Harold A. Shertz Essay

The Detrimental Effects of Hostile Takeovers, Leveraged Buyouts, and Excessive Debt on the Airline Industry

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I. Takeover Speculation Coupled With Excessive Debt May Push the Airline Industry to the Brink of Disaster

A. *Introduction*

Within the past several years, takeover bids for airline carriers have been in vogue. The individuals bidding for these airlines have been attracted by the high level of concentration which has occurred since the advent of deregulation. A handful of mega-carriers which have amassed enormous market power now dominate the skies.[1] By developing hubs at

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1. At present, the eight largest mega-carriers dominate roughly 94% of the domestic airline passenger market. Dempsey, *The Dangerous Cost of Airline Deregulation*, The Christian Science Monitor, Sept. 27, 1989, at 18. Indeed, this situation has been summed up by public-

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major airports, the airlines have in essence created "mini-monopolies" in which they can maintain relatively stable prices.[2] This concentration is reinforced, moreover, by the incumbents' use of frequent flyer programs and ownership of computerized reservation systems.[3] This, coupled with an industry-wide increase in cash-flow and a belief that carriers' assets are undervalued, make these companies prime takeover targets.

The recent trend in hostile takeover bids for airlines, however, may bring the industry to the precipice of economic catastrophe. An industry which has been marginally profitable during most of the 1980's cannot afford to be saddled with the mountain of debt which can result from hostile takeovers or leveraged buyouts (LBOs). This is reinforced by two key factors: (1) the airlines have a great need for liquidity in order to replace an aging fleet of geriatric jets; and (2) the airline business is cyclical and thus is exposed to the risk of a severe downturn at the end of the current economic expansion. In addition, an increase in uncontrollable costs, such as fuel prices or labor costs, and/or a decrease in demand resulting from an economic recession or threats of terrorism, could also send the debt-laden carriers into deep trouble.[4]

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interest attorney Donald Pevsner as "a *de facto* cartel of eight major airlines that is dictating the travel patterns of 250 million people for their own gain." Friday & Schwartz, *Who Wins the Air Wars*? NEWSWEEK, Sept. 18, 1989, at 41.

2. An added benefit of establishing a hub at a major airport is the virtual domination the hub-carrier can exercise over that facility. A carrier's possession of the majority of landing gates at a terminal may not only allow it to limit the entry of new competitors into that city-market, but also to increase fares in that market due to the resultant lack of competition. This situation has led the Justice Department this summer to initiate an investigation into the possible antitrust violations of these practices. Nomani & Barrett, *Control of Major Airports by Carriers is Focus of Justice Department Inquiry*, Wall St. J., June 18, 1990, at A3, col. 2.

3. Frequent flier programs serve to keep the mega-carriers' customers loyal, at least for the limited time of the promotion. The frequent flier concept, which was initiated by American Airlines in 1981, finds its success in the fact that frequent fliers are usually business people who can accumulate miles and then use the free trips or reduced fares on nonbusiness trips. Bailey & Williams, *Sources of Economic Rent in the Deregulated Airline Industry*, 31 J. L. & ECON. 173, 188 (1988).

Moreover, the control of computerized reservation systems by the major carriers allows them to participate in various anti-competitive practices. Customers are often steered to the flights offered by the carrier-owner of the system the travel agent uses, a practice usually known as the "halo effect." In exchange, the travel agent often receives bonuses from the carrier. *Airline Concentration at Hub Airports: Hearings Before Senate Comm. on Commerce, Science, and Transportation*, 100th Cong., 2nd Sess. 41 (1988)(statement of Kenneth Mead, Assoc. Dir., United States General Accounting Office).

4. The recent events in the Persian Gulf area have clearly shown these factors to be a genuine threat to a carrier's survival. Since the start of the hostilities on August 2, the price of oil has doubled. In concrete terms, a $3 per-barrel increase results in an 11-cent per gallon rise in jet fuel costs. For every cent-per-gallon increase in fuel prices, the industry suffers $160 million in additional costs. Gaines, *Overseas Air Fare to Rise 7%*, Chicago Trib., Sept. 25, 1990, § 3, p.1, col. 2.

The escalating price of jet fuel coupled with a drop in passenger bookings attributed to

Indeed, the industry's total debt now stands at roughly $15 billion, with another $108 billion set aside to purchase new aircraft.[5] Excessive debt, however, will make it not only extremely difficult for the airlines to accomplish this much needed modernization of their fleets, but also to adequately maintain the planes it already operates. Recently, an aviation task-force of public and private experts, formed after a section of fuselage ripped off an Aloha Airlines 737, called for a $563 million overhaul of 1,900 aging McDonnell-Douglas jetliners.[6] This group's call followed a Federal Aviation Association (FAA) order for the overhaul of 1,300 aged Boeing aircraft. These moves were taken in an effort to rejuvenate the 3,300 United States jet fleet, which on the average contains aircraft which is thirteen years old, making it the oldest fleet in the non-communist world.[7]

Thus, in response to public concerns for aircraft safety, the U.S. carriers have placed enormous orders for new aircraft. This comes at a time when the industry's cash flow for 1988, which by industry standards was a very good year, totalled less than $5 billion.[8] It is estimated that by 1997, less than seven years from now, U.S. carriers will take delivery of these new jets with their multi-billion dollar price tags, and the industry will be forced to hire 50,000 new mechanics to service these planes.[9] These enormous increases in capital and labor costs will be extremely difficult for a carrier to meet if it is strapped for cash. This foreshadows the fact that highly-leveraged airlines will be forced to finance these aircraft purchases and increased labor costs by adding even more debt. Therefore, any increase in debt brought about by speculative takeover activity clearly increases the threat of an economic catastrophe.

Such takeover activity is extremely troublesome when coupled with the estimate that the profits of the U.S. carriers will drop by about one-half

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travelers' uncertainties over world events, has left many carriers with financial problems. For example, Pan Am has stated that the current economic and political situation has caused it to slash 2,500 jobs (8.6% of its work force) from its payroll and to curtail much of its trans-Atlantic service. Nomani, *Pan Am to Slash Payroll, Trim Service As Fuel Costs Surge and Demand Drops*, WALL ST. J., Sept. 20, 1990, at A3, col. 2. Unfortunately, Pan Am appears to be a harbinger of the problems which will face the industry in the coming months. Northwest Airlines estimated that its fuel bill this year may increase by $180 million, thereby significantly decreasing expected profits. Valente, *GE, Airbus Give Northwest Air A Cash Infusion*, Wall St. J., Sept. 20, 1990, at A3, col. 1.

5. Sheets & Dworkin, *A Dogfight for Dominance of the Skies*, U.S. NEWS & WORLD REP., Sept. 11, 1989, at 54 [hereinafter *Dogfight for Dominance*].

6. Greenwald, *Debt Propelled; The Airline-Buy-Out Binge Raises Fears That Jet Safety Will Suffer*, TIME, Sept. 25, 1989, at 52 [hereinafter *Debt Propelled*].

7. *Id.*

8. Labich, *Can United Afford to be Taken Over?*, FORTUNE, Sept. 11, 1989, at 145 [hereinafter *Can United Afford to be Taken Over?*].

9. *Debt Propelled*, *supra* note 6, at 54.

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in 1990 because of a sluggish economy. The signs of this industry slowdown have already begun to appear: the number of passengers on U.S. airlines has fallen from 212.7 million during the first half of 1988 to 208.3 million during the same period in 1989.[10] This overall downturn in the amount of air travelers could precipitate a resurgence of the cut-throat fare wars which were the catalyst for a shake-out of the industry during the 1980's. Therefore, in order to attract consumers to the market, the airlines may have no choice but to offer lower and lower fares, in an attempt to grab market share from the nearest competitor in order to stay alive. Such cut-rate pricing may be especially necessary in light of the excess capacity which may result from an infusion of new aircraft into the airline system over the next few years. Thus, a price war this time may lead to even more devastating consequences than those of the price wars of the early 1980's. A downturn in the economy, causing a concomitant decrease in air travel, coupled with excessive capacity due to the delivery of new jets, and the enormous debt saddled on the carriers due to hostile takeovers and purchases of new aircraft may spell bankruptcy for many major carriers, as well as total disaster for the industry as a whole. The minimal amount of competition which has remained during the past decade could finally be eliminated and the industry may be characterized by even tighter concentration.

