wilson and Frederik Malek put up only $40 million, KLM put up $400 million (for which KLM received nearly 70% of Wings nonvoting preferred stock, 31% of its nonvoting common stock, and 4.9% of its voting common stock. Elders IXL put up $80 million.[46]

KLM had the right to name a representative to the 12-member Wings Board of Directors. KLM had the right to name a 3-member committee to advise Wings on financial matters and to enter into a variety of commercial arrangements with Northwest. It also had the power to block such arrangements with other potential airlines. DOT concluded that unless KLM reduced its equity to 25%, it would be in a position to influence *actual and effective* "control". DOT expressed concern since the $400 million participation by KLM gave it a 57% of total equity.[47] DOT observed that from the precedent point of view, a large share in a carrier's equity poses citizenship problems, even when the interest does not take the form of voting stock, particularly if there are other ties to the foreign entity. Analysis has always been on a case by case basis since there are several avenues of controlling an airline. The DOT seeks to investigate if the foreign entity exercises actual control over the airline. Thereafter DOT and Northwest entered into a consent order where KLM agreed to reduce its stake in the

[45] Paul Dempsey, & Andrew Goetz, *Airline Deregulation & Lassez-Faire Mythology* (Westport, Conn.: Quorum Books, 1992) 14.

[46]Wings became the parent company of Northwest airlines and loaded it with huge debt as a result of the Leveraged Buy Out; Department of Transportation*, Order in the matter of the Acquisition of Northwest Airlines by Wings Holding , Inc*., DOT Order 89-9-29, Docket No. 46371 (29th Sept, 1989).

[47] Statement of Samuel Skinner before the Aviation Subcomm. of the House Comm. on Public Works and Transportation (Oct. 4 , 1989).

equity to 25%, the power to establish a financial advisory committee would be revoked, and Northwest would fulfill certain reporting requirements. This gives a sense of how DOT reviews the citizenship of a US carrier.[48]

Linking 'Ownership and Control' to the Chicago Convention

The truth of the matter is that "substantial ownership" and "effective control" have never been defined in *any* international treaty concerning air law. They find no explicit reference or mention even in the relevant sovereignty/nationality based articles of the historic and path-breaking Chicago Convention of 1944.[49] It has been subject to interpretation and can be predominantly attributed to mention of nationality in several articles which find place in the Chicago Convention. States have taken the liberty of interpreting such nationality based articles to suit their own needs.

The ownership and control restrictions and their presence in the web of bilateral air services agreements in which they are placed, were originally founded on the basic principle that a nation State *retains sovereignty over its airspace*.[50] With few exceptions, States require that airlines which are established in their own territory, and which they license, should be owned and controlled by their own nationals.

Article 1 of the Chicago Convention speaks of sovereignty and states that "The contracting States recognize that every state has complete and exclusive sovereignty over the airspace above its territory." The fact that States can impose limitations on flights of foreign aircraft stems from the principle embodied in the Paris Convention as mentioned earlier.[51] The fundamental rule has been repeated and sanctioned in the Chicago Convention.

Article 6 states that "No scheduled international air service may be operated over or into the territory of a contracting State, *except with the special permission* or other authorization of that State, and in accordance with the terms of such permission or authorization."[52] The special permission

[48] As a practical matter, however much of the foreign ownership in US airlines has been an economic failure.
[49] *Supra* note 13; See Article 1; Article 6; Article 7; Article 12; Article 21; Article 77.
[50] *Supra* note 13; See Art. 1.
[51] *Ibid.* at 4.
[52] *Supra* note 13.

exchanged in the form of bilateral service agreements demands compliance with terms and conditions. Adherence to ownership and control provisions as terms and conditions included in Air Service Agreements was started after the IASTA[53] was ratified and adopted and more specifically on the lines of the Bermuda agreement between the US and the UK.

Article 7 is a provision on cabotage (originated either from the French word "cabot" or Spanish word "cabo")[54] and one of the most controversial and misunderstood provisions of the Convention. It stresses that each State has the right to refuse permission to the aircraft of other contracting States to carry cabotage traffic. Article 7 of the Convention addressed the issues in two sentences. The first is the crucial sentence which says "Each Contracting State shall have the right to refuse permission to aircraft of other Contracting States to take on its own territory passengers, mail, and cargo carried for remuneration or hire and destined for another point within its territory".[55] Thus, each State has exclusive sovereignty over its airspace, and may reserve its domestic traffic to its domestic carriers. Here we see again that the first sentence of Article 7 reinforces the notion of sovereignty by each State over its air space as codified in Article 1 of the Convention and reaffirms a State's right to prohibit aircraft from other states from engaging in commercial transportation within its territory. [56]

The motivation behind such restrictions was the protection of the domestic market, carriers and workers from foreign competition. This in turn was based on the fear that carriers would use predatory pricing tactics to outdo each other in order to capture market share and harm service levels. Thus transportation service would be rendered unsafe as opposed to the needs of commerce and public interest, postal service and national defense.[57]

The primary reason for preventing foreign competition is to allow national citizens to benefit from cabotage in the domestic market. Domestic airlines participating in cabotage must be owned and controlled by nationals of the

[53] *Supra* note 21.
[54] Schraft & Rosen, "*Cabotage Or Sabotage"* (Oct, 1987) Airline Pilot at 27.
[55] Though not intended as an instrument for the economic regulation of international air transport, Article 7 of the Chicago Convention of 1944 specifically addresses issue of cabotage.
[56] Howard Kass, "*Cabotage and Control: Bringing US 1938 U.S Aviation Policy into the Jet Age*" (1994) 26 Case W. Res. J. Int'l L. 152.
[57] *Supra* note 56 at 154.

State in which the airline has its principal place of business.[58] Not only that the State must also have granted an Air Operators Certificate (AOC).[59] In most jurisdictions, an airline's operating license and AOC must be issued by the country where that airline has its principal place of business.

Article 12 of the Convention, which speaks of the rules of the air, states that:

> "Each contracting State undertakes to adopt measures to insure that every aircraft flying over or maneuvering within its territory and that every aircraft carrying its nationality mark wherever such aircraft may be, shall comply with the rules and regulations relating to flight and maneuver of aircraft there in force. Each Contracting State undertakes to keep its own regulations in these respects uniform, to the greatest possible extent, with those established from time to time under this Convention. Each Contracting State undertakes to ensure the prosecution of all persons violating the regulations applicable."[60]

As can be clearly seen, nationality is yet again an important feature of the article. It is an obligation for States to ensure that the aircraft bearing the nationality mark of another country's airline and operating in its airspace follow the rules of the air of that nation.

Article 17 requires that aircraft bear the nationality of the State in which they are registered although it does not say that the aircraft be necessarily owned and/or controlled by nationals. Article 20 requires the aircraft engaged in international air navigation to display its appropriate nationality and registration marks. There are no international rules concerning aircraft registration and the transfer of such registration and regulation of these aspects is expressly left to the domestic law of the State concerned.[61] The law would answer the question of who is entitled to register an aircraft in that State, whether the ownership of the aircraft or a determined share of that ownership may be vested in foreign nationals and the like. The narrow and rigid concept of national registration as laid down in the Chicago

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[58] "*Principal place of business"* is predicated upon the following factors*: the airline is established and incorporated in the territory of its designating Party in accordance with relevant national laws and regulations, has substantial amount f its operations and capital investment in physical facilities in the territory of the designating Party, pays income tax, registers and bases its aircraft there, and employs a significant number of nationals in managerial, technical and operational positions*; See ICAO, Working Paper "*Substantial Ownership and Effective Control"* No. ATConf/5 - WP/ 17 (27 January, 2003) 17.

[59] The internationally agreed regime for the operation of international air services requires an airline must hold an operating license and an AOC i.e. certifying that an airline has complied with safety requirements.

[60] *Supra* note 13.

[61] The *Chicago Convention*, *supra* note 13; Article 19.

Convention does not account for the "nationality" of the airline (operator of aircraft).

According to Article 21, reports of registration of aircraft in a State can be solicited by another State or the International Civil Aviation Organization (ICAO)[62] on demand. Any information regarding the registration and ownership of any particular aircraft registered in that State can be solicited. In addition, each contracting State shall furnish reports to the ICAO, under such regulations that the latter may prescribe by giving such pertinent data as can be made available concerning the *ownership and control* of aircraft registered in that State and habitually engaged in international air navigation.[63] This is the first time that ownership and control is mentioned under any article in the convention. Though they are not defined in the Chicago Convention yet their mention in Article 21 further bolstered national ownership and control restrictions imposed by States as practice. As such there is no mention of a mandatory rule requiring national ownership and/or effective control of airlines under any article. Joseph Gertler emphasized that "the Chicago Convention does not impose any 'genuine link' requirement."[64]

In completing the present survey, mention has to be made of the "International Air Services Transit Agreement" and "International Air Transport Agreement" which were drafted at the Chicago Convention and are included as annexes to its "final act."[65] They were separate agreements opened for acceptance by States. Strictly speaking, from a legal point of view,[66] these agreements were nothing more than arrangements under Article 6 providing the situation in which scheduled services of contracting States may use airspace or surface territories of other contracting States which have become parties to one or the other of these agreements. Last but not the

[62] The ICAO is the specialized agency of the United Nations handling issues of international civil aviation. ICAO was established by the Convention on International Civil Aviation on 7th December, 1944. The overarching objectives of ICAO are, as contained in Article 44, to develop the principles and techniques of international air navigation and to foster planning and development international air transport.

[63] Art. 21, *supra* note 13.

[64] Dr. Joseph Gertler, "*Nationality of Airlines: A Hidden Force in the International Air Regulation Equation"* (1982) 48 J. Air L. & Com. 51, 65-66.

[65] See "Proceedings of the International Civil Aviation Conference" (1948) I Department of State Pub. No 2820 at 175-183.

[66] John Cobb Cooper, *Backgrounds of International Public Air Law* (Montreal: McGill University Press, 1967) c.1

least, Article 1(5) of the International Air Services Transport Agreement (IASTA) will always be held responsible for the introduction of ownership and control requirements. IASTA, which was negotiated and adopted at the same time as the Chicago Convention states that:

> "Each contracting State reserves the right to withhold or revoke a certificate or permit to an air transport enterprise of another State in any case where it is not satisfied that substantial ownership and effective control are vested in nationals of a contracting State, or in case of failure of such air transport enterprise to comply with the laws of the State over which it operates, or to perform its obligations under this Agreement."[67]

This is the real and legal justification why States adopted and incorporated ownership and control restrictions in their national laws, regulations and Bilateral Air Service Agreements (Hereinafter referred to as ASAs) since the late 1940s and protected their airlines from foreign ownership. In essence, it was always meant to benefit citizens of the designating Party.

The introduction of the thesis has not only investigated the genesis of 'ownership and control' requirements but has also studied the definition of "substantial ownership" and "effective control" in different regimes and traced the mention of "Ownership" and "Control" to the IASTA of 1944.

In Part I, the thesis seeks to unravel the rationale of imposing the traditional criterion requirement and why States promote national ownership and control. Part II of the thesis analyzes the adverse effects of ownership and control on the airline industry and scrutinizes exceptions made by national governments or agencies to the rule.

Part III will elucidate the manifold benefits flowing from the elimination of ownership and control restrictions in bilateral agreements, letting go of State practice and embracing prevalent market forces. It will seek to impress upon the fact that there are employee gains and prospects of a healthy industry to be realized through liberalization. Lastly, the means of safeguarding against practical risks posed by lifting of restrictions in the near future will also be discussed.

Part IV will appraise ongoing liberalization efforts in different fora and levels to alleviate the troubles of an ailing industry and recommend practical approaches to lift the restrictions in the system. [68]

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[67] Art 1(5), *supra* note 21.

[68] The information in this thesis is up to date as of 29 August 2008.

PART I. THE IMPORANCE OF AIR TRANSPORT, THE NATIONALITY OF AIRLINES AND THE RATIONALE OF IMPOSING OWNERSHIP & CONTROL REQUIREMENTS

1.1 Scope and Importance of Air Transport

Transportation plays a multi-faceted role in the pursuit of the development objectives of a nation as well as the need to maintain international communication networks. Air transport enables goods and passengers to be transferred between and within production and consumption centres. Therefore air transport is vital to the development of commerce, growth and exchange of good and services. Quite plainly speaking, 'Air Transport' is "the transport of passengers, mail and cargo via airplanes for remuneration or hire from one point to another. Linking one point on the map to another in less time than other means of transport is truly one of the hallmarks of the air transport industry. From the moment the Wright Brothers made the first recorded flight to modern day air transport, aviation has been one of man's greatest accomplishments. In the 20th century, aviation has emerged as the principal means of allowing the world to become smaller by promoting economic growth and intellectual development of man."[69] Not only has it helped in shrinking the planet but has offered mobility to mankind and promoted trade and tourism who are heavily reliant on it.[70]

Aviation has been responsible for stimulating social and cross cultural intermingling, creating growth in an increasingly global environment and sustaining a variety of important sectors such as hotels, automobiles rental firms, convention business and tourist destinations which are dependent on safe and reliable commercial air transport.[71] As mentioned earlier, air transport is an integral part of the tourism and travel industry which is arguably the largest industry in the world.[72] According to Paul Dempsey, "The travel and tourism industry accounts for 5.5 per cent of the world's

[69] Paul Dempsey & William Thoms, *Law & Economic Regulation in Transportation* (Westport, Conn.: Quorum Books, 1986) 5.
[70] Paul Dempsey, *Law and Foreign Policy in International Aviation* (Dobbs Ferry, N.Y.: Transnational Publishers, 1987) 6.
[71] See George James, *Airline Economics* (Lexington, Mass: Lexington Books, 1982) 5-8.
[72] Gunter Eser, "*Airlines Bleeding to Death*" (April, 1991) IATA Review 3.

Gross National Product (GNP) and its growth can be attributed to aviation. Investment in air transport has a beneficial effect on the robust synergy between aviation and tourism, particularly because of the overarching dependence by the tourism industry on aviation for the carriage of tourists to their destinations. The growing interdependence of the two industries has resulted in a significant increase in the combined contribution of aviation and tourism to Gross Domestic Product, generating employment and investment opportunities."[73]

The aviation and tourism industries have a strong symbiotic relationship. The vast majority of the 919 million international passengers in 2007 were tourists.[74] An impact on tourism will often knock on to aviation and an impact on aviation will almost inevitably knock on to tourism. Since the commercial flights started in the early 20th century, air traffic has increased at an astonishing pace. Progress of air transport can be measured in terms of air traffic growth. Air traffic was pegged at 9 million in 1945 and by the mid-1990s more than 1.25 billion people flew annually, representing about 25% of the world's population.[75] This just goes to show how important the aviation industry has become in transporting people who prefer it since it is safe, reliable, dependable, efficient and reasonably priced. Over the past half century, 25 billion passengers have flown aboard commercial aircraft, the equivalent of nearly five times the world's current population; 350 million tons of freight has been carried by air, equivalent of one million fully laden Boeing 747s. The world's airlines have flown 36 trillion passengers-kilometers during the past half century, equivalent of about 120,000 round-trips to the sun.[76] By 2010, the airline industry is expected to carry 2.3 billion passengers and be responsible for 31 million jobs worldwide.[77]

Aviation is undoubtedly one of the most important industries upon which economic growth is based and built. A healthy aviation industry offering

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[73] Paul Dempsey, & Laurence Gesell, *Airline Management: Strategies for the 21st Century* 2nd ed. (Coast Aire Publications, 2006) 4.

[74] ICAO records passengers in terms of numbers on each flight; thus an international tourist travelling by air may count as at least two international passengers (inbound and outbound at destination, plus any connecting international flights). The UN definition of a tourist encompasses business as well as leisure travel.

[75] *Supra* note 73 at 5.

[76] ICAO, *Information Kit for ICAO's 50th Anniversary* (1994) 1.

[77] Giovanni Bisignani, Message to ICAO: *100 Years of Civilization* 23 (2003).

reasonably priced fares and prompt services to the public is important to any nation which seeks to participate in a global economy. Air Transport is at the crossroads of globalization and liberalization today and the future looks promising.

1.2 Liberalization of 'Ownership and Control'

Air transport, despite being one of the most international of industries, differs from other industries because of the special nationality-based restrictions placed on the ownership and control of airlines. These restrictions and the web of bilateral service agreements through which they are regulated were originally founded on the aforementioned basic principle that a nation State retains sovereignty over its airspace.[78] With few exceptions,[79] States require that airlines which are established in their own territory, and which they license,[80] should be owned and controlled by their own nationals. It has been observed that with respect to ownership and control requirements, States have slowly but surely started maturing and are finding these restrictions anomalous, particularly in the broader context of increasing economic globalization and liberalization of air transport.

The commercial pressures that have prompted firms in other industries to expand through mergers or take-over of foreign companies, or to establish themselves in foreign States in order to achieve efficiency gains, also applies to the aviation sector. Indeed aviation by its very nature is international. An increasing number of States are responding to these pressures by exposing their airlines to market forces, and in many cases, privatizing them. Airlines themselves respond through seeking increased efficiency and extending their global reach through alliances.

Airlines are, however, prevented from responding to this pressure in the same way as other businesses by the aviation-specific inward investment rules applied by most States. Therefore, the purpose of liberalizing airline

[78] Article 1 of Chicago Convention of 1944: "The contracting States recognize that every State has complete and exclusive sovereignty over the airspace above its territory."

[79] Hong Kong Special Administrative Region (SAR) and Macau SAR follow the 'principle place of business' criterion for designation of their airlines.

[80] Operating license is granted based on economic and financial criteria. Air Operators Certificate (AOC) is granted based on compliance of safety standards by the airline and airworthiness of aircraft flown etc.

ownership and control provisions is to place aviation on the same footing as other industries, and to enable an efficient allocation of resources across the whole economy. It is pertinent to note that 'liberalized' or 'liberalization' will be used interchangeably throughout. These words imply in general 'introduction of competition', 'lowering of barriers', and 'doing away with national ownership and effective control requirements'. However their primary focus is loosening of ownership and control regulations.

Liberalization of ownership and control despite its many benefits and advantages carries its risks that need to be addressed as States consider their options for change. ICAO created a panel which studied the risks involved in the liberalization process. It has been noted and debated upon by the Air Transport Regulation Panel[81] of the ICAO that:

> "1. Circulation of foreign capital may lead to less stable operation of airlines as it tends to be more mobile, flowing in and out of particular sectors of the global economy as it seeks best returns.
> 2. Here is a risk that, with a diffusion of international airline ownership and increasing emphasis on commercial outcomes. Safety and security standards may potentially deteriorate and the potential for "flags of convenience"[82] may increase; and
> 3. The promotion of mergers and acquisitions on a global level has the potential to lead to a global market concentration, which will lead, particularly in the absence of competition policy, to reductions in consumer benefits, increase in air fares, lesser routes being serviced and to a reduction on the ability of national airlines to operate on the basis of equality of opportunity."

Beside the inherent risks involved which will be discussed later on, liberalization also offers several opportunities and benefits for international airlines and government as discussed below.

1.2.1 Economic Efficiency

Air Transport liberalization will promote efficiency in several ways. The ICAO panel studied the benefits as well and came up with several conclusions. The Air Transport Regulation Panel in 2002 stated that:

> "Firstly, liberalization has the potential to improve the economic efficiency of the airline industry by:
> 1. Strengthening competition in international aviation markets by increasing, both in terms of numbers and variety, the pool of possible competitors in any given market. This in turn has the potential to lead efficiency gains feeding through into consumer gains and improved global economic welfare;

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[81] ICAO, *Report of Air Transport Regulation Panel Working Group on Air Carrier Ownership and Control*, ICAO Doc. ATRP/10/WG (2002) 9.

[82] Herman, "*Flags of Convenience - New Dimension of an Old Problem"* (1978) 24 McGill L.J. 1.

> 2. Permitting airlines to build global networks through mergers, acquisitions or alliances[83] as they see fit, subject only to normal competition policy.[84] The steady expansion of alliances for strategic purposes was to achieve greater market access and synergies. This may provide a more secure base for airlines to exploit their strength in the longer term;
> 3. Providing greater scope for in-depth integration of activities and effective management control which may be superior to the potentially unstable alliance arrangements presently observed; and
> 4. Providing airlines with wider access to capital markets ought to result in their being able to obtain capital more cheaply." [85]

Thus, it can be clearly seen that liberalization of the economic criterion will truly render the airlines commercially free and operate like any other industry. Liberalization of the traditional criterion is the need of the hour in the wake of bankruptcies and rising fuel prices. The consequences of liberalization will be discussed in Part III in detail.

Reduced reliance on debt / subsidy

The aforementioned Air Transport Regulation Panel in 2002 advanced the cause of liberalizing ownership and control which creates a potential for reduction of debt and subsidy dependence on national governments. In a notoriously cyclical industry, debt is a risky method of financing over the long term. This risk is also increasing the cost of capital available to airlines as investors put a premium on capital they are willing to provide. As a result, governments are frequently called upon to bail the ailing airlines out of the sticky situation.[86]

1.3 Legal and Regulatory Framework of 'Ownership & Control'

Aviation relations are a part of the bilateral diplomatic relations to further national interests and also to promote the airline industry. Air transport is governed by a 60 year-old set of archaic rules - the bilateral system[87], which is defined as international trade in service agreements whereby two sovereign nations regulate the performance of commercial air services

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[83] Regis Doganis, *The Airline Business in the 21st Century* (London; New York: Routledge Publications 2001) 71.
[84] Alfred Kahn, *"Market Power Issues in Deregulated Industries"* (1991) 60 Antitrust L.J. 857.
[85] *Supra* note 81.
[86] Lars Gorton, "*Air Transport And EC Competition Law*" (March 1998) 21 Fordham Int'l L.J 602.
[87] P.P.C Haanapel, "*Bilateral Air Transport Agreements"* (Unpublished).

between their respective territories,[88] and beyond[89] in many cases.[90] The national airlines of a designating Party starts operations based on the negotiation of rights to fly into foreign territory based on bilateral air service agreements concluded by governments of the States concerned. Although standardized to a large extent, these agreements may involve lengthy and often hard fought negotiations. States often strive to maintain these rights and secure the interests of their own national carriers.

Ownership and control restrictions are nowadays a standard legal clause in such air service agreements. Historically, they have been put in practice by inclusion in the first air service agreement called the Bermuda Agreement[91] between the governments of the UK and the US in 1946. However their *legal foundation* or source owes its existence to the Chicago Convention's International Air Services Transit Agreement (IASTA).[92] Article 1(5) of the IASTA expressly gives States the legal right to revoke or withhold a certificate or permit to an air transport enterprise of another State in any case where it is not satisfied that substantial ownership and effective control are vested in nationals of a contracting State, or in case of failure of such air transport enterprise to comply with the law of the State over which it operates, or to perform its obligations under this agreement. In other words, each of the States reserves "the right to prohibit the exercise of traffic rights" under the respective agreements, if it is not satisfied as to the nationality of the operator or owner.[93] Thus, States have increasingly availed themselves of the prerogative given by IASTA to withhold or revoke an airline's operational permit to enter into their territories for purposes of landing and take-off on a commercial basis. States use this right to restrict foreign investment in their own airlines or flag carriers by including a clause with

[88] Most Bilateral Air Transport Agreements define "territory" in approximately the same fashion or by mere reference to Article 2 of the Chicago Convention. "Territory" would thus include the overseas possessions of a nation.

