# AIRLINE DEREGULATION AND LAISSEZ-FAIRE MYTHOLOGY

Paul Stephen Dempsey, Andrew R. Goetz

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To the Honorable
L. Welch Pogue

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# PREFACE

Deregulation is a rather peculiar phenomenon. Its most fervent proponents continue to embrace it, not merely as an abstract economic theory, but with political, almost theological, devotion. No matter what evidence is adduced of widespread failure (and there is plenty), they tenaciously insist such evidence can be reinterpreted as proof of the success of deregulation. Some go so far as to assert that its failures can be attributed to not carrying deregulation far enough. Privatize the airports and let foreign airlines in, they insist, and we will at last achieve textbook levels of perfect competition.

Airlines were among the first of the major infrastructure industries to be deregulated. With the promulgation of the Airline Deregulation Act of 1978, Congress took the unprecedented step of sunsetting a major regulatory agency—the Civil Aeronautics Board—which had been established four decades earlier.

Beginning in the Carter administration, and reaching its zenith in the Reagan administration, federal oversight of industries as diverse as airlines, buses, railroads, trucking, telephones, cable television, radio and television broadcasting, banking, savings and loans, and oil and gas was significantly trashed. The transformation and radical shrinking of government proceeded along two, sometimes independent planes. Congress passed major legislation mandating various forms of deregulation between 1976 and 1985, while successive presidents appointed free market theologians to the regulatory agencies with the mission to exceed their legislative mandates and ignore their oaths of office.

The laissez-faire economists who convinced Congress to promulgate the Airline Deregulation Act of 1978 assured us that deregulation would result neither in increased concentration nor in destructive competition. This was true, they insisted, because the industry was structurally competitive, possessed few economies of scale, and was impeded by few barriers to entry. This book compares those predictions and assurances with the unfortunate results of deregulation:

- Under deregulation, the airline industry lost all of the money it made since the Wright Brothers' inaugural flight at Kitty Hawk in 1903, and $1.5 billion more.
- After more than 200 bankruptcies and 50 mergers, we now fly the oldest and most repainted fleet of aircraft in the developed world.
- Of the 176 airlines to which deregulation gave birth, only one remains and, as of 1992, it too was in bankruptcy.
- In 1991, fully 30 percent of the nation's fleet capacity was in bankruptcy or close to it.
- All the U.S. airlines together are now worth less than Japan Airlines individually.
- Despite predictions to the contrary, deregulation has produced the highest level of national and regional concentration in history.
- Although more people are flying than ever before, the percentage increase in domestic airline passenger boardings was lower during the first decade of deregulation than in every decade that preceded it.
- While most passengers now fly on a discounted ticket, the full fare has risen sharply under deregulation, far exceeding the rate of inflation, and the discounts are now encumbered with onerous prepurchase, nonrefundability and Saturday-night-stayover restrictions. Today's airline ticket is therefore an inferior product compared to its counterpart under regulation, which provided passengers with considerable flexibility.
- Despite allegations to the contrary, average real fuel-adjusted ticket prices are higher than they would have been had the pre-deregulation trend continued. Pricing has not only increased above pre-deregulation trend levels, it has grown monstrously discriminatory.
- Industry costs increased sharply under deregulation, while the long-term trend in productivity improvements fell flat.
- Hubbing-and-spoking, the dominant megatrend on the deregulation landscape, has caused some air travel to regress back to the DC-3 era, robbing aviation of its inherent advantage and people's most precious commodity—time.
- Business travelers lose billions of dollars in productivity as a result of circuitous and time-consuming hub-and-spoke operations.
- Service has declined under deregulation, while consumer fraud has increased.
- Although fatality statistics do not reflect it, the margin of safety has also declined.
- Labor-management relations have deteriorated.
- Americans now rate airlines as the industry in which they have the least confidence.

Neither economic nor equity goals have been advanced by deregulation. The assumptions on which it was based—that there were few economies of scale in aviation, that destructive competition was unlikely, that "contestability" of markets (the purported ease of potential entry) would discipline pricing—have proven false.

The time has come to reconsider the experiment of deregulation. Air transport is too critical to the productivity of the economy and the well-being of our citizens to abandon it to private concentrations of market power. This book examines the industry, its history, and the metamorphosis of deregulation. It also sets forth an agenda for legislative reform.

We are friends of this industry, not enemies of it. We recognize and appreciate the fundamental role commercial aviation plays in supporting the nation's commerce, communications, and national defense. We do not believe that government should apply command economy–type restrictions over price and supply. We do believe that somewhere between the regulatory regime established for airlines in 1938, and the contemporary environment of laissez-faire market Darwinism, lies the appropriate level of government oversight for this critical infrastructure industry.

We recognize the unpopularity of our position, and the power and strength of the opposition to any meaningful restoration of the public interest to airlines. But we would rather be right than loved.

Despite its profound economic losses, the industry itself opposes reregulation. The few survivors are on the verge of realizing the dream of every industrialist—to control an unregulated oligopoly (and in many markets, a monopoly) providing an essential infrastructure service that the public cannot do without.

The free market, laissez-faire movement is a passionate one. Indeed, not since the Bolshevik Revolution has the discipline of economics embraced an ideology with such zeal. Most of the Washington-based laissez-faire think tanks will fight to the death the restoration of any responsible government oversight of this industry. Notwithstanding their inability to predict the future with any respectable degree of accuracy, economists tend to view their discipline as a science ("dismal" though they concede it to be), and tend to see truth clearly. Only deeply religious people appear able to make the leap of faith from belief (economists call it theory) to reality that some economists do.

One particular Washington think tank has been at the forefront of the tenacious "deregulation-is-a-success" movement. Housed in a massive concrete edifice on Massachusetts Avenue in Washington, D.C., the Brookings Institution developed a reputation as a leading liberal think tank in an earlier part of this century. Paradoxically, its founder was a man who understood the importance of government as a modest participant in the economy. In the 1930s, Brookings' economists were at the forefront of New Deal efforts to regulate a number of important infrastructure industries, including transportation.

If Rip Van Winkle had fallen asleep in 1938 and awoken a century later, he would have been astounded at the transformation that has overcome Brookings. Beginning in the 1980s, Brookings published a series of studies proving conclusively that transportation deregulation saved consumers billions and billions of dollars. These findings were applauded on the editorial pages of major American newspapers, including the *New York Times* and *Wall Street Journal.* We devote a full chapter to Brookings.

In May 1990, Brookings put on a conference entitled "Deregulation: Success or Failure?" A balanced program it was not. It should have been entitled: "Deregulation: A Splendid, Magnificent, Unbelievable Success!"

All the nation's prominent deregulators were assembled to praise the remarkable achievements of deregulation. One after another, Alfred E. Kahn, Darius W. Gaskins, Jr., Steven Morrison, Michael E. Levine, and James C. Miller III patted each other on the back for their tremendous public policy contributions in dismantling government. All lavished accolades on their own and each other's brilliance in leading the country to the pinnacle of economic truth. They were the High Priests—the repositories of all truth to be known. It was deregulation's day in the sunshine. Not one representative of a contrary viewpoint had been invited to speak.

They spoke with contempt about those foolish enough to oppose them. Fred Kahn scornfully observed, "When they search for someone to appear on the MacNeil-Lehrer News Hour to oppose deregulation, they have to look under rocks."

So be it. We crawled out from under rocks to write this book because the story needs to be told: the Emperor has no clothes. Deregulation is a failure.

# ACKNOWLEDGMENTS

The authors are deeply indebted to Kevin Quinn, staff economist at the Economic Policy Institute, who provided the airline pricing analysis and supporting appendix to chapter 21 of this study. The authors would also like to thank Theodore P. Harris and Harvey Wexler for their insights on airline economics and corporate policy. The authors also wish to thank the Economic Policy Institute for allowing them to publish material originally appearing in their study "Flying Blind: The Failure of Airline Deregulation," authored by Paul Stephen Dempsey.

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# Part I

# AN INTRODUCTION TO THE DEREGULATED AIRLINE INDUSTRY

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# 1

# INTRODUCTION

Few industries inspire the passion that airlines do. The romantic allure of exotic destinations to which airlines provide access makes commercial aviation among the most glamorous of industries. Defying the law of gravity still gives many travelers sweaty palms on takeoff and landing. And few industries are as fundamentally important to the nation's commerce, communications, and national defense as is aviation.

All that has made this an industry with sex appeal, attracting suitors like Frank Lorenzo, Carl Icahn, Alfred Checchi, Donald Trump, Peter Ueberroth, Jay Pritzker, and Marvin Davis. Like the railroad robber barons of the nineteenth century, they all want membership in an exclusive and dwindling club of powerful entrepreneurs, dominating the travel patterns of 250 million Americans and their largest cities. And the profound change in government policy during the last decade—deregulation—let them loose while sending service, ticket prices, route patterns, the margin of safety, and the identity of the carriers painted on the fuselages of aircraft on an unprecedented roller-coaster ride. This book takes the reader on that ride.

Transportation is among the nation's most important industries, accounting for nearly 18 percent of the gross national product.[1] Of those infrastructure industries that have been traditionally either regulated or operated by industrialized nations (i.e., transportation, communications, and energy), in the United States, transportation has been deregulated more thoroughly than any other. And among the several modes of transport (i.e., air, rail, water, bus, and motor), airlines have been subjected to more comprehensive deregulation than any other.

It was not always so. The metamorphosis of governmental policy in this industry has been profound. The first airlines were encouraged by governmental subsidies, mainly to carry the mail. But much of the economic regime in which they developed was laissez-faire before 1938, when our federal government regulated the industry, and has been laissez-faire since 1978, when the industry was deregulated. Sandwiched between are four decades of economic regulation.

Paradoxically, transportation was the nation's first industry to be regulated by our federal and state governments and, a century later, the first to be deregulated. One can only observe with fascination that the transportation industry has come full circle, from its genesis in an unrestrained laissez-faire economic environment, through almost a century of comprehensive governmental regulation of entry, rates, and other corporate activities, and now back again to the unconstrained free market. The excesses of the market preceded deregulation, and those excesses have reappeared under deregulation.

Market failure gave birth to economic regulation. In the late nineteenth century, pricing discrimination and destructive competition in the railroad industry prompted Congress to establish our nation's first independent regulatory agency, the Interstate Commerce Commission, in 1887.[2] During the Great Depression, Congress concluded that the economic condition of the airline industry was unstable and that a continuation of its anemic condition could imperil its tremendous potential to satisfy national needs for growth and development. To avoid the deleterious impact of "cutthroat," "wasteful," "destructive," "excessive," and "unrestrained" competition and to avoid the economic "chaos" that had so plagued the rail and motor carrier industries, Congress sought to establish a regulatory structure similar to that devised for those industries that had also been perceived to be "public utility" types of enterprises.[3] Three years after motor carriers were brought under the regulatory umbrella, Congress added airlines to the regulatory scheme, promulgating the Civil Aeronautics Act of 1938. In so doing, Congress created a new agency to regulate this industry, the Civil Aeronautics Board (CAB).[4]

Beginning in the late 1970s, regulatory failure became the catalyst for deregulation. Various forms of de jure and de facto interstate deregulation resulted both from legislation passed by Congress in the mid-1970s and early 1980s and from the appointment by Presidents Carter and Reagan to the federal regulatory commissions of individuals fervently dedicated to deregulation.

The movement in favor of a reduced governmental presence found support on both ends of the political spectrum. America became infected by a mass psychology of antagonism toward government, stimulated on the Right by the Great Society and the growth of government and taxation and on the Left by Watergate and the war in Vietnam. For once, both sides viewed government as an enemy, rather than a friend.

In the 1960s and early 1970s, economists published a generous volume of literature critical of economic regulation.[5] Principal among their criticisms was that pricing and entry restrictions gave consumers excessive service and insufficient pricing competition, inflated airline costs, and denied the industry adequate profits. Senator Edward Kennedy chaired subcommittee hearings that served as the political genesis of congressional reform. The Kennedy Report concluded that deregulation would allow pricing flexibility, which would stimulate new and innovative offerings, allow passengers the range of price and service options dictated by consumer demand, enhance carrier productivity and efficiency, increase industry health, and result in a superior allocation of society's resources.[6]

With the inauguration of Jimmy Carter as president in 1976, the deregulation movement had a disciple in the White House. Carter appointed Alfred Kahn, a Cornell economics professor, to be chairman of the Civil Aeronautics Board.[7] Kahn criticized traditional CAB regulation as having "(a) caused air fares to be considerably higher than they otherwise would be; (b) resulted in a serious misallocation of resources; (c) encouraged carrier inefficiency; (d) denied consumers the range of price/service options they would prefer, and; (e) created a chronic tendency toward excess capacity in the industry."[8] As CAB chairman, Kahn implemented a number of initiatives that liberalized entry and pricing. In the late 1970s, the immediate results of the relatively modest efforts at regulatory reform were quite positive, creating in Washington and in the media a general euphoria that we were on the right course. Carriers in the late 1970s filled capacity, stimulated new demand by offering low fares, and enjoyed robust profits.[9]

Working with the White House, Kahn put his charismatic personality solidly behind the legislative effort for reform.[10] By the late 1970s, Congress had embraced deregulation as a major policy objective. The most sweeping such legislation was the Airline Deregulation Act of 1978. That statute abolished the Civil Aeronautics Board (as of January 1, 1985), which had regulated the airline industry for four decades. The legislation received overwhelming bipartisan legislative support. But the economic health of the industry was soon to spiral downward.[11]

The Airline Deregulation Act of 1978 was intended to provide a gradual transition to deregulated entry and rates, although the CAB quickly dropped any notion of "gradual" deregulation under Chairman Marvin Cohen. What had begun as a program of modest liberalization became an avalanche of abdication of responsible government oversight. Implementation of the new policy was immediate and comprehensive, and as the 1970s came to a close, the industry entered the darkest financial period in its history.[12] These problems were then exacerbated by the worst national economic recession since the Great Depression and an escalation in fuel prices. The Deregulation Act also called for the "sunset" of the CAB in 1985, when its remaining responsibilities were transferred to the U.S. Department of Transportation (DOT), an executive branch agency, which during the Reagan administration was wedded to the ideology of laissez-faire.[13] But even the

Bush administration's DOT tenaciously insists that, despite growing evidence to the contrary, "transportation deregulation has been a notable success."[14] It is this conclusion with which this book takes issue.

It was assumed that deregulation would create a healthy competitive environment, with lots of airlines offering a wide array of price and service options and a high level of safety. We now have more than a decade of empirical evidence to compare with those sanguine predictions.

Deregulation has become one of America's most important contemporary legal and political phenomena, dominating the domestic policy of recent presidents. Because deregulation has been implemented far more aggressively than anyone would have dared dream at its inception, it has had profound social and economic consequences.[15]

This book examines where the great American airline deregulation experiment has been, where it is, and where it appears to be going. We begin with an introduction to the contemporary airline industry—the identity and corporate cultures of the megacarriers and the men who dominate them. We then proceed chronologically, beginning with a historical review of the political, legal, and economic dimensions of airline regulation and reviewing the events that led our nation to establish a regime of economic regulation on the transportation industry and, a century later, to dismantle it. We will examine the metamorphosis of deregulation, focusing on several of the areas in which there has been a significant adverse impact, including an unprecedented level of national concentration, discriminatory pricing, fares that today are higher than the pre-deregulation trend, a deterioration in service, and a narrower margin of safety. Throughout this book, we will compare the empirical results of deregulation with the theories and assumptions of its major proponents, particularly Alfred E. Kahn, its principal architect and, on balance, a staunch defender.[16] We will also examine the issue of whether the fundamental theories of deregulation rested on false assumptions. The reader will begin to see strong parallels between the conditions preceding regulation and those following deregulation.

We will also address the issue of whether a bit more regulation might be in the public interest and, if so, what form it should take. We will conclude with an analysis of the public interest in transportation and the need for a new national transportation policy.[17] After a decade of deregulation, it seems appropriate to evaluate the empirical evidence and determine whether the policy has achieved desirable social and economic ends and, if not, how we might correct its course.

Since airline deregulation was the prototype for a decade of aggressive deregulation throughout the American economy (in industries such as telecommunications, broadcasting, railroads, trucking, buses, and banking), the results of our examination of this industry may have wider implications. It would be a mistake, for instance, to take the experience of the early years of airline deregulation—when low, simply structured fares and dramatic competition from new entrants seemed to justify the wildest claims of its proponents—as a model of the benefits that deregulation can bring generally. These short-term gains were followed by medium-term and, arguably, long-term pain.

So let us examine the theories, the myths, and the realities of the airline industry in the 1990s. We begin by introducing you to the megacarriers and the men who rule them.

## NOTES

1. *See Gridlock!*, TIME, Sept. 12, 1988, at 52, 55.

2. P. DEMPSEY & W. THOMS, LAW & ECONOMIC REGULATION IN TRANSPORTATION 7–17 (1986) [hereinafter cited as P. DEMPSEY & W. THOMS].

3. Dempsey, *The Rise and Fall of the Civil Aeronautics Board—Opening Wide the Floodgates of Entry*, 11 TRANSP. L.J. 91, 95 (1979) [hereinafter cited as *The Rise & Fall of the CAB*].

4. The agency was initially named the Civil Aeronautics Authority.

5. *See* Hardaway, *Transportation Deregulation (1976–1984): Turning the Tide*, 14 TRANSP. L.J. 101, 106 n.17 (1985) [hereinafter cited as Hardaway] and articles cited therein. *See also* L. KEYES, FEDERAL ENTRY CONTROL OF ENTRY AND EXIT INTO AIR TRANSPORTATION (1951); R. CAVES, AIR TRANSPORT AND ITS STUDY: AN INDUSTRY STUDY (1967); and W. JORDAN, AIRLINE DEREGULATION IN AMERICA: EFFECTS AND IMPERFECTIONS (1970).

6. *Civil Aeronautics Board Practices and Procedures, Senate Subcomm. on Administrative Practice of the Judiciary Comm.*, 96th Cong., 1st Sess. (1976). *The Rise & Fall of the CAB*, *supra* note 3 at 114–18.

7. Alfred Kahn is perhaps more responsible for transportation deregulation than any other individual. It was he, as Jimmy Carter's chairman of the Civil Aeronautics Board, who forcefully lobbied in support of the Airline Deregulation Act of 1978, which, after a transition period, abolished airline entry and price regulation and terminated the Civil Aeronautics Board. It was Kahn, as Jimmy Carter's chairman of the Council on Wage and Price Stability, who lobbied strongly on behalf of trucking regulation, ultimately leading to the promulgation of the Motor Carrier Act of 1980. *Trucking Deregulation: Is It Happening? Hearing before the Joint Economic Committee*, 97th Cong., 1st Sess. 3 (1981). Along the way, Kahn made various predictions as to the benefits likely to flow from deregulation. Laced throughout this book is a comparison of Kahn's early assumptions and predictions with his more recent admissions and the empirical results of deregulation.

The predictions of what deregulation would bring were quite optimistic, despite strong misgivings by most of the industry. Kahn assured a skeptical public that the benefits of deregulation would be universally shared: "I am confident that . . . consumers will benefit; that the communities throughout the nation—large and small—which depend upon air transportation for their economic well being will benefit, and that the people most closely connected with the airlines—their employees, their stockholders, their creditors—will benefit as well." *Statement of Alfred E. Kahn before the Aviation Subcommittee of the House Public Works and Trans-*

*portation Committee on H.R. 11145,* 95th Cong. 2d Sess. 8 (Mar. 6, 1978). *Aviation Regulatory Reform, Hearings before the Subcomm. on Aviation of the House Comm. on Public Works and Transportation,* 95th Cong., 2d Sess. 124 (1978). It is clear, however, that many of these constituencies, including stockholders and labor (and, arguably, much of the traveling public), have not benefited. Take labor. In his book, Kahn recently wrote, "In several of the industries, especially in the airlines and trucking, competition has exerted powerful downward pressure on egregiously inflated wages—*painful for the workers* affected but healthy for the economy at large." A. KAHN, THE ECONOMICS OF REGULATION xx (1988) [emphasis supplied] [hereinafter A. KAHN]. So, employees are not better off as he predicted, but he justifies that on grounds that they must suffer while the rest of us benefit. In his book, he also acknowledges that several of the deregulated industries have "sharply reduced their work forces." *Id.* Elsewhere, Kahn has conceded, "Labor unrest and the insecurity and downward pressure on the wages of the preexisting labor force have been an undeniable cost of deregulation." Kahn, *Surprises from Deregulation,* 78 AEA PAPERS AND PROCEEDINGS 316, 317 (1988) [hereinafter *Surprises from Deregulation*].