Debt laden carriers, moreover, may be tempted to decrease capital spending due to their lack of cash, thereby jeopardizing their future growth.[11] These carriers may be unable to develop new business, hubs, and routes in such untapped and growing markets as East Asia.[12] Similarly, serious labor disputes may arise if the companies are forced to demand further concessions from the employees in order to cut costs. This, combined with the constant threat of not being able to meet the debt payments and the threat of ultimate bankruptcy, severely circumscribes management's freedom. These considerations may force management to pull back from investment plans because the company's cash flow is instead largely dedicated to the suppliers of capital. In essence, changing the company's capital structure from one laden heavily with equity to one laden with debt effectively transfers control over the company's cash flow from managers to creditors. This is an inefficient allocation of society's scarce capital resources. The service of needless debt, brought about solely because of takeover speculation and individual greed, surely is not the optimum use of society's capital. These transactions serve merely to rearrange capital; they do not create capital.

10. *Can United Afford to be Taken Over?*, *supra* note 8, at 148.

11. Power, *Off We Go Into The Hazy Blue Yonder: Just How Will Today's Buy-out Boom Shape The Airlines of Tomorrow?*, BUS. WK., Sept. 18, 1989, at 26.

12. *Id.*

B. Debt Financing: Its Evolution from Sacred Cow to Pariah

Years ago, however, it was thought that corporate debt was quite a wonderful tool in catapulting a company to the top of the heap. The rationale for debt financing was based upon the premise, advanced by economists Merton H. Miller and Franco Modigliani during the 1950's, that a company's earning power, not its financial makeup, is what determines its market value.[13] It was also thought that a high debt level spurred a company to be more competitive and more efficient.[14] This philosophy may in part explain why, during this decade, corporate America has retired nearly $500 billion in equity, and replaced it with almost $1 trillion in debt.[15] The interest payments on this mountain of debt absorb almost 30% of the total cash flow, a figure surpassing by several percentage points the record levels of debt reached during the two worst post-war recessions.[16] Thus, instead of investing in research and development, training, and long-term goals, American business has fallen into the habit of gambling on short-term deals that jeopardize the nation's long-term economic security.

Worse, not only does a high level of debt serve to detour a company's capital from more productive uses, it also impairs the competitiveness of the company as well. Indeed, a company which is buried under a mountain of debt cannot easily respond to changes in the market. Cash-rich, non-debt-burdened competitors can easily wrest market-share away from the debt-laden company through aggressive price-cutting. An increase in competition coupled with a change in technology can diminish revenues as easily as an economic downturn. High debt levels are especially a hindrance to companies, such as airlines, involved in areas where there is constant technological change. A company deeply in debt will not be able to keep up with this change and soon may find itself in a decided competitive disadvantage.[17]

The airline industry is particularly ill-suited for carrying high levels of debt. Airlines are particularly sensitive to even the smallest change in the economy, and any recession could spell catastrophe for those carriers mired in a swamp of debt. The carriers must not only be able to service the debt, but also must be able to meet the unforeseen changes in day-to-day business. For example, a one-cent change in the price per gallon of

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13. Farrell & Nathans, *The Bills Are Coming Due: With So Many Companies So Deep in Debt, The Leverage Binge Winds Down*, Bus. Wk., Sept. 11, 1989, at 84 [hereinafter *The Bills Are Coming Due*].

14. *Id.*

15. *Id.*

16. *Id.*

17. Mitchell, *Junk Bonds Fail to Recover From Recession Scare*, Wall St. J., Sept. 11, 1989, at C1, col. 4.

jet fuel may mean a $15 to $20 million change in a carrier's operating profits.[18] This could mean that the carrier may not be able to meet its heavy obligations and thereby default on its loans. Couple this with the ever-present threats of terrorism, labor disputes and new FAA safety rules, plus increased global competition, and the skies may become quite unfriendly for the industry, especially in light of the fact that this year the industry as a whole is expected to make only $3 billion in operating profits, even though the carriers have been charging higher fares.[19]

Some observers may believe that these predictions of doom and gloom are exaggerated since presently there is no recession and interest rates are relatively low. However, a look at the impact of excessive debt in other industries reveals the serious problems debt creates. The newspapers are filled with stories about companies, saddled with enormous debt obligations due to takeovers and LBOs, which are defaulting on their loans. The debt financing which looked so easy a few years ago is now turning into a nightmare for many companies. In 1989 alone, there were bond defaults and debt moratoriums amounting to more than $4 billion.[20] This suggests that companies swamped with debt may find themselves on the verge of collapse even without any type of economic downturn. Companies which must meet astronomical debt repayments may be vulnerable to even the mildest setbacks in their markets.

Because of the increasing number of defaults on corporate debt, equity is beginning to come back into fashion. Today the thinking concerning debt is starting to change; many companies disdain the use of junk bonds as antithetical to their corporate image.[21] Moreover, those companies which took on a great deal of debt as part of leveraged buyouts or stock buy-backs are now attempting to "deleverage" their balance sheets by replacing their debt with equity.[22] Ironically, even junk-bond king Michael Milkin has now called for companies to return to equity financing, urging an exchange of their junk debt for a combination of equity

18. Power, *Raiders May Not Make The Best Airline Pilots,* BUS. WK., May 15, 1989, at 35 [hereinafter *Raiders May Not Make The Best Pilots].*

19. *Id.*

20. *The Bills Are Coming Due, supra* note 13, at 84.

21. Dobrzynski, *Deals, Yes. Maniac Deals, No,* BUS. WK., Oct. 30, 1989, at 30.

22. Berman & Weisman, *Be Wise, Equitize,* FORBES, Nov. 27, 1989, at 38. Indeed, the trend towards de-leveraging is not surprising in view of the current condition of the debt market. For example, the junk-bond market during 1989 was disastrous. The purchasers of junk, worried about a possible recession and concomitant defaults on these high-yielding securities, had been demanding ever-increasing premiums from borrowers. In 1989 the spread between the Treasury Bill rate and the average rate on junk bonds widened to five to six points, the largest spread since the creation of the junk-bond concept. At the same time, the total return for investors of junk bonds had dropped into negative numbers. Hector, *Junk After Milken,* FORTUNE, Nov. 6, 1989, at 121.

and higher-grade debt carrying a lower interest burden.[23]

C. THE CORPORATE RAIDER'S GAMEPLAN

Much damage has already been done to the American corporate landscape; a great deal of it precipitated by the making of hostile, unwanted bids for large companies.[24] These bids are usually made by corporate "raiders" whose first, and most likely, only concern is making a profit on the stock which they have accumulated at bargain-basement prices. This is especially true of airline stocks, which usually sell at a discount of approximately one-third of the stock market's price-to-earnings ratio, which is currently pegged at about thirteen times earnings.[25] This discount is directly attributable to the fact that airline earnings are subject to the cyclical ups and downs of the economy.[26]

Instead of seeing the cyclical perils, some individuals look to airline stocks and see previously overlooked assets, such as the value of the carrier's air fleet, landing slots at overcrowded airports, computer reservation system, spare parts, and even orders, delivery dates and deposits on new airplanes from backlogged manufacturers such as McDonnell-Douglas and Boeing.[27] These individuals also see untapped value in the sale and lease-back of the carrier's planes. In such a transaction, the

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23. Winkler, Sandler, Hilder & White, *The Party's Over: Mounting Losses Are Watershed Event For Era of Junk Bonds*, Wall St. J., Sept. 18, 1989, at A1, col. 6.

On April 20, 1990, Michael Milken agreed to plead guilty to six felony counts and to pay $600 million in fines and restitution, the largest individual criminal settlement ever. This decision came just before a grand jury was to indict him on charges of insider trading, bribery, cheating customers and his former employer, Drexel, Burnham, Lambert, and destroying incriminating evidence. Cohen, *About Face: How Michael Milken Was Forced To Accept The Prospect of Guilt*, Wall St. J., April 23, 1990, at A1, col. 1.

Milken's guilty plea came on the heels of the December 1989 guilty plea by Drexel to six felony counts relating to securities fraud. Drexel settled civil charges brought by the SEC and paid a record $650 million in fines and restitution. *Id.* In February 1990, Drexel filed for bankruptcy court protection and thereafter stated that it would cease doing business. Dobrzynski, *After Drexel*, BUS. WK., Feb. 26, 1990, at 37.

