Foreign Investment in U.S. Airlines: Restrictive Law is Ripe for Change

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FOREIGN INVESTMENT IN U.S. AIRLINES: RESTRICTIVE LAW IS RIPE FOR CHANGE

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I. INTRODUCTION

In recent years, the twenty-five percent statutory cap on foreign voting equity in U.S. airlines has received much attention. Supporters of the cap claim it protects national security interests by limiting foreign control over U.S. air routes, and that it protects U.S. jobs by effectively preventing foreign airlines from absorbing the operations of domestic air carriers. Opponents claim it is overly protectionist and outdated, and unnecessarily prohibits U.S. airlines from tapping foreign sources of much-needed capital.

In its final report to the President and Congress, the National Commission to Ensure a Strong Competitive Airline Industry1 joined the fray:

We recommend [that the] Federal Aviation Act be amended to allow the U.S. to negotiate bilateral agreements2 that permit foreign investors to hold up to 49 per-

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1 The Commission's final report was released on August 19, 1993. The ninety-day Commission was established to study the U.S. airline industry and to provide recommendations on what the new administration can do to reform the industry. The Secretary of Transportation called the Commission "the policy vehicle for where we are going." Mead Jennings, U.S. Airline Policy is Still Up for Grabs, AIRLINE BUS., Sept. 1993, at 26.
2 International air routes are negotiated in bilateral treaties between the origin and destination countries. Liberal bilateral treaties place few limits on the flights and routings
cent voting equity in U.S. airlines, providing those bilateral agreements are liberal and contain equivalent opportunities for U.S. airlines; the foreign investor is not government-owned; there are reciprocal investment rights for U.S. airlines, and the investment will advance the national interest and the development of a liberal global regime for air services.  

The Commission's recommendation will certainly fuel the foreign ownership debate. This debate has intensified since the late 1980s because of large scale alliances between U.S. and foreign airlines, including links between Northwest Airlines and KLM Royal Dutch Airlines (KLM), and between USAir and British Airways (BA).

Deciding whether foreign investment in a U.S. airline will affect a carrier's U.S. citizenship is not, however, contingent merely on whether the current twenty-five percent foreign ownership cap is being met.  

The Civil Aeronautics Board (C.A.B.) and its successor, the Department of Transportation (D.O.T.), have interpreted the citizenship test of the Federal Aviation Act of 1958 as requiring two separate determinations. First, certain numerical standards must be met: Seventy-five percent of the airline's voting interest must be owned and controlled by U.S. citizens, and its president and two-thirds of its board of directors must also be U.S. citizens.  

Second, the structure of the investment deal is closely analyzed by the

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government to ensure that the foreign investor will not have the potential to directly or indirectly control the carrier. It is this "control" prong of the U.S. citizenship test that causes the most problems for foreign investors.

This paper examines the evolution of the U.S. air carrier citizenship test. Part I briefly explores the historical roots of the limits on foreign ownership. Part II traces the development of the law on foreign investment in U.S. airlines before the late 1980s when most citizenship cases involved non-airline foreigners investing in relatively small U.S. air carriers. Part III takes an in-depth look at the developments in the law since the late 1980s, when most citizenship cases involved major foreign air carriers investing in major U.S. airlines.

II. HISTORICAL BASIS OF AIRLINE OWNERSHIP RESTRICTIONS

Current law on foreign ownership of U.S. air carriers is based on the political thinking of the 1920s, 1930s and 1940s. As commercial aviation took shape in the mid-to-late 1920s, the first restrictions on foreign ownership of U.S. air carriers began to appear in congressional discussions. Congress "initiated the citizenship requirement to assure aircraft availability for national defense purposes." Members of Congress and the military "advocated government intervention in commercial air carrier development for the dual purpose of training a reserve corps of pilots and maintaining an auxiliary air force for United States military service during national emergencies." From these military concerns, they derived the need for citizenship requirements for air carriers, to prevent foreign control over an "auxiliary" of the country's military. The Air Com-

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8 Gjeret, supra note 7, at 181.

9 Id.
merce Act of 1926\textsuperscript{10} codified these rules, requiring air carriers to maintain fifty-one percent of voting stock under U.S. citizenship and a sixty-six and two-thirds percent U.S. citizen contingent on their board of directors.\textsuperscript{11}

Military protectionism was replaced by economic protectionism during the New Deal era in the 1930s. Calls for increased protection of the airline industry and for making airlines "a part of the commercial arm of the nation"\textsuperscript{12} were frequently heard. In response, the Civil Aeronautics Act of 1938\textsuperscript{13} increased from fifty-one percent to seventy-five percent the amount of an airline's voting stock that must be in U.S. hands for the carrier to be able to qualify as a U.S. operator.\textsuperscript{14}