[89] "and beyond" is added for those bilateral air transport agreements which exchange fifth freedom traffic rights.

[90] P.P.C Haanapel, "*Bilateral Air Transport Agreements 1913-1980* " (1980) 5 The Int'l Trade L.J 241.

[91] Final Act of the Civil Aviation Conference, held at Bermuda, January 15th to February 11, 1946; *Supra* note 15.

[92] Heller, *The Grant and Exercise of Transit Rights in Respect of Scheduled International Air Services* (Wellington, N.Z.: 1954) 12-15.

[93] Bin Cheng, *The Law of International Air Transport* (New York: Oceana Publications Inc, 1962) 203.

specific conditions on nationality of their aircraft in the bilateral air services agreements in conformity with Article 6 of the Chicago Convention. States who were apprehensive and war ravaged during World War II had included and adopted the ownership and control provision in IASTA so that nationals of a designating State benefit most from the hard-fought rights won by negotiations of commercial rights.[94] Governments promoted the provision for another reason which was to allow State-owned carriers to reap the benefits. Hence it is Article 1(5) of IASTA which provides for the substantive ownership and effective control requirements.

As mentioned earlier, bilateral agreements are used to govern and *regulate* scheduled commercial international air services between two nations. Exchange of traffic rights are negotiated and expressed in the air services agreements. Ownership and control requirements are also included in bilateral agreements entered into by States. Despite its global presence, the airline industry operates within one of the most constrained regulatory frameworks of any major industry, governed by an intricate network of bilateral agreements[95] between States that constrain their freedom to pursue commercial strategies considered normal by most other international industries. Typically, these bilateral agreements only allow services to be operated by a limited number of airlines designated by each side. Regulatory measures like inauguration of services, route fixing, traffic streams, capacity regulation, change of gauge, and operating permission have been put in place to control airline operations between States party to the agreement.

In addition, they restrict the type of services those designated airlines can provide. Market access constraints includes a tight controls on "traffic rights": Limiting the number, size and destination points of flights that can take place between countries; restricting the type of direct connecting services or code-share[96] arrangements that airlines can offer; limiting the airlines' freedom to set their own fares, often requiring fares to be approved

[94] Peter Van Fenema, "*Substantial Ownership and Effective Control As Airpolitical Criteria"* (1998) Essays to Wassenbergh 27.

[95] More than 3000 Bilateral Air Service Agreements have been signed to date.

[96] Code-sharing involves listing of one carrier's flight as another's (placing its designator code on the flight of another carrier) so as to deceive consumers into believing that they will be connecting onto two flights of a single airline.

by one or both of the contracting nations. In addition and the main subject of this thesis, almost all bilateral agreements (and many national laws as well) place limitations on the constitution of the designated airlines themselves by requiring majority investor ownership and effective control to reside with nationals of the relevant country.

In the European Union, in keeping with Article 4 of the Council Regulation 2407/92, national authorities are vested with the power of granting operating licenses based on the criterion that the principal place of business of the carrier applying for the license must be located in the licensing Member State; the carrier must be involved in air transportation as its main occupation; the holder of the license must be under direct or majority ownership of nationals of the European Union; and the licensee must be effectively controlled by such nationals.[97] The United States law too contains explicit requirements pertaining to nationality in terms of management of airlines[98], in contrast to Regulation 2407/92 of the EU which does not expressly address issues regarding nationality of management. Arguably, the EU addresses external control by stockholders of a company, and not particularly, as envisaged by United States law, management control of the enterprise and running of the air transport corporation.

The national restrictions have had a profound effect on the way that the industry has grown. The speed and pattern of traffic growth has in the past been dictated more by governments' willingness to loosen existing bilateral restrictions than by airlines response to the market demand for air travel, with spill-over effects for other sectors of the economy. However, governments are increasingly recognising the benefits that the removal of constraints and subsequent enhanced competition, increased economic activity and heightened consumer benefit can bring, with the consequence that limits on traffic rights, tariffs, frequency and destination points are gradually being eased or lifted entirely.[99] Despite this growing consensus in favour of liberalisation of traffic rights, there appears to be greater

[97] *Supra* note 35.

[98] 49 U.S.C. 40102 (a) (15) 1994; US laws prevents more than 25% ownership of voting stock and EU law allows a maximum of 49% only.

[99] 'Open Skies' type air service agreements started by USA have led to deregulation of frequency, capacity, pricing, multiple designation of airlines, routes etc.

reluctance to reform ownership and control rules, and progress on this front has been much slower.

Sixty years ago scheduled operators flew 9 million passengers with DC-3s. In the last three decades, air transport grew 700%, more than double the 300% GDP expansion.[100] Liberalization has yielded benefits for all, but despite the manifold benefits, ownership and control is still held onto tightly by concerned governments who are not willing to compromise. Therefore, liberalization of air transport is a critical decision which must be accepted on an increased basis.

A healthy air transport industry fuels economic growth. Airlines are the billion dollar heart of a value chain. An industry study on liberalisation, in which IATA[101] participated, quantified the spin-off effects even further. The doubling of traffic in European single market generated 1.4 million new jobs. The study looked at a random sample of restricted city-pairs around the globe. The impact of liberalisation would be a 63% increase in traffic, 24.1 million jobs and US$450 billion in additional economic activity. That's almost equal to the GDP of Brazil![102]

The role of the governments lies at the core of the liberalization debate. They must allow airlines to functions as real businesses and grant them commercial freedom to serve markets where they exist and to merge and consolidate where it makes business sense. For that to happen, the traditional criterion restrictions must be lifted progressively. Recent regulatory efforts will be discussed to offer a better perspective of developments on the ownership and control aspect. Regulatory arrangements have been proposed in the recent times to ensure a smooth transition from national to foreign ownership albeit with safeguards attached to them. Changes to existing bilateral system on a broader scale can ensure acceptance of foreign ownership and control. ICAO has addressed this issue extensively to meet changing needs. As early as 1983, the 24th Session of the Assembly adopted a resolution which introduced the concept of "community

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[100] Message by Giovanni Bisignani, "*Liberalization"* (Montreal: ICAO Global Symposium on Air Transport Liberalization, 2006).

[101] International Air Transport Association is a trade association of nearly 230 international scheduled airlines.

[102] *Supra* note 100.

of interest" in respect of airline designation involving developing countries.[103] At the 1994 World-wide Air Transport Conference (Hereinafter referred to as ATConf/4),[104] broadened criterion were endorsed (one widening the ownership and control criteria to one or more States parties to an agreement) and the other extending the "community of interest" concept to all States. On the recommendation of the ATConf/4 and ATConf/5, the ICAO developed a further criterion based on the "principal place of business plus a strong link" concept (Recommendation ATRP/9-4) which was subsequently approved by the Council as guidance for optional use by States.[105] The "community of interest" and "principal place of business" provisions each appear today in a limited number of air service agreements. These will be discussed in detail later on in the following chapters.

1.4 Economic point of view

The traditional criterion has been put forth essentially to protect the economic interests of several key players in the airline sector. This part will enumerate diverse interests at stake and possible ramifications of the liberalization process. Employees, domestic airlines, passengers, loss of transport operations and cabotage are just some of the issues at hand while discussing the liberalization process.

1.4.1 Passengers Interests:

The importance of securing passengers interests in the wake of liberalizing foreign ownership rules and allowing mergers and acquisitions is a very relevant and an extremely tricky issue for airlines to resolve. Passengers are concerned and also skeptical about high prices, reduced service quality assurances and uncertainty regarding liability regime post mergers and acquisition. It has been observed that mergers and acquisitions usually allow an increase in price as the merged airline dominates the market and take control of previous routes and market shares held by the merged entities.[106]

[103] Resolution A24-12 (now incorporated in A33-19).
[104] ICAO, *World-wide Air Transport Conference on International Air Transport Regulation: Present & Future* (April 1994) 58-60.
[105] ICAO, *Policy and Guidance Material on the Economic Regulation of International Air Transport*, ICAO Doc. 9587 (1999) 43.
[106] L. Miller "*Airline Mergers Offers fliers No Pie in the Sky"* (1996) Wall St. J. Eur. 8.

The rise in air fares can be attributed largely to the decrease in competition but these fears are groundless and based on ill-conceived public fears. With the presence of many players in the aviation market and intense anti-trust scrutiny before the merger, chances of fare increase are less.

There are significant advantages of mergers. Firstly, it allows economies of scale[107] which may lead to lower costs and probably lower prices. Secondly, merger processes are undertaken to increase shareholder value, multiply market share and extract maximum synergy. Barney Gimble, a journalist, says that, "Airline mergers create value and help reduce network overlap. By shedding duplication of routes, cutting overlapping routes to slash costs and expanding globally to increase revenue, airlines propose efficiencies which will save the merged entity hundreds of millions. An extremely successful example of an airline merger is the Air France – KLM model as it succeeded in streamlining operations while preserving two distinct brands."[108] Mergers amongst airlines also offer benefits of a frequent flyer program i.e. loyalty programs. Merged entities allow frequent flyers to take advantage of a larger pool of destinations to fly to and accumulate miles to redeem later on.

Service quality is another important factor to be kept in mind while merging and ensuring that the new product is liked and well received by the flying public. For example in the US airline industry, mergers did not *always* lead to a good service as airlines had to iron out labor unrest, pilot seniority list integration, schedule and operations coordination. But on a global basis, airline mergers and acquisitions can lead to different service cultures being integrated and operations being shared and improvised upon. From the economic point of view, mergers create more value for passengers in the form of wider network, frequent flyer program sharing, generate better services and reasonable fares. Airlines who seek to merge can not afford to lessen quality of services post-merger for fear of losing traffic and

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[107] Economies of scale are realized when increases in total production simultaneously decrease unit cost; long-run average cost decreases as output increases. As the scale of production grows, the enterprise becomes more efficient. For example, a large capital-intensive piece of equipment operating at full capacity such as a Boeing 747 will have a lower CASM *vis-à-vis* a smaller aircraft like Boeing 737; See *Supra* note 73 at 76.

[108] Barney Gimbel, "*Why Airline Mergers Don't Fly"* (March 17, 2008) Fortune Magazine. 26.

consequently hurting their market share. Thus mergers, in theory, augur very well for the flying public.[109]

1.4.2 Employee Interests:

Apart from the airlines themselves, there is no greater barrier to the liberalization process than the skeptical employee. There is a deep seated and unfounded fear of losing their jobs if foreign restrictions are lifted.[110] This section of the thesis will try to explain the benefits to the interests of labor and make attempts to allay their fears. The impact of foreign ownership on national employment has always evoked skepticism and hesitation. So far, employees of national airlines have always opposed changes in ownership ad control.

Lifting restrictions has a two-fold effect on employees through issues of employment and integration in the new merged or acquired entity. It is more of an apprehension and less of a realistic appraisal. However there are a few legitimate concerns which need to be addressed for fear of being enhanced later on.

Employment:

Many unions are concerned that foreign investors who own and control national airlines will replace their jobs with foreign workers.[111] Pilots unions, which are the strongest labor lobby in the aviation industry, appeal vociferously for the retention of their jobs (BA/US Air proposal) for fear of losing their seniority and place to foreign pilots.[112] Pilot associations have expressed fear about the impact on their employment, such as Federation of Airline Pilot's Association.[113]

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[109] Isabelle Lelieur, *Law and Policy of Substantial Ownership and Effective Control of Airlines*, (LL.M Thesis, McGill University, Institute of Air and Space Law 2003) 58. [unpublished]

[110] American Bar Association, "*Cross-Border Investment in International Airlines: Presenting the Issues"* (2000) Air & Space Law. 22. [Hereinafter called ABA Doc]

[111] K. Bohmann, "*The Ownership and Control Requirements in U.S and European Union Air Law and U.S Maritime Law- Policy: Considerations and Comparisons*" (2001) 66 Air L. & Com. 689 at 713. [Hereinafter called Bohmann Doc].

[112] D.T Arlington, "*Liberalization of Restrictions on Foreign Ownership in U.S Air Carriers: The United States must take the First Step in Aviation Globalization*" (1993) 59 J. Air L. & Com. 133 at 165 [Hereinafter Arlington Doc]; See*"Ownership Trend Creates Need for New Links Between States and Airlines*" (June, 1992) 47 ICAO J. 14.

The main point of concern appears to be that, under an OAA[114]:

> "1. US airlines will decide to lay off US workers and substitute lower wage EU workers, either directly or as a result of moving more operations to a wet-leased[115] basis;
> 2. Airlines from EU countries may be able to exploit wage differentials to win business from US airlines (resulting in US employees, particularly pilots, losing jobs or seeing a deterioration in their pay , terms and conditions);
> 3. A US airline which merged with an EU airline could substitute a cheaper EU flight crew for its existing US flight crews; and
> 4. US businesses could adopt "flags of convenience" and operate transatlantic services out of a low-wage EU country."[116]

T. Ross and W. Stanbury agree with the theory, in the context of the Canadian industry, that "Through monopoly, jobs are guaranteed in a nice way through restructuring."[117] Fear of replacement by foreign workers due to lower labor costs is another issue in the way of liberalization. It is an accepted fact that presently, there are no national laws, rules and regulations which prevent employment of foreign staff and crew. Airlines are keen on picking up foreign crew so that labor costs are reduced in an industry with high operational costs. Removal of the traditional criterion[118] will further embolden the airlines to hire on a bulk basis as mergers and alliances will create huge entities with a diverse personnel and work force from different cultures and countries.[119]

Integration of employees is undoubtedly a difficult task. Indeed, many mergers and consolidations have resulted in labor unrest which has effectively blocked an otherwise successful merger. Integrating and streamlining cultures and policies, and creating a transition in operations of two different organizations is an extremely arduous task which can create doom for many a merger. For example, pilots will inevitably be pushed

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[113] Coalition of Airline Pilots Association (CAPA) document, CAPA minutes, *Memorandum of Understanding*, APA Headquarters, Fortworth , Texas (Feb, 2000).
[114] The Transatlantic Open Aviation Area (OAA) between the US and the EU under the "Open Skies Plus" agreement.
[115] *See* Donald Bunker, *International Aircraft Financing: Volume 1,* 1st ed. (Montreal; Geneva: IATA, 2005) 229.
[116] UK CAA, "*Ownership and Control Liberalization: A Discussion Paper*" (October 2006) c.4.
< http://www.caa.co.uk/publications>
[117] T.W Ross & W.T Stanbury, "*Avoiding the Maple Syrup Solution: Comments on the restructuring of Canada's Airlines Industry*" (17th Nov, 1999) The Fraser Institute: Online Publication <http://www.fraserinstitute.ca/publications/pps/32/>.
[118] *Supra* note 3.
[119] *Supra* note 109 at 59.

down the seniority ladder[120] which will be unacceptable to many. Thus the abovementioned are real risks which have to be considered and safeguarded. However these risks will be tackled and dispelled in Part III.

1.4.3 Domestic Airline Interests:

Last but certainly not the least, domestic airlines are the most concerned entities when we speak of foreign ownership and control. Despite increasing privatization of airlines and the consequent structural separation of the State from the national flag carriers, the exposure of national airlines to competition from foreign-owned carriers is not always considered to be in the national interests. Airlines are large employers and can be large profit and tax revenue generators, although SARS, 9/11, recent soaring crude oil prices and structural overcapacity[121] created by the rescue of chronically inefficient flag carriers[122] have combined to ensure that the airline sector as a whole has been far from profitable over recent years.

There is consequently a temptation for the government to continue to shield their national airlines from competition, particularly where they regard foreign carriers as being more competitive, perhaps due to cost and/or service quality advantages. However countries do seem increasingly willing to remove bilateral restrictions and thereby expose national carriers to greater competition, recognizing that competition is capable of honing a more internationally competitive domestic industry and acknowledging that more services to the country are likely to produce benefits to the wider economy.

The appetite for reform is often closely linked to the degree to which all parties to an agreement consider the competition to be "fair". The presence of distorting or discriminatory factors, such as State aid[123], may radically affect this support for change. Let us examine some of the possible risks of liberalization:

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[120] J. Mosteller, "*The Current and Future Climate of Airline Consolidation: The Possible Impact of an Alliance of Two Large Airlines and an Examination of the Proposed American Airlines-British Airways Alliance*" (1999) 64 J. Air L. & Com. 575 at 599 [Hereinafter Mosteller Doc].

[121] *Supra* note 73 at 48-56.

[122] *Supra* note 83 at 203-206.

[123] *Supra* note 84 at 619.

1.4.4 Risk of transport operations:

As mentioned earlier, mergers and acquisitions have to be very carefully coordinated and planned in advance else they collapse and fail in their purpose.[124] To understand the significance of carefully orchestrated mergers and acquisitions, it is necessary to scrutinize the resultant effect on the merged airline operations. Air transport operations are essentially composed of two key elements: the internal operations and the outcome of such operations.[125] Internal operations are inclusive of flight schedule design created by the planning services and the outcome of the internal operation is also part of the daily operations of an airline.

Mergers of airlines is an extremely arduous process and in order to streamline operations and make maximum use of synergies, careful advanced planning spread over months has to be pursued.

Scheduling of airline operations is undoubtedly an important and expensive process soliciting efforts from employees and involving hard work, time and money. When a merger takes place, flight schedules of two different airlines have to be combined, a complicated process involving time and lots of money. The planning services orchestrate the possible synergies. Merging entities have to keep in mind the economic benefits of merging and thus a long term perspective must be formulated. The general rule in successful post-mergers management is that it is critical to get value quickly. But in airline mergers, a large portion of the synergies are *revenue improvements,* especially given the restraints of reducing high fixed costs. Unfortunately, these benefits require long-lead time decisions supported by careful planning of integration of operations. By the time the dust settles on the mergers, these critical decisions are far, far behind schedule.[126]

Critics suggest that facilitation of airline mergers post-relaxation of foreign ownership and control would most likely impede the flight schedule design management and create turbulence in the skies. Unless planning services come up with a successful flight schedule design based on network optimization, airline mergers are in for a costly aftermath. Airlines would be

[124] *Ibid* at 27.
[125] *Supra* note 109 at 66.
[126] *See* McKinsey & Company. "*Making Mergers Work"* (June 2001) Airline Bus. 110 at 111.

unable to absorb these high costs as nearly 85% of an airline's cost is fixed to its schedule.[127] However, if the merged leadership chalks out a process that matches expectations and reality, then the newly formed corporation should face no troubles in airline operations. Thus, if a well managed policy is put in place, the merged entity will in the long-run be an extremely well oiled, profitable and healthy airline.

1.4.5 Risk of decline in competition:

It is an accepted fact that removal of foreign investment restriction has its many advantages and promotes and fosters healthy competition. However some authors insist that a spurt of foreign investment will inevitably lead to a distorted market structure and unfair competition. Arguments against cross-border investments suggest that state-owned air carriers will dominate the international airline market. Several national carriers of developed and developing countries, inclusive of private and state-owned operators both, are concerned about the potential scenario in which heavily subsidized foreign airlines would invest in other carriers. Taking advantage of their State's unwilling financial support they would enjoy an unfair advantage over the privately owned carriers with limited funds at their disposal.[128] State-owned airlines would be tempted to offer lower fares than the prevailing market fares and can afford to stick to predatory pricing[129] in order to drive their competitors out of the market as they have the financial backing of their State.

It is arguable that the number of state-owned carriers has declined since the 1990s. From 1985 to 1994, the government announced privatization plans or expressed intentions of privatization for approximately 115 national airlines.[130] Since 1995, another 50 carriers have joined the list.[131] The threat

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[127] On the argument about the effects of mergers on airline schedules, see McKinsey & Company, *supra* note 126 at 111.

[128] Bohmann doc., *supra* note 111 at 715.

[129] "Predatory pricing" has been defined as pricing below an approximate measure of cost for the purposes of eliminating competitors in the short-term and reducing competition in the long-term, see *Cargill Inc v. Monfort of Colorado Inc.,* (1989) 479 U.S 104.

[130] Paul. S Dempsey, "*Competition in the Air: European Union Regulation of the Commercial Aviation*" (2001) 66 J. Air L. & Com. 979 at 983 [Hereinafter Dempsey Doc].

[131] ICAO, *The World of Civil Aviation, 2000 – 2003* (Provisional publication of the Circular 287), ICAO Doc. AT/122 (9 October 2001) 69.

of state-owned carriers is looming large upon the skeptical US carriers.[132] This is so because of the ongoing US-EU "Open Skies Plus" Treaty negotiations which are in its second and most important stage of development. The second stage of negotiations deals with lifting of foreign ownership restrictions by the US and bringing it on a minimum at par with EU ownership limits.[133] If it goes through by the end of 2009 then we have a situation where state-owned EU carriers will in all probability acquire and/or merge with US carriers and make use of State aids and subsidies to dominate the market. However this is a speculative situation with variables as there are stringent regulations in place in the EU with respect to State aids[134]. Nevertheless it is a legitimate risk for the transatlantic aviation market and US carriers.

1.4.6 Risk of loss of traffic rights:

This potential risk of loss of negotiated traffic rights is undoubtedly one of the biggest economic concerns of the airline industry and governments all over the world who are getting used to the ways of liberalization. Although there have been several exceptions[135] to the rule of "substantial ownership" and "effective control", this principle has not been effectively rendered obsolete; in fact it is the dominant standard for establishing the nationality of airlines, particularly as it relates to the designation of traffic rights. International air traffic rights involve negotiations between two States who agree upon designation of airlines and routes to be flown, capacity to be carried, prices to be fixed and frequency of flights to an fro from the territories of the concerned States amongst other things. State parties designate airlines that are authorized to operate between the two countries.

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[132] ABA doc., *supra* note 110 at 21.
[133] EU, *Council Regulation 2407/92 on Licensing of Air Carriers,* (1992) O.L.J 240/1.
[134] See Dempsey doc., *supra* note 130 at 1124-1139.
[135] In the 1990s, Brazil raised its ceiling on foreign ownership from 20% to 49.5%; Korea raised it from 20% to 49%; Peru increased it to 70%; Singapore government chose to abolish foreign restrictions so that investors could hold upto 100% in Singapore International Airlines. *See* Ionides, "*Expanded Horizons*" (Nov. 1999) Airline Bus. 36.; Australia and New Zealand both relaxed the their airline markets; Iberia Airlines owns and controls more than 60% of Aerolineas Argentinas and jeopardized Argentina-US bilateral agreement but US acquiesced to the Iberia-Aerolineas arrangement in exchange for greater traffic rights from the Argentinian government arguably providing proof that a liberal ownership works. *See* Peter van Fenema, "*Ownership Restrictions:Consequences and Steps to be Taken*" (1998) 23 Air & Space L. 63 at 65 [Hereinafter Fenema Doc].

The traditional criterion is the national ownership and control requirement of the designated airlines.

