A New Approach to Foreign Ownership of National Airlines

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by Brian F. Havel
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I. A System Bolted Shut by Nationality Restrictions—Exter-
nally and Internally

A. The Consequences of a Citizenship Purity Test

Deregulation was supposed to take the government out of the business of second-guessing airline management decisions with respect to investments and capital structure. Ironically, however, there is still a citizenship purity test that applies to the deregulated U.S. airline industry. Simply put, U.S. airlines must be owned and controlled by U.S. citizens. In fact, opening U.S. national airlines to majority foreign ownership and control never became part of the deregulation reform agenda. Now, as the airline industry seeks ways to restructure after the "perfect economic storm" that devastated air carrier finances for the past several years, government and airline leaders are finally confronting the pernicious legacy of the citizenship test. It has excluded U.S. airlines from foreign capital markets, disqualified them from mergers or acquisitions involving foreign airlines, and forced them to enter artificial "alliances" with foreign airlines instead of becoming the kinds of strong multinational corporations that have developed in virtually all other transnational industries.

The nationality restriction is part of U.S. domestic law, but it is also a treaty obligation that the United States has accepted in common with all other countries engaged in air transport. In effect, the bar on foreign ownership and control is a double-bolted legal
The lock's external bolt is a "nationality clause" that for over 50 years has been included in all of the air services agreements by which countries still regulate which foreign airlines have access to their airspace. The nationality clause ensured (for reasons of both national security and commercial protectionism) that only airlines bearing the nationality of the countries negotiating each bilateral treaty would serve the routes awarded under the treaty.

The internal bolt, which ensures compliance with the nationality clause, is each country's domestic legislation requiring majority national ownership of its national air carriers. Although the treaty-based nationality clause has been the object of highly creative reform proposals, the system cannot change unless and until the internal bolt is disabled by significant aeropolitical powers such as the United States and the European Union.

B. The Double-Bolt System Explained

More specifically, the nationality clause (the external bolt) gives each country the right to reject another country's air carrier which has been "designated" to serve routes into that country if the carrier is not "substantially owned and effectively controlled" by the country making the designation or by the nationals of the country making the designation. The ownership test is quantitative (do nationals have a majority shareholding?). The control test is qualitative (do non-nationals, even if they hold only a minority of shares, nevertheless have power to determine the business decisions of the air carrier?). The ownership/control protocol featured originally in two now largely ignored treaties on route rights signed in 1944, but it has acquired its current prominence through repeated incorporation in major bilateral aviation agreements. As one commentator has written, "who can perform transport services most efficiently is secondary; what matters is whether [that person] is a foreigner or a national."

Domestic legislation (the internal bolt) provides strong bracing for the external nationality clause. Under U.S. law, for example, the notion of "substantial ownership" has been converted into precise mathematical formulas, so that at least 75 percent of the voting stock of a U.S. airline corporation must be (says the statute) owned or controlled by U.S. citizens. The U.S. statute also requires that the president and two-thirds of the board of directors and other managing officers of the airline must be U.S. citizens.

C. Reasons for the Citizenship Test

Why have countries restricted foreign ownership of their airlines under domestic law? The primary reason is to ensure that their airlines are not rejected by other countries under the bilateral
treaty system. Countries are caught in a kind of prisoner's dilemma under this system. If a country unilaterally allows foreign ownership and control of its airlines, it risks compromising the access of its airlines to international routes to other countries.

In the United States, the nationality restriction actually existed before the bilateral treaty system adopted it. Originally, the restriction reflected a congressional judgment (most prevalent in the interwar years of the 1920s and 1930s) that U.S. wartime security required access to an auxiliary air force. The creation of the Civil Reserve Air Fleet (CRAF), discussed below, has certainly diminished that concern. Later, the nationality restriction acquired a protectionist, anticompetitive rationale to support the exclusion of foreign airlines from the huge U.S. domestic air transport market.

D. Cabotage Rights are not the Solution

Domestic markets like the United States have also been protected from foreign competition by another locking system that operates separately from the nationality restrictions. By international treaty, the so-called "cabotage" exclusion prohibits foreign carriers from serving wholly domestic routes in another country (New York to Chicago, for example). U.S. law, like the internal laws of most countries, currently includes a specific prohibition on cabotage services by foreign carriers. But international law also permits countries to waive the cabotage exclusion (provided they do so in a non-discriminatory way). Lifting the cabotage exclusion would be hard for a government to do (in addition to labor union objections), because under international treaty law foreign airlines which serve cabotage routes are still regulated by their home countries.

More importantly, however, opening up access to cabotage routes would be unlikely to tempt foreign carriers to compete with entrenched local carriers. The economics of domestic competition are very different from the economics of providing international services, and (at most) foreign carriers would make piecemeal efforts to serve these routes, occasionally adding extension services to existing international routes. Air France might fly New York to Chicago as an extension of its Paris/New York service, for example. To enter another country's domestic market as full competitors, and to allow for that country to provide national safety oversight, foreign carriers would need the right to establish themselves by setting up a subsidiary, or buying or merging with an existing airline, in that country. Because of the nationality restriction (the internal bolt), however, these commercial opportunities have always been forbidden.
E. U.S. Application of the Citizenship Test: Unpredictability and Inconsistency

Countries expend much legal brainpower and ingenuity in defense of the nationality restriction. In the United States, the ownership criteria are matters of simple mathematics: 75 percent of the voting stock must be in the hands of U.S. nationals, so up to 25 percent of voting stock can be owned by foreign nationals. If that test is satisfied, and if the president and two-thirds of the board of directors and other managing officers are U.S. citizens, then one might reasonably conclude that control would follow ownership. In fact, the language of the Federal Aviation Act seems to reflect this assumption, since it speaks disjunctively (unlike the bilateral treaty language!) of requiring ownership or control to be in the hands of U.S. citizens. The DOT has always read the statutory language conjunctively, however, and so its citizenship review also includes the significantly more fact-dependent (and hence pliable) issue of "control."

