Robber Barons in the Cockpit: The Airline Industry in Turbulent Skies*

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I. INTRODUCTION

During 1989, three of the four largest airlines in the United States became targets for leveraged buy outs (LBOs): Northwest, United and American. As of this writing, only the former has been successfully concluded. The failure of the United LBO sent the Dow Jones Industrials skidding 190 points on Friday, October 13, 1989—the twelfth most serious collapse in Wall Street history.

Two reasons account for the sudden surge of interest in airline acquisitions. First, after more than 150 bankruptcies and 50 mergers, the industry has become an oligopoly. Eight megacarriers dominate 94% of the domestic passenger market. With fortress hubs and shared monopolies, ticket prices are ascending into heaven. Now that airlines are becoming money machines, they have become targets for leveraged buyouts.

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Second, the glamor of the industry has always attracted men with huge egos. In the old days, it was buccaneers like Howard Hughes, Eddie Rickenbacker and Juan Trippe. These days it is Marvin Davis, Donald Trump, and Peter Uberroth. Owning an airline is more prestigious than owning an NFL franchise, for there are fewer of them. Owning an airline also means becoming emperor of several fiefdoms, for the fortress hubs are a stranglehold over the cities they serve and the regions they dominate.

For example, in buying Northwest for $3.7 billion, Alfred Checchi became king of Minneapolis, Detroit and Memphis—Northwest's hubs. If Marvin Davis' $6.2 billion bid for United had been successful, he would have been lord of Chicago (O'Hare is the world's busiest airport), Denver, San Francisco and Washington—United's hubs.

Prior LBOs reveal that corporate raiders leverage airlines to the teeth to pay for their acquisitions. In the mid-1980s, Frank Lorenzo gobbled up Continental and Eastern, while Carl Icahn grabbed TWA and Ozark. Both added millions in indebtedness to these once proud airlines, while stripping them of assets. Before Eastern fell into bankruptcy, it carried $2.5 billion in long-term debt; its debt service was a crushing $575 million. TWA carries $2.4 billion in debt and lease obligations, and has a negative net worth of $30 million. Checchi may load Northwest with more than $3 billion in debt. United will carry more than $6 billion, no matter who buys it. This article will introduce the reader to several of the major actors in the Monopoly game, their enormous egos and their ruthless game plan.

Foreign airlines are gobbling up significant shares of U.S. airlines. Already Northwest, Delta, Texas Air, America West and Hawaiian Airlines have significant foreign equity. Not only does debt pose significant problems for the long-term viability of airlines, foreign ownership adds national security concerns. This article will examine the motivations behind airline LBOs and the policy reasons why they are not in the public interest.

Criticism of LBOs centers on the impact massive amounts of debt will have on the ability of airlines to make new aircraft purchases or maintain existing aircraft properly, expand operations, maintain competition, and withstand the vicissitudes of the market cycle. A deep and prolonged recession will likely cause a new round of bankruptcies and consolidations among debt ridden airlines which will leave the industry even more concentrated than it is today. Finally, foreign ownership of U.S. airlines raises competition and national security concerns. We begin with a look at deregulation.

II. DEREGULATION

The Airline Deregulation Act of 1978 was designed to create a more competitive environment in commercial aviation.[1] But as deregulation has matured, we have an industry more highly concentrated than at any point in its history, and a horizon devoid of new competitors. Deregulation has proceeded through four stages:

A. *PRICE WARS*

In the beginning, deregulation sent fares tumbling, as new entrepreneurs such as People Express and Air Florida emerged to rival the megacarriers. Although the new entrants never accounted for more than five percent of the domestic passenger market, with lower costs they drove prices down, and consumers enjoyed a bonanza of low fares. But industry profitability soon plummeted to the worst losses in the history of domestic aviation. These losses were exacerbated in the early 1980s by the worst recession since the Great Depression. During the first decade of deregulation, the industry as a whole made enough money to buy two Boeing 747s.[2]

Two economic characteristics of airlines lead to destructive competition when carriers compete head to head. First, airlines sell a product which is instantly perishable. Once a scheduled flight closes its door and pulls away from the jetway, any empty seats are lost forever. They cannot be warehoused and sold another day, as can manufactured goods. It is as if a grocer was selling groceries which had the spoilage properties of open jars of unrefrigerated mayonnaise. He would be forced to have a fire sale every afternoon, for any unsold inventory would have to be discarded.[3]

Second, the short term marginal costs of production are nil. Adding another passenger to an empty seat costs the airline another cardboard meal and a few drops of fuel. Thus adding nearly any bottom is profitable in the short term. Head to head competition between carriers usually results in destructive competition, for carriers price at the margin and fail to cover long-term and fixed costs.[4]

1. Dubric, *Significant Legislative Development in the Field of Aviation Law*, 45 J. AIR L. & COM. 1, 21 (1979). *See also* P. DEMPSEY & W. THOMS, LAW & ECONOMIC REGULATION IN TRANSPORTATION 28-29 (1986).

2. *See* Dempsey, *Transportation Deregulation—On A Collision Course?*, 13 TRANSP. L.J. 329 (1984); Dempsey, *The Rise and Fall of the Civil Aeronautics Board—Opening Wide the Floodgates of Entry*, 11 TRANSP. L.J. 91 (1979).

3. *See* Dempsey, *The Empirical Results of Deregulation: A Decade Later and the Band Played On*, 17 TRANSP. L.J. 31 (1988).

4. *See* P. DEMPSEY, THE SOCIAL AND ECONOMIC CONSEQUENCES OF DEREGULATION 95-104 (1989).

The hemorrhaging of dollars led management to slash wages, trim maintenance, reduce service, and defer new aircraft purchases. It also led to a massive shakeout of smaller firms. During the first decade of deregulation, more than 150 carriers collapsed into bankruptcy.[5]

B. Consolidations

In order to stave off bankruptcy, carriers began to reconfigure their operations. The entry and exit freedom produced by deregulation enabled them to establish hub and spoke operations. Four hubs (i.e., Atlanta Hartsfield, Chicago O'hare, Dallas/Ft. Worth International, and Denver Stapleton) became duopolies, while all the rest became monopolies, with a single airline controlling more than 60% of the takeoffs and landings, gates, and passengers.[6]

A rash of mergers also produced greater concentration. During the first decade of deregulation, there were more than 50 mergers, acquisitions and consolidations, the major ones concluded in 1986 and 1987, when the Reagan Administration's Transportation department embraced an exceptionally permissive antitrust policy.[7] Indeed, the Department of Transportation approved each of the 21 mergers submitted to it.[8] The following chart graphically depicts the pedigree and the market share of the nation's largest airlines:

5. P. Dempsey, *supra* note 4 at 86-92.

6. *Id.*

7. Goetz & Dempsey, *Airline Deregulation Ten Years After: Something Foul in the Air*, 54 J. Air L. & Com. 927, 931 (1989).

8. Dempsey, *Antitrust Law & Policy in Transportation: Monopoly I$ the Name of the Game*, 21 Ga. L. Rev. 505, 593 (1987).

CHART I — MAJOR AIR CARRIER MERGERS, ACQUISITIONS, PURCHASES AND CONSOLIDATIONS SINCE PROMULATION OF THE AIRLINE DEREGULATION ACT OF 1978

		Market share*		
		1989	1988	1987
American	AMERICAN	16.6	15.2	13.8
Air Cal				
United	UNITED	16.2	16.4	16.9
Pan Am (transpacific routes)				
Texas International	TEXAS AIR	15.9	19.3	19.0
Continental				
New York Air				
Frontier				
People Express				
Britt				
PBA				
Eastern				
Braniff (Latin America)				
Rocky Mountain				
Delta	DELTA	13.3	12.0	12.2
Western				
Northwest	NORTHWEST	9.6	8.9	10.3
Republic				
North Central				
Southern				
Hughes Airwest				
TWA	TWA	7.2	7.4	8.2
Ozark				
Allegheny	US AIR	7.2	7.2	7.1
PSA				
Piedmont				
Empire				
Henson				
Pan Am	PAM AM	5.9	7.1	6.3
National				
Ransome				

* Percentage market share as measured by revenue passenger miles. Sources: Business Week, Oct. 5, 1987, at 40, and Wall Street Journal, Mar. 10, 1989, at A8.

The eight largest airlines today dominate nearly 94% of the domestic passenger industry and almost all hubs. Not only are passenger airlines highly concentrated; mergers in the all cargo industry have reduced it to a duopoly. Federal Express acquired Flying Tigers, which itself consumed Seaboard when deregulation was young. Consolidated Freightways, one of the nation's largest trucking companies, acquired Emery Air Freight, which itself earlier consumed Purolator.

C. PROFITABILITY

With such tremendous concentration, carriers have been able to raise ticket prices significantly. In 1989, the General Accounting Office reported that prices were 27% higher in monopoly or duopoly hubs than at competitive airports.[9]

The oligopoly which has emerged from deregulation has grown increasingly profitable. The two years ending June 30, 1989, was the most profitable period for airlines in history.[10] One source noted, "after a decade of turbulence, [the industry] is entering a new period of prosperity: a period where tight airport space and increasing demand for air travel will produce the steady cash flow necessary for a smooth buyout."[11] Contestability theory, which provided much of the intellectual foundation for deregulation, has not been sustained by the empirical evidence.[12] Hence, significant new entry now appears unlikely.

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9. GENERAL ACCOUNTING OFFICE, AIR FARES AND SERVICE AT CONCENTRATED AIRPORTS (1989).

10. *Hearing on Leveraged Buyouts and Foreign Ownership of United States Airlines; Before the Aviation Subcomm. of the House Comm. of Public Works and Transp.*, 101st Cong., 1st Sess. (1989) U.S. Senate Committee on Commerce, Science and Transportation, (Oct. 4, 1989) (Statement of Timothy Pettee, first vice president, Merrill Lynch Capital Mkt.)

> Operating earnings of the major airlines, which account for more than 90% of the U.S. industry's traffic, rose by 10% in the second half of 1987 compared with the same year earlier period. For 1988, industry revenues grew 11% and operating earnings by 28%. Traffic, revenue passenger miles, increased a modest 5% for the year. However the 5% unit growth was accomplished amidst a 7% advance in the average fare, or yield per passenger mile . . . .
>
> The first half of 1989, the period during which the trend toward recapitalization of the airline industry became evident, saw the continuation of record revenues and earnings in the airline industry. Boosted by late 1988 fare restructurings, and a still strong economic environment, the average fare rose 11% in the first quarter of the year, compared with the year before, and second quarter yields were up 6%. The average yield in the month of March alone rose 17%, year to year. Despite softening traffic trends, particularly in domestic markets, industry revenue growth in the first half of this year was 8%.

Id. at 14-15.

11. Ellis, *United's Buyers May Be Wearing Rose-Colored Goggles*, BUS. WEEK, Oct. 16, 1989, at 36.

12. Dempsey, *The Empirical Results of Deregulation: A Decade Later and the Band Played On*, 17 TRANSP. L.J. 31 (1988).

D. LEVERAGED BUY-OUTS

With unprecedented profitability, and the innate glamor of the industry, three of the nation's four largest airlines became targets for LBOs in 1989. Denver oil king Marvin Davis launched a $2.7 billion bid for Northwest Airlines. Northwest ultimately fell victim to a $3.7 billion bid by Alfred Checchi.[13] Davis enjoyed a $30 million profit on the Northwest raid, then turned around and put a siege on United. That raid was preempted by a management/pilot bid for United led by CEO Stephen Wolf for $300 a share, or nearly $7 billion. In October 1989, Donald Trump, former suitor of United,[14] and purchaser of the Eastern Air Lines New York-Washington-Boston shuttle,[15] launched a $7.54 billion bid for American Airlines.[16]

One source summarized the principal reasons motivating airline LBOs:

> 1) The belief that the significant earnings and earnings potential demonstrated during the last two years, and the concurrent strong level of cash flow generation is sustainable. Inherent in this tenet is the expectation that the degree of cyclicality and even seasonality airline earnings and cash flow have historically demonstrated will be absent or lessened in the future.
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> 2) The realization of premium values for used aircraft, facilities as well as new aircraft delivery positions, which has increased the liquidity (and enhanced the equity capital) of many carriers. Included in the strong market for airline assets is premium values being accorded gates, slots, real estate and other tangible and intangible assets.
>
> 3) The availability of capital, both equity and debt, due in part to the renewed interest in airline lending by commercial banks and the current favorable interest rate environment. Included in this tenet is the tremendous increase in leasing capital, which has provided, and is expected to continue to provide more than half the capital expenditures in the 1990s.[17]

As of this writing, financing for the $7 billion management/labor bid for United has collapsed, Donald Trump has withdrawn his $7.5 billion bid for American, bids for Delta and USAir are rumored, and Congress is considering legislation that would make airline acquisitions more difficult.