8. Quoted in P. DEMPSEY, LAW & FOREIGN POLICY IN INTERNATIONAL AVIATION 24 (1987) [hereinafter P. DEMPSEY]. *See also* Kahn, *The Theory and Application of Regulation,* 55 ANTITRUST L.J. 177, 178 (1986) [hereinafter *Theory and Application*], and Kahn, *Transportation Deregulation . . . and All That,* ECON. DEVELOPMENT Q. 91, 92 (1987) [hereinafter *All That*].

9. As a young CAB attorney, Paul Stephen Dempsey was also swept up in the movement. In 1978, he praised the benefits of partial deregulation:

> The objective of [deregulation] has been to provide the consumer . . . with improved service at reduced fares. In general, the theory has been that increased competition among air carriers will lead to improved quality and an increased variety of services available to the public at competitive prices reasonably related thereto, and that the price elasticity of the passenger market will ensure more efficient utilization of capacity for the carriers and, consequently, increased revenue. Enhanced reliance upon competitive market forces has tended to lower air fares and stimulate innovative price/service options. It has also tended to fill empty seats and thereby increase carrier revenue. The policies appear to have had an affirmative impact upon both consumers and the regulated industry that serves them.

Dempsey, *The International Rate and Route Revolution in North Atlantic Passenger Transportation,* 17 COLUM. J. TRANSNAT'L L. 393, 441 (1978).

10. Although most of the airline industry opposed deregulation, it was supported by Federal Express and United Airlines, the latter the largest airline in the free world.

11. By 1981, Paul Stephen Dempsey had reevaluated the deregulation experiment, looked into his crystal ball, and concluded that the metamorphosis would proceed through three major phases:

> In the first, price and service competition are increased, carriers become innovative and imaginative in the types of price and service combinations they offer, and consumers thereby enjoy lower priced transportation. Carriers are free to maximize their profits by leaving unprofitable markets and investing their equipment in more lucrative ones. In the airline industry, lower prices initially generated increased passenger traffic, thereby enabling air carriers to fill seats which might have otherwise flown empty. . . . [A]ir carriers left many of the small, remote, isolated communities of our nation and transferred their aircraft to the more heavily

traveled markets. Passengers in these dense markets enjoyed intense pricing and service competition. Airlines generally enjoyed higher profits, at least during stage one. . . . The first stage is the one to which deregulators point to demonstrate the attributes of deregulation.

The second stage is an embarrassment to deregulators. . . . Because of excess capacity and unrestrained price and service competition, air carrier profits have plummeted; indeed, the industry is experiencing the worst losses in the history of aviation. . . . [Economist Michael Evans] succinctly summarized the market effects of deregulation upon the airline industry:

"In the short run, deregulation does indeed seem to be the promised land. Prices rise more slowly, productivity increases, service expands, and everyone is happy. However, after the initial euphoria, it turns out that profits are not really increasing after all.

"As a result, rationalization of the route structure begins, which turns out to mean price-cutting on primary routes, coupled with higher prices and less service on secondary routes.

"When this happens, the gain in productivity slows or even reverses, thereby negating much of the benefits of deregulation. We end up with no improvement, or even higher prices and lower productivity in that industry. . . ."

The continued inability of many carriers to balance their books due to the intensive competition they are forced to endure under deregulation will force many carriers to float "belly up" in bankruptcy. . . . During the second stage, prices will continue to be set at reasonable levels in highly competitive markets, and will continue to grow at unreasonable rates in monopolistic or oligopolistic markets. Service will begin to deteriorate in both.

Stage three of deregulation will constitute the ultimate transportation system with which the nation is left. The carriers which have suffered most during stages one and two will, by this point, have gone bankrupt, leaving many markets with very little competition. A monopolistic or oligopolistic market structure will result in high prices, poor service, and little innovation or efficiency. Potential entrants, having witnessed the economic calamity of destructive competition, may be unwilling to enter so cutthroat an industry. . . . Small communities will receive poorer service and/or higher rates than they enjoyed under regulation. . . . In the end, the industry structure created by the free market may be much less desirable than that which was established by federal economic regulation.

Dempsey, *The Experience of Deregulation: Erosion of the Common Carrier System,* 13 TRANSP. L. INST. 121, 172–75 (1981) [citations omitted]. The author continued, "Let us pray that this pessimistic portrait the author has painted of deregulation turns out to be inaccurate, for if the effects of deregulation are less than desirable, can all the king's horses and all the king's men ever put it back together again?" *Id.* at 176.

12. *See The Rise & Fall of the CAB, supra* note 3.

13. *See* P. DEMPSEY & W. THOMS, *supra* note 2, at 28–29.

14. U.S. DEP'T OF TRANSPORTATION, MOVING AMERICA 6 (1990).

15. *See* P. DEMPSEY, THE SOCIAL AND ECONOMIC CONSEQUENCES OF DEREGULATION (1989).

16. In theory, deregulation should have brought us lots of new entry and a healthy competitive environment—things that, in general, have not resulted. In fact, deregulation was premised on several false assumptions, including the contestability of airline markets. By the late 1980s, Kahn had become somewhat conciliatory about the problems that had emerged under deregulation and the inability of pro-deregulation economists to have predicted them. He insisted that the Department of Transportation was largely to blame for these ills by, for example, approving every merger submitted to it and not sufficiently expanding airport capacity. Nonetheless, Kahn noted, "There have of course been severe problems and reasons for concern even from the public's standpoint: most prominently sharply increased

congestion and delays, increased concentration at hubs, monopolistic exploitation of a minority of consumers, and possibly a narrowing of the margin of safety." Kahn, *Airline Deregulation—A Mixed Bag, But a Clear Success Nevertheless,* 16 TRANSP. L.J. 229, 251 (1988) [citation omitted] [hereinafter *A Mixed Bag*]. To his credit, Kahn has also become quite candid about his and his compatriots' failure to foresee the "explosion of entry, massive restructuring of routes, price wars, labor-management conflict, bankruptcies and consolidations and the generally dismal profit record of the last ten years." Kahn, *Surprises of Airline Deregulation,* 79 AEA PAPERS AND PROCEEDINGS 316 (1988).

17. Because the economic rationales and regulatory structure created for economic regulation of the other infrastructure industries (i.e., communications and energy) have so many parallels with those of transportation, the empirical experience with deregulation in this industry should provide insights into the impact of additional deregulation in telecommunications, broadcasting, oil and gas, and electric power.

# 2

# CORPORATE PIRATES AND ROBBER BARONS IN THE COCKPIT

During the 1980s, several of the nation's largest airlines became targets for leveraged buyouts (LBOs): Continental, Eastern, Frontier, People Express, TWA, Ozark, Northwest, United and American. Only the last two acquisition efforts failed. 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 accounted for the interest in airline acquisitions. First, after more than 150 bankruptcies and 50 mergers, the industry became an oligopoly. Eight megacarriers dominate 94 percent of the domestic passenger market. With fortress hubs and shared monopolies, ticket prices are ascending.

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 Ueberroth. Owning an airline is more prestigious than owning an NFL franchise, for there are fewer airlines. Owning an airline also means becoming emperor of several fiefdoms, for the fortress hubs wield a stranglehold over the cities they serve.

For example, in buying Northwest for $3.7 billion, Alfred Checchi became king of Minneapolis, Detroit, and Memphis—Northwest's hubs. If Marvin Davis's $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 would have carried more than $6 billion in debt had its LBO been successful. This chapter 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 also gobbling up significant shares of U.S. airlines. Already Northwest, Delta, Texas Air, America West, and Hawaiian Airlines have significant foreign equity. Whereas debt poses significant problems for the long-term viability of airlines, foreign ownership raises national security concerns.

Criticism of LBOs centers on the impact of massive amounts of debt 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. This debt, coupled with the recession of the early 1990s, produced a new round of bankruptcies and consolidations among debt-ridden airlines, which left the industry even more concentrated. Finally, foreign ownership of U.S. airlines raises competition and national security concerns. We begin with a look at deregulation.

## DEREGULATION

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

### 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 5 percent of the domestic passenger market, with lower costs they drove prices down. But industry profitability 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 that 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 with the spoilage properties of open jars of unrefrigerated mayonnaise. The grocer 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 bag of peanuts, a cup of Coke, 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]

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]

### Consolidations

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 systems. Four hubs (Atlanta Hartsfield, Chicago O'Hare, Dallas/Ft. Worth International, and Denver Stapleton) became duopolies, whereas all the rest became effective monopolies, with a single airline controlling more than 60 percent 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]

As the 1990s dawned, the eight largest airlines dominated 94 percent of the domestic passenger industry and almost all hubs. Not only are passenger airlines highly concentrated: mergers in the cargo industry have reduced it to a duopoly. Federal Express acquired Flying Tigers, which itself had consumed Seaboard when deregulation was young. Consolidated Freightways, one of the nation's largest trucking companies, acquired Emery Air Freight, which itself had consumed Purolator.

### Profitability

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

The oligopoly that emerged from deregulation grew increasingly profitable. The two years ending June 30, 1989, represented 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] But it has been a roller coaster ride, for the two-year period ending December 1991 was the most dismal in the industry's history, with losses totaling $5.7 billion.[12]

## Leveraged Buyouts

With unprecedented profitability, and the innate glamor of the industry, three of the nation's four largest airlines became targets for LBOs in 1989. The Denver oil king Marvin Davis launched a $2.7-billion bid for Northwest Airlines. Northwest ultimately fell to a $3.7-billion bid by Alfred Checchi.[13] Davis enjoyed a $30-billion 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 [late 1980s], 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.
> 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]

Financing for the $7-billion management/labor bid for United collapsed, and Donald Trump withdrew his $7.5-billion bid for American.

Some LBOs can be justified on grounds that they rid companies of ineffective management and improve productivity, profitability, and performance by paring unrelated assets and squeezing labor. But American and

United are generally viewed as among the best-managed and most-efficient companies in the business. Let us examine America's two largest megacarriers, the assaults by corporate raiders, and the entrepreneurs who battle for control of the nation's aviation system.

*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] Said CEO Robert Crandall, "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.

Although initially a critic of deregulation, Crandall moved quickly to capitalize on its opportunities for growth. His aggressive policies of reinvesting earnings, growing from within, establishing new hubs from scratch (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 is a chain-smoker and an avid jogger—two packs and four miles a day, respectively.[21] One commentator noted, "His tough stance on union wages, his bare-knuckled price-cutting and his proclivity for salty phrases have all contributed to Robert 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 "legalized warfare in the industry."[24]

After a series of price wars that left both American and Braniff bleeding in their Dallas hub,[25] Crandall sought to discuss prices with Braniff's president, Howard Putnam. 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 out 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.[26]

Putnam taped the conversation and turned the tape over to the Justice Department for antitrust prosecution. Price-fixing is, after all, a per se violation of the Sherman Act, one that could have landed 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.[27] Ultimately, the Reagan administration settled for less still—a consent decree in 1986 in which Crandall neither admitted nor denied guilt.[28]

But nothing was to save Putnam from demise. Braniff entered bankruptcy in 1982.[29] After scaling down significantly, selling its Latin American routes to Eastern and selling 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 that dominated Dallas—American and Delta—proved infeasible. With a generous loan from American to buy new aircraft, Braniff abandoned Dallas and moved its hub to Kansas City, where it died.

Southwest Airlines dominates tiny Dallas Love Field while American dominates Dallas/Ft. Worth International Airport. Southwest's Chairman Herb Kelleher once joked to Crandall that their relationship was analogous to that of tiny Finland and mighty Russia. "There's only one difference," Crandall retorted with a Siberian stare, "I ain't reducing troops."[30]

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."[31] He has repeatedly insisted: "My friends call me Mr. Crandall. My enemies call me Fang."[32]

Destroying competitors means more to Crandall than running them out of town. It includes assailing their character. In 1987, Crandall bought 15,000 copies of a scathing *Texas Monthly* article about Texas Air's Frank Lorenzo to distribute at employee meetings.[33] For his part, Lorenzo describes Crandall as "hypocritical" and "afraid of competition"—the pot calling the kettle black, so to speak.[34]

But Crandall didn't like it when the shoe was on the other foot. In response to John Nance's book about Braniff, in which Crandall was portrayed unfavorably, Crandall 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.[35]

Crandall's aggressive character also strongly manifests itself 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?"[36]

Crandall loves detail. He likes to immerse himself in the numbers. Crandall was once spotted humped over paperwork three inches high on an American flight on Christmas morning.[37] He brags that he cut $40,000 in operating expenses by removing olives from American's dinner salads.[38] 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 then replaced with a part-time guard and later with a guard dog. Finally, Crandall inquired whether it might be possible to replace the dog with a loudspeaker system broadcasting a tape recording of barking dogs.[39]

Crandall's tight-fisted managerial style, entrepreneurial bravado, marketing acumen, and streetwise shrewdness made American the largest airline in the free world, second in number of aircraft only to the former Soviet Union's Aeroflot. Under Crandall, American's revenue passenger miles grew steadily since 1981; its market share increased steadily since 1980; it turned a profit every year between 1983 and 1991; and its debt-to-equity ratio was superior to that of the Dow Jones airlines since 1985.[40] That such a lean, mean flying machine as American would be assaulted in a leveraged buyout left most analysts stunned in disbelief in October 1989 when Donald Trump made a bid of $120 a share, or $7.54 billion.[41] It was like a minnow swallowing a whale. Trump purchased the Eastern shuttle, which flies 21 aircraft between three cities; American has 480 aircraft.[42] In 1988 American earned $476.8 million on revenue of $8.8 billion.[43] Trump's acquisition would have added $6.5 billion in debt to American.[44] 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.[45]

Trump promised not to rename American Airlines, Trump Airlines, however. But after the stock market collapse of Friday, October 13, 1989, Donald Trump withdrew his bid for American. His financial empire began to crumble around him in the 1990s.

*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 United executive, "Monte Lazarus [a lieutenant of Ferris's] 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 percent of the domestic passenger market. By the mid-1970s, its share had declined slightly, to 20 percent. Under regulation, the CAB had long favored smaller and weaker airlines in route awards, depriving United of new markets. Ferris believed that United would have few opportunities for expansion under a benevolent CAB.[46] 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 United soon found that it needed regional feed into its hubs to fill the long-haul capacity, and it reversed course, repurchasing many of the small 737s that is had just sold. Today, United 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.[47] Take his role in the demise of Frontier. In the mid-

1980s, Denver's Stapleton Airport was the only airport in the country to be used as a hub by three airlines. As a consequence, Denver consumers enjoyed some of the lowest airfares 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 bought 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 bloodbath ensued.

In July 1986, United agreed to take Frontier off Burr's hands for $146 million, with the contract condition that United negotiate with Frontier's unions to reach an agreement satisfactory to United. United met with the pilots, but not the other four Frontier unions. After several weeks, during which additional Frontier assets were transferred to United, United announced that the labor negotiations were at an impasse.[48] Burr had little choice but to put Frontier into bankruptcy in late August 1986. And then there were 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.[49] But a 29-day strike by United's pilots in 1985 began a seething relationship that caused Ferris to begin flying private jets, avoiding his own company's planes. At a dinner in 1986, Ferris was overheard boasting to American's CEO Robert Crandall that United would one day have some of the lowest labor costs in the industry.[50]

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 on 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 wormy, but the combination made United ripe for a hostile takeover, for its dismemberred parts were worth more than its barely unified whole. Although 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 market concept), it never really got off the ground before the vultures began to circle.

In 1987, Donald Trump, who owned 5 percent of the company, urged Ferris to break up the conglomerate and sell all its parts separately.[51] The pilots, angry with Ferris for different reasons, began to put together their own $2.3-billion bid for the company.[52] And other suitors were waiting in 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."[53]

Ferris was a fiery-tempered executive who attacked problems by promptly moving on the offensive.[54] In addition to the usual poison pills and golden parachutes, he concluded a unique financial arrangement with Boeing that gave it some unusual powers over the business operations.[55] 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.[56]

Shareholder resistance and difficulty in financing 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.[57]

Although the company had spent $7.3 million on the name change (to which Wall Street gave a thumbs down), United abandoned the Allegis title in 1987.[58] 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, the Denver oil king Marvin Davis offered $240 a share, or $5.4 billion, for United, later raising his bid to $275.[59] Management responded with a $300 a share, or $6.75-billion, buyout of its own, involving the pilots. British Airways was also a partner, putting up $750 million, or about 78 percent of the equity.[60] Management was to have owned 10 percent, British Airways 15 percent, and the pilots 75 percent.[61] To pay for their share, the pilots would take pay cuts of up to 10 percent, less overtime pay, and fewer vacation days.[62] The debt would have created interest payments of $600 million to $700 million annually.[63] The machinists union criticized the deal as unrealistic, saying, "Placing billions of dollars of additional debt on the carrier . . . would seriously jeopardize the carrier's operation, safety and future existence."[64]

The financing fell through on Friday, October 13, 1989, sending the Dow Jones Industrial averages tumbling 190 points.[65] Oddly, the stock market panic was motivated, at least in part, by anxiety over junk bonds. But the United financing had none, to which the Japanese banks objected.[66]

Shortly thereafter, Marvin Davis withdrew his bid, and British Airways backed out of the management/pilot buyout.[67] Under the deal that collapsed, United CEO Stephen Wolf was to have earned $76.7 million and new UAL stock options.[68] Management would have then spent $15 million for a 1 percent stake and been given 9 percent more in stock options.[69] Everyone's eyes had become 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.[70] The investment bankers would get $59 million and lawyers $45 million.[71] United's 25,000 machinists and 25,000 noncontract employees criticized Wolf's greed in pursuing an LBO that would enrich him while forcing pay cuts and benefit reductions on labor, and they called for his resignation.[72]

The failed management/pilot bid saddled UAL with $58.7 million in expenses, nearly enough to buy two B-737s.[73] The action of the board of directors to pay this indebtedness was challenged by some as a waste of corporate assets, and their decision to pay themselves $20,000 for life was challenged as a breach of fiduciary responsibility to stockholders.[74] Wolf earned some $17 million in 1990, despite the fact that United's profits fell more than 60 percent that year.

## DEBT—ON BALANCE SHEET AND OFF

As the 1990s dawned, four of the nation's largest airlines—Continental, Eastern, Pan Am and TWA—had a negative net worth, a debt-to-equity ratio in excess of 100 percent.[75] Three of these companies were owned by two corporate raiders—Frank Lorenzo's Texas Air controlled Continental and Eastern while Carl Icahn owned TWA. By 1992, Eastern and Pan Am had both ceased operations, while Continental was struggling to emerge from bankruptcy.

Northwest was saddled with $3.3 billion to pay for the Checchi acquisition (quadrupling its long-term debt).[76] The industry as a whole is burdened with excessive debt, which makes it difficult for it to weather recessions, expand operations, modernize fleets, and maintain older equipment.[77] Such economic difficulties enhance public concerns over airline safety. Table 2.1 depicts the huge amounts of debt with which the nation's airlines have been burdened by virtue of gluttonous acquisitions, mergers, and buyouts in recent years. By reducing competition, the acquisition or merger of one airline by another enhances the survivor's profitability. But the acquisition by corporate raiders produces no such benefits.

Not only LBOs but also aircraft acquisitions are burying airlines in debt. Media attention has focused on the geriatric jets—the peeling skin and the exploding doors (known in the industry as Kahndoors, after the father of deregulation, Alfred Kahn). The fear of flying, as well as the cost of operating the aging aircraft, has prompted many airlines to order huge new fleets of aircraft. The conventional wisdom also identifies mass as a key ingredient of survival. So fleets grow.