To understand the risk of foreign ownership and control better, let us take an example of a potential complex situation. If the US has a restrictive bilateral air transport agreement with France and a liberal bilateral with the Netherlands, Air France should not be able to profit from KLM's free market access into the US by buying a controlling stake in KLM. This is so because Air France would thus get market access to the US mainland without having given a reciprocal market access into France to the US carriers.[136] The problem here is that France has not negotiated with the US for traffic rights through the Netherlands. However if it is linked via the Netherlands to the US and so US would not be keen on allowing such a situation if France does not offer free reciprocal market access. US would face stiffer competition because through financial operations with airlines of State parties (mergers, acquisitions, share purchases etc), third countries would benefit from the same routes unless offering reciprocal market access. Inevitably, States would be forced to cancel traffic rights and revoke the bilateral agreement unless the State of the purchased airline renegotiates its traffic rights with its partners. It would appear now that traffic rights of designated airlines are jeopardized by the lifting of foreign investment restrictions. In order to avoid risking the loss of traffic rights, the international community should first consider liberalizing air traffic rights on a larger scale before starting the arduous process of opening up cross-border investments liberalization. If Open Skies [137]agreements are replaced with

[136] Fenema doc., *Supra* note 135 at 64.

[137] *Supra* note 99; International traffic rights are unrestricted in an Open Skies agreement. Its salient features are:

1) No limits on the number of airlines that may be designated (Multiple designation);
2) Unrestricted capacity and frequencies on all routes;
3) Full fifth freedom and sixth freedom rights, unlimited "change of gauge", coterminalization, and substantial routing flexibility;
4) Double-disapproving pricing provision on all routes, including fifth/sixth freedom markets,
5) Liberal charter arrangements,
6) Open code-share opportunities,
7) The right to convert earnings and remit them in hard currency promptly and without restrictions;
8) The right of airlines to perform ground handling of their own passengers and cargo;
9) Procompetition doing-business provisions, including commercial opportunities, user charges, fair competition, and intermodal rights,

multilateral and/or plurilateral agreements, which would completely liberalize air transport markets, there would be less concern of loss of traffic rights. Lifting of foreign investment restrictions does not have a detrimental effect on the traffic rights, given that an alterative solution can be found.

1.4.7 Risk of loss of cabotage:

Cabotage is the "transportation of passengers, cargo or mail by a foreign airline between two points in the territory of the same nation."[138] Traditionally it has always been granted to and reserved for the national carriers which are owned and controlled by nationals of the State and have their principal place of business[139] in the State too. The reasons for granting cabotage rights to national carriers have been been mentioned earlier.[140] States have been extremely cautious in granting cabotage rights to foreign airlines since the advent of the airline industry. Issues of ownership and control and cabotage rights are intertwined and raise the same concerns for national airlines and States. The State and domestic carriers fear that relaxation of either of these two restrictions would allow foreign carriers access to their market.

Relaxation of cabotage rights would allow access to domestic market and in turn give them the market share by virtue of supplying a better product and quality service levels. Thus competitive advantage would be in the foreign airlines's favor if they end up buying domestic carriers. For example, a simple increase in ownership limits to 49% would give too much control to the foreign airlines; thus this increase will allow foreign carriers to indirectly commit cabotage via actual control of domestic airlines. Therefore liberalization of the domestic market will create the threat of potential foreign dominance. Such an opportunity would allow foreign carriers to circumvent cabotage rules by starting internal air transport operations.[141]

10) An explicit commitment for nondiscriminatory operation, and access of, and access for, computer reservation systems ; and
11) US model provisions for safety and security; See Michael Aubuchon, "*Testing the Limits of Federal Tolerance: Strategic Alliances in the Airline Industry*" (1999) 26 Transp L.J 219 at 227.

[138] A.L Schless, "*Open Skies: Loosening the Protectionist Grip on International Civil Aviation*" (1994) 8 Emory Int'l L. Rev. 435 at 447.
[139] *Supra* note 58.
[140] *Ibid* at 15.
[141] *See* Edwards doc., *Supra* note 29 at 626.

They could achieve this by setting up their national subsidiaries in the domestic market of the target country. National concerns and protectionism come to the forefront when States have decided against grant of cabotage rights to foreign carriers. Granting of domestic operations would result in the taking over of all routes and market advantages previously held and used by the target carrier.[142]Arguments forwarded against foreign ownership and control are usually used in the same context for cabotage too. They include protection of national security and national employment. However security and employment justifications are irrelevant as both of them are more wary of ownership and control of domestic airlines rather than cabotage.[143]

Thus it can be concluded for the time being that it is difficult to asses the true benefits and potential of cabotage. The national consequences and subsequent effect on the economy need a deeper analysis. However it can be stated that cabotage benefits the whole industry and public interest as it fosters competition and introduces better products and service levels with an international experience.

1.5 Legal justifications

Since airlines have always commanded a strategic, political, social and economic importance from the States[144] the possible effects, both positive and negative, on such spheres is a point of heated discussion in the face of cross-border investment and foreign ownership and control.[145] The topic has always engaged aviation entities for decades and several articles and conferences later the debate rages on. Other 'strategic' industries such as telecommunications, broadcasting, nuclear power, and shipping have attracted foreign investment and have been exposed to market rules[146] but aviation continues to be protected. The time is now ripe for governments to ease ownership rules in the face of rising global crude oil prices, weakening economy, bankrupt airlines and sluggish growth to throw open the sector to

[142] *See* Edwards doc., *Supra* note 29 at 628-629.
[143] S.M Warner, "*Liberalize Open Skies: Foreign Investment and Cabotage Restrictions Keep Non citizens in second Class*" (1993) 43 Am. U.L. Rev. 277 at 305.
[144] H. Wassenbergh, "*Towards Global Economic Regulation of International Air Transportation through Inter-Regional Bilateralism"* (2001) The Hague 5. [unpublished]
[145] See ABA doc., *supra* note at 110 at 20.
[146] *Supra* note 143 at 277.

commercial needs and let it flourish as a real industry for a change.[147] This part of the thesis seeks to carefully analyze the legal and economic justifications of national restrictions and dispel them as legitimate. Lastly, the thesis pictures a potential legal and economic impact upon the interests of passengers, employees, aligned sector players and airlines post lifting of restrictions.

The international private air law liability regimes are based on the 'Warsaw system' and the recently introduced Montreal Convention.[148] Concerns about the liability regime are unjustified as the regime is an international regime applicable to the whole airline community. Change of ownership will not jeopardize the interests of the passengers as the airlines will still be held liable irrespective of ownership and control.

In matters of safety, a clear line of accountability has to be established for responsibility over the safety of airlines. With respect to aircraft operations, the Chicago Convention and certain annexes assign responsibility for safety oversight to the State of an aircraft's registration, the State issuing operator's certificate, and the aircraft operator itself.[149] It is the State of registration which is responsible for competence in the technical aspects of airline licensing and aircraft certification. Where these parties are of the same State, as is traditional, it is easy to follow: the aircraft operator is responsible to the State that issued its operating certificate, which also happens to be the State of registry. The State of registration irrespective of the ownership of the airlines will be the State responsible for technical defects.

1.6.1 Aviation safety justifications

Relying on the previous discussions regarding ownership and control requirement, it has become quite clear that States use the safety and security argument effectively and legitimately to retain ownership and control

[147] Giovanni Bisignani, "*Our Industry in Crisis"* (2008) Airline Business Daily 3.
[148] *Convention for the Unification of Certain Rules for International Carriage by Air,* signed at Montreal, 28th May 1999, ICAO DCW Doc. No. 57 (came in force in Nov. 2003).
[149] Wang Yuanzheng, "*Evolving Commercial and Operating Environment Presents Safety and Security Challenges"* (2006) 61 ICAO Journal. 5.

requirements of air carriers as a prerequisite to maintain a close link[150] with the operator and State in which it has its principal place of business.

In air transport, safety and security are two different concepts altogether. Safety is understood as prevention of accidental or unintentional events that can affect material or people (design of aircraft, maintenance, etc), while security is prevention of intentional acts which aim to affect planes and/or people. In the present study, both safety and security will be analyzed in the context of the ownership and control argument given the fact that both of them are two of the most important features of the airline industry.[151]

The present regulatory system in respect of aviation safety and security is based on the Chicago Convention, which through Article 37 imposes upon Contracting States the responsibility for compliance with Standards and Recommended Practices (SARPS)[152]and procedures adopted by the ICAO,[153] unless differences are notified. Under this system, a clear linkage is established between an operator and the State in which it is established and has its principal place of business (through Annex 6-Operation of Aircraft), and clear lines of responsibility may be identified between parties involved for the regulatory oversight of international air transport. This mechanism has been working well for the last fifty years and more. It is thus very clear that sufficient ICAO safety and security standards are in place and there is no valid reason to justify a restriction on multinational ownership and control. ICAO is still trying to bring about more harmonization amongst the Contracting States by enforcing strict compliance with the SARPS through its Universal Safety Oversight Audit Program (USOAP) [154] since January, 1999.[155]

Many States in the recent years have relaxed restrictions on foreign investment in their national air carriers. In air service agreements, States have also increasingly accepted designation of airlines with broadened

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[150] Recommendation ATRP / 9-4; The ATRP / 9-4 recommends the "Principal place of business plus a strong regulatory link" approach.

[151] R.I.R Abeyratne, *Emergent Commercial Trends and Aviation Safety* (Aldershot: Ashgate, 1999) 165.

[152] SARPS are presented in 18 Annexes of the Chicago Convention.

[153] *Supra* note 62.

[154] Through USOAP, experts assessed capacity of States to control safety and was extended to Annex 1, 6 and 8.

[155] ICAO, *Annual Report of the Council,* ICAO Doc. 9770 (2001) 10.

ownership and control criteria. While liberalization may bring many benefits, it has also raised some concerns in the form of 'flags of convenience'[156] risk in the absence of regulatory measures to prevent them. Let us explain the concept by an example in a potential future scenario. A country ABC decides to open up its domestic airline market to foreign ownership and control by foreign carriers. A national carrier of ABC called X was taken over by a foreign carrier Y of country DEF. The new airline called Y with substantial ownership and control vested in the hands of the nationals of the State DEF can *actually* rebase itself in countries offering lower regulatory standards and thereby eroding safety and employee standards. This is a possible side-effect of liberalization allowing airlines to become more footloose.

As the UK Civil Aviation Authority paper states that:

> "It is not impossible to foresee in the near future that an airline with an open access to a number of markets in the future and no ownership and control restrictions might pursue a policy of 'brass-plating', i.e. 'flagging for convenience'. Traditionally, an airline's entire operation would radiate out from no more than a handful of airports in the home country. Most air carriers have chosen their main operational centre as their main place of business. However fewer ownership and control criteria will allow an airline to never touch down in its regulator home country and to operate wholly outside of the designating country."[157]

Why should 'ownership and control' interfere with safety in the first place? In principle, the nationality of an airline's ownership and control should not in itself pose any threat to safety standards. A global regulatory convergence would ensure smooth harmonization amongst safety standards and nullify flags of convenience. Although many carriers would like to cut corners with respect to safety to lower operational costs and establish their principal place of business in States which have weak safety standards and even weaker regulatory oversights, the idea of doing so does not make much commercial sense. There are several reasons to dissuade carriers from doing so. Firstly, an airline will opt for a State that has an efficient regulatory setup with lucrative traffic rights. They would not opt for a country with low standards

[156] "Flags of convenience" is used to describe the situation where laws of various countries allow ships registered in foreign countries and owned by foreign nationals or corporations to sail by raising the flag of a country other than the country of registration. For example, a vessel registered in Greece and owned and controlled by Greeks could raise the flag of Egypt and sail.

[157] Supra note 116; See UK CAA Chapter 4.

of safety and compliance costs whose national airlines have been blacklisted[158] by the European Union.[159] Secondly, an equally potent cause of concern would be the public release of safety audit reports by ICAO under USOAP and also Article 54(j)[160] which jeopardizes their reputation and harms business. Thirdly, ICAO has already proposed an alternative resolution in the form of Air Transport Regulation Panel Recommendation / 9-4[161] and also through the ATRP/10 which calls for liberalizing ownership and control without compromising with safety standards. This alternate regulatory arrangement would be that parties to a bilateral agreement would accept the designation of an airline for the use of the agreed market access if the airline has its "principal place of business" in, and there is "effective regulatory control" by, the designating party. The proposed arrangement will seek to broaden the economic criteria for airline designation and authorization while preserving the necessary link between the carrier and the designating State, and strengthening regulatory controls including those concerning aviation safety and security. Such control is envisioned primarily through licensing which can include both economic and operational elements.

This proposed arrangement should help to create a more favorable operating environment in which airlines can conduct business according to the market conditions and their commercial needs. It could benefit all such States whose air carriers need access to international capital, notably those from developing countries, thereby enhancing their participation in the world air transport system. It would not lead to drastic changes in the existing bilateral

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[158] R.I.R Abeyratne, "*Blacklisting of Airlines by the European Union and the Disclosure of the Safety critical Information*" (May 2008) J. Air L. & Com. 1135 at 1136; Prohibition of foreign airlines from flying into or through EU airports if such aircraft are poorly maintained, antiquated or obsolete. Other considerations are inability of airline to rectify shortcoming and unwillingness of authorities to enforce safety standards on airlines.

[159] EU Regulation 473/2006; Criteria broadly based on safety deficiencies reflected in reports that show persistent failure by the carrier and identified by ramp inspectors performed under the Safety Assessment of Foreign Aircraft (SAFA) programme implemented by Joint Aviation Authorities (JAA).

[160] Article 54 (j) states that "it is a mandatory function of the Council to report to any Contracting State any infraction of the Chicago Convention as well as any failure to carry out recommendations and determinations of the Council.", *supra* note 13.

[161] *Supra* note 150; The ATRP / 9-4 recommends the "Principal place of business plus a strong link" approach.

framework since it would be introduced through the normal bilateral negotiation and consultation process.

1.6.2 Security considerations

National security has always been used as a basis for protectionist policy[162] to justify and prevent foreign investment in domestic carriers. The national security argument has been forwarded time and again to protect national economy from foreign competition. Security is extremely important for a strong domestic airline industry. This is so because a State may need the services of its airlines in times of catastrophe or an emergency situation. Evacuating citizens under attack in foreign countries,[163] and airlifting citizens during natural disasters are just few of the examples when the service of national airlines may be called into play. No doubt patriotism is important but it would be more comforting for a State to know that most of the scheduled airlines in the domestic market are owned and controlled by nationals and can be called into service or would not go against the interests of the State . Post 9/11 attack on USA, security measures have been used even more potently to argue against foreign ownership and control. The US government has become even more wary after the attacks and has prevented investment in national carriers for the same reason.

Given the political polarity in the world, States would not want nationals of certain States to own and control airlines.[164] It jeopardizes bilateral designation and airline business. Airlines are instruments of the foreign policy of several governments and so they would want their airlines to be held in reliable hands.

Despite the arguments for security based restrictions on investments, it can be nullified by effective alternative arrangements. Firstly, nationals of foreign countries who seek to invest in airlines should be subject to thorough and high level security and background check. Any suspicious antecedents should immediately bar potential investors from participating in any present

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[162] *Supra* note 109 at 83. [unpublished]

[163] Air India, a national carrier, evacuated thousands of Indian nationals from Kuwait when Iraq attacked in 1990.

[164] C.M Petras, *'Foreign Ownership of US Airlines and the Civil Reserve Air Fleet Program: Cause for Concern?'* (2001) [unpublished]

and future equity stake. Equally important is placing an even more intense check on the source and legality of their funds. Secondly, in some States like USA, where the government imposes an obligation on carriers to transfer or assign aircraft to the State in times of war or conflicts may ensure the availability of aircraft despite foreign ownership and control.[165] This may be enforced through mandatory participation in CRAF by registering of aircraft in the United States. There is no doubt that security is a legitimate argument but despite its importance it should not be an impediment in the way of liberalization and growth of the airline industry. National security considerations are not insurmountable and alternatives mentioned above would be a step in the right direction as investment is the need of the hour. It is in public interest that national security be imposed but it would suit the public and national needs better if foreign investment was allowed in national airlines. It is recommended that safety and security should not be treated as barriers but rather as incentives to usher in an era of liberalization and strengthened accordingly for a better working arrangement in the future.

Legal, safety, security and economic justifications have been put forth since the beginning of aviation in order to protect national airlines and economies from being run over by foreign powers. Such considerations evolved upon the conclusion of the World Wars which had left an indelible impression on the minds of newly formed governments. States wanted the benefits of airline profits to trickle down to their own citizens who would own and control them. Hence the abovementioned were forwarded as "excuses" to protect national economies. However security was the core argument as States were still wary of the effect of war on society. Security issues can be resolved through comprehensive security programs and arrangements.[166] Safety, responsibility regimes and cabotage can be resolved independent of ownership and control issues.

Such archaic justifications seem less valid now in an era of globalization and free market. If anything should be justified, it is the commercial freedom to

[165] The Civil Reserve Air Fleet (CRAF) Program which was established in 1952 contractually binds the airline operators to supply aircraft with directors and management being liable for the same. See Isabelle Lelieur, *Law and Policy of Substantial Ownership and Effective Control of Airlines*, (LL.M Thesis, McGill University, Institute of Air and Space Law 2003) 83.

[166] *Ibid.* at 44.

be offered to airlines in order to find itself on an equal footing with other industries. The airline industry is in desperate need of credit and capital. Soaring crude oil prices, sluggish economy and dampening passenger demand will sound the death-knell of many an air carrier. The industry has to evolve and governments should step in to usher in an era of liberalization and prosperity. Recent exceptions to the rule should be seen as a trend and not as deviations. On the basis of analysis in foregoing paragraphs, there is a justification for review of the traditional criterion.

PART II. THE ADVERSE EFFECTS OF 'OWNERSHIP AND CONTROL' ON RESTRICTIONS AND EXCEPTIONS TO THE RULE

Part II of the thesis seeks to scrutinize the reasons behind the adverse effects of the foreign ownership and control restrictions and how they are preventing the airlines from operating in a commercially free environment. The airline industry has been rendered an anomalous industry with an inherent paradox – it is still bound by national ties despite its international nature and activities.

2.1 State-owned airlines and State Aid

"Unjustifiable state aid to flag carriers is the greatest obstacle to the emergence of a viable, competitive airline industry"

(Sir Michael Bishop, Chairman, British Midland Airways)

Until the mid-1980s most international airlines were wholly or majority owned by their national governments. There were exceptions, and most notably in the United States, where all the airlines were privately owned. Two factors pushed the airline industry into the hands of the government. Firstly, during the 1920s and the 1930s there was growing realization that air transport was going to be of major significance and importance in economic and social development. Governments required stable airlines or flag carriers, which were designated by them and controlled and owned by nationals to operate on routes on which traffic rights had been exchanged. Governments needed to ensure that there was at least one strong, well-run and effective airline that could be designated as its country's flag carrier.[167] Secondly, the Second World War had emphasized the economic potential and value of air transport. Government involvement and financial support was required in many cases to build up the defunct airlines after the war.[168] The trend towards state-owned airlines was reinforced in the 1960s and

[167] *Supra* note 83 at 184.

[168] In France, air transport was nationalized and the Societe Nationale Air France was set up on 1st January, 1946. Similarly the British government set up three state-run Air Corporations in 1946.

1970s. Even after this phase, further nationalization occurred, when privately owned airlines ran into financial and organizational trouble.

The trend changed in the mid-1980s towards privatization.[169] Liberalization of international air transport was gathering pace and was forcing state-owned airlines to abandon government mentality. There was a political view that privatization of state-owned airlines would increase efficiency and service quality. In the case of many state-owned airlines there was another reason why privatization came to be seen as necessary. Nearly all such airlines were heavily undercapitalized. Their government owners had rarely put additional equity capital into the airlines they owned. Despite these developments, an astonishingly large number of state airlines are still in existence after the new millennium started. Over seventy international airlines were majority owned by their governments and of these, about forty were 100 per cent government owned.[170]

Mr. Regis Doganis, an aviation expert states that:

> "The distressed state airline syndrome is a problem plaguing most of the state-owned airlines throughout the world. They face financial difficulties, are heavily undercapitalized with huge debts, overpoliticised, heavily unionized, overstaffed and lack a clear and explicit development strategy. Historical losses in many state airlines are much greater than those shown on paper because many state airlines have received indirect subsidies from their governments which artificially reduced their costs. For instance, state airlines have not paid airport landing fees on domestic sectors and sometimes not even on international flights, as was the case for Olympic Airways or Royal Jordanian in the past."[171]

This is a clear violation of Article 15 of the Chicago Convention which prohibits discrimination in airport landing fees for international flights between a State's airlines and foreign airlines.[172] They may not be charged for rents for office space, check-in desks or land they use at the national

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[169] In 1984, Malaysia Airlines had to raise commercial loans. It was heavily in debt and interest charges were likely to be high. The airline's development was in jeopardy and so the government decided to inject capital by privatizing it. British Airways was floated on the Stock Exchange through an IPO in 1987. LanChile was sold off in September 1989, see Regis Doganis, *The Airline Business in the 21st Century* (London; New York: Routledge Publications 2001) 186.

[170] *Supra* note 83 at 186.

[171] *Supra* note 83 at 188.

[172] *Supra* note 13; Article 15 which states that " Any charges that may be imposed or permitted to be imposed by a contracting State for the use of such airports and air navigation facilities by the aircraft of any other contracting State shall not be higher ,

a) As to the aircraft not engaged in scheduled international air services, than those that would be paid by its national aircraft of the same class engaged in similar operations
b) As to aircraft engaged in scheduled international air services, than those that would be paid by its national aircraft engaged in similar international air services."

airports. Some have obtained aviation fuel from the government owned oil companies at reduced prices or even for free. Invoices presented to the airline from other government agencies for services and goods provided may remain unpaid for years. Government guarantees for loans or aircraft purchases may also have reduced the cost of past borrowing by as much as 0.5 per cent to 1.0 per cent.[173]

Since virtually all State-owned airlines face financial troubles, they are in urgent need of financial restructuring. Private investors don't invest in government entities to bail them out or merely as a commercial investment as it involves a bureaucratic setup with plenty of red tap and not much of say in management since the airline is state-owned. The governments are also averse to privatization as it means stiff opposition by strong unions who resist change for fear of loss of jobs. Profitable foreign state-owned airlines with the same mentality but a better performance could be allowed to invest and make good the losses. Unfortunately not much success has been achieved on that end either. Lifting foreign restrictions would help the government attract funds and fresh ideas and a more efficient business-minded management.[174] Thus, national ownership and control requirements are preventing a prospective turnaround for state-owned airlines and will gradually restrict 'State aid'.

In many cases there will also be a need to inject fresh capital into the airline. For example, in the process of financial restructuring the state-owned airlines of southern Europe required huge amounts of 'state aid' to be pumped into them by their respective governments. This had to be approved by the European Commission.[175] Approval was forthcoming *only* after very detailed examination by the Commission to ensure that the state aid was part of a detailed recovery plan whose prime purpose was to turn the airline around and enable it to be financially self-supporting without any further government help. In the period 1991-94, the airline industry faced the worst

[173] *Supra* note 160 at 188.

[174] *Ibid.* at 65.