What constitutes "the shadow of substantial foreign influence," to use the DOT's dark phrasing, is to say the least a matter of shifting moods of interpretation. The Department has tried to be categorical, looking at numerous "indirect" indicia of foreign influence that fall outside the numerical parameters of "direct" stock ownership. These indirect factors include foreign representation on the airline's board of directors or in management, indebtedness of the airline to a foreign entity, the existence of close business, cross-hiring, or personal relationships between an airline's leadership and foreign entities, foreign ability to control fundamental corporate governance actions (for example, through a veto power), undifferentiation of physical office space and communications systems, common name and marketing, common legal counsel and consultants, and so on.

None of these indicia, of course, can actually be predetermined by the DOT. They have emerged (and will continue to emerge) through the forensic process of citizenship review, on a case-by-case basis, and therefore have no a priori validating or invalidating power. The intensely factual nature of the DOT's analysis, and the lack of any single determinative factor, most often produces a "gestalt" outcome that one commentator has criticized as a "misty moor of legal uncertainty." The DOT disavows the use of a preconceived "checklist" of factors, but gestalt outcomes require a "thumb on the scale" when all of the factors or indicia are stacked up side-by-side in a particular case. The "thumb on the scale," unfortunately, is often a DOT proprietary secret.
F. Two DOT Decisions: Daetwyler and KLM/Northwest

The seminal 1971 finding in Daetwyler demonstrates this unpredictability.\(^9\) There, the Civil Aeronautics Board (the DOT’s predecessor) and the administrative examiner who conducted the initial citizenship hearing divided completely on the nature of a Swiss businessman’s influence over the challenged corporation’s citizenship. The examiner, characterizing the live testimony of the businessman and his U.S. citizen associates, found that Daetwyler had the magnanimous purpose of extending a majority equity interest to his U.S. associates as part of a reward program that recognized their past contributions and the integrity of their independent judgment. The examiner found that the U.S. shareholders had conducted their commercial activities in "a completely responsible manner," serving a "useful public purpose" and meeting "a public need."

The Board, cynical in its review of the record on appeal—and pressured by Daetwyler’s U.S. air freight competitors acting through their trade association—made the converse finding that Daetwyler would not restrain himself from meddling in a corporation in which he retained the statutory maximum stockholding and board representation, which belonged to his system of companies, and which had U.S. shareholders and directors who were employed in related Daetwyler-controlled entities. But there was no dominating predictive fact in the Board’s review. It is impossible to distinguish the nuances that might separate the examiner’s finding that Daetwyler would exercise "a degree of influence" in the operations of the corporation from the Board’s conclusion that he would exercise "control in fact." The outcome is ultimately impressionistic, premised on a gestalt view of a foreign citizen’s suspected (sinister) intent. The Daetwyler examiner suggested that a complete evaluation ought logically to require an indication of some purpose to be achieved by the foreign citizen in asserting the control that the Board visualized. The absence of any consideration of purpose (harmful or otherwise) in agency practice simply accentuates the sense that citizenship reviews inevitably become subjective and opinionated.

When U.S. regulators do allow some measure of foreign influence, the thumb on the scale may again have little to do with the precise factual circumstances. In analyzing KLM’s proposed equity investment in Northwest Airlines in 1989, the DOT juggled the details of voting and non-voting stock percentages, the preclusory powers of certain non-voting preferred stock issued to KLM, the structure of Northwest’s board and its finance sub-committee, and
the terms of KLM/Northwest collaboration in marketing, sales, scheduling, operations and customer services.

Nevertheless, a single decisive external circumstance, rather than a specific factual element of the control analysis, ultimately shaped each of the Department's two rulings (in 1989 and, upon KLM's petition for modification of the initial order, in 1991). In the first ruling, the DOT determined that KLM was an actual competitor of Northwest in a number of markets and a potential competitor in others, so that KLM's strong structural presence in Northwest's governance needed to be rolled back. But the Department's apparent toughness in its first ruling was tempered considerably when it looked at KLM's later petition for modification. There, the decisive circumstance was not competition-related but aero-political. The United States and KLM's home state, the Netherlands, were about to consummate a liberal bilateral treaty relationship. The regulators allowed KLM to increase both its equity stake in Northwest (to 49 percent, provided no more than 25 percent was voting equity) and its board representation. The DOT explained its generosity as the product of its "reassessment of the complexities of today's corporate and financial environment" and the relationship between non-voting equity and control, an assessment that it had conducted "in the context of the liberalized relationship that prevails between the United States and KLM's homeland." In addition to unilaterally raising the ceiling on permissible foreign equity to 49 percent, the DOT also acknowledged, and treated benignly, the fact that "many U.S. carriers have taken on sizeable amounts of debt from foreign sources," such as aircraft manufacturers or lessors. These debt relationships, in its opinion, "revealed very few indications of potential foreign control."

G. Back to the Misty Moor of Legal Uncertainty

In KLM/Northwest, the U.S. regulators appeared to exercise a power constructively to waive the control requirement—part of the internal bolt that supports the nationality clause in bilateral treaties—if it deems such action to be in the public interest of the United States. While this flexibility is commendable, the outcome, again, could not have been predicted based solely on the facts presented by the airlines. For lawyers (and their airline clients) seeking predictability and consistency, the shifting moods of investment control interpretation could hardly be more frustrating. It is unwise, as a matter of both law and policy, to allow unpredictable impressionistic criteria—the perceived intent of a foreign citizen, the projected competitive relationship of two carriers, the treaty relationships of the United States and its partners—to trump simple examination of any restrictions on the voting powers of the
voting equity held by the majority owner (or any other collateral constraint on the voting powers of the voting equity held by the majority owner).

Impressionistic assessments can also unduly inflate the significance of specific facts. For example, to deny citizenship on the basis of having a large (or even dominant) foreign customer source would create insurmountable barriers for U.S. corporations dependent on a steady-state overseas customer base. In this respect, the recent (temporary) Congressional appropriations enactment, in P.L. 108-11 (the Emergency Wartime Supplemental Appropriations Act of 2003), § 2710, that 50 percent reliance on such a source for any consecutive three-year period would render an air carrier under the "effective control" of foreign interests, only affects acquisitions of airlift by the Department of Defense (and consequent eligibility for DoD contracts). But the enactment could, in an impressionistic analysis, be accorded the kind of ultimate determinative power that the DOT was willing to give to the U.S./Netherlands treaty, for example. This is so even though the appropriations act is a lex specialis, a time-bound statute targeted at the circumstances of a specific military engagement.

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The European Union regulations on control, adopted in 1992 but only once applied (in the controversial Swissair/Sabena decision), have an equally problematic target in their search for rights or contracts which confer a "decisive influence" on the vote composition or business decisions of a commercial enterprise. Indeed, the European Commission in its Sabena decision showed that in applying the new regulations it is just as susceptible to impressionistic outcomes as the DOT. Echoing the U.S. regulators in KLM/Northwest, the Commission stated, at the end of a lengthy opinion justifying even the most suspect components of the transaction, that major investments by a third country's air carrier in an EU carrier "should also take into account the broader context" of that investment, including the nature of EU aviation relations with the third country in question. At the time of the decision, Switzerland
was about to open negotiations which have led ultimately to its full incorporation into the EU internal air transport market.

**H. Leaving the External Bolt Unlocked**

The unpredictability of the nationality restriction becomes even more pronounced when one discovers how the external bolts are often left unlocked. The United States, for example, has emphasized that the external bolt is permissive, so that U.S. international aviation policy sometimes waives the requirement that another country’s airlines are majority owned and controlled by nationals of that country. In fact, the gritty details of who owns and controls the airlines designated for service into the United States by other countries have never unduly preoccupied U.S. air transport regulators. Typically, because of the domestic legislation that virtually all countries have adopted, mere "designation" by another country tends to satisfy the U.S. authorities. Other countries also typically inform the United States of any change in ownership and control (given the preponderance today of privatized, publicly-quoted airline corporations, this information could hardly be hidden). Yet it appears that this information, even if it reveals a shift to foreign ownership, will not necessarily cause the United States to withdraw or suspend traffic rights.

The reasons why the United States has granted waivers of the nationality restriction are both juridical and aeropolitical. Juridically, there is in fact no statutory requirement in the Federal Aviation Act or elsewhere in U.S. law requiring that substantial ownership and control be in the hands of the designating foreign country or its citizens. It is solely a treaty-based requirement. With respect to aeropolitics, the United States makes waiver determinations based on whether a change in the ownership/control composition of a foreign airline affects U.S. aviation policy or interests (and typically it will not). For example, when the European Court of Justice recently applied EU anti-discrimination rules to declare illegal the nationality clauses in EU members’ air services agreements with third countries, the United States responded by proposing an amended form of the nationality clause that would, for example, accept designations of airlines by France even if those airlines were owned and controlled by other EU members or their nationals—be they Germans or Dutch or Italians. Similarly, the United States did not suspend the traffic rights of Aerolineas Argentinas when that company fell under primarily Spanish ownership and control. Most remarkably, the DOT relied on a pre-existing open skies relationship to accept a Luxembourg-designated cargo airline, Cargo Lion, in which no Luxembourg national had ownership interest (a German national owned 49 percent, a Swiss
national owned 41 percent, and a UK and Canadian national each owned five percent.)

But ad hoc escapes from the ownership and control restrictions are not likely to create the regulatory certainty and predictability needed for airlines to assume that they can engage in crossborder investment activity without concern about losing traffic rights. Even if the United States recognizes a German-owned French airline, will Japan also do so? What about Brazil? The tolerance of the bilateral network for change is itself unpredictable. Although the worldwide airline trade group, the International Air Transport Association (IATA), in 2001 and again in 2003 invited governments to issue unilateral generalized waivers with respect to the foreign ownership (but not control) restriction in bilateral agreements, the best that can be expected is for the grant of piecemeal waivers. And that is a poor substitute, as far as most air carriers are concerned, for knowledge-based forward planning.

Moreover, air carriers may wonder why the United States and other countries are relatively complacent about waivers to some foreign airlines and yet unbending in their application of their national citizenship laws. The inconsistency (again) has not escaped the eye of some U.S. officials. As U.S. Under Secretary of Transportation for Policy Jeffrey Shane recently stated, reflecting on the European Court of Justice ruling, "... the United States is prepared to look creatively at nationality clauses. We certainly do not treat the traditional formula as sacrosanct."

His interesting statement could apply just as readily to the domestic citizenship test.

II. The Business Rationale for Liberalizing Citizenship Tests

Having described the obsolete reasons why the nationality restriction exists, and the inconsistency and unpredictability of its application, the business justification for its abolition should be manifest. It is captured in the statement that the world's most global service industry lacks even a single global competitor. Economists would refer to the nationality restriction (in its external and internal manifestations) as "output-restricting." Its cumulative decades-long impact on passenger and cargo costs can scarcely be imagined. It has trapped the air transport industry inside an impenetrable commercial bubble, unable to provide services (and to seize strategic opportunities) with the operational and structural flexibility that is automatically assumed in virtually all other major industries and services.

Most damagingly, the nationality restriction has perpetuated a climate of commercial uncertainty within and among airlines. Because national markets are typically closed to foreign participants, airlines cannot, for example, establish subsidiaries in other countries.
to take advantage of market opportunities in those countries. This remains the case even though many airlines are no longer state-owned, which in the past created concerns that they were kept aloft unfairly by the public treasury and not because of any commercial acumen. Some privatized carriers are actually approaching the point where homeland nationals hold only a bare majority of shares. In this context, the nationality restriction imposes the additional burden of monitoring and turning back any threat of rising foreign dominance, even if the foreign-owned shareholdings are diffuse and deeply fragmented. The articles of association of British Airways, as amended in 1992, give the board of that fully privatized airline the power to reduce nonnational ownership of its shares to the extent necessary to neutralize any aeropolitical challenge to its nationality.\(^\text{19}\) And KLM’s board can ask the Dutch government to buy shares up to a 50.1 percent percentage in order to re-establish majority national ownership of the airline.\(^\text{20}\)

With respect to relationships among airlines, the internal and external components of the nationality restriction have made it impossible to launch cross-border investment initiatives through mergers and acquisitions. A decision to merge with or acquire another airline, for example, cannot be pursued unless the airlines involved provide air services entirely within a single country (or region, in the case of the European Union). The nationality bar was a contributory reason why British Airways was unable to consummate its plan to merge with or buy KLM in 2000.\(^\text{21}\) If it had, the BA/KLM combination, converted to UK national ownership and control, would have risked a withdrawal or suspension of traffic rights from the Netherlands by the United States and other countries. The United States did in fact threaten precisely this outcome, because Britain had earlier balked at liberalizing the U.S./UK aviation relationship. The merger was called off, but it served as a forceful and timely reminder of how rational commercial plans can be foiled by citizenship restrictions.

As sometimes happens when regulation proves stifling, entrepreneurial ingenuity has tried to outmaneuver the regulatory obstacles. Despite the pervasiveness of the external and internal nationality restrictions, airlines have managed to create working transnational alliances that loop together their respective route networks into something resembling a cohesive grid. The bonding agent for most of these transborder pseudo-mergers is code-sharing (which most commonly allows each airline to sell seats on the other partner’s flights using its own two-letter identification code). Governments regard code-sharing as sometimes misleading to consumers but tolerate it because alliances produce consumer benefits and
allow airlines to circumvent the full force of the nationality rule.\textsuperscript{22} Originally, alliances also involved transborder equity investments (KLM and British Airways made large capital injections into Northwest and U.S. Air, respectively). But regulatory suspicion of why an investor would provide large tranches of capital without expecting some degree of control quickly doomed this form of collaboration.\textsuperscript{23}

Large alliances like Star and oneworld are touted as offering "seamless service" (the industry's marketing formula \textit{du jour}), and there is some evidence that they bring measurable benefits in the form of more competitive service, price reductions, and network expansion through increased feed. But they are, after all, merely artificial contrivances that the industry has invented to compensate for its inability to pursue the mergers and consolidations (and more sophisticated equity-based alliances) that would occur if cross-border investment restrictions disappeared. And, of course, it is axiomatic in the airline industry that alliances are unstable. Each airline still has to function as an independent company as well as part of the alliance team, a commercially anomalous existence that leads to frequent withdrawals or even dissolutions. Weaker airlines, which are prevented by the nationality restriction from attracting a cross-border white knight, are often excluded from alliance opportunities. While it is true that airlines would probably enter alliances even if the foreign ownership restrictions were relaxed or removed, they would then have a rich array of commercial alternatives to consider.

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Virgin Atlantic Airways' external affairs director, Barry Humphries, told a 2003 world air transport conference that retention of the nationality restrictions "borders on madness."\textsuperscript{24} This is particularly so in a time of severe economic stress in the industry. The alternatives for troubled airlines, as has been seen in the United States, are market-distorting and highly unreliable contingencies like bankruptcy and government aid. The airline industry is capital
intensive, its fluctuating financial cycles are notorious (correlating with the cycles of home markets), and infusions of capital investment are always needed. While the U.S. capital market is large, it has not proven sufficiently flexible to support the airline industry in its periodic downturns. The U.S. domestic airline industry would look quite different if foreign ownership and control were permitted. At the very least, the current low asset prices of U.S. carriers would be boosted as domestic buyers faced greater competition. Given that EU direct investment in the United States is now almost $900 billion, and includes such conspicuous transportation names as Chrysler and Jeep, straitjacketing the airline industry with a legal test that prevents access to global capital markets is anomalous and commercially inexcusable.

III. Unlocking the External Bolt—The Forces for Change

A. U.S. and European Initiatives

Successive U.S. administrations have been at the forefront of remodeling global aviation regulation to conform more to the image of the deregulated U.S. home market. Although the United States did not abolish the domestic nationality restriction or remove the ban on serving wholly domestic (cabotage) routes, it has liberalized on other economic fronts. American air transport officials invented and promoted the "open skies" idea of unrestricted airport selection, pricing, frequency, and capacity on all international routes to and from the United States.

In this setting, recent congressional appropriations legislation on foreign ownership (mentioned above in Section I.G) contradicts the thrust of U.S. international aviation policy on the future of the nationality clause. Through treaty arrangements and other means, the United States has aggressively sought to reduce the strength of the external bolt by substituting citizenship tests that are more flexible than compulsory percentages of national ownership. In November 2000, the United States led a group of APEC states (Brunei, Chile, New Zealand, and Singapore) into the first multilateral open skies treaty outside the specialized framework of the European Union. A country belonging to the founding group of five is required to accept another group member's designation so long as the designating country or its nationals (or both) effectively control that airline and the airline is incorporated and has its principal place of business in the designating country. Technically, a national shareholder bloc of only 25 percent could control the corporation, provided that the other 75 percent comprised a highly fragmented pool of non-national owners. To that degree, the revised nationality clause does in principle expand the airlines' access to
foreign equity financing, although the forced absence of control by foreign investors will probably be regarded as commercially unappealing.

As more EU members signed open skies agreements with the United States, the Europeans themselves became prophets of liberalization. In 1997, EU legislation created the concept of the "Community air carrier," which means any carrier licensed by a member country according to EU licensing benchmarks (including the requirement of a principal place of business in the licensing country) and which is owned and effectively controlled by any EU member country or by the nationals of any EU member country. Non-member nationals can own up to 49.9 percent of the voting rights of a "Community air carrier." An airline satisfying the common licensing qualifications enjoys a non-discriminatory right to fly anywhere within the European Union, including on cabotage routes that are wholly within each member country. Thus, the Europeans have out-deregulated the Americans, ending both the nationality restriction and the cabotage restriction for all EU-licensed air carriers and increasing permissible non-EU ownership to almost 50 percent.

With respect to third countries outside the European Union, however, the nationality clause still haunts the EU liberalization plan. As a consequence, fearing withdrawal of international traffic rights by the United States and other aviation powers, EU airlines have rarely taken advantage of their new freedom to merge, acquire, and consolidate across EU borders. The only carrier combinations producing multinational ownership and control have involved smaller airlines that operate entirely within the European Union. As noted earlier, the European Court of Justice recently ruled that an EU member country cannot disallow any licensed "Community air carrier" from serving third country international routes out of that country. Compliance with this ruling raises intriguing possibilities that threaten to disrupt traditional expectations of the nationality clause. France may very well designate British Airways to compete with Air France on the Paris/New York route, but will the United States accept British Airways, a UK-owned airline, under its bilateral agreement with France?

Now that the U.S. and EU internal air transport markets have been largely deregulated, U.S. and EU transport officials have launched a marquee initiative that may lead to a transatlantic Open Aviation Area. This initiative would eventually create a free trade zone in air transport, including an extension of the "Community air carrier" concept to cover the United States as well as the European Union. If this reform were achieved, both the external
and internal citizenship bolts would be unlocked within the Open Aviation Area. It would end restrictions on ownership and control of U.S. airlines by EU-based investors (including EU airlines), as well as on ownership and control of EU airlines by U.S. investors (including U.S. airlines). Moreover, without a citizenship test, U.S. and EU airlines would be able not just to acquire or merge with existing airlines in the other's territory, but also to set up local service operations (whether through a subsidiary or an entirely new entity) in each other's territory. To do so, as will be discussed further in Section IV.B, they would have to become legally "established" in the foreign territory.

B. Global Initiatives

U.S./EU leadership is not idiosyncratic or isolated. Other liberalizing initiatives have been promoted by the aviation industry's super-national governance and trade organizations, notably IATA, the International Civil Aviation Organization (ICAO), and the European Civil Aviation Conference (ECAC), as well as by the intergovernmental economic research agency, the Organization for Economic Co-operation and Development (OECD). ICAO, the intergovernmental U.N. agency that generates global safety and operation standards, made liberalization of the foreign ownership restrictions a headline theme of its 2003 Worldwide Air Transport Conference. It has already eased the severity of the nationality clause for some developing countries by persuading ICAO members to recognize a joint designation by several countries of a single carrier owned and controlled by only one of those countries or its nationals where that country is bound to the others in a "community of interest." Some Caribbean Economic Community (CARICOM) members, for example, have used the ICAO initiative to designate BWIA International Airlines, substantially owned and effectively controlled by Trinidad and Tobago, as their designated carrier to operate services under their respective bilateral agreements with the United Kingdom, Germany, and the United States.

The question for all of the international entities looking at the issue of liberalization is the same one. Can the national ownership and control rules be scrapped without creating an anarchical system where airlines are certified in low-regulation, low-cost countries, serving the world's air transport routes out of legal refuges in Panama or Liberia (as happened in maritime transport)? Countries wish to ensure that national aviation safety standards remain high, that other countries continue to accept their airline designations on international routes, and also (because of pressure from airline labor unions) that airlines are still required to use local labor forces when serving the domestic and international routes of a particular coun-
try. Consequently, the common talismanic phrase in all of these initiatives is that there must be a "strong link" between an airline and its designating state. Building on that idea, this White Paper proposes a "corporate affinity" test that would replace the citizenship tests of national ownership and control. Affinity would be demonstrated in the first instance by familiar corporate law tests like principal place of business, place of incorporation, place of central administration, and place of permanent residence. Other refinements to give countries the assurance needed to scrap their foreign ownership and control rules, including requiring national economic and operational certification, will be discussed in Section IV.B

IV. Adapting to Change—A New Corporate Affinity Test

A. The Internal Bolt Must Also Be Unlocked

The pace of reform at the international (external) level cannot probably not be stopped. Too many participants in aviation’s global webs of influence have staked out liberal positions. And other initiatives are set to continue. The European Union is about to undertake a massive country-by-country renegotiation of EU member bilateral agreements to require third countries to accept the designation of "Community air carriers" by each member country. And, as more and more countries waive or renegotiate the strict terms of the nationality clause to allow EU members and other countries to designate airlines owned by non-nationals, the treaty paradigm of strict national ownership will gradually be weakened.

But, while efforts are under way to liberalize the nationality clause at treaty level (the external bolt), major aeropolitical powers like the United States and the European Union member countries still require their own national airlines to satisfy citizenship purity tests created under domestic (or EU) legislation. As long as the major aviation powers keep their nationality restrictions in place, other countries will rarely be tempted unilaterally to abolish their own internal restrictions and to risk a loss of negotiated and valuable traffic rights. The prisoner's dilemma of the bilateral system will remain a powerful deterrent. For the airline industry, unless the major powers unlock the internal bolt, reform efforts to free airlines from the shackles of national ownership will remain largely theoretical, the stuff of well-intentioned position papers but not of commercial reality. Occasional politically-inspired waivers of the nationality clause, and support for global reform initiatives, will not substitute for the predictability that airlines need in order to begin a serious process of cross-border restructuring of their industry.
The case of Australia is instructive. Australia, in fact, has made the most eye-catching change to the traditional domestic nationality rule. Responding to high fares and declining competition in its domestic air transport markets (and Singapore Airlines' professed interest in buying Australia's weakest carrier, Ansett), Australia amended its domestic airline legislation in 1999 to enable non-nationals to own up to 100 percent of any Australian airline with exclusively domestic operations. While Australia's concession is dramatic, it is limited in effect because it deliberately avoids any problematic third-country designation issues. As applied, the legislation also generally permits foreign investors to establish a new aviation business in Australia, provided that the airline remains incorporated and headquartered in Australia and (again) serves only internal routes. IATA, representing most of the world's international carriers, recently complimented Australia's "evolution in thinking."

In the United States, consistent with U.S. international aviation policy on the nationality clause, a constituency has been forming to press for reform of the domestic legislative tests for citizenship. The reformist constituency now includes many of the U.S. airlines that often sheltered behind the nationality clause in the contented years when the U.S. domestic market was flourishing. United Airlines, for example, has undergone a dramatic conversion since its bankruptcy, recently calling liberalization of the foreign ownership restrictions "a promising policy option whose time is ripe." The U.S. Department of Transportation, as it showed in its KLM/Northwest ruling, has tweaked the prevailing system to dilute some of its preconceived notions of sinister foreign control. Even the Bush Administration, often portrayed as jingoistic and reactionary in these matters, has kept faith with earlier liberal initiatives by asking Congress to follow Europe's lead by raising the foreign voting stock ownership cap to 49 percent from 25 percent (with all of the implications for the control test that such an increase would involve).

B. Replacing the Domestic Citizenship Tests

Given the powerful worldwide impact of U.S. air transport law and policy, what kinds of changes should the United States make to liberalize the nationality restrictions in the Federal Aviation Act? Congress could (but apparently will not for the moment) accede to U.S. Transportation Secretary Norman Mineta's recent call to raise the ceiling of foreign voting stock ownership to 49 percent. Given the persistence of the "control" requirement in DOT citizenship review procedures, however, as well as the commercial uncertainties associated with less than a majority shareholding, this change would
be unlikely to spur any sizeable new foreign investment in the U.S.
airline industry.

Another possibility, not requiring legislation, would be for the
DOT to depart from its long-standing precedent which interprets
the Federal Aviation Act to require ownership and control by
citizens—the language of the nationality clause in U.S. bilateral
treaties—even though the precise language of the Act requires only
"ownership or control" of the voting interest by U.S. citizens. The
DOT's analysis overlooks the fact that the meaning of the word
"control" is clearly different in the statute and in the treaty
language. The "control" required by the treaty language is obvi-
ously something other than mere ownership of stock. The wording
refers separately to "substantial ownership" and "effective con-
trol," without a common antecedent, so that it is clear that the
latter relates to managerial and executive supervision of the airline
as opposed to title to stock. In the U.S. legislation, in contrast,
ownership and control do have a common antecedent. As long as
"seventy-five percent of the voting interest is owned or controlled"
by U.S. citizens, the plain meaning of the statute is satisfied. Thus,
notwithstanding the DOT interpretation, there is no separate test of
managerial or executive control in the Federal Aviation Act (al-
though, as noted earlier, the president and two-thirds of the board
and other managing officers must be citizens, an implicit indication
that this control will likely exist). The DOT's conjunctive reading,
incidentally, finds no support in any of the legislative history of the
federal legislation, and was roundly criticized in an early citizen-
ship review hearing.34

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—Brian F. Havel

No doubt the DOT prefers to interpret the words of the statute
consistently with the nationality clause used in bilateral treaties.
But the "control" element of the treaty language has no statutory
basis in U.S. law and could be re-negotiated with other countries. In
any event, even if the DOT changed its interpretation, it is hard to
imagine that a foreign airline investor would find it appealing to
seek the highly contingent managerial control of a U.S. airline that comes with 25 percent or less of the stock and at most one-third of the seats on the board. And this change would do nothing to allow foreign airlines to build subsidiaries or new ventures in the United States.

The most productive strategy, therefore, would be to respond to the international consensus—forged among airlines, airline organizations, and government and non-government international organizations—to abolish the ownership and control tests and require instead that U.S. airlines continue to demonstrate a "strong link," or what this White Paper calls a "corporate affinity," with the United States. Replacement of the citizenship test by a corporate affinity test will involve making a clear conceptual separation between commercial and regulatory control of an airline. For a private investor, "control" means a majority of the voting equity and also probably some measure of managerial or strategic influence. If the U.S. government decides to concede that kind of commercial control to a foreign investor, then (as noted above) it will need to settle three critical questions of law and policy.

First, how does the U.S. government ensure that an airline remains under effective U.S. regulatory control for safety and security standards (as indeed it must do under international treaty law)?

Second, how does the U.S. government ensure that other countries will accept its designation of an airline as a U.S. carrier for service on international routes?

Third, how does the U.S. government ensure that the foreign investor does not simply maintain a shell identity in the United States and move the airline’s true commercial operations to a low-regulation, low-wage third country (the "flag of convenience" problem notorious in the global maritime industry)? U.S. airline labor unions fear that foreign-owned airlines will locate themselves in flag of convenience countries and then cherry-pick the most profitable domestic ("cabotage") and international U.S. routes using foreign crews and foreign-registered aircraft.

As to the first question—regulatory control—Section III.B introduced a new test of corporate affinity which amplifies well-understood corporate law criteria such as place of incorporation and principal place of business. Any airline (including a subsidiary of a foreign-owned airline) that operates domestic (cabotage) services in the United States, or that is designated by the United States to serve its international routes, must legally "establish" itself in the United States by incorporating under state law, by having a principal place of business in the United States, and by holding current
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Economic and operational certifications granted by the U.S. aeronautical authorities (the DOT and the Federal Aviation Administration (FAA)). These requirements would apply both to existing U.S. airlines which are acquired by foreign investors (including foreign airlines), and also to U.S. subsidiaries or new ventures created by foreign airlines.

A principal place of business can be determined based on such details as the amount of capital invested in U.S.-based physical facilities, payment of U.S. corporate income tax, U.S. registration of aircraft, amount of localized managerial and technical employment in the United States, and so forth. Here, in fact, a DOT checklist (of affiliating factors) would actually make sense. Moreover, to maintain a principal place of business in the United States, an airline must be in full compliance with all applicable federal and state laws, including taxation, environmental, immigration and labor measures, as well as federal safety and security oversight and participation in the military CRAF program. The term should be flexible enough to accommodate the new forms of airline enterprise that will arise. A multinational airline corporation—such as a unified United/Lufthansa—could have multinodal principal places of business.

American military security interests present a related issue of regulatory control. The U.S. Department of Defense has expressed concern that foreign-owned U.S. airlines would not provide supplemental airlift support through the voluntary CRAF system during emergencies such as the recent Iraq war. This program provides over 90 percent of the passenger air transportation required by the military during an activation, and nearly 40 percent of the cargo transportation. While participation is optional for U.S. airlines, it is a prerequisite to eligibility for significant military business and for doing business with civilian government agencies. U.S. airlines, all the while beating their patriotic breasts, have consistently ranked the importance of peacetime economic incentives of CRAF participation more highly than the contingent risks of emergency activation. As a general matter, foreign ownership would not alter this calculus of economic self-interest either in peace or war. Also, annulment of the foreign ownership laws could be accompanied by measures to make CRAF a compulsory obligation for all U.S.-certificated carriers or at least a pre-condition for foreign investment.

As to the second question—acceptance of U.S. designations on international routes—American aeropolitical power is such that third countries would very probably accept designations based on the corporate affinity test so long as the United States maintained

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its regulatory control over the airline. This is even more likely because of a perceptibly more liberal U.S. attitude to third country ownership and control of airlines designated by other countries to serve routes into the United States.

The third question—avoidance of shell identity and flag of convenience abuses—should be resolved by the stringency of the corporate affinity test. With respect to domestic (cabotage) routes, a foreign entity serving those routes would have to "establish" itself (as a subsidiary of a foreign airline, or in the form of an entirely new airline venture as envisaged by Virgin Atlantic chairman Richard Branson). The same corporate affinity test would apply for airlines wishing to serve U.S. international routes, with the added safeguard that (unlike in maritime transport) access to international air routes requires not only a designation by one country but also an acceptance by the other country at the end of each route. The United States can simply refuse designations by countries to which a foreign-owned U.S. airline has attempted to "re-flag."

V. Conclusion: The Air Cargo Industry as a Laboratory for Change

This White Paper has attempted to make the case that disqualification of foreign nationals from majority ownership and control of national airlines is an anachronism in today's commercial environment. Air transport is a mature industry that denies its participants the power to make strategic decisions involving domestic and transborder mergers, acquisitions, joint ventures, and the establishment of foreign subsidiaries.

The legacy of restrictions on foreign ownership and control will take time to dismantle. This White Paper strongly urges that a sectoralized approach should be adopted, focused on the OECD's proposal for an accelerated liberalization of domestic and international all-cargo air services. There are several reasons why air cargo can be a laboratory for the legal and policy reforms advocated in this Paper. First, the timing is opportune. The current DHL citizenship case is shining a spotlight on the air cargo industry, revealing how a national citizenship test is fundamentally at odds with the transnational basis of modern air cargo operations. The old notion of "national" traffic—where "national" air cargo carriers are supposed to cater predominantly to cargo within their own countries—has become irrelevant as globalization has transformed the world business environment. Relatedly, even within the existing strict bilateral system, international air cargo has been the most creative and fastest-growing sector of the world airline industry. The cargo sector, therefore, would offer a powerful model for the kinds of restructuring and network efficiency enhancements that
could be obtained without the impediment of the nationality restrictions. Finally, in the immediate future the political environment for reform of air cargo is likely to be much more hospitable. Governments have been less sensitive about the political implications of liberal reforms in the air cargo industry, and indeed some countries have already granted air cargo substantially more liberal traffic rights under bilateral agreements than they permit in the air passenger sector. A successful paradigm change in this sector, therefore, could be the catalyst for governments to pursue broader reform in the much larger and more complex air passenger sector. The United States, in its submission to the 2003 ICAO Worldwide Air Transport Conference, confirmed its experience that, in the context of U.S. open skies policy, "liberalizing cargo may build confidence and provide an important step towards full liberalization."40

The eventual dynamics of change could combine initiatives that are unilateral (a bold policy announcement by the United States or European Union, for example), bilateral (as occurred between the United States and Argentina), regional (as has already taken place within the European Union and could still occur within NAFTA), and multilateral (within the framework of a new U.S./EU air services treaty). The more aeropolitically powerful the protagonists of reform, the more unilateral internal changes in foreign ownership and control laws will find acceptance by other countries. That is precisely why the effects of the European Court of Justice ruling on member state nationality clauses have ricocheted throughout the worldwide bilateral network.

Eventually, the entire byzantine system of exchanging air traffic rights bilaterally (comprising some 4000 treaty instruments) will pass into commercial history. Airlines will have the right to enter and exit all domestic or international routes within and between the countries which participate in a new multilateral dispensation. The timetable for this new dispensation remains unclear, but it will certainly happen. The projected U.S./EU Open Aviation Area could be a highly significant milestone. Meanwhile, it is already well past time to repudiate the most pernicious legal obstacle to a globally competitive and efficient airline system—the timeworn rule that foreign nationals cannot be trusted to own and operate national airlines.

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Endnotes


10 Willye Peter Daetwyler, d/b/a InterAmerican Freight Co., Foreign Permit, 58 C.A.B. 118 (1971).

11 In re Acquisition of Northwest Airlines, Inc. by Wings Holdings Inc., Order No. 89-9-51, 1989 DOT Av. LEXIS 643 (Sept. 29, 1989), and In re Acquisition of Northwest Airlines, Inc. by Wings Holdings, Inc., Order No. 91-1-41, 1991 DOT Av. LEXIS 55 (Jan. 23, 1991).


13 See Jeffery N. Shane, Associate Deputy Secretary, U.S. Department of Transportation, Address, Open Skies Agreements and the European Court of Justice, American Bar Association Forum on Air and Space Law (Hollywood, Florida, Nov. 8, 2002).


15 See id. at 13,180; see generally European Court of Justice, Cases C-466/98, C-467/98, C-468/98, C-469/98, C-471/98, C-472/98, C-475/98, and C-476/98.
against the United Kingdom, Denmark, Sweden, Finland, Belgium, Luxembourg, Austria, and Germany.


18 Shane, supra note 13.

19 BRITISH AIRWAYS PROSPECTUS (1987).


21 See Mendelsohn, supra note 14., at 13,175-76.


24 Barry Humphreys, Director of External Affairs and Route Development, Virgin Atlantic Airways, Address, Liberalised Airline Ownership and Control, Seminar Prior to the ICAO Worldwide Air Transport Conference: Challenges and Opportunities of Liberalization (Montreal, Canada, Mar. 22 and 23, 2003).


26 See generally <www.maliat.govt.nz>


31 See van Fenema, supra note 20, at 24.
32 Whitaker, supra note 25.
35 See Boaz Moselle et al., THE ECONOMIC IMPACT OF AN EU-US OPEN AVIATION AREA 9-3 (2002).
39 See OECD, Liberalization of Air Cargo Transport, supra note 28.