24. For example, the largest LBO was that of RJR Nabisco, which was done for $26 billion in debt, an amount of debt greater than that of "most developing countries." Dobrzynski, *Running the Biggest LBO: RJR's Lou Gerstner Has A Plan. So Far, It Works*, BUS. WK., Oct. 2, 1989, at 73. In order to meet the multi-billion dollar interest payments RJR has, among other things, cut its work force and sold several well-known assets, such as Chun King and Del Monte Foods. Not surprisingly, the employee morale at RJR has steadily declined. *Id.* at 72-73.

25. Smith & Hilder, *Just How Much Is UAL's Stock Worth?*, Wall St. J., Oct. 23, 1989, at C1, col. 3.

26. *Id.*

27. *Dogfight for Dominance*, *supra* note 5, at 54. For example, McDonnell-Douglas has a record order backlog of $18 billion. The company has 401 firm orders, which will take well into 1993 to fill; it also has 518 options, which if exercised, would keep its work force busy until the end of the century. Henkoff, *Bumpy Flight at McDonnell-Douglas*, FORTUNE, Aug. 28, 1989, at 80. Similarly, Boeing has an $80 billion backlog of orders to fill. Boeing's orders jumped 70%

airline sells its planes, and then leases them back from the purchaser. Takeover raiders have discovered that such arrangements allow them not only to borrow from banks at interest rates lower than those attached to junk bonds, but also allows them to convert debt into an operating expense that usually does not appear on the carrier's balance sheet as a liability.[28] Nevertheless, whether these amounts are part of the balance sheet debt, or are merely contained in a financial footnote, no amount of financial sleight of hand can obviate the fact that the airline is still obligated to meet these lease payments.

Yet, many corporate raiders never get as far as having to worry about their target's financial books. The usual *modus operandi* of these individuals is to make a bid and/or launch a hostile tender offer merely to shake up the market, hoping to draw in other bidders, or to force the company to restructure in order to fend off the hostile attack. The final goal is to drive up the airline's stock price in order for the raider to reap substantial profits on his investment when he sells his shares to the eventual purchaser. In any event, the airline may end up buried under a mountain of debt, and the management may find itself selling off bits and pieces of the company, or even declaring bankruptcy.[29] Such a situation may further increase industry concentration.

Moreover, and perhaps more frightening, a company buried under debt will certainly be less able to devote economic resources to upgrading and maintaining its equipment when its very existence as a business entity is on the line. Yet, it is precisely within the deregulated environment that more, not less, attention must be devoted to aircraft maintenance.

The emergence of hub-and-spoke systems has caused flights to be shorter, but more frequent. This constant pressurization and depressurization places the greatest stress on an aircraft, and concomitantly shortens its life-span.[30] This would appear to suggest that the nation's airfleet may be in need of more maintenance. However, during 1987 the airlines allocated roughly 11.2% of operating expenses to aircraft mainte-

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during 1988, and its orders during the first half of 1989 equaled all of 1988's orders. Ramirez, *Boeing's Happy, Harrowing Times*, FORTUNE, July 17, 1989, at 40.

28. *Dogfight for Dominance*, *supra* note 5, at 55.

29. Indeed, a great amount of the corporate debt is based upon the premise that it will be paid off as the issuing company is broken up and sold off, piece by piece. *See* Hector, *supra* note 22, at 128.

30. Payne & Vogel, *Sure, The Plane is Old - But Is It Dangerous?*, BUS. WK., March 13, 1989, at 36. For example, the Aloha Airlines plane in which the jet's fuselage tore away like a convertible top in March of 1989, had made more than 89,680 flights during its nineteen year life. This figure exceeds the manufacturer's own "design objective" of 75,000 flights. A design objective is the number of flights a jet could make before the airline would find maintenance so expensive that it should consider replacing the plane. Ramirez, *How Safe Are You In The Air?*, FORTUNE, May 22, 1989, at 80 [hereinafter *How Safe Are You?*].

nance, less than the 13.2% which was allocated in 1977, even though the nation's fleet today is older and therefore, costlier to maintain.[31]

Perhaps one plaintiffs' attorney correctly pinpointed the emerging problem when he succinctly stated: "[t]he overall problem is the aviation industry right now is being run and acquired by financiers — not aviation people — whose business is business."[32] A recent study done by the U.S. Office of Technology Assessment found that "airline management practices are an important control valve for commercial aviation safety," and that recent FAA inspections showed that "airlines undergoing management turmoil tend to overlook details of safety programs."[33] Thus, the constant machinations involved in protracted takeover fights may very well be diverting the attention of airline management from safety to dollars.

Instead of focusing their attention on running safe, efficient, and stable carriers, airline executives such as Frank Lorenzo and Carl Icahn, devote most of their energy to making the bottom line look attractive. This has not only shifted the airlines' primary focus away from resembling a public service organization towards a money-making business, but also may portend a concomitant decrease in the safety of the carriers. In order to stay competitive and make the financial reports look good, airlines have made efforts to reduce the amount of operating costs, including costs for maintenance.[34] Indeed, in the airline environment of today, a company which strives to increase its margin of safety by devoting more resources to maintenance may be punished in the marketplace if its fares are higher than those of its competitors who cut safety corners in order to have lower fares.[35]

Corporate raiders such as Lorenzo and Icahn, however, are not afraid to launch hostile attacks because they know that the law concerning such tender offers usually runs in their favor if they play their cards correctly. Since there is no federal common law which defines the fiduciary duties owed by directors of a corporation to its shareholders, takeover activities are subject to the corporate laws of the state in which the target corporation is incorporated. Since a majority of the major corporations are incorporated in the state of Delaware, most other states follow the lead of Delaware's courts in the area of corporate law. A landmark case

31. *Id.* at 76.

32. Blum, *So, Is It Really Safe to Fly?*, Nat'l L. J., Oct. 2, 1989, at 26 (comments of Richard F. Schaden).

33. OFFICE OF TECHNOLOGY ASSESSMENT, SAFE SKIES FOR TOMORROW: AVIATION SAFETY IN A COMPETITIVE ENVIRONMENT, 14-15 (1988).

34. *Id.* at 34.

35. *See, Maintenance at Eastern Airlines: FAA Oversight: Hearings Before the Subcomm. of the House Comm. on Government Operations*, 100th Cong. 1st Sess. 33 (1987)(statement of Capt. Donald McClure, Chairman, Accident Investigation Board, Air Line Pilots Association).

in Delaware corporate law, *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, provided many takeover artists with the ammunition they needed to mount assaults on large companies.[36]

When a company is faced with the receipt of an unsolicited merger or tender offer, often termed a "bearhug," the question becomes whether the target's board has a duty to negotiate with the potential acquirer. Although it has been held that there is no duty to negotiate *per se*, this may not prevent the potential acquirer as well as dissatisfied shareholders from asserting that the board did have such a duty. The basis for a rejection of an unsolicited offer rests in the so-called business judgment rule, which generally states that if a board acts with good faith and with loyalty to the corporation, the decision of the board is protected from legal attack.[37]

However, if a board, as in *Revlon*, should decide to implement anti-takeover measures in response to a hostile suitor's attempts to buy up a large share of the company's stock, the board's decisions are subjected to a type of intermediate-scrutiny, for the specter arises that the board may be fending off the bid in an attempt to merely entrench itself.[38] This potential for conflict places a burden upon the directors to prove that they

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36. 506 A.2d 173 (Del. 1986). The Revlon litigation arose out of a series of events beginning in June 1985 when the heads of Revlon, Inc. and Pantry Pride, Inc. privately met to discuss a friendly acquisition of Revlon by Pantry Pride. (MacAndrews & Forbes Holdings, Inc. was the controlling shareholder of Pantry Pride). After these talks proved unsuccessful, Pantry Pride launched an all-cash for all-shares hostile tender offer for Revlon stock in August 1985, with the intent of financing the acquisition through a later sale of the company. Revlon's investment banker advised Revlon's board that Pantry Pride's $45 per share offer was inadequate. *Id.* at 177.

Subsequently, Revlon's board adopted a two-fold defensive strategy to ward off Pantry Pride's attack. First, Revlon commenced a self-tender offer for up to ten million shares. *Id.* Second, Revlon implemented a "shareholder's rights plan" by which the shareholders received the right to be bought out by the acquirer at a stated premium. *Id.* at 180.