[175] European Commission is a body having extensive powers stemming from the Treaty of Rome and subsequent EC legislation, which is composed of 17 Commissioners appointed by the EU governments and supported by an administrative staff of about 10,000 divided into 23 administrative departments called Directorate-General (DG). Those which are closely involved with air transport matters are DG VII (Transport), DG IV (Competition) and DG XI (Environment, Consumer Protection and Nuclear Safety).

financial crisis in its history. During that period, most of the European airlines experienced heavy losses. Whether state or privately-owned, many airlines required capital injections. In the case of seven state-owned airlines within the EU, capital injections came in the form of state aid which required European Commission approval. The sums involved were very substantial, controversial and high profile, totaling over ECU 11 billion or over US$ 12 billion. In addition, over ECU 1 billion of capital was injected but not classified as state aid. The Commission deemed these injections as consistent with the 'market economy investor' principle.[176]

Inevitably, the huge amounts granted by some governments to their airlines in the form of 'state aid' created reaction and opposition from those airlines which had not received any aid and which had been largely dependent on raising capital from private or commercial sources. They repeatedly argued that 'state aid' leads to a distortion of the competitive working of the free market and is contrary to consumer interests.[177] It is a general rule, enshrined in Art 88(1) of the Treaty of Rome that state aid in whatever form are prohibited. In November 1994, the Commission approved guidelines for the evaluation of proposals for State aid for airlines.[178]

Prospective state aid will not solve the problem as previously used state aid has not ensured the transformation of distressed state airlines into efficient competitors. It can be attributed to lack of political will and failure to provide political support to managers put in to restructure the airlines. Apart from capital, loans and guarantees, many States have provided assistance to their national airlines through more indirect methods such as: preferential

[176] *Supra* note 83 at 202; In other words, the Commission judged that a private investor would have considered it a commercially viable investment to inject these sums into the particular airline at that point of time.

[177] *Supra* note 83 at 203.

[178] The following conditions might be imposed by the Commission while evaluating proposals:

1. The aid must be part of the comprehensive restructuring programme which can ensure viable operations for the airline within a reasonably short period.
2. No additional aid should be required in the future.
3. Aid should not be used to increase the capacity of the airline to the detriment of the direct EU competitors.
4. If the restoration of financial viability requires capacity reduction it should be included.
5. Aid should be used only for restructuring and the recipient must not acquire shareholding in other airlines.
6. Aid must not be used to increase direct competition with other EU carriers.
7. Grant of aid must be transparent and controllable.
8. Aid must not interfere in the airline's management for reasons other than those stemming from its ownership rights and must allow it to run on commercial principles.

tax status; discounts or exemptions on charges for airport services (including landing fees); discount on price of supply of fuel and other fiscal privileges. State aid in an indirect manner includes loan guarantees, restructuring of loans at low interest rates and taxation concessions. Such support in a variety of forms has underlined the perception of the air transport industry as a strategic sector, and for many States, their national carriers as strategic investments.[179]

2.2 Prevention of market access

Market access has been fundamental in aviation relations between States and to the success of air carriers in international air transport. ICAO Doc. 9626 goes on to define many important market access related terms such as:

> "An air transport market is defined as *between any two places consists of the actual and potential traffic in persons and goods that does move or may move between such places on commercial air services*"; and
> "Air transport market access, *by any particular air carrier or carriers, is the nature and extent of the basic rights (with any accompanying conditions and limitations) that are granted/authorized by the relevant governmental authorities as well as ancillary rights such as those covering product distribution*."[180]

Access by an air carrier to a State's domestic air transport market is typically obtained (with relatively few exceptions) only if it is a carrier of that State and is usually acquired by a licensing process.[181] Access to the international air transport market access is also usually acquired by a licensing process in each state involved. Scheduled international air services are regulated by Article 6 of the Chicago Convention.[182] Article 6 prohibits such services without special authorization or permission of the foreign State involved.[183] Foreign investment or inward investment in the air carrier of a State, including investment by foreign carriers (i.e. purchase of equity holding with some possible degree of influence in management decisions if not control) is an additional means of obtaining market access. Obtaining the *right of*

[179] ICAO, Working Paper, No.ATConf/5 – WP/12 (Montreal: 24 - 29 March, 2003) 3.
[180] ICAO, *Manual on the Regulation of International Air Transport*, ICAO Doc. 9626 (2004) 32.
[181] *Supra* note 105.
[182] *Supra* note 13.
[183] In practice, a State extends such permission or authorization for scheduled international air services by foreign carriers in licenses or permits of fixed or conditioned duration and does so on the basis of the service being utilization of the market access rights which that State has granted to the home State of the air carrier.

establishment, i.e. freedom to establish an air carrier in the territory of a foreign State is also a means of acquiring market access. However, these additional means are in limited use in liberalized markets, either as exchanges between States or unilateral grant.

States regulate air carrier ownership and control at the international level primarily through the discretionary criteria for licensing air carriers to use the market access rights under the relevant bilateral air service agreements. Criterion used by many States in most bilateral agreements for airline designation and authorization have been that the airline must be substantially owned and effectively controlled by the designating State or its nationals. Use of the criteria is discretionary. To establish an international air service, a State, under the bilateral regulatory regime, must not only secure the necessary market access rights from all its partner States but also their acceptance of the airlines(s) it has designated to use those rights. Herein, lays the problem with foreign ownership and control restrictions and market access penetration by airlines.[184]

In the liberalization process, the role and treatment of market access continues to be the most important element in air service agreements between States and pivotal to any substantive regulatory liberalization. The 1994 Worldwide Air Transport Conference considered an ICAO Secretariat proposal for the liberalization of market access, which included essential elements of full market access[185] and possible means of full or progressive introduction, together with associated safeguards and dispute resolution. After extensive discussions, the conference concluded that there was no global commitment to full market access at that stage of air transport development, and that each State will make its own choice as to the degree and pace of liberalization, on a case-by-case basis and in light of its particular needs and objectives using bilateral, regional and/or plurilateral avenues.

[184] *Supra* note 105.

[185] Unrestricted route, operational and traffic rights between parties, optional so-called Seventh Freedom right and cabotage are the basic and key elements of full market access.

Recent developments

Since ATConf/4, progress has been made in liberalization with respect to market access, notably at the regional and sub-regional levels. Progress was in the form of more than 600 bilateral agreements being concluded or amended from 1995 to 2001. About 70 per cent of these agreements and amendments contained some form of liberalized arrangements though not focusing on the liberalization of the traditional criterion. At the regional and sub-regional level, group of States have created multilateral regulatory regimes aimed at fostering cooperation and liberalizing air transport regulation amongst member States. "Before ATConf/4, there were just two regional arrangements.[186] Since 1995, eight more regional arrangements have emerged with a worldwide dispersion (two in the Americas, one in Asia Pacific, one in the Middle East and four in Africa). Of these arrangements, 7 have provided for instant or phased-in liberalization leading to full market access. Several potential arrangements are also in the pipeline (in Europe, the North Atlantic, the South Pacific and the Caribbean)."[187]

One notable development in the liberalizing trend is the considerable increase in the number of bilateral agreements involving unrestricted market access provisions. By June 2002, some 85 "open skies" agreements have been concluded involving approximately 70 countries. These agreements involved not only developed countries but also an increasing number of developing countries. With respect to market access, these agreements generally provide for unrestricted route and operational rights, as well as Third to Fifth and Sixth Freedom rights; many also grant Seventh Freedom rights for all-cargo services. Some of them allow progressive or phased introduction. However, exchange of broader or full market access rights between States, while gaining acceptability, is still very country-specific.[188] Unfortunately, despite all the progress made, there is a glaring absence of inclusion of cabotage rights and lack of foreign ownership and control

[186] The European Union and the Andean Pact; The European Council Regulation 2407/92 allowed a community carrier to operate services within the European Common Aviation Area (ECAA). Under the Andean Pact (concluded by 5 Latin American States), an air carrier entitled to operate services between the Pact States will be determined by the national law of the Pact State designating the airlines.

[187] See ICAO, Working Paper "*Substantial Ownership and Effective Control"* No. ATConf/5 - WP/ 8 (17th Sept. 2002) 2.

[188] *Supra* note 187.

relaxation to allow complete market access. Only the 2001 APEC agreement[189] or "Kona Accord" allows ownership relaxation and the Single Aviation Market (SAM) arrangement of New Zealand and Australia which allows a "SAM" carrier[190] to operate services within and between both countries but with limits or beyond rights. Therefore market access which is actually required and can be successful with modifications is denied in reality. The culprit in this case is the archaic and obsolete bilateral system. The bilateral agreements are still guided by the IASTA arrangement of 1944 with respect to national ownership and control requirements.[191]Cabotage can only be allowed if ownership and control is relaxed. In order to truly gain market access, the solution lies at the heart of the IASTA and its amendment of the ownership and control requirements. Nowadays the free market forces and liberalization trends demand commercial freedom for the airline industry. Accordingly, full market access can be realized by doing away with national restriction and abolishment of ownership and control restrictions. Full market access goes further in establishing a fully integrated market in which all carriers would be free to operate and provide services to all participating countries.

Until now, the national ownership and control criterion for designation has constrained parallel processes of concentration amongst air carriers operating under traditional bilateral agreements irrespective of whether these carriers operate with liberalized air traffic rights. A combination of liberalized market access and abandonment of ownership and control criterion will pave the way for a period of strong industrial cooperation and corporate reorganization. Of course, liberalization of traffic rights does not necessarily entail liberalization of true market access.[192] Airport capacity limitations, growing sensitivity about noise implications and environmental

[189] Brunei, Chile, USA, New Zealand and Singapore; The plurilateral agreement permits APEC members to allow designated airlines of another Party to be one whose effective control is vested in the designating Party and has its principal place of business in the territory of the designating Party. The traditional substantial ownership requirement is longer a condition.

[190] Air carrier at least 50 per cent owned and controlled by Australian and/or New Zealand nationals with its head office and operational base in Australia or New Zealand; See *Australia-New Zealand Single Aviation Arrangement,* 1 November 1996, online: Australian Department of Foreign Affairs and Trade, http://www.dfat.gov.au/geo/new_zealand/sam.pdf.

[191] *Supra* note 19.

[192] ICAO, Working Paper (*World-Wide Air Transport Conference: Challenges and Opportunities of Liberalization)* No. AT Conf/5 – WP/74 (28th Feb. 2003) 3.

impact etc are some of the factors which dampen the ambitions of liberalization proponents.

2.3 Restrictions of capital flow and cross border investments

The airline industry is faced with several bankruptcies and heavy losses since the early millennium and exacerbated further by the September 11 tragedy. Generally, capital flow spurs national growth and development and represents an engine for growth in developed and developing nations alike. Hence the importance of capital is an understatement. This chapter scrutinizes the need for foreign investment, its panacea-like effect and how governments turn a blind eye to the manifold problems faced by their own airlines. Foreign investment in the airline industry is the need of the hour.

Foreign investment keeps airlines competitive in the international air transport market. Capital flows prevent bankruptcies of airlines for airlines are extremely fragile due to external factors.[193] Capital flow allows proper development of air services and enables airlines to survive and grow. Airlines can seek the much needed capital in two ways; internal or external capital. Firstly, internal capital can be solicited by sale of assets or exchanging labor concessions for equity[194]; secondly, external capital can be obtained by national or international investments. In the absence of national capital, foreign capital must be attracted. Cross border investments must be encouraged and used to their fullest in the airline industry for the list of needy entities is long.

The airline industry has its own peculiar characteristics which are also its biggest weaknesses. High fixed costs, cyclical and segmented demand, excess capacity, fungible commodity and below cost pricing in the face of intense competition are the problems plaguing the airline industry.[195] It is a well-known fact that airline business runs on wafer-thin margins of profit.[196] Due to the aforementioned reasons and a host of several other factors, capital needs of airlines are urgent and necessary. Many airlines do invest in other

[193] *Supra* note 73 at 39.
[194] *Supra* note 27 at 63.
[195] Paul Dempsey, & Laurence Gesell, *Airline Management: Strategies for the 21st Century* 2nd ed. (Coast Aire Publications, 2006) c.2.
[196] Paul Dempsey, "*Airlines in Turbulence: Strategies for Survival*" (1995) 23:15 Transp. L. J. 15 at 97.

airlines but since they can't go beyond a permissible limit, it ends up being an alliance or commercial arrangement. Except for the EU (where mergers are rare),[197] international mergers and acquisitions are unheard of.

Since the 1960s, capital spending has gone up. Airlines in various regions of the world have been plagued by prolonged mid-term and long-term financial crisis.[198] For example, in US and Canada, the permissible limits of foreign investments are very low. Despite the need for outside capital to support airlines operations and keep them afloat, the US and the Canadian airlines are still soliciting national capital. Hopefully the success of the US-EU Open Skies Plus second stage negotiations will allow opening up of foreign ownership and control restrictions in the near future. Similarly in developing countries, national airlines are completely dependent on it and are severely under-capitalized. Certain liberal and forward thinking areas like Hong Kong and Macao China have opened up their markets by amending their bilateral agreements and incorporating the "principal place of business" clause as criteria for establishing and designating airlines in their territory. Thus airlines registered in such territories can receive unlimited foreign capital as ownership and control restrictions don't prevent inward investment. New Zealand and Australia have gone a step further and allowed the right of establishment of airlines in their territories with certain requirements.[199]

Foreign Direct Investment (FDI) caps are a way of preventing inward investment by governments who seek to protect ownership and control of nationals in designated airlines. What some governments fail to realize is that there will not be any national ownership and control to protect if the airlines do not survive. There is a paucity of capital in the airline world which is faced by a credit crunch and sluggish economy and rising fuel prices in 2008. Airlines need it and yet are restricted by protectionist government policy. However there have been substantial increases in FDI

[197] Air France-KLM merger and Lufthansa-Swissair merger.

[198] Swissair's collapse in October of 2001was mainly due to their excessive financial expenditure. Belgium's airline, Sabena was also troubled as Swissair's main investor, Sairgroup, was running short of capital resources. As a result, Sabena collapsed in November of the same year.

[199] *Supra* note 190.

caps over the years.[200] Some governments have taken a more liberal interpretation in their bilaterals "to facilitate any cross-border mergers or acquisitions necessary to maintain the viability of the aviation industry during the crisis."[201] Despite that it is not enough to prevent liquidation of airline corporations who desperately seek foreign capital to keep them afloat and survive troubled times or by merging with them to allow consolidation in the true spirit of commercial freedom. There is no doubt that IASTA requirements are at the heart of the problem and have been a throat in the flesh of airlines since 1944. Progress has been made over the years but there is still no critical mass of multilateral ownership and control relaxation on the horizon.

2.4 Creation of loose unstable alliances

Airlines skirt around ownership and control restrictions by forming alliances and cooperative arrangements to achieve market access. While numerous agreements concerning cooperation are on a limited scale, wide ranging and strategic alliances have been on the rise. Despite the benefits such as penetration of market, ability to provide more capacity and load factors, increase revenue and yield, ability to capture market share, reduction in cost of equipment, services, airport handling, operations, travel agent commissions and more, there are inherent risks involved as well. The ICAO Secretariat in its working paper (WP/21) in the fifth World-wide Air Transport Conference enumerated the disadvantages of alliances and states:

> "A relatively recent and rapidly evolving global phenomenon is the formation of alliances by airlines. Alliances are voluntary unions of airlines held together by various commercial cooperative arrangements. There are now over 600 such alliance agreements in the world which contains a variety of elements such as codesharing,[202] blocked space,[203] cooperation in marketing, pricing, inventory control and frequent flyer program,[204] coordination in scheduling, sharing of offices and airport facilities, joint ventures and franchising. Inter modal alliances with railways have also grown in Europe and North America. The steady expansion of transnational alliances for strategic purposes and to achieve market access and synergies are a consequence of air

[200] *Supra* note 135.
[201] ICAO, Working Paper (*Substantial Ownership and Effective Control of Designated Airlines)* No. A33- WP/ 181 (25 September 2001) 5.
[202] *Supra* note 96.
[203] Blocked space arrangement is an agreement whereby one carrier buys a guaranteed block or volume of space on a flight / series of flights of another carrier for a specified period. In any cases, a blocked space agreement contains a provision on the commercial use of the designator code of the carrier buying the space.
[204] *Supra* note 73 at 643.

> carrier's response to, *inter alia*, perceived regulatory constraints (for example, bilateral restrictions on market access, ownership and control), a need to reduce their costs through economies of scope and scale[205]; and a more globalized and increasingly competitive environment."[206]

Most notable was the emergence of several big competitive strategic "global alliances". Each group is composed of some major airlines having different geographical coverage with fairly extensive networks.

The three existing global alliances are:

1. "Star Alliance" founded in 1997 by Air Canada, Lufthansa, SAS, Thai Airways International and United Airlines (currently 15 members and to be joined by two additional carriers);[207]
2. "ONEWORLD" founded in 1998 by American Airlines, British Airways, Canadian Airlines, Cathay Pacific and Qantas;
3. "SkyTeam" founded in 2000 by AeroMexico, Air France, Delta Airlines and Korean Air.

These alliances were originally formed to circumvent restrictive bilateral agreements between countries and protectionist foreign ownership laws that impede airline aspirations for global supremacy. By every measure, the Star Alliance is by far the largest of the three airline alliances.[208]

Unfortunately the partnerships of these global alliance groups are unstable and changes very often. For instance, British Airways and American Airways could not obtain regulatory approval and were prevented from forming a transatlantic alliance amongst each other as thee two core ONEWORLD members. On the other hand, a proposed trans-Tasman alliance involves Qantas's (ONEWORLD) equity investment in Air New Zealand (Star Alliance). Thus, it is shown that airlines might be tied to each other with a previous arrangement but still explore commercial opportunities. The Swissair-led European alliance group was dismantled in 2001 following the demise of Swissair and Sabena.[209] Instability of alliances can be further shown by the "spats that have erupted between KLM and

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[205] *Supra* note 107.

[206] See ICAO, Working Paper "*Liberalization Development Related to Market Access"* No. ATConf/5 - WP/ 21 (3rd Mar. 2003) 4.

[207] Star Alliance enjoys 798 destinations in 140 countries. It has a world market share of 21.9% (RPKs); 19.5% (passengers); and 24.9% (revenue); See *supra* note 73 at 38.

[208] *Supra* note 73 at 38.

[209] ICAO, Working Paper "*Liberalization Development Related to Market Access*" No. AT Conf/5 – WP/21 (3rd Mar. 2003) 5.

Northwest over money and between US Airways and British Airways over infidelity. British Airways owned about 25% of USAir's stock, and USAir owned about 15% of United's CRS (Galileo). United has a code-sharing pact with Lufthansa, coordinating operations under an antitrust immunity arrangement. USAir has code-sharing partnership with British Airways, which sought code-sharing agreements and immunity with American Airlines, which owned around 33% of Canadian Airlines before it was absorbed by Air Canada."[210] As Peter Harbison, managing director of the Center for Asia Pacific Aviation, observed, "The alliances are all being opportunistic, jumping into bed with each other and wondering whether the other bed looks warmer."[211]

To understand the promiscuous nature of alliances and airlines forming them, a recent case study involving a US carrier, Continental Airlines, will be explained to show how and why airlines switch allegiances for profit and better market access.

Recent Case in Study

The instability of airlines has been discussed earlier. David Grossman, a columnist, wrote recently on the switching of alliances by Continental Airlines. He explains that:

> "Only four years after Continental joined SkyTeam, Continental and Delta now operate non-stop flights to 30 or more destinations on the other side of the Atlantic Ocean from their respective New York hubs, and they compete directly on more than half of those routes. With over 60 non-stop trans-Atlantic destinations currently served by all airlines from New York, Continental and Delta still have great potential for continued international expansion. While the two U.S. SkyTeam members dominate trans-Atlantic service from New York, their U.S. competitor in ONEWORLD (American Airlines) serves only a half dozen or so non-stop markets, and U.S.-based Star Alliance members United and US Airways have no flights across the Atlantic from New York. This unbalanced scenario provides a strong impetus for Continental's desire to desert SkyTeam and join the Star Alliance. They can deliver a major share of the New York trans-Atlantic market overnight and can capture a large portion of Star Alliance trans-Atlantic traffic and feed passengers through their Newark hub. The cataclysmic event precipitating Continental's alliance switch was the Delta-Northwest merger. Star Alliance gave us the best footing for succeeding in the future and giving our customers access to the kind of international network they want."[212]

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[210] *Supra* note 73 at 646-647.
[211] D. Riordan, "*Airlines Do a Dance of Alliance*" Auckland Star – Times (Apr. 2, 2000) 1.
[212] David Grossman, "*Continental's bold move redraws the alliance map*" ATA Smartbrief: USA Today (14th July, 2008).

Thus, in order to gain more load factors and a strategic advantage, Continental will seek to reap benefits from the Star Alliance induction rather than be threatened by the merger between Northwest and Delta. As mentioned earlier in the arguments against alliances, airlines are fickle with their choice of partners and change alliances to suit their needs and penetration of markets. Lifting of the traditional criterion will go a long way in diminishing the concentration trend and ushering in consolidation in the industry.

Thus, Part II of the thesis clearly establishes the adverse effects of retaining the ownership and control restrictions in the airline industry. These restrictions perpetuate the 'crown of thorns' worn unwillingly by the airlines. State aid, prevention of market access, creation of unstable alliances and last but not the least, the limits on capital flow and cross-border investments render the airline industry weak and unsure of its viability. Doing away with the requirements of the traditional criterion will ameliorate the present situation and offer a strong, healthy and commercially sound airline industry for years to come. Therefore, the conclusion of Part I that the traditional criterion which requires a review is further strengthened by the analysis of the adverse affects of having the traditional criterion as carried out in Part II.

PART III. BENEFITS OF ELIMINATION OF OWNERSHIP AND CONTROL RESTRICTIONS

3.1 Mergers and acquisitions

International airlines all over the world aspire to pursue the advantages of enhanced market strength through mergers, acquisitions or operational integration. Airlines, as commercial entities, have a desire to implement a growth strategy by expanding their existing market share, gaining market access to new markets, to achieve unit cost reduction, shield themselves against fierce competition, and increase the scale of operations in order to attain a critical market position.[213] Corporate strategy suggests that consolidation through mergers and acquisitions or the threat of it plays an important role in improving business performance by "encouraging good corporate governance through the replacement of under-performing managers; and capturing synergies between firms."[214]

Essentially many of the modern day airline mergers and acquisitions have been achieved within a same country.[215] "However, most attempts to initiate cross-border investments or acquisitions were abandoned in the face of aero-political, economical and regulatory complexity (for example, Alitalia-KLM and British Airways-KLM[216] mergers plans in 2000). Even in the case of successful cases, the control and management of foreign carriers was not financially risk-free (for example, Iberia and its parent company SEPI's majority control of Aerolineas Argentinas, and Air New Zealand's acquisition of Ansett, both of which fell through in 2001)."[217]

Despite the paucity of mergers and acquisitions on an international level, the opportunity for cross-border mergers and investments has increased as many States have adopted a new policy or amended existing rules on foreign

[213] *Supra* note 206.
[214] *Supra* note 116; Chapter 3. < http://www.caa.co.uk/publications>
[215] Air Canada's acquisition of Canadian Airlines in 2000; American Airlines's bankruptcy buyout of Trans World Airlines in 2001; Japan Airlines System jointly established by Japan Airlines and Japan Air System in 2002; Alianza Summa jointly established by Avianca, Aces and SAM Columbia in 2002; and ongoing government-led consolidation of the Chinese airline industry.
[216] For instance, this problem between the Great Britain and the Netherlands over the merger, *see* P.P.C Haanappel, "*Airline Ownership and Control and some Related Matters*" (2001) 26-2 Air & Space L. 90 at 99.
[217] *Supra* note 206.

investment or control in national carriers,[218] and relaxed the air carrier ownership and control conditions in their bilateral agreements on air service. Due to the difficulties of implementing cross-border mergers and acquisitions, most foreign investments in the airline industry, have been made on a limited scale instead of taking a majority stake or pursuing a full-scale merger, and often as a part of a strategy to forge or strengthen alliances and expand market access. As of December 2002, about 60 carriers had shareholdings in foreign carriers while over 200 airlines had equity owned by foreign investors in various degrees.[219] In the absence of ownership and control restrictions, airlines would be able to pursue any commercially attractive option such as merger with another airline (subject to scrutiny by relevant competition authorities). This could help to restructure the airline industry along more sustainable lines by removing duplicated costs, exploiting synergies and enhancing efficient operations.

