



**COMMENTARY**

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*This Commentary is based on a presentation by Institute Director Brian Havel at the Institute of Economic Affairs' 13<sup>th</sup> Annual Conference, "The Future of Air Transport," in London on November 29, 2005. Professor Havel was responding to presentations by Ludolf van Hasselt, Head of Unit, Air Transport Policy, Economic Regulation & Multilateral Relations, European Commission, and Paul Gretch, Director, Office of International Aviation, U.S. Department of Transportation. Mr. van Hasselt and Mr. Gretch, respectively, outlined the framework of the proposed US/EU open skies agreement currently under negotiation, and the Notice of Proposed Rule-Making initiated by the Department of Transportation to relax the criteria by which foreign control over US airlines is assessed in the Department's financial fitness reviews.*

I. Introduction

In principle, the airline industry in the United States (US) was deregulated in 1978, and the deregulation of the industry in the European Union (EU) was complete with the final elimination of intra-Union cabotage restrictions on April 1, 1997. The reality, however, is that access to international capital markets remains subject not only to restrictive regulation, but to an anachronistic procedure that continues to require airlines in the US and EU to pass a citizenship purity test.

It has become clear that deregulation of the global airline industry requires dismantling the citizenship test which appears both in bilateral air transport treaties (whereby each party requires that the other party's airlines must be majority owned and effectively controlled by the other party's citizens), and under similarly-minded domestic laws (requiring citizens to own and control the State's airlines). The EU test has been broadened to allow citizens of any of the 25 EU members (and of a few other affiliated States) to own and control an EU airline, but the test remains in place for relations with most non-EU States.

The result of this "double lock" (international and national law operating together) is that airlines have aircraft which fly internationally, but the airline industry is not genuinely a global one. There is not even a single global competitor in the international air transport industry. Airlines

have managed to construct alliances (using consumer-unfriendly devices such as code-sharing), but those alliances would probably wither rapidly if genuine transborder mergers and acquisitions could occur. As Leo van Wijk, chairman of KLM, has remarked, “if a rule of similar effect existed in Hollywood, we would still be watching silent movies.”

Thus, the airline industry has an exceptional status in global commerce as a result of, among other special regulatory features, the ironic persistence of the citizenship rule in the era of the global shareholder. While this exceptional status has clear downsides, it has also allowed the industry to negotiate its future as an industry apart, freed from the cross-sectoral bartering that other industries must confront in fora such as the World Trade Organization. Thus, the current US/EU open skies negotiations actually reflect the positive side of the airline industry’s exceptionalism, and must be welcomed for their scope and for the expectation of regime change that they invite. Arguably, these negotiations could result in changes every bit as significant as those caused by US domestic deregulation after 1978.

## II. The New US/EU Agreement

Most of the provisions of the current US/EU draft agreement, frankly, are not startling. The draft respects the US Government’s desire to pull back from regulatory harmonization (the so-called “level playing field”) of the kind previously advocated by the European Commission and also by the Association of European Airlines in its famous September 1999 policy statement, “Towards a Transatlantic Common Aviation Area.” Thus, while a number of important regulatory issues are included (security, safety, the environment, competition, subsidies, consumer protection, and international wet leasing), the focus under each rubric is on consultations and cooperation rather than formal harmonization. (See Draft US/EU Air Transport Agreement, Articles 8, 7, 14, 19, 15 and Article 9, Sec. 8, respectively.) Under subsidies, for example, EU airlines have already criticized a list that does not include Chapter 11 bankruptcy protection, and the procedure contemplates exchanges of “observations” between the parties rather than a WTO-like system of red light/yellow light/green light prohibitions and permissions. (See *id.*, Article 13, Secs. 2 and 3.)

On the other hand, the draft does bring the US and EU competition authorities into consensus on the US doctrinal mantra that antitrust law supports competition rather than competitors, and includes a major US concession that will permit wet-leasing (although only for international routes). (See *id.*, Article 19, Sec. 1 and Article 9, Sec. 8, respectively.) The draft creates one institutional structure, a Joint Committee to be formed by officials from both sides, but the Committee has no supervisory or enforcement authority. (See *id.*, Article 17.) In one respect, the existence of the Committee may prove a marginal disimprovement on the present system of bilateral arbitration, since the additional step of a reference to the Joint Committee will be required before a dispute can proceed to conventional arbitration. (See *id.*, Article 18, Sec.1.)