The issues of foreign investment in and cross-border ownership of air carriers were first raised in multilateral discussions during the Chicago Convention of 1944.\textsuperscript{15} For the first time, a number of nations gathered together to establish international aviation accords.\textsuperscript{16} Since World War II was still underway, much talk of regulating airspace focused on national security concerns rather than economic protectionism. U.S. officials wanted to assure the safety of U.S. airspace from operations by enemy states.\textsuperscript{17} The United States sought the right to prohibit carriers from operating "if substantial ownership and effective control raised questions of a political nature or a threat to national security."\textsuperscript{18} Germany and Italy were the main targets of these sentiments, particularly because they had extensive ties to Latin American airlines operating within the U.S. sphere of influence. Latin American countries, however, benefitted from large foreign investments in their carriers, including investments by Pan

\textsuperscript{11} Id.
\textsuperscript{12} Aviation: Hearing on H.R. 5234 and H.R. 4652 Before the Comm. on Interstate and Foreign Commerce, 75th Cong., 1st Sess. 72 (1937) quoted in Gjerset, supra note 7, at 183.
\textsuperscript{14} Id.
\textsuperscript{15} Dr. Marc L.J. Dierikx, Bermuda Bias: Substantial Ownership and Effective Control 45 Years On, 16 AIR L. 118, 119 (1991).
\textsuperscript{16} Windle Turley, AVIATION LITIGATION, § 6.05 (1986).
\textsuperscript{17} Dierikx, supra note 15, at 119.
\textsuperscript{18} Id.
Am and TWA, and successfully opposed the inclusion of foreign ownership restrictions in the Chicago Convention.

The Bermuda Convention of 1946, held between the United States and the United Kingdom to negotiate a bilateral aviation route accord, marked the first time language for ownership and effective control of air carriers was articulated in a treaty. Unfortunately, the wording of the applicable provision in the Bermuda Agreement was vague and subject to various interpretations. The United States interpreted it as a political control against ownership by ex-enemy states; the United Kingdom viewed it as an economic shield preventing aviation from falling under the control of a few countries. In subsequent discussions on the meaning of this provision, both governments concluded that it allowed either government to limit or prevent a foreign owned carrier from operating between the two countries. Apparently, the United Kingdom and the United States did not want to preclude cross-ownership in international civil aviation, but simply wanted veto power in the event that they believed their political and/or economic interests were being violated.

By the early 1950s, however, the United States and other nations began to narrow their interpretations of citizenship restrictions on air carrier owners. The United States felt particularly uncomfortable about the prospect of granting rights to a country that would subsequently become unfriendly to the United States. This stance grew out of the Cold War and uncertainties surrounding countries susceptible to a growing Communist influence. In response to these fears, the United States and the United Kingdom set forth a new interpretation of the Bermuda Agreement “emphasizing a re-

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19 Id. at 120.
20 Id. at 121.
21 “Each Contracting Party reserves the right to withhold or revoke the exercise of the rights specified in the Annex to this Agreement by a carrier designated by the other Contracting Party in the event that it is not satisfied that substantial ownership and effective control of such carriers are vested in nationals of either Contracting Party . . . .” Id. at 121, note 11 (alteration in original).
22 Id.
23 Id. at 123.
24 Id. at 122.
25 Id. at 123.
strictive interpretation of substantial ownership and effective control, based on the political realm of East-West relations."^{26}

The Federal Aviation Act of 1958^{27} replaced the Civil Aeronautics Act of 1938, maintaining the twenty-five percent limit on voting control of a foreign investor in a U.S. carrier.^{28} The Federal Aviation Act's twenty-five percent cap on foreign voting equity in U.S. airlines is still in effect today.

III. CASE PRECEDENT BEFORE THE LATE 1980S

The Civil Aeronautics Board (C.A.B) and the Department of Transportation (D.O.T.) have decided each citizenship case on the basis of its particular facts.^{29} The D.O.T. has stated that by simply meeting the percentage requirements of the Federal Aviation Act, an airline still may not qualify for U.S. citizenship if foreign nationals control the airline through the ownership of non-voting stock, debt, or other means.^{30}

An early test of the Federal Aviation Act's foreign ownership rule came in 1971 with the application of the Interamerican Airfreight Company to the C.A.B. for a U.S. permit.^{31} Willye Peter Daetwyler, a Swiss citizen, owned twenty-five percent of the voting stock of the Interamerican Airfreight Company, which he had formed.^{32} Daetwyler also represented one-third of the company's board of directors. The other key players in the company (share-
holders, directors, and officers), though United States citizens, were also employees of other companies wholly owned by Daetwyler.\(^{58}\)

The C.A.B. looked beyond the mere ownership percentages in Interamerican Airfreight in attempting to determine whether the carrier could be certified as a U.S. citizen. The Board found that the relationship that existed between Daetwyler and the other members of the corporation would allow him to exert too much control over the carrier. The Board stated that the carrier would in fact be doing business as part of Daetwyler's other companies.\(^{54}\) On paper the transaction appeared to fall within the requirements of the law; the Board, however, denied the Interamerican Airfreight Company a U.S. operating permit because of its substantial links with a foreign national.