As the 1990s dawned, the airline industry had $150 billion in orders or options for more than 2,500 new aircraft.[78] In contrast, the foreign debt of Brazil, which has the highest debt of all Latin American nations, is a paltry $114 billion.[79] The industry as a whole had operating cash of less than $5 billion in 1988, which was a very good year.[80] The industry's

Table 2.1
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 STREET JOURNAL, (Oct. 6, 1989), at A3.

capital expenditures between 1991 and 1994 were estimated to be $15 billion per year.[81]

In 1989, United placed a record $15.7-billion order for 370 Boeing 737s and 757s (180 firm orders and 190 on option). American had 259 aircraft on order and 302 on option, totaling $14.5 billion.[82] In late 1988, Delta placed $13 billion in 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-90s and 50 B-737-300s and options for 110 MD-90s and 50 B-737s).[83] 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.[84] Even debt-saddled Northwest signed a $5.2-billion contract with Boeing for 80 757s (half of which are options) and 10 747-400s (4 of which are options).[85] Northwest placed a $3.2-billion order for 50 Airbus A320s in 1986.[86]

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.) But aircraft futures bring a profit only during a bull market for planes, an environment that exists only when growth in passenger demand exceeds existing capacity.

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. For example, American Airlines owns only about a third of its 476 aircraft outright.[87] 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 these obligations reveals that the industry's debt-to-equity ratio is significantly worse than it was in the mid-1980s, although the industry's performance has dramatically improved since then. For example, Delta's balance sheet debt as a percentage of total capital is only 31 percent, but adding the debt equivalent of aircraft leases (about $3 billion to balance sheet debt of $1.2 billion) increases the debt-to-equity ratio to 61 percent.[88]

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 that could be liquidated, thereby making them less attractive targets. The increased operating costs of leasing and the loss of residual aircraft values on retirement from the U.S. system (many aging 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.[89]

Whether purchased outright or leased, new aircraft not only impose tremendous debt but 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 raises industry costs, particularly with fuel-guzzling hub-and-spoke operations (a 10-cent-per-gallon increase shaves $1.3 billion from the industry's operating earnings, which were $2.3 billion in 1988).[90] The latter two curtail demand.

When 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 businesspeople to tighten their belts. Passenger demand plummets.

As noted above, the seats airlines sell resemble 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 crumbles.

Couple a prolonged recession with excess capacity and high debt service and we 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. Recession and a modest spike in fuel costs caused the industry to suffer its worst losses ever ($3.9 billion) in 1990, and to lose nearly half as much again ($1.8 billion) in 1991. These combined losses consumed all profits made by the industry since the flight of the Wright Brothers at Kitty Hawk, N.C., in 1903.

## CORPORATE PIRATES AND ROBBER BARONS

The airline industry has always attracted people 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 Ueberroth 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 to belong to the exclusive and dwindling club of airline entrepreneurs. And it is much less regulated.

So it attracts men with extraordinary egos, as it always has. From the earliest days of deregulation, the prevailing wisdom has been that after 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.

A century after the railroad robber barons appeared,[91] 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 honest, 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 band of intuitive executives who counted few pygmies in their numbers."[92]

The new generation of airline entrepreneurs are giants too. But under deregulation, their devotion to the public interest is an anathema to their lust for wealth. A senior executive of Boeing predicted, "The only guys who'll survive [under deregulation] are those who eat raw meat."[93]

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

### 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 nine different airlines, becoming, for a short while, the largest airline company in the nation. Only the former 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."[94]

Like Crandall, Lorenzo is an avid jogger.[95] The son of Spanish-born immigrants who ran a beauty parlor in Queens, New York, 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.[96] 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."[97]

Lorenzo worked and borrowed his way through Harvard Business School, ironically as a card-carrying teamster driving a Coca-Cola truck.[98] After graduating, Lorenzo became a financial analyst for TWA and then Eastern.

In 1969, Lorenzo and a classmate, Robert Carney, created Jet Capital Corporation. Jet Capital became an advisor to nearly bankrupt Texas International Airlines (called Trans-Texas before 1968).[99] Lorenzo and Carney acquired Texas International in 1972 by helping to refinance it.[100] 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 were listed on the directory of the skyscraper he occupied.[101]

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 and passing out peanuts to customers. Texas International billboards showed flying peanuts grinning from ear to ear. Somehow it all seemed appropriate. Jimmy Carter, the former peanut farmer from Plains, Georgia, was President, and it was he who had 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 firms. Neither Jimmy Carter nor his CAB chairman, the 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 more clearly than Frank Lorenzo that only giant gorillas would rule the jungle.

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 idea than the one he had the day before."[102] 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."[103] But after the Eastern bankruptcy, another observer pointed out that although 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."[104]

In 1979, Lorenzo began a hostile takeover attempt of National Airlines, a company three times the size of Texas International.[105] National was a carrier with a route structure radiating north and west from Florida and east to London. At $26 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 could supply for Pan Am's international routes, ultimately concluded a nonhostile "white knight" acquisition for $55 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 with a cool $46 million in arbitrage.[106]

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.[107]

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 CEO, desperately tried to arrange an employee buyout. But it was too little, too late. Lorenzo had 51 percent of Continental for $100 million.[108] Feldman put a revolver to his head and pulled the trigger.[109]

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, and appealing over the heads of the union chiefs to labor.[110]

After acquiring Continental, Lorenzo established a nonunion subsidiary, New York Air, to fly in the northeastern United States. The threat of transferring aircraft out of unionized Texas International and Continental into nonunion 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 acquiring 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 Kahn's two principal deputies, Michael Levine (CAB director of pricing and domestic aviation) and Phil Bakes (CAB general counsel), to the Texas Air empire. Kahn would repeatedly testify before Congress in favor of deregulation. Levine would head New York Air while Kahn would sit on its board of directors and Bakes would lead both Continental and Eastern into bankruptcy. Bakes had served on Teddy Kennedy's Senate Judiciary Committee staff when deregulation was on the table, and after joining Lorenzo, he recruited many Kennedy deputies and prominent Democratic staffers as Texas Air lawyers and lobbyists, as impressive an array as had ever been seen on Capitol Hill.[111] Lorenzo also picked up the head of the transportation section of the Antitrust Division of the U.S. Department of Justice, Elliott Seiden. Seiden, as father confessor of the industry's antitrust sins, perhaps more than any government official 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.

Texas Air spent more money on political action committees than any other airline.[112] It has been estimated that Texas Air spent at least $2 million a year on lobbying and public relations alone.[113]

In September 1983, Lorenzo made his most infamous move. After two years of wrangling over wages with the machinists union and six weeks after the union's strike, Lorenzo led Continental into Chapter 11 reorganization bankruptcy proceedings. Three days thereafter, he tore up all his labor agreements, including those of the nonstriking pilots, fired all of Continental's 12,000 employees, and unilaterally cut wages between 40 and 60 percent.[114]

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 three o'clock in the morning by the sound of crashing glass. Someone had thrown an elk head through the plate-glass window of 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 instead on the parallel taxiway. The union ended their strike in 1985. But by then, their backs had been broken. Lorenzo had earned the reputation of being a union buster.[115]

Lorenzo's reputation as a union buster was to cost him other acquisitions, including runs at Frontier and TWA in 1985. At both airlines, the pilots surrendered millions of dollars in wage and work-rule concessions to avoid the dreaded Lorenzo.

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 for Frontier the year before.[116] After the offer had been accepted, as the People Express position became increasingly untenable, Lorenzo tendered an even lower counteroffer to People's CEO Donald 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.[117]

Also in 1986, Lorenzo made his boldest purchase of all—Eastern Air

Lines, for $615 million.[118] Eastern had cash of $463 million, more than Lorenzo's outlay.[119] Lorenzo had Eastern borrow about $300 million to finance his purchase of it.[120]

Eastern had been managed, badly, by the 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 percent of Eastern's stock and labor presence on the board of directors. While the other unions had taken salary cuts of about 28 percent, the machinists union, headed by Charlie Bryan, a small but feisty and contentious Irishman, would stand for none. One Eastern executive described Bryan as "an 800-pound gorilla."[121] The presence of Bryan on Eastern's board made life for Borman a living hell.[122]

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 on 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."[123] 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."[124]

After acquiring Eastern, Lorenzo prepared for the siege. He had barbed wire stretched along the top of fences around the Miami headquarters. He had closed-circuit cameras mounted in hangars to monitor mechanics. He also had manhole covers in the base welded shut.[125] Lorenzo 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 loved to hate, Lorenzo, "the devil incarnate, a hard-headed, hard-hearted wheeler-dealer intent on destroying their unions, their airline and their lives."[126] They would paint him as the Great Satan—the Antichrist.

Lorenzo's Texas Air corporate structure was complicated, and intentionally so. Lorenzo owned 52 percent of Jet Capital Corporation. With 1 percent of Texas Air's equity, Jet Capitol enjoyed 34 percent voting control of Texas Air and the right to elect seven of Texas Air's directors through a special class of stock.[127] Texas Air, in turn, had more than 20 subsidiaries.[128] In the late 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 that its worth was between $200 million and $320 million and it was generating $255 million a year in cash.[129] To finance the acquisition, Texas Air gave Eastern a 25-year note at 6.5 percent interest.[130] Eastern, of course, was left without a computer reservations system, and was required to buy services from System One, for which it paid $130 million *a year* to Texas Air.[131]

Lorenzo controlled a fuel-brokerage firm, from which Continental and Eastern had to buy all their fuel, at a 1 percent commission, or about $30 million a year.[132] Eastern was forced to buy a $25-million unsecured note from People Express, bringing Texas Air a $4-million profit.[133] Thus, Texas Air upstreamed cash to the parent in the form of management and service fees charged the subsidiaries, Continental and Eastern.

Lorenzo transferred 11 of Eastern's gates at Newark to Continental for an $11-million promissory note paying 10 percent interest. In contrast, Piedmont paid $25 million to Eastern for eight gates and related facilities at Charlotte.[134] Lorenzo also transferred the lucrative Miami-to-London route and 20 aircraft to Continental.[135] Eastern also paid Continental $30 million to train 400 pilots to keep Eastern flying in the event of a strike.[136]

Lorenzo closed Eastern's Kansas City hub and laid off about 25 percent 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 Capital arranged a juicy $1.25-million fee for itself for advising Texas Air.[137] The shuttle was responsible for one-third of Eastern's profits. Its transfer was abated only when blocked by court order.[138]

Lorenzo leveraged Eastern heavily with debt, mortgaging its unencumbered assets. In 1988, its annual debt-service burden was a staggering $575 million.[139] Before Eastern's bankruptcy, its long-term debt was estimated to be $2.5 billion.[140] Although secured by equipment, the debt had interest rates as high as 17.25 percent—radically higher than the 10 percent note accepted by Eastern from Continental for 11 gates and the 6.5 percent note accepted by Eastern from Texas Air for the System One computer reservations system.[141] But Eastern's creditors could reach Texas Air for only about 10 percent of the debt, for Lorenzo has carefully shielded the parent.[142] As one source noted:

> Mr. Lorenzo has built one of the most leveraged major corporations in the nation while insulating Texas Air—and himself—from 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.[143]

The unions, which owned 25 percent of Eastern's stock, complained that Lorenzo was draining off its assets for his own benefit.[144] In one lawsuit, the pilots union alleged that Lorenzo intended to "loot Eastern for the benefit of Texas Air."[145] 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."[146] When asked whether he intended to bust Eastern's unions so that he could enjoy a cost structure comparable to that of Continental, Lorenzo insisted, "That's utter bullshit."[147]

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."[148] In response to inquiries 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."[149] 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."[150] 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 Lorenzo could not tear up the union contracts at Eastern, as he had in the Continental bankruptcy. 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 the TWA raider Carl Icahn and Major League Baseball Commissioner Peter Ueberroth. 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 noted: "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 Texas Air Corp."[151]

An editorial summed up the mark Lorenzo has made on the 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.[152]

Lorenzo's self-image is more positive. Said he, "I'm not a guy associated with a lot of ego."[153] If not that, he is associated with lots of other things. Lorenzo left the airline industry in 1990, taking $30 million from Scandinavian Airline System (SAS) for his shares in Texas Air (renamed Continental Airline Holdings) and agreeing to leave the industry for at least seven years. Shortly thereafter, Continental entered bankruptcy, and in 1991, Eastern ceased operations.

### 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 leader 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."[154]

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 had acquired TWA in 1986, paying $440 million for 22 million shares.[155] He soon took TWA private and moved its headquarters out of Rockefeller Center in Manhattan to Mt. Kisco, New York, near his home.[156] The Mt. Kisco facilities are adorned with gilded chandeliers hanging from high ceilings and with oil paintings of dueling cavalrymen, Napoleon with his marshals, and ferocious sea battles.[157] The thrill of battle consumes Icahn. So too does the glamor of the airline industry.

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 percent of the gates at Lambert International Airport and 86 percent of passenger enplanements.[158] This enabled TWA to raise ticket prices, which it promptly did.[159]

In 1987, Icahn made a $1.6-billion bid for USAir at a time when 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.[160] As one analyst noted: "He's gone everywhere trying to sell TWA. There aren't any takers."[161] Others speculated that Icahn wanted to "green mail" USAir into buying back his 14.8 percent stock interest at a premium.[162]

In 1987, the Securities and Exchange Commission (SEC) began an investigation of Icahn's activities as part of a wider insider-trading probe 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.[163]

Icahn leveraged TWA to the teeth, doubling its long-term debt to raise cash for other acquisitions, including USX and Texaco. TWA's $2.5-billion debt and lease obligations crushes the airline's earnings with annual interest charges of $375 million.[164] TWA has a negative net worth of $30 million.[165] The company has a 15-1 debt-to-equity ratio.[166] 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."[167] 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."[168]

TWA flies the oldest fleet of aircraft in the industry. Icahn's failure to reinvest TWA's capital in the airline led the pilots union to charge that Icahn had betrayed them at TWA's acquisition when he had assured them that he would not dismember the airline. But until the spring of 1989, TWA 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.[169] (The hulking, blunt-talking Corr subsequently became Continental's CEO for a short while.)[170] 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 narrowbodied aircraft to replace aging aircraft.[171] 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 still further. With long-term debt of $2.5 billion, TWA had already pledged its aircraft and engines to existing lenders. In June 1989, Icahn announced a $300-million high-interest junk bond offering secured on TWA's spare parts such as light bulbs, gaskets, and landing slots.[172]

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 into 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.) Soon he had a union on its knees, anxious to return to work at sharply reduced wages and benefits and under 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.[173] Something is rotten at TWA.

## FOREIGN OWNERSHIP

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.[174] The second wave of alliances occurred when foreign airlines affiliated with U.S. carriers' computer reservations systems. The most recent round of foreign interest in U.S. airlines has involved direct ownership.[175]

Several public-policy concerns arise over foreign ownership of U.S. airlines. The first surrounds national security. America depends on its Civil Reserve Aviation Fleet (CRAF) for airlift capacity in time of war. Foreign ownership may jeopardize access to the fleet. The second concern surrounds the integrity of 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.[176] 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? These issues will be developed in chapter 25.

## NOTES

1. See P. Dempsey & W. Thoms, Law & Economic Regulation in Transportation 28–29 (1986).

2. *See, generally,* 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).

5. *Id.* at 86–92.
6. *Id.* at 86–92.
7. Goetz & Dempsey, *Airline Deregulation Ten Years After: Something Foul in the Air,* 54 J. AIR L. & COM. 927 (1989).
8. Dempsey, *Antitrust Law & Policy in Transportation: Monopoly I$ the Name of the Game,* 21 GA. L. REV. 505 (1987).
9. GENERAL ACCOUNTING OFFICE, AIR FARES AND SERVICE AT CONCENTRATED AIRPORTS (1989).
10. Statement of Timothy Pettee before the U.S. Senate Committee on Commerce, Science and Transportation, Oct. 4, 1989, at 14.
11. Ellis, *United's Buyers May Be Wearing Rose-Colored Goggles,* BUS. WEEK, Oct. 16, 1989, at 36.
12. Dempsey, *supra* note 3, at 31. *U.S. Airlines Will Lose Another $1.8 Billion in 1991,* AVIATION DAILY, Dec. 10, 1991, at 429.
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 percent 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. Statement of Timothy Pettee before the Senate Comm. on Commerce, Science and Technology (Oct. 4, 1989), at 14.
18. Phillips, *AMR Earnings Decrease 8.8% in Third Period,* WALL ST. J., Oct. 19, 1989, at A3.
19. *Here Comes Donald, supra* note 15, at 52.
20. *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.
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. Complaint of U.S. Dep't of Justice in United States v. American Airlines, Inc., and Robert Crandall (N.D. Tex.).
27. P. DEMPSEY & W. THOMS, LAW & ECONOMIC REGULATION IN TRANSPORTATION 214 (1986).
28. Brown III, *supra* note 23.
29. Karr, *Airline Deregulation after Braniff's Fall,* WALL ST. J., June 14, 1982, at 16.
30. *American Aims for the Sky,* BUS. WEEK, Feb. 20, 1989, at 54.
31. Loeffelholz, *supra* note 21, at 28.
32. *Id.* at 33.

33. B. Nash & A. Zullo, The Misfortune 500 140 (1988).

34. *See* Easterbrook, *Lorenzo Braves the Air Wars,* N.Y. Times, Nov. 29, 1987, at 17.

35. *Id.*

36. Brown III, *supra* note 23.

37. *American Aims for the Sky, supra* note 30.

38. *Id.* at 55.

39. *Loeffelholz, supra* note 21, at 30.

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

41. O'Brian & Valente, *supra* note 16, at 1.

42. *An Ego as Big as American,* Newsweek, Oct. 16, 1989, at 56.

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

44. *Id.* at A3.

45. *Id.* at A3.

46. S. Davis, *supra* note 27, at 12.

47. *Rising UAL Turmoil Threatens Ferris's Job as the Chief Executive,* Wall St. J., Apr. 17, 1987, at 1.

48. Amended Complaint of Frontier Airlines in In re Frontier Airlines Reorganization, Case No. 860B-802IE (Jan. 2, 1987).

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

50. *Id.*

51. *Id.*

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

53. *Id.*

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

55. *Allegis Shakeup Came as Shareholder Ire Put Board Tenure in Doubt,* Wall St. J., June 11, 1987, at 1.

56. *Id.*

57. *Id.*

58. B. Nash & A. Zullo, *supra* note 33, at x.

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

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3

# THE MEGACARRIERS

The initial development of commercial aviation in the United States, as well as the identity of America's largest airlines and their geographic emphasis, was largely determined by the original airmail contracts let in the first third of this century. Indeed, without the airmail subsidies, commercial aviation would not have become ubiquitous so early. Mail went in the belly of the aircraft while passengers rode on top.

On New Year's Day 1914, commercial air transportation was born with the world's first regularly scheduled air passenger flight of a Benoist flying boat on a 22-mile route from Tampa to St. Petersburg, Florida. The operation was a financial failure, but it afforded the world a glimpse into the future of commercial air transportation.[1]

By 1926, 14 airmail routes were in operation by the forerunners of today's airlines. However, passenger air travel lagged in development until Charles Lindbergh's solo flight across the Atlantic on May 20–21, 1927, which inspired the world to fly. Soon thereafter, it was realized that only coherent route systems would develop solid passenger revenue. The McNary–Watres Act of 1930 gave Postmaster General Walter F. Brown wide-ranging control over the 43 existing airlines, through airmail contract awards. These contracts developed a pattern of airline routes that formed the basis for today's system.[2]

Government sponsorship and regulation are inextricably bound with the birth and growth of U.S. airlines. Through the airmail contract awards, Brown fostered the amalgamation of small, financially weak airmail contractors and passenger carriers into three transcontinental airlines—the predecessors of United, American, and TWA.

United won the airmail contract between New York and San Francisco, via Chicago, and between Seattle and Los Angeles, via San Francisco. American flew between Boston and New York to Los Angeles via Chicago,

Table 3.1
Domestic Airlines Ranked by Revenue Passenger Miles under Deregulation, 1978–1989

| | 1978 | 79 | 80 | 81 | 82 | 83 | 84 | 85 | 86 | 87 | 88 | 89 | 90 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| AMERICAN | 2 | 2 | 3 | 3 | 2 | 2 | 2 | 1 | 2 | 2 | 2 | 1 | 1 |
| UNITED | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 2 | 1 | 1 | 1 | 2 | 2 |
| DELTA | 5 | 5 | 4 | 6 | 6 | 6 | 6 | 5 | 4 | 3 | 3 | 3 | 3 |
| NORTHWEST | 11 | 8 | 7 | 7 | 7 | 7 | 7 | 7 | 5 | 4 | 5 | 4 | 4 |
| CONTINENTAL | 9 | 10 | 12 | 10 | 8 | 10 | 8 | 8 | 8 | 5 | 4 | 5 | 5 |
| USAIR | 12 | 11 | 10 | 12 | 11 | 11 | 11 | 12 | 9 | 9 | 9 | 7 | 6 |
| TWA | 3 | 4 | 6 | 5 | 5 | 5 | 4 | 4 | 6 | 7 | 6 | 6 | 7 |
| PAN AM | 6 | 6 | 5 | 2 | 3 | 3 | 5 | 6 | 7 | 8 | 7 | 9 | 8 |
| EASTERN | 4 | 3 | 2 | 4 | 4 | 4 | 3 | 3 | 3 | 6 | 8 | 8 | 9 |

*Source:* AVIATION DAILY, From Department of Transportation data.