Some LBOs can be justified on grounds that they rid companies of

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13. Hughes & Smith, *Failed Bid for NWA Leaves Marvin Davis Richer and Still Ready*, Wall St. J., June 21, 1989, at 1.

14. In March 1987, Trump purchased 4.9% of UAL, selling it in April for $73 a share, making him a $55 million profit. *Donald Trump's Investment Track Record*, Wall St. J., Oct. 6, 1989, at A3.

15. The Trump Shuttle operates 21 aircraft between three cities. In contrast American Airlines has 480 planes. *An Ego As Big as American*, NEWSWEEK, Oct. 16, 1989, at 56. Another source reports that American has 683 aircraft. *Here Comes Donald, Duck!*, TIME, Oct. 16, 1989, at 52.

16. O'Brian & Valente, *Crandall's American Is Unlikely Recipient of $8 Billion Trump Bid*, Wall St. J., Oct. 6, 1989, at 1.

17. *See supra* note 10, at 14.

ineffective management and improve productivity, profitability, and performance by paring unrelated assets and squeezing labor. But American, United, Delta and USAir are generally viewed as among the best managed and most efficient companies in the business. Let us examine America's two largest megacarriers, the assault by corporate raiders upon them, and the entrepreneurs who battle for control of the nation's aviation system.

1. *American Airlines and CEO Robert Crandall*

American Airlines has been the most vocal opponent of LBOs, describing Trump's bid as "ill considered and reckless",[18] and insisting that "excessive levels of debt in the airline industry are not in the public interest."[19] As AMR Chairman Robert Crandall said, "The disadvantages of excessive leverage, and its effects are heightened by the continuing volatility of airline earnings."[20] American called for congressional protection against LBOs, a plea to which, as we shall see below, Congress appears to be responding.

Robert Crandall is Chairman and President of American Airlines. Although initially a critic of deregulation, he moved quickly to capitalize on its opportunities for growth. His aggressive policies of reinvesting earnings, growing from within, establishing new hubs from scratch (i.e., Nashville, Raleigh-Durham and San Jose) and thereby outflanking the dominant southeast hub of Atlanta, aggressively managing yield, inventing frequent flyer programs, and getting out early with a computer reservations system have made American Airlines the largest airline in the United States in terms of revenue passenger miles.

The man has a Vitalis look, with his oily hair combed straight back. He is a chain smoker and an avid jogger—two packs and four miles a day, respectively.[21] One commentator notes that, "His tough stance on union wages, his bare-knuckled price-cutting and his proclivity for salty phrases have all contributed to Robert L. Crandall's public image as a hard-nosed street fighter."[22] Above all, Crandall is a fierce competitor. As one acquaintance noted, "He doesn't want anybody to beat him . . . . He's in business to put his competition out of business."[23] Crandall views the deregulated environment as one in which he can wage "legal-

18. Phillips, *AMR Earnings Decrease 8.8% in Third Period*, Wall St. J., Oct. 19, 1989, at A3.

19. *Here Comes Donald, Duck!*, Time, Oct. 16, 1989, at 52.

20. *See generally With Trump Gone, AMR Targets Growth*, USA Today, Oct. 18, 1989.

21. Loeffelholz, *Competitive Anger*, Financial World, Jan. 10, 1989, at 28.

22. *'I'm Going to Run This Joint'*, N.Y. Times, Dec. 8, 1985, at 8F.

23. Brown III, *American Airlines Boss Blossoms as Champion of the Poor Passenger*, Wall St. J., Mar. 4, 1988, at 1.

ized warfare in the industry."[24]

After a series of price wars which left both American and Braniff bleeding in their Dallas hub,[25] Crandall sought to fix prices with Braniff's President, Howard Putnam. Putnam recorded the conversation and turned the tapes over to the Justice Department.[26] But nothing was to save Putnam from demise. Braniff entered bankruptcy in 1982.[27] After scaling down significantly, selling off its Latin American routes to Eastern and many of its aircraft, the new Braniff emerged from reorganization under the control of the Pritzker family of Chicago (who control the Hyatt hotel chain), and reassumed its Dallas/Ft. Worth operations. But head to head competition with the two megacarriers which dominated Dallas—American and Delta—proved infeasible. With a generous loan from

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24. S. Davis, Delta Air Lines: Debunking the Myth 166 (1988).

25. Salpukas, *The Braniff-American Air Duel*, N.Y. Times, Mar. 29, 1982, at 25.

26. Crandall and Putnam had the following conversation on February 1, 1982:

> CRANDALL: I think it's dumb as hell for Christ's sake, all right, to sit here and pound the shit of each other and neither one of us making a fucking dime.
> PUTNAM: Well—
> CRANDALL: I mean, you know, goddamn, what the fuck is the point of it?
> PUTNAM: Nobody asked American to serve Harlingen. Nobody asked American to serve Kansas City, and there were low fares in there, you, know, before. So—
> CRANDALL: You better believe it, Howard. But you, you, you know, the complex is here—ain't gonna change a goddamn thing, all right. We can, we can both live here and there ain't no room for Delta. But there's, ah, no reason that I can see, all right, to put both companies out of business.
> PUTNAM: But if you're going to overlay every route of American's on top of over, on top of every route that Braniff has—I can't just sit here and allow you to bury us without giving our best effort.
> CRANDALL: Oh sure, but Eastern and Delta do the same thing in Atlanta and have for years.
> PUTNAM: Do you have a suggestion for me?
> CRANDALL: Yes. I have a suggestion for you. Raise your goddamned fares 20 percent. I'll raise mine the next morning.
> PUTNAM: Robert, we . . .
> CRANDALL: You'll make more money and I will too.
> PUTNAM: We can't talk about pricing.
> CRANDALL: Oh, bullshit, Howard. We can talk about any goddamned thing we want to talk about.

Complaint of U.S. Dep't of Justice in United States v. American Airlines, Inc., 759 F.2d 1241 (1985), 1 Trade Cases p. 66, 605 (N.D.Tex). Crandall was a bit red faced when he learned that Putnam had taped the conversation, and turned the tape over to the Justice Department. No doubt, Crandall screamed the last words indelibly recorded on the tape in the black box by most pilots immediately before they crash, "Oh, shit!" Price fixing is, after all, a per se violation of the Sherman Act, one which could throw Crandall in prison. Most convicted wealthy white collar criminals actually end up in Club Fed as did Ivan Boesky, working on their muscles and tans in minimum security institutions. It is, nonetheless, an embarrassing way to spend your time. The Justice Department was less ambitious. It initially sought a court order prohibiting Crandall from working in any responsible airline position for two years, and prohibiting American Airlines from discussing pricing for a decade. P. Dempsey & W. Thoms, Law & Economic Regulation in Transportation 214 (1986). Ultimately, the Reagan Administration settled for less still—a consent decree in 1986 in which Crandall neither admitted nor denied guilt. Brown III, *supra*.

27. Karr, *Airline Deregulation After Braniff's Fall*, Wall St. J., June 14, 1982, at 20.

American to buy new aircraft, Braniff abandoned Dallas, and moved its hub to Kansas City.

Southwest Airlines dominates tiny Dallas Love Field, while American dominates Dallas/Ft. Worth International Airport. Southwest's Chairman Kelleher once joked to Crandall that their relationship was analogous to that of tiny Finland compared with mighty Russia. "There's only one difference," Crandall retorted with a Siberian stare, "I ain't reducing troops."[28]

Crandall has adopted an extremely aggressive approach to capitalizing on the opportunities afforded by airline deregulation. American had adopted the philosophy of, in its words, "competitive anger." As Crandall put it, "We like to be successful. When we're not, we're angry with ourselves, our colleagues and the world at large."[29] He has repeatedly insisted, "My friends call me Mr. Crandall. My enemies call me Fang."[30]

Destroying the competition means more to Crandall than running them out of town. It includes assaulting their character. In 1987, Crandall bought 15,000 copies of a scathing article about Texas Air's Frank Lorenzo which appeared in *Texas Monthly* to distribute at employee meetings.[31] For his part, Lorenzo describes Crandall as "hypocritical" and "afraid of competition"—the pot calling the kettle black, so to speak.[32]

But Crandall didn't like it when the shoe was on the other foot. In response to a book about Braniff in which Crandall was portrayed unfavorably, he bought 25,000 copies to take them out of circulation, then paid the publisher $150,000 to discard existing inventory and print a reworded edition.[33]

Crandall's aggressive character also manifests itself strongly in his internal domination of American. He has a fiery temper. Richard Murray, a former American Airlines executive, recalls being fired at several meetings, only to be rehired before adjournment. Once, Crandall became so angry at a competitor that he flew into a rage, and accidentally pulled some blinds off a window and onto his head. When aides rushed to help, he responded, "To hell with my head. What are we going to do about this problem?"[34]

Crandall loves detail. He likes to immerse himself in the numbers. Crandall was once spotted humped over paperwork three inches high on

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28. *American Aims for the Sky*, BUS. WEEK, at 54.
29. Loeffelholz, *Competitive Anger*, FINANCIAL WORLD, at 28.
30. *Id.* at 33.
31. B. NASH & A. ZULLO, THE MISFORTUNE 500 140 (1988).
32. *See* Easterbrook, *supra* note 88.
33. *Id.*
34. Brown III, *supra* note 23.

an American flight on Christmas morning.[35] He brags that he cut $40,000 in operating expenses by removing olives from American's dinner salads.[36] When Crandall took over as chief operating officer in 1980, he reduced the number of guards at an American facility from three to one. The lone guard was replaced, first, with a part-time guard, and then with a guard dog. Finally, Crandall inquired whether it might be possible to replace the dog with loudspeaker system broadcasting a tape recording of barking dogs.[37]

Crandall's tight fisted managerial style, entrepreneurial bravado and marketing acumen made American the largest airline in the free world, second in number of aircraft only to the Soviet Union's Aeroflot. Under Crandall, American's revenue passenger miles had grown steadily since 1981; its market share increased steadily since 1980; it has turned a profit every year since 1983; and its debt to equity ratio was superior to that of the Dow Jones airlines since 1985.[38] That such a lean, mean flying machine as American would be assaulted in a leveraged buy-out left most analysts stunned in disbelief in October 1989 when Donald Trump made a bid of $120 a share, or $7.54 billion.[39] It was like a minnow swallowing a whale. Trump purchased the Eastern shuttle which flies 21 aircraft between three cities; American has 480 aircraft.[40] In 1988 American earned $476.8 million on revenue of $8.8 billion.[41] Trump's acquisition would have added $6.5 billion in debt to American.[42] Perhaps Trump's ego got the best of him. As one source noted:

> Mr. Trump, a billionaire with a towering ego who made his fortune with glitzy skyscrapers and casinos, entered the airline business last Spring by buying Texas Air Corp.'s Eastern shuttle for $365 million and renaming it the Trump shuttle. He owns New York City's famed Plaza Hotel, plus buildings named Trump Tower, Trump Parc, and Trump Palace.[43]

He promised, however, not to rename American Airlines "Trump Airlines". But after the stock market collapse of Friday, October 13, 1989, Donald Trump withdrew his bid for American.

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35. *American Aims for the Sky, supra* note 28, at 58.

36. *Id.* at 55.

37. *Loeffelholz, supra* note 21 at 30. God help us if he is shaving the margin of safety so finely.