The C.A.B.'s restrictive stance toward foreign investments in U.S. air carriers continued through the 1980 application of Silvas Air Lines, Inc. for U.S. carrier certification.\(^{55}\) Silvas' application was denied because of a foreign investor's veto power over loan disbursements. Although the foreign investor owned only twenty-five percent of the voting stock, the Board found that his requirement of specific approval on fund disbursement from a loan he made to the carrier amounted to actual control of the carrier.\(^{56}\) In the 1982 *Premiere Airlines Fitness Investigation*,\(^{37}\) the C.A.B. approved a carrier's application for U.S. citizen certification only after one of its co-founders resigned from the carrier's management and board of directors.\(^{58}\) Though a U.S. citizen, this individual had borrowed money for the establishment of the company from his employer, a Saudi Arabian citizen.\(^{59}\) The Board held that as a result, the Saudi Arabian citizen was in a position "to exert overriding influence and control" over his employee, and therefore the carrier.\(^{40}\) Once the co-founder was removed from any influential posts in the corporation,

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\(^{58}\) *Id.* at 128-129.
\(^{54}\) *Id.* at 131-133.
\(^{36}\) *Id.* at 14,183.
\(^{37}\) Premiere Airlines, Fitness Investigation, C.A.B. Order No. 82-5-11 (1982).
\(^{58}\) *Id.* at 3.
\(^{59}\) *Id.* at 2.
\(^{40}\) *Id.*
the C.A.B. found that the investor’s influence was also removed, and U.S. citizenship requirements were met.

In *In re Page Avjet Corp.*, the Board initially found that Page did not meet the Federal Aviation Act’s citizenship requirements because a foreign investor held one hundred percent of the carrier’s non-voting stock, although his ownership of voting stock was within the requisite limits. The C.A.B. determined that as the company was structured, the non-voting stock gave the foreign investor the power to block a merger, consolidation, liquidation, and other major company actions, thereby allowing him to control the company. However, when the carrier established a buy-out provision where the voting shareholders could buy back the non-voting shares if they blocked a corporate action, the Board found the citizenship requirements had been met.

In *In the Matter of Intera Arctic Services, Inc.* in 1987, the D.O.T. (which by then had replaced the C.A.B.) reiterated its position that mere compliance with the ownership percentage limits does not necessarily establish that an air carrier is not under foreign control. The D.O.T. cited several points in refusing to certify Intera Arctic Services as a U.S. carrier. These included the fact that foreign interests would receive most of the carrier’s profits or assets in a liquidation and that two of Intera Arctic’s directors, who together owned seventy-five percent of the company’s voting stock, were also directors of a foreign carrier which was obtaining an interest in Intera Arctic. The D.O.T. found that foreign interests would essentially be running the carrier under these arrangements and therefore denied U.S. certification.

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42 *Id.* at 1.
45 *Id.* at 14,712.
46 *Id.*
IV. CASE PRECEDENT SINCE THE LATE 1980S

A. The Economic Climate

In the late 1980s and early 1990s, conditions in the United States and abroad favored large-scale cross-border airline alliances, which until then had been almost unheard of.\textsuperscript{47}

In the United States, a deepening recession, the Persian Gulf War, sky-rocketing labor costs, and fierce fare wars had contributed to the deterioration of the financial health of the airline industry. Between 1989 and 1992, the industry lost $10 billion.\textsuperscript{48} Although the “Big Three” U.S. carriers (United, American, and Delta) experienced record losses, the second tier of smaller U.S. airlines found itself in dire straits. Eastern, Pan Am, and Midway were liquidated, the bankruptcy cases of Continental, TWA, and America West dragged on, and Northwest and USAir experienced severe financial difficulties.

At the same time overseas, particularly in Europe, airlines were looking for ways to compete on an equal footing with the growth of the Big Three. Having secured their supremacy in the U.S. domestic market,\textsuperscript{49} by 1989 the Big Three began to purchase the international routes of their ailing domestic rivals in a bid for global dominance.\textsuperscript{50} The Big Three’s combined share of transatlantic traffic went from 3% a decade earlier to 69% in 1992, with each carrying