For authentic regime change to occur, however, the citizenship test for ownership and control must be abolished. Until this happens, the international regulatory environment will continue to prevent cross-border mergers and acquisitions as well as the creation of foreign subsidiaries. EU

airlines, to be sure, can already pursue transnational transactions of this kind with one another, but strictly within their 25-member Union (and associated States Switzerland, Norway and Iceland). However, a merger between two EU airlines from different Member States risks the loss of traffic rights under bilateral treaties with non-EU countries which continue to include the traditional citizenship purity test.

An Air France-owned KLM may lose its transatlantic traffic rights, for example, under the US/Netherlands bilateral treaty because Dutch citizens no longer own and control KLM. That is why KLM and Air France have been unable to consummate a true merger. Simply put, therefore, at present no EU carrier can own more than 25% of a US airline, nor can a EU carrier establish a subsidiary to offer air transport in the US domestic market. Similarly, no U.S. carrier can own more than 49.9% of a EU airline, nor can a US carrier establish a subsidiary to offer air transport in the EU internal market. And, in all cases, US or EU citizens must also be in actual or effective control of the airlines they own.

### III. US Recognition of the “Community Carrier”

Neither the draft US/EU treaty nor the US Department of Transportation’s Notice of Proposed Rule-Making will abolish the citizenship purity test, but taken together these instruments propose significant changes to the test that are drawing the attention of the aviation community. First, the draft treaty requires the US to recognize the internal EU legal construct of the “Community carrier.” Under this concession, an EU airline that is licensed in any Member State will be permitted to fly to any US airport from any airport in the EU regardless of the identity of the citizens who own or control it (as long as they are citizens of an EU Member State). KLM, therefore, will be permitted to fly from Paris Charles de Gaulle to New York without a home link to Amsterdam and Air France will be able to use Schiphol for similar turnaround services to points in the United States. These so-called “seventh freedom” services will allow the EU Member States to claim compliance (vis-à-vis the US) with the 2002 opinion of the European Court of Justice which struck down the ownership and control clauses in their bilateral treaties with third countries as violating the anti-discriminatory freedom of establishment rule in Article 43 of the European Community Treaty.

It is worth noting that the European Court of Justice in its 2002 ruling ignored the interplay between the right of establishment and the existing airline licensing laws. A literal reading of the treaty certainly suggests that Czech Airlines could operate turnaround services from Paris CDG even if it has only a ticket office in France (indeed, some American authorities have taken the view that, as far as the US is concerned, KLM need only have a telephone answering machine in France). Yet the Memorandum of Consultations that accompanies the draft treaty makes clear that an airline’s “principal place of business” will be responsible for safety, security, and regulatory oversight. (See Memorandum of Consultations, paras. 7, 8). Bilateral treaties have traditionally included requirements about regulatory oversight, and most countries have internal laws that regulate the conditions for recognition of airlines designated under bilaterals by third countries. (See, e.g., Article 21 of the German Aviation Act.) The International Civil Aviation Organization also has adopted rules about bilateral recognition of airlines. (See Rainer Munz,

“The Future of Ownership and Control Clauses: The German Point of View,” copy on file with author.)

The idea, therefore, that Czech Airlines could operate a seventh freedom service between CDG and New York, even though the company’s principal place of business is in Prague and it owns only a telephone answering machine in Paris, may be consistent with the letter of Article 43. But it is out of keeping with the likely requirements of both the French and American aviation authorities if Czech Airlines were to be designated by France to serve U.S. routes. France (and also the US authorities) would likely require something closer to full “establishment” in the sense of being a full operating subsidiary of Czech Airlines, with a local French license and aircraft registration. France would certainly be reluctant to designate “Czech Airlines” to serve the France/US market, but could nonetheless comply with EU law by designating “Czech Airlines (France),” a French company owned and controlled by Czech Airlines.

The Commission itself has said that there must be “effective and real exercise of air transport through stable arrangements,” a benchmark that seems to expect more than a perfunctory presence in the designating State. (See European Commission, Staff Working Document, SEC(2005) 336, 11.03.05.) While this baseline could mean merely a ticket office (or a telephone), the safety, security, tax, labor, and sheer logistical implications of designation suggest that much more work needs to be done to clarify the terms of the proposed new freedom of EU carriers to operate from territories outside their home States.

#### IV. The Notice of Proposed Rulemaking

##### A. Background

The second new initiative affecting the citizenship purity test is a proposed modification of the test which determines whether the citizenship of a US airline has been compromised by foreign control—the “actual control” test. That modification, an initiative of the US Department of Transportation (DOT), is now the subject of an administrative procedure called a “Notice of Proposed Rule-Making” (NPRM). DOT Dkt. No. OST-03-15759 (“Actual control of US air carriers”), Nov. 2, 2005.) Although the US authorities offered the proposal unilaterally *pour encourager les européens*, its adoption has now become a virtual pre-condition to EU acceptance of the draft treaty. (See Joint Statement of EU/US Delegations, Nov.18, 2005.)

