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Airline ownership restrictions

The prospect of getting married is much improved

If an alliance is like an engagement and a merger is like a marriage, for the majority of airlines the best they can do is get engaged because marriage is not an option. This is because of the restrictions on airline ownership and control that has been in place since the Chicago Convention over 60 years ago. On 24 March 2011 in the final step of the procedure, the European Parliament gave its consent to the EU-Canada 'Open Skies' agreement which is a significant milestone in the softening of the restriction as it foresees the total liberalisation of airline ownership and airline travel between the parties' territories. This client update describes the ownership restriction, identifies key examples of it being softened, and concludes that this softening has important consequences for the future of airline ownership and control compared to the current common currency of airline partnerships and alliances. Being engaged is not the same as being married, and the consequences in terms many key factors may favour a merger.

The Restriction[1]

The restricted language appeared in the Chicago Convention's Two Freedoms and Five Freedoms Agreements: "each contracting state reserves the right to withhold or revoke a certificate or permit to an air transport enterprise of another state in any case where it is not satisfied that substantial ownership and effective control are vested in the national of a contracting State".

This iconic language contains both a quantitative test (substantial ownership) and qualitative test (effective control). Its importance and impact cannot be understated, with its replication in some 90% of bilateral agreements in the intervening 60 years. At the EU level, it appears in Regulation (EU) No. 1008/2008 article 4 (f).

1 This paper was first delivered at the Hansonwade "Airline Partnerships & Alliances Summit", London 29-30th March 2011.

In the face of a similar restriction, express or implied, the EU's coal and steel sectors were populated by national champions, but also plagued by over-capacity and loss making business, with little positive prospects. In order to overcome the effect of this nationality restriction in the EU it took some 50 years, a ground-breaking treaty and still the coal sector struggles to deal with its past. Given that context, with the continual negative effect of the nationality restriction in the airline sector, it is surprising that the airline sector is not in a far worse situation than it is.

It is a credit to the airline industry's corporate leaders that despite the restriction airlines have found a work-around. Through alliances and partnerships of various depths and scope, the airline industry has coalesced through code-sharing pseudo-mergers.

The various States have also played a role. They have the ability, through strict application of the restriction or through other tools, such as antitrust laws, to prevent such alliances. However, in practice States have played a balanced to positive role, such as the USA's Department of Transport's ability to grant antitrust immunity to such alliances.

This softening of the restriction is evident in other ways, of which I describe briefly two examples. The first example is the Sabena/Swissair merger. It may be described as a merger because it met the jurisdictional test under the EU's Merger Regulation, which captures large pan-European and global mergers and allows the EU to block those that would create a significant impediment to effective competition.

Regulation 2407/92, which applied at the time of the Sabena/Swissair agreement, was the predecessor to the current Regulation 1008/2008. Both are identical in relation to the qualitative test of "effective control", namely that:

> *"effective control" means a relationship constituted by rights, contracts or any other means which, either separately or jointly and having regard to the*

considerations of fact or law involved, confer the possibility of directly or indirectly exercising a decisive influence on an undertaking, in particular by:

a) The right to use all or part of the assets of an undertaking;

b) Rights or contracts which confer a decisive influence on the composition, voting or decisions of the bodies of an undertaking or otherwise confer a decisive influence on the running of the business of the undertaking.

Sabena/Swissair

- *Application of the restriction*

Without entering into all the details of the Sabena/Swissair agreement, the Commission concluded that:

- Swissair's ownership of 49.5% of the equity capital of Sabena;
- Swissair's holding of €10 million in Sabena loan notes;
- Swissair's appointment of 5 out of the 12 board member positions; and
- The two parties' ten year strategic cooperation agreement

did not qualify Swissair as having the possibility of decisive influence over Sabena. It is noteworthy that in the final paragraphs of its decision of July 1995 the Commission identified the rationale for the existence of the restriction, namely the safeguarding of the EU's air transport industry and that four months earlier the EU's Council had authorised the Commission to negotiate an "open skies" agreement with Switzerland with the view to extending to Switzerland – and presumably vice-versa- the EU's rules governing the internal air transport market. Consequently, the Commission concludes in its decision that the Sabena/Swissair agreements "provide an interim solution until the existing ownership and control restrictions between Switzerland and the [EU] are lifted on a reciprocal basis" [2].

- *Application of the Merger Regulation*

The day after the Commission's decision, the Commission made a decision under the EU Merger Regulation. The test under the EU Merger Regulation is that a "concentration", namely an acquisition or merger will arise where a "change of control on a lasting basis" results from, *inter alia*, "the acquisition...direct or indirect of control" by one business of another business (article 3(1)). By article 3(2), "control shall be constituted by rights, contracts or any other means which, either separately or in combination and having regard to the considerations of fact or law involved, confer the possibility of exercising decisive influence on an undertaking, in particular by: (a) ownership or the right to use all or part of the assets of an undertaking; (b) rights or contracts which confer decisive influence on the composition, voting or decisions of the organs of an undertaking". Finally, by article 3(4) the creation of a joint venture "performing on a lasting basis all the functions of an autonomous economic entity shall constitute a concentration...".

In applying this test the Commission concluded that there was a concentrative joint venture between the Belgian State and Swissair because "each of the two parents will have the possibility to exercise a decisive influence on Sabena's commercial policy". This conclusion was based on the following three points:

- The two parents have a strong common interest to run Sabena in active cooperation;
- The CEO, who will be responsible for daily management cannot be appointed by the board without the joint proposal of both parties; and
- The cooperation agreement gives expression to decisive influence because its purpose is to achieve operational synergies in areas of great strategic and commercial importance..."[3]

The ability under one set of rules for the Commission to decide that Swissair did have decisive influence over Sabena, even if jointly with the Belgian State, and in another set of rules to decide that Swissair did not have decisive influence over Sabena suggests there was by the relevant stakeholders (countries, corporations and the EU institutions) a community of the willing to soften the application of the ownership restriction, not the application of the EU's competition rules.

This is not as provocative as it might at first seem, in the light of the second example, namely the Open Skies cases, particularly when considered in the context of the proximity of Switzerland to the EU under the Treaty creating the European Economic Area.

2 The EU/Swissair bilateral open skies agreement was entered into 21 June 1999.

3 Case No IV/M.616-Swissair/Sabena paragraphs 8 to 12.

The Open Skies cases

The Open Skies cases are eight cases brought by the Commission against seven Member States concerning each of their bilateral open skies agreements with the United States. Each of those agreements contain the ownership restriction. The Commission argued that the ownership restrictions meant that the Member States were in breach of the EC Treaty, because the restrictions distorted the EU's internal market for aviation services and were discriminatory on grounds of nationality. The Commission commenced the Court action in 1998 and in 2002 the Court ruled in favour of the Commission's arguments.

Whilst the Open Skies cases are a Court forced softening within the EU of the restriction, the effect on and response of third countries is perhaps the more important point, at least internationally. The effect of the Open Skies cases on third countries on top of the liberalisation within the EU on airline ownership that came about in 1992 with the so-called " third liberalisation package"[4] means that, for example, if BA wished to acquire Air France, then the United States' bilateral open skies agreement with France would be relevant, given the nationality change of ownership of Air France. Either the United States would have to waive the restriction, or insist on its application with the effect, of course, that BA would not seek to acquire Air France. Acceptance of the new EU regional designation following the Open Skies cases – the "Community designation" – is widespread, with 839 bilateral agreements having been brought into conformity as at September 2009[5]. There are, of course, notable hold-outs in recognition of the Community designation, such as the United States and this has required transactional lawyers to jump through hoops in an attempt to give effect to the business rationale of parties to an airline acquisition, whilst attempting not to trigger the restriction. As the discretion ultimately rests with third countries to recognise or not that the restriction need not apply to a transaction, the degree of confidence that the transactional lawyers have done the job correctly can only be high if there has been meaningful dialogue with third countries. Russia's serious questioning in March 2010 of the Lufthansa/Austrian Airlines transaction is just one example of the potential for the restriction to strip-out the benefits of a transaction.

4 The Council Regulation No 2407/92 on licensing of air carriers; the Council Regulation No 2408/92 on access for Community air carriers to intra-Community air routes and Council Regulation No 2409/92 on fares and rates for air services.

5 http://ec.europa.eu/transport/air/international_aviation/doc/status_table.pdf

EU/Canada Open Skies agreement

It is beyond the purpose of this paper to consider why or how it is that the EU has been able to obtain a softening of the restriction from so many countries, or why that in relation to some important trade partners the issue remains unresolved. However, just as history records in bold the Chicago Convention, so it may do the EU/Canada bilateral open skies agreement.

The agreement had been initialled on 30 November 2008 in London and was politically endorsed by the EU-Canada summit on 6 May 2009 and signed on 17-18 December 2009. The European Parliament on 24 March 2011 gave its consent to the agreement[6], which is the final step in the procedure. This Agreement can fairly be described as the most ambitious air transport agreement between the EU and a major world partner. The agreement provides for gradual phasing in of traffic rights, investment opportunities, removes restrictions on routes, prices, number of weekly flights between Canada and the EU and also specifies that airlines are free to enter into arrangements such as code-sharing. The agreement contains provisions for phased opening-up of the market linked to the grant of greater investor rights.

Phase one applies where the foreign ownership of airlines is limited to 25 per cent, as was the case when the negotiations on the agreement were completed. Airlines have unlimited freedom to operate direct services between any point in Europe and any point in Canada. There will no longer be limitations on the number of airlines flying between the EU and Canada nor on the number of services operated by any airline. Cargo airlines will have the right to fly onward to third countries. Phase two starts when Canada has taken the steps necessary to enable European investors to own up to 49% of a Canadian carriers' voting equity. This means certain additional rights, including the right for cargo operators to provide services to third countries from the other party without connection to their point of origin (so called "7th freedom" rights) will be available. In fact, Canada introduced this possibility in March 2009.

Phase three begins once both sides enable investors to set-up and control new airlines in each others' markets. Then passenger airlines will be able to fly onward to third countries. Thus there would be a right or freedom

6 Under the EU's 'Lisbon Treaty' the European Parliament's consent is required for the negotiation and conclusion of international agreements in the field of transport.

of establishment to each other's citizens. For example, a European airline could have a wholly owned subsidiary to provide for intra-Canada service which could also supply feeder traffic to its own transatlantic airline. Phase four is the final step with full rights to operate between, within and beyond both markets, including between points in the territory of the other party ("cabotage"). It will be granted once both sides complete steps to allow the full ownership and control of their carriers by nationals of the other party.

It is more ambitious and specific than the EU-US Agreement with regard to traffic rights, ownership and control. Thus, the benefits for an EU airline are:

- The possibility for any "Community air carrier" to fly between any point in the EU to any point in Canada, without any restrictions on the number of flights. This freedom did not exist before.
- Freedom to enter into commercial arrangements with other airlines, i.e. code-share agreements, which are important for airlines when serving a large number of destinations, and no restrictions for airlines to establish their tariffs in line with competition law.
- The Agreement contains provisions for the phased market opening linked to the granting of greater investment freedoms by both sides, as described above.

Conclusion

The airline industry has energetically invested in the creation of alliances and partnerships to develop trans-national and international airline brands, despite the ever present chilling effect of the nationality restriction that has over-shadowed the industry for the last sixty years. The success of these pseudo-mergers is evident and it may be expected that the number and size of these alliances will grow.

However, on the assumptions that synergies and other transaction efficiencies are optimized through mergers and acquisitions, and that absent the nationality restriction airlines would have merged many years ago, there is the desire to enter into stronger more structural forms of integration - mergers and acquisitions. The formal and informal softening of the nationality restriction means that more than ever airlines can seriously include in their strategic thinking and actions such closer forms of integration. In this corporate environment, both in terms of finding the best marriage partner and keeping that partner in the face of the usual regulatory issues, such as competition law, first mover advantage cannot be ignored. Perhaps now is the time for the airline industry to reflect on which of the two sayings they most adhere to: (i) marry in haste, repent at leisure; or (ii) he who dares, wins.

For inquiries related to this Legal Update, please contact:

Kiran S. Desai
Partner
+32 2 502 5517
kdesai@mayerbrown.com

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