\textsuperscript{47} Marketing alliances between U.S. and foreign airlines also became popular, but do not raise the citizenship issue because they include little, if any, equity investment. Such agreements have been reached between Delta and Swissair (July, 1989), Delta and Singapore Airlines (October, 1989), Continental and Air France (July, 1993), United and Lufthansa German Airlines (October, 1993), and others. Marketing alliances typically involve merged frequent flyer programs, schedule coordination for cross-feeding of passengers, and some code sharing (see infra note 85). See generally Tom Eblen, \textit{Asian Carrier and Delta OK Marketing Deal, ATLANTA J.}, Oct. 27, 1989; \textit{U.S., France Forge Link, AVIATION WK. & SPACE TECH.}, Aug. 2, 1993, at 39; Robert L. Rose and Bridget O’Brien, \textit{United, Lufthansa Form Marketing Tie, Dealing a Setback to American Airlines}, \textit{WALL ST. J.}, Oct. 4, 1993, at A4.\textsuperscript{48}

\textsuperscript{48} Irwin M. Stelzer, \textit{Airlines’ Wisdom of ’80s Didn’t Get Off the Ground}, \textit{BOSTON HERALD}, Apr. 5, 1993, at 33.\textsuperscript{49}

\textsuperscript{49} The Big Three increased their combined share of the U.S. domestic market from 38% in 1982 to 60% in 1992. Janice Castro, \textit{Air Wars}, \textit{TIME}, Nov. 23, 1992, at 38, 47.\textsuperscript{50}

\textsuperscript{50} \textit{Id.} United purchased Pan Am’s Latin American route network and Pan Am’s U.S. to London Heathrow routes, growing from no European service in 1989 to service to fifteen cities in nine countries by 1993. American purchased TWA’s routes from three U.S. gate-
more passengers in 1992 than the entire European commercial fleet combined. While European carriers had hubs in their own countries that they used to connect local passengers to their U.S.-bound transatlantic flights, they could in no way compare to the huge U.S. hubs that the Big Three used to feed transatlantic flights. After all, the U.S. domestic market represented over forty percent of the world’s airline traffic. Restrictive aviation treaties, however, prohibited foreign airlines from creating domestic hub systems in the U.S. Only by aligning themselves with an already established U.S. airline could foreign airlines connect the vast U.S. traffic base to their own transatlantic flights.

Consequently, by the late 1980s, the weaker U.S. carriers, desperate for capital, and foreign airlines, seeking ways to combat the international expansion of the Big Three, suddenly discovered that they could work well together. They began to forge alliances that tested the limits of U.S. laws on foreign ownership. In applying the citizenship test to these cases, the Department of Transportation continued to look beyond mere ownership percentages, closely studying the terms of the investment deal to determine whether they directly or indirectly gave the foreign airline effective control over the key activities of the U.S. carrier.

B. Northwest and KLM

The test case for a major foreign airline investment in a major U.S. airline occurred in 1989 when KLM sought to participate in Alfred Checchi’s leveraged buy out of Northwest Airlines, the United States’ fourth largest carrier. As initially structured, the deal provided for KLM to contribute 56.75% ($400 million) of the equity in Northwest’s new holding company (Wings Holdings). This amount represented non-voting stock. As part of its investment, KLM also had the right to name a three-person committee to advise...
Northwest on the management of its financial affairs. There were no restrictions placed on the extent of the advice or the power wielded by this committee.

The D.O.T. found both the equity and financial committee provisions of the deal to be in violation of the control prong of the Federal Aviation Act's citizenship test. The D.O.T. ruled that as structured, the deal would allow KLM to be "in a position to exercise control over Northwest, and that the latter would thereby cease to be a U.S. citizen for the purposes of the Federal Aviation Act." The D.O.T. stated that KLM's stock in Wings, though non-voting, was equity representing a genuine ownership interest. Because of the large dollar investment, KLM would be inclined to oversee Northwest's decisions closely, and would have a high incentive to participate in the airline's business decisions. The D.O.T. stated that KLM would be able to exert substantial control over Northwest by preventing the issuance by Wings of securities for purposes of liquidation, dissolution, or dividends. KLM could also block any amendments to the Certificates of Incorporation or Designation that would "materially and adversely affect the specified designations, preferences, or special right of its preferred stock." As to KLM's power to appoint a three-person financial committee, the D.O.T. felt that it would give KLM influence over senior management on matters concerning the airline's financial affairs which could extend throughout the company.

The D.O.T. stated that it would adhere to stricter scrutiny in cases where a foreign investor in a U.S. carrier is an airline, since "if that foreign carrier is also an actual or potential competitor, it may well have an interest in attempting to exercise control over the U.S. carrier..." Ultimately, the D.O.T. issued a consent order requiring KLM's interest in Northwest to be limited to twenty-five percent of equity and that the financial advisory committee be elimi-
nated. The D.O.T. also required the recusal of KLM’s Wings board member from certain sensitive board responsibilities.\textsuperscript{60}

A year later, Northwest applied to the D.O.T. for the relaxation of the terms of the D.O.T.’s 1989 consent order for the Northwest/KLM transaction. Still in need of cash, Northwest asked for permission to allow KLM to increase its non-voting equity ownership of Wings to forty-nine percent and to permit KLM to designate three members of the Wings board of directors, which was being increased from twelve to fifteen members.\textsuperscript{61}

