



## Preparing for takeoff

Manu Mohan of Mayer Brown examines ownership and control restrictions in the airline sector, and asks whether the application of competition laws will force a change in the rules of the game



### Manu Mohan

Manu Mohan is an associate at Mayer Brown in Brussels. Manu focuses on the practice of competition law, and his experience encompasses merger control, businesses' conduct including cartels and also sector enquiries. Manu has a focus on aviation, energy and media sectors. Manu has worked in an in-house role and has also practiced law in India.

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# PREPARING FOR TAKEOFF

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In today's economy corporations are seeking to become global businesses rather than national champions. Multinational corporations have sought to extend their reach around the globe by setting up their own subsidiaries or by acquiring existing local businesses.

Despite the fact that airlines constitute an important cog in the wheel of globalisation, there is no single airline that can claim to be truly international in its operations. Ownership and control restrictions hinder the international expansion plans of airlines as consolidation can occur only between domestic or regional (European) airlines. However, there have already been two instances of regional airline mergers being blocked in Europe. Further consolidation between domestic/regional airlines may face significant competition law hurdles.

In Europe, the possibility of a sector-specific relaxation of competition laws being applied to airline mergers is minimal. The easier method for furthering consolidation plans of airlines seems to be the relaxation of the airline ownership and control laws. This seems to have been recognised by the European Union, which is aggressively pursuing the liberalisation of airline ownership and control through comprehensive bilateral aviation agreements with other countries to facilitate cross-border consolidation. Other countries could follow the lead and pursue similar bilateral/multilateral aviation agreements for the relaxation of airline ownership and control laws.

## Current airline ownership rules

There is no requirement under international law that the current airline ownership and control restrictions should be maintained. The Chicago Convention (“**Convention**”) forms the basis for the myriad bilateral agreements among countries governing air travel. The International Air Transport Agreement (“**Transport Agreement**”) was intended to complement the Convention with the “five freedoms of the air.” These are the right to:

- fly over a foreign country without landing
- land in a foreign country for non-traffic purposes (refuel, maintenance)
- fly from one's own country to another
- take passengers and cargo destined for the territory of the aircraft's nationality
- take on passengers and cargo, and to drop-off passengers and cargo, destined for or coming from the territory of any state signatory to the Convention.

The first two freedoms are contained in the International Air Services Transit Agreement that came into force in 1945 with

122 contracting states. However, only 11 states have signed up to the Transport Agreement and therefore it is ineffective. The concerns regarding national security and safety are cited as primary reasons for retaining the ownership restrictions.

The Convention established the International Civil Aviation Organization (ICAO) and common standards are set out for the operation of commercial air carriers. An operator of a commercial air carrier must have the following:

- (i) an Air Operator's Certificate,
- (ii) an Operating License
- (iii) a Route License or Permit.

These documents are typically issued by National Authorities. The effect of requiring them is that bilateral rights are available only to those airlines registered in the countries entering into the bilateral Air Service Agreements. The bilateral agreements lead to the situation where flying rights are subject to the agreement of not just the country where the airline is registered, but also the country the airline intends to fly to.

To qualify as a US flag carrier, a company must obtain a certificate of public convenience and necessity from the US Department of Transport. The exercise of US international air route rights are reserved to airlines controlled by US citizens, and owned 75 percent or more (voting stock) by US citizens.

The regulations applicable in the EU are slightly more liberal in that they permit cross-border acquisitions within Europe, but do require that European airlines must have majority European ownership and effective control.

### Working around ownership and control restrictions

To work around these ownership restrictions, some airlines have resorted to using complex ownership structures for mergers, for example British Airways/Iberia and Air France/KLM. The jury is still out on the validity of these structures as overseas states may challenge these in future.

Attempts at consolidation have also led to outcomes that seemingly contradictory outcomes as in the Swissair/Sabena decision where the European Commission (“**commission**”) concluded that the agreement to acquire 49.5 percent of Sabena's share capital did not qualify Swissair as having the possibility of decisive influence over Sabena. The Swissair/Sabena decision was made in accordance with Regulation 2407/92 (predecessor to Regulation 1008/2008) for the grant

of an Operating License on satisfaction of the ownership and control criteria. One day after this decision, in the context of a decision under the EU Merger Regulation, the commission found that Swissair did have decisive influence over Sabena jointly with the Belgian state.