In view of the abovementioned prospects of mergers and consolidation, it is important to mention that there has been a lack of widespread profitability within the airline sector as a whole which is suggestive of underlying structural problems. The airline industry sector has continually failed to deliver in terms of its return on capital employed. This could be attributed to the combined impact of SARS,[220] 9/11, and high fuel prices. Returns have been consistently low since the early days of the industry before the Second World War. For example, statutory filings by the US airlines to the US Department of Transportation ('Form 41 filings') for the 65-year period, 1940 to 2003, show that although the US industry made a profit in 55 of those years, its average margins have been well below the return on risk-free bonds and therefore substantially below average returns on equity for all sectors.[221] The UK CAA paper states:

> "The US airline industry has been one of the worst performers in the airline industry and yet is not the only one suffering losses. Although a number of explanations have been forwarded for these poor margins, consistent underperformance by the sector suggests that it is a structural problem rather than a cyclical issue. It would be very easy to conclude that bilateral constraints and ownership and control rules are the sole reason for this, their existence only exacerbates the underlying problems. It means that options such as buyout, mergers and acquisitions or consolidation with international

[218] *Supra* note 135.
[219] *Supra* note 206.
[220] Severe Acute Respiratory Syndrome (SARS).
[221] Department of Transportation, Form 41 Filings (1940-2003); See *supra* note 116.

> partners are off the agenda.[222] Loosening the regulatory structure would at least remove one characteristic of the sector that may contribute to structural overcapacity."[223]

The airline industry is notorious for its dismal performance and huge losses. Introducing commercial freedom by liberalizing the traditional criterion will help it make financially appropriate choices in order to alleviate the dismal situation.

Let us take the case of the Air France-KLM merger to understand the difficulties faced by airlines in consolidating under the current ownership and control rules. In May 2004, Air France and KLM, two of the largest network airlines in Europe, merged to create the largest single airline in terms of revenue generation. However, it is an unorthodox merger, resting on a complex set of agreements which had to ensure that the merger would still preserve the appearance of two distinct nationally owned and controlled carriers. The two airlines had to reach an agreement on how to comply with undertakings by the European Commission and US Department of Justice. They had to keep in mind specific business concerns of job losses at Charles de Gaulle and Schipol airports post-merger respectively. Air France and KLM had to consider the impact of the merger on their ability to use traffic rights as designated carriers under their bilaterals:

> "a) Separation of economic and traffic rights: Separation had to be undertaken in order to separate national control of the airlines. A number of measures were taken in the form of a new share swap which separated economic and voting rights.
>
> b) Majority of the subsequent voting rights attached to KLM's shares will be in hands of the Dutch shareholders, split between the two holding foundations and the Dutch Government.
>
> c) Company and board structure: The company is held by the parent holding company, Air France/KLM, controlled by the former shareholders of the two merged companies. Below the holding company, the separate identities for the two halves of the merged company have been maintained with both companies maintaining their separate management boards, appointed by shareholders from both airlines."[224]

Thus the above provisions heavily restrict the integration of the merged entity. Compromises have been made on voting and economic rights which

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[222] Flag-carriers receive 'state aid' support, enabling them to "limp on" indefinitely, despite the lack of a viable business model. "Chapter 11" bankruptcy legislation in the US makes it easier for airlines to restructure and get protection from creditors.

[223] *Supra* note 116; UK CAA, "*Ownership and Control Liberalization: A Discussion Paper*" (October 2006) c.3.

[224] *Supra* note 116; Chapter 3.

have been successful in convincing French and Dutch bilateral partners that KLM and Air France remain sufficiently separate national carriers.[225]

The need to "square the circle" on ownership and control explains why international mergers are still rare and those which have been attempted resemble alliances. During 1999, there were $ 150 billion worth of global airline Merger and Acquisition transactions according to Thompson Financial Securities Data.[226] The efficiencies of mergers over alliances are the reasons why the elements of an OAA model are more attractive than the "Open Skies" model. In a study of the potential EU-US transatlantic OAA, the Brattle Group estimated that such a deal would create EUR 2.9 Billion of cost savings annually, equivalent to about 4.2 per cent of the overall costs. [227] The current rules of the airline business hurt not just the airlines but the consumers too. In other industries, globalization is fuelling mergers and acquisitions and other sorts of business combinations. As Don Carty, ex – CEO of American Airlines puts it, "Since there are no flag chemical companies or flag shoe companies, these combinations are able to progress so long as they will create efficiencies in areas like R&D, the elimination of duplicative staff, economies of scale and so on."[228] Studies have shown merger efficiencies in other industries to be between 1.5 and 2.7 per cent,[229] and it could be claimed that similar gains can be replicated in a liberalized aviation sector. The UK CAA paper states that,

> "For an industry with global costs of many billions, this represents a significant potential saving. However empirical evidence of the benefits of mergers and acquisitions is variable, with a number of experts suggesting that they ca be value-destroying in the longer term. This is possible because the pre-purchase equity prices often rise considerably on news of possible mergers reflecting the premium over the prevailing share price purchasers often have to pay to shareholders. However, the key point is that liberalization of ownership and control will allow owner of companies greater control over strategic and economic future of their aims, something that should be in best interests of the industry and the consumers."[230]

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[225] "*Two's Company*" Airline Business (Nov 2003); "*Merger creates European giant*" Flight International (October 2003).

[226] S. Gawlicki, "*Virtual Mergers: With Traditional Mergers Difficult to Pull Off Airlines Finding Creative Ways to Consolidate*" (2000) Inv. Dealers Dig. (WL 4666779).

[227] "*The Economic Impact of an EU-US Open Aviation Area*" (2002) By The Brattle Group.

[228] Speech by Don Carty, ex-CEO of American Airlines to the AAAE Conference, Texas (May 2002).

[229] Francesco Guerrera, "*It is Wrong to Defend National Icons*" (18 August, 2005) Financial Times.

[230] *Supra* note 116; Chapter 3.

3.2 Fostering competition and introducing managerial expertise

As discussed earlier in Part I dealing with the disadvantages likely to arise out of foreign ownership and control relaxation and resultant effect on competition, there are speculations of distortion of competition and unfair play upon lifting of foreign ownership and control restrictions by state-owned carriers and large legacy carriers with deep pockets.[231] However not all hope is lost in the face of such arguments. It can be counter-argued that lifting of foreign ownership and control restrictions will increase competition in the airline industry and benefit the public at large. There are several ways to go about increasing competition in the airline industry. Firstly, by lifting the national restrictions, new entrants will gain market exposure and penetrate the markets. More market players would mean enhanced competition which will lead to a decrease in fares and better and more choices for consumers.[232] As a matter of fact, it would be beneficial for the entire market. Secondly, an increase in competition will deter monopoly which has a detrimental effect on the market on the whole. A monopolist has no incentive to lower its cost of production, offer better quality services and becomes increasingly inefficient due to lack of competition and the society suffers as a result.[233] Increase in competition will lead to better quality services which will create more demand and attract consumers to fly. Thirdly, the government has to change its mindset and play a role of fostering intense competition amongst the service providers. It has to start with relaxing of foreign restrictions and then allow capital to flow in leading to a setting up of partnerships of foreign and private nature. Fourthly, withdrawal of restrictions will allow foreign capital to flow into the domestic market thereby creating new entrants in the domestic airline industry. Capital flow promotes availability of funds and increases competition by enabling domestic players to diversify and expand operations.[234] Not only will airline players compete on the domestic front, they will also seek to

[231] *Ibid.* at Part 1.
[232] Bohmann doc., *supra* note 111 at 715.
[233] C.W Hill, *International Business: Competing in the Global Marketplace,* 2nd ed. (Chicago: Richard D. Irwin, 1997) at 39.
[234] Department of Transportation, "*Entry and Competition in the U.S Airline Industry: Issues and Opportunities*" (July 1999) Special Report 255.

compete with dominant developed nations on the international level and reap the benefits.[235] Thus competition will only benefit the air transport market through a better deal for all but also introduce foreign capital and bring in managerial expertise.

As many countries interpret control in a way that limits foreign representation at board or at senior management level, liberalizing control should have significant effect on the freedoms available to a company when looking to recruit specialist expertise at these levels, with subsequent benefits for the company as a whole. Foreign expertise will bring a fresh perspective and offer new strategies which may not have been considered previously. Adapting the foreign views, not necessarily superior, to suit the needs of the specific domestic market will be of utmost importance. Taken together, greater restructuring opportunities, cheaper capital and an injection of foreign management expertise and new routing freedoms, in particular in foreign domestic markets, should result in significant benefits for airlines considering strategies for growing or re-focusing o their business. This is something that may be of particular importance for the so-called "legacy carriers" as they seek to respond to competition from no-frill carriers.[236]

3.3 Economic consolidation of the airline industry

In the face of a high growth experienced in the civil aviation sector, globalization has received an impetus. This has resulted in airlines scurrying for cooperation in the face of intense concentration and consolidation. Due to foreign ownership and control restrictions, the industry has cocooned itself into a few global mega-carriers in the face of competition.[237] Airlines have availed of business benefits by entering into various global alliances,[238] code-sharing agreements etc, This has proved successful for airlines who seek economies of scale and manifold benefits offered by unstable alliances although mergers would hold them in good stead for the future. Alliances allow airlines to gain market access, develop synergies and gain access to

[235] *Supra* note 109 at 68-70.
[236] *Supra* note 116; Chap.3.
[237] Supra note 182 at 97.
[238] *Ibid*. at 73.

new routes. Alliances contribute for the 70 per cent of the airline synergies in terms of services, marketing, costs and network.[239]

Despite the heavy reliance on alliances, mergers and acquisitions have allowed consolidations in the airline industry. There has been a progressive shift from concentration of mega-carriers to consolidation through mergers. Airlines are now more aggressive and keen on seeking control as light equity investments don't really solve the purpose and objective.[240] Consolidation is on the rise but happens rarely on the international scene due to national ownership and control concerns.[241] Despite the alliance and benefits, the airline industry needs to further integrate. As mentioned earlier, alliances have their own positives but mergers offer the benefits applicable to any industry, such as bargaining power, cost rationalization, skill sharing around combined company in addition to benefits that are specific to the airline industry such as network optimizations, increased market power and improved alliance position.[242]

3.4 Employee benefits

This thesis argues that the removal of ownership and control restrictions in a liberalized environment does not pose significant obstacles or hazards to employee prospects. Labor organizations[243] claim that employment standards are likely to suffer from liberalization as footloose airlines seek to locate to lower cost destinations with lower staffing costs.[244] Previous work conducted on this thorny issue has found no evidence that liberalization hurts the interests of the employees.[245] In fact, the opposite appears to be true. Some of the reasons why employees will not be at the receiving end are:

1. "It is very difficult for cheap labor to "undercut" and ultimately supplant crew in other countries; airline cabin crew and pilots are highly trained personnel with a close interface with the passengers. This makes it harder for airlines to recruit cheap, unqualified labor from third countries, as is perceived to have occurred in the maritime sector. In practice, it is unlikely that cross-border investments would significantly

[239] John Balfour, "*Airline Mergers and Marketing Alliances – Legal Constraints*" (1995) 20 Air & Space L. 112 at 112.
[240] IATA doc., *supra* note 24 at 7.
[241] The Air France – KLM merger was highly unconventional; *Ibid*. at 62,63.
[242] *Supra* note 108 at 95.
[243] International Transport Worker's Federation (ITF)
[244] ICAO, Working Paper (*The Orderly Evolution of Air Transport Services: Secure and Safe Economic Regulation in an Area of Globalization*) No. A33- WP/227 (2001) 16.
[245] *Supra* note 116; Chap.3.

> change the staff representation since it is hard to imagine big carriers using staff from developing nations as public image and service levels are extremely important in retaining the customer's loyalty.
> 2. Operational requirements also mean that labor needs to be located near the airline's "centre of gravity" i.e. its operational centre. For example, if an airline wants to offer services to passengers living in London area, then it needs to have a centre of operations somewhere nearby. This will in part drive the location of its staff and reduce the degree to which it can take advantage of cost saving by relocating labor supply.
> 3. The experience from Europe and elsewhere suggests that liberalization drives innovation and growth in aviation services, to the benefit of employees. Employment in European aviation grew considerably over the last ten years of liberalization."[246]

Consolidation in the form of mergers and acquisitions in the airline industry will bring about benefits for the employees as alliances may not allow them to stay competitive for long. J. Mosteller states that, "Mergers will keep airlines strong else profits would decrease by such a margin that layoffs and downsizing would happen in any case."[247]It is important for the airline industry to be competitively strong and the employees will benefit from it. The employment levels will be enhanced as a competitive industry produces more output than a monopoly.[248] A competitive environment will be created when there is an infusion of capital. Inward investment will bring about much needed development of fleet modernization which will consequently widen the network resulting in increase in workforce requirements.[249]

Despite the fear of being replaced once mergers start taking place, workers need not fret too much as foreign airlines which take over or acquire airlines of countries in which labor costs are lower will automatically retain those workers. There would be an economic incentive to employ workers with lower wages. [250] Thus employees have unfounded fear s which is normal for most of them who are unaware of the manifold benefits that consolidation brings in.

3.5 The right of establishment

As mentioned earlier in the thesis,[251] nationality was emphasized when the Chicago Convention was drafted and adopted. Nationality of airlines, nationality of aircraft, sovereignty of airspace, nationality marks on aircraft

[246] *Supra* note 116; Chapter 3.
[247] *Supra* note 120 at 599.
[248] Ross & Stanbury, *supra* note 117.
[249] Arlington doc., *supra* note 112 at 166.
[250] Bohmann doc., *supra* note 111 at 714.
[251] *Ibid.* at 15-17.

etc are just some of the examples of the legal regime applicable to civil aviation nowadays. Airline companies are usually required to be incorporated in the country where the aircraft are registered. The Air Operator Certificate (AOC)[252] will be granted by the regulatory authority where the airline has established its principal place of business and accordingly, the national laws will be applicable to the airline company. Foreign investors, keen on setting up businesses in another country, are presently allowed to set up subsidiaries or enter into joint ventures with nationally incorporated companies. They may also set up airline companies but have to follow the national laws which would entail national ownership and control rules which cannot be circumvented.

In a future scenario where foreign ownership and control are recognized and implemented, the right of establishment[253] can be recognized and accepted. If through a merger or a takeover, a foreign airline acquires a national airline, then the foreign airline will no longer be considered a foreign airline governed by the laws of its State. Instead it will be deemed a national operator under the rule of law of the acquired airline. The best example to explain this situation is to describe the present law of the EU where in the aviation sector, EU nationals have the right to own and operate a carrier in any of the EU member State.[254] "This right of establishment is a legal consequence of the change in ownership and control regime. The foreign airline shall become a national scheduled or non-scheduled operator and hence will be allowed to participate in domestic air transportation. This opens up cabotage to foreign airlines through the right of establishment. Thus the application of national law to the new airline will prevent a negative impact on the liberalization of ownership and control of airlines. If a US carrier acquires an Indian carrier and operates within the Indian air transport market then it will be subjected to all the national laws as if it were an Indian scheduled or non-scheduled operator. Tax, corporate, regulatory and commercial laws etc will be applicable as if it were an Indian national.

[252] *Supra* note 80.
[253] The right of a foreign operator, investor or airline to set up an airline company in a given country.
[254] EU, *Council Regulation 2407/92*.

The right of establishment would allow the industry to evolve and progress like any other industry."[255]

3.6 Safeguards against practical risks posed by lifting of restrictions

This part of the chapter discusses and examines how the removal of ownership and control could best be achieved in a way that manages a smooth transition from the *status quo*, with its delicate mix of interwoven restrictive bilaterals, to a fully liberalized market, whilst maintaining string safety standards. It explores a number of options that are open to countries in renegotiating ownership and control restrictions for airlines to bring them into line with other comparable international sectors, and concludes that with possible solutions to the "problems" of liberalization identifies in the earlier chapters.[256] The UK Civil Aviation Authority (hereinafter called the UK CAA) elaborates on the safeguards of liberalization and states that, "In considering the solutions to the problem of regulating safety in a liberalized environment, it is clear that any changes must not permit the dilution of safety standards. Any new scenarios must therefore maintain effective enforcement, including a clear line of accountability between the license holder and the relevant safety authority."[257]

3.6.1 "Flags of Convenience" and selective liberalization

One way of avoiding the safety risk of flags of convenience is to liberalize only with those countries in whose safety standards one can have confidence. This approach would be a natural next step from that taken by the US in its dealing with potential "Open Skies" partners, whereby the US Federal Aviation Administration (FAA) carries out its own audits of third countries safety oversight and will only sign their version of a liberal agreement if the partner State is deemed to meet the Category 1 safety standard. The FAA has established two categories of countries to signify the status of a safety authority's compliance with minimum international safety standards.[258] Variations on the US approach have been adopted elsewhere.

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[255] *Supra* note 109 at 89.
[256] *Ibid.* at 36.
[257] *Supra* note 116; See UK CAA paper.

As a complement to the ICAO audits, ECAC[259] in 1996 launched it own SAFA (Safety Assessment of Foreign Aircraft) program whereby individual member states carry out ramp inspections of foreign aircraft landing in their territory (the UK performed around 200 in 2005). "Ramp inspections can by their nature allow only a limited inspection of the aircraft. The importance of these inspections is that non-compliance with ICAO standards are identified and may lead to action being taken where particular airlines or safety authorities give rise to concern. These systems of auditing could be used as a mechanism for ensuring that all members of an enlarged OAA[260] meet the required safety standards."[261] This approach would give the applicant States clear incentive to raise their standards to the requisite level. Traditionally this type of approach has created some sensitivity amongst those countries under scrutiny, but in the context of a candidate country hoping to join an OAA, such sensitivities would seem less likely to exist.

3.6.2 Safety Blacklists

Information from safety audits of foreign safety authorities, can be used to refuse or revoke operating permission on the grounds of safety concerns. In the EU, information from hundreds of periodic ramp inspections that take place across Europe has been used to form an assessment of the airworthiness of third-country carriers. "The EU has recently established an EU-wide safety "blacklist". The list bans airlines which do not conform to the rules governing, *inter alia*, maintenance of aircraft, modernity of technical standards and safety management. The list, based on harmonized standards across Europe, has replaced the individual blacklists that were previously administered by individual countries. Now the European Commission publishes a consolidated blacklist on the basis of information provided by EU national safety agencies. Both the US and EU policy create

[258] Category 1 is in compliance with minimum international standards for aviation safety. Category 2 is not in compliance with minimum international standards for aviation safety.
[259] ECAC is the European Civil Aviation Conference, a non-regulatory organization aimed at promoting growth of a safe, efficient and sustainable European air transport system.
[260] Open Aviation Area; EU is an example of an OAA where all the 27 Member States follow the common rules and regulations in the aviation sector which allow cabotage, 7th Freedom rights, right of establishment and lack of ownership and control restrictions within the community apart from liberalized traffic rights.
[261] Supra note 116; See UK CAA paper.

similar lists of "undesirables", the only difference being that the US system is based on an audit of the State safety authorities whilst the EU's relies, *inter alia*, on data on foreign airlines gathered from Member States ramp inspections."[262] A combination of these two methods could be used to screen potential applicants to an Open Aviation Area, in the event that ownership and control liberalization was envisaged.

3.6.3 Strengthening "principal place of business"

This part of the chapter scrutinizes the importance of ensuring the safety standards are properly applied and that it is made clear to the airline and the authority granting the AOC that they retain the accountability for safety regulation. If controls are in place then the concerns will be lessened. There will still be an advantage to ensuring a strong link between an airline and its regulator. Given this, it seems to be wise to alter the "principal place of business" definition to include a link to the airline's operations.[263] This would go a long way towards ensuring that airlines could not "artificially" locate in States remote from their principal markets, simply for regulatory gain. Unfortunately there is no commonly accepted definition of the "principal place of business" but in practice, many countries consider a company's principal place of business to be defined by where it is incorporated, and has its head office and senior management.[264] This type of formulation means that an airline's principal place of business could be at a destination far away from its main centre of operations. Thus it is clear that there is a strong support for the closer link between an airline's principal place of business and its operational centre. "However, for airlines operating from several different markets, their principal place of operations could change over time, suggesting that they would constantly face the threat of having to re-license the carrier, with undesirable levels of uncertainty and cost. Thus there is a greater focus on the concept of principal place of business and center of operations link in order to facilitate the trend of trans-

[262] R.I.R Abeyratne, "*Blacklisting of Airlines by the European Union and the Disclosure of the Safety critical Information*" (May 2008) J. Air L. & Com. 1135 at 1136-1139.
[263] *Supra* note 105.
[264] *Supra* note 58.

national operations."[265] The ultimate aim is to facilitate truly global airlines, with several regional hubs serving several different continents and trans-continental markets. The increasingly dispersed nature of operations would pose a lot of problems for day-to-day regulatory oversight, especially if large scale operations are carried out entirely separate from the carrier's regulatory home.

3.6.4 Free-rider problem

The issue of "free-riders"[266] is frequently cited by opponents of liberalization of the traditional criterion as a legitimate concern. It raises strong commercial, strategic and presentational concerns about the fairness of allowing the ownership of airlines by nationals from countries without reciprocal and equivalent ownership and control rules. Several options have been put forth in order to avoid the effects on inequitable removal of the traditional criterion.

In order to avoid exploitation, it would be appropriate to allow investor rights extended to only those countries who have signed up a similar liberal and equivalent agreement. Those countries should be excluded who have not concluded a similar open agreement and are not prepared to offer equal concessions for their airlines. Such an approach will give countries an incentive to reciprocate and take advantage of liberalization.

3.6.5 Essential Services

Another safeguard that has to be taken care of is the loss of essential services as and when national airlines are merged with or acquired by foreign airlines. Some of the national carriers have their aircraft deployed on certain routes which do not support or generate enough demand to be profitable. They are essentially operated upon by the State-owned airlines or private airlines which are subsidized for the losses they incur. "In some cases the yield may be so low that they do not cover their directly attributable costs.