The D.O.T., perhaps surprisingly, granted both of these requests. It stated that it had reassessed “the complexities of today’s corporate and financial environment,” and had reexamined “the relationship between nonvoting equity/debt and control in light of our recent experience in this area, and our observations of who controls Northwest since the Wings acquisition.”\textsuperscript{62}

With respect to Northwest’s request that KLM be allowed to increase its non-voting equity to forty-nine percent, the D.O.T. undertook a detailed review of who was actually in charge of the operations at Northwest. The D.O.T. concluded that the Checchi group held the key positions in the company and made all the important managerial decisions.\textsuperscript{63} The D.O.T. said “we see no potential for the foreign interest represented by KLM to exert control. . . .”\textsuperscript{64} Similarly, the D.O.T. believed that the increase in the number of directors on the board would preclude foreign control of the airline. The D.O.T. stated that the chairman could not be a foreign citizen, that subcommittees of the board must have their KLM membership limited, and it extended to all KLM representatives on the Wings board the recusal requirements on certain board issues that it imposed in the earlier consent order.\textsuperscript{65} However, the D.O.T. stressed that the underlying foundation of its favorable attitude toward

\textsuperscript{60} Id. at 15,163. KLM’s representation on the board of directors was restricted with respect to access to information and involvement in competitively sensitive matters being considered by Northwest. Id. at 15,160.

\textsuperscript{61} In the Matter of the Acquisition of Northwest Airlines, Inc. by Wings Holdings, Inc., Order No. 91-1-41, 1991 WL 247884 (D.O.T.) at *3.

\textsuperscript{62} Id. at *5.

\textsuperscript{63} Id.

\textsuperscript{64} Id.

\textsuperscript{65} Id. at *7. See supra note 60.
Northwest's requests was the liberal bilateral agreement in place between the United States and the Netherlands.\(^6\)

While taking a more expansive view of foreign ownership of U.S. airline non-voting equity, the D.O.T. emphasized that the twenty-five percent limit on voting stock is still good law. It stressed that increased membership of foreign nationals on Wings' board was acceptable as long as they exerted no influence on key decisions or day-to-day management of the firm. Additionally, in emphasizing the importance of the Netherlands' liberal aviation policy in its decision to relax the restrictions on KLM's investment in Northwest, the United States was for the first time linking freer foreign investment to freer international route rights.

In 1992, the D.O.T. went one step further when it officially defined "Open Skies" agreements (in which two nations drop all aviation restrictions between them) and solicited foreign nations to enter into such agreements with the United States.\(^6\) The United States promised to provide antitrust immunity to foreign carriers who wished to combine services with a U.S. carrier, if their home countries signed Open Skies agreements with the United States.\(^8\)

The Netherlands rushed to be the first country to reach such an accord with the United States.\(^6\) Shortly thereafter, the D.O.T. approved Northwest and KLM's request to merge functions and to act as one airline, cooperating in "crucial" areas such as pricing and strategy,\(^7\) and granted KLM and Northwest antitrust immunity. It

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\(^7\) The U.S. defined Open Skies according to the following criteria: 1) Open entry on all routes; 2) Unrestricted route and traffic rights; 3) Liberalized price setting; 4) Liberal charter arrangements; 5) Liberal cargo regime; 6) Prompt conversion of earnings to hard currency and prompt remission to homeland; 7) Open code sharing; 8) Rights to control airport functions; 9) Pro-competitive provisions on commercial opportunities; and 10) Non-discriminatory operation and access for computer reservation systems. *See* Mead Jennings, *Defining an Open Skies Concept*, *Airline Bus.*, Sept. 1992, at 129.

\(^8\) *Id.*


\(^7\) Agis Salpukas, *U.S. Backs Merger of Northwest Air and Dutch Carrier*, *N.Y. Times*, Nov. 17, 1992, at A1. The airlines also planned to create a joint identity by "operating under the same trademark and using the same branding for aircraft exteriors and interiors, uniforms, vehicles, and stationery." *Id.* at C3.
was the first time that a foreign and a domestic carrier "would have the ability to function as one carrier even though legally they would remain separate companies."\(^{71}\)

### C. Continental and SAS

During the summer of 1990, Scandinavian Airlines System (SAS) proposed to increase its nominal holdings in Continental Airlines (the nation's fifth largest airline) to 16.8% of common equity, representing 18.4% of voting power.\(^{72}\) SAS would also hold three of the fifteen seats on Continental's holding company's board of directors.\(^{73}\) Paying special attention to the D.O.T.'s *Northwest* ruling, the Continental/SAS agreement limited the power SAS' board members would have over decisions being made at Continental.\(^{74}\) The D.O.T. approved the plan, concluding that "SAS does not have a sufficient stake to direct the affairs of the company, nor can it exercise a veto over corporate actions. Also, the dollar value of the SAS acquisition is not so large as to raise concerns that, by reason of the sheer size of its cash infusion, SAS could exercise control."\(^{75}\)