38. *Sizing Up AMR Corp.*, Wall St. J., Oct. 6, 1989, at A3.

39. *Supra* note 16, at 1, col. 6.

40. *An Ego As Big As American*, NEWSWEEK, Oct. 16, 1989 at 56.

41. Smith, *Trump Bid $7.54 Billion to Acquire American Air*, Wall St. J., Oct. 6, 1989, at A3, col. 1.

42. *Id.*, at col. 2.

43. *Id.*, at col. 1.

2. *United Airlines and CEOs Richard Ferris and Stephen Wolf*

Stephen Wolf is presently chief executive officer of United. But much of its corporate culture was shaped by his predecessor, Richard Ferris. Ferris was one of the major actors in the quest for deregulation. As United's chief (from 1976 until 1987), Ferris led the carrier to break ranks with the rest of the industry and promote deregulation.

As the nation's largest carrier, United believed that the deregulated skies would be friendly to it. United worked long and hard behind the scenes to persuade Congress and the Carter Administration to pass the Airline Deregulation Act of 1978. "If the truth be known," said a former Untied executive, "Monte Lazarus [a lieutenant of Ferris] wrote the Airline Deregulation Act." Ironically, Lazarus, a former assistant to CAB Chairman Secore Brown, was known as the consummate Washington bureaucrat even after joining United.

Under regulation, United had been hindered from growing. In 1938, United enjoyed about 22% of the domestic passenger market; by the mid-1970s, its share had declined slightly, to 20%. Under regulation, the CAB had favored the smaller airlines in awarding new routes. Ferris believed that United would have few opportunities for expansion under a benevolent CAB.[44] Deregulation would be the means for United to grow.

Once deregulated, United pulled out of many of its thin markets, abandoning a large number of small and medium-size cities, and concentrated on dense, long-haul routes. But it soon found that it needed regional feed into its hubs to fill the long-haul capacity, and reversed course. Today, it serves at least one airport in each state so that it can boast, "We serve all 50 states."

Working from a stand up desk, Ferris was known to be a tough, hot tempered competitor.[45] Take his role in the demise of Frontier. In the mid-1980s, Denver's Stapleton Airport was the only airport in the country used as a hub by three airlines. As a consequence, Denver consumers enjoyed some of the lowest air fares in the country. But for the three airlines—United, Continental and Frontier—the results were disastrous. Profitability in the market plummeted.

So in 1985, United purchased 30 of Frontier's jets for $360 million. Later that year, Donald Burr's People Express bought the rest of Frontier for $307 million. People's "no frills" fares were matched by United and Continental, and an economic blood bath resulted. Between September 1, 1985, and July 31, 1986, Frontier alone lost $47 million. It was a loss that parent People Express could not long withstand.

44. S. Davis, *supra* note 24, at 12.

45. *Rising UAL Turmoil Threatens Ferris's Job As the Chief Executive*, Wall St. J., Apr. 17, 1987, at 1, col. 6.

In July 1986, United agreed to take Frontier off Burr's hands for $146 million, with the condition that United reach an agreement with Frontier's unions satisfactory to United. United met with the pilots, but not the four other Frontier unions. After several weeks during which additional Frontier assets were transferred to United, United announced that the labor negotiations were at an impasse.[46] Burr had little choice but to put Frontier into bankruptcy in late August, 1986. And then there were but two in Denver. Prices and profitability began to climb.

Ferris began his reign at United with good rapport with labor, frequently visiting the cockpits, and taking the time to earn a pilot's license.[47] But a 29-day strike by United's pilots in 1985 began a seething relationship with labor that caused Ferris to begin flying private jets, avoiding his own company's planes. At a dinner in 1986, Ferris was overhead boasting to American's CEO Robert Crandall that United would one day have some of the lowest labor costs in the industry.[48]

Ferris came to head United through the ranks of its Westin Hotel chain, which may explain his obsession with creating a vertically integrated travel conglomerate. Already owning Westin, United went on a binge under Ferris in which airline profits were spent on developing a computer reservations system (Apollo), and buying a rental car company (Hertz), and yet another hotel chain (Hilton International, formerly owned by TWA). In 1986, the combined company flew 50 million passengers, controlled about one-third of the car rental business, and owned 150 hotels. To reflect its scattered emphasis, United dropped the UAL label and renamed the holding company Allegis, a bastardization of the words "allegiance" and "aegis".

Not only was the name bad, but the combination made United ripe for a hostile takeover, for its dismembered parts were worth more than its barely unified whole. While the idea of a unified full-service travel empire was not a bad one (selling a customer an airline ticket, hotel room and rental car as a package intuitively seemed an attractive marketing concept), it never really got off the ground before the vultures began to circle.

In 1987, Donald Trump, who owned 5% of the company, urged Ferris to break up the conglomerate and sell its parts separately.[49] The pilots, angry with Ferris for different reasons, began to put together their own $2.3 billion bid for the company.[50] And other suitors were waiting in

46. Amended Complaint of Frontier Airlines, In re Frontier Airlines Inc., 74 BR 973 (BANKR. D. Colo 1987) Reorganization, (Case No. 860B-8021E).

47. *Rising UAL Turmoil*, *supra* note 45.

48. *Id.*

49. *Id.*

50. Cohen & Kilman, *Talk of a Possible Takeover of UAL Inc. Is in the Air*, Wall St. J., Apr. 9, 1987, at 6, col. 1.

the wings, including the Coniston Partners. As one analyst noted, "If the pilots wanted to stir up a hornet's nest, it looks like they have."[51]

Ferris was a fiery tempered executive who attacked problems by moving on the offensive promptly.[52] In addition to the usual poison pills and golden parachutes, he concluded a unique financial arrangement with Boeing that gave it some usual powers over the business operations.[53] When that wasn't enough, he proposed to saddle the company with a $3 billion recapitalization to thwart the takeover attempts, distributing the proceeds as a $60 a share dividend.[54]

Shareholder resistance and difficulty in financing it led the Board of Directors to balk. Ferris resigned red faced in June 1987. He was succeeded for a short term by Frank Olson, chairman of the Hertz unit.[55]

Although the company spent $7.3 million on the name change (to which Wall Street gave a thumbs down), United abandoned the Allegis title in 1987.[56] United also sold off the hotel and car-rental businesses, took on $3 billion in debt, and paid shareholders a hefty dividend. Olson was subsequently replaced by Stephen Wolf, a former chairman of Flying Tigers.

In early August 1989, Denver oil king Marvin Davis offered $240 a share, or $5.4 billion, for United, later raising his bid to $275.[57] Management responded with a $300 a share, or $6.75 billion buy-out of its own involving the pilots. British Airways was also a partner, putting up $750 million, or about 78% of the equity.[58] Management was to have owned 10%, British Airways 15%, and the pilots 75%.[59] To pay for its share, the pilots would take pay cuts of up to 10%, less overtime pay, and fewer vacation days.[60] The debt would have created interest payments of $600 million to $700 million annually.[61] The machinists union criticized the deal as unrealistic, saying, "[p]lacing billions of dollars of additional debt on the carrier . . . would seriously jeopardize the carrier's operation, safety

51. *Id.* at col. 2.

52. Rising UAL Turmoil, *supra* note 45.

53. *Allegis Shakeup Came As Shareholder Ire Put Board Tenure in Doubt*, Wall St. J., June 11, 1987, at 22, col. 5.

54. *Id.*

55. *Id.* at 1, col. 6; *Id.* at 22, col. 5.

56. B. NASH & A. ZULLO, *supra* note 31.

57. Storch & Jouzaitis, *Little Hope Seen in UAL Bid's 2d Wind*, Chicago Tribune, Oct. 22, 1989, at C1, col. 5.

58. *Id.* at col. 3.

59. *British Air May Balk at Any Haste In Reformulating a UAL Buy-Out*, Wall St. J., Oct. 18, 1989, at A3, col. 1.

60. Valente & Smith, *United Air Pilots Face Cuts in Wages, Overtime Pay, Vacation to Finance Bid*, Wall St. J., Sept. 11, 1989, at A4, col. 2.

61. Smith & Valente, *Can UAL Pilots Bury Their Old Animosities as Firms Co-Owners?*, Wall St. J., Sept. 18, 1989, at A4, col. 3.

and future existence."[62]

The financing fell through on Friday, October 13, 1989, sending the Dow Jones Industrial average tumbling 190 points.[63] Oddly, the stock market panic was motivated, at least in part, about anxiety over junk bonds. But the United financing had none, and that was an issue about which the Japanese banks objected.[64]

Shortly thereafter, Marvin Davis withdrew his bid, and British Airways backed out of the management/pilot buy out.[65] Under the deal which collapsed, United CEO Stephen Wolf was to have earned $76.7 million and new UAL stock options.[66] Management would have then spent $15 million for a one percent stake, and been given nine percent more in stock options.[67] Everyone's eyes became filled with dollar signs. The Board of Directors voted lifetime first-class passes for themselves and their spouses, and $20,000 a year for life.[68] The investment bankers would get $59 million and lawyers $45 million.[69] United's 25,000 machinists and 25,000 noncontract employees criticized Wolf's greed in pursuing an LBO which would enrich him while forcing pay cuts and benefit reductions on labor, and called for his resignation.[70]

III. Debt—On Balance Sheet and Off

Today, four of the nation's largest airlines have a negative net worth—a debt to equity ratio in excess of 100%. They are Continental, Eastern, Pan Am and TWA. As of this writing, Eastern is in Chapter 11 bankruptcy, Pan Am is regularly rumored near collapse, it and TWA are actively seeking merger partners of outside investors, and Continental is reportedly on the block to be sold.[71] Three of these companies are owned by two corporate raiders—Frank Lorenzo's Texas Air controls Continental and Eastern, while Carl Icahn owns TWA. Continental also

62. Smith & Valente, *UAL Machinists Attack Proposal Backed by Pilots*, Wall St. J., Sept. 6, 1989, at A3, col. 1.

63. Storch, *Bankers Bring Down United Buyout*, Chicago Tribune, Oct. 14, 1989, at 9, col. 1.

64. *Banks Rejecting UAL Saw Unique Defects In This Buy-Out Deal*, Wall St. J., oct. 16, 1989, at A1, A6, col. 4.

65. Carroll, *UAL Drops; Bid Is Still Up In the Air*, USA Today, Oct. 18, 1989, at 3B, col. 1-2; Valente, *British Airways Won't Revive UAL Buy-Out*, Wall St. J., Oct. 20, 1989, at A3, col. 1.

66. *After Buyout Diet, Wolf May Be Dessert*, Chicago Tribune, Oct. 22, 1989, at C12, col. 2.

67. Storch & Jouzaitis, *United Execs Could Score Buyout Bonanza*, Chicago Tribune, Sept. 23, 1989, at 1, 6, col. 1.

68. Bailey, *Two UAL Officers Get No Parachutes in Stock's Free Fall*, Wall St. J., Oct. 18, 1989, at A3.

69. Storch & Jouzaitis, *supra* note 67, at 6, col. 2.

70. *After Buyout Diet*, *supra* note 66.

71. *See* Valente, *Transportation Agency May Rein In Airline Buy-Outs, Foreign Investments*, Wall St. J., Aug. 31, 1989, at A3, col. 3.

entered bankruptcy in 1983. We will examine how these men have stripped these companies of assets below.

With Northwest having been saddled with $3.3 billion to pay for the Checchi acquisition (quadrupling its long-term debt),[72] with the two largest carriers (i.e., American and United) under siege, and with two more (i.e., Delta and USAir) rumored as targets, the industry looks like it will be burdened with excessive debt. That will make it difficult for the industry to weather recessions, expand operations, modernize fleets, and maintain older equipment.[73] Such economic difficulties enhance public concerns over airline safety. The following chart depicts the huge amounts of debt with which the nation's airlines have been burdened by virtue of gluttonous acquisitions, mergers and buy-outs in recent years:

CHART II — MAJOR MERGERS AND ACQUISITIONS SINCE 1986

Date Completed	Acquirer (Acquired)	Value (in Millions)
Aug. 86	NWA (Republic	$884
Sept. 86	TWA (Ozark)	250
Sept. 86	Texas Air (Eastern)	676
Dec. 86	Texas Air (People Express)	112
Mar. 87	AMR (Air Cal)	225
Apr. 87	Delta (Western)	860
May 87	USAir (Pacific Southwest)	400
Oct. 87	USAir (Piedmont)	1,590
Nov. 88	Carl Icahn (TWA) privatization	N.A.
May 89	Trump (Eastern Shuttle)	365
July 89	Checchi Group (NWA) buy out	3,650
Withdrawn	Management/Labor (UAL) buy out	6,790
Withdrawn	Trump (AMR)	7,540

N.A. = not applicable

Source: Airlines Restructure, Wall St. J., Oct. 6, 1989, at A3.