Figure 3.1
U.S. Industry Traffic Market Share in Percentage of Revenue Passenger Miles

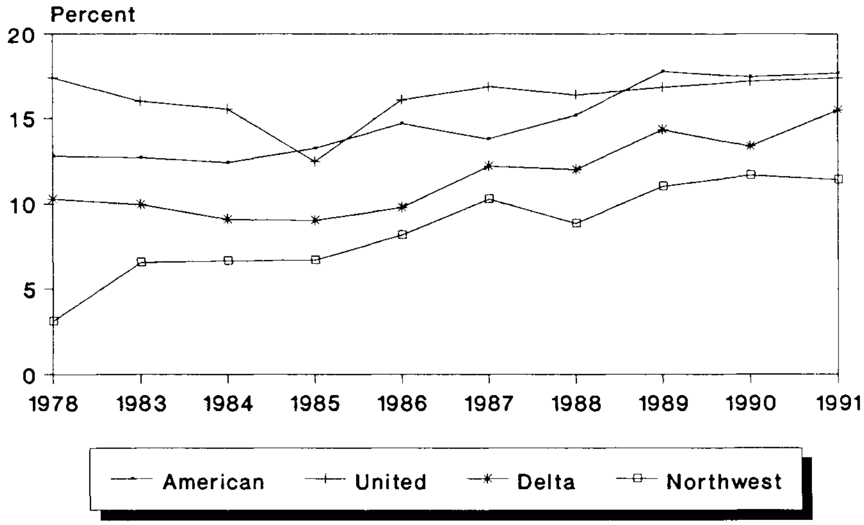
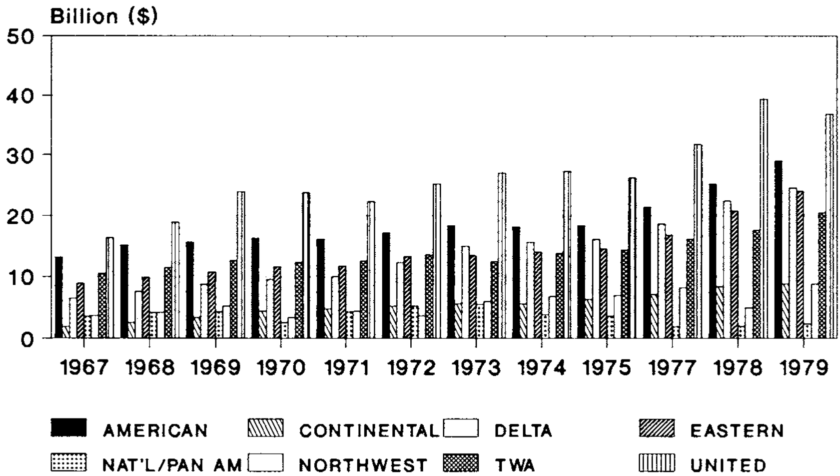


Table 3.2
Market Shares of the Largest Airlines
(in Revenue Passenger Miles, January 1990)

| Airline | RPMs (in millions) | Share (%) |
|---|---|---|
| 1. American | 5,676,675 | 16.720 |
| 2. United | 5,428,222 | 15.988 |
| 3. Delta | 4,418,700 | 13.015 |
| 4. Northwest | 3,935,990 | 11.593 |
| 5. Continental | 2,988,344 | 8.802 |
| 6. USAir | 2,522,339 | 7.429 |
| 7. TWA | 2,423,400 | 7.138 |
| 8. Pan Am | 2,342,000 | 6.898 |
| 9. Eastern | 1,520,000 | 4.477 |

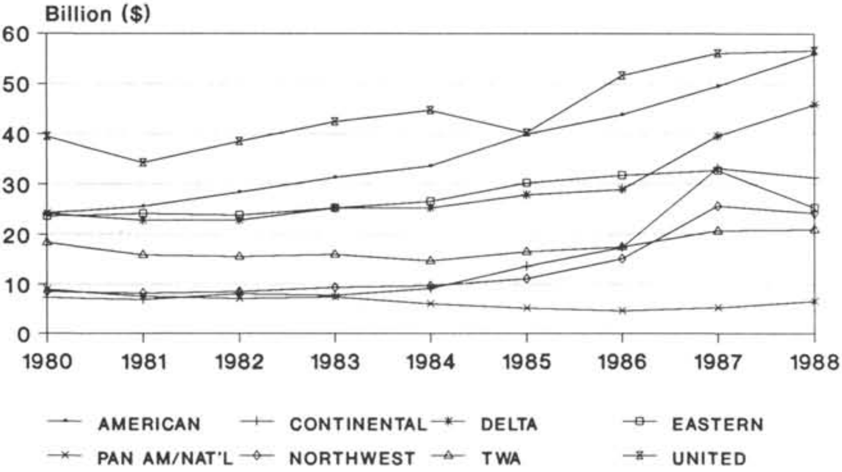
*Source:* AVIATION DAILY, Feb. 21, 1990, at 365.

Figure 3.2
Comparison of Eight Airlines, 1967–1979 (in Revenue Passenger Miles)




No 1976 stats; Pan Am begins 1977-79

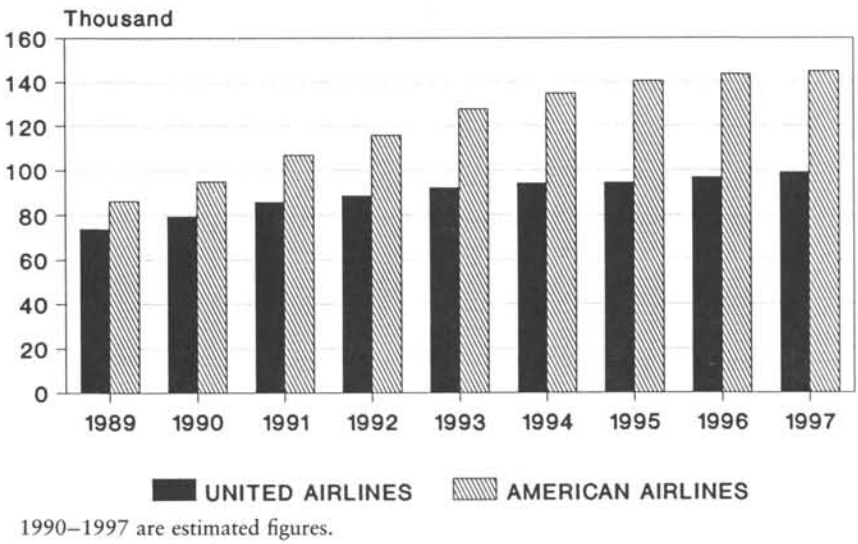
Figure 3.3
Comparison of Eight Airlines, 1980–1988 (in Revenue Passenger Miles)




Pan Am Includes Nat'l Results (1980-88)

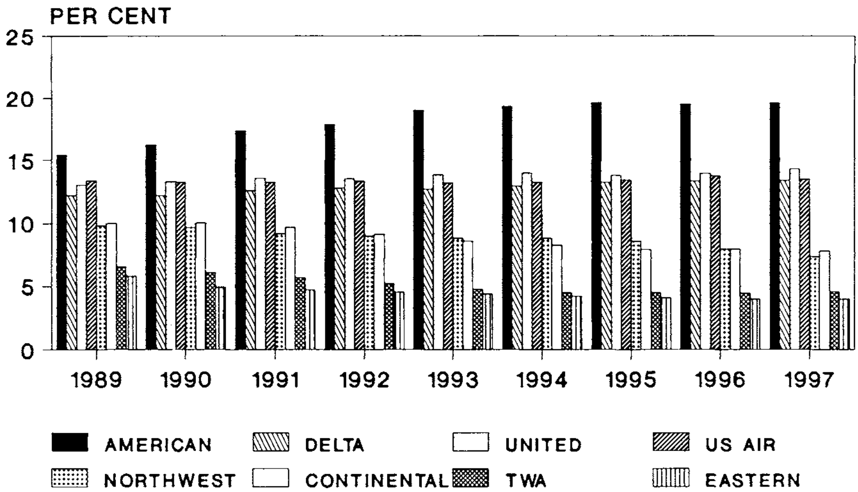
Nashville, and Dallas/Ft. Worth. TWA carried the mail between New York and Los Angeles via St. Louis and Kansas City. Eastern was the only one of the "big four" without a transcontinental route, flying between New York and New Orleans and between Chicago and Miami via Atlanta.[3]

Figure 3.4
United versus American Total Seats




1990–1997 are estimated figures.

Figure 3.5
Airline Comparison—Top 8 No. of Aircraft/Total Aircraft




1990–1997 are estimated figures.

Table 3.3
The World's Largest Airlines, 1988
(in Revenue Passenger Kilometers)

| Rank | Airline | RPKs (000,000) |
|---|---|---|
| 1. | Aeroflot | 213,171 |
| 2. | United | 111,184 |
| 3. | American | 104,216 |
| 4. | Delta | 83,266 |
| 5. | Qantas | 66,223 |
| 6. | Continental | 66,077 |
| 7. | Northwest | 65,728 |
| 8. | British Airways | 58,200 |
| 9. | TWA | 55,998 |
| 10. | Pan Am | 47,273 |

*Source:* AIR TRANSPORT WORLD, June 1989, at 91.

These "big four" airlines were grandfathered in—issued certificates of "public convenience and necessity"—when the Civil Aeronautics Board was created in 1938. These airlines retained their original geographic emphasis during the ensuing decades.

By the time of deregulation in 1978, the big four had become the "big

**Table 3.4**
**U.S. Carrier Market Share at Concentrated Major U.S. Airports (January–June 1989)**

| Airport | Dominant Carrier(s) | % of total passengers |
|---|---|---|
| Atlanta Hartsfield | Delta | 78.6 |
| | Eastern | 12.3 |
| Charlotte Douglas | USAir | 94.1 |
| Chicago O'Hare | United | 49.0 |
| | American | 33.3 |
| Dallas/Fort Worth | American | 63.8 |
| | Delta | 28.5 |
| Denver Stapleton | United | 48.8 |
| | Continental | 36.2 |
| Detroit Metro Wayne | Northwest | 65.3 |
| Houston Intercontinental | Continental | 76.1 |
| Memphis | Northwest | 82.2 |
| Minneapolis/St. Paul | Northwest | 79.3 |
| New York Kennedy | Pan Am | 31.2 |
| | TWA | 31.1 |
| | American | 22.6 |
| Newark | Continental | 50.2 |
| | USAir | 13.9 |
| | United | 10.7 |
| | American | 10.1 |

Table 3.4
Continued

| | | |
|---|---|---|
| Orlando | Delta | 34.4 |
| | USAir | 18.5 |
| Philadelphia | USAir | 47.3 |
| | American | 11.3 |
| | Delta | 10.5 |
| | United | 10.0 |
| Phoenix Sky Harbor | America West | 40.8 |
| | Southwest | 22.3 |
| Pittsburgh | USAir | 88.3 |
| Salt Lake City | Delta | 82.6 |
| San Francisco | United | 37.2 |
| | USAir | 15.9 |
| St. Louis Lambert | TWA | 81.8 |

*Note:* Airports listed are those at which one or two airlines are responsible for more than 50 percent of passengers enplaned. Piedmont's market share data were folded into that of USAir.

five," with Delta entering their ranks, having acquired Central & Southern in 1953 and Northeast Airlines in 1972.[4] Delta flew the mail between Charleston and Dallas/Ft. Worth via Atlanta. The predecessor of Chicago & Southern Airlines (Pacific Seaboard) carried the mail between Chicago and New Orleans while Northeast's predecessor (Boston & Maine) flew the mail in New England.[5]

The smaller airlines too owe their geographic emphasis to the original airmail contracts. Northwest flew the mail between Chicago and Seattle via Minneapolis. The predecessors of Western Air Lines (General Air Lines and Wyoming Air Service, merged in 1944) carried the mail between Los Angeles and Salt Lake City and north and south from Denver. The predecessor of Continental (Varney) flew in Colorado and New Mexico. Braniff had the contract between Dallas/Ft. Worth and Chicago via Kansas City.[6] Note that these airlines, by and large, continued to dominate the geographic regions and cities (today, hubs) for which they originally earned their airmail contracts.

In 1938, when Congress passed the Civil Aeronautics Act, the four largest domestic carriers were American, United, TWA, and Eastern. Another

Table 3.5
Fleets of the Major Airlines (as of January 1, 1990)

| Aircraft | AMR | CON | DEL | EAL | NWA | PAN | TWA | UAL | USA |
|---|---|---|---|---|---|---|---|---|---|
| B767 | 45 | - | 30 | - | - | - | 11 | 19 | 16 |
| B757 | 8 | - | 52 | 24 | 33 | - | - | 5 | - |
| B747 | 2 | 8 | - | - | 44 | 35 | 19 | 34 | - |
| B737 | 11 | 94 | 72 | - | - | - | - | 147 | 217 |
| B727 | 164 | 94 | 129 | 50 | 71 | 89 | 69 | 140 | 44 |
| DC-10 | 59 | 15 | - | 2 | 20 | - | - | 55 | - |
| DC-9 | - | 40 | 36 | 65 | 105 | - | 41 | - | 74 |
| DC-8 | - | - | - | - | - | - | - | 27 | - |
| MD-80 | 180 | 65 | - | - | 8 | - | - | - | 31 |
| MD-82 | - | - | - | - | - | - | 29 | - | - |
| MD-83 | - | - | - | - | - | - | 4 | - | - |
| MD-88 | - | - | 48 | - | - | - | - | - | - |
| L-1011 | - | - | 40 | 14 | - | - | 35 | - | - |
| A320 | - | - | - | - | 6 | - | - | - | - |
| A310 | - | - | - | - | - | 7 | - | - | - |
| A300 | 25 | 12 | - | 18 | - | 24 | - | - | - |
| BAE146 | 6 | - | - | - | - | - | - | - | 21 |
| F28 | - | - | - | - | - | - | - | - | 45 |
| FOKKER100 | - | - | - | - | - | - | - | - | 8 |
| SHORTS360 | - | - | - | - | - | - | - | - | 5 |
| TOTAL | 500 | 328 | 407 | 173 | 287 | 155 | 208 | 427 | 461 |

*Source:* AVIATION DAILY, Jan. 26, 1990, at 188.

U.S. carrier, Pan American World Airways, had no domestic routes but was developing a monopoly in rapidly expanding international markets.[7] By 1972, the 10 largest airlines were United, American, TWA, Delta, Eastern, Western, National, Continental, Braniff, and Northwest.

## Table 3.6
## Major Air Carrier Mergers, Acquisitions, Purchases, and Consolidations since Promulgation of the Airline Deregulation Act of 1978

| | | | Market Share | | | | |
|---|---|---|---|---|---|---|---|
| | | | 1987 | 1988 | 1989 | 1990 | 1991 |
| American | | AMERICAN | 13.8 | 15.2 | 17.8 | 17.5 | 17.0 |
| Air Cal | | | | | | | |
| TWA (London routes) | | | | | | | |
| Eastern (Latin American routes) | | | | | | | |
| United | | UNITED | 16.9 | 16.4 | 16.9 | 17.2 | 16.8 |
| Pan Am (Transpacific, Latin American, & London Routes) | | | | | | | |
| Air Wisconsin | | | | | | | |
| Delta | | DELTA | 12.2 | 12.0 | 14.4 | 13.4 | 13.0 |
| Western | | | | | | | |
| Pan Am (European routes and N.Y. shuttle) | | | | | | | |
| Northwest | | NORTHWEST | 10.3 | 8.9 | 11.1 | 11.7 | 11.5 |
| North Central | Republic | | | | | | |
| Southern | | | | | | | |
| Hughes Airwest | | | | | | | |
| Texas International | | TEXAS AIR* | 19.0 | 19.3 | 12.2 | 12.7 | 8.7 |
| Continental | | | | | | | |
| New York Air | | | | | | | |
| Frontier | People Express | | | | | | |
| Britt | | | | | | | |
| PBA | | | | | | | |
| Braniff (Latin America) | Eastern | | | | | | |
| Rocky Mountain | | | | | | | |
| USAIR | | USAIR | 7.1 | 7.2 | 8.2 | 8.1 | 7.9 |
| PSA | | | | | | | |
| Empire | Piedmont | | | | | | |
| Henson | | | | | | | |
| Midway (Philadelphia gates and Canadian routes) | | | | | | | |
| TWA | | TWA | 8.2 | 7.4 | 8.5 | 7.8 | 7.9 |
| Ozark | | | | | | | |
| Pan Am | | PAN AM | 6.3 | 7.1 | 7.0 | 7.0 | 5.9 |
| National | | | | | | | |
| Ransome | | | | | | | |

Sources: 1987 statistics, *Business Week*, Oct. 5, 1987, at 40.
1988-89 statistics, *Wall Street Journal*, Mar. 10, 1989, at A8.
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1991 statistics (First Ten Months only), *Aviation Daily*, Nov. 26, 1991, at 859.

* Renamed Continental Airline Holdings

In the post-deregulation environment, several characteristics have been identified as critical to survival: (1) hub/spoke route structures; (2) yield (pricing) management; (3) capacity (aircraft) management; (4) low labor costs; (5) computerized reservation system; and (6) ability to take advantage of size.[8] Table 3.1 displays how well the various carriers have fared under deregulation. Note that whereas American, United, and Delta remain strong, TWA and Eastern dropped sharply from the leading pack. And today's "big three"—American, United and Delta—account for more than 50 percent of the domestic market.[9] The metamorphosis of America's largest airlines under deregulation is shown in table 3.1.

One interesting phenomenon emerging after a decade of deregulation is that the "big four" (American, United, Delta, and Northwest) are pulling away from the pack, dominating more than 60 percent of the market (as measured in revenue passenger miles) (figure 3.1). American, Delta, and United are pulling away from the pack in terms of profitability (accounting for nearly 82 percent of the industry's third-quarter 1989 profits, for example).[10] This occurred at a time when three of the original airlines (TWA, Pan Am, and Eastern), with dwindling market shares, were on the endangered species list—candidates for bankruptcy and/or liquidation (Eastern and Pan Am, in fact, expired in 1991). Table 3.2 reveals the market shares of the megacarriers. (See also figures 3.2 to 3.5.)

The combined market share of the eight largest airlines in 1990 was 92 percent and in late 1991, 95 percent, compared with between 80 and 82 percent before deregulation.

Many proponents of deregulation pointed gleefully to the entry of People Express, Air Florida, Midway, and America West. The former four no longer exist, and the combined market share of the latter two was not quite a puny 3.5 percent.[11]

The collapse of the time-space continuum is, of course, the premier contribution of aviation. In a global economic environment, the international picture is necessary for perspective. Compare the above figures with the global data of international airlines, as measured in passenger kilometers traveled (table 3.3). America's airlines still account for seven of the top ten carriers in the world, but their relative share of the international market is slipping.[12]

Another measure of market strength is dominance of the nation's largest airports. Table 3.4 reveals the dominant airlines at the leading airports.

Still another measure of size is the number and type of aircraft in each of the megacarriers' fleets. Table 3.5 depicts the fleet composition and size of the largest airlines.

The next several chapters will take a closer look at the megacarriers that have emerged from deregulation, in alphabetical order. Table 3.6 graphically depicts the mergers that have transpired since deregulation, and the carriers' relative market shares.

## NOTES

1. *Air Transport,* COLLIER'S ENCYCLOPEDIA I, 387 (1985).

2. In February 1934, all airmail contracts were canceled by the government on the grounds that there had been collusion in route awards. The army started flying the mail, but a string of fatal crashes occurred and the airlines regained their mail business, providing that there be complete reorganization of the airlines. The Civil Aeronautics Act of 1938 was eventually passed and later insured such reorganization. See Air Transport, I ENCYCLOPEDIA AMERICANA 402 (1988).