### D. USAir and British Airways

In 1992, British Airways (BA) announced plans to invest $750 million in cash in USAir, the sixth largest airline in the United States, in exchange for forty-four percent of USAir's common equity and twenty-one percent of USAir's voting stock.\(^{76}\) This proposal

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\(^{71}\)*Id.* at A1. It was hoped that this step would strengthen the alliance, which until then had been a "tremendous profit drain for KLM and [had] yielded little in synergies." See Keith L. Alexander and Seth Payne, *USAir: This 'Dog' May Be Having Its Day*, Bus. Wk., June 21, 1993, at 74, 76.

\(^{72}\)*Id.* at A1.


\(^{74}\)*Id.* at 15,403.

\(^{75}\)The D.O.T. looked favorably upon these self-imposed limitations on SAS' directors. The limitations included limiting membership on the Continental Holdings Board's Nominating and Executive Committees to only one SAS director. *Id.* at 15,405.

\(^{76}\)*Id.* at 15,404.

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immediately attracted much attention, because of its high dollar value and because BA was already one of the largest international airlines in the world.

The airline resulting from the combination of USAir and British Airways would have ranked first in the world in destinations served (linking three hundred thirty-nine destinations in seventy-one countries) and third in revenue passenger miles (RPMs) (behind American and United).77 BA and USAir planned to integrate operations under a global master brand, with three regional sub-brands: Intercontinental, North America, and Europe.78 The deal would have given British Airways direct access to U.S. domestic travelers, via USAir flights,79 particularly in USAir's east coast stronghold, where two-thirds of U.S. transatlantic journeys originate.80 The deal would have also given USAir access to BA's valuable international traffic. Having lost $973 million since 1989, it was unclear whether USAir had a viable future without a foreign partner.81

The Big Three U.S. carriers and Federal Express assembled an unprecedented unified opposition front against the deal,82 calling it

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77 Castro, supra note 49, at 38, 47. Revenue passenger miles is the gauge used by airlines to measure traffic.
79 The practice of cabotage, when a foreign carrier flies within another country's domestic market, is prohibited by U.S. law. But by linking up with USAir, BA would gain access to U.S. domestic markets via USAir's own flights. See infra note 85 on code sharing.
81 Castro, supra note 49, at 47. Analysts differed as to whether USAir's domestic system was viable in the long run without a foreign partner. Key strategic purchases beginning in 1991, including the Trump Shuttle, New York LaGuardia takeoff and landing slots and terminal space, combined with a focus on "Big East" flying out of New York, Boston, and Washington National's business markets, and wage concessions were seen as positive steps. See James T. McKenna, USAir Expands Northeast Service in Effort to Regain Profitability, AVIATION Wk. & SPACE TECH., Jan. 27, 1992, at 58.
82 The United Kingdom and the United States had widely divergent points of view with regard to BA's proposal. United Kingdom: "If any [U.K. airline] wants to put money into a U.S. carrier, the U.S. air transport industry should be grateful. It's a bit rich asking for concessions." United States: "A BA stake in USAir is seen as a 'Trojan horse' approach to obtaining full U.S. cabotage rights." Mead Jennings, BA Stakes Out USAir, AIRLINE BUS., Aug. 1992, at 10.
"tantamount to unilateral economic disarmament." Their main point of contention was that as a result of the deal, British Airways would be given access to the riches of the U.S. market through USAir, while U.S. carriers would still be locked out of the United Kingdom since its bilateral aviation agreement with the U.S. was extremely restrictive. The Big Three claimed that since British Airways would be able to combine operations with USAir, it would be the only carrier with gateways on both sides of the Atlantic, and it would have a monopoly on 8,000 origin and destination markets in which U.S. carriers could not compete. For example, only BA/USAir would be able to provide single carrier service between San Diego and Nairobi, Denver and Capetown, Austin and Riyadh or Indianapolis and Dhaka, Bangladesh. The Big Three predicted that they would lose "about $500 million within a few years" if the deal were approved. Opponents of the proposal also contended that once inside the United States, the British would lose all incentive to negotiate for Open Skies.

The U.S. carriers demanded that the U.S. government seek concessions from the British in return for approval of the deal:

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86 While still separate companies, BA and USAir would "code share." That means that in its reservations system, BA would be able to sell trips with connections to USAir flights under the BA code instead of the USAir code. This would allow passengers to make connections between the two airlines without having the sense that they are switching between carriers. (Most agree that passengers overwhelmingly prefer to stay on the same airline when they are making connections. Robert L. Crandall, *Open Skies for BA and KLM if for U.S. Airlines Too, WALL ST. J.*, Sept. 23, 1992, at A14.) Code sharing would therefore have the effect of steering passengers away from competitors and feeding them between BA and USAir in their combined system. Castro, supra note 49, at 47.


