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CANADIAN AIRLINES AND AMR PROPOSAL: NATIONAL TRANSPORTATION AGENCY DECISION

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INTRODUCTION

On 27 May 1993, the National Transportation Agency ("the Agency") unanimously concluded that the proposed acquisition of a 25% voting equity interest and a one-third economic interest in Canadian Airlines International Ltd. ("Canadian Airlines") by Aurora Investments Inc. ("Aurora"), a wholly-owned subsidiary of AMR Corporation ("AMR"), is not against the public interest;[1] nor is a proposed corporate reorganization of Canadian Airlines.

This paper will outline the reasons for the Agency's decisions.

JURISDICTION OF THE AGENCY

Under the *National Transportation Act, 1987*, ("the Act") persons wishing to acquire an interest or an increased interest in a transportation undertaking in Canada must first give notice of the proposed acquisition to the National Transportation Agency, which then gives the public notice of the proposal. If no objection is filed within a prescribed period, the acquisition will not be reviewed. If, however, an objection is received, the Agency must review the proposal.

In its review, the Agency has to decide whether the proposed acquisition is against "the public interest," defined in part under the Act as the public interest that is consistent with the national transportation policy as set out in section 3(1). This states that the national transportation policy includes the "... safe, economic, efficient and adequate network of viable and effective transportation services ..." It goes on to list matters to be considered by the Agency in connection with this policy, including legal and constitutional requirements.

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(1) AMR Corporation is a public United States corporation. Its primary subsidiary is American Airlines Inc. American Airlines operates a computer reservation system known as SABRE.

One of these legal requirements is that persons holding domestic and certain international air licences must be "Canadian," defined in section 67(1) of the Act as a "... Canadian citizen or a permanent resident within the meaning of the *Immigration Act*, a government in Canada or an agent thereof or any other person or entity that is controlled in fact by Canadians and of which at least seventy-five per cent, or such lesser percentage as the Governor in Council may by regulation specify, of the voting interests are owned and controlled by Canadians..."

The Agency views the legal requirement to be Canadian as a major public interest consideration. If it finds that the proposed acquisition would result in a loss of Canadian status under the Act, the Agency must conclude that the proposal is against the public interest.

MATTERS BEFORE THE AGENCY

The Agency's review in this case involved an examination of Aurora's proposed acquisition of an interest in Canadian Airlines and Canadian Airlines' proposed acquisition from PWA Corporation ("PWA") of an interest in three of its associated feeder air carriers. The latter transaction is part of a proposed corporate reorganization related to the former transaction.

Aurora's proposed acquisition of Canadian Airlines is based on a complex set of agreements and plans which include a stock purchase agreement, shareholder agreement, services and marketing agreements, an employee restructuring plan, a debt restructuring plan and government assistance.

Under the proposed stock purchase agreement, for $246 million cash consideration, Aurora would purchase voting and non-voting shares and acquire a 25% voting interest and an approximate one-third economic interest in Canadian Airlines. The percentage of voting shares Aurora could acquire would be limited by the requirement that Canadian Airlines must continue to be defined as Canadian under the Act.

The shareholder agreement relates to the corporate governance of Canadian Airlines. Among other things, it provides that Canadian Airlines would have a Board of Directors consisting of eight directors, six of whom would be designated by PWA (one of these would represent employees) and two by Aurora.

Some corporate actions would require the approval of a majority of the directors while others would require the approval of a majority including at least one of the Aurora designates. Matters requiring the approval of an Aurora director would include the Corporation's annual capital and financing plan, the declaration of dividends above a threshold amount, commitments to capital spending, asset sales and mergers, and equity investments and acquisitions. The agreement also contains provisions relating to the transfer of the shares of Canadian Airlines.

Canadian Airlines and AMR would enter into a 20-year services agreement under which AMR would provide services in the area of pricing and yield management, operations planning, international base operations, food and beverage support services, reservations, ground operations, capacity planning, technical services and accounting. This would give Canadian Airlines access to the technology and computer-based information and management support systems developed by AMR and American Airlines. Canadian Airlines could terminate the services agreement at any time during the 20-year term. Canadian and American Airlines could also enter into reciprocal marketing agreements allowing passengers on one airline to earn frequent flyer points on the other and to utilize credits or claim awards by using the other carrier.

Most of the employees of Canadian Airlines have agreed to an investment plan whereby they would receive a portion of their wages (up to $207 million over four years) in the form of a right to acquire PWA common shares. Collective bargaining agreements would be extended to 31 December 1995 and wage increases would be limited to amounts that could be offset by productivity gains.

A debt restructuring plan, if approved by creditors, would result in the reduction of Canadian Airlines' long term debt, capital lease obligations and operating lease commitments as well as the elimination of other obligations.