After these measures were implemented, Revlon negotiated with Forstmann, Little, & Co., and agreed to a leveraged buyout by Forstmann, even though Pantry Pride continued to increase its offer. *Id.* at 178. Forstmann also increased its offer, but the increase was based upon several conditions. First, Revlon would grant Forstmann a lock-up option to purchase Revlon's vision and health care unit for $100-$175 million below its estimated value if another acquirer were successful in obtaining 40% of Revlon's shares. Second, Revlon was required to accept a no-shop provision. *Id.*

37. *See, e.g.*, Revlon, 506 A.2d at 179-181; Pogostin v. Rice, 480 A.2d 619, 624 (Del. 1984); Unocal Corp. v. Mesa Petro. Corp., 493 A.2d 946, 953, 955 (Del. 1985); Moran v. Household Int'l, Inc., 500 A.2d 1346, 1350 (Del. 1985).

The business judgment rule is a fundamental axiom of corporate law which restricts the scope of judicial review into the managerial decisions of a corporation's board of directors. Traditionally, the business judgment rule has been applied to shield directors who have no financial interest in the questioned transactions and who follow an appropriately deliberative process from personal liability for damages arising out of an action taken by the board.

38. Revlon, 506 A.2d at 180; Unocal, 493 A.2d at 954.

had reasonable grounds for believing there was a danger to corporate policy and effectiveness. The board can satisfy this burden by showing it was acting in good faith and with reasonable investigation.[39] In addition, the board must analyze the nature of the takeover attempt and its effects on the corporation in order to ensure that the defensive response is reasonable in relation to the threat posed.[40] Once this is shown, the business judgment rule then attaches and the decision of the board is insulated from judicial attack.

The actions the board takes in order to defend against a hostile attack, however, may lead to a series of events which will legally mean that the company is "for sale." For example, if, as in *Revlon*, the defensive measures cause the acquirer to increase his offering price to extremely high levels, or if the target company attempts to negotiate a friendly merger with a third party, this may effectively mean that the company is "for sale."[41] Under the *Revlon* decision, when a company is deemed to be for sale, the duties of the directors change from the preservation of the company as an entity to the "maximization of the company's value at a sale for the stockholders' benefit."[42] In essence, "[t]he directors' role change[s] from the defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company."[43] Thus, once a hostile acquirer tenders a bid for a company, and the company makes a move to defend itself, or if the bid attracts other bidders to the fray, then the directors may find themselves in a *Revlon*-type situation where they are legally required to "auction" off the company to the highest bidder in order to fulfill their fiduciary obligations to the shareholders. The raiders are aware of this; thus, many will launch a hostile bid just to attract others to the fray in hopes that the company will be forced to put itself on the auction block, thereby providing the raider a hefty return on his investment.

This Delaware view, however, is considered to be rather pro-corporation when compared with the far more free-market-oriented "Chicago School" of economic thought. The basic tenet of "Chicago School" economics is that any takeover, either friendly or hostile, which is successful in the market is of benefit to the economy and thereby beneficial to the majority of individuals who participate in it.[44] The proponents of this view

39. Revlon, 506 A.2d at 180; Unocal, 493 A.2d at 955.

40. *Id.*

41. Revlon, 506 A.2d at 182.

42. *Id.*

43. *Id.*

44. *See, e.g.*, Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981)[hereinafter *Proper Role of Target's Management*]. Ironically, this is the same type of free-market philosophy which led to airline deregulation and the excessive market concentration in the industry today.

assert that any and all resistance to takeover attempts is to the detriment of shareholders, as well as to the economy as a whole.[45] They contend that resistance to takeovers results in inefficient management as well as management entrenchment; after all, they argue, the company would not be a target if it was run properly in the first place.[46] Therefore, they assert that hostile takeovers are a significant means of displacing these inefficient managers, because the constant threat of a takeover increases the incentive to perform in the best interests of the shareholders.[47]

A major problem with this theory is that these commentators argue that resistance to an offer is premised on one of two grounds: mismanagement or self-interest. They in essence raise this belief to an irrebuttable presumption, and therefore eliminate the need for a case-by-case determination of whether management is acting in the best interests of the shareholders. Thus, they maintain that defensive measures are never engaged in for the best interests of the shareholders. Because of this, the argument goes, the company should remain passive and allow any predator which comes along the opportunity to feast upon the company under the premise that if this is allowed by the free market, then it must be the best and most efficient use of society's resources.

It appears that the better view is that expressed by the Ninth Circuit Court of Appeals in connection with a 1984 takeover case: "It is nowhere written in stone that the law of the jungle must be the exclusive doctrine governing parties in the world of corporate mergers."[48] When a corporate takeover results in the liquidation of a company or some of its parts, real jobs are lost, real communities are disrupted or destroyed, and real production is lost. These events spill over into the rest of the business world where employee morale may be destroyed, corporate policies disrupted, and employees forced to live in a constant state of fear.

This is especially true of the airline industry which is among the most vital parts of the nation's transportation infrastructure. The stability of the nation's economy is dependent upon the efficient and safe transportation of people from one destination to another; transportation is the lifeblood for all communities.[49] In light of this, the constant wrangling over who will get this air carrier or that airline not only hurts the carrier itself, but also

45. *Id.* at 1174-75.

46. This was precisely the philosophy of "junk bond king" Michael Milken, who was on a crusade to save corporate America from itself. He liked to generalize corporate executives as being poor managers who squandered excess capital and did not put their assets to the best use. Although these statements may be true in certain situations, Milken used this as justification for creating the junk bond market. BRUCK, THE PREDATOR'S BALL, 12 (1989)[hereinafter THE PREDATOR'S BALL].

47. *The Proper Role of Target's Management*, *supra* note 44, at 1175.

48. Jewel Companies v. Payless Drug Stores Northwest, 741 F.2d 1555 (9th Cir. 1985).

49. *See generally*, Dempsey, *Market and Regulatory Failure as Catalysts for Political*

harms the industry as a whole, thereby adversely affecting the nation. The carriers are forced to play the bidders' game, where short-term profits are glorified and long-term stability and growth are forsaken. Speculative manipulation of corporate ownership has come to replace productive investment and competition.

D. Examples of the Detriment of Excessive Debt and Takeover Speculation on the Airline Industry and the National Economy

There have been several recent examples illustrative of the destabilization which takeover machinations in the airline industry have wrought on various aspects of the nationwide economy. Perhaps most notorious is the United Airlines fiasco which resulted in a collapse of the stock market on the day it was announced a management-led LBO of the carrier had failed. However, the United Airlines case does not stand alone. Continental Airlines, Eastern Airlines, and TWA, all victims of earlier leveraged takeovers, today find themselves in deep financial trouble. Each of these situations will be examined individually.

1. United Airlines

United Airlines, the second largest U.S. carrier, has one of the oldest fleets of planes, and as recently as 1986, only earned $11.6 million.[50] United also has obligations of $19 billion, for new aircraft which it has on order.[51] Marvin Davis, a former oilman and self-styled Hollywood mogul who has no experience in running an airline, launched a tender offer for United's parent, UAL Corp., which eventually reached $300 per share, when months earlier, UAL's shares had been trading for around $120.[52] Davis's offer sent UAL stock soaring, helping to push the Dow Jones average to within ten points of the previous record high.[53] In order to fend off this hostile attack, UAL's management put together an LBO which had a price tag of almost $7 billion. The deal was structured so that British Airways would invest $750 million in cash equity in exchange for a 15% voting stake in UAL; 75% of the company would have been owned by UAL employees, and the remaining 10% would have been owned by UAL

Change: The Choice Between Imperfect Regulation and Imperfect Competition, 46 WASH. & LEE L. REV. 1, 21-22 (1989).

50. *Can United Afford to be Taken Over?*, *supra* note 8, at 145.