3. R. DAVIES, AIRLINES OF THE UNITED STATES SINCE 1914 168 (1972).

4. *Id.* at 566.

5. *Id.* at 168–69, 604–5.

6. *Id.* at 168–69, 604–5.

7. P. DEMPSEY, LAW & FOREIGN POLICY IN INTERNATIONAL AVIATION 8 (1987).

8. AIRLINE ECONOMICS, INC., AIRLINE CONSOLIDATION 2 (1987).

9. *See An Industry Poised for Expansion,* N.Y. TIMES, February 20, 1990, at C5.

10. *American, Delta, United Account for Most of Industry Profits,* AVIATION DAILY, Jan. 9, 1990, at 57.

11. AVIATION DAILY, Feb. 21, 1990, at 365.

12. *See* DEMPSEY, *supra* note 7, 86–91.

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# 4

# AMERICAN AIRLINES

*Hubs:* Dallas/Ft. Worth, Chicago, Nashville, Raleigh/Durham

*Mini Hubs:* Miami, San Juan, San Jose

*Post-deregulation Merger:* Air Cal (1987)

*Computer Reservations System:* SABRE

*Rank and Market Share:* 1978—second, 12.8%; 1990—first, 17.5%

American Airlines has been described as the most "widely regarded of late as the industry's best managed and most innovative carrier."[1] Headed by tenacious Robert Crandall, American pioneered two-tier wage rates for labor in 1984. This made expansion a lower-cost endeavor, an opportunity on which American capitalized by creating new hubs in Nashville and Raleigh/Durham, San Juan and San Jose, and by expanding geographically into Europe, the Caribbean, and Mexico, as well as buying Eastern's Latin American and TWA's London operations. In just six years, American doubled its payroll, to 67,000 workers (from 42,000 in 1984).[2] Today, about half of its workers earn lower, B-scale wages.[3]

In 1989, American purchased Eastern's Latin American routes for $349 million at the bankruptcy sale (which, ironically, Eastern had bought from bankrupt Braniff for $30 million in 1983).[4] To reach these international destinations, American has 446 aircraft on order or option.[5]

American has not paid dividends since 1982, reinvesting all its profits and throwing labor a bone or two in profit sharing. In 1988, American paid each worker an average of $2,000 in profit sharing.[6] Thus, it has enjoyed meteoric growth, in 1990 surpassing United as the nation's largest airline.

American was also an innovator in computer reservations systems. Its

SABRE system is dangerously successful, hooked up to more than 50,000 locations. American earns a 20 percent return on SABRE operations, far more than it earns on its airline services.[7] American also inaugurated frequent-flyer programs.[8] Let us explore American's long and proud history, beginning in the 1920s.

On March 1, 1929, "The Aviation Corporation (Avco)" was established.[9] Avco acquired five airlines, three of which were holding companies themselves, controlling eleven individual carriers. To these eleven, Avco added two independent airlines: Embry-Riddle[10] and the fast-growing Colonial Airways Corporation, which then added another holding company and three more airlines to the roster. The biggest acquisition and the third independent airline was Universal Air Lines System, a combination of six airlines.[11]

Next, Avco acquired a third holding company in the South: Southern Air Transport, which was a combination of two airlines, Gulf and Texas Air Transport. The Avco network was extended even further when the holding company bought out Interstate Airlines, which possessed another prime mail route.[12] By the end of 1929, Avco had acquired thirteen airlines, eleven mail contracts, a fleet consisting of virtually every type of civil aircraft available, and an impressive route system, which lacked a cohesive structure.[13]

Avco's first president was Graham Grosvenor. Since starting its acquisition spree, Avco had lost $1.4 million, which was massive red ink in those depression-plagued days. Avco's board of directors then decided to consolidate all of Avco's domestic airline holdings into a new subsidiary corporation.[14] The Avco board elected a new president, Frederic G. Coburn, who was expected to straighten out the mess and bring order to the chaotic 9,100-mile system. Coburn became president of both Avco and the airline on January 25, 1930, and on that date, American Airways, Inc., came into existence.[15]

In the first three years of American's existence, Coburn brought some order out of the chaos by trimming Avco's 80 subsidiaries down to 20 and cutting operating losses from $3.4 million in 1930 to $1 million in 1931. Still, Coburn failed to centralize control of American's operations.[16]

Postmaster Brown felt that the existing 44 airlines were too many. He therefore persuaded Congress to promulgate the McNary–Watres Act in 1930, which eliminated the smaller airlines from the market.[17] Brown also summoned the heads of the large airlines to Washington for the "Spoils Conference." Brown's main thrust at the conference was for three transcontinental routes. American Airways won the southern route, which collided with the routes of Southwest Air Fast Express (SAFE).[18] After a lot of haggling, SAFE sold out to American.[19]

In 1932, unable to stem the flow of red ink or bring unity to the airline's four divisions, Coburn resigned. Lamotte T. Cohu succeeded Coburn as American Airway's president.[20]

Cohu lasted for only nine months, but while president, he was able to consolidate American Airways' four unwieldy divisions into two: Southern and Eastern. The Southern headquarters was in Fort Worth, and the Eastern headquarters was in New York. Under this arrangement, C. R. Smith headed the Southern Division but also commanded both, as vice president of operations based in St. Louis.[21]

After a proxy fight, Errett Lobban Cord became the new chairman of the board, and Avco became a subsidiary of the Cord Corporation.[22] Cord proceeded to chop heads in the company. Cohu was the first to go, and others followed. Eddie Rickenbacker left voluntarily.[23] Lester D. Seymour became the new president of American Airways.[24]

American still lacked a direct New York–Chicago route. American's purchase of Transamerican, with it strong Chicago-Detroit-Cleveland-Buffalo service, was the first step in closing the New York–Chicago gap. The next was the acquisition of Martz Airlines, the possessor of a passenger route from Newark and Buffalo. In 1932, the Chicago–New York route was complete. American no longer had to fly north to Albany and then west to serve Chicago, competing hopelessly against United's and TWA's more direct routing.[25]

In 1934, the hearings involving Postmaster Brown's award of American's southern transcontinental route came under close scrutiny. Brown's defense was that the mail contract awards were merely a means of developing the passenger traffic, which only the larger, more experienced airlines could accomplish.[26]

The domestic airmail contracts were cancelled on February 19, 1934.[27] Theoretically, American had the most to lose from the cancellation, since it operated more airmail mileage than anyone else. Cord kept American from protesting, since he foresaw the blunders the army would make when it took over the airmail routes.[28] Stripped of their mail revenues, the airlines were forced to furlough hundreds of employees, mostly pilots, and American was no exception. American alone was running about $300,000 per month in the red.[29]

The Air Mail Act of 1934 set new standards for the newly opened bids for the airmail routes.[30] During this time, American Airways was incorporated as American Airlines, and American bid for the same routes it had held before.[31] American was awarded its old routes with a few modifications.[32] Cord was now looking ahead to a bright future for passenger traffic.[33] C. R. Smith was formally elected president of American Airlines in 1934.[34]

Smith's master plan was to develop passenger traffic through safety, marketing, customer service, and equipment innovations. Safety and reliability of aircraft would be the thrust of his marketing plan, since the fear of flying was predominant among the public in the 1930s.[35]

By the end of 1936, American had 20 DC-3s in operation.[36] United had only 10 DC-3s, and TWA was still waiting for the first of 8 to be delivered.[37] The impact of the DC-3 can best be measured by the number of people who began flying them. In 1936 alone, the U.S. airlines, for the first time in history, carried more than a million passengers, double the 1934 total, and the traffic curve was to point steadily upward for decades. In 1939, the airlines flew 42.2 percent more people than in the previous year, a staggering rate of growth that had to be credited almost solely to the DC-3, which by then was carrying 90 percent of the nation's air traffic.[38] The DC-3 freed the airlines from complete dependency on government mail pay. It was the first airplane that could make money by just handling passengers.[39]

In 1939, C. R. Smith decided to move American's headquarters to New York, where the nation's most modern airport was being built, LaGuardia Field.[40] On July 5, 1945, the CAB simultaneously approved American's control of American Export Airlines (AEA) and granted the merged carrier the routes across the North Atlantic to the United Kingdom, Scandinavia, the Netherlands, and Germany.[41] In 1950, after observing the handicaps of AEA and its detriment to American, American sold AEA to Pan American.[42] With the jet age looming over the horizon, American bought 58 piston-driven DC-7s.[43] The DC-7s would serve American for only 10 years.[44]

The Air Line Pilots Association's (ALPA) 1958–59 strike was symptomatic of airline unions' growing strength, accompanied by increasing militancy. There were 10 strikes in the industry in 1958 alone. Labor was trying to solidify its position in anticipation of the expected jet-age travel boom. Over the next five years there would be 25 airline shutdowns by various unions, with some carriers hit more than once.[45]

In anticipation of further labor problems and also knowing that the industry could not afford crippling strikes or equally crippling settlements, C. R. Smith developed a Mutual Aid Pact, which was signed by virtually every scheduled carrier in the United States. The Mutual Aid Pact was an agreement that would come into effect during labor strikes; the airlines benefiting from a competitor's strike would turn those strike-generated extra revenues over to the shutdown carrier. The pact did not stop strikes, but it eased the financial pains of an affected airline and increased management's bargaining power. The pact was repealed with the promulgation of the Airline Deregulation Act of 1978.[46]

American began transcontinental jet service between New York and Los Angeles on January 25, 1959.[47] But in 1961, American lost its rank as the nation's largest airline as United absorbed Capital in what was then the biggest merger in U.S. airline history.[48]

In 1959, American took the lead in the airline industry in another area when it and IBM announced the development of a Semi-Automated Business Reservations Environment (SABRE). Until the 1970s, SABRE's unduplicated efficiency was a major weapon against United's size.[49]

In the mid-1960s, the airline industry suffered from an overcapacity problem due to the enormous influx of larger aircraft.[50] American initiated reduced-fare plans to fill its aircrafts' empty seats to solve the capacity problem.[51]

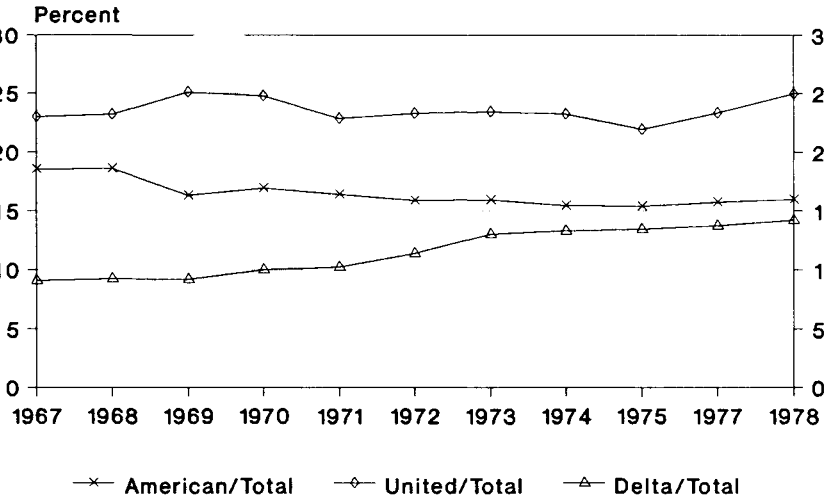
Between June 3 and October 30, 1970, there were 10 separate contacts between officials of American and Western Airlines over a possible merger between the two companies.[52] Before the American/Western merger agreement was signed, American had acquired Trans-Caribbean Airlines (TCA). The TCA merger was submitted to the CAB in January 1970 and was approved the following December.[53] The unions, along with Continental, United, the Justice Department's antitrust division, and the CAB's Bureau of Operating Rights, strongly opposed the American/Western merger.[54] The CAB rejected the merger on July 28, 1972, and President Richard Nixon upheld the decision.[55]

Several of American's officers were charged with taking illegal kickbacks in the early 1970s, which eventually cost them their jobs and seriously hurt the airline's image.[56] As a result, employee morale sank even further. The average employee was getting the impression that many officials had been stealing large amounts of company funds. They had seen fellow workers furloughed, labor relations deteriorate, a succession of mistakes made by management, a highly touted merger go down the drain, millions spent on new planes with consistently empty seats, and international routes with no traffic potential expensively promoted. The employees reacted with indifference, sloppy performance, and a poor attitude. Management had lost their respect, and they had lost their pride. By January 1973, service had seriously deteriorated and was further damaged by labor troubles. Hundreds of flights in late December had been cancelled by a combination of weather and pilots' deliberate slowdowns over dragging contract negotiations.[57] The pilots' subtle sabotage tactics were a reaction to President George Spater's indecision and his inability to communicate.[58]

American's image as a professionally run carrier had been badly damaged. And the causes went far beyond the excuses of recession and overcapacity. In trying to cut costs, American had indiscriminately cut into its greatest strength, customer service.[59]

In 1973, Spater lured Bob Crandall away from his position as senior vice president and treasurer of Bloomingdale's to the post of American's senior vice president of finance. Crandall was joining an airline in serious trouble. Spater remained optimistic, until he assumed full responsibility for a possible illegal contribution to President Nixon's reelection campaign in violation of campaign-financing laws. His admission was still another blow to the airline's morale, and it spelled the end of his career at American.[60]

Figure 4.1
Top Three Airline Comparison 1967–1978 (in Revenue Passenger Miles)



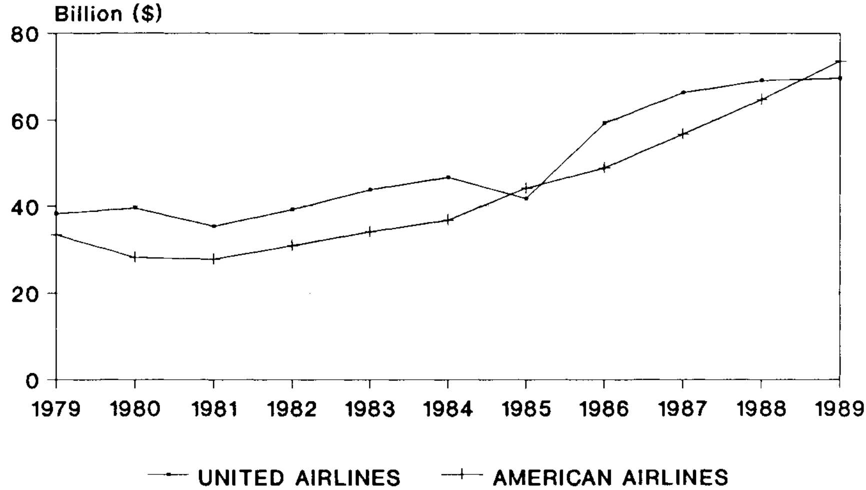

C. R. Smith was Spater's temporary successor. In the late 1960s, Smith had left American to be secretary of commerce under President Lyndon Johnson, and he had turned over American to George Spater.[61] Now Smith was back to help American Airlines clean up its mess. Smith served American for only six months, as he had promised, but he accomplished what the directors wanted. Smith helped improve the morale among American's employees, which glued the airline back together and made the company a more viable enterprise for the man who would succeed him.[62]

Albert Vincent Casey became Smith's successor on February 20, 1974. Casey did not find the airline in as sorry a state as he had expected. Smith already had started the turnaround with cost-cutting moves, including the furloughing of some 1,300 employees and the dumping of the South Pacific albatross. Furthermore, the airline had a healthy positive cash flow from equipment depreciation while capital spending had been light since 1972.[63]

In 1976, American began to establish SABRE's data-processing capabilities among travel agents. SABRE would eventually serve more than 10,000 travel agents and corporate travel departments, or 41 percent of computerized travel agencies, compared with United's 39 percent.[64]

The financial pendulum began to swing back in 1976. Profits that year hit $76.3 million and jumped to nearly $81 million the following year, reaching $134.4 million in 1978, a record figure despite a $101-million hike in fuel costs. Part of the comeback in the mid-1970s was due to Crandall's innovative marketing schemes, such as the famous Super Saver fares

Figure 4.2
United vs. American, 1979–1989 (Revenue Passenger Miles)




program. Super Saver was a device used to discount fares without diverting traffic from regular fares by giving discounts to passengers who purchased tickets well in advance and stayed at their destinations at least 14 days.[65] But throughout the decade, American remained second to United. (See figure 4.1.)

In 1978, Casey announced that American's general offices were moving

Figure 4.3
United vs. American, 1979–1989 (Available Seat Miles)

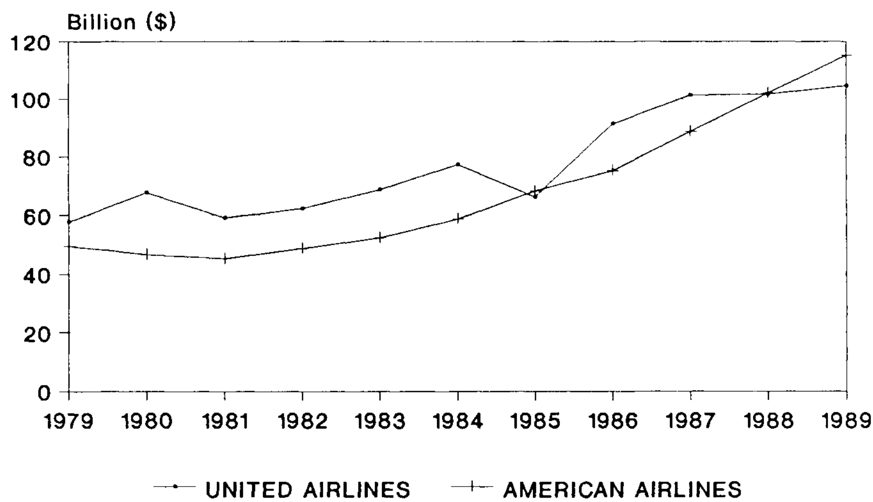
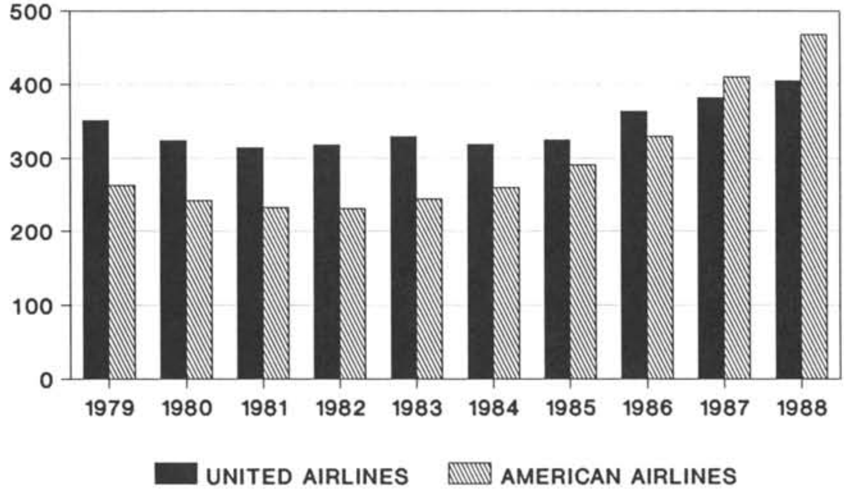


**Figure 4.4**
**United vs. American, 1979–1988 (Total Aircraft Fleet)**




from New York to Dallas/Ft. Worth, Texas. The move took place in the summer of 1979.[66]

Congress passed the Airline Deregulation Act in 1978. Virtually overnight, the established carriers were playing a different ball game under different rules, with an invasion of key markets by new low-cost airlines, an epidemic of cutthroat fare wars, and the end of the industry's traditional way of life. To meet this challenge, Chairman Al Casey picked a new leader, Robert Lloyd Crandall.[67] Crandall became president of American on July 16, 1980.[68]

At the time of deregulation, American faced soaring fuel prices, a fleet almost 10 years old on average, and expensive contractual commitments to its unions. The only bright spot on the horizon was the 1978 order for 30 fuel-efficient Boeing 767s.[69] In 1980, American put its entire 707 fleet up for sale, withdrew from a number of unprofitable routes in the northeast, focused its operations on the Dallas/Ft. Worth hub, and reconfigured all aircraft to provide more seats.[70]

Crandall directed American back to the industry leadership through innovative programs such as A-Advantage, Super Saver, Ultimate Super Saver, and a two-tier wage structure.[71] Crandall also had his mind on buying new planes. So American worked out a lease deal with McDonnell-Douglas for the new MD Super 80s, introducing the Super 80 into service in May 1983.[72] American took its B-747s out of passenger service, and Crandall sold the B-747 freighters and traded the remaining passenger B-747s to Pan Am in exchange for an equal number of DC-10s.[73]

Casey retired in February 1985, with Crandall becoming chairman, chief executive officer, and president of American Airlines.[74] Crandall turned American into the nation's most formidable airline.