The proposal (as it must) leaves unaltered the 25% cap on foreign ownership of US airline voting equity, and also the statutory control indicia that mandate that the president and two-thirds of the board of directors must be US citizens. But it intends to sweep away the subjective, impressionistic, “gestalt” requirement, long imposed by US administrative practice, that US citizens must also be in “actual control” of a US airline. Much expensive legal brainpower has been employed in figuring out what DOT Under Secretary for Policy Jeffrey N. Shane recently described as the “it’s for us to know and for you to find out” official thinking on actual control. (See “Aviation Deregulation: A Work in Progress,” Speech to the International Aviation Club, Nov. 8, 2005.) Many factors might suggest a baleful “foreign” influence, including having a

dominant foreign customer or an overlap of board members between the US and foreign corporations. Because the DOT has never provided a checklist, and sometimes has allowed aeropolitical factors to be influential (such as the existence of an open skies agreement with an investor's home country), no single factor could be said to have had any a priori validating or invalidating power.

Under its NPRM, the DOT is proposing that, except for certain ring-fenced areas of operation such as the documents of corporate organization, participation in the Department of Defense Civil Reserve Air Fleet (CRAF), and issues concerning safety and security, a foreign investor in a US airline will be able to exercise actual control over the commercial aspects of the airline's operations, including sales, marketing, pricing, route selection, and scheduling. DOT Under Secretary Shane, incidentally, suggested such a "tweaking" of the DOT's interpretive practice as early as 1992. At that time, British Airways was planning to invest \$750 million in struggling USAir and wanted DOT officials to take a more flexible view of its level of involvement in its American partner's operations.

Given the stakes in the current negotiations, including the possible opening up of London Heathrow to all US and EU airlines in addition to the current four incumbents, the US authorities believe that the NPRM represents a significant and important concession. Within the last clause of the last sentence, however, lurks the danger. The more significant the proposal, the more likely it is to be beyond the power of the DOT to grant it in the absence of legislative change—in other words, it may be *ultra vires*. Two questions, therefore, need to be asked. Is the proposal beyond DOT authority? And, if not, must one conclude that it is not, therefore, a significant proposal?

#### B. Will The Proposal Withstand Judicial Challenge?

With respect to the issue of authority, the NPRM implicates complex questions of US administrative law. Only some general ideas can be canvassed here, but they are nonetheless useful to consider. The DOT has decided that the outcome of its rule-making procedure will be a "Statement of General Policy." (See Dkt. No. OST-03-15759: "We are proposing to place this guidance in 14 CFR Part 399, which is reserved for general policy statements.") As such, it will be non-binding, discretionary (as to whether it will apply in any given case), and unilaterally rescindable. (See *Columbia Broadcasting System, Inc. v. United States*, 316 U.S. 407 (1942).) On the other hand, the Department has chosen to adopt its new proposal by means of a formal notice of rule-making, which is not a required procedure for policy statements. Indeed, courts have suggested that a policy statement adopted by an agency after a formal NPRM procedure has a reduced level of alterability by the agency. (See, e.g., *AMREP Corp. v. FTC*, 768 F.2d 1121 (10th Cir. 1985), cert. den. 475 U.S. 1034 (1986).)

The use of an NPRM procedure, coupled with the level of specificity in the language of the proposal, suggest that the Department is actually on track to create a "regulation" rather than a mere statement of policy. While the courts (not the DOT) will ultimately make the determination as to what kind of administrative instrument the Department has promulgated, the

EU negotiators should take comfort from the likelihood that it would be construed by the courts to be a regulation. As such, it would carry the force of law (as though it were a statute), would bind the courts, and would not be discretionary in each case where it is applied by the DOT.

In addition, a regulation gains the protection of the so-called *Chevron* doctrine, which requires courts to give deference to a regulation in the absence of arbitrary action by the agency. Thus, the courts will enforce the regulation without permitting a challenge to the validity of the policy which underlies it (or requiring the agency, in this case the DOT, to mount a justification for the policy). (See, e.g., *Pacific Gas & Elec. Co. v. Federal Power Commission*, 506 F.2d 33 (D.C.D.C. 1974.) Moreover, the underlying legislative history (*i.e.*, the Congressional debates on the legislation under which the DOT has acted) supports the argument that the Department has a congressionally-delegated power to enact a regulation. An requirement of “actual control,” previously a DOT interpretive gloss on the ambiguous words of the airline citizenship statute, was explicitly inserted into that statute in 2003. (See 2004 U.S.C.C.A.N. 2212.)