51. Ellis, *United: Why Labor Need Some Parachutes on Board*, BUS. WK., Sept. 18, 1989, at 28.

52. *Id.*

53. Reibstein & Padgett, *In Hot Pursuit of Airlines: UAL is Latest Target*, NEWSWEEK, Aug. 21, 1989, at 40.

management.[54]

The agreement, however, was beset with problems from the beginning. United's machinist union asked several government agencies to investigate the deal, including the Treasury Department, the Securities and Exchange Commission, the Labor Department, and the Department of Transportation.[55] The machinists had opposed the management-led buyout from the onset because they were not invited to participate and they had reservations that the enormous amount of debt involved would overburden the company.[56]

The management-led LBO collapsed on "unlucky" Friday the 13th, of October 1989. The deal was unsuccessful because the management group could not get the financing from the Japanese banks which were originally part of the agreement. These banks were very skeptical of the rosy predictions made by UAL's commercial and investment bankers, especially in light of the bumpy, cyclical nature of the airline industry. As one senior executive of a Japanese bank was quoted as stating, UAL's projections were "stretched — it's a cyclical industry, and all the projections that the banks are working off are straight up. So where's the cycle?"[57] The Japanese banks were not persuaded that the carrier could generate enough cash to cover the interest payments, and instead believed that UAL's advisors had overvalued many of the airline's assets, such as the airline's Pacific routes, which if needed to be liquidated would not have covered the value of the loan package.[58] The banks were also wary of the opposition to the management-led deal by UAL's 25,000 member machinist's union.[59] Ironically, just as Davis's original offer for United sent the stock market soaring, the collapse of the management-led buyout sent the stock market crashing, with UAL stock plunging

54. Valente, *British Airways Won't Revive UAL Buy-Out*, Wall St. J., Oct. 20, 1989, at A3, col. 4.

55. *Id.*

56. Bailey & Nomani, *Flawed Portent: Banks Rejecting UAL Saw Unique Defects in this Buy-Out Deal*, Wall St. J., Oct. 16, 1989, at A1, col. 6 [hereinafter *Flawed Portent*]. However, to some it appeared that the machinists were more interested in obtaining substantial new wage increases than in owning a stake of a heavily-leveraged UAL. Smith & Valente, *UAL Shares Again Fall Amid Concern U.S. Regulators May Hinder Buy-Out*, Wall St. J., Sept. 26, 1989, at A3, col. 1.

57. *Flawed Portent*, *supra* note 56. For example, the management group projected that the carrier's revenue would maintain an average growth rate of 10% for the next few years. It also estimated that income yields for United would increase an average of 3.5% per year. Finally, they projected that load factors would remain constant. Apparently, the management group decided that the nation would not suffer an economic downturn during the next few years.

58. Holden & Glasgall, *The Hard Line Coming From Tokyo Banks*, Bus. Wk., Oct. 30, 1989, at 29.

59. *Id.*

$111.25.[60] After this, British Airways withdrew from the deal.[61]

After the collapse of the $6.75 billion bid, the UAL board decided that it would seek to keep the company independent.[62] The board's announcement came as UAL's shares were trading for $178. After the board made the announcement, the shares of UAL dropped to around $151.[63] The board appeared to be in a holding pattern: it did not put the company up for sale, yet it also did not state that it would not consider a better offer. Yet, the options available to the board at this time all had potential drawbacks. For instance, if the board decided to buy-back a large portion of UAL's stock from the public in order to make a takeover more difficult, it would probably have had to sell and lease-back its aircraft in order to gain the cash necessary to carry out the transaction. Such a transaction, however, could have conceivably resulted in a large capital-gains tax liability. Alternatively, the board stood to lose all credibility, as well as expose itself to shareholder lawsuits, if it agreed to accept a bid lower than the original LBO agreement and the financing for that bid fell through as well.[64] Finally, the prospect of putting the company up for sale and then receiving no bids could also have been very embarrassing to the board.

If the board opted to do nothing to alter the previous status quo, however, it may have found itself in the proverbial "catch-22," leaving itself open to legal challenges from those speculators and arbitragers who accumulated large positions in the company's stock on the assumption that the airline was for sale and there would be a buyout. These arbitragers are estimated to have suffered paper losses amounting to $600 million due to the collapse of the deal.[65] Indeed, many of these takeover traders purchased their stock at $280 per share with the expectation that the deal for $300 per share would materialize.[66] Because over one-third of the UAL stock resided in the hands of these arbitragers, the board was vul-

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60. Bradsher, *UAL Tries to Keep Itself Intact*, N. Y. Times, Oct. 24, 1989, at 25 [hereinafter *UAL Tries to Keep Itself Intact*].

61. Jouzaitis & Storch, *British Airline Pulls Out of Bid for UAL*, Chicago Trib., Oct. 20, 1989, § 3, at 1. There has been speculation that British Airways initially decided to become involved in the deal primarily as a means to cement a lucrative marketing relationship between itself and United. However, the Department of Transportation (DOT) has recently begun to scrutinize airline deals which involve foreign ownership of U.S. air carriers. In this particular deal, DOT expressed its view that British Airway's involvement might have allowed it to exert effective control over United in violation of U.S. law, which states that no foreign investor can own more than 25% of a U.S. carrier.

62. *UAL Tries to Keep Itself Intact*, *supra* note 60, at 25.

63. *Id.*

64. *Id.*

65. Ellis, Power & Grover, *Still Trying to Land UAL*, Bus. Wk., Nov. 20, 1989, at 28 [hereinafter *Trying to Land UAL*].

66. Bradsher, *Arbitragers Face Big Losses on UAL*, N. Y. Times, Oct. 24, 1989, at 30.

nerable to a consent solicitation procedure, whereby these arbitragers/shareholders could call for a special vote to replace the members of the current UAL board.[67]

Six months after the $7 billion management bid for United collapsed, the UAL board broke this deadlock by accepting a $4.38 billion buyout offer made by United's three labor unions.[68] This offer includes $2 billion in wage concessions by the unions over the next five years, translating into first year pay cuts of 11% for pilots, and 7.6% decreases for flight attendants and machinists with more than five years' seniority.[69] The union bid is supported by Conniston Partners, an investor group which owns 11.8% of UAL and which has pressured the board to sell the company, threatening a proxy fight to unseat the board if it blocks any future bids.[70] Once again, however, this buyout bid for United faces the serious obstacle of financing. Analysts predict that the unions will have great difficulty in lining up the almost $4.4 billion required to make this deal fly.[71]

In the end, all these needless machinations brought about by Davis's original unwanted bid, partly contributed to a 38% drop in UAL earnings for the third quarter of 1989.[72] Moreover, this series of events saddled UAL and its shareholders with a $58.7 million bill from investment bankers, analysts, advisors and attorneys, all participants in the failed deal.[73]

These figures accurately foreshadowed UAL's net decrease in earnings during 1989 by 71% to $324 million.[74] Thus, this situation, which has resulted in increases in operating costs, decreases in profits, and embarrassment for the airline, has left UAL with both unhappy shareholders and an unhappy labor force, the two key components necessary to run a viable and efficient company.[75] Yet, at this point, it appears that

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67. Valente & Smith, *Revised Offer for UAL Corp. Being Readied*, Wall St. J., Oct. 23, 1989, at A3, col.4; *Trying to Land UAL*, *supra*, note 65, at 38. Under Delaware Corporate Law (Delaware is the state of UAL's incorporation), shareholders may act by written consent if the consents are signed by the holders of a number of shares that would have been sufficient to take the action in question at a meeting at which all shareholders were present and voting. 8 Del.C. 228 (1988).

68. Alpert, *Summer Storms For The Airlines?*, FORTUNE, May 7, 1990, at 12.

69. *Another United Airlines Deal: Will It Fly?*, NEWSWEEK, April 16, 1990, at 63.

70. Alpert, *supra* note 68.

71. *Id.*

72. Jouzaitis & Storch, *UAL Earnings Fall 38% in 3rd Period*, Chicago Trib., Oct. 27, 1989, § 3, at 1. United was also hurt by rising expenses, such as fuel prices and slower increases in domestic traffic.

73. Storch, *UAL Defends Bill for Fees in Failed Buy-Out*, Chicago Trib., Dec. 1, 1989, § 3, at 1.

74. Alpert, *supra* note 68.

75. *See* Ellis, Bernstein, Meehan & Friedman, *This is Too Big a Genie to Put Back in the Bottle*, BUS. WK., Nov. 6, 1989, at 43. The bickering among United's unions has intensified since the failure of the management LBO. The machinists, who favor a recapitalization for the shareholders and an employee ownership plan coupled with assurances of job protection from themselves, are angry that management was willing to profit so handsomely from the LBO without

however the events during the next few months unfold, the UAL board probably will be unable to satisfy all its constituencies. Labor would prefer increases in wages and benefits, but under the circumstances will agree to wage cuts in order to purchase the carrier and preserve their jobs; the shareholders want an increase in the value of their shares; and management may want to fortify the company's capital base to ensure future growth. With the omnipresent specter of future turmoil ahead, however, it is unlikely that any of these desires will be fulfilled soon.