By reducing competition, the acquisition or merger by one airline of another enhances the survivors' profitability. But the acquisition by corporate raiders produce no such benefits.

Not only are LBOs burying airlines in debt, new aircraft acquisitions are as well. Media attention has focused on the geriatric jets—the peeling skin and the exploding doors (known in the industry as Kahndoors, after

72. Dallos, *U.S. Conducts Fitness Exam of Northwest Airlines; Debt Cited*, L.A. Times, Sept. 5, 1989, at 1, col. 4.

73. McGinley, *Skinner Warns About Airlines Piling Up Debt*, Wall St. J., Sept. 20, 1989, at A4, col. 3.

the father of deregulation, Alfred Kahn). The Fear of Flying has prompted airlines to order huge new fleets of aircraft. The conventional wisdom also identifies mass as a key ingredient of survival. So fleets grow.

The airline industry now has more than $130 million in orders or options for 2,500 new aircraft. In contrast, the foreign debt of Brazil, which is the highest of all Latin American nations, is a paultry $114 billion.[74] The industry as a whole had operating cash of less than $5 billion in 1988, which was a very good year.[75] The industry's capital expenditures between 1991 and 1994 are estimated to be $15 billion per year.[76]

In 1989, United placed a record $15.7 billion order for 370 Boeing 737s and 757s (180 firm orders, and 190 on option). American has 259 aircraft on order and 302 on option, totaling $14.5 billion.[77] In late 1988, Delta placed options or orders for 215 jets, including 40 giant MD-11s, and expanded that with a $10 billion order in November 1989 for up to 260 aircraft (firm orders for 50 new MD-90's and 50 B-737-300's, and options for 110 MD-90's and 50 B-737's).[78] Texas Air placed an order for 100 jets in early 1989—50 firm and 50 on option—and then a second order on behalf of Continental in November 1989 for 40 Airbus medium and long range jets—20 firm and 20 on order.[79] Even debt-saddled Northwest signed a $5.2 billion contract with Boeing for 80 757s (half of which are options) and 10 747-400s (four of which are options).[80] Northwest had placed a $3.2 billion order for 50 Airbus A320s in 1986.[81]

In part, airlines may be trading in aircraft options. Their huge orders enable them to enjoy volume discounts from the manufacturers. Before delivery, should they need the cash more than they need the planes, they can sell their delivery positions, as financially strapped Pan Am did in 1988 when it sold deliveries of 50 Airbus A320s to Braniff for $115 million. (Braniff overreached and consequently found itself in bankruptcy for the second time this decade). But aircraft futures only bring a profit during a bull market for planes, an environment which only exists when growth in passenger demand exceeds existing capacity. While that is the

74. *Brady strategy: Rest in Peace*, Wall St. J., Jan. 22, 1990, at 1, col. 1.5.

75. *Hearing on Leveraged Buyouts and Foreign Ownership of United States Airlines Before the Aviation Subcomm. of the House Comm. on Public Works and Transp.*, 101st Cong., 1st Sess. (1989) (statement of Philip Baggeley, vice president, Standard & Poor's Corp.) at 3.

76. *Id.*, (statement of Timothy Pettee, first vice president, Merrill Lynch Capital Mkt.), at 5.

77. O'Brian & Valente, *Crandall's American Is Unlikely Recipient of $8 Billion Trump Bid*, Wall St. J., Oct. 6, 1989, at 1, col. 6.

78. Waldman & Wartzman, *Delta Air Sets Orders, Options for $10 Billion*, Wall St. J., Nov. 15, 1989, at A3.

79. Manges, *Texas Air's Continental Unit Set to Buy Up to 40 Airbus Jetliners for $4.5 Billion*, Wall. St. J., Nov. 17, 1989, at A3.

80. Nomani, *NWA to Unveil Major Order With Boeing*, Wall St. J., Oct. 12, 1989, at A4, col. 1.

81. *NWA Orders 90 New Jets*, MSP AIRPORT NEWS, Oct. 19, 1989, at 1, 11.

present market, it may not be the market in the mid-1990s when most of these planes will roll off the assembly lines at Boeing, McDonnell-Douglas and Airbus.

Adding new jets will mercifully reduce the age of the nation's fleet. That will be a welcome blessing for the margin of safety. But it saddles the industry with even more debt.

What's worse, unlike the days before deregulation when airlines actually owned most of their aircraft, today they lease them. For example, American Airlines owns only about a third of its 476 aircraft outright.[82] Even solid carriers like Delta have sold large numbers of aircraft only to lease them back. That increases debt, but decreases value. Potential and successful LBOs will accelerate this trend.

Lease obligations usually don't show up on balance sheets as debt, but like accumulated frequent flyer mileage, they should. Including it reveals that the industry's debt to equity ratio today is significantly worse than it was in the mid-1980s, although the industry's performance has dramatically improved since then. For example, Delta's on balance sheet debt as a percentage of total capital is only 31%; but adding the debt equivalent of aircraft leases (about $3 billion to on balance sheet debt of $1.2 billion) increases the debt to equity ratio to 61%.[83]

Leasing has become an increasingly popular means of retiring debt assumed in LBOs, or for LBO targets, as a means of reducing the availability of assets which could be liquidated, thereby making them less attractive targets. The increased operating costs of leasing and the loss of residual aircraft values upon their retirement from the U.S. system (many ageing Boeing 747s today sell for more than their purchase price when new) are partially offset by flexibility and the sharing of risk that leases offer. Leasing companies are stimulated by the underlying margins in the interest rate environment and the tax advantages of a leasing portfolio.[84]

Whether purchased outright or leased, new aircraft not only impose tremendous debt, but they also flood the market with capacity. For example, American Airlines may have a fleet of more than 800 aircraft by the late 1990s. If we learned nothing else from deregulation, we should have learned that excess capacity causes prices to spiral downward, and leaves the airlines hemorrhaging red ink. A soft economy may dissuade the airlines from retiring the geriatric jets.

So now the wild cards—fuel prices, aerial terrorism or recession. The former will raise industry costs, as they did in the 1970s and 1980s (a

82. In contrast, United owns 80% of its $3 billion fleet outright. Morris, *Soaring Airline Stocks: A Leveraged Way to Fly*, Sept. 3, 1989, at V-3.

83. *Statement of Philip Baggaley*, *supra* note 75, at 3.

84. *Statement of Timothy Pettee*, *supra* note 76, at 19.

10 cent per gallon increase will shave $1.3 billion from the industry's operating earnings, which were $2.3 billion in 1988);[85] the latter two will curtail demand. If recession rears its ugly head, watch out.

Few industries are as susceptible to downward turns in the economy as are airlines. Recessions prompt travelers to cancel their vacations, and businessmen to tighten their belts. Passenger demand plummets.

As noted above, the seats airlines sell are in the nature of an instantly perishable commodity, and short term marginal costs (another meal and a few more drops of fuel) are nil. So during slack demand periods, ticket prices spiral downward. Undoubtedly, falling prices will cause Alfred Kahn to babble on about how thankful we should be that he deregulated the airlines. But carrier profitability will crumble.

Couple a prolonged recession with excess capacity and high debt service and we will see another round of bankruptcies and mergers like the one we endured in the early 1980s. When the dust settles, the industry will be even more concentrated than it is now. As the economy improves, the surviving megacarriers will raise prices more ruthlessly.

IV. Corporate Pirates and Robber Barons

The airline industry has always attracted men with huge egos. Millionaires like Howard Hughes and flying aces like Eddie Rickenbacker found the allure of the heavens irresistible. These were men who built and pioneered the industry and nurtured its technological development. They came from a class of pilots and engineers who appreciated the beauty and necessity of flight, and were awed by its technology. They were buccaneers, explorers, and brash entrepreneurs. But unlike their contemporary counterparts, they saw aviation as strongly grounded in the public interest.

What attracts the likes of Marvin Davis, Carl Icahn, Frank Lorenzo, Jay Pritzker, Donald Trump, and Peter Uberroth to an industry like airlines? Is it the glamor of flight, the defiance of gravity, the sweaty palms many passengers still get on takeoff and landing, the allure of exotic destinations, or the raw sex appeal of the industry? Yes, partly that.

Owning an airline is a terribly prestigious endeavor, more prestigious today than owning an NFL franchise, for there are far fewer airline clubs playing in the league for domination of the heavens and America's largest cities. Only the very elite can afford entry into the exclusive and dwindling club of airline entrepreneurs.

And so it attracts men with very large egos, as it always has. From the earliest days of deregulation, the prevailing wisdom has been that af-

85. *See supra* note 75, (statement of John F. Peterpaul, vice president, Int'l. Assoc. of Machinists & Aerospace Workers).

ter the dust settles, only a small handful of gargantuan carriers will dominate the industry. Each Chief Executive Officer recognized that the pile of airline corpses would be high, but each believed he would rise to the top of the heap. Much chest beating and bravado was exhibited by CEOs under deregulation, even as their firms went bankrupt or as they were gobbled up by larger airlines.

But a different breed of entrepreneurs is now attracted to the airline industry, for reasons beyond fascination with aviation. Now that the dust is settling on the first decade of deregulation, we see an industry devoid of serious competition, and a small number of very large megacarriers sharing effective monopolies, raising prices and improving profitability. Dollars and status, the stuff of American free enterprise, lures the modern generation of corporate pirates. It is not just power and prestige that make today's corporate raiders salivate. It is raw greed as well—the allure of megabucks. For government no longer protects the public's right to decent service at a fair price.

A century after the railroad robber barons appeared,[86] the same thirst for wealth and power has motivated a new generation of robber barons to dominate airlines and use this industry's tremendous market power to pillage the nation. The primordial desire to dominate the nation's transportation industry, it seems, is nearly as old as the invention of the wheel.

But the original airline entrepreneurs were more honest businessmen, devoted to aviation and its role in serving the needs of a great nation. These men built the great service oriented airline companies and ran them from the 1930s until the 1960s: William (Bill) Patterson of United; Cyrus (C.R.) Smith of American; Edward V. (Cap'n Eddie) Rickenbacker of Eastern; Juan Trippe of Pan American; Howard Hughes of TWA; and C.E. Woolman of Delta. These men were "giants among a bank of intuitive executives who counted few pygmies in their numbers."[87]

The new generation of airline entrepreneurs are giants too. But under deregulation, their devotion to the public interest, or even a sense of business ethics, is an anathema to their lust for wealth. A senior executive of Boeing predicted that "The only guys who'll survive [under deregulation] are those who eat raw meat."[88]

Under the stewardship of Frank Lorenzo and Carl Icahn, the once proud Continental, Eastern and TWA have been stripped of assets, have little cash, aging fleets, a sliding reputation and declining market shares. Let us introduce you to two of the most ruthless airline Robber Barons, the

86. *See supra* note 4, at 6-12.