It is clear from the record that Congress inserted the requirement because of a pending DOT citizenship proceeding in which the Department’s glossing of an “actual control” test onto the words of the statute was being challenged (and not for the first time). (See 149 Cong. Rec. S. 7813.) The record indicates that the explicit actual control test was intended also to incorporate the interpretive practice of the DOT (see *id.*)—a practice which includes constant re-interpretation of the actual control criteria to reflect changing market and aeropolitical circumstances. The recent ruling of the Court of Appeals for the District of Columbia Circuit in *Sabre, Inc. v. DOT* (decided November 22, 2005) confirms that the courts will show deference to an agency’s broad reading of a broadly-worded statute.

No doubt it is possible that the DOT’s proposal, once adopted in final form, could be subject to judicial challenge. A pre-enforcement challenge would also be possible, since a refusal to repeal an adopted regulation constitutes an agency “final action” for purposes of recourse to the courts. (See, e.g., *Air Brake Systems, Inc. v. Norman Y. Mineta*, 357 F.3rd 632 (6th Cir. 2004).) The *Sabre* case, for example, involved a pre-enforcement challenge to a final rule which expanded the DOT’s supervisory powers over unfair competition to include computer reservations systems (even though the statute referred only to “ticket agents”). If the complainant opposing the current DOT proposal could persuade the court that it can forecast the effects of an “as-applied” injury, as *Sabre* did, the challenge would be allowed. In *Sabre*, however, the *Chevron* doctrine ultimately enabled the DOT’s rule to withstand a substantive challenge.

### C. Will The Proposal Have A Significant Commercial Impact? How Can The Proposal Be Strengthened?

Even though the DOT proposal will likely survive a judicial challenge (because it is in substance a regulation and therefore strongly protected by *Chevron*), it remains to be asked whether the proposal is nonetheless significant. It is certainly a positive step in the direction of regime change. While it is far from the New Jerusalem of abolishing all inward restrictions on ownership and control, the Department is throwing out a lot of law in order to create this

initiative. Simply stated, 25% ownership with broad operational control is better than 49% ownership (the Bush Administration's now-defunct proposal) without control. Under the DOT proposal, a foreign investor with 25% ownership can presumably also own far more than 50% of the non-voting equity, insist on supermajority voting, and gain control over the scheduling operations of a U.S. airline.

In practical terms, the proposal should serve its avowed purpose (as portrayed by Under Secretary Shane) of prising open access to foreign equity investment. US airlines under the current bilateral arrangements with the EU, route structures are at least technically more favorable. US airlines, for example, have broad fifth freedom connecting rights throughout the EU whereas EU airlines cannot access the US home market. But the price of the protected US national market is the limitations placed on inward capital investment. Lately, US airline leaders have called for repeal of the US laws concerning foreign ownership and control of national airlines. (See, e.g., Remarks of Glenn F. Tilton to the Chicago Council on Foreign Relations, available at <http://www.united.com/speech/detail/0,6862,52872,00.html> ) At present, only two of the major U.S. carriers (Continental and Northwest) have more than five per cent foreign equity investment. (See GAO, "Issues Relating to Foreign Investment and Control of US Airlines," GAO-04-34R (2003).)

Is the proposal workable (a key factor in its significance)? Some have likened the DOT proposal to a centrifuge. When the centrifuge revolves it throws off corporate organizational documents, CRAF, security, and safety, leaving all other aspects of operations still spinning within the center. No doubt there are aspects of the normal commercial operations of an airline which overlap with the elements spun off by the centrifuge—fleet planning, for example, must surely take place with an eye toward future CRAF participation and revenues. Nonetheless, the courts may appreciate the logic of the DOT's argument—to eliminate actual control scrutiny for areas where there has been a renunciation of significant government regulation, namely, in routes, pricing, fleet selection, capacity, marketing, and so on.

Critics argue that the proposal is premised on an unrealistic model of airline operations. (See, e.g., Continental Airlines, Press Release, Nov. 3, 2005.) The DOT could moderate this criticism, and better serve industry stakeholders, by going beyond the exclusionary criteria listed in the NPRM (*i.e.*, that foreign control will not be permitted with respect to organizational documentation, any operational plans and actual operations that concern CRAF participation, implementation of the security requirements of the Transportation Security Administration, and the safety requirements of the Federal Aviation Administration). Instead, the revised final text could include an explicit statement that the "actual control" factors previously considered by the Department will no longer include any factor (other than the factors specifically mentioned in the NPRM) previously considered by the DOT in any citizenship proceeding. See, for example, Under Secretary Shane's recent observation that "[r]ather than the long list of subjective tests created by years of case law, we would seek only four objectively verifiable answers" [*i.e.*, with respect to corporate documents, CRAF participation, safety, and security]. (See Shane speech, Nov. 8, 2005, *supra*.)