2. *Frank Lorenzo's Texas Air, Inc.*

Frank Lorenzo, who began his career as a financial analyst for TWA, set up a holding company, Jet Capital Corp., during the early 70's and raised cash through a public offering of its stock.[76] This allowed him to enter the exclusive club of airline owners by using Jet Capital's funds to take over frail Texas International Airlines in 1972.[77] Thereafter, Lorenzo and Texas Air took over Continental Airlines, and in 1986 borrowed heavily for the purchase of Eastern Airlines, assuming a $300 million annual interest liability required to service this high level of debt.[78] Eastern is currently in the midst of bankruptcy proceedings precipitated by a fifteen month strike by its machinists, who were unhappy with what they believe were Lorenzo's anti-union policies.[79] As a means to quell the union uprising, Lorenzo had Eastern file for Chapter 11 bankruptcy protection in March 1989. Thereafter, he replaced many of the striking union members with non-union employees.[80]

As a result of Eastern's labor troubles and bankruptcy proceedings, the airline posted a $852 million loss for 1989, the largest single-year loss ever recorded by a U.S. carrier, leading Lorenzo's Texas Air Corp. to report a 1989 net loss of its own of $886 million.[81] Lorenzo's other carrier, Continental, managed to post a net income of $3.1 million for 1989, after a disastrous loss of $315.5 million the previous year.[82] This gain,

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thought to reinvest the money back into the company. The flight attendants favor an ESOP or a "white knight" investor to buy the company before another hostile bidder emerges. Finally, the pilot's union wants to pursue a plan which will give it a majority stake in UAL.

76. Bruck, *Kamikaze: How Texas Air's Frank Lorenzo Wrecked His Own Chance to Acquire TWA - and Carl Icahn Picked Up the Pieces*, AM. LAW., Dec. 1985, at 77.

77. THE PREDATOR'S BALL, *supra* note 46, at 173.

78. Labich, *The Showdown at Eastern Airlines*, FORTUNE, April 11, 1988, at 66 [hereinafter *Showdown at Eastern*].

79. *Debt Propelled*, *supra* note 6, at 53.

80. Ivey & DeGeorge, *Lorenzo May Land a Little Short of the Runway*, BUS. WK., Feb. 5, 1990, at 46, 47.

81. Fotos, *Record Losses at Texas Air Stem From Eastern Strike*, AVIATION WK. & SPACE TECH., Feb. 12, 1990, at 135.

82. *Id.*

however, came after Continental sold $60 million in assets.[83]

Indeed, Eastern's present position is precarious. The carrier's once highly-respected image is now significantly tarnished. Recently, in response to a substantial decline in passenger bookings after Eastern's preferred shareholders informed the bankruptcy court that they favored liquidation of the carrier, Eastern implemented a refund protection program to assure ticket holders that they would not lose money in the event of a liquidation.[84] Contributing further to Eastern's tarnished image, Standard & Poor's debt-rating service has rated Eastern's subordinated debt at "D" for default.[85] As if this is not bad enough, during 1988 Eastern finished last in on-time performance and had the highest number of passenger complaints except for Continental, Lorenzo's other national carrier.[86]

On March 1, 1990, a report filed by bankruptcy court examiner David I. Shapiro provided more fuel for the fire. The report investigated the pre-bankruptcy asset exchanges between Texas Air, Continental, and Eastern, disclosing evidence that Eastern was stripped of between $285 million and $403 million in assets, a contention strongly denied by Eastern's management.[87] Approximately two months later, federal bankruptcy Judge Burton Lifland removed Lorenzo from the helm of Eastern, saying that Lorenzo and his management team were "not competent to reorganize this estate. . .It is time to change the captain of Eastern's crew."[88] Ironically, Lorenzo's court-appointed replacement is Martin Shugrue, who Lorenzo pressured out of Continental's presidency in 1989.[89]

Nevertheless, Lorenzo discovered a way to transform this seemingly dismal situation into a windfall for himself. On August 9, 1990, Lorenzo resigned as Chairman and Chief Executive Officer of Texas Air [which changed its name to Continental Airline Holdings shortly after Shugrue was appointed to head Eastern] although he retained a seat on the company's board.[90] Lorenzo sold the majority of his stock to Scandinavian Airline Systems for a reported $10 million, and reaped another $19.7 million in salary and severance pay. Lorenzo was replaced by Hollis L. Harris, the former president of Delta Airlines. Lorenzo, therefore, has ended

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83. Ivey & DeGeorge, *supra* note 80, at 48.

84. Fotos, *supra* note 81.

85. *Id.*

86. *Showdown at Eastern*, *supra* note 78, at 65. During this time only 61.5% of Eastern's flights arrived within 15 minutes of schedule.

87. Oneal & DeGeorge, *Promises, Promises: How Eastern's Creditors Got Creamed*, BUS. WK., March 19, 1990, at 43.

88. Schwartz & Katel, *Frank Lorenzo Gets Grounded*, NEWSWEEK, April 30, 1990, at 49.

89. *Id.*

90. Ivey, DeGeorge & Oneal, *Continental's New Boss Has the Same Old Problem: Empty Seats*, BUS. WK, Oct. 1, 1990, at 36.

his tenure at the helm of Texas Air by bailing out before the ship has completely sunk.[91]

It is Shugrue who must now contend with Eastern's myriad of problems. He must attempt not only to rebuild passenger confidence in the carrier, but also restore harmonious relations with Eastern's employees. Shugrue's mission, however, will be further hampered by the recent criminal indictment lodged against Eastern based upon alleged maintenance abuses. The indictment, handed down by a New York Grand Jury on July 26, 1990, charged Eastern with falsifying aircraft and safety maintenance records between July 1985 and October 1989.[92] Yet, perhaps the most pressing of Shugrue's problems is the handling of Eastern's debt. Presently, Eastern owes creditors roughly $2.3 billion.[93] Indeed, when Eastern filed for bankruptcy in March 1989, it defaulted on $1 billion in unsecured debt.[94] At that time Lorenzo explicitly promised that Eastern would repay its unsecured creditors in full.[95] Thereafter, Texas Air proposed a settlement whereby creditors would be paid only fifty cents for every dollar Eastern owed.[96] In order to raise cash, it was rumored that Frank Lorenzo would sell part or all of Continental Airlines, which itself is in debt for $2.4 billion.[97] Indeed, market analysts have calculated that Lorenzo's Eastern and Continental have an incredibly high ratio of debt to capital; Continental's amounting to 96.6% debt to capital, and Eastern's amounting to 100.1% debt to capital, only faring better than Carl Icahn's TWA and industry laggard Pan Am.[98]

Shugrue has his work cut out for him in trying to bring Eastern back to life. If he is unsuccessful, however, the demise of Eastern will further increase the concentration in the airline industry. Moreover, if Eastern's sister carrier, Continental, flies into trouble again, the airline industry and the traveling public may suffer not only one loss, but two.

3. TWA

Carl Icahn took over TWA in 1986 because, according to him, the management of the airline was inefficient and lax, as evidenced by the

91. *Exiting Lorenzo Cites Bad Labor Reputation*, Chicago Trib., Aug. 10, 1990, § 3, p. 1 col. 2.

92. Washburn & Franklin, *Eastern Charges Refuel Safety Debate*, Chicago Trib., July 26, 1990, § 1, p. 1, col. 2.

93. *Debt Propelled*, *supra* note 6, at 53.

94. Oneal & DeGeorge, *supra* note 87.

95. *Id.*

96. *Id.*

97. *Debt Propelled*, *supra* note 6, at 51.