87. R.E.G. DAVIES, AIRLINES OF THE UNITED STATES SINCE 1914, 532-33 (1972).

88. S. DAVIS, *supra* note 24, at 10.

ones who have stripped these companies of assets, and thereby raised Congressional concern about further LBOs:

A. Francisco Anthony Lorenzo of Texas Air

Frank Lorenzo, the Darth Vader of the airline industry, feared by his competitors and despised by labor, is among the greatest Robber Barons of all time. In a decade of bold acquisitions, adept financial maneuverings, mergers, bankruptcies, union busting, asset stripping, and old fashioned wheeling and dealing, his Texas Air empire amassed some nine different airlines, becoming, for a short while, the largest airline company in the nation. Only the Soviet Union's Aeroflot flew more aircraft. As the *Wall Street Journal* observed, "Mr. Lorenzo is widely viewed as a master at acquiring airlines and a genius at high finance. No one questions his vision in creating the nation's largest and lowest-cost airline-holding company from a rag-tag assemblage of operations . . . ."[89]

An avid jogger, his skin is pulled taut around his icy reptilian eyes and slim frame.[90] The son of Spanish-born immigrants who ran a beauty parlor in Queens, N.Y., young Frank grew up in the flight path of LaGuardia Airport. Lorenzo was given the nickname Frankie Smooth Talk while a student at Columbia University. At Columbia, Lorenzo resigned a dorm council position after he and several other students allegedly attempted to rig a student election.[91] While he has a reputation of being pleasant and charming in personal encounters, an Eastern pilot noted, "He shakes your hand and smiles, and then as you start to walk away, he slaps you."[92]

Lorenzo worked and borrowed his way through Harvard Business School, ironically as a card-carrying Teamster driving a Coca-Cola truck.[93] After graduating, Lorenzo became a financial analyst for TWA, and then Eastern.

In 1969, Lorenzo and a classmate, Robert Carney, created Jet Capitol Corporation. Jet Capitol became an advisor to nearly bankrupt Texas International Airlines (called Trans-Texas prior to 1968).[94] Lorenzo and

89. Thomas, *Frank Lorenzo, Builder of Airlines, Now Faces Task of Running One*, Wall St. J., July 24, 1987, at 1, col. 1.

90. *See* Easterbrook, *Lorenzo Braves the Air Wars*, N.Y. Times, Nov. 29, 1989, § 6 (magazine) at 17.

91. B. NASH & A. ZULLO, *supra* note 31, at 140. *See The New Master of the Skies*, FORTUNE, Jan. 5, 1987, at 72.

92. Christensen, *Unions, Eastern spent 2 Years Gearing for Strike*, Atlanta Journal & Constitution, Mar. 5, 1989, at 11A.

93. *The New Master of the Skies*, *supra* note 91, at 72.

94. *See* R.E.G. DAVIES, *supra* note 87, at 416.

Carney acquired Texas International in 1972 by helping to refinance it.[95] Lorenzo became President and Chief Executive Officer at the age of 32. Lorenzo's headquarters have been in Houston ever since, although curiously, neither Texas Air nor its many subsidiaries are listed on the directory of the skyscraper he occupies.[96]

Lorenzo initially opposed deregulation, arguing that small firms like his would be gobbled up or driven under by the big boys. But once deregulation became a fait accompli, Lorenzo jumped aboard with some enthusiasm, offering discount "Peanuts fares" to fill his planes, passing out peanuts to customers on them. Texas International billboards showed flying peanuts grinning from ear to ear. Somehow it all seemed appropriate. Jimmy Carter, the former peanut farmer from Plains, Ga., was President, and it was he who blindly championed deregulation.

The more savvy analysts and industry executives predicted that when the dust of deregulation finally settled, the industry would be dominated by a handful of megacarriers, perhaps no more than four or five huge firms. Neither Jimmy Carter nor his CAB Chairman, economist Alfred Kahn, could afford to agree with so dire a prediction, for that would mean that deregulation would be an imprudent experiment. But most of the industry's elite knew better. No one understood it more clearly than Frank Lorenzo.

And no one enjoyed the Monopoly game better than Lorenzo. As a former associate said, "Frank's into making money and doing deals. He's the classic entrepreneur. Every morning when he wakes up he's got a better one than the one he had the day before."[97] He has a reputation of successfully executing complex transactions that put him on top of the heap. As one commentator noted, "In his 16-year campaign to build his vision of an airline for the future, he has taken no prisoners, using adroit maneuvers, leveraged buyouts and tough negotiating to conquer one airline after another."[98] But after the Eastern bankruptcy, another observer pointed out that while his strength lies in making deals, his inability to manage people may be his undoing: "I see Lorenzo as a deal-maker, a guy who has never been noted for having a very clear strategy for how to build the human organization and is now reaping the [results of] that lack of vision."[99]

In 1979, Lorenzo began a hostile takeover attempt of National Air-

95. Thurow, *Frank Lorenzo Tries to Navigate 3 Airlines Through Stormy Skies*, Wall St. J., Feb. 18, 1982, at 1, col. 1.

96. Christensen, *supra* note 92, at 1.

97. Thurow, *supra* note 95, at 1 col. 1.

98. Christensen, *supra* note 92, at 1.

99. Bennett, *Personalizing the Conflict at Eastern Air*, Wall St. J., Mar. 9, 1989, at B1, col. 3.

lines, a company three times the size of Texas International.[100] National was a carrier with a route structure radiating north and west from Florida, and east to London. At $26.00 a share, National offered a stable of used aircraft at a premium price. After Lorenzo began his raid, a number of other airlines jumped in, including Pan American, Eastern and Air Florida. Pan Am, which wanted National for the domestic feed it might supply for its international routes, ultimately concluded a non-hostile "white knight" acquisition for $55.00 a share, or a total of $400 million, and swallowed National. National would give Pan Am an almost fatal bout of indigestion, but Frankie Smooth Talk walked away from the arbitrage with a cool $46 million as loser's consolation.[101]

The money was not to sit in his icy hands for long. He invited Edwin Smart, TWA's Chairman, to breakfast at the Hotel Carlyle in New York and offered to buy TWA, then ten times the size of tiny Texas International. An insulted Smart left abruptly without eating.[102]

Rebuffed by TWA, Lorenzo soon began a hostile acquisition of Continental Airlines, whose stock was selling at less than the book value of the aircraft it owned. Continental had tried mergers with Western Airlines, but had not been able to conclude them. In a desperate move to avoid Lorenzo's assault, Alvin Feldman, continental's dynamic and talented CEO, tried desperately to arrange an employee buy-out (ESOP). But it was too little, too late. Lorenzo had 51% of Continental for $100 million.[103] Feldman was found shot to death in his office—a reported suicide.[104]

Lorenzo also believed that just being big was not enough. He felt that the key to long-term success in the deregulated airline industry was to be a large low-cost carrier, one with a computer reservations system. He began his assault on labor by letting contracts with Texas International pilots drag on for a year and a half before settling them, refusing to negotiate, appealing over the heads of the union chiefs to labor.[105]

After acquiring Continental, Lorenzo established a non-union subsidiary, New York Air, to fly in the northeastern United States. The threat of transferring aircraft out of unionized Texas International and Continental into non-union New York Air gave him additional leverage in reducing wages and revising work rules with the unions.

Although deregulation meant that Washington's role would be reduced, it still was important, particularly in approving mergers and in ac-

100. Hamilton, *A Tale of Two Airlines: Texas Air, USAir Survive at Different Speeds*, Washington Post, May 22, 1988, at H1, H7, col. 1.

101. Easterbrook, *supra* note 90, at 18.

102. Ennis, *Sky King*, BUSINESS MONTH, Sept. 1988, at 27, 32.

103. Witkin, *Texas Air's Continental Takeover*, N.Y. Times, Mar. 25, 1982, at D 1, col. 3.

104. *See* Easterbrook, *supra* note 90, at 62.

105. Thurow, *supra* note 95, at 1, col. 1. *See also* Easterbrook *supra* note 90, at 18.

quiring international routes. So Lorenzo began recruiting the Washington airline establishment. He lured Alfred Kahn, who had been the misguided Chairman of the CAB at the time the Airline Deregulation Act was enacted, and his two principal deputies, Michael Levine (CAB Director of Pricing and Domestic Aviation) and Phil Bakes (CAB General Counsel), to the Texas Air Empire. Levine would head New York Air while Kahn would sit on its Board of Directors. As Lorenzo's henchman, Bakes would eventually come to lead Eastern into bankruptcy, much as he helped lead the CAB to its shallow grave. Bakes had served on Teddy Kennedy's Senate Judiciary Committee staff when deregulation was on the table, and since has recruited many Kennedy deputies and prominent Democratic staffers as Texas Air lawyers and lobbyists, as impressive array as had ever been seen on Capitol Hill.[106]

Lorenzo also picked up the head of the transportation section of the Antitrust Division of the U.S. Department of Justice, Elliot Seiden. As father confessor of the industry's antitrust sins, perhaps more than any government official, Seiden was privy to the darkest secrets of Lorenzo's competition and indeed, Lorenzo himself. With friends in high places, Lorenzo could proceed without the government breathing down his neck.

In recent years, Texas Air has spent more money on Political Action Committees than any other airline.[107] It has been estimated that Texas Air spends at least $2 million on lobbying and public relations alone.[108]

In September of 1983, Lorenzo made his most infamous move. After two years of wrangling over wages with the machinists union, and six weeks after their strike, Lorenzo led Continental into Chapter 11 reorganization bankruptcy proceedings. Three days thereafter, he tore up all his labor agreements, including those of the non-striking pilots, fired all of Continental's 12,000 employees, and unilaterally cut wages between 40 and 60%.[109]

Labor felt betrayed. At no time during negotiations with pilots had management ever suggested cutting wages below the average for large established trunk line carriers. Continental was hardly near liquidation, with several hundred million dollars in ready cash. The pilots and flight attendants began their strike in October.

It was a bitter strike. At one point a scab pilot, sleeping in his home in Evergreen, Colorado, was wakened abruptly at about 3:00 in the morning by the sound of crashing glass. Someone had thrown an elk head

106. Abramson & Sarasohn, *On Board With Frank Lorenzo*, LEGAL TIMES, May 16, 1988, at 1, 10, 11.

107. *See* AVIATION DAILY, Mar. 7, 1988, at 349.

108. Abramson & Sarason, *supra* note 106, at 12.

109. *How the Continental Strategy Worked*, Wall St. J., Mar. 10, 1989, at A11. *See also*, Easterbrook, *supra* note 90, at 64. Ennis, *supra* note 102, at 32.

through his plate glass window into his living room. At about the same time, Lorenzo flew into Denver's Stapleton Airport aboard a Continental jet, whose pilot missed the runway, landing it on the parallel taxiway.

The unions ended their strike in 1985. But by then, their backs had been broken. Lorenzo had earned the reputation of being a union buster.[110]

Lorenzo's reputation as a union-buster was to cost him other acquisitions, including runs at Frontier and TWA in 1985. At TWA, the pilots surrendered millions of dollars in wage and work rule concessions to Carl Icahn so that he would acquire it instead of the dreaded Lorenzo.

General Tire and Rubber, which owned Frontier, sold half of its aircraft to United in 1985, and then the rest of the company to People Express. People was headed by the flamboyant and unorthodox Donald Burr. Burr had been a former Lorenzo deputy at Texas Air and indeed, was the best man at Lorenzo's 1972 wedding.

People Express had a difficult time digesting Frontier and Burr's other smaller acquisitions, Britt and PBA. Chronic service problems led consumers to dub it "People's Distress." In 1986, People concluded an agreement to sell Denver-based Frontier to United. The deal fell through, ostensibly because United could not reach an agreement satisfactory to it with Frontier's unions. This left Burr holding a leaking bag. He was forced to put Frontier into bankruptcy to stem the hemorrhaging of dollars, then amounting to $10 million a month.[111]

In late 1986, Lorenzo swept in with an offer to buy People Express and its Frontier, Britt and PBA subsidiaries for $298 million, less than the $307 million that People had paid just for Frontier the year before.[112] After the offer had been accepted, as People Express' position became increasingly untenable, Lorenzo tendered an even lower counter-offer to Burr on a take it or leave it basis. Burr had no choice but to accept. He rejoined the Texas Air empire, but soon left, his tail between his legs. Lorenzo folded all the airlines—New York Air, People Express, and Frontier into Continental in a messy overnight transition on February 1, 1988.[113]

Also in 1986, Lorenzo made his boldest purchase of all—Eastern Air Lines, for $615 million.[114] Eastern had cash of $463 million, more than

110. O'Brian, *A Look at Troubled Eastern's Options*, Wall St. J., Mar. 8, 1989, at B1, col. 3.

111. Cohen & Koten, *People Express Delays Filing on Frontier Air*, Wall St. J., Aug. 26, 1986, at 3, col. 1.

112. Dempsey, *Antitrust Law & Policy in Transportation: Monopoly I$ the Name of the Game*, 21 GA. L. REV. 505, 540-41 (1987).