As the 1990s began, American appeared poised to expand rapidly, particularly into international markets. It inaugurated service to Australia. It purchased Eastern's Latin American routes and Miami-London and Miami-Madrid authority and TWA's Chicago-London route. It was building its Miami hub to 100 flights a day. It was seeking authority to Japan and from Chicago to Milan and Rome.[75] And it bought TWA's primary routes to London's Heathrow Airport. Under Robert Crandall, American began to pull ahead of United, as shown in figures 4.2 through 4.4.

## NOTES

1. S. Davis, Delta Air Lines: Debunking the Myth 26 (1988).
2. Woodbury, *How the New No. 1 Got There,* Time, May 15, 1989, at 57.
3. Salpukas, *Steve Wolf's Big Test,* N.Y Times, Jan. 8, 1989, at 24.
4. P. Dempsey, Law & Foreign Policy in International Aviation 88 (1987).
5. Salpukas, *Airlines' Big Gamble on Expansion,* N.Y. Times, Feb. 20, 1990, at C1, C5.
6. Woodbury, *supra* note 2.
7. S. Davis, *supra* note 1, at 46, 49.
8. Hayes, *American Joins the Low-Cost Ranks,* N.Y. Times, Dec. 8, 1985, at 8F.
9. R. Serling, Eagle: The Story of American Airlines 11 (1985).
10. The prospect of commercial aviation as a potentially viable enterprise attracted investors such as the Embry-Riddle Company of Cincinnati, which had just won a contract to fly the mail between Cincinnati and Chicago. Embry-Riddle was founded by John Paul Riddle and T. Higbee Embry in 1925. Embry, a businessman, provided most of the capital, and Riddle was a pilot. *Id.* at 10.
11. *Id.* at 12–13.
12. *Id.* at 15.
13. *Id.* at 15. The largest and most critical gap in Avco's route system was the lack of a Chicago–New York link.
14. *Id.* at 16.
15. *Id.* at 16.
16. *Id.* at 17.
17. *Id.* at 32.
18. *Id.* at 33.
19. *Id.* at 34.
20. *Id.* at 37.
21. *Id.* at 39, 45.
22. *Id.* at 44.

23. *Id.* at 44.
24. *Id.* at 53.
25. *Id.* at 53.
26. *Id.* at 65.
27. *Id.* at 67.
28. *Id.* at 68.
29. *Id.* at 69.
30. *Id.* at 69.
31. *Id.* at 70–71.
32. *Id.* at 71.
33. *Id.* at 72.
34. *Id.* at 73. Avco today is one of America's best-run diversified conglomerates; its roots to American withered away until only dusty files of the past remain. *Id.* at 79.
35. *Id.* at 81–82.
36. C. R. Smith placed an order with Douglas for a greatly modified DC-2, which, when built, was the Douglas Sleeper Transport (DST) for the night traveler and the DC-3 for the daytime model, the most famous single airplane in the history of commercial aviation. The DC-3s were called "Flagships," which was to become an American Airlines trademark for years to come. *Id.* at 89–91. The DC-3 era began June 25, 1936. *Id.* at 101.
37. *Id.* at 110.
38. *Id.* at 109.
39. It cost American more per mile to operate the DC-3 than the DC-2, but the DC-3's additional seven seats made up the difference. Eventually, American would be operating an all-DC-3 fleet of 94 aircraft, but it was the first 20 that made aviation history. The DC-3s also made possible American's first employee bonus, which American gave to its 2,000 employees in late December 1938. *Id.* at 110.
40. *Id.* at 131, 133. By 1940, the airline was carrying 32 percent of the nation's air traffic in the industry's largest fleet, with 64 DC-3s and 15 DSTs. C. R. Smith went off to the war as an army colonel and left Ralph Damon to run the airline while he was gone. *Id.* at 164. By 1944, American was the second-largest international air carrier in the world; its ATC operations were topped only by Pan American. *Id.* at 179. Those who returned after the war found American Airlines far bigger. American was operating 93 DC-3s, and personnel had nearly tripled since 1940, from slightly over 4,000 to 11,450. The increase in American's fleet size stemmed from aircraft the military had turned back to the airlines as Douglas assembly lines spewed out some 10,000 C-47s specifically designed for military cargo work. American started getting planes back in the summer of 1944 and discovered that they had to almost completely rebuild. *Id.* at 183.
41. DEMPSEY, *supra* note 4, at 19. The price tag for the deal was $3 million, with American obtaining 51.4 percent control via stock purchases. With AEA's C-54s converted to DC-4 Flagships, American became a full-fledged international carrier operating AEA as a separate subsidiary under a new name: American Overseas Airlines. R. SERLING, *supra* note 9, at 188–89.
42. *Id.* at 225–26.
43. The first Boeing 707s rolled off the assembly line in 1954. *Id.* at 254.
44. *Id.* at 261.

45. *Id.* at 305.
46. *Id.* at 305.
47. *Id.* at 306.
48. *Id.* at 333.
49. *Id.* at 347–48.
50. With the arrival of the Boeing 747 in 1970, the airlines suffered their worst overcapacity problem in the industry's history. American's gimmick of a piano bar on its 747s helped alleviate the overcapacity problem until passenger traffic started an upswing. *Id.* at 402. The DC-10 went into service the first week in August 1971, between Chicago and Los Angeles. The DC-10, whose capacity fell somewhere between that of the 707 and the 747, was vindicated in just this one key market where American was competing with TWA, United, and Continental. The 707 had been too small and the 747 too large. The DC-10 was just right. *Id.* at 404.
51. *Id.* at 368–69.
52. *Id.* at 399.
53. *Id.* at 399.
54. *Id.* at 400–401.
55. *Id.* at 401.
56. *Id.* at 405.
57. *Id.* at 412–13.
58. *Id.* at 413.
59. *Id.* at 413–14.
60. Spater resigned on September 18, 1973. *Id.* at 415.
61. *Id.* at 416–18.
62. *Id.* at 418.
63. *Id.* at 439–41.
64. *Id.* at 443–44. Also in 1976, Casey thought of the twice-tried merger route with Pan Am, after a $20-million loss in 1975. *Id.* at 445.
65. *Id.* at 446.
66. *Id.* at 453.
67. *Id.* at 454.
68. *Id.* at 455.
69. *Id.* at 455.
70. *Id.* at 457.
71. *Id.* at 459–60.
72. *Id.* at 463.
73. *Id.* at 465.
74. *Id.* at 466.
75. *American Positions Itself for the Nineties*, AVIATION DAILY, Feb. 7, 1990, at 263.

# 5

# CONTINENTAL AIRLINES

*Hubs:* Houston, Denver, Newark, Cleveland

*Post-deregulation Mergers:* Texas International (1988), People Express (1988), Frontier (1988), and New York Air (1988)

*Computer Reservations System:* System One, owned by Texas Air (renamed Continental Airline Holdings)

*Rank and Market Share:* 1978—seventh, 3.8%; 1990—fifth, 8.8%

## CONTINENTAL AIRLINES CORPORATE CULTURE

Continental Airlines, a Texas Air subsidiary, is a blend of companies and a blend of cultures. Before Frank Lorenzo consumed it, Continental was the "Proud Bird with the Golden Tail"—the premium-service long-haul carrier formed by its flamboyant chairman, Robert Six, with a route structure focused on the western United States. It had an excellent reputation among business travelers. Chivas Regal was served in economy class.[1]

With the mergers of the 1980s, Continental is today a low-cost, low-service blend of one national airline (Continental), two former local-service carriers (Texas International and Frontier), and two post-deregulation upstart airlines (People Express and New York Air). Texas International was Frank Lorenzo's first airline, acquired in 1972. Its operations focused on Dallas, then Houston. New York Air was Lorenzo's creation in the early 1980s, a nonunion airline flying in the northeastern United States.[2]

All of these disparate cultures were rammed together on February 1, 1987, under the Continental banner. It came as no surprise that Continental became difficult to manage, with hundreds of flights cancelled, thousands of passengers stranded, and a mountain of luggage warehoused. The reasons for factionalization and deteriorating service in the merged airline were obvious:

The mergers have thrown together young, enthusiastic employees and jaded veterans of a bitter strike that lasted through Continental's three year reorganization under the bankruptcy laws. The labor force includes former Frontier Airlines employees, who have filed suit after being forced to the bottom of company seniority lists, and former People Express employees, whose almost fanatical devotion to their chairman, the imaginative Donald Burr, was lost when he resigned from Texas Air.[3]

But let us go back in time and observe an earlier, prouder Continental.

## CONTINENTAL'S PROUD TRADITION

Robert Six was the man who built Continental Airlines into the prestigious airline of the West. A high school dropout, as a young man Six was fired by Pacific Gas & Electric for learning to fly on company time and was expelled from the United Airlines school for pilots for using company mechanics to prepare his plane for weekend races.[4]

In 1936, Six borrowed $90,000 from his father-in-law to purchase 40% of Varney Air Transport, a small western airline headquartered in El Paso and serving six cities (Denver, Colorado Springs, Pueblo, Santa Fe, Albuquerque, and El Paso).[5] By 1938, Six was president of Varney, had moved the corporate headquarters to Denver, and had changed its name to Continental Airlines.[6] Continental then had 29 employees and six aircraft, served 624 route miles, and had carried 2,316 passengers more than 1.1 million miles without accident or fatality.[7]

Six was Continental Airlines. He built it, he ran it, he dominated it. He had a fiery temper. But he ran it hands on—in the early years more like a family business than a large corporation.[8] Throughout, he remained loyal to Continental, rebuffing offers to leave and head TWA in the 1940s and in the 1960s.[9]

Continental grew robustly until World War II, when the War Department appropriated 50 percent of the airline's fleet for military service.[10] Six himself entered the war as a U.S. Army air corps captain in 1942.[11]

After the war, Six modernized Continental's fleet, expanded the route system, and hired more employees. Through interchange agreements with other airlines, Continental expanded into Houston, Los Angeles, and St. Louis.[12] In 1954, Continental merged with Pioneer Air Lines, giving the combined company access to 46 cities in six states.[13]

Although Continental lost money in 1958 (the first losses in 17 years),[14] by 1960 it had introduced Boeing 707s into its fleet and enjoyed the highest daily jet utilization in the world, the lowest operating costs, and the lowest break-even load factor.[15] By 1962, Continental had flown 10.5 million passengers more than 6 billion passenger miles without a fatality. But in that year, a 707 came apart over Missouri during a heavy storm (an accident later determined to be the work of sabotage).[16] Also that year, Six moved the corporation's headquarters from Denver to Los Angeles.[17]

In 1964, Continental expanded into the transpacific market, gaining access to Hawaii, Guam, the Philippines, Japan, Taiwan, Korea, Okinawa, South Vietnam, and Thailand.[18] In the 1960s, Continental enjoyed record profitability.

The relationship between management and labor remained healthy until 1976, when the pilots struck.[19] Six shut Continental down for 26 days before submitting to most of the union's demands.[20] Despite these difficulties, Continental employees generally enjoyed a sense of community with the company, with employee tenure rivaling that of a Japanese corporation.[21]

With the advent of deregulation in 1978, Continental had the fourth-strongest balance sheet of all major carriers.[22] But it needed to restructure its routes around hubs, since feed traffic from other airlines would dry up. Moreover, it was crippled in 1979 when the FAA ordered all DC-10s grounded for 38 days after an American Airlines crash in Chicago, when an engine fell off the plane. DC-10s accounted for 42 percent of Continental's capacity.[23] And fuel prices were escalating.

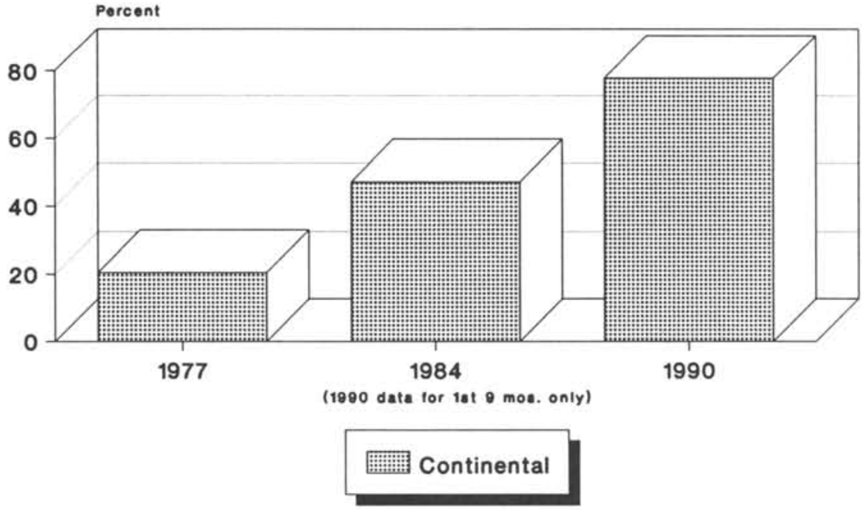
## FRANK LORENZO ACQUIRES CONTINENTAL

As Continental entered the Brave New World of deregulation, Six passed the reigns of power to Alvin L. Feldman, an engineer who formerly, and successfully, headed Frontier.[24] Feldman began a dual-hub system, radiating primarily from Denver and secondarily from Houston (see figure 5.1).[25] But Continental's widebodied aircraft were ill suited for short hauls, and the company needed to merge with another carrier. It attempted to merge with Western Air Lines twice, the first try denied by the CAB and the second scuttled by an 18-month dispute with the flight attendants.[26]

While the second merger attempt with Western was pending, Frank Lorenzo began buying Continental's stock. After acquiring 48.5 percent, Lorenzo made a tender offer to Continental. Feldman tried several maneuvers to keep Continental free of Lorenzo, including an employee stock-ownership plan (ESOP) allowing Continental's employees to buy controlling interest in the airline.[27] Feldman insisted that the combination would simply not work. He told Lorenzo:

> [Although you won 48.5% of Continental's stock, we] cannot accept a proposal that is not fair to our remaining public shareholders. Any merger must be fair as well to our employees. Continental's employees have borne the largest burden in building our great airline and must not be treated as pawns in a financial transaction. Finally, we cannot accept a proposal that will result in a company so weak that it cannot survive and prosper in today's environment. . . . As I understand

**Figure 5.1**
**Airline Market Share at Houston**




*Sources:* AVIATION DAILY, Apr. 19, 1985, at 28; Feb. 1, 1990, at 230; Apr. 29, 1990, at 628; Mar. 29, 1991, at 590; and CONSUMER REPORTS.

your proposal, you intend to effect the consolidation of the two airlines through a two-step transaction. In the first step, you would pass the 48.5% of Continental's stock now owned by Texas International up to Texas International's parent, Texas Air Corporation, while leaving the cost of that stock an obligation on the books of Texas International. The result of that first step is to reduce your equity in Texas International by about $93 million. Since Texas International has a present net worth of only $53 million, that would leave Texas International with a negative shareholders equity of $40 million.

In the second step of the transaction, Texas International and Continental would be merged into a new company in which you expect to receive 56% of the common stock—in exchange for Texas International's negative net worth and your minority position in Continental—while Continental's public shareholders would be diluted from their present majority position to 44% of the common stock, plus shares of a non-voting preferred. In effect, the new company would end up paying off the debt Texas International incurred to buy its Continental stock.

Your proposal hardly seems fair. But, more important, the resulting company would be very weak. I believe its chances for survival would be poor. Even before it purchased Continental's stock, Texas International was a highly leveraged company with $183 million in debt and only $53 million in equity. When you add to Texas International the burden of the additional borrowings you made to purchase the Continental stock, the situation becomes almost intolerable. The combined company would have long term obligations of $642 million, and equity of only $142 million. This results in an 82:18 debt to equity ratio, which is worse than

Braniff Airways at the end of 1979. More importantly, the debt service coverage requirement, including the dividend on the preferred stock you propose, approaches $150 million annually. The operating profit required to service this debt is more than our two companies together have ever earned.[28]

But Lorenzo was not to be stopped by Feldman's pleas or his eleventh-hour ESOP maneuver, and Continental was soon his. Feldman died from a bullet to the head, a suicide. But Feldman's prophecy was soon true—within two years, Lorenzo had led ailing Continental into bankruptcy. A labor impasse led the machinists to strike on August 13, 1983. On September 24, Lorenzo put Continental into bankruptcy.

Continental's soul was crushed when the unions' backs were broken as Lorenzo waltzed the company through Chapter 11 bankruptcy and shed himself of union contracts. Frontier had been known as a polished little airline serving the Rocky Mountain region with sharp service and a splendid safety record. Its soul too collapsed when People Express put the company in bankruptcy in 1986, after which both Frontier and People Express were consumed by Texas Air and folded into Continental.

## FRONTIER AIRLINES

Frontier began service in 1946 as Monarch Airlines. Merging with Arizona Airways and Challenger Airlines in 1950, the newly named Frontier Airlines provided regional service with DC-3 aircraft in several western states. In 1962, Maytag sold its 67 percent interest in Frontier to Goldfield Corporation of San Francisco, a mining firm. In 1965, controlling interest was sold to RKO General, Inc., a subsidiary of General Tire and Rubber Company.[29] After its merger with Fort Worth's Central Airlines in 1967, Frontier covered 7,465 miles of routes in 14 states (the fourth-largest route system in the nation, after United, Eastern, and Delta).[30] By the mid-1970s, Frontier served more cities than any other airline.[31]

As deregulation dawned with the Airline Deregulation Act of 1978, Frontier was one of the few airlines that had a hub-and-spoke system (radiating from Denver's Stapleton International Airport), serving 89 cities in 20 states as well as Mexico and Canada. Between 1978 and 1982, Frontier restructured its route system, discontinuing service to 39 cities, adding 29 others, increasing frequencies, and expanding operations at Denver.[32] In 1979, under the leadership of Alvin Feldman, Frontier enjoyed record profitability and the second-lowest complaint rate of any airline (behind Delta).[33] In 1980, Feldman left to head Continental, and Glen Ryland became Frontier's CEO.[34]

Frontier was a technical leader, one of the earliest users of Boeing 727 and 737 aircraft and one of the first airlines to use a computer reservations system to handle its passengers.[35] For the 10-year period preceding 1982, Frontier enjoyed consistent profitability each and every quarter, with profits totaling $163 million.[36]

In the summer of 1982, Frontier offered 38 nonstop flights from Denver, compared with United's 24 and Continental's 16.[37] But that year United launched a campaign to dominate Denver's Stapleton Airport by increasing its flights by a third and invading many of Frontier's markets. Moreover, seven new carriers had come to Denver since deregulation, including American, Eastern, Northwest, Piedmont, and Southwest.[38] The recession of 1982 also hit the airline industry, and Frontier, hard. That year, the industry suffered the worst losses in its history.

Denver's Stapleton International Airport was the only airport in the nation with three carriers competing for hub dominance. By 1983, Denver was the most overserved market in the nation.[39] That year, United (which had dumped 100,000 seats per week into Denver since deregulation) had 40.8 percent of the market at Stapleton; Frontier had overtaken Continental for second place at 24.3 percent; and Continental was third at 18.5 percent.[40] United had 27 gates and 174 departures at Stapleton; Frontier had 51 gates and 138 daily departures.[41]

United, the nation's largest airline, was determined to dominate Denver. With a deep pocket that could cross-subsidize losses in competitive markets, a powerful computer reservations system that could discriminate against competitors, and an attractive frequent-flyer program that could lure business travelers (the most lucrative segment of the passenger market), United, the nation's largest airline, began to turn up the heat on Frontier. In September 1983, Continental entered the domain of Chapter 11 reorganization bankruptcy, allowing it to shed itself of its union contracts and emerge as a low-cost cut-rate airline. It too joined the Darwinian struggle for dominance.