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[265] Supra note 116; See UK CAA paper, Chapter 5.

[266] "Free-riders" describes the situation where a party not subject to an inclusive agreement exploits the ownership and control advantages offered by a liberal inclusive agreement between two other States, despite not offering similar opportunities to investors of the signatory States; See *supra* note 116 (Chapter five on page 9).

This is so because the national governments expect their national carriers to fly certain unprofitable routes irrespective of whether they reap benefits or not. Essential services are certain routes which are deemed necessary by the government with the purpose of fulfilling certain social or economic objectives or in the case of foreign routes to "show the flag". Many such routes are millstones around the airlines necks but airlines will find it impossible to withdraw despite the commercial sense. Governments will also frequently veto any attempt to cut routes."[267] Airlines in the wake of ownership and control liberalization will control national airlines and seek to do away with commercial madness. However it could be controlled as national laws or public policy could mandate retention of such unprofitable routes albeit with government support. Signing a contract during merger or acquisition could guarantee serving certain routes in the 'public interest'. Last but not the least, acquiring airlines could be paid for by central or federal governments to make good for the losses incurred by them.

3.6.6 Regulatory Convergence

The issue of unfair or anti-competitive situation due to liberalization of traditional criterion has been cited as another risk by those states not in favor of liberalization. It has been discussed that the competition within OAA may be harmed by unfair allocation of state aid or significant difference in regulatory standards in areas like enforcement of competition laws. It is also suggested that signing up of a commitment on competition and state aid may be one solution. To enforce the commitment, a dispute resolution mechanism and arbitration process needs to be set up.

Thus, Part III amply demonstrates the benefits which will follow the liberalization of ownership and control restrictions. Economies of scale and widening of network through mergers and acquisitions, increase in market players and increased competition, potential consolidation instead of growing concentration, allaying the fears of skeptical employees are some of

[267] *Supra* note 83 at 190.

the benefits that will be available to the airline industry on liberalization of the current ownership and control rules.[268]

In view of the foregoing discussions, a change in the regime of the traditional criterion is of utmost importance. The thesis has also outlined potential problems which may arise due to change in the regime of the traditional criterion and some ways of tackling them. While moving forward on the path of liberalization of the traditional criterion has its positives, some of the pitfalls as listed above have also been raised by the opponents of the liberalization of the traditional criterion. Many such problems and issues as discussed earlier and in this Part will need to be addressed and solved before ushering in further changes in the regime of the traditional criterion.

[268] *Supra* note 116; see UK CAA paper.

PART IV. STEPS TAKEN TO LIBERALIZE OWNERHIP AND CONTROL CRITERION

4.1 Progress in Liberalization of the traditional criterion

4.1.1 ICAO and bilateral air service agreements regime

The International Civil Aviation Organization (ICAO) was set up in 1944 as Provisional ICAO (PICAO) and in 1947 as ICAO after signing of the Chicago Convention in 1944. The ICAO is an organization set up under the Chicago Convention which lays down harmonized standards for safety, security, environment, efficiency and continuity of international civil aviation and also guidance on economic regulation for operation of global air transport.[269]

Under the bilateral air services agreement, an air transport entity willing to undertake international commercial and scheduled operations is required to possess an Air Operator' Certificate (AOC)[270] issued by the concerned safety regulator of a State after satisfying that the entity meets all safety standards laid down by the regulator and further that the entity has capability to continue to comply with safety requirements during operations. An operating permit is then issued by the state regulator on the basis of the operator fulfilling laid down commercial requirements which typically include legal evidence regarding "principal place of business" in the issuing State, an AOC and host of other requirements. One of the most interesting requirements of the bilateral agreements is the ability of the entity to demonstrate to the accepting State that it is substantially owned and effectively controlled by the nationals of the issuing State. These requirements are generally followed by all contracting States of ICAO.[271]
The commercial airlines undertake their international operations between States on the basis of bilateral agreements (ASA) executed between States

[269] *Supra* note 13; See ICAO Annual booklet (Montreal: External Relations and Public Information Office) 1.
[270] *Supra* note 80.
[271] *Supra* note 116; Chapter 2 at Para 2.2.

on the principle of reciprocity and are generally governed by national laws or regulations laid down by States. An ASA typically regulates all aspects of a commercial operations ranging from size of flights to fares and number of designated airlines. These ASAs are seen as constraining the commercial operations of international airlines in particular requiring respective airlines to prove that the majority of ownership and effective control of the airlines are in the hands of the nationals of respective States. These ASAs containing the traditional criterion which have controlled the international civil aviation operations for over sixty years have impacted the growth of global air transport. In fact, the State retains the right to withhold, revoke or impose conditions on the operating permission of foreign airlines if the airline does not fulfill the criterion with regard to ownership and control.[272]

A study by the UK Civil Aviation Authority has very rightly remarked on the requirement of substantive ownership and effective control as below:[273]

"These restrictions have had a profound effect on the way the industry has grown and evolved. The speed and pattern of traffic growth has in the past been dictated more by government's willingness to loosen existing bilaterals restrictions than by airline's response to the market demands for air travel with spillover effects for other sector of economy. However, governments are increasingly recognizing the benefits that removal of constraints- and subsequent enhanced competition, increased economic activity and heightened consumer benefit- can bring, with the consequence that limit on traffic rights, frequency and destination points are gradually being eased or lifted entirely"

4.2 ICAO initiatives through Assembly Resolutions and Air Transport Conferences since 1980

Despite limited liberalization of traffic rights, the loosening of restriction on ownership and control has not made much headway in further liberalizing air transport. The criterion has been in existence since the 1940s as providing a link between the airline and the designating State. The issue did not engage attention of ICAO, at least in its first four decades of existence due to the then prevailing regime of air transport in the world. During this period, the air transport was a highly regulated state affair. The airlines were mostly run by States in a non-competitive environment with severe restriction on almost every aspect of commercial air transport such as size of aircraft, number of points of call, frequency and most of all, capacity.

[272] IASTA., *Supra* note 19.
[273] *Supra* note 116; Chapter 1 at Para 1.3.

The ICAO has held five Air Transport Conferences (hereinafter referred to as ATConf) in 1977, 1980, 1985, 1994 and 2003. The issue of ownership and control did not figure in ATConf/1 in 1977, ATConf/2 in 1980 and ATConf/3 in 1985 even after lapse of nearly four decades of the existence of the ownership and control criterion. "The three previous conferences in 1977, 1980 and 1985 dealt with co-ordination and harmonization of policy for regulation of capacity, tariff and non-scheduled air transport and did not engage itself with the issue of ownership and control. It is likely that the then prevailing air transport environment did not warrant discussion on the issue."[274]

In 1983, the 24th Assembly of the ICAO by resolution A24-12 (also incorporated in subsequent assembly resolutions) for the first time introduced the concept of "community of interest" in respect of designation of airlines involving developing countries particularly islands and small States of the Caribbean community. It was argued by these States that they were very dependent upon the presence of air carriers to exploit the economic gains of tourism but do not have enough financial resources either by the governments or domestic financial sector to finance their not so profitable airlines. The ICAO recognized the difficulty and rationale behind the arguments and brought together a pre-defined group of nations as a community thereby enlarging the potential of community investors which can invest legitimately in the community carriers owned by "community" or pre-defined group of States. Such a principle will help in maintaining the bilaterals of the community states with other States on the criterion of ownership and control. St. Lucia, a Caribbean State not having their own national airlines made use of the above clause and designated BWIA from Trinidad and Tobago as its designated carrier under its bilateral agreements with US and Canada.[275] Despite inviting the attention of the 24th Assembly and a resolution in hand, the ICAO did not address the issue of ownership and control restriction in the ATConf/3 held in 1985. The ICAO should have undertaken a review of the progress made regarding the concept of

[274] ICAO, "*Report of the Worldwide Air Transport Conference on International Air Transport Regulation: Present and Future*" Introduction to ATConf/4 (1994).

[275] ICAO, Assembly Resolution A24-18/2 (1983) 3.

"community carriers" and flow of additional international capital in these Caribbean countries. The ICAO in the process lost valuable time until the next ATConf/4 in 1994.

In the nineties, the air transport environment changed rapidly due to the process of globalization, liberalization and privatization[276] and the emergence of a new world trading arrangement developed through the Uruguay Round of the General Agreement on Tariffs and Trade (GATS) and WTO.[277] These developments had implications for air transport which called for the review of the future of international air transport regulation. In this background, the ICAO Council convened in April 1992 a Worldwide Air Transport Colloquium on the theme of 'Exploring the future of International Air Transport Regulation' where exchange of views and ideas amongst experts led to formulation of several conclusions. The Colloquium identified the need for ICAO to maintain the momentum established and develop future regulatory arrangements to reflect the rapidly changing requirements and conditions of international air transport.[278]

The ICAO, following on the conclusions of the Colloquium, established a small study group of experts to address several prescribed topics. Finally, the ICAO Council in 1993 decided to convene the ATConf/ 4 in 1994.

4.2.1 4th Air Transport Conference of 1994

The ATConf/4 attended by 137 States and 28 observers held ten meetings in November 1994. The conference included for the first time a bold and comprehensive agenda on the issue of ownership and control. Agenda 2 of the ATConf/4 discussed the future regulatory content. Agenda 2.3 dealt with the air carrier ownership and control aspect and criterion for licensing of foreign designated air carriers and possible elimination, replacement or modification of the traditional criterion, implications of privatization, inward (foreign) investment in national air carriers and the right of establishment of foreign airlines and nationality of aircraft.[279]

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[276] *Ibid.* at 46.
[277] See GATS, *The Results of the Uruguay Round of Multilateral Trade Negotiations: The Legal Texts* (Geneva: June, 1994).
[278] *Supra* note 274 at 6 (Introduction).
[279] *Supra* note 274 at 2 (Introduction).

ATConf/4 received nine working papers from various stakeholders.[280] Interestingly, USA, a major aviation market, Latin American Civil Aviation Commission (LACAC) did not present their working papers.

The discussion in the ATConf/4 centered on the working paper (WP/8)[281] presented by the ICAO Secretariat which made two proposals as below:

> "Para 2.3.3.1: The broadened criteria provide that each party to agreement could expect that any air carrier it designate would be permitted to use the market access granted to it by the second party, and that second party would so commit itself, provided that the air carrier:
> a) is and remains substantively owned and effectively controlled by nationals of any one or more States that are parties to an agreement or by any one or more of the parties themselves; or
> b) has its headquarters, central administration or principle place of business in the territory of the designating party, regardless of its ownership and control."[282] and

> "Para 2.3.41 Parties would agree to work towards:
> a) removal or lessening of any existing impediments to inward(foreign) investment in their air carrier(s), including investment by foreign air carriers; and
> b) creating a right of establishment of air carrier in their territories by foreign nationals. Both (a) and (b) above would be conditioned by reciprocity and the need to maintain competition."

Contracting States attending the ATConf/4 were confronted with the above complex issues for the first time in ICAO since 1944. Therefore, it will be interesting to look at responses of the stakeholders in the conference.

Forty three African States found the broadened criteria an improvement over the current practice of "community interest" and were supportive of the "headquarters" principle provided it utilizes national resources. However, the criterion of right of establishment of foreign airlines was not acceptable.[283] Brazil was supportive of the "headquarters" principle.[284] ECAC and EU opined that complete elimination of the restriction on ownership and control was not opportune and put forward several formulae

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[280] ICAO Secretariat; 43 African States; Brazil; European Civil Aviation Conference (ECAC) and the European Conference (EU); Airports Council International (ACI); International Air Transport Association (IATA); International Chambers of Commerce (ICC); International Federation of Airline Pilot's Associations(IFALPA).

[281] ICAO, Working Paper "*Report of the Worldwide Air Transport Conference on International Air Transport Regulation: Present and Future*" No. ATConf/4 – WP/8 (1994) 5.

[282] *Supra* note 281, see ICAO, "*Report of the Worldwide Air Transport Conference on International Air Transport Regulation: Present and Future*" Introduction to ATConf/4 27 (1994).

[283] ICAO, Working Paper "*Report of the Worldwide Air Transport Conference on International Air Transport Regulation: Present and Future*" No. ATConf/4 – WP/68 (1994)2.

[284] ICAO, Working Paper "*Report of the Worldwide Air Transport Conference on International Air Transport Regulation: Present and Future*" No. ATConf/4 – WP/49 (1994)3.

for consideration.[285] ACI[286] advocated at least modification of these restrictions if not abolition altogether. They considered these restrictions discriminatory and limiting competition and should be dealt with under competition laws.[287] IATA found justification for modification of restrictions but noted lack of consensus on replacement of criterion.[288] They proposed nine possible options for broadening current criterion by various means and mechanisms including creation of multinational air carriers. ICC[289] supported removal of all clauses and replacement by "headquarters" principle. IFALPA stressed the need for labor protection from upheaval and dislocation of workers due to change in restrictions.[290] ITF highlighted the problem of development of "flags of convenience" besides stressing labor protection from future regulatory arrangements.[291]

The conference generally acknowledged that some changes in the traditional criterion was needed to enhance participation by States in international civil aviation to broaden the sources of investment in air carriers, market access and to adapt to the current industry situation. There was broad support for broadening the criterion within a pre-defined group of States either parties to an agreement or based on "community of interest". It may be noted that this broad support was mere reiteration of the earlier stand taken by the 24th Assembly of ICAO.

The "headquarters" principle did not receive support of most of States (though some States were in favor of incorporating the "headquarters"

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[285] ICAO, Working Paper "*Report of the Worldwide Air Transport Conference on International Air Transport Regulation: Present and Future*" No. ATConf/4 – WP/47 (1994) 2.

[286] Airports Council International is a trade association, like the IATA, for airports throughout the world.

[287] ICAO, Working Paper "*Report of the Worldwide Air Transport Conference on International Air Transport Regulation: Present and Future*" No. ATConf/4 – WP/30 (1994) 3.

[288] ICAO, Working Paper "*Report of the Worldwide Air Transport Conference on International Air Transport Regulation: Present and Future*" No. ATConf/4 – WP/18 (1994)2.

[289] International Chamber of Commerce; ICAO, Working Paper "*Report of the Worldwide Air Transport Conference on International Air Transport Regulation: Present and Future*" No. ATConf/4 – WP/72 (1994) 3.

[290] International Federation of Airline Pilots Association; see ICAO, Working Paper "*Report of the Worldwide Air Transport Conference on International Air Transport Regulation: Present and Future*" No. ATConf/4 – WP/52 (1994) 4.

[291] ICAO, Working Paper "*Report of the Worldwide Air Transport Conference on International Air Transport Regulation: Present and Future*" No. ATConf/4 – WP/43 (1994) 2.

principle in their ASAs) due to the emergence of "flags of convenience" on account of lack of regulatory control and social dumping. It seems that ICAO did not anticipate the problem and was not ready with effective measures against "flags of convenience" problem.[292] It was also argued by States that there was no agreed definition of headquarters principle which could be misused by different interpretations and applications by States. The view was expressed that ICAO define the terms of headquarters, central administration or principal place of business.[293]

Most of states were not in favor of giving right to foreign nationals to set up air carriers in their territories. However, states agreed to continue to adjust their individual foreign investment rules and regulations and would retain the right of accepting or rejecting foreign investment in national carriers and whether or not to retain a policy of ownership and effective control for such carrier.[294] The conference agreed that the concepts of substantive ownership and effective control did not come from the Chicago Convention.[295] The conference reiterated the right of states to withhold or revoke the operating permit of an air carrier if it is not satisfied that the carrier is not substantially owned and effectively controlled by nationals of the designating party or by the party itself.[296] Actually, the conference should not have reiterated this right which was already in existence and should have instead focused on new aspects of the issue. Mere reiteration of the right of the state has neutralized the momentum that could have been generated in 1994.

4.2.2 9th Air Transport Regulation Panel (ARTP/9)

Building on the work of the conference in 1994 and particularly taking into account the relevant safety and economic considerations, the Air Regulation Transport Panel(comprising of experts from member states in their personal capacity) in February 1997 concluded that a criterion based on a combination of principal place of business and permanent residence of airlines could be used to further broaden the traditional criterion. In the

[292] *Ibid.* at 3.
[293] *Supra* note 274 at 28, 29(d).
[294] *Supra* note 274 at 29(e)(f).
[295] *Ibid.* at 4.
[296] *Supra* note 21.

panel's view, the principal place of business and permanent residence criterion would result in the firm link to the designating State which would not result in degradation of safety, and will meet the concerns regarding safety expressed at the ATConf/4. The Panel developed the following recommendation:

"That States wishing to accept broadened criteria for air carrier use of market access in their bilateral and multilateral services agreements agree to authorize market access for a designated air carrier which:
i) has its principal place of business and permanent residence in the territory of the designating State; and
ii) has and maintain a strong link to the designating State.
In judging the existence of a strong link, States should take into account elements such as the designated air carrier establishing itself and having a substantial amount of its operations and capital investment in physical facilities in the designating State, paying income tax and registering its aircrafts there and employing a significant number of nationals in managerial, technical and operational positions."
Where a State believes it requires conditions or exceptions to the criterion based on national security, strategic, economic or commercial reasons, this should be the subject of bilateral or multilateral negotiations or consultations, as appropriate."[297]

The Council approved the recommendation of ATRP/9 in May 1997 and sent Doc. 9587 to the States for their guidance through a State letter.[298]

Assessment of outcome of ATConf/4

Judging by the slow progress in the relaxation of traditional restrictions, the outcome of ATConf/4 cannot be termed successful. The conference only recommended that States give due consideration to broadened principles in their economic and regulatory responsibilities and international air transport relationship. The conference conclusions and recommendations are not binding on states and predictably were not followed. Even the guidance material and state letter issued by ICAO duly approved by the Council did not yield satisfactory progress between the period 1994 and 2003. It will be interesting to assess the progress made by states on the two principles i.e. "principal place of business" and "community of interest". According to the ICAO report presented in 2003, these two principles appear in only a limited number of ASAs. It was also pointed out by ATRP/10 in its report in 2002, of the 225 ASAs registered with ICAO up to 1999, 193 retained substantial ownership and effective control as their designation criterion. This goes to

[297] ICAO, Working Paper "*Report of the Air Transport Regulation Panel"* ATRP/9-WP/23 (1997) 22.
[298] ICAO, State letter SP 38/1-97/58 (27 June 1997); ICAO, *Policy and Guidance Material on the Economic Regulation of International Air Transport*, Doc 9587, See *supra* note 105.

show that States have not supplanted traditional restrictive clauses. Despite very poor response from States, some practical alternatives to the traditional clause have been formulated in different parts of the world between 1994 and 2003 which will be discussed subsequently in this Part of the thesis.

On the other hand it should also be taken into consideration that the conference took place at a difficult time for air transport, in the background of overcapacity and depressed yields in many markets, disparity in resources to participate and growing infrastructural constraints and costs. The timing of ATConf/4 also coincided when relationships between the government and air carriers, particularly national air carriers, was undergoing changes.[299] Moreover, several interests such as workers, trade and tourism were having concerns on the future of air transport policy.[300] The conference was considered an opportunity to review regulatory fundamentals and their future so that industry adjust to a more open, competitive and dynamic environment. Viewed against this background, the conference could only conclude in general terms such as broad support for the need to review and consideration of the option of broadening the criterion. At least, the subject of the traditional criterion appeared on the horizon of ICAO for future debate and consideration.

4.2.3 Continued work of ICAO on liberalization of air transport into the 21st century

First Survey on ownership and control in 2001

As a part of the on-going liberalization trends in international civil aviation, a comprehensive questionnaire was circulated by ICAO in 2001 on State's policies and practices on the subject.[301] In all, 54 states responded to questions ranging from their national laws, policies on inward investment to foreign control. One of the important findings of the survey relates to the rationale of having traditional criterion and in particular the differences in emphasis on each rationale and is quite meaningful and worth noting. The rationale of national defense or security appears at the bottom and less

[299] *Ibid.* at 46.
[300] *Ibid.* at 17.
[301] ICAO, *Questionnaire on State's Policies and Practices concerning Air Carrier Ownership and Control*, Attachment to State letter SC 5/2-01/50 (2001).

essential. National development or economic interests appears to be on the top of consideration followed by the economic interest of air lines. In particular, adherence to international agreements is the major factor why States have formulated the traditional criterion. The question of effective control was found to be a very complex one as there was no accepted definition or common practice.

At an international level, the survey further revealed, only a small number (11%) of ASAs were not adhering to the traditional criterion which only goes to show that the broadened criterion developed by ATConf/4 were not widely used. It can also be said that 11% is a good sign of gaining acceptability of the ATConf/4 recommendations. While a majority of States did not have compelling reasons or incentives to change the status quo unless negatively impacted by it, a number of them were willing to accept the use of broadened criterion. More importantly, it was also found in the survey that States rarely take action against foreign airlines not meeting the traditional criterion.[302]

The above survey also showed that ATConf/4 and its rather conservative conclusions and recommendations have proven unrealistic and unproductive in achieving global consensus on how States should adjust their national laws and policies governing their airlines. However, the survey paved the way to undertake future work on improving or refining the existing guidance on ATRP/9-4 recommendations on the principal place of business and a strong link between the State and the airline operator.[303]

4.3 Air Transport Regulation Panel / 10

The Air Transport Regulation Panel of ICAO held its tenth meeting in Montreal from 13 to 17 May in 2002 and considered the text of a draft bilateral designation and revocation clause prepared by ICAO Secretariat on the traditional criterion.[304] The ATRP/10 decided to set up a working group to encourage wider and more immediate application of the agenda and also

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[302] ICAO, Working Paper "*Results of the Survey of State's Policies and Practices concerning Air Carrier Ownership and Control*" AT – WP/1933 (2 Apr. 2002) 6.
[303] *Ibid.* at 91.
[304] ICAO, *Report of the Air Transport Regulation Panel Working Group on Air Carrier Ownership and Control* (Sept, 2002).

to carry out further work on coordinated action by States to liberalize the traditional criterion. The working group was mandated to report on identifying the reasons for coordinated action, formulate options for coordinated action and also to provide a report for ATConf/5.

The working group concluded that States have the sovereign right to set their own agenda for liberalization. States can amend the traditional criterion in their bilaterals or agree to flexible interpretation where they find willing bilateral partners to do so. However this right is constrained by the risk and uncertainty of rejection of the designation of the airline with foreign ownership and control by one or more partners under the existing web of bilaterals that may be created by unilateral or bilateral liberalization of the traditional criterion. This risk and uncertainty prevented states from liberalizing their own rules and from seeking foreign investment. Therefore, states need a better sense of their willingness of their bilateral partners and this can be achieved by coordinated action amongst like minded States. The required critical mass of such bilateral partners can be developed only by coordinated action as individual renegotiation of ASAs will take unduly long time. Further, it was noted that a core group of important markets of willing partners will then create a momentum for liberalization of the traditional criterion. While individual action by certain States remains a valid option, the coordinated action will expand the benefits on a broader and secure basis.[305]

It was further concluded that like minded States willing to take coordinated action should not reject the designation of foreign airlines on the ground of liberalized traditional criterion and will find it easier if they can develop a multilateral guarantee of market access for these airlines to operate successfully without risk to their designations.[306] The multilateral guarantee can be offered reciprocally or non-reciprocally but unilateral waiver without reciprocity (either of authorization or inward investment) leads to problems relating to the free rider situation.