113. Hamilton, *supra* note 100, at H7.

114. O'Brian & Dahl, *Uberroth Group Plans to Acquire Eastern from Texas Air Under $464 Million Pact*, Wall St. J., Apr. 7, 1989, at A3, col. 1.

Lorenzo's outlay.[115] Lorenzo had Eastern borrow about $300 million to finance his purchase of it.[116]

Eastern had been managed, badly, by former astronaut Frank Borman. Eastern lost about a billion dollars during the first decade of deregulation. Borman had tried to trim costs by rolling back wages, concessions he exchanged with labor for 25% of Eastern's stock, and labor presence on the Board of Directors. While the other unions had taken salary cuts of about 28%, the Machinists Union, headed by Charlie Bryan, a feisty and contentious Irishman, would stand for none. One Eastern executive described Bryan as "an 800-pound gorilla."[117] The presence of Bryan on Eastern's Board made life for Borman a living hell.[118]

Borman criticized labor for failing to see the "big picture." To that, one labor leader responded, "I know why we can't see the big picture. We can't see the big picture because it's written across the far side of the moon. And [former astronaut] Borman is the only one who's seen the far side of the moon."

Eastern's serious financial problems led Borman to three options: "Fix it, sell it, or tank it."[119] He concluded that he couldn't fix it and didn't want to tank it, so he sold it . . . to the monster Lorenzo. But, it seems, what he really did was to tank the unions, with a vengeance.

Borman was gone, but the unions were no happier. The battle between Lorenzo and Eastern's unions began almost from day one. There is one episode the unions love to tell:

> It is March 1986, and Lorenzo is locked in ferocious battle with the unions over the future of Eastern Air Lines. The negotiations have been punctuated by loud noises and nasty words. Insults have been exchanged. Then Charlie Bryan, head of the Eastern machinists union and Lorenzo's chief antagonist, undergoes an epiphany. He extends an olive branch, sending Lorenzo a telegram suggesting that they meet and calmly discuss their differences with an eye toward working together. Lorenzo's reply is swift and clear: "I do not talk to union leaders."[120]

After acquiring Eastern, Lorenzo prepared for the siege. He had barbed wire stretched along the top of fences around its Miami headquarters. He had closed circuit cameras mounted in hangars to monitor mechanics. He also had manhole covers in the base welded shut.[121] Lo-

115. Ennis, *supra* note 102, at 32.

116. Nelson, *Lorenzo Has His Cake and Sells It Too*, Denver Post, Mar. 29, 1988, at 6B.

117. Stockton, *Tearing Apart Eastern Airlines*, N.Y. Times Nov. 6, 1988, § 6 (magazine) at 36, 39.

118. *See* Borman, *Showdown In Miami*, Bus. Month, Sept. 1988, 39.

119. Castro, *Eastern Goes Bust*, Time, Mar. 20, 1989, at 52, 53.

120. Labich, *The New Master of the Skies*, Fortune, Jan. 5, 1989, at 72.

121. Christensen, *supra* note 92.

renzo wanted major wage concessions from the machinists, and the machinists weren't about to surrender them without a fight.

As Lorenzo began to turn up the heat, the unions began their own assault on the man they love to hate, Lorenzo, "the devil incarnate, a hard-headed, hard-hearted wheeler-dealer intent on destroying their unions, their airline and their lives."[122] They would paint him as the Great Satan, the "antichrist."

Lorenzo's Texas Air corporate structure is complicated, and intentionally so. Lorenzo owns 52% of Jet Capital Corp. With 1% of Texas Air's equity, Jet Capital enjoys 34% voting control of Texas Air and the right to elect seven of Texas Air's directors through a special class of stock.[123] Texas Air, in turn, has more than 20 subsidiaries.[124] In the 1920s, financial pyramiding of a similar nature gave birth to federal public utility regulation.

Shortly after acquiring Eastern, Lorenzo looted it of some of its more valuable assets. He began by stripping Eastern of its computer reservations system (System One), for a paltry $100 million at a time when Eastern's bankers estimated its worth between $200 million and $320 million, and it was generating $255 million a year in cash.[125] To finance it, Texas Air gave Eastern a 25-year note at 6.5% interest.[126] Eastern, of course, is now without a computer reservations system, and must buy services from System One, for which it pays $130 million a year to Texas Air.[127]

Lorenzo controls a fuel brokerage firm from which Continental and Eastern must buy all their fuel, at a 1% commission, or about $30 million a year.[128] Eastern was forced to buy a $25 million unsecured note from People Express, bringing Texas Air a $4 million profit.[129] Thus, Texas Air upstreams cash to the parent in the form of management and service fees charged the subsidiaries, Continental and Eastern.

Lorenzo transferred eleven of Eastern's gates at Newark to Continental, another Texas Air subsidiary, for an $11 million promissory note paying 10% interest. In contrast, Piedmont paid $25 million to Eastern for eight gates and related facilities at Charlotte.[130] Lorenzo also transferred the lucrative Miami-to-London route and 20 aircraft to Continental.[131]

122. *Id.*

123. Petzinger & Thomas, *House of Mirrors: Lorenzo's Texas Air Keeps Collecting Fees From Airline Units That Have Continuing Losses*, Wall St. J., Apr. 7, 1988, at 1, col. 6.

124. Ennis, *supra* note 102, at 33.

125. Petzinger, *supra* note 123.

126. *Id.*

127. Nelson, *supra* note 116; Petzinger, *supra* note 123.

128. Nelson, *Lorenzo's Empire Under Scrutiny*, Denver Post, Apr. 18, 1988, at 6B.

129. *The Other Side of the Coin*, AIRLINE BUS., Dec. 1988, at 24.

130. Petzinger, *supra* note 123.

131. Castro, *supra* note 119, at 53.

Eastern also paid Continental $30 million to train 400 pilots to keep Eastern flying in event of a strike.[132]

Lorenzo closed Eastern's Kansas City hub, and laid off about 25% of the work force. He also proposed to transfer the lucrative Boston-New York-Washington shuttle to a Texas Air subsidiary for $225 million, a transaction for which Jet Capitol arranged a juicy $1.25 million fee for itself for advising Texas Air.[133] The shuttle was responsible for one-third of Eastern's profits. Its transfer was abated only when blocked by court order.[134]

Lorenzo leveraged Eastern heavily with debt, mortgaging its unencumbered assets. In 1988, its annual debt service burden was a staggering $575 million.[135] Before Eastern's bankruptcy, its long term debt was estimated to be $2.5 billion.[136] Although secured by equipment, the debt has interest rates as high as 17.25%—radically higher than the 10% note accepted by Eastern from Continental for 11 gates, and the 6.5% note accepted by Eastern from Texas Air for the System One computer reservations system.[137] But Eastern's creditors can reach Texas Air for only about 10% of the debt, for Lorenzo has carefully shielded the parent from it.[138] As one source noted:

> Mr. Lorenzo has built one of the most leveraged major corporations in the nation while insulating Texas Air—and himself—for most of the cost and much of the risk . . . . Mr. Lorenzo presides over some of the nation's sickest airlines . . . . All are losing money at some of the fastest rates in aviation history and rank as the industry's biggest debtors. As a group, the Texas Air companies have piled up $5.4 billion in debt. Last year they had to pay $623 million simply to service the long-term part of that debt—an interest bill higher than the annual revenue of each of nearly 100 companies at the bottom of the Fortune 500.[139]

The unions, which owned 25% of Eastern's stock, complained that Lorenzo was draining off its assets for his own benefit.[140] In one law suit, the pilot's union alleged that Lorenzo intended to "loot Eastern for the

132. Hamilton, *Eastern Head Tells of Paying Continental*, Washington Post, Aug. 18, 1988, at B1.

133. Thomas, *Texas Air Drops Plan to Transfer Eastern Shuttle*, Wall St. J., July 5, 1988, at 4, col. 2. Petzinger, *supra* note 121.

134. Ennis, *supra* note 100, at 33; *EAL Recalls Shuttle Plan to Clear Contempt Ruling*, TRAVEL WEEKLY, Apr. 14, 1988, at 5.

135. O'Brian & Petzinger, *Bankruptcy Strategy for Eastern Airlines Could Fail Lorenzo*, Wall St. J., Mar. 10, 1989, at A1, col. 6.

136. *Id.*

137. *See* Luke, *Next Two Weeks Could Decide Eastern's Fate*, Atlanta Journal & Constitution, Mar. 5, 1989, at 11A.

138. O'Brian, *supra* note 135.

139. *See supra* note 83, at 9-10.

140. Nelson, *supra* note 128.

benefit of Texas Air."[141] An Eastern pilot noted, "I think it's clear to even the most casual observer that they're engaged in union-busting by spinning off the airline's most valuable assets."[142] When asked whether he intended to bust Eastern's unions so that he could enjoy a comparable cost structure to Continental, Lorenzo insisted, "That's utter bullshit."[143]

Before Eastern's bankruptcy, a Texas Air spokesman promised, "Frank [Lorenzo] and [Eastern President] Phil Bakes have absolutely no plans for a Chapter 11 filing at Eastern."[144] In response to inquires by reporters as to whether Eastern would be placed in bankruptcy, Bakes himself said, "We've ruled that out. Bankruptcy never has been an option."[145] No doubt, these false assurances were designed to calm nervous passengers booking flights and buying tickets.

Hatred for Lorenzo galvanized the unions. As an Eastern pilot said, "As long as money is flowing up into a tornado called 'Jet Capital', I see no reason why I or any other employee should feed this whirlwind with money out of our pockets."[146] When the machinists struck, the pilots honored their picket lines, and Eastern was shut down. Despite the earlier assurances, Lorenzo quickly flew Eastern into Chapter 11 bankruptcy, further dismembering its assets. But unlike the Continental bankruptcy, Lorenzo could not tear up the union contracts at Eastern. Partly in response to Lorenzo's use of bankruptcy in 1983 to shed Continental of its union contracts, Congress had amended the Bankruptcy Code in 1984 to make such an action impossible without permission of the bankruptcy judge.

Offers were made for Eastern by TWA raider Carl Icahn and former National Baseball League Commissioner Peter Uberroth. Both were rejected by Lorenzo. Eastern was dismembered by selling the shuttle to Donald Trump, its Latin American routes to American Airlines, and its Philadelphia gates and Canadian routes to Midway Airlines, along with scores of aircraft.

Eastern employees burned Lorenzo in effigy. As one commentator note, "among many of them, a sense of betrayal runs deep. And the lightning rod for their anger is Frank Lorenzo, the steel-willed chairman of

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141. Petzinger, *supra* note 123, at 24.

142. Knox, *Lorenzo, Eastern's Unions Square Off*, Rocky Mountain News, Feb. 21, 1988, at 72.

143. Lorenzo, *Being Frank*, AIRLINE BUS., Jan. 1989, at 18, 21.

144. Knox, *supra* note 142.

145. Hamilton & Swoboda, *Lorenzo Faces Turbulent Skies at Eastern*, Washington Post, Mar. 20, 1988, at H1, H3.

146. Stockton, *Tearing Apart Eastern Airlines*, N.Y. Times, Nov. 6, 1988, § 6 (magazine) at 36, 39.

Texas Air Corp."[147]

A recent editorial summed up the mark Lorenzo has made ont he airline industry:

> The trouble with Lorenzo is that his only genuine successes have been in creating an empire of misfits which has accumulated debts of over $5 billion, in attracting undiluted hatred from his workforce, in bringing on an unprecedented investigation by the DOT into his fitness to manage an airline, and in his blatant efforts in asset-stripping.[148]

Lorenzo's self image is more positive. Said he, "I'm not a guy associated with a lot of ego."[149] If not that, he is associated with lots of other things.