Thus on the one side Frontier was squeezed by an 800-pound gorilla, United, and on the other by the new low-cost Continental. In 1983, Frontier suffered its first annual loss since 1971.[42] Frontier's employees agreed to substantial pay cuts in 1983 and 1984 to help the company restore profitability.[43]

Average fares in 1984 of $127.24 at Denver were among the lowest in the country (significantly lower than at the rival hubs of Chicago, Dallas, Detroit, Houston, New York, San Francisco, St. Louis, or Washington, for example). The averages then fell 8.3 percent in 1985 and another 4.6 percent in 1986.[44] Denver's consumers enjoyed the lowest air fares of all major markets, but the squeeze was on Frontier.

Although only 69 percent of Frontier's nonstop seat miles faced a competitor before deregulation, by 1984 more than half its seat miles had two or more competitors.[45] Frontier tried several attempts to avoid erosion of its market, including establishing an alter-ego airline, Frontier Horizon. In early 1985, Frontier launched this small nonunion carrier flying seven 727s on long-hauls out of Denver.[46]

Frontier was doing a lot of things right. Its load factors surpassed industry averages.[47] It had a history of lawful and safe compliance. Based on the number of takeoffs and landings, Frontier had the best safety record in the history of domestic aviation. Frontier's compliance with regulatory obligations was ranked "outstanding" by the CAB (in contrast to the "unacceptable" ranking of People Express).[48] It had exceptional labor-management relations, never having lost a day of service due to a strike.

But with the strain placed on Frontier's balance sheet by United and Continental, its principal owner, RKO General (which owned 45 percent of Frontier), concluded that it had two options—liquidation or sale. Frontier's President, Hank Lund, attributed the company's problems to competing "head to head against larger airlines with greater resources and new, or reorganized carriers with low cost structures."[49] It was a squeeze play by United and Continental. In early 1985, Frontier sold Frontier Horizon Airlines to Skybus and sold five MD-80 aircraft to United for $95 million.[50]

But labor was eager to own the company if RKO General wanted out. Preliminary discussions between management and labor in late 1984 and early 1985 led to a series of transactions in which some assets would be sold to make Frontier debt-free so that an ESOP could be consummated. In May 1985, Frontier sold 25 of its 51 Boeing 737-200 aircraft to United for $265 million.[51] The money was used to pay down about $92 million in long-term bank debt.[52] United leased 15 of these planes back to Frontier.[53] Frontier's assets were being cannibalized, and United was enjoying the feast. As Frontier delivered planes to United, it dropped service to several cities.[54]

The Frontier board of directors formally approved an ESOP in July 1985 (allowing Frontier's 4,750 employees to buy the company for $220.4 million, or $17 a share, with significant labor concessions).[55] But the employees were subsequently outbid, first by Frank Lorenzo's Texas Air (at $250 million, or $20 a share) and then by Donald Burr's People Express (for $307 million, or $24 a share, with a proviso that the concessions surrendered by labor for the proposed ESOP remain in effect).[56]

Continental's interest was predicated on "forestall[ing] tougher competition from a lower-cost Frontier operating under labor concessions" and significantly expanding Continental's presence at Denver.[57] Continental and Frontier together had 245 flights out of Denver, compared with United's 165.[58] Continental and Frontier together had 46 gates at Denver's Stapleton Airport, compared with United's 21.[59] The two had overlapping service to 17 cities, and Frontier served 36 cities that Continental did not.[60] Nationally, the combined carriers would have flown 2.2 billion revenue miles, compared with Northwest's 2.5 billion and Delta's 2.7 billion.[61]

But labor was willing to concede the wage reductions demanded by People Express in order to avoid being clutched by the union-busting Lorenzo.[62] In exchange, People Express made the following agreement with Frontier's employees:

1. Except for circumstances outside the control of the company, Frontier employees would be protected from furlough until August 1, 1989;
2. Frontier would not be merged or consolidated with another airline until at least February 1, 1990;
3. Frontier would not dispose of assets in excess of $25 million total and asset sales must be at fair market value;
4. People Express would make available to Frontier sufficient working capital to operate the company; and
5. People Express intended Frontier to be a viable entity and strengthened as an airline.

As we shall see, not one of these contractual obligations was fulfilled.

The fact that there were three bids for the company suggests that Frontier was indeed a potentially valuable asset. Frontier had the following strengths:

- A strong hub at Denver, geographically one of the most desirable locations in the nation, with sufficient gates (21) and maintenance facilities (including two hangars) to compete (Frontier had about 23 percent of the airport's passengers, about the same as Continental)[63]
- A productive and dedicated labor force that had surrendered major pay and work-rule concessions (worth about $32 million annually)[64]
- A good history of high service and dependability (Frontier had 1.11 complaints per 100,000 passengers in 1985, compared with People's 4.59 in 1985)[65]
- An impeccable safety record (the best in the industry)
- A dedicated and loyal corps of travelers and ticket agents
- A standardized fleet of 38 Boeing 737-200s and four MD-80s aircraft, with advanced thrust engines, in top condition[66]

## DONALD BURR AND PEOPLE EXPRESS

To understand the corporate culture of People Express, one needs to understand the psychology of the man who built and destroyed it. As a young boy in South Windsor, Connecticut, Donald Burr had admired the organizational structure of his local Congregational church—free and fiesty, yet disciplined. He told everyone he wanted to grow up to be a clergyman.[67]

Burr joined Frank Lorenzo's Texas International in 1973, rising to the position of chief operating officer in three years.[68] He left Texas Air in 1980 to start his own airline, People Express. He later recalled: "In 1980 people told me it was the worst time in the world to start an airline. Interest rates were 21%, and we were in a recession. 'You're starting an airline in Newark? ' they'd say. 'You're insane!' "[69]

Burr started People Express with three used Boeing 727s (then selling for about $4 million each), flying from Newark to Buffalo, Cleveland, and Norfolk.[70] Raising $24 million in capital, he quickly expanded, making down payments on 17 used 737 jets and establishing a hub-and-spoke operation radiating from Newark.[71] Flyers were thrilled to see $19 fares from Newark to Buffalo. Burr's perceived "niche" for People Express was across-the-board ultra-low no-frills airfares. The absence of frills meant the nonexistence of advance seat reservations, a $3 charge to check a bag or buy a sandwich, 50¢ for a cup of coffee, and paying for tickets on board.[72] Flight attendants would come down the isle with a cart, accepting cash, credit cards, money orders, personal checks, or traveler's checks in exchange for an airline ticket.[73]

As his financier said, "Donald Burr is really operating from a philosophical base, rather than a financial one."[74] Burr used army style interrogation techniques to select just the right people to staff People Express. Burr had a vision of a low-priced airline with a loose ("you're the boss") management style. Every employee would be an "employee-manager" who, as a stockholder, would thrive on dividends while agreeing to hard work, long hours, small salaries, and no overtime pay.[75] Each had to buy 100 shares of the company at a 70 percent discount, borrowing the money to buy the stock and repaying it with paycheck deductions.[76]

Burr expected his employees to buy additional People Express stock. In the early days, People Express would post its stock price on bulletin boards around the system to raise morale.[77] The *Wall Street Journal* described People Express as a "cult-like company in which all employees were 'managers,' and to whom Mr. Burr often gave inspirational speeches via video screens."[78] Some called the company an "aerial 'Love Boat.' "[79] In the early days, People Express had an unusual esprit de corps.[80]

People Express had only three levels of management, with everyone given the title of "manager."[81] There were customer-service managers (ticket agents and flight attendants), maintenance managers (who kept up the aircraft), and flight managers (pilots).[82] The organizational chart was an inverted pyramid, with Burr at the bottom.[83] Burr eschewed hierarchy and specialization, emphasizing instead self-management and voluntary cooperation.[84]

Burr refused to recruit experienced airline executives, training his from within. Top managers, all making less than six figures a year, were denied secretaries and expense accounts.[85] Every employee was given two jobs (a pilot would sometimes double as an inventory manager, for example), an approach dubbed "cross fertilization" by Burr.[86] Harvard Professor John Meyers observed: "Burr broke rank by not following the hierarchical, paramilitary model. People is run more like a commune."[87]

Burr's corporate structure was relatively devoid of middle managers. Burr met personally with all 1,000 of his team leaders on a regular basis—about 20 at a time in sessions that could last up to eight hours.[88] "They think my meetings are too long," grumbled Burr. "I like that. It means we go into detail."[89]

But not everyone at People Express shared Burr's passion for his unusual management style. His efforts to instill his philosophy led several top aides to quit and one to be fired.[90] And not all workers were in the aviation business for a cause. After spending thousands of dollars to train pilots, People Express saw more than 200 leave to fly for other, better-paying, airlines. "Low pay, no work rules, no seniority," were described as reasons for leaving.[91] The exodus grew after People Express stock began to plummet.[92] (The stock reached a high of $25.875 in 1983, then fell below $5 by mid-1986, and dropped to about $0.50 by the time Frontier discontinued operations.)[93] In November 1986, People Express cut salaries by 12 percent.[94]

A former People Express executive remarked: "Burr has brainwashed employees into working 60-to-80-hour weeks by calling them all managers. They're in Disneyland. But his spell can go only so far."[95] Some employees began to refer to Burr's indoctrination as "Kool-Aid," presumably referring to the Jim Jones mass suicide in Guyana.[96] *Time* magazine observed:

> People [Express] has been a kind of continuing social experiment. Much of its past success has come from the willingness of full-time employees, all shareholders, to slash overhead by performing many jobs. Talk around the airline's Newark headquarters centers on how the company operates like a family. . . .
>
> But critics contend that much vital work—aircraft scheduling, for example—would be performed far better by full-time professionals than by pilots or flight attendants who delve into it intermittently. . . .
>
> Last winter's economic slump revealed another potential weakness in the People Express system—the flip side of employee ownership. When the value of their stock plunged, some flight attendants became markedly unenthusiastic about taking an extra turn at the reservations counters, and some pilots weren't quite so eager to tackle a stack of paperwork between flights.[97]

Burr wanted all employees to have direct eyeball-to-eyeball contact with customers. Thus, People Express had no inside legal or accounting staff and shed itself of its computer reservations system.[98] Reservations and baggage handling were contracted out, and ticketing was turned over to part-time college students.[99]

As one source noted:

> Burr's alma mater, the Harvard Business School, was . . . agog over its alumnus for putting in place such a radical and apparently profitable management structure. It made a great case study to teach aspiring business managers and was cited extensively in books like "In Search of Excellence" and "Re-Inventing the Corporation."[100]

Burr appeared to be America's dream of a resurgence in productivity and pride at a time when the country suffered from an inferiority complex over foreign producers. The media lapped up the seeming success of this avant-garde management philosophy. Burr's face graced the cover of *Time* and *Inc.* But unfortunately, Burr became intoxicated by the attention and the power. He become autocratic, surrounding himself with yes men.[101]

One of People's board members observed that Burr was "absolutely fearless" and took "business risks that are unbelievable."[102] Burr was consumed by ambition. As late as January 1986, Burr was predicting, "In five years, People Express will be a worldwide transportation company, carrying people and freight, and packaging hotels and rent-a-cars, the works."[103]

The People Express fleet was growing at lightning speed. In 1983, Burr doubled the size of his fleet from 20 to 42 aircraft, many purchased from bankrupt Braniff.[104] People Express grew to 55 planes by the end of 1984 and 80 aircraft by the end of 1986.[105] It took delivery of a 727 on the average of one every 20 days.[106] People Express doubled its capacity from 2.8 billion seat miles in the first quarter of 1984 to 5.5 billion in 1985.[107] Donald Burr described the People Express "mystique" in these terms: "We couldn't do anything wrong. We just bought planes, hired people, and put them in the air. Grow, grow, grow. . . . The expectations at this place are colossal. And self-generated. We went around telling everybody that we're going to be great, do great, and conquer the world."[108] The messianic fervor of Donald Burr was driving People Express to go boldly where no airline had gone before.

People Express was buying aircraft before it had decided where to fly them.[109] Between July 1984 and January 1986, People Express added service to 29 U.S. cities, as well as Montreal and Brussels, and was seeking authority to serve Shannon, Amsterdam, Frankfurt, Luxembourg, and Zurich.[110] Some noted the parallel between Donald Burr and Freddie Laker, whose cut-rate transatlantic carrier (Laker Skytrain) expanded too fast and went belly up.[111] One commentator observed: "The preoccupation with growth has left the carrier with huge expansion costs, which have led to losses and enormous capacity. It has also chastened Mr. Burr and some of his top managers, who now concede that the enormous expansion led to major problems and tactical mistakes."[112] Another noted, "Burr's management philosophy was not adaptable to a really large company."[113]

People Express was being squeezed out of its East Coast market niche by the big boys—the megacarriers. The larger airlines, with their deeper pockets, were not about to surrender their lucrative routes to People Express.[114] By shrewdly managing yields through their sophisticated computer programs, gargantuan carriers like United and American (with their powerful computer reservations systems, Apollo and Sabre, respectively) were able to offer a limited number of seats at fares competitive with People Express—including, for example, the "ultimate super saver" fare—thereby flooding the low end of the market with excess capacity, without significantly diluting yield.[115] Burr knew he was in trouble when his mother told him that she was about to book a flight on American because she didn't mind their 30-day advance-purchase requirement.[116] (Burr would ultimately blame the demise of People Express on these sophisticated computer programs, which allowed the large airlines to manage yield to fill empty seats at People Express ticket prices.)[117] The megacarriers were matching People's fares on some seats but were also offering full service. As one source noted:

> In 1984, it was increasingly obvious that competing strictly on the basis of low fares and no frills was a failing proposition. Big airlines spent hundreds of millions of dollars on advance computer booking and found ways to match People's fares.
>
> By sticking rigidly to no-frills, the airline played into the hands of competitors. They knew a customer's rationale would always be: Why should I pay 50 cents for a cup of coffee when I can get the same air fare somewhere else and get my bags checked for free?[118]

Business travelers, the most lucrative segment of the air travel market, steered clear of People Express. People had a reputation for overbooking and cancelling flights, and its rat-infested 50-year-old Newark North Terminal was decrepit, requiring passengers to tromp through the snow and up wet steps in order to enter the aircraft.[119]

The competition was turning up the heat. The megacarriers forced People to abandon service to Minneapolis, Detroit, and cities in South Carolina.[120] At its Minneapolis hub, Northwest adopted a "scorched-earth" policy.[121] So long as People Express was flying to cities off the beaten path, the megacarriers left People alone. But when Burr took on the major carriers on the most profitable routes, they made him suffer unmercifully.[122]

People's load factors and profits were plummeting. For the first 10 months of 1985, its planes were 62 percent full, compared with 71 percent the preceding year. Between October 1984 and March 1985, People suffered operating losses of $21 million. Its stock dropped from over $25 a share at its peak in 1983 to less than $10 a share in 1986.[123]

People Express was desperate to improve its fortunes. Donald Burr thought westward expansion would be just the ticket.

## DONALD BURR ACQUIRES FRONTIER AIRLINES

Following the advice of Horace Greeley ("go west, young man"), Burr sought to expand nationally by acquiring another airline, hoping that the synergism between the two companies would improve the fortunes of both. In an interview during the summer of 1985, Burr noted: "We need to be able to take on other entities, either develop them ourselves or acquire them. . . . Our systems are becoming more and more McDonaldish, and as they become more and more replicable, it's my view that we could, relatively simply, install them on other properties."[124] Burr was beginning to believe that People Express was becoming the MacDonald's of the airline industry.

Not long thereafter, Burr was playing tennis with a friend who suggested he go after Frontier. Burr thought it was a splendid idea and made the decision to acquire Frontier without consulting the other People Express executives. Said Burr, "I was convinced that it was the brilliant thing to do."[125]

Burr also decided to purchase two small airlines, Britt and PBA.[126] Britt was the nation's third-largest commuter airline, serving 29 midwestern cities.[127] PBA, in Chapter 11 bankruptcy, and operating 41 aircraft in 20 cities, cost People Express about $10 million (unsecured creditors received $300,000 for their debt of $6 million, and holders of its 4.8 million shares got nothing). Britt floated 10-year $35-million notes, loaning the proceeds to People Express.[128] Here again, the acquired carriers provided most of the capital for their acquisition. Burr was emulating the tactics of Lorenzo, who had served as his mentor at Texas Air. Lorenzo had made raids at Texas International, National, TWA, Continental, and Eastern and, where successful, had used the acquired company's money to finance much of the purchase price. Burr was an observing protégé. As one source noted, "The two men . . . have become archrivals, fighting for supremacy in the chaos and cutthroat competition of the deregulated airline world."[129]

Deregulation brought the destruction of more than 200 airlines through bankruptcy or merger. The prevailing wisdom in the industry, then as now, was that size, or mass, was essential to survival. Burr deemed expansion necessary to gain "critical mass."[130] According to People Express, "The Company believes that an airline must have a national transportation system in order for it to emerge from the current period of consolidation in the industry as a strong and viable competitor."[131] People's acquisition of Frontier would combine the nation's ninth-largest airline with the fifteenth-largest.[132] Together, they would become the nation's fifth-largest airline in terms of numbers of passengers flown, behind United, American, Eastern, and Delta.[133]

Frontier looked like a choice prize. It was relatively debt-free. Through the first nine months of 1985, Frontier earned a $59.2-million net profit on $453.3 million in revenues.[134] (In contrast, People Express suffered a $27.5-million net loss during 1985, contrasted with a razor-thin $1.6-million profit during 1984.)[135] Frontier's coffers would provide the lion's share of its purchase price, and its labor was willing to surrender pay and work-rule concessions worth tens of millions of dollars. One source noted, "Some industry experts think Burr was also attracted by something else he could use: a fresh supply of managers."[136] And Frontier offered access to the strategically important hub of Denver—the nation's fifth-busiest airport. One analyst described People's acquisition of Frontier as

> the airline coup of the year, possibly the entire post-deregulation era. This upstart airline, headquartered in the backwater of New York, snatched Frontier from the grasp of Texas Air and used Frontier's own money to finance the deal. . . . People, with 368 flights a day to 32 U.S. cities—plus London, has grown to a size where it's just big enough to challenge the majors, but lacks the routes to carry much clout.
>
> Frontier's operations will give People 120 more flights. In addition—with its low cost, no-frills fares—People attracts travelers away from cars and buses, but lacks the loyal passenger base Frontier can provide.
>
> Denver as a second hub for People gives it a door to lucrative western markets. It's an important hub for any airline because traffic can be routed through Stapleton International Airport from all directions, say airline sources.[137]

Multiple hubs were widely viewed as essential to survival, and People Express had been looking for another hub for several years.[138] Frontier's Denver hub would give People a national base (within a 1,000-mile radius lie major markets like Minneapolis, Chicago, St. Louis, Kansas City, Dallas, Houston, Los Angeles, and San Francisco). Ruth Hennefeld, an investment manager at Merrill Lynch, observed: "The deal is a bargain for People. The company bought into the Denver market for far less than it would have cost it to start from scratch."[139] Frontier's computer system would also offer new opportunities.[140] The combined company would serve 104 cities in 43 states.[141] People Express purchased Frontier on November 22, 1985, for $307 million. Donald Burr boasted, "We're one of the big boys now."[142]

Burr took 93 percent of Frontier's working capital ($193 million), mostly raised through an earlier sale of assets, as a "dividend" to help finance the transaction.[143] This left Frontier with less than $14 million in working capital.[144] As we shall see, stripping Frontier of its working capital would be fatal. Frontier's unencumbered assets (eight airplanes and seven engines) were used as collateral to secure a $50-million note to pay a due tax bill of $44 million from the proceeds of aircraft sold to support the proposed ESOP.[145] Of the $307-million purchase price, Frontier supplied $212 million and People Express put up only $95 million, or about 31 percent.[146]

But People Express did not halt its buying binge. The company's philosophy was expressed as follows:

> Management believes that the airline industry may be entering a period of consolidation. In such an environment, opportunities to acquire scarce strategic re-

sources, such as access to certain airport facilities, landing slots and passenger traffic flows, may present themselves at any time. Management believes that the future expansion of operations may be dependent upon its ability to make such acquisitions and, consequently, the Company continues to evaluate other possible acquisitions in addition to Frontier Airlines.[147]

As noted above, People Express soon bought Britt and PBA.