98. Vogel, *Carl Icahn Has Lots of Cash. Will He Spend it on TWA?*, Bus. Wk., July 17, 1989, at 86 [hereinafter *Carl Icahn Has Lots of Cash*].

fact that the carrier was losing money.[99] Over four years later, TWA still finds itself in a mess. Its service is notoriously bad, its planes are falling to pieces, and labor is unhappy. Moreover, TWA's operating income lags far behind those of other carriers. While industry-wide operating income rose 33% in 1988, TWA's increase amounted to an anemic 8%.[100] Even this figure, however, is somewhat inflated. TWA's operating income would have been $44 million less if it had not adopted an industry-accepted accounting change which served to stretch out the carrier's depreciation charges over a longer term.[101]

TWA's financial situation worsened during 1989. Last year, TWA lost $298 million on revenues of $4.5 billion,[102] and its market share has decreased from 15.3% to 13.1%, each percentage decrease representing a revenue loss of more than $80 million.[103] Many observers believe that TWA's problems can be traced directly to Icahn's lack of investment in the carrier. Compared to industry norms, Icahn's capital outlays for TWA have totaled a paltry 5.4% of revenues, compared with expenditures made by American Airlines of 20%, 18% by Delta, and 16% by United.[104] These minuscule capital outlays prevent TWA from performing needed capital improvements, leading to increased passenger disenchantment with the carrier, directly translating into decreased revenues. Without capital investment, TWA is unable to secure a second U.S. hub to unclog the heavy traffic at TWA's St. Louis hub. The congestion in St. Louis has led to increased flight delays and baggage mishandling.[105] TWA, moreover, has one of the oldest fleets of jets in the industry, a fleet in serious need of replacement.[106]

In light of the financial turmoil at TWA, Icahn has turned up the heat on the carrier's pilot union in an effort to make them agree to at least $80 million in wage concessions.[107] Icahn stated that "I'm not running the airline for the purpose of losing money. If we don't get concessions, we're going to have to shrink it."[108] The pilots, on the other hand, believe they have already granted enough concessions for Icahn to begin rebuilding the airline, in terms of new planes and routes, but Icahn has instead pared the carrier's assets, and it appears, he will continue to do so.[109]

99. Icahn, *Icahn on Icahn*, FORTUNE, Feb. 29, 1988, at 55 [hereinafter *Icahn on Icahn*].
100. *Carl Icahn Has Lots of Cash*, *supra* note 98, at 86.
101. *Id.*
102. Carey, *Can Raiders Run What They Raid?*, FORTUNE, June 4, 1990, at 193.
103. *Id.* at 196.
104. *Id.* at 193.
105. *Id.* at 196.
106. *Id.*
107. *Icahn's Incredible Shrinking Airline*, BUS. WK., Feb. 19, 1990, at 42.
108. Alpert, *supra* note 68.
109. *Icahn's Incredible Shrinking Airline*, *supra* note 107.

For example, on February 7, 1990, TWA received permission to sell part of its reservation system to Delta Airlines.[110] Furthermore, TWA is close to finalizing deals whereby the airline would sell $400 million worth of its aging jet fleet, thereafter leasing back the same planes.[111] If Icahn does not receive the concessions, it is thought that he may shut down the St. Louis hub and retain the deeds to the jets still owned by TWA. He could then lease the jets to the hub's next owner.[112] Whatever he may do, Icahn has clearly stated that "I don't want to preside over an airline bleeding to death."[113]

How did Icahn, a one-time stock trader, and of late a "greenmailer,"[114] end up with control of TWA? How did this individual, who has stated "I enjoy collecting money,"[115] and who, in a memo to recruit partners during 1980, wrote: ". . . sizeable profits can be earned by taking large positions in 'under valued' stocks and then attempting to control the destinies of the companies. . . by convincing management to liquidate or sell the company. . . waging a proxy contest. . . making a tender offer. . . [or] selling back our position to the company,"[116] end up owning an airline? Initially, Icahn purchased TWA stock with the belief that he could either extract greenmail from the board, or that he could at least put the airline "in play" so that it would eventually be bought at a premium by someone else, allowing Icahn a tidy return on his investment when he tendered his shares to the new purchaser. At the worst, he would end up with an airline which he intended to partially liquidate.[117]

Enter Frank Lorenzo of Texas Air. Up to this point, Icahn's script was being followed perfectly. Here was the "white knight" that would rescue TWA and would present Icahn with a hefty profit of $95 million.[118] However, complications arose which destroyed Icahn's best-laid plans, among them the fact that TWA's unions preferred Icahn over Lorenzo, who in 1983 had sought Chapter 11 bankruptcy protection for Continental

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110. *Id.*

111. *Id.*

112. Carey, *supra* note 102, at 196.

113. *Id.*

114. The term "greenmail" refers to a corporation's purchase of a takeover bidder's shares at a premium which is not available to the other shareholders. This premium is the "ransom" which must be paid to the hostile bidder in order for him to leave the corporation alone. *See*, Unocal Corp. v. Mesa Petro. Corp., 493 A.2d 946, 956 note 13 (Del. 1985).

115. *Icahn on Icahn*, *supra* note 99, at 54.

116. Brill, *The Roaring Eighties*, AM. LAW., May 1985, at 11.

117. THE PREDATOR'S BALL, *supra* note 46, at 171-173. Icahn quickly changed his tune as to liquidating the airline when he testified during an evidentiary hearing before a U.S. District Court as part of various lawsuits brought against him by TWA. Icahn testified he was "never in love with liquidating a lot of planes. . ." *Id.* at 172.

118. *Id.* at 173.

Airlines, abolished union contracts and cut labor costs by 50%.[119] Thus, by way of unforeseen events, Icahn found himself the owner of TWA. His often-used script had suddenly been rewritten. Icahn, however, has turned this unanticipated outcome to his own advantage. In taking TWA private, Icahn recouped his entire $436 million investment plus an additional $33 million.[120]

Moreover, it may not be too surprising that, amidst the mess which TWA is in today, Icahn has come up with a new, innovative way to fatten up his war chest for future raids: sell $300 million in junk bonds, paying 16% interest, and secure them with TWA's light bulbs and spare gaskets.[121] This new debt was piled on top of about $2.5 billion already owed by the airline, secured by practically all of the airline's assets. Furthermore, the airline has a negative net worth of approximately $30 million.[122] Ironically, TWA documents state that it does not yet know what it will do with the additional $300 million.[123] This, from an airline where interest payments alone will amount to $90 million every quarter, or $360 million per year, if this new financing goes through.[124] This, however does not appear to phase Icahn, who has used TWA as an investment vehicle for his past two raids on Texaco and USX Corp.[125]

II. Conclusion and Recommendations

Although the major carriers today have tremendous market power, this does not mean they also have financial health. Only in the last two years have the carriers become profitable. Yet, because the airline industry is cyclical, the carriers' financial health is directly linked to the fluctuations in the economy. Any downturn in the economy will be accompanied by a concomitant decrease in the number of travelers, an event which will hit the industry especially hard in the coming years due to the infusion of new aircraft and thus an increased number of seats which must be filled. The industry is also keenly susceptible to changes in operating costs, such as labor and fuel prices, and also to threats of terrorism which may scare away the traveling public in droves.

The carriers' financial health may be further diminished by speculative takeovers. The recent trends in hostile takeovers shifts the focus of management to short-term results, burdens companies with excessive

119. *Id.*

120. Carey, *supra* note 102, at 200.

121. Sandler, *TWA to Sell $300 Million Notes Secured in Part by Light Bulbs*, Wall St. J., June 2, 1989, at C1, col. 3 [hereinafter *TWA Notes*].

122. *Raiders May Not Make the Best Pilots*, *supra* note 18, at 35.

123. *Id.*

124. *TWA Notes*, *supra* note 121.

125. *Id.*

debt, and threatens the viability of communities. Short-term gains and takeover defenses become top priority instead of capital reinvestment to foster research and development needed to sustain long-term growth. This also shifts management's focus away from the maintenance of planes. Moreover, if a hostile raider, such as Carl Icahn or Frank Lorenzo, is successful in acquiring an airline, he may have no qualms about burying it under debt, stripping it of its assets, curtailing service, cutting corners on safety, and breaking labor contracts all in the name of their own greed. Today, the manipulation of money for speculation rather than for financing production appears to be the name of the game.

Hostile takeovers and the excessive amount of debt they create, can exacerbate any decline in ridership or profits and push the industry to the precipice of financial ruin. The consolidations and bankruptcies such a catastrophe would cause could leave the industry with one or two major carriers, and leave the public with even higher fares for even less service. This could also have repercussions throughout the entire economy, since airline transportation is an infrastructure industry vital to the health of the nation's economy.

Enlightened regulation is desperately needed, however lately it appears that Congress will only act once it is faced with a catastrophe. The recent upswing in the economy appears to be coming to an end, and the following downturn has the potential to create a catastrophe meriting Congress' attention. Congress can avoid such a melee by acting now, before the situation becomes any worse. Arguments that the financial problems existing in the airline industry merely mirror problems of other unregulated industries which are remedied by the market, simply miss the point. The airline industry cannot be equated with other industries, for the transportation of people from here to there facilitates the economic growth which a country requires to remain globally competitive. If an airline finds itself in financial trouble, moreover, Congress' own study shows that the first expense which may be cut is maintenance, and in this industry such a cut is deadly. The airline industry needs limited regulation which will help return to it the element of stability.