B. CARL ICAHN OF TWA

Unlike many of the other Robber Barons, Carl Icahn is not a builder of great airlines. He is a corporate raider, a financial pirate, pure and simple, whose interest in companies focuses on what they can produce at the bottom line, in nice crisp dollars. A TWA union head summarized the difference between Icahn and Lorenzo: "Mr. Lorenzo wants to own the largest airline in the world. Mr. Icahn wants to be the richest man in the world."[150]

As noted above, an attempted takeover of Trans World Airlines by Frank Lorenzo led its unions to give major wage and work rule concessions to Carl Icahn, who acquired TWA in 1986, paying $440 million for 22 million shares.[151] He soon took it private, and moved its headquarters out of Rockefeller Center in Manhattan to Mt. Kisco, N.Y., near his home.[152] The Mt. Kisco facilities are adorned with gilded chandeliers hanging from its high ceilings, and with oil paintings of dueling cavalrymen, Napoleon with his marshalls, and ferocious sea battles hanging from its walls.[153] The thrill of battle consumes Icahn. So too does the glamor of the airline industry. Few airline barons so relish the lights, the glitz, and the television camera focused on Icahn's smiling face.

In 1986, TWA concluded a $224 million agreement to acquire Ozark Airlines, which shared TWA's St. Louis hub. The merger gave the consolidated firm 76% of the gates at Lambert International Airport, and 86% of

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147. Solis & de Cordoba, *Broken Family: Eastern Strike Bares Long-Festering Anger Over Sense of Betrayal*, Wall St. J., Mar. 17, 1989, at 1, col. 6.

148. *Gratitude or Vitriol?*, AIRLINE BUS., Aug. 1988, at 5.

149. Stockton, *supra* note 146, at 86.

150. Hamilton, *TWA's Unions Try to Ground Icahn*, Washington Post, Sept. 30, 1988, at F1, F2.

151. Carley & Agins, *TWA to Go Private in $1.2 Billion Plan That Would Boost Icahn's Stake to 90%*, Wall St. J., July 23, 1987, at 3, col. 2.

152. *Id.*

153. Vogel, *Carl Icahn Has Lots of Cash: Will He Spend It On TWA?*, BUS. WEEK, July 17, 1898, at 86.

passenger enplanements.[154] This enabled TWA to raise ticket prices, which it promptly did.[155]

In 1987, Icahn made a $1.6 billion bid for USAir at a time USAir was attempting to acquire Piedmont. USAir rejected the bid, but there was speculation on Wall Street that what Icahn really wanted was to force USAir to buy TWA.[156] As one analyst noted, "He's gone everywhere trying to sell TWA. There aren't any takers."[157] Others speculated that Icahn wanted to "green mail" USAir into buying back his 14.8% stock interest at a premium.[158]

In 1987, the Securities and Exchange Commission began an investigation of Icahn's activities as part of a wider probe of insider-trading created by the Ivan Boesky scandal. In particular, the SEC was looking at Icahn's proposed bid for Phillips Petroleum in 1985, and his stake in Gulf & Western.[159]

Icahn has leveraged TWA to the teeth, doubling its long-term debt, in order to raise cash for other acquisitions, including USX Corp. and Texaco. TWA's $2.5 billion debt and lease obligations crushes the airline's earnings with annual interest charges of $375 million.[160] TWA has a negative net worth of $30 million.[161] The company has a 15-1 debt to equity ratio.[162] In 1988, the Consumer Federation of America became so concerned about these manipulations that it alleged, "After running up huge amounts of debt, the Icahn-led group now proposes to take all its money (and then some) out of TWA, leave the company with absolutely no equity, and leave the airline on the brink of bankruptcy."[163] Ironically Carl Icahn recently noted, "There is no question that leverage during the past year has gotten out of hand—it was almost a feeding frenzy."[164]

TWA flies the oldest fleet of aircraft in the industry. Icahn's failure to reinvest TWA's capital in the airline led the pilot's union to argue that Icahn had betrayed them upon TWA's acquisition, when he assured them that he would not dismember the airline. But until the Spring of 1989, TWA

154. Dempsey, *supra* note 8, at 511-12.

155. GENERAL ACCOUNTING OFFICE, AIRLINE COMPETITION: FARE AND SERVICE CHANGES AT ST. LOUIS SINCE THE TWA-OZARK MERGER (1988).

156. Agins, Cohen & Bean, *US Air Rejects TWA's Takeover Proposal of $52 a Share, or More Than $1.6 Billion*, Wall St. J., Mar. 6, 1987, at 4, col. 1.

157. *Id.*

158. Cohen & Agins, *TWA Ends Bid for USAir, Confirms Icahn Is Under Investigation by SEC*, Wall St. J., Mar. 17, 1987, at 3, col. 2.

159. *Id.*

160. Vogel, *supra* note 153, at 87.

161. Power, *Raiders May Not Make the Best Airline Pilots*, BUS. WEEK, May 15, 1989, at 35.

162. *See supra* note 75, (statement of Bill Hoffman, treasurer of the Indep. Fed'n. of Flight Attendants)

163. Consumer Federation of America, Press Release of September 20, 1988.

164. Vogel, *supra* note 153, at 87.

had placed no orders for new aircraft. TWA President Joseph Corr resigned when he became convinced that Icahn would not buy the planes the airline needed. Subsequently, the hulking, blunt talking Corr became Continental's CEO.[165] To stem the criticism, TWA ordered a few Airbus A-330 widebodies. But there was some speculation that they might be sold off before their scheduled delivery in 1994. Former TWA executives claim that the company also needs another 50 to 100 narrow bodied aircraft to replace aging aircraft.[166] Any order for the Boeing or McDonnell-Douglas aircraft TWA desperately needs would also not see delivery until 1994.

Nonetheless, to fatten his war chest for future raids, Icahn proceeded to leverage TWA further still. With long-term debt of $2.5 billion, TWA's aircraft and engines were already pledged to existing lenders. In June 1989, he announced a $300 million high interest junk bond offering secured on TWA's spare parts such as light bulbs, gaskets, and landing slots.[167]

Ironically, Icahn acquired TWA with generous concessions from the pilots, who were intent on avoiding the union-busting Lorenzo's hostile acquisition. But soon after climbing in TWA's cockpit, Icahn was to crush a union himself—the flight attendants, who struck in 1986. He had trained an army of scabs to pass out the dinner trays and pour drinks. (Actually, flight attendants are on board because the FAA requires their presence to protect passenger safety). But soon, he had a union on its knees, anxious to return to work at sharply reduced wages and benefits, and stiffer work rules. Icahn, the union buster.

Icahn is not without his dirty linen. He so slashed costs that TWA reduced the frequency with which it washed its blankets, with malodorous results.[168] Something is rotten at TWA.

V. FOREIGN OWNERSHIP: THE GLOBALIZATION OF AVIATION

Not only is the debt caused by LBOs of serious public concern, so too is the rapidly growing phenomenon of foreign ownership. Foreign alliances with U.S. airlines began around the frequent flyer programs created by the U.S. carriers.[169] The second wave occurred when foreign airlines affiliated with U.S. carriers' computer reservations systems. For example, the two dominant European systems have the following alliances:

165. Vogel, *A Mr. Fix-It Goes to Work on Lorenzo's Continental*, BUS. WEEK, May 22, 1989, at 134.

166. Vogel, *supra* note 153, at 87.

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

168. Vogel, *supra* note 153, at 87.

169. *See supra* note 76, at 3.

CHART III — EUROPEAN COMPUTER RESERVATIONS SYSTEMS PARTNERS

Covia	Amadeus
United	Texas Air
British Airways	Air France
KLM	Lufthansa
Swissair	Iberia
Alitalia	SAS

The most recent round of foreign interest in U.S. airlines has involved direct ownership in them.[170] The following chart depicts the substantial foreign airline interests in U.S. flag carriers:

CHART IV — FOREIGN AIRLINE OWNERSHIP OF U.S. AIRLINES

Foreign Airline	Percentage Ownership	U.S. Airline
SAS	9.9%	Texas Air
Swissair	5%	Delta
Air Singapore	5%	Delta
Ansett Airlines	20%	America West
Japan Air Lines	20%	Hawaiian Airlines
KLM	25%	Northwest
British Air	15%*	United

* proposed; later withdrawn

The equity interests by Scandanavian Airline System [SAS] in Texas Air and by Australia's Ansett Airlines in America West were inspired by the Americas carriers' need for a substantial infusion of new capital. From SAS's perspective, the Texas Air alliance gave it new feed into its transatlantic routes; SAS moved its international hub from New York Kennedy Airport to Newark, where Texas Air's Continental and Eastern could provide domestic feed. It is reported to be negotiating for 24.9% of Continental, which Lorenzo has placed on the block.[171] Swissair's and Air Singapore's interest in Delta appears to have been inspired by different reasons—the desire by Delta to have a friendly partners poised to fend off LBOs.

But most are motivated by foreign airlines' interests in creating operating and market alliances. Thus, they invest "dumb equity", accepting sub-optimal returns because they will receive synergistic revenue on combined interline operations that they would not otherwise enjoy. For-

170. *See generally*, Winter, *Congress Questions DOT's Role in Airline Leveraged Buy-Outs*, TRAFFIC WORLD, July 24, 1989, at 35.

171. *Repeating Mistakes*, J. COM., Aug. 30, 1989, at 8A.

eign airlines want some control to assure U.S. feed, and thus are willing to give a raider a very favorable rate to finance the deal.

Not only are foreign airlines affiliating with U.S. carriers. Other international aviation alliances are emerging, including British Airway's acquisition of British Caledonian, the British Airways/KLM proposed 20% stake in Belgium's Sabena Airlines, the SAS interest in Aerolinas Argentinas, and the purchase of 35% of Air New Zealand by a consortium consisting of Qantas, Japan Air Lines and American Airlines.[172]

International airline alliances have been stimulated by the prospect for liberalizing European transport in 1992.[173] The conventional wisdom is that, when the dust settles from U.S. deregulation and international aviation liberalization, only a handful of global megacarriers will dominate air transport. Wanting to be among the survivors motivated the contemporary surge in international combinations and alliances. Tremendous commercial synergy is perceived in international aviation partnerships. Moreover, with the Europe's aviation infrastructure even more saturated than America's, opportunities for growth are largely limited to acquiring or affiliating with existing airlines.

Several public policy concerns arise over foreign ownership of U.S. airlines. The first surrounds national security. America depends upon its Civil Reserve Air Fleet [CRAF] for airlift capacity in time of war. Foreign ownership may jeopardize access to it. The second surrounds the integrity of bilateral air transport negotiations between the United States and foreign governments. International routes are traded by nations on a bilateral basis, usually with candid input from their carriers.[174] Multiple allegiances may well jeopardize the integrity of that process. Third, these alliances may significantly reduce competition in international aviation. How strongly will United and British Airways compete in the U.S.-U.K. market, for example, if the two carriers have common ownership?

In 1989, Secretary of Transportation Samuel Skinner became very concerned about the Checchi group acquisition of Northwest Airlines, not only because the LBO would increase Northwest's debt fourfold, but also because of the $400 million equity participation by KLM Royal Dutch Airlines, which would give it about 57% of total equity.[175] As Skinner said,

> While KLM's voting share technically fell within the statute's numerical limits [which requires that the airline's President and two-thirds of its Board

172. *Going Steady*, ECONOMIST, July 22, 1989, at 39.

173. Dempsey, *Aerial Dogfights Over Europe: The Liberalization of EEC Air Transport*, 53 J. AIR L. & COM. 615 (1988); P. DEMPSEY, LAW & FOREIGN POLICY IN INTERNATIONAL AVIATION 93-108, 241-56 (1987).

174. *See generally*, P. DEMPSEY, LAW & FOREIGN POLICY IN INTERNATIONAL AVIATION (1987).