The ATRP/10 further concluded that the guarantee can be offered by a legally binding instrument or through a commitment that is not legally

[305] *Supra* note 306 at 7, 8.
[306] *Supra* note 306 at 8, 9.

binding. The latter can be through letters of comfort or a statement of common policy and both these approaches can be applied regionally or globally.[307]

The Panel further emphasized two areas for further consideration namely the need to maintain an economic link between airline and designating State and safety and security oversight of the airline it designates. The Panel also touched upon definitional issues of economic linkage criterion and challenges arising out of absence of the criterion. The ATRP/10 based upon the report of the working group made recommendations for ATConf/5.[308]

It is evident from the above that ICAO ATRP/10 attempted to deal with the difficult issue of coordinated action for liberalization of the traditional criterion and options for taking coordinated action. This work was considered important from the view point of threat and risk arising out of rejection of designation of foreign airline by a state from another state or partner states. It can be concluded that ICAO through ARTP/10 played a role in further refining options after ATConf/4 and ARTP/9 and in providing a forum in which they can be discussed and thus prepared the ground for ATConf/5.

4.4 5th Worldwide Air Transport Conference in 2003

In ATConf/5,[309] 145 contracting States and 26 observers participated in March 2003. ATConf/5 was held at a time when airline industry faced its worst crisis ever due to changing world economy and various external shocks. The rise in fuel prices in 2004 once again underlined the fragility of the airline business and the need for the industry to take appropriate measures to ensure long-term financial sustainability.[310]

ICAO with background of the survey conducted in 2001 and 2002 on the subject and the recommendations of ATRP/10 presented proposals through a Secretariat paper before the ATConf/5 with policy options and new alternative criterion for use of market access by airlines. The above survey

[307] *Supra* note 306 at 10.
[308] *Supra* note 306 at 12, 13.
[309] ICAO, *Worldwide Air Transport Conference: Challenges and Opportunities of Liberalization* (Montreal: 24th -29th March, 2003) 4.
[310] ICAO, Working Paper " *Advancing the Liberalization of Ownership and Control*" A35 – WP/64 (8 July 2004) 15.

had earlier shown that broader perspective of national development and economic interests have become overriding factors. Many States were receptive to the use of certain broadened criterion and the survey confirmed the need for ICAO to undertake further work to address the needs and concerns of both designating and receiving States.[311] The paper of the ICAO Secretariat recounting the previous work of ICAO noted that majority of ASAs, including "Open Skies", still retain the traditional criterion though exceptions to the criterion have also existed. It was further noted in the paper that the traditional criterion by virtue of the right of refusal held by other States has effectively prevented a state from liberalizing more rapidly in respect of airline designation for the use of market access.[312]

The paper raised the issue whether the economic connection between designating State and the airline should be dispensed with and only regulatory control of safety and security by the designating State be retained as the link between the airline and the State. The paper highlights the benefits of liberalization of the traditional criterion and risks which may cause concerns due to the removal of the traditional criterion, such as flags of convenience, deterioration of safety and security standards and possible flight of foreign capital with long run implications on airline competition due to the emergence of industry consolidation and mega carriers through mergers or acquisitions. However, the paper stated that these risks could be addressed by the development of regulatory measures in parallel. In further discussion, the paper presented the major challenge of how to have States that do not wish to liberalize at present not inhibit others from doing so on account of the right of rejecting the designation due to a failure to meet the traditional criterion. The constraint originally and mainly arises from bilateral arrangements. Therefore, in order to have any meaningful progress in advancing the cause, it is necessary to first develop an alternative regulatory arrangement.[313]

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[311] *Supra* note 304.
[312] ICAO, Working Paper "*Worldwide Air Transport Conference: Challenges and Opportunities of Liberalization*" ATConf/5-WP/7 (21 Oct. 2002) 8.
[313] *Supra* note 314.

4.4.1 New alternative regulatory arrangements

An alternative regulatory arrangement has been put forth by the ICAO Secretariat paper in the ATConf/5 based on recommendation of ATRP/10 that parties to a bilateral agreement would agree to accept the designation of an airline for the market access if the airline has its principal place of business in, and there is effective regulatory control, by the designating state. The arrangement would not require the State to change its existing laws pertaining to the traditional criterion but would allow such changes if and when the state wishes to do so. ICAO believed that such an arrangement would help to create a more favorable operating environment in which airlines can do their business according to market conditions and commercial needs as in other industries. It would not lead to drastic changes to the existing bilateral framework as it can be introduced through the normal bilateral negotiation and consultation process. [314]

The ICAO paper introduced the following new alternative designation criterion:

Model Clause on designation and authorization in the Template ASA[315]

" Article X: ***Designation and Authorization:***

1. Each Party shall have the right to designate in writing to the other Party (an airline) (one or more airlines) (as many airlines as it wishes) to operate the agreed services (in accordance with this Agreement) and to withdraw or alter such designation.
2. On receipt of such a designation, and of application from the designated airline, in the form and manner prescribed for operating authorization (and technical permission,) each Party shall grant the appropriate operating authorization wit minimum procedural delay, provided that:

a) the designated airline has its principal place of business* (and permanent residence) in the territory of the designating party;
b) the Party designating the airline has and maintains effective regulatory control** of the airline;
c) the Party designating the airline is in compliance with the provisions set forth in Article __ (Safety) and Article __ (Aviation Security); and
d) the designated airline is qualified to meet the other conditions prescribed under the laws and regulations normally applicable to the operation international air transport services by the Party receiving the designation.

3. On receipt of the operating authorization of Paragraph 2, a designated airline may at any time begin to operate the agreed services for which it is so designated, provided that the airline complies with the applicable provisions of this agreement.

Notes:

[314] *Supra* note 314.

[315] ICAO, Working Paper "*Substantial Ownership and Effective Control"* ATConf/5-WP/ 17 (27 January, 2003) 12.

> evidence* of *principal place of business* is predicated upon the following factors*: the airline is established and incorporated in the territory of its designating Party in accordance with relevant national laws and regulations, has a substantial amount f its operations and capital investment in physical facilities in the territory of the designating Party, pays income tax, registers and bases its aircraft there, and employs a significant number of nationals in managerial, technical and operational positions.*
>
> *** evidence of effective regulatory control is predicated upon but is not limited to: the airline holds a valid operating license or permit issued by the licensing authority such as an Air Operator Certificate (AOC), meets the criteria of the designating Party for the operation of international air services, such as proof of financial health, ability to meet public interest requirement, obligations.*"[316]

While proposing the model clause, ICAO paper drew the attention of the conference to the fact that the proposed arrangement may have implications for the States

party to the International Air Services Agreement (IASTA)[317] that some airlines may cease to qualify under the traditional criterion of the agreement.[318]

4.4.2 Possible Approaches to facilitating Liberalization (Means to implement the reform)

Keeping in view the facts that the majority of States still follow the traditional criterion and that it is a long and complex process to amend bilateral agreements, the ICAO paper suggested some practical means as follows:

> (i) Allow other bilateral partners to use broadened criterion while retaining the traditional criterion for its designated airlines
> (ii) Exercise discretionary right to accept the designated airlines not meeting the traditional criterion provided that airline meets other overriding requirements of safety and security.
> (iii) A case by case approach does not give certainty to airlines and therefore States can make public their positions on the conditions under which States will accept the designation of airlines and preferably as a general public policy.

ICAO favored a coordinated multilateral arrangement as a better means to generate a critical mass of bilateral partners committing not to reject the designation of airlines not meeting the traditional criterion. The core group of the states comprising the critical mass will promote better usage of the

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[316] *Supra* note 314 at 5, 6.
[317] *Supra* note 19.
[318] *Supra* note 314. at 6.

alternative model clause. The ICAO paper reiterated all recommendations of ATRP/10 working group as mentioned earlier ranging from multilateral guarantee to transparency of bilateral agreements. The ICAO paper drew conclusions and made recommendations for consideration of the ATConf/5.[319]

4.4.3 Views of stakeholders on liberalization of 'Ownership and Control'

ICAO in its proposal before the conference moved past the existing principle of "community of interest" and "pre-defined group" of states and towards "principal place of business and effective regulatory control" by designating state and a more flexible arrangement by states wishing to liberalize and maintaining safety and security. ATConf/5 witnessed the presence of at least ten new states/stake holders compared with ATConf/4 showing wider interest in the subject. Views of only those stakeholders will be discussed that have presented their working papers.

Cuba supported the ICAO proposal on the ground that it would assist in evolution of safe and orderly international air transport.[320] Barbados supported relaxation of substantial ownership rules to permit authorization of airlines that have at least 25 % of share of ownership vested in the nationals of the designating State.[321] New Zealand supported the proposal.[322] Pakistan supported a flexible arrangement within the bilateral framework on case by case basis and emphasized the need to avoid flags of convenience.[323] Republic of South Korea was of the view that the traditional criterion was suited for bilateral framework and the alternative model could be applied to regional framework.[324] It was further stressed that while the alternate

[319] *Supra* note 314. at 8, 9.
[320] ICAO, Working Paper "*Substantial Ownership and Effective Control"* ATConf/5-WP 52 (14 March, 2003) 9.
[321] ICAO, Working Paper "*Substantial Ownership and Effective Control"* ATConf/5-WP/ 48 (4 February, 2003)5.
[322] ICAO, Working Paper "*Substantial Ownership and Effective Control"* ATConf/5-WP/ 114 (4 February, 2003)3.
[323] ICAO, Working Paper "*Substantial Ownership and Effective Control"* ATConf/5-WP/ 57 (14 March, 2003) 6.
[324] ICAO, Working Paper "*Substantial Ownership and Effective Control"* ATConf/5-WP/ 101 (4 February, 2003) 4.

proposal takes care of safety, security and free rider problem, yet there will be concerns about third party free rider situation where a member State concludes a bilateral containing this criterion with a State outside of the region. Singapore urged States to engage in an open and consultative approach and find a common middle ground without compromising their interests.[325] United States noted that under the new proposed regime, the responsibility and lines of authority for safety and security oversight must remain clear which in all cases will be the State of operator regardless of delegation to others.[326]

Since ATConf/4, the number of African States increased from 43 to 53 and they supported the alternate model clause provided states incorporate both the conditions in their laws to prevent discrimination amongst states. This was a huge support because Africa saw great benefit in liberalization of the regime.[327] The Arab Civil Aviation Commission (ACAC)[328] were cautious and wanted staged liberalization-first for non-scheduled and cargo only and in the regional setting and using traditional criterion for all other parties.[329] EU and ECAC and their members represented by Greece emphasizing the need for liberalization proposed a very flexible approach based on three elements:

> i) States should accommodate any other state that wishes to liberalize its traditional criterion unilaterally or as a part of a group of like-minded States
> ii) Assurance on safety consideration should be given to designation of airlines based in a third country
> iii) ICAO members should develop a common approach towards liberalization of the traditional criterion.[330]

The Latin American Civil Aviation Commission (LACAC)[331] was very cautious on the subject and listed concerns such as flags of convenience,

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[325] ICAO, Working Paper "*Substantial Ownership and Effective Control"* ATConf/5-WP/ 39 (14 March, 2003) 4.
[326] ICAO, Working Paper "*Substantial Ownership and Effective Control"* ATConf/5-WP/ 96 (4 February, 2003)2.
[327] ICAO, Working Paper "*Substantial Ownership and Effective Control"* ATConf/5-WP/ 80 (4 February, 2003)3.
[328] ACAC comprises of the following: Bahrain, Egypt, Iraq, Jordan, Lebanon, Libyan Arab Jamahiriya, Morocco, Oman, Qatar, Saudi Arabia, Sudan, Syria, Tunisia, United Arab Emirates, Yemen and an observer from Palestine.
[329] ICAO, Working Paper "*Substantial Ownership and Effective Control"* ATConf/5-WP/ 65 (14 March, 2003)5.
[330] ICAO, Working Paper "*Substantial Ownership and Effective Control"* ATConf/5-WP/ 84 (14th March, 2003)2.
[331] ICAO, Working Paper "*Substantial Ownership and Effective Control"* ATConf/5-WP/ 99 (14 March, 2003)2.

safety and security, flight of capital, impact on labor, national emergency requirements and in the long run anti-competitive effects from industry concentration.

ITF[332] and IFALPA[333] did not change their earlier stand and reiterated their position as taken in the ATconf/4. The ALADA emphasized on the need for legislation by states of the new regime and the responsibility of the state of operator.[334] IATA[335] duly supported by IACA[336] advocated four steps for liberalization:

(i) distinguish between commercial control from ownership and regulatory control exercised by licensing authority
(ii) remove restriction on ownership
(iii) make regulatory control the responsibility of the designating state and
(iv) provide control of safety and security through adoption and implementation of model clauses of ICAO/ECAC.

Discussions in ATConf/5

The conference throughout recounted the benefits as well as the risks associated with liberalization of the traditional criterion and emphasized the safeguards in the process.

A number of States favored retaining the traditional criterion in their bilaterals taking into account their economies, markets and competitiveness of airlines of partners to the agreements and also reciprocity. There was support for applying liberalized criterion such as "community of interest" as well as a Model Clause within the region over and above the community of interest concept. In particular, small islands without airlines favored the dual application of these two principles. The conference in conclusions noted that there was wide support by states for liberalization of the traditional criterion though the approaches vary widely from broadening the traditional criterion in the near term to gradual reduction of national ownership and to

[332] ICAO, Working Paper "*Substantial Ownership and Effective Control"* ATConf/5-WP/ 75 (14 March, 2003)3.
[333] ICAO, Working Paper "*Substantial Ownership and Effective Control"* ATConf/5-WP/ 34 information paper (14 March, 2003)7.
[334] ICAO, "*Substantial Ownership and Effective Control"* ATConf/5-WP/ 71 information paper (14 March, 2003) 8.
[335] ICAO, Working Paper "*Substantial Ownership and Effective Control"* ATConf/5-WP/ 26 (3 December, 2002)4.
[336] International Air Carrier Association; ICAO, Working Paper "*Substantial Ownership and Effective Control"* ATConf/5-WP/ 33 (3 December, 2002)5.

application within certain regions or simply on a case by case consideration.[337]

Irrespective of approaches of liberalization, it was noted that safety and security should remain paramount along with clear lines of responsibility and accountability for these factors and all States agreed to it. Further, the need to address the concerns of labor was to be taken into account. It was further agreed that the proposed alternate Model Clause could serve as a catalyst for broader liberalization without necessitating changes in existing laws of States. There was a need for flexibility to enable States to follow the approach of their own choice at their own pace while accommodating the approaches chosen by other States.[338] The conference agreed to the Model Clause proposed in the working paper.[339]

The conference made eight recommendations and finally issued a "Declaration of Global Principles for the Liberalization of International Transport".

Some of the recommendations made by the conference can be recounted briefly as below:

"1. Liberalization of the traditional criterion should be at each state's pace and discretion progressively, flexibly with full consideration of safety and security through effective regulatory control.

2. Liberalization of traditional criterion in their international relationship may be done by the use of, as an option at their discretion and in a flexible manner, the alternative Model Clause.

3. States at their discretion take positive approaches including coordinated action to accept designation of foreign airlines which do not meet the traditional criterion or of alternate Model Clause and such States may do so by (i) by issuing individual statements of their policies regarding acceptance of designation of foreign airlines (ii) issuing joint statements of common policy; and/or (iii) developing a binding legal instrument

4. States to follow and ensures the provisions of safety and security of their designated airlines in accordance with the standards established by ICAO and also to keep ICAO informed of their policies, position and practices on the traditional criterion, individual and joint statements of common policies; ICAO in turn to maintain and make public information on such notifications; ICAO to further assist States and continue to monitor development in the process.

The conference finally issued a "Declaration of Global Principles for the Liberalization of International Transport". These principles include two important principles on liberalization namely:

5. Each State will determine its own path and pace of change in international transport regulation, in a flexible way and using bilateral, sub-regional, regional, plurilateral or global avenues according to circumstances

6. States should give consideration to accommodating other states in their efforts to move towards expanded trans-border ownership and control of air carriers and/or towards designation of air carriers based on principal place of business provided that clear responsibility and control of regulatory safety and security oversight is maintained."[340]

[337] ICAO, "*Report of the World-wide Air Transport Conference*", ICAO Doc. 9819 (2003) 23.

[338] *Supra* note 339.

[339] *Supra* note 314.

[340] *Supra* note 339.

4.5 Assessment of results of ATConf/5

A growing number of states participated in the conference with a willingness to consider and debate the issue with an open mind. In fact, States agreed to a document containing alternate Model Clause and also expressed their willingness to accommodate those states which want to move faster in reforming the traditional criterion. The conference treaded a very cautious path in reiterating time and again the need fora flexible regulatory arrangements whereby states choose their own path, pace, at their discretion progressively, flexibly and with effective regulatory control regarding safety and security. One wonders whether any state could have taken a more open approach on the issue of liberalization following so many constraints outlined by the conference. The conference left every thing to states to try out to liberalize the traditional criterion. It did not ask specifically ICAO to play a proactive role in promoting liberalization of the traditional criterion through coordination amongst like-minded states. Interestingly, ICAO assumed to continue to play a leading role in facilitating liberalization. It was expected of ICAO to get a mandate from the conference to be bold and the real leader in liberalization of the traditional criterion. It is true that the conference did not have legal binding effect and ICAO acted only as a facilitator. The degree of success of ATConf/5 in relaxation of the traditional criterion can be determined by compilation of the progress achieved by states at bilateral, sub regional, regional and global levels. ICAO made some efforts for compilation of the progress after ATConf/5 as described in next paragraphs. However, the lack of time and resources by the ICAO have been cited as main reasons for not actively pursuing the recommendations of ATConf/5 and directly pertaining to ICAO for actions. Again, probably ICAO could have given push to the momentum of liberalization of the traditional criterion.

4.6 Follow-Up Action by ICAO Post ATConf/5

ICAO issued the first State letter in July 2003 enclosing Conclusions, Model Clause, Recommendations and Declaration of Global Principles for the Liberalization of International Air Transport for use by States. The communication also gave a summary of implementation actions by States as

proposed by ATConf/5.[341] ICAO further asked States to forward case study-type material for the analysis and dissemination of information on such experiences of states at national, sub-regional, regional or plurilateral levels.[342] A State letter was sent out to gather information on States' current policies and practices with regard to:

> i) how it deals with its own designation of airlines;
> ii) how it deals with foreign designation; and
> iii) what is its position on future designations.[343]
> (iv) a study was commissioned in 2004 to identify areas which could have safety or security implications and determine if any gaps exist in the existing ICAO provisions.

In 2005, the study concluded that due regard should be paid by states to safety and security and potential problems for identifying the line of responsibility where operation or arrangement involves multiple parties from different States or where aircraft is based and operated in places other than the State of registry and /or State of operator. The study further concluded that existing ICAO provisions and guidance material regarding State responsibility for safety and security are generally adequate in addressing various situations arising out of the proposed liberalization. The study recommended to ICAO to undertake more work on existing SARPs and /or guidance material to adapt to the evolution of business practices such as lease, code-sharing, alliances or franchising, different State of registry and operator and surveillance by State other than State of registry or operator etc. Use of Article 83*bis* of the CC by States involving aircraft transferred abroad was strongly advised including improving SARPs implementation.[344]

Flags of Convenience

ICAO has also been working to address the problem of flags of convenience. The Council by its decision in 2006 approved a study as a part of the follow-up action. The Council followed up this study on the basis of the Air Navigation Commission's (set up by the CC as a technical body to advise the Council of ICAO and hereinafter referred to as ANC) report in 2008. The ANC based its approach on International Maritime Organization (IMO)'s strategy on the

[341] ICAO, State letter SC 5/1-03/71 (25 July 2003).
[342] ICAO, State letter SC 5/6-03/89 (26 September 2003).
[343] ICAO, State letter SC 5/6-03/88 (26 September 2003).
[344] ICAO, Working Paper "Study on the Safety and Security Aspects of Economic Liberalization" No. AT-WP/1993 (12 Apr. 2005) 12.

subject and stated that foreign registered aircraft that operate outside the State of registry and/or state of operator will not pose serious problem as arrangement are generally made between States to ensure proper safety oversight and that this category is a growing reality in the liberalized world. It is the other category of foreign registered aircraft that are flying outside the State of registry and/or State of operator with inadequate safety oversight which pose the real problem of "flags of convenience". The ANC has now been asked by the Council, firstly, to work to suggest amendment in relevant Annexes to empower States to take appropriate action regarding international operations within their territory to preserve the safety and secondly to apply suitable technology to assign unique 'identifiers' to aircraft on the lines of International Maritime Organization. What is directly relevant to the issue of liberalization of the traditional criterion is the conclusion of the ANC report that existing provisions of ICAO and guidance material regarding the responsibilities of States on safety and security are generally adequate and is a confirmation of an earlier study of ICAO in 2005.[345]
The follow up actions outlined above by ICAO show that ICAO has been taking action on the ATConf/5 recommendations. However, it appears that these actions have not been taken by the ICAO in a coordinated, sequential and time-bound manner. There are inordinate delays in some areas. Consequently, the needed liberalization has not received required momentum as States have not been brought together to push the agenda of liberalization. Regrettably, ATConf/5's recommendations have still not found their way into ASAs and many actions assigned to ICAO are yet to be acted upon.

4.7 IATA's current position as the industry leader on the progress of liberalization of the traditional criterion since ATConf/5

Advancing the cause of liberalization of the traditional criterion remained a goal of the aviation community and IATA in particular. In ATConf/5, IATA argued that there was an increasing need for governments to grant airlines the same degree of freedom to adjust to global change as enjoyed by other industries. With this argument behind, IATA at ATConf/5 presented a four step liberalization of the traditional criterion proposal and went to the extent of

[345] ICAO, Working Paper "*Progress Report on the Issue of Flags of Convenience*" No. C-WP/ 13133 ANC Report (20 Feb. 2008) 5.

proposing that States should accept designation of foreign airlines if they fulfill safety and security control criterion only, without any economic control by the designating State. IATA has been suggesting that a nucleus of like minded States was essential for liberalization of the traditional criterion to take place.[346]

In a Symposium organized by ICAO in 2006 in Dubai on Air Transport Liberalization, the IATA stated that over 98% of the traffic is still governed by bilaterals with the traditional clause. Giovanni Bisignani, Director General of IATA, stated in the Symposium that "200 of 3000 bilaterals account for 75% traffic, so changing only a few agreements can have a big impact. The most important aviation relationship in the world is the North Atlantic and there was a need for liberalization of the traditional criterion." He also stated that "Open Skies" was only part of the answer" and invited attention towards cross border consolidations in aviation sector like any other industry. He further showed disappointment at the speed of the process of liberalization by saying that not much has happened in past three years since 2003. It seems that the industry is not satisfied with the pace of the liberalization and the denied commercial opportunities to airlines industry, consumers and to the national development. The industry demands more in terms of speed and normalization of airlines industry just like banking, telecom, and automobiles.[347]

In the recent Annual General Meeting (AGM) of IATA at Istanbul in June 2008, a resolution has been passed stating that "Governments must eliminate archaic rules that prevent airlines from restructuring across borders".[348] The Director General, IATA, in his address stated that "The bilateral system is a problem. The so called freedoms of the air are really restrictions in our business. We cannot fly to new market without an international agreement. We cannot look beyond national borders to try new ideas, grow our business, access global capital, or merge and consolidate."[349] He further stated revolutionary remarks "Let us rip up the 3500 bilaterals and replace them with a clean sheet of paper without any reference to commercial regulation". He advocated an agenda for

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[346] ICAO, Working Paper "*Advancing the Liberalization of Ownership and Control*" No. A35-WP/64 (8 July 2004) 6.