The federal government has provided PWA with a guarantee of $50 million to finance working capital and other operating expenses; financial commitments have also been received from the governments of Alberta and British Columbia.

AGENCY ANALYSIS AND CONCLUSIONS

As mentioned earlier, the Agency had to decide whether the proposed acquisition was against the public interest. In its review, the Agency examined the following eight areas of public interest.

A. The Canadian Ownership Requirement

To be defined as Canadian under section 67(1) of the Act, an air carrier must meet two requirements. First, if the carrier is a corporation, at least 75% of its voting interests, or such lesser amount as the Governor in Council may specify, must be owned and controlled by Canadians. Second, the carrier must be controlled in fact by Canadians.

On the first question, the Agency concluded that at least 75% of the voting shares of Canadian Airlines would be owned and controlled by Canadians. Aurora would own no more than 25% of Canadian Airlines' voting shares with the remaining 75% held by PWA, which would remain Canadian.

Next the Agency considered whether control in fact of Canadian Airlines would continue to be held by PWA or would be transferred to Aurora. In examining this issue, the Agency looked at all the agreements forming part of the proposed transaction.

The Agency concluded that Aurora's proposed purchase of a one-third economic interest in Canadian Airlines would not, by itself, amount to a transfer of control in fact to Aurora. It also found that Aurora's right to designate two members to the Board of Directors of Canadian Airlines was normal and reasonable and did not raise concerns that control might pass to Aurora.

The requirement for one of the Aurora directors to approve certain corporate decisions troubled the Agency somewhat. Would this merely protect Aurora's investment or would it amount to a transfer of control to Aurora? Matters requiring Aurora's approval would include Canadian Airlines' annual capital and financing plan, which, among other things would have to provide a monthly schedule of all capital expenditures, cash forecasts and planned indebtedness. Aurora approval would also be required for annual dividends of more than $5 million, airline-related capital expenditures in excess of $30 million and for cases where the aggregate annual amount of capital expenditures, indebtedness, agreements, contracts, real property lease, arrangements and commitments exceeded $50 million.

The Agency noted that the parties do not intend this provision to apply to everyday operating expenditures or the day-to-day operation of the airline. While recognizing that such a requirement would constrain Canadian Airlines, it felt that the constraint would not amount to a transfer of control to Aurora.

The shareholder agreement provides that PWA and Aurora would have a right of first refusal to purchase new shares of Canadian Airlines. New offerings would be made to the two corporate shareholders in proportion to their current holdings. Each shareholder would also have a right of first refusal to purchase the other's shares, but Aurora would not be permitted to own sufficient voting shares to jeopardize the requirement for Canadian Airlines to remain Canadian under the Act. The Agency found the reciprocal rights of first refusal to be standard arrangements and not to imply an "undue or determining influence" by Aurora over Canadian Airlines.

The Agency concluded that no ownership concerns arose from the frequent flyer agreements to be entered into by the parties.

As noted earlier, the services agreement between Canadian Airlines and AMR would consist largely of computer-based support systems and services developed by American Airlines would be intended to assist Canadian Airlines in managing and planning its operations. Canadian could terminate the agreement if it paid AMR all unrecovered start-up costs, all reduction of capacity costs resulting from the loss of the contract and the net value of anticipated future profits for AMR during the remainder of the contract. In addition, Canadian Airlines would be required to purchase the shares owned by Aurora.

One witness expressed concern that contracting-out such services to AMR would cause Canadian Airlines to lose control to AMR over certain critical functions through having to rely on data provided by AMR for decision-making purposes. Others noted that contracting-out these kinds of services is not unusual and is becoming more widespread because it gives smaller companies access to sophisticated systems that they could not develop themselves.

The Agency concluded that, though the services agreement would make Canadian Airlines to some extent more dependent on AMR, the dependency was inevitable in the circumstances and would have resulted from any agreement to contract out services. Even though a form of dependency would exist, the Agency concluded that it would not be sufficient to transfer control to AMR.

Thus, the Agency was able to conclude that the series of agreements making up the Canadian Airlines-Aurora deal would not result in a transfer of control in fact to Aurora; Canadian Airlines would remain Canadian as defined in the Act.

B. Competition

The national transportation policy states that competition and market forces are important to the provision of viable and effective transportation services.

The Agency heard considerable evidence about how the proposed transaction would affect competition. Air Canada testified that it would be severely damaged if AMR completed the deal with Canadian Airlines. Some contended that Canada could not support two national airlines and others argued the opposite. Representatives of Canadian Airlines felt that if the Aurora acquisition did not go ahead, the airline would be likely to fail.