A. *Formulate Legislation Giving the Government Broader Oversight of Debt-Financed Takeovers*

A good place for Congress to start would be to carefully redraft Section 408 of the Federal Aviation Act[126] to cover hostile bids/acquisitions by corporate raiders. Presently, this section provides that the government has regulatory oversight over combinations of carriers only if the acquirer is "*substantially* engaged in the business of aeronautics." (emphasis ad-

126. Federal Aviation Act of 1958, § 408 (codified at 49 U.S.C. § 1378(a) (1982)).

ded)[127] Ironically, this language considerably narrowed the class of persons whose involvement in combinations was subject to government oversight. Previously, the statute provided that government oversight would attach when "any person engaged in any other phase of aeronautics,"[128] attempted to consolidate carriers. The statute also previously provided that government oversight would attach when "any other person [wished to] acquire control of any air carrier in any manner whatsoever."[129] Thus, before this section of the Federal Aviation Act was redrafted during the deregulation wave in 1978, the government had far more power to not only supervise combinations where one party was merely "engaged" in aeronautics, but also where "any person" attempted to acquire control of a carrier.

Furthermore, although there is Department of Justice oversight of anti-competitive aspects of airline consolidations, there is no similar oversight for detrimental results of hostile and/or leveraged takeovers. Perhaps Congress could draft legislation requiring an individual who wishes to acquire a carrier to show that his acquisition will not be detrimental to the public interest and that the carrier will be financially viable. The burden of proof should be placed upon the acquirer. These two changes are vitally important, for the traveling public should be worried most about acquisitions of carriers by individuals who have no experience in the airline industry and may be solely motivated by reaping windfall profits from the carrier by either stripping it of all its assets and thus rendering in noncompetitive, and/or squeezing all the cash out of it and totally neglecting maintenance. The public deserves some amount of protection from such a situation.

Along these same lines, Congress should pass legislation strengthening the "fitness" requirement contained in section 401 of the Federal Aviation Act.[130] Congress should mandate that "fitness" be determined in terms of the carrier's economic well-being, and as a way to examine its debt to equity ratio. Indeed, Transportation Secretary Samuel Skinner has made proposals along these lines.[131] He has proposed that those carriers saddled with a great deal of debt be required to make more frequent and more detailed financial reports than other carriers. They would also need to obtain government approval before any major refinancing or major sale of assets.[132] Recently, the financial condition of the airline

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127. *Id.*

128. *Reprinted in*, LEGISLATIVE HISTORY OF THE AIRLINE DEREGULATION ACT OF 1978, House Comm. on Public Works and Transportation, May 1979, at 98.

129. *Id.*

130. Federal Aviation Act of 1958, § 401 (codified at 49 U.S.C. § 1371 (1982)).

131. *Can United Afford to be Taken Over?*, *supra* note 8, at 148.

132. S. Wildstrom, *Airlines*, BUS. WK., Sept. 25, 1989, at 58.

industry has also prompted action on Capital Hill, where a House Subcommittee has approved a bill vesting the Transportation Secretary with authority to review and approve leveraged buyouts of carriers.[133] These recommendations could be further strengthened by a provision that all debt secured by assets of an airline be used solely for the airline, and not as a means to finance other takeovers or similar speculative transactions which have nothing to do with the airline's well-being. Although it appears that the Bush Administration, at present, is not in favor of such legislation,[134] these are good ideas which should be implemented in order to return a level of stability to this important industry.

B. Provide Tax Incentives Favoring the Use of Equity Instead of Debt

Another way to attack the problem of excessive debt is a tax incentive aimed at encouraging the use of equity instead of debt. At present, the country's tax laws are definitely biased against the formation of capital and equity. For example, corporations which invest in research and development usually must account for these expenses in the years they are made.[135] The depression of earnings effected by this accounting requirement may make a company look less attractive to potential investors. The expensing of research and development costs in the year incurred depresses earnings because the company cannot offset these costs against any long-term benefit it derives from the investment. In order to provide an impetus for increased funding of research and development in the private sector, Congress should make it easier for companies to match these costs against the benefits in the year derived.

In addition, the tax code requires corporate earnings to be taxed to the corporation at its tax rate. Then, if the corporation declares a cash dividend from this already-taxed income, the funds received by the shareholders are considered to be part of their gross income,[136] and thus is taxed again. This amounts to double taxation. The bias in the Internal Revenue Code thus makes the payment of interest on debt, which is tax deductible, look more appealing, especially if the company is in the 35% tax bracket. A firm is allowed to deduct interest expenses, but not dividends and retained earnings.[137] This, in essence, amounts to the gov-

133. Hall, *House Panel Backs Bill On Reviewing Airline Buyouts*, Wall St. J., Oct. 17, 1989, at A3, col. 1.

134. McGinley, *Transporation Chief's Warnings on Airline LBO's Put Him in Hot Seat Over Role in Stock Sell-Off*, Wall St. J., Oct. 17, 1989, at A30, col. 1.

135. I.R.C. § 174 (1988).

136. I.R.C. § 61(a) (1988).

137. I.R.C. § 163 (1988). Indeed, two highly respected commentators have stated that Section 163(a) contains a "pro-debt bias," and that it "encourages the corporation to meet its fi-

ernment paying a portion of a company's interest expenses, the percentage equal to the company's nominal tax rate.

One way to lessen the tax code's bias towards debt would be to phase out the double taxation of corporate dividends. Congress could thereby make equity look far more attractive. Equity financing is preferable for the airline industry to debt financing because debt must be repaid whereas there is no requirement for the company to pay cash dividends, and in some states, such distributions are prohibited if the company finds itself in a precarious financial position.[138]

C. Require Airline Acquirers to Disclose Their Intent, Subject to Fines if They Make False Statements

This suggestion does not advocate that LBOs or takeovers should be banned across the board, for under certain situations they effect legitimate business purposes. Instead, the focus should be on transactions performed purely for speculation. Perhaps there should be restrictions on junk-bond financing of takeovers and restrictions on the amount of debt used to purchase stock. Moreover, the government could formulate a "test" to determine whether an LBO is "good." A "good" LBO could be defined as a transaction where buyout investors intend to hold the property for the long-term, with the goal of ownership-management, as opposed to an intent to turn around and sell the company and/or strip its assets just to make a profit.

Of course, such a determination is dependent upon statements made by the acquirers. One way to ensure they provide truthful answers would be to implement a system of fines similar to that found in Section 16 of the Securities and Exchange Act of 1934, which imposes penalties for short-swing profits made on a company's stock by insiders.[139] This section requires that all officers, directors, and shareholders who own 10% of the company must file reports disclosing their stock positions in their company, and must update these every time they transact in the company's stock.[140] Thereafter, if one of these insiders enters into a purchase and sale of the company's stock within six months of each other, the company can claim the profits made by the insider. Under Section 16, the corporation can claim these profits without proving that the trader used inside information: the matching of a purchase and sale within six months of

nancing needs by borrowing . . ." Bitker & Eustice, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, § 4.01, at 4-3, 4-4 (5th ed. 1987).

138. *See* Darrow, *Tax Considerations — From the Company's Standpoint — In Structuring Venture Capital Investments, 45* BUS. LAW. 233, 239 (Nov. 1989).

139. 15 U.S.C. § 78(a) (1982).

140. 15 U.S.C. § 78ff (1982).

each other acts as a conclusive presumption of a violation of the law.[141]

Similarly, then, if the airline acquirer's acts deviate from his statements, he could be subject to fines amounting to a percentage (or all) of the gain reaped by selling off the airline's assets. The statute could mirror Section 16's conclusive presumption that if the acquirer stated he would be a manager-owner and then sells the company piece-by-piece, within, say, two years of purchase, his acts amount to a violation of the law.

In conjunction with this, Congress should aim to formulate a policy which recognizes that in an industry affecting the economy and the public interest as much as the airline industry does, takeovers directly affect constituencies other than the shareholders of the airlines. In these situations, the effect of the acquisition on all groups should be considered. Perhaps legislation should require acquirers to prepare a social-impact study of the effect of their takeover on travelers as well as the nation.

These are only a few suggestions which can start the process of thinking of limited re-regulation of the airline industry. It is a fact that if government regulation is dropped, then this must be replaced with a "regulation" of a different kind: competition. This has not happened in the case of the airline industry. The problems posed by the lack of competition have been exacerbated by the trend in hostile takeovers of airlines and the resultant debt saddled on the carriers. Simply, deregulation without competition does not serve the public interest. A "competitive" market is not a self-perpetuating entity — in some cases it must be protected from anticompetitive forces by government supervision.

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141. *See generally* Liability, 15 U.S.C. § 78t-1 (1982).