[347] Giovanni Bisignani, "*Liberalization- Remarks by the DG and CEO to the ICAO Global Symposium*" (IATA: Sept. 2006)2.

[348] IATA, 64th AGM Resolution, see Giovanni Bisignani, "*State of the Air Transport Industry*" Istanbul Resolution (2-3 June 2008).

[349] *Supra* note 349, see Kerry Azard, "*Cry Freedom*" Airline Bus. Daily (June 2008)4.

freedom as far as commercial regulations are concerned so that airlines will be free to innovate, free to compete, free to grow, free to disappear and free to become financially sustainable and the role for the government would be regulating global standards for safety, security and environmental performance."[350]

IATA in its AGM in Istanbul once again expressed disappointment at the pace of liberalization and mentioned that very little has actually happened in practice since 2003 ATConf/5. ICAO adopted the vision but States have not acted. To give further momentum to the process, IATA will organize an "Agenda for Freedom" in Istanbul later in 2008. According to IATA, several States from across continents have agreed to participate and include Australia, New Zealand, Singapore, India, UAE, Turkey, EU, Morocco, Chile, Panama, the US and Canada.

4.8 Various regulatory regimes on liberalization of the traditional criterion existing in different parts of the world

European Union (EU)

The EU had evolved an important regional plurilateral agreement before ATConf/4. The EU promulgated a series of comprehensive regulations mandating intra-Community air transport liberalization. This series is known as "packages" which culminated in the "Third Package", put into effect in 1993.[351] The European Council[352] Regulation EEC/2407/92 states that the free market is accessible to all carriers holding an EC air transport operators' license. The EC Regulation further explained that in order for a carrier to obtain license, the majority of its capital must be held by the EU Member States or nationals of the EU which must also have de facto control of the carrier.[353] This regulation allows all carriers holding an EU license to have unrestricted access to all international routes inside the EU. Such carriers enjoy the right of establishment anywhere in the EU and cabotage rights

[350] *Supra* note 349.
[351] The Third package brought the EU commercial aviation market closer to true cabotage rights.
[352] The Council, whose members represent the Member States, is responsible for carrying out the objectives of the EU through legislative enactments.
[353] *Supra* note 35.

within any member State. The "Third Package" opened the EU cabotage markets to the EU carriers and the EU and the European Commission started making efforts to take over the negotiation and implementation of such agreements on behalf of the Member States.[354] On November 5, 2002 the European Court of Justice (ECJ) gave its long awaited landmark decision on the complaint of the European Commission against eight EU Member States and ruled that amongst other provisions, nationality clauses of bilateral agreements (including establishment) violate the right of establishment guaranteed under Article 43 of the Treaty of Rome[355] and further ruled that bilaterals of eight members were illegal under EU law i.e. nationality clause infringed Community Law by limiting the freedom of establishment of Community carriers of the EU States. Thus, the community carrier can operate air service any where within the European Common Aviation Area (ECAA). The decision also required that no Member State may conclude a bilateral that excluded any community carrier from operating on the traffic rights provided under the bilateral. The EU members were required to include unrestricted designation of all carriers having community nationality. Following on this ruling, the European Commission was given specific mandates regarding external aviation relations. The Horizontal mandate permits the European Commission to negotiate with all other third countries on a restricted basis to amend the nationality clause in ASAs that restricts the freedom of establishment of community companies and another to negotiate a single comprehensive agreement for an Open Aviation Area (OAA) with the US in place of the existing bilateral agreements.

The Horizontal mandate implies that the European Commission has to renegotiate the nationality clause and amend several thousand ASAs by replacing national ownership clauses with a community ownership clause.

US-EU "Open Skies Plus" Agreement

In furtherance to the Horizontal mandate and creation of a Transatlantic Common Aviation Area, the EU and the US signed an "Open Skies Plus"

[354] Bruce Bernard, "*EC Ministers Reject Pooling of Air Traffic Agreements*" (Mar. 16, 1993) J. of Com 3.

[355] The Treaty of Rome includes rules intended to promote competition in various economic sectors, including transportation.

agreement in April 2007. "On 30 March 2008, the most ambitious air service deal ever negotiated, the EU-US "Open Skies Plus" came into effect. For the first time, EU airlines can fly without restrictions from any point in the EU to any point in the US. The new EU-US Air Transport Agreement signed on 30 April 2007 will bring more competition and cheaper flights to the biggest international air transport market"[356]

The stage II of the agreement is still being negotiated and includes relaxation of foreign ownership and control and grant of cabotage rights to each other's airlines in their respective markets. Fresh talks started between the EU and the US on 15 May 2008 in Ljubljana on a second stage agreement which promises a new perspective on how aviation is structured in future, potentially removing restrictions on the foreign ownership of airlines, exchanging access to domestic markets and a more consensual approach to the regulation of the industry.

The US Deputy Assistant Secretary of State for transportation affairs, John Byerly, has stated in Brussels on the occasion of stage II negotiations that "Washington had an open mind on Europe's long standing demand to ease American restriction on foreign ownership of US airlines. Washington would seek a far wider deal by pledging to forgo access restrictions on airlines from more than 60 nations, based on the nationality of owners a deal which could be expanded to other countries in the future. Such a move would involve dismantling the "sticky spider's web" of restriction in bilateral aviation agreement that form a huge impediment to expanded cross-border investment in and around management of airlines around the world"[357] The EU was surprised by the US proposal to broaden the liberalization talks.

[356] EU, Newsletter by the Office of the European Commission in Montreal (July 2008).
[357] "*US Shocks EU with Global Airline Ownership Plan*" Air Transport (14 May 2008)2.

Andean Pact

The Andean Pact[358] was concluded by five Latin American States and stipulates that an air carrier entitled to operate the services within the Pact will be determined by national law of the Pact state designating the airline.[359]

Regional Arrangements

Seven regional arrangements since 1995 have come into existence and include in the Caribbean (CARICOM), South America (Fortaleza Agreement,1997), West Africa (Banjul Accord,1997), Asia (CLMV Agreement between 4 States in 1998), an agreement among 16 Arab States members of ACAC, Central Africa (CEMAC Agreement,1999), Eastern and Southern Africa (COMESA Agreement between 20 States in1999) and the Yamoussokro II Ministerial decision (52 African states in 1999) .All of these are in the direction of partial liberalization only and do not deal with the relaxation of the traditional criterion.[360]

Of the above, the CARICOM agreement being different from the others and requires that a CARICOM airline[361] providing service under the agreement be owned and controlled by one or more member states or the nationals of the community.

Australia

Australia is one country which has taken lead in unilaterally liberalizing the traditional criterion in domestic sector. The Australian government with a view to attracting international capital market and increasing opportunities of competition in the domestic market, has amended foreign investment guidelines to allow foreign persons including foreign airlines to acquire up to 100% of equity of an Australian domestic airline (with the exception of

[358] The "Andean Group" was founded by five South American States in 1969 under the Cartagena Agreement (more often called "Andean Pact"). The original Member States were Bolivia, Chile, Colombia, Ecuador and Peru. Venezuela joined the Group in 1973, while Chile withdrew in 1976.

[359] ICAO, Manual on the Regulation of International Air Transport, ICAO Doc. 9626 (2004) 4.4-2.

[360] *Supra* note 347.

[361] British West Indian Airlines.

Qantas) unless it is contrary to the national interest.[362] As a result, Air New Zealand acquired an initial 50% stake in Ansett Australia in 1996 and full ownership in 2000 but it confined its ownership in Ansett International to 50% to satisfy the traditional criterion. It is a different matter that Ansett, the major competitor to Qantas liquidated in 2001.[363]

New Zealand

The most liberal system with regard to the traditional criterion has been evolved in New Zealand where the government has removed "all restrictions on ownership and control for some of their bilaterals, thereby enabling domestic and international routes to be operated by airlines owned by foreign nationals."[364] This shows that such a liberalization can be achieved. Importantly, the decision by New Zealand was taken unilaterally after concluding that it was in the national interest to allow full foreign ownership of their carriers.[365]

The Single Aviation Market (SAM) [366]

The Single Aviation Market concluded between Australia and New Zealand allows a SAM carrier i.e. a carrier at least 50% owned and controlled by Australian and /or New Zealand nationals with its head office and operational base in Australia or New Zealand, to operate air services with and between both countries but with the limit of beyond rights.[367]

Hong Kong - China[368]

The bilaterals involving Hong Kong China allows the airlines designated by Hong Kong China to be those which are incorporated and have their principal place of business in Hong Kong, China. The designated airline of

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[362] "*Australian Government to Ease Foreign Ownership Restrictions*" Aviation Daily (19th Aug. 1999) 3.
[363] *Supra* note 116; Chapter 5 at 12.
[364] "*ANZ Asks government To Lift Foreign Ownership Limits*" Aviation Daily 345:10 (16 July 2001) 5.
[365] *Supra* note 116; Chapter 2 at 3.
[366] *Australia-New Zealand Single Aviation Arrangement,* 1 November 1996, online: Australian Department of Foreign Affairs and Trade, http://www.dfat.gov.au/geo/new_zealand/sam.pdf
[367] *Supra* note 191.
[368] *Supra* note 360.

the other party to the bilateral may however by subjected to the traditional criterion.[369]

The 2001 APEC Agreement: Multilateral Agreement on the Liberalization of International Air Transport (MALIAT)-Kona Accord

The MALIAT was the first modern multilateral open skies agreement signed between the US, Brunei, Chile, New Zealand and Singapore in 2001. Later, Peru and Samoa and Tonga joined in 2004. Subsequently, Peru withdrew (signatories are from Asia, North and South America).The agreement permits the designated airline of a party to be one whose effective control is vested in the designating party and is incorporated and has its principal place of business in the territory of the designating party. The traditional criterion requirement is no longer a condition but the agreement protects against flags of convenience carriers. However, despite the fact that the agreement is open for ratification, many states have not signed it.[370]

There have also been other examples of some initiatives on liberalization of the traditional criterion on bilateral basis between two States on an ad hoc basis by accepting designated airline not meeting the traditional criterion and this has usually involved negotiations on *quid pro quo* basis.

Liberalization of Air Cargo services

In addition to the abovementioned regulatory regimes in the world related to passenger carriage, parallel initiatives have been made by ICAO through the air transport conferences[371] and OECD[372] for liberalization of air cargo services.

However, the progress on relaxation of the traditional criterion in respect of air cargo services by states has also not been monitored adequately to determine the progress.

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[369] *Supra* note 79.

[370] *Multilateral Agreement on the Liberalization of International Air Transportation,* (entered into force on 21 December 2001), online: State Department, http://www.maliat.govt.nz/agreement/index.shtml (date accessed: 24th July 2008).

[371] ICAO, Working Paper "*Liberalizing Air Cargo Services*" No. ATConf/5-WP/10 (13 Sept. 2002) 4.

[372] ICAO, Working Paper "*Liberalizing Air Cargo Services*" No. ATConf/5-WP/59 (12 Feb. 2003) 7.

World Trade Organization

The World Trade Organization (WTO) through the General Agreement on Trade and Services (GATS) is another available forum for multilateral liberalization of traffic rights and services associated with the traffic rights. At present, the annex on Air Transport to the GATS contains only three services (soft rights) namely aircraft repair and maintenance, selling and marketing of air transport and Computer Reservation Systems (CRS). Interestingly at present, traffic rights and related services (hard rights) are not included in the annex. The WTO and the council for trade in service are required to review the agreement and the annex respectively at prescribed periodicity for the possible further application of the agreement in air transport. The first review of the annex which ended in 2005 remained inconclusive on the subject. The second review of the annex is underway and no decision as yet been made for inclusion of hard rights.[373] Members of WTO are yet not ready for a shift from ICAO to WTO through GATS.

The WTO itself is a difficult forum to achieve global consensus on trade in services issues due to divergent economic interests of 153 member countries. A recent case of collapse of the current Doha Round of trade negotiations in the WTO in Geneva in July 2008 shows the formidable task of bringing 153 member states of the WTO on board and achieve consensus. The WTO was divided between rich and poor countries. In fact, the failure to agree in Geneva damages the credibility of the multilateral system and encourage regional and bilateral trade deals which are politically easier but economically less beneficial than a global deal as reported in the media. In this background of uncertainty, the ICAO must continue to shape and speed up the liberalization of the traditional criterion progressively.[374]

4.9 Way forward for the process of liberalization of traditional criterion

A review of initiatives undertaken so far to liberalize the traditional criterion in Part IV shows that some progress has been made under different

[373] WTO, Note by the Secretariat "*Second Review of the Air Transport Annex*" No. S/C/W/270 (18 July 2006).

[374] ICAO, Working Paper "*Development of Trade in Services*" No. AT-WP/1867 (13 Oct. 1999) 3.

frameworks in the recent past but it is still far short of expectations of the air transport industry. The industry is far from being normalized. The question that arises is what is the best way forward for the liberalization of the traditional criterion. States have different options for relaxation of the traditional criterion. These options include regulatory regimes evolved by the ICAO, the EU, the CARICOM, and others as discussed in the preceding paragraphs.

At present, the following options exist as the way forward for liberalization of the traditional criterion:

(i) Unilateral approach

A country decides unilaterally to fully liberalize the traditional criterion for its air carriers. Examples of such approach include Australia[375] for its domestic sector in 2000 and India for air cargo for international transport in 1990. This approach has inherent shortcoming. The designating State of an airline under unilateral approach faces an uncertainty of being rejected by its bilateral partners for not meeting the traditional criterion as agreed in their air service agreement. This, however, can be overcome by willing bilateral partners by including a flexible clause in their agreements at the time of their conclusion. For this reason, the unilateral approach may only really be open to countries with a significant domestic market.[376]

(ii) The bilateral approach

Two willing States partners to a bilateral air service agreement can agree to liberalize the traditional criterion in the ASA. This approach is also limited by the uncertainty of rejection of their designated air carriers by other bilateral partners or other States for not fulfilling the traditional criterion. Many States may not be willing to liberalize their traditional criterion in the interest of their national economy and development. This approach is feasible when a critical mass of like minded States are ready to relax their traditional criterion as the fear of uncertainty of designated air carriers in the third country is mitigated to a great extent. For example, the UK attempted bilateral approach through a Model ASA on the basis of principal place of business and effective regulatory oversight and encouraged many states to

[375] *Supra* note 191.
[376] *Supra* note 116; Chapter 5 at 12.

agree with the approach.[377] The UK was limited by the EU laws which require the community carrier to be majority owned and controlled by the EU nationals. It implies that even if other States agree with the approach of the UK, the UK can not reciprocate. Of course, this EU laws places a constraint on the EU members that they can not achieve the liberalization of the traditional criterion on a reciprocal basis with other non-EU States unless the EU laws are relaxed.[378]

(iii) The multilateral Open Aviation Area approach

Liberalization of the traditional criterion has occurred in the regional setting in the recent past in different parts of the world. The examples include the "community carrier" in CARICOM, Latin America and Africa. Another example is the EU "community carrier" approach. The EU approach is based on the development of the OAA and has been quite successful in applying the concept within ECAA due to legal and political support of the EU bloc. The EU also pursued to enlarge the ECAA and OAA to other States.[379] The ongoing OAA plus negotiations between the EU and US is one example. The multilateral OAA approach will be strengthened and successful as more and more States or partners join the OAA.[380]

(iv) The global trade approach

There are two systems available under this approach. One is ICAO regime which in the context of economic regulations of air transport has limited role only to issuing policy guidance material for States and also as a forum for debates on issues involved in air transport. The recent major initiative by ICAO was ATConf/5 of 2003 which drew several conclusions and made recommendations for progressive liberalization at State's own choice and chosen path and pace. The outcomes of the ATConf/5 have been assessed earlier in this Part.

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[377] *Supra* note 103.

[378] *Supra* note 116; Chapter 5 at 13.

[379] Switzerland applied for membership of the EU in 1992, but as a result of two negative referenda (on the EEA in 1992, and on the start of accession negotiations in 2001) the issue is on ice for the foreseeable future. Nevertheless, in 2004 the Swiss Parliament decided to maintain the application for membership, while the European Union maintains its position that the EU stays open for Switzerland to join.

[380] *Supra* note 116; Chapter 5 at 14.

The other alternative available is the WTO and GATS where at present only soft rights are included and addition of hard rights i.e. traffic rights is strongly resisted by many States and also the ICAO and has remained inconclusive.[381]The multilateral approach in the liberalization of the traditional criterion in the context of airlines industry through WTO and GATS is still far from consideration and will be less practical and very time consuming with uncertainty of outcomes.

(v) An International Multilateral Treaty for Exchange of Traffic Rights

If one goes back to the origin of the traditional criterion, one finds that the criterion does not figure in the Chicago Convention.[382] It finds expression in the agreement that was negotiated at the time of signing the Chicago Convention namely the International Air Services Transit Agreement. The traditional criterion subsequently appeared in Bermuda Agreement signed between the USA and the UK in 1946 and has thereafter appeared in all bilaterals signed by States all over the world.[383] So far, ICAO has followed a mild route of promoting liberalization of the traditional criterion through conferences that have no legal sanctity under the Chicago Convention. The results of various conferences are not binding on States. In this background, one way forward could be to renegotiate the IASTA with a view to remove the traditional criterion clause or provide an alternate helpful provision or alternatively ICAO can undertake an amendment of the Chicago Convention to provide a liberalized legal regime for the traditional criterion in the Chicago Convention itself. Both approaches are extremely complex and long drawn processes on which a global political consensus may be very difficult to build.

In view of the foregoing analysis, the unilateral and global approaches offer a very slow and incremental progress to the process. At present, either a bilateral approach with a critical mass of like-minded States will provide momentum to the process or a multilateral OAA type approach with like-minded States fulfilling safety and security requirements joining the OAA

[381] *Supra* note 116; Chapter 5 at 15.
[382] Ibid. at 4.
[383] *Supra* note 15.

are the possibilities offering good chances of success. Much will depend upon the success of the on-going negotiations between the EU and the US. The latter is already willing to expand the OAA to 60 nations by sweeping the "spider's web" of bilaterals.[384] That moment is eagerly awaited by the aviation community. The proactive role of the ICAO as a multilateral body for international civil aviation with very high acceptability amongst Member States is crucial in bringing about the required coordination and cooperation amongst like minded bilateral and/or multilateral OAA States.

[384] *Supra* note 357.

CONCLUSION

The time is ripe to usher in an era of a mature airline industry. A new regulatory arrangement has to be evolved in order to bring about a much needed change in the ownership and control criterion of designated airlines for the sake of bright future prospects of the airline industry. This is essential in order to provide the airlines with the commercial freedom missing conspicuously in their business. In the earlier days, the justifications for imposing national ownership and control on airlines were admissible. However, in modern times with the airline industry needing a desperate structural change, the system has to be abolished progressively. An overhauling of the regime will allow restructuring of the airline business on an international level in an era of liberalization and privatization. The thrust and focus is on the airline industry to taste the benefits from which it has been deprived of and shielded for decades. The airline industry deserves to charter its own destiny without government interference. The governments also have to do their bit to do away with the archaic bilateral system. It will all begin with the removal of ownership and control clause included in the bilateral air service agreements since that would allow the future global consolidation of airlines and herald a state of normalization of the industry.

The tumultuous times faced by airlines in the new millennium warrants a change of ownership and control regime with adequate safeguards. More than twenty airlines have already been folded up due to rising fuel costs in 2008. A sluggish economy, rising crude oil prices and a credit crunch have sounded the death-knell for many a carrier. In the face of all such troubles, consolidation of the industry is the only way out.[385] Consolidation is not only desirable but has become a necessity to address the urgent demand for foreign capital. One cannot predict the future but it is quite clear that airlines are low on confidence with even lower market capitalization and clearly under tremendous pressure. In order to avoid a grim future, tough decisions

[385] M. Glackin, "*Airline consolidation is the only route to survival* " (24th December, 2001) The Scotsman.

will have to be taken by the players and governments on a bilateral, multilateral and/or plurilateral basis.

However this is easier said than done for there have been calls for liberalization since the early nineties. Despite several initiatives and numerous attempts by international organizations and regional bodies and some States, marginal success has been achieved in the form of regional arrangements and a very low number of ASAs are operating with the liberalized ownership and control criterion. This is so because of inherent obstacles lying in the way of the acceptance of liberalized ownership and control criterion. The recent credit crunch and paucity of investors outside the industry to invest within the industry has been one of the prime reasons why a majority of airlines are operating under losses. Rising crude oil prices have only exacerbated the situation. Another reason is national security, a dominant preoccupation since September 11, which can be tackled with several initiatives to tie up all loose ends and secure the confidence of the government and the passengers alike. This thesis has mentioned various ways of addressing the safety and security concerns besides "flags of convenience" and "free rider" problem used by States and opponents not to liberalize the traditional criterion.

The success of the US-EU "Open Skies Plus" agreement's second stage negotiations, which deal with the relaxation of the ownership and control of airlines, will make or break the liberalization issue because transatlantic aviation market garners about 60 per cent of the world market. The US carriers are cash starved and in dire need of foreign capital. However, the skeptical employees would need to be coaxed and cajoled to see the bright side. The US politicians would oppose the agreement in order to protect the national interests but evidence suggests otherwise.[386] Despite the fierce opposition, it is an undeniable business truth and reality that airlines need the change and the US will probably push for the change in order to secure the interests of the industry in peril. If successful, it will become a model of change. The involvement of the US and the EU member States in the agreement, both developed countries and big aviation markets, will give the aviation world some level of confidence to embrace the liberal criterion

[386] *Ibid.* at Part III.

progressively through any of the approaches mentioned earlier.[387] Acceptance of the agreement must proceed with safeguards which have been discussed in various Parts of the thesis so that the airlines are protected from practical risks. Participation by more States in the OAA agreement will be necessary to make it successful on a global scale. Like-minded States may employ a model agreement based on the US-EU OAA model through regional, sub regional and bilateral approaches.

The thesis propagates the agenda for liberalization of the ownership and control criterion and suggests that the overhaul of the regime is the only way out for the airline industry. The airlines are aware of the benefits and keen on moving forward. However the governments seem to be dragging their feet on the matter due to sheer lack of political will. The thesis concludes that the ICAO holds the key and must take the bull by the horns and develop effective cooperation and aggressive coordination amongst like-minded States. ICAO should orchestrate the changes in the international treaties, if required, to facilitate liberalization of the traditional criterion and free the airlines industry by breaking the shackles of the traditional criterion. The aviation community in general and the airline industry in particular await that path-breaking moment when the airline industry will enjoy the winds of change.

[387] *Ibid.* at 111.

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