Burr made it clear from the outset that he wanted to have Frontier adopt People's organizational style and no-frills, low-cost product.[148] He wanted a "top-to-bottom revolution in the corporate culture at Frontier."[149] Burr replaced Frontier's CEO, Joe O'Gorman, with 36-year-old Larry Martin, described by a Frontier officer as "really an arm of People Express."[150] In cutting costs, Martin "gutted" Frontier's management.[151] Said Martin, "We intend to be the dominant carrier in the Denver market."[152] Young Martin would revamp Frontier's fare structure and marketing strategy in Burr's image.[153]

Martin was a member of both the Frontier policy committee and the People Express policy committee—the directing arm of the company.[154] But every major decision of both companies was made by the People Express policy committee.[155] Frontier executives began to jump ship in protest to People's dominance.[156] A Frontier vice president noted an example of how the company was run:

The Frontier policy committee was adamantly opposed to charging for coffee and bags and on-board snacks, which was the People Express way of doing business. We strongly urged them not to do it. We felt that it wouldn't work in Denver. Nonetheless, the People Express policy committee dictated to us that we would do that. And we did it.[157]

Burr turned Frontier's traditional full-service operations into a low-fare no-frills discount operation—an approach that had worked well in Newark but went over like a lead balloon in Denver. Westerners had grown accustomed to the high-quality service Frontier had consistently provided.

Frontier's fares were slashed (up to 60 percent systemwide initially, then 70 percent)[158] while the passenger paid for soft drinks and $3 extra for checking a bag or getting a cold snack. A first-class cabin was added by jamming the coach seats closer together rather than by reducing the number of coach seats.[159] Hot meals were discontinued, and ovens were removed from planes.[160] While coach passengers could buy a sack lunch, usually consisting of some crackers, cheese, and sausage (referred to as "Kibbles and Bits" in the industry), first-class passengers could spend $6 for a "multi-course, gourmet meal."[161] Both Frontier's coach and first-class passengers were unaccustomed to paying for food or soft drinks or for the privilege of checking a bag, and never had the quality of the product fallen so low. Continental scored a marketing coup by passing out "Sympathy Lunches" on Frontier's Denver concourse D, a free sack lunch with a sandwich and fruit for any poor soul who displayed a Frontier ticket. All this destroyed Frontier's traditional customer base.

Continental and United met the new low fares but offered full service—free checked bags and free hot meals. The People Express marketing approach was an unmitigated disaster for Frontier, alienating loyal customers who abandoned Frontier and flew United or Continental. Frontier hemorrhaged dollars unmercifully.[162] Load factors remained high, but yields plummeted. Meanwhile, Continental expanded service at Denver and signed marketing pacts with Rocky Mountain Airways and Trans-Colorado Airlines to provide feeder service at Stapleton.[163]

Frontier stopped offering advance seat assignments either by travel agents or its own reservations department.[164] Needless to say, travel agents had little enthusiasm for the difficulty they were encountering in satisfying customers' needs, the absence of sufficient phone lines, the overbooking, the decision to charge customers for food and drink, or the low commissions offered by the discount fares.[165] They began to dissuade their customers from using Frontier.[166]

But economic problems were rippling throughout the industry.[167] *Aviation Daily* summarized the difficulties caused by the fare wars and the dampening of industry profitability in 1986:

> [Robert] Joedicke [of Shearson Lehman/American Express] believes the stage was set for accelerated yield deterioration when American last year introduced ultimate super savers, restricted fares matching or undercutting tariffs by low-cost new entrants. Even greater pricing competition was spurred at the end of 1985 when People Express bought Frontier. For some time, Denver has been "a hotbed" of fare cutting. "The slugfest between United and Continental for supremacy at this key hub squeezed Frontier into an unviable and distant third position. Now, the impact of ever fiercer competition with a reconstituted Frontier has spread to several other markets in a classic example of the "domino theory". . . .
>
> Joedicke characterized the current pricing fracas as "a knock-down battle" between arch competitors Frank Lorenzo of Texas Air and Donald Burr of People Express, "with many other participants being caught in the crossfire." This form of competitive attack can be dangerous, he said, citing as an example United possibly reacting with "a nationwide array of giveaway fares that would maul its weaker competitors in a financial bloodbath."[168]

In chess, checkers, war, and business, those with greater resources can best withstand a war of attrition.[169] People Express had so highly leveraged itself and Frontier that neither could long endure the bloodbath Burr had started.

As noted above, Frontier had been consistently profitable before the last quarter of 1982 when United and Continental began to dump seats in

Denver. Then Frontier earned operating profits during the third quarter of 1983 ($6 million), the third quarter of 1984 ($12 million), and the second quarter of 1985 ($10.9 million). But after People Express acquired it, Frontier failed to turn an operating profit during any quarter.[170] Between September 1, 1985, and July 31, 1986, Frontier experienced 11 straight months of losses, totaling $47 million, by People's calculations.[171]

By the spring of 1986, People Express had realized its tactical mistake and reinstituted Frontier's full-service operations.[172] Donald Burr confessed, "It was a mess—it was a disaster."[173] People Express announced that Frontier's ticket prices would be increased between $20 and $40 and that lower fares would require a 14-day advance purchase.[174] It reintroduced advance seat assignments and boarding cards.[175] By summer 1986, Frontier had borrowed $50 million, secured by eight 737-200s, to provide operating capital.[176] It also sold off its nonairline subsidiaries to raise cash.[177]

## THE SINKING SHIP OF PEOPLE EXPRESS

People Express was hemorrhaging dollars as well. The economic problems that had preceded the acquisition of Frontier continued. In 1983 and 1984, People Express paid $10 million and $37 million in interest, respectively, on debt of $247 million and $326 million, respectively.[178] By 1985, People's half-billion-dollar debt burdened it with $60.5 million in interest payments, wiping out its operating revenue and leaving it with a net loss of nearly $28 million.[179]

By 1986, People Express had become the nation's fifth-largest carrier, but it was in serious trouble. In the first quarter alone, People Express suffered a $47.4-million operating loss and a net loss of $58 million (more than twice its losses for the entire preceding year).[180] In the second quarter, it suffered a $57-million operating loss and a $74-million net loss.[181] During the first six months of 1986, its operating expenses had increased by $66 million while its operating revenue remained stagnant over the same period in 1985.[182] By spring, People Express was near bankruptcy, down to a paltry $9 million in cash.[183] It was saddled with a crushing $560.5-million debt—2.8 times the company's equity.[184]

It was becoming clear that Burr's unorthodox organization and management style was ill suited for a company its size and that its operations and marketing efforts were a flop. Although the company had two hubs (Newark and Denver) and low labor costs, the other essential ingredients of survival in the deregulated airline environment were woefully lacking: People Express had failed to install yield and capacity management systems, a computer reservations system, or a process of measured and timely expansion.[185] As one analyst observed, "They've organized themselves with a very lean organization with no fat in it, but not much muscle either."[186] Another noted: "They still don't have secretaries. They were quite proud of the fact, but you try calling them on the phone. They just got someone as chief financial officer, but it's too late now."[187] The *New York Times* observed, "People Express, according to analysts, has long-term problems that might be solved only by a change of ownership or radical replanning."[188]

And service was miserable. As noted in a 1986 article in the *Wall Street Journal:*

> In the past year, [People Express] operations have deteriorated badly, leaving many travelers in the lurch. Flights are being overbooked by huge margins, bags are being lost by the thousands, passengers complain that bargain fares are boosted unexpectedly, and planes are chronically late.
>
> As a result, People Express has shot to the top of the charts in passenger complaints filed about major carriers.[189]

People Express was overbooking many of its flights by more than 100 percent. Its 185-seat Boeing 727s were being booked for 400 passengers; its 481-seat 747s were being booked for as many as 1,000 passengers.[190] During its final year, People Express cancelled 4.4 percent of its flights, more than seven times that of the industry's leader, Delta.[191] The result was thousands of bitter, stranded passengers and, in at least one instance, a near riot at the airport.[192] Frequent flyers began to refer to the company as "People's Distress." By May 1986, it was ranked worst in terms of number of complaints per 100,000 passengers.[193] The business editor of the *Rocky Mountain News* had these observations about People's service:

> These People don't know what they're doing.
>
> They don't know the airline business.
>
> They have absolutely no concept of customer service.
>
> "You get what you pay for," my mother-in-law bellowed. Agreed, but you don't pay for incompetence and deception.
>
> In the future, I might buy my kids tickets on People Express if they turn into miserable teenagers. . . .
>
> People Express doesn't deserve to share hangars with a classy airline like Frontier, and the only upside to the merger would be the hope that Frontier's professionalism might rub off.
>
> A great deal of praise has been heaped on People Express founder Donald Burr for his "new wave" concept of corporate management. He encourages his employees to buy stock in their company and preaches that such ownership motivates his people.
>
> Phooey.
>
> What Burr does is hire kids (average age, 27) who, in their youthful idealism, believe the line he hands them. He gives them minimal training, a foot in the door of the airline business, stock in a company Wall Street loves, better-than-average pay and the opportunity for cheap travel with airline passes.[194]

People Express was hungry for cash. In 1985, the company offered $125 million in secured equipment trust certificates to repay debt and acquire aircraft and for operating expenses.[195] Most of it appeared to go to finance the purchase of Frontier Airlines.[196] It also issued an additional million shares of preferred stock.[197] In 1986, People Express announced the sale of $115 million in equipment certificates secured by fourteen 737-100s and seven 727-200s, $93 million of which went to refinance debt owed to nine banks and other creditors.[198] But even that wasn't enough. An internal Texas Air memorandum to Frank Lorenzo summarized the sad state of People Express:

> But for $130 million in cash-on-hand, it would not be difficult to argue that People Express, Inc. is bankrupt. The company's stated equity amounts to $152.7 million at March 31, 1986 included redeemable (company elective) preferreds. Fair market value equity amounts to a negative $7.2 million including the preferreds.[199]

In June 1986, People Express announced it was exploring the possibility of selling all or parts of the company.[200] As one analyst noted: "Needless to say, People Express Inc. is facing a cash squeeze. The company has sold almost all its planes and has reduced cash flow from depreciation."[201]

By mid-1986, People's financial position was precarious. Burr tenaciously insisted: "I think we're here to stay. The reports of our death are greatly exaggerated."[202] But with more than $600 million in debt, People's interest payments and preferred dividends consumed nearly 8 percent of its revenues, the most of any major airline.[203]

But again, these problems preceded People's acquisition of Frontier. Julius Maldutis, an analyst for Salomon Brothers, observed: "[People Express] has been unable to generate a satisfactory level of earnings [since 1982]. . . . The company has funded its aggressive capital expenditures program and losses through debt, equity or equity-type financing."[204] As *Aviation Daily* noted, "People Express' current problems, according to some assessments, date to mid-1984."[205]

As the summer of 1986 dawned, People Express had $103 million in cash (the proceeds from the sale of equipment-secured debt obligations); but by midsummer, it had barely half that.[206] People Express was losing approximately $4 million a week.[207] Many of its suppliers complained that they were having serious problems collecting on debts owed by the airline.[208] Both Merrill Lynch and Salomon Brothers projected People Express to have the largest per-share losses of all airlines.[209] A power struggle ensued on the People Express board of directors, in which the board "clipped Burr's wings" and began restructuring the company.[210]

A business plan adopted in the summer of 1986 noted, "The Company must undergo a fundamental transformation if it is to survive the competitive pressures of a rapidly consolidating industry environment."[211] People

Express began installing a much-needed computer reservations system and planned for a move into new and badly needed terminal facilities at its Newark hub.[212] It also announced that it was abandoning its "no-frills" approach (catering to vacationers and backpackers) and becoming a more traditional full-service airline (targeting all types of flyers, including business travelers).[213] It would be adding first- and business-class sections, leather seats and plush carpeting throughout its aircraft, more leg room, and prices "bundled" with new perks, including "premium coach" (in which meals and baggage handling would be free), and a more generous frequent-flyer program than those of its rivals.[214] It was dropping service to Dayton, Greensboro, Columbia, Montreal, and Nashville and replacing jet service to Albany, Providence, and Melbourne with turboprop service from PBA's fleet.[215] It was reducing its fall schedule by 110 departures and downsizing its fleet by two 747s and eight 727s.[216]

The entire package was about as strong an admission of failure as a corporation could make. People Express had blundered badly by following Donald Burr's autocratic and unconventional rule, and it was drowning in a sea of red ink. But the changes came too late to avoid collapse.[217]

In July 1986, rejecting a bid by Texas Air to purchase People Express for $237 million, People agreed to sell Frontier to United for $146 million.[218] At that time, United dominated Denver, with nearly 40 percent of its domestic passengers (followed by Continental, with 28 percent, and Frontier, with 18 percent).[219] United needed Frontier's assets "to keep competing carriers out of Denver."[220] The deal would allow United to consume Frontier's 42 aircraft, 15 of its 18 gates at Denver's Stapleton International Airport, and 4,600 employees.[221]

But People Express was desperate for cash. Hence, the agreement was structured so that United could buy Frontier assets immediately while infusing People Express with cash. This allowed United to buy several of Frontier's valuable properties, including five takeoff and landing slots at Chicago O'Hare, three gates at Dallas/Ft. Worth, two hangars at Denver, contracts to acquire two MD-80 aircraft, and six gates at Denver.[222] These asset sales, totaling $43.2 million, were not contingent on consummation of the stock transaction and indeed were paid to People rather than Frontier, despite agreements that payments were to be made to Frontier.[223] Thus, Frontier's assets were being cannibalized in order to save ailing People Express.

People Express was losing money so fast it needed the $43 million infusion merely to stay aloft and was counting on the remaining $100 million from United to give it "time to complete its new main terminal in Newark and realign as a low-cost full-service carrier."[224] People Express begged the DOT to approve the United acquisition under the failing-company doctrine, saying that it "urgently" needed the cash to stay in business.[225] In the third quarter of 1986, People Express suffered a $27-million operating loss and a $112.9-million net loss.[226] People Express was a very sick bird.

As Bankruptcy Judge Charles Matheson noted: "People Express got the net cash . . . and, perhaps, willingly abandoned the remaining shell of its failing subsidiary, Frontier. The shutdown of Frontier gave United the opportunity to gain part or all of Frontier's share of the Denver air carrier market utilizing the assets it had acquired."[227]

Meanwhile, Continental was causing trouble, trying to tie up the transaction with threats of antitrust litigation. Said a former Frontier official: "People Express has about $50 million in cash and that is about all. Texas Air [TAC] is not about to be accommodating and let the deal go through particularly since it has twice been beaten out for control of Frontier. TAC wants gates at Denver. If they can tie up this merger in court and have People Express bleed financially at the same time, that will not bother them."[228]

The United-People agreement also included a proviso that labor agreements "satisfactory to United" be concluded by August 31, 1986, with the unions of United and Frontier and that United "use its best efforts to obtain such agreements." The machinists union, which had experienced some acrimony with Frontier's management under People Express, anticipated a harmonious relationship with United, saying, "United was one of our top choices."[229]

But United met only with the United members of the Air Line Pilots Association (ALPA), with United demanding that the labor contract be amended to keep the low wages Frontier pilots had accepted when People Express consumed them (in effect, creating a new "C"-tier pay scale at United, at wages 40 percent below those of United "A"-scale pilots).[230] At the time, a Frontier 737 captain earned an average $68,000 a year, whereas the equivalent United captain earned $115,000.[231] One analyst described United's posture in these terms: "United was in no mood to be overly generous, mainly because the Frontier people are between a rock and a hard place, between working and not working."[232] But the Frontier pilots (indeed, all Frontier unions) were locked out of the negotiations and had no say. And both United and the United pilot Master Executive Council (MEC) were dragging their feet in the labor negotiations. It was at this point that United was offered all of People Express for nothing if United would just complete the Frontier acquisition. But United had no interest in People Express, even for free.

On August 24, 1986, People Express shut down Frontier, grounding its 42 Boeing 737s, putting its 4,700 workers out of work, cancelling 325 flights, and stranding 17,000 passengers in 55 cities and airports.[233] People Express claimed that it had to shut down Frontier because it was out of cash and its liabilities exceeded its assets by $60 million.[234] People announced, "[Frontier] is out of funds and, in the absence of assurances that the sale to United will take place, People Express is unwilling to commit any more of its funds to Frontier."[235] The truth was that People Express was nearly broke. By now, it was losing about $7 million a week (up from $4 million a week in midsummer) and was largely being kept alive on the $43.2-million cash infusion from United for Frontier's assets.[236]

Frontier became the first airline to go out of business because of an attempted merger. Texas Air aptly summarized the reasons for Frontier's demise: "During 1986, Frontier suffered significant losses as a result of the fare wars in Denver which at times depressed yields below costs, and the loss of passenger traffic as a result of its adoption of the no-frills marketing strategy of People Express Airlines."[237] In four decades of operation, Frontier had never suffered a service disruption due to labor strife and had earned the industry's best safety record.

Having stripped Frontier of the assets it wanted and having eliminated Frontier as a hub competitor at Denver, United dusted its hands off and walked away from the deal, leaving Frontier and People Express dangling in the wind. United announced that it would not purchase the rest of Frontier because the grounded airline had been damaged beyond repair. Said a United spokesman, "The airline we attempted to purchase does not exist anymore."[238]

In fact, United walked away with everything it wanted. As one source noted, "The collapse of Frontier is seen as a major blow for People Express and as a triumph for arch-rival United."[239] Another observed: "United will benefit from eliminating the instability of Denver's three-carrier hub. This will translate into higher fares and better returns and will ensure that another carrier does not attempt to build a presence in Denver."[240] Yet another said, "Airline executives and observers concurred that the elimination of a below-cost fare competitor, Frontier, should bring some revenue relief to both United and Continental, the two other major carriers serving Denver."[241]

United had the best of both worlds—the essential assets it wanted from Frontier without paying the full purchase price and without absorbing Frontier's employees and, better yet, the demise of Frontier at the Denver hub.[242] The United-Continental-Frontier oligopoly had at long last become the United-Continental duopoly.

Frontier formally entered bankruptcy on August 28, 1986. (Ironically, Continental emerged from bankruptcy one week later.) At that time People Express was losing money at the rate of $35 million a month.[243] But People's economic position had been precarious long before the acquisition of Frontier. As Paul R. Schlesinger, an analyst at DLJ Securities, noted, "People Express made a big splash, but they've never made any money."[244] Table 5.1 reveals that People Express was never a bastion of profitability.

As People Express stockholders were later to charge, in misleading financial statements, reports, proxy statements, and other documents, Peo-

Table 5.1
People Express Revenue and Profit (Loss)
(in Millions of Dollars)

| Year | Revenues | Profit |
|---|---|---|
| 1981 | 38.4 | (9.2) |
| 1982 | 138.9 | 0.5 |
| 1983 | 286.6 | 6.5 |
| 1984 | 586.8 | 1.7 |
| 1985 | 977.9 | (27.5) |
| 1986 | (1250.0)* | (345.0)* |

* estimates

*Source:* CHRISTIAN SCIENCE MONITOR, Jan. 26, 1987, at 16.

ple Express, its officers and financial institutions "sold a misinformed public millions of dollars of various types of People Express securities, while concealing the fact that the company and its subsidiaries were heading towards economic disaster."[245] People Express, its directors, and investment bankers allegedly engaged in fraud, deceit, and negligent misrepresentation in connection with the public offering of securities and the filing of reports and documents required under the securities laws. These gave the public "a false and misleadingly and unduly optimistic picture" of the business operations of People Express.[246] The stockholders ultimately recovered $10.5 million in settlement of their suit alleging deception of the financial condition of People Express.[247]

## FRANK LORENZO ACQUIRES PEOPLE EXPRESS AND FRONTIER AIRLINES

In September 1986, Frank Lorenzo offered $138.4 million for People Express and $176 million for Frontier—an offer that Burr quickly accepted.[248] (Recall that People Express had bought Frontier for $307 million the year before and that Texas Air had offered $237 million for People Express and its subsidiaries only two months earlier.)

Texas Air promised that if 75 percent of Frontier's pilots, flight attendants, agents, and dispatchers dropped their claims against Frontier and People Express, Continental would hire them.[249] Of course, the employees were hardly in an equal bargaining position, for they were then out of work because of the Frontier shutdown. They had little choice but to sign away their legal rights to work for Continental. Those who went to work for Continental were promised seniority under a "fair and equitable formula."[250]

People Express was desperate to consummate the transaction. It begged the DOT to approve its acquisition by Texas Air under the failing-company doctrine, saying that without it, People Express would be unable to meet upcoming interest payments of $13.4 million and $31 million.[251] People owed $309 million in equipment certificates, secured on 53 of its 59 aircraft, and $165 million in unsecured notes.[252] Texas Air's debt load would reach $5.5 billion with the People Express purchase.[253]