86 To this last example, a USAir senior official countered that traffic in that city pair is only two people per month, i.e. negligible. Bill Poling, *United, American Spar with USAir, BA Over Proposed Deal, TRAVEL WkLY.*, Nov. 12, 1992, at 49.


86 Crandall, supra note 85.
"When British Airways and the U.K. government are ready to give U.S. carriers the same rights in British Airways markets that British Airways seeks in U.S. markets, we will withdraw all objections to [the] proposed investment." However, at least one U.S. carrier, American Airlines, indicated that gaining access to the domestic U.K. market or even the larger intra-European Community (EC) market was not a fair trade. American cited the strength of Europe's ground transportation network, the lack of acceptable facilities to sustain high frequency traffic at European airports, and the fact that only ten to twelve percent of the world market belongs to the EC (versus over forty percent for the United States) as reasons why U.K. or EC access would not be a fair trade. American was more interested in gaining rights to fly from London to Nairobi, South Africa, and other lucrative long haul destinations. U.S. carriers also wanted the right to buy into U.K. airlines as BA was able to buy into USAir. Under current EC rules, a U.S. carrier cannot buy into a U.K. carrier and have the level of control that BA had built into the USAir deal.

Apart from the tremendous opposition to the deal from the Big Three, its structure presented several problems vis a vis the control prong of the U.S. citizenship test. The percentages of USAir equity and voting stock BA sought to acquire clearly fell within the limits set forth by U.S. law. BA and USAir officials admitted that if it were not for these limits, they would have discussed a merger instead of an alliance. A major roadblock to the deal, however, proved to be a super majority provision that gave BA four seats on USAir's sixteen member board. Major decisions had to be approved by eighty percent of the board, giving BA effective veto power over aircraft acquisitions, the appointment and salaries of key officers, operating and capital budgets, and spending of more than $10 mil-

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92 Id.
93 Id.
94 Id.
96 Christopher P. Fotos, American, Delta to Fight USAir Pact if British Fail to Offer Concessions, AVIATION WK. & SPACE TECH., Aug. 10, 1992, at 32.
Adding fuel to the fire, British Airways called this part of the deal "non-negotiable." The provisions of the investment proposal gave British Airways the potential to effectively control USAir, much like the provisions of the original Northwest/KLM plan gave KLM too much control of Northwest. Realizing that the deal could be rejected by the D.O.T., in a last ditch effort to get it approved, the British government accelerated talks with the United States to liberalize the U.K.-U.S. bilateral aviation treaty. The Netherlands had just signed an Open Skies pact with the United States, leading to the immediate approval of KLM's plan to fully integrate its operations with Northwest, and the U.S. indicated that similar action by the U.K. would lead to approval of the BA/USAir proposal.

The negotiations, however, were not successful. The United Kingdom refused to drop protectionist barriers on U.S. carrier access to London, the most desirable destination in Britain. In the face of certain rejection by the United States, British Airways withdrew its investment proposal. The United States had, at least informally, established a "new litmus test for cross-border investments when management control of an airline comes into question . . . [: t]he U.S. will now require an Open Skies agreement with the foreign airline's government."

One month after the withdrawal of its $750 million proposal, British Airways in early 1993 announced a revised proposal to invest $300 million in USAir. In return for its investment, BA would receive three seats on USAir's sixteen member board, 24.6% of total equity, and a 21.8% voting stock share. Also, BA and USAir

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98 BA’s chief executive, Sir Colin Marshall, has stated “You couldn’t possibly invest $750 million in an airline and not have that kind of control so that you can veto certain financial investments.” Kevin O'Toole, BA Insists on USAir Boardroom Veto, FLIGHT INT'L, Nov. 25-Dec. 1, 1992, at 8.
100 James Ott, U.S. Sets Litmus Test for Foreign Investments, AVIATION WK. & SPACE TECH., Jan. 4, 1993 at 30.
101 BA Invests $300 Million in USAir, AVIATION WK. & SPACE TECH., Jan. 25, 1993 at 31.
102 Id.
would consummate a plan similar to the earlier proposal whereby both carriers would integrate their services, feeding each other's flights to and from thirty-eight U.S. cities by the end of 1993, and up to eighty U.S. cities and towns by the end of 1995. The new deal included an option for further investment by BA of $450 million in USAir by 1998 under the terms of the earlier proposal if U.S. government approval could be obtained.

To the consternation of the Big Three, BA's new proposal did not violate the control prong of the U.S. citizenship test. The level of control that BA had built into its new deal was substantially less than that set forth by the super majority provisions of the defeated proposal. As a result, the D.O.T. approved the investment. But it limited its approval of the duration of the cooperative operations between the two carriers to one year, pending the consummation of a liberal aviation pact between the United States and the United Kingdom. The Secretary of Transportation described his tentative approval as “the hook” for drawing the British into an Open Skies agreement with the United States: “My objective is to use [the BA-USAir proposal] as a vehicle in rewriting the current bilateral agreement with [the United Kingdom].”

E. Continental and Air Canada

Despite capital infusions from SAS, by 1992 Continental Airlines was in bankruptcy, searching for new investors to bail it out. Air Canada proposed to inject $450 million in Continental in exchange for 27.5% of the reorganized Continental’s equity and 24%
Air Canada's partners in the deal, Air Partners L.P., a Fort Worth investment group, would acquire 27.5% of Continental's equity and 41% of the voting stock. Air Canada's bid for Continental won over competing bids by Aeromexico and a Houston investor, and a withdrawn bid by Lufthansa German Airlines and Marvin Davis.

Air Canada's investment team worked closely with D.O.T. officials to structure their investment deal within the requirements of U.S. air carrier citizenship law. Super majority provisions were eliminated to avoid the problems of the first BA/USAir proposal. Because Air Canada's partner was a major U.S. investment group and the U.S.-Canada bilateral relationship was less offensive than the U.S.-U.K. relationship, the control prong of the U.S. citizenship test was not violated and the D.O.T. ultimately approved Air Canada's proposal.

The Air Canada/Continental deal did not attract as much attention as the BA/USAir proposal, because "the Canadian market [was] not as hotly pursued as the destinations involved" in the latter. Through the alliance, Air Canada gained access to Continental's U.S. traffic base, particularly its Newark hub, although the U.S.-Canada agreement does not allow code sharing to the great extent of the U.S.-U.K. agreement. Besides coordinating schedules, Continental and Air Canada planned to share computer tech-

107 Id. at 27.
111 Id.
112 David A. Brown, Continental Board to Name Winning Bid, AVIATION WK. & SPACE TECH., Nov. 9, 1992 at 34.
113 Mead Jennings, One Flew East, One Flew West, AIRLINE BUS., Feb. 1993, at 21.
114 Id.
115 Id.
116 Castro, supra note 49, at 47.
118 Continental Accepts Bid from Investors, TRAVEL WKLY., Nov. 12, 1992, at 4. Air Canada's chairman had stated that gaining a larger share of U.S.-Canada traffic was one of his most important objectives. See Christopher J. Chipello, Midsize Air Canada Plots Survival in Industry of Giants, WALL ST. J., Nov. 12, 1992, at B4. During its partnership with SAS, Continental and SAS fed each other four hundred passengers a day at Newark. See Continental Accepts Bid from Investors, TRAVEL WKLY., Nov. 12, 1992, at 4.
nology\textsuperscript{118} and Air Canada hoped to win some of Continental's maintenance contracts.\textsuperscript{120} For Continental, the agreement meant the end of Chapter 11 bankruptcy, and increased access to Canadian passengers.

V. CONCLUSION

The national security concerns of the 1950s that underlaid the 1958 Federal Aviation Act's foreign ownership restrictions are no longer valid. The U.S. government's primary goals today should be to protect U.S. economic interests at home and abroad, by permitting U.S. carriers to benefit from foreign capital and expanded international route rights.

The recommendation of the Commission to Ensure a Strong Competitive Airline Industry, advocating an increase in the foreign investor voting equity cap to forty-nine percent, would further these goals. Requiring that a country enact a liberal bilateral aviation treaty with the United States in exchange for the higher equity cap would assure that U.S. carriers receive rights abroad commensurate with the benefits a U.S. carrier would give a foreign forty-nine percent shareholder.

If Congress does change the numerical standards of the citizenship test, however, the D.O.T. will have to loosen the control prong of the test as well. The acceptable level of control should be in line with that of a large (forty-nine percent) rather than a small (twenty-five percent) minority owner. It is difficult to imagine a situation in which an investor would agree to buy forty-nine percent of a corporation, but have no say in its major operating decisions.

Without a change in the control prong of the citizenship test, the original BA/USAir proposal that permitted BA's representatives on USAir's board to block major decisions would still be illegal. Even KLM, which has been given permission to operate jointly with Northwest in every way, would continue to be prohibited from having a say in Northwest's day-to-day operations.


The debate on foreign investment in U.S. airlines will not end soon. It is likely that the current administration will pursue the Commission to Ensure a Strong Competitive Airline Industry's recommendation through Congress. Discussions between the United States and the United Kingdom on an Open Skies agreement will continue, and the result of those talks may have a significant effect on future U.S. government policy on foreign investment in the U.S. airline industry. In the meantime, U.S. air carriers will continue to court foreign airlines, further eroding the global airline industry's economic and political boundaries.

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