Thus, for example, a foreign investor could predict from such a statement that its business relationships with a US airline (for example, the foreign investor supplies 90% of the cargo revenues of the US carrier) would not indicate “actual control” by that foreign airline. Moreover, such an explicit reference to the DOT’s past precedents on “actual control” would align the NPRM even more precisely with the intent of Congress described earlier.

It is worth noting, incidentally, that the DOT will limit access to the benefits of the proposed change of policy to those countries which offer “reciprocity” in terms of investment opportunities to US carriers. Technically, the EU is not offering a reciprocal modification of its own “effective control” test, but the US may well take the view that reciprocity does not have to mean identical treatment. The EU’s 49.9% ownership ceiling, for example, may be broadly interpreted as sufficiently reciprocal, and EU negotiators have indicated that they will examine their own rules to consider whether greater flexibility could also be introduced into EU effective control determinations.

The NPRM proposal could have a number of interesting industry effects. The new proposal might allow Virgin Airlines, for example, to enforce brand identity standards on a related US operation in which it took up to a 25% interest. There have also been suggestions that the proposal would allow deeper integration of transnational alliances such as Star and oneworld, and even a return to the abandoned era of intra-alliance equity investments. A caveat is that the US Supreme Court’s *Copperweld* doctrine only extends antitrust immunity on pricing and market division collaboration to related entities, and not to independent competitors such as the members of airline alliances. (See *Copperweld Corp. v. Independence Tube Corp.*, 467 U.S. 752 (1984).) To deepen their integration, therefore, US/EU alliance partners will likely continue to need the special gift of antitrust immunity for international operations that the US Department of Transportation, by historical accident, is permitted to confer. And mention of that strange artifact of antitrust immunity is a reminder, surely, of the wisdom of moving to a 100% foreign investment regime.

## V. Moving Towards A Right Of Establishment

The regime change of abolishing the citizenship purity test is not part of the present negotiations, but steps in that direction are being taken. A broader vision of the “right of establishment” (much broader than Article 43 of the EC Treaty) would still regard an airline’s “nationality” as important, but would de-link commercial and regulatory nationality. Commercial nationality (the right of private investors, regardless of citizenship, to own 51% or more of a foreign airline and to manage it without restriction) would be entirely deregulated. But an airline would still have (and must have) a regulatory nationality, a State in which it is incorporated, where it has its principal place of business, where it pays taxes, employs local management and employees, obeys local laws, and is subject to safety, security, and fiscal supervision. The NPRM, through its creative splitting of commercial operations from operations that must be controlled by citizens, implicitly hints at this distinction between commercial and regulatory nationality.

The broad “right of establishment” is an exciting but underappreciated idea in international air transport. If implemented, it would ensure that airlines continue to have a “national” regulatory affiliation but without the anti-investment burdens of a narrow citizenship requirement. Congress, which has embraced the WTO, NAFTA and recently CAFTA, surely can be informed of the advantages of the right of establishment as a trade-expanding, labor-friendly, and consumer welfare-enhancing approach to foreign investment in US airlines. The NPRM, unfortunately, is too oblique (and too derivative of the present regime) to be able to make these arguments effectively. Instead, it can easily be depicted by its opponents as merely a collateral attempt, by appeasing the European airlines, to undermine the integrity of the citizenship purity test.

It might well be the case that even generalized abstractions like “right of establishment” are less useful than the simple statement that multilateral airline liberalization really consists of giving expanded rights to compete in geographically-defined markets to selected countries and operators in whose financial and operating integrity we have confidence. That, after all, is exactly the mission of the US/EU negotiators.

*In the next International Aviation Law Institute Commentary, Professor Brian Havel will suggest an alternative initiative to unlock the ownership and control bolts, using the World Trade Organization as a forum for change. Until now the WTO has not been favorably viewed as a potential venue for this kind of change (in part because of the airline industry’s “exceptionalism,” as noted earlier). However, with the coming review of the Air Transport Services Annex in spring 2006, another look at the WTO process is certainly worthwhile and initiatives from several countries on airline liberalization will be part of the review agenda.*