The Agency agreed that Canadian Airlines' failure would be a distinct probability if the Aurora transaction was not completed. Moreover, if Canadian Airlines failed, so would the majority of its feeder airlines and Air Canada, unless controlled or restricted, would control the market.

The Agency examined the possibility that new airlines might then compete with Air Canada but concluded that any new competition would not be broad-based. The Agency also felt that the transaction with Aurora would not put Air Canada at a disadvantage in transborder markets.

Thus, the Agency concluded that the deal with AMR, by improving Canadian Airlines' financial outlook and substantially increasing its ability to survive, would benefit competition.

C. Impact on International Air Services

It was argued that the Canadian Airlines-Aurora transaction would be contrary to the public interest, since it would allow American Airlines to gain control of Canadian Airlines' routes to the Pacific Rim. The Agency noted, however, that under present Canadian law American Airlines could not acquire such control and concluded that the proposed transaction with Aurora was not against the public interest when examined from the perspective of international air services.

D. Impact on Gemini

In the late 1980s Air Canada and Canadian Airlines merged their computer reservations systems to form Gemini. A subsequent agreement gave Gemini the exclusive right to manage the internal reservations systems of the two airlines. The Gemini arrangement also included limited partnership in which both airlines participated. As part of the proposed transaction with Aurora, however, Canadian Airlines would have to terminate its hosting contract for computer reservation services with Gemini or dissolve the Gemini Group Limited Partnership and transfer its hosting arrangements to SABRE, the system owned by American Airlines.

Gemini argued that this would be contrary to the public interest and highly prejudicial to Gemini – jobs would be lost, regional economic development in telecommunications services would be stifled, there would be less competition in the computer reservations systems business and growth of the airline business would be discouraged. Gemini also contended that if the hosting contract with Canadian Airlines was terminated, it would lose hosting revenues and revenues from travel agencies as well as its "functionality" and its reputation in the marketplace as a stable company.

The Agency concluded the Aurora transaction would have an impact on Gemini, but would not destroy it and so would not be against the public interest.

E. Employment Impacts

The transaction with Aurora would result in the direct loss of 1,271 jobs at Canadian Airlines, while AMR's workforce in the United States would increase by about 500. If Canadian Airlines were to fail, some 15,000 jobs would be lost.

The Agency concluded that the failure of Canadian Airlines would result in far greater job losses than would the services agreement with AMR. Though additional jobs at Canadian Airlines might be lost as a result of AMR's providing further services, the Agency held that the proposed Aurora transaction was not against the public interest. It noted, however, that it would closely monitor the relationship between Canadian Airlines and Aurora and that further "outsourcing" of services would not be permitted if it might result in the transfer of control of Canadian Airlines to AMR.

F. Regional Economic Impact

Opponents of the deal contended that it would harm certain regions of the country. Moreover, the rationalization of routes would disadvantage persons living in small communities. Others suggested that the Montreal region would lose jobs if the transaction were approved because, to continue to be competitive, Air Canada would eventually have to form an alliance with a major U.S. carrier. Air Canada also contended that the transaction would reduce activity at Canadian airports.

Those who supported the transaction maintained that the survival of Canadian Airlines was critical to regional economies in parts of Alberta and British Columbia. If the airline were to fail, there would be substantial direct job losses and many other positions would be indirectly affected.

The Agency concluded that the failure of Canadian Airlines would have an adverse impact on all regions of Canada. Regions with competitive air services would likely be deprived of competition and Canadian airports would be under-utilized. Therefore, the proposed acquisition was not against the public interest from the perspective of its impact on regional economic development.

G. Accessible Transportation Services

Groups representing the disabled felt that the acquisition would reduce service to the disabled – flights might be re-routed through U.S. hubs, and the number of direct flights decreased. This could increase travel time for the disabled and aggravate health problems. The Agency concluded, however, that the transaction would not create obstacles for the disabled.

H. Safety and Health Concerns

Some witnesses suggested that safety and health-related concerns would arise from the transaction. The Agency noted that no evidence had been presented to indicate that Canadian Airlines intended to contract aircraft maintenance to American Airlines. Nor was there evidence that, even if contracting-out did take place, safety standards would be compromised. The Agency concluded that the proposed transaction was not against the public interest from a health and safety perspective.

CONCLUSION

Under the Act, the Cabinet has the authority to review a decision of the Agency. An Air Canada request for such a review, however, was rejected by the Cabinet.

Although this decision gives the go-ahead to the Canadian Airlines-AMR deal, AMR will not conclude the transaction until Canadian Airlines extricates itself from the Gemini relationship. A decision of the Competition Tribunal in connection with this matter is now under appeal. In the interim, Canadian Airlines is attempting to negotiate a settlement with its Gemini partners.