175. *See supra* note 75, (statement of Samuel Skinner, United States Secretary of Transportation) at 4.

and other managing officers by U.S. citizens, and that not less than 75% of voting interest be owned and controlled by U.S. citizens], we concluded that KLM's ownership of 57 percent of NWA Inc.'s total equity, together with the existence of other links between the carriers and KLM's position as a competitor, could create the potential for the exercise of influence and control over the carrier's decisions. This would be inconsistent with the law.[176]

In September 1989, Skinner convinced Checchi and Northwest to agree, *inter alia*, to limit KLM's equity to 25%, and to limit KLM's representation on Northwest's Board of Directors to "matters relevant to KLM's pecuniary interest." The KLM board members must recuse themselves when the board is dealing with certain matters, such as bilateral negotiations and competitive issues.[177] Thus, Skinner appears to interpret the section 101(16) of the Federal Aviation Act as limiting foreign equity interest to 25%. Nonetheless, foreign participation in Northwest's total debt and equity capitalization will still exceed 60%.[178] Foreign financing is being provided not only by KLM, but also by Japanese banks and the Australian Elders IXL group, a brewer.[179] Had the management/pilot deal for United not fallen through, British Airways was prepared to supply $570 million, or 78% of the total $965 million equity.[180]

VI. Proposed Legislation

Prior to promulgation of the Airline Deregulation Act of 1978, the Civil Aeronautics Board had jurisdiction under section 408 of the Federal Aviation Act of 1958 to approve (or disapprove) any merger or acquisition of an airline by any person in "any phase of aeronautics." The 1978 Deregulation legislation changed the triggering mechanism to require approval only by a "person substantially engaged in the business of aeronautics."[181] Thus, a corporate raider not already owning an airline or aircraft manufacturing enterprise would not need CAB approval to acquire an airline. The 1978 bill also sunset the Civil Aeronautics Board on January 1, 1985, when its remaining responsibilities were transferred to the U.S. Department of Transportation.

During the reign of Transportation Secretary Elizabeth Dole and Undersecretary Matt Scocozza, the DOT approved each and every one of the 21 mergers submitted to it. This led Congress to strip the DOT of

176. *Id.* at 5.

177. *Id.* at 6.

178. *Id.* at 8.

179. Dallos, *U.S. Conducts 'Fitness' Exam of Northwest Airlines; Debt Cited*, L.A. Times, Sept. 5, 1989, at 1, col. 4.

180. Valente & McGinley, *UAL Machinists Refuse to BAck Buy-Out Plan*, Wall St. J., Oct. 5, 1989, at A6, col. 1.

181. P. Dempsey & W. Thoms, Law & Economic Regulation In Transportation 29, 241-51 (1986).

jurisdiction over mergers, transferring such power to the U.S. Department of Justice on January 1, 1989. As a consequence, an air carrier need not seek advance DOT approval of any ownership change. However, DOT continues to hold jurisdiction under section 401 of the Federal Aviation Act to scrutinize the fitness of airlines (which includes safety and compliance fitness), and under section 101(16) to review foreign ownership (which cannot exceed 25% of the U.S. flag carrier). The present DOT Secretary, Samuel Skinner, appears prepared to exercise the agency's fitness jurisdiction if need be. Said he, "I will not allow excessive debt in the airline industry to jeopardize the public interest, especially in the area of safety."[182]

In October 1989, the Senate Commerce Committee approved a bill which would prevent any person from acquiring more than 25% of an airline unless it is approved by the Secretary of Commerce.[183] That same month, the House Public Works and Transportation Committee passed a bill which would give the Secretary of Transportation authority to disapprove ownership of more than 15% of an airline if it would so weaken the carrier as to injure its ability to compete, to jeopardize safety, or to give control to a foreign interest.[184] In the findings sections of the bill, it is recognized that

> (3) An air carrier in seriously weakened financial circumstances may take actions designed to—
>
> (A) reduce maintenance expenditures;
>
> (B) avoid or reduce commitments to modernize its fleet; or
>
> (C) avoid or reduce commitments to ground improvements at airport facilities; in order to meet its financial obligations.
>
> (4) Air carriers with excessive debt burdens may pose an increased risk to air carrier safety and reliability.
>
> (5) The public interest requires a review of acquisitions of control of air carriers which significantly increase air carrier indebtedness to assure that the public interest in air carrier safety and service is adequately protected.[185]

This bill is a step in the right direction. Other pending legislation is targeted at LBOs more generally. As one source noted:

> While LBOs will surely be tested during an economic turndown, the problems are emerging despite a surging stock market and a stable economy. LBOs are going bust like never before. In the past five years, corporate debt has risen by $840 billion dollars while equity has fallen by $300

182. McGinley, *Skinner Warns About Airlines Piling Up Debt*, Wall St. J., Sept. 20, 1989, at A4, col. 3.

183. *Here Comes Donald, Duck!* TIME, Oct. 16, 1989, at 52, 57. (discussing senate bill 1277).

184. McGinley, *Bill That Gives Skinner Power to Block Airline Buy-Outs Clears a House Panel*, Wall St. J., Oct. 19, 1989, at A3, col. 1.

185. H.R. 2321, 101st Cong., 1st Sess, (1989). *See also* H.R. 2891, 101st Cong., 1st Sess. (1989).

billion. Corporate interest payments account for 26 percent of cash flow, which is higher than the percent that prevailed in the past two recessions . . . . [C]orporations in cyclical industries (like airlines) accounted for 50 percent of the LBOs since 1982.

The consequences to the government are also staggering. The movement from equity to debt will permanently reduce corporate tax collections by tens of billions of dollars. The government is subsidizing the de-capitalization of U.S. industry . . . .

In the first half of 1989, $3.2 billion dollars in junk bond defaults occurred, more than double the pace of a year ago.[186]

A pending bill would eliminate the tax deductability of junk bonds used to finance LBOs.[187] This would jeopardize many of them, although the Northwest and proposed United acquisitions did not employ junk bonds, using bank debt exclusively.[188]

VII. Conclusion

Recently, the *Wall Street Journal* asked Americans to identify the industries in which they have most, or least, confidence. The largest number by far, 43%, said they had no confidence in the airline industry. The disapproval rating for the industries which followed—insurance (27%), banking (23%), oil and gas (22%), and stockbrokers (22%)—was not nearly as high as that for airlines.[189]

Note the common denominator of each of these five industries. Insurance has never been regulated by the federal government, and airlines, banks, oil and gas companies and securities have all undergone significant deregulation during the last decade.

Several empirical studies suggest that the grand experiment in deregulation needs some stiff course correction. Leveraged buy-outs and foreign ownership are but two of the serious problems which have emerged. He is a short list of the major problems of airline deregulation:

Concentration. With more than 150 bankruptcies and 50 mergers, deregulation has produced unprecedented concentration in aviation. The eight largest airlines now control 94% of the domestic passenger market, and dominate the nation's busiest airports. A recent GAO study reveals that pricing at hub monopolies and duopolies is 27% higher than at competitive airports. The megacarriers also control the computer reservations systems, the frequent flyer programs, and queues for aircraft rolling

186. *See supra* note 84, at 6-7 [citations omitted].

187. Salwen, *Two Legislative Proposals Would Raise Cost of Leveraged Buy-Outs Up to 10%*, Wall St. J., Oct. 19, 1989, at A3.

188. Smith & Sesit, *UAL Clouds Banks' Bigger Buy-Out Role*, Wall St. J., Oct. 20, 1989, at C1, col. 2.

189. Winans & Dahl, *Airlines Skid On Bad Moves, Bad News*, Wall St. J., Sept. 20, 1989, at B1.

off the assembly lines at Boeing, McDonnell-Douglas and Airbus. Prices appear to be rising everywhere.[190]

Pricing. The Bureau of Labor Statistics reports that the average cost of flying has tripled since the airlines were deregulated in 1978, while the cost of everything else has only doubled.[191] Carriers extract monopoly rents from the markets they dominate. Not only are prices rising, they are highly distorted and volatile (there are 40,000 rate changes every day).

Curious pricing policies have emerged. A passenger flying from Atlanta to Denver often pays more than one flying the same airline from Atlanta to Denver via Chicago, even though the carrier's fuel and labor costs are higher on the more circuitous routing. A passenger flying from Washington to Detroit can pay more than the one seated beside him flying from Washington to Cleveland via Detroit.[192]

Something is fundamentally wrong with a market in which pricing can so often bear an inverse relationship to costs. This is hardly the textbook model of perfect competition we were promised by the pro-deregulation economists.[193]

Consumer Abuses. From false and misleading (including "bait and switch") advertising, to deliberate overbooking, unrealistic scheduling, demand based flight cancellations, travel agent commission overrides, and onerous lost luggage rules, the industry appears to be dominated by the philosophy of P.T. Barnum—"there's a sucker born every minute. The archaic common law doctrine of caveat emptor has emerged to shield the airline industry from liability.[194]

Leveraged Buy-Outs. Recent raids on three of the four largest airlines—American, United and Northwest—promise to load them with enormous debt. Another four of the nation's giants—Continental, Eastern, Pan Am and TWA—have a negative net worth (a debt to equity ratio in excess of 100%). Corporate pirates like Frank Lorenzo and Carl Icahn have already stripped these once proud airlines bare. Debt service will force carriers to raise ticket prices and trim service (and perhaps the margin of safety) even more.[195] If the economy turns soft, debt could bankrupt a few highly leveraged airlines, leading to even less competition than we now have. As Representative Byron Dorgan (D-N.D) said, "I'm not so alarmed if they load up a lipstick company with debt and it fails. But if you

190. P. DEMPSEY, *supra* note 4, at 129-93.

191. *Who Wins the Air Wars?*, NEWSWEEK. Sept. 18, 1989, at 41.

192. *See* G. BROWN, THE AIRLINE PASSENGER'S GUERILLA HANDBOOK: STRATEGIES & TACTICS FOR BEATING THE AIR TRAVEL SYSTEM. (1989)

193. P. DEMPSEY, *supra* note 4, at 95-104.

194. *Id.*, at 105-113.

195. Dempsey, *The Dangerous Cost of Airline Deregulation*, Christian Science Monitor, Sept. 27, 1989, at 18.

do that to an airline, it's a real blow to the public interest."[196]

Foreign Ownership. Foreign ownership has invaded several U.S. airlines, including Texas Air, Delta, Northwest, and America West, and promises to snare United as well. Some deregulation ideologues, like Alfred Kahn, insist that Congress should repeal U.S. cabotage laws, allowing foreign airlines to provide domestic service. They have forgotten that most of the technological breakthroughs in aviation were inspired by its military applications—the ability of aircraft to deliver bombs and troops. How many Pearl Harbors would there have been if Japan Air Lines and Lufthansa had been the dominant U.S. airlines in the 1930s?

American's lack of confidence in the airline industry may well reflect more than public disenchantment with a few lost bags and late arrivals. It may also suggest that Americans have misgivings about deregulation.

Sooner or later, we will reregulate the airlines. The bills now before Congress to provide governmental scrutiny over airline acquisitions are a few steps in the right direction. It would be better if government jumped in sooner, rather than later—better to halt widespread failures in an industry so important to the nation's commerce, communications and national defense, and preserve what little competition remains.

Concentrations of wealth and power served as the catalyst for regulation with the promulgation of the Interstate Commerce Act of 1887, and three years later, the Sherman Antitrust Act. A nation which does not learn from its history is doomed to repeat it.

There are more important interests than the greed of a small and exclusive club of corporate robber barons. America needs a safe and dependable transportation network, providing its citizens a decent level of service at a fair price. Responsible government oversight of this important infrastructure industry is essential to restore its position as a servant of the public interest.

The airline industry is vitally important to the nation's commerce, communications and national defense. We need a strong, viable domestic transport system providing good and safe service at a reasonable price. That can only be provided with responsible government oversight.

That is not to say that we need to return to the rigid regulatory regime of the early 1970s. It is to say that deregulation has gone too far, and that the nation is ill served by *laissez faire.*[197] It is time to roll back deregulation.

196. Smith, *supra* note 41, at A3.

197. Dempsey, *Market Failure and Regulatory Failure As Catalysts for Political Change: The Choice Between Imperfect Regulation and Imperfect Competition*, 46 WASH. & LEE L. REV. 1 (1989).