A couple of attempts to merge European airlines have also failed to clear the competition law hurdle. Of the four transactions that have been blocked by the commission in the last decade, two are from the airline sector, namely Ryanair/Aer Lingus and Olympic/Aegean Airlines. In the last few months there have been renewed attempts to conclude these transactions, and the commission will soon be taking a decision on the proposed transactions. It is to be seen whether the commission will adopt a different decision this time.

As ownership restrictions are a significant hurdle in the path of establishing a truly international airline, airlines have come up with creative solutions such as alliances, code-share agreements etc. Such arrangements are subject to the scrutiny of competition regulators. Unlike the United States, where immunities from the application of antitrust laws to alliance agreements can be granted by the Department of Transportation, Europe has no sector-specific exemptions applicable to airlines. The European Commission is currently investigating certain agreements between members of the Star and Oneworld airline alliances. Two other code-share agreements are also being investigated by the European Commission.

**The EU has negotiated a few bilateral agreements to overcome ownership and control restrictions**

### Effect on consolidation in Europe

In comparison with the market in the US airline market, Europe seems to be more fragmented, with several players. Several European airlines are suffering losses and some are propped up by state measures – recent examples include Czech Airlines and Alitalia. This has prompted rumours about consolidation in the European airline market.

However, despite the deregulation of the airline market within Europe, the mergers have been few and far between. This may be the result of the significant regulatory burden involved in seeking compliance with ownership restrictions and competition laws. In a number of mergers between European airlines, the commission has sought to remedy competition concerns through slot divestitures. However, fear of significant erosion of deal value or loss of synergies as a result of the remedies imposed and the complex ownership and control structures that need to be established in order to comply with the restrictions, may be acting as deterrents to potential suitors.

The acquisition of minority stakes by airlines operating outside Europe would allow access to capital; such was the case of the acquisition by Etihad Airlines of a minority stake (29 percent) in Air Berlin. A minority stake may however not be sufficient for some other operators. It was widely reported that one of the reasons for Turkish Airlines losing interest in the struggling Polish airline Lot was that Turkish Airlines would not have actual control over Lot.

### Conclusion

It is not only European airlines that are suffering from financial difficulties: airlines in the United States (American Airlines) and Asia (Kingfisher Airlines) are also facing huge losses. For some of the airlines, a merger/acquisition would open possibilities for future market development, cost optimisation through price setting and increased synergies.

The likelihood of competition concerns being raised by the commission or national competition authorities in the case of an acquisition of a European airline by a non-European airline is low. But such transactions would have to overcome ownership restrictions. On the other hand, it is proving more costly for European airlines to obtain clearance from the competition authorities considering the costs of remedies imposed. In addition, the challenge of the airline status by third parties remains a concern in spite of the complex structures devised to allow for compliance with the ownership restrictions and maintenance of flying rights. Alliances or other forms of co-operation agreements are also facing increased scrutiny from the European Commission, and risk infringing competition law.

A relaxation of the ownership rules to the airline sector by the commission or the grant of a sector-specific exemption is unlikely. More likely, alternatives will need to be devised.

Recognising that the airline business is struggling in Europe, the EU has negotiated a few bilateral agreements to overcome ownership and control restrictions. Agreements have been signed with the United States seeking to liberalise airline ownership and control in order to enable airlines to attract investment irrespective of the nationality of the investors. Similar agreements have been negotiated with Canada and Brazil. More of such comprehensive aviation agreements can be expected, with the European Commission receiving the authorisation to negotiate such similar agreements with Australia and New Zealand.

Such agreements seek a gradual opening of the market based on a full liberalisation of all the direct traffic between a country and the EU and later traffic via intermediate points or to points beyond. It is likely that other countries will pursue a similar strategy, given how difficult it is to obtain multilateral treaties that liberalise airline ownership and control. ■

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*Manu Mohan is an associate at Mayer Brown in Brussels. The views expressed in this article are personal to the author and do not reflect the view of Mayer Brown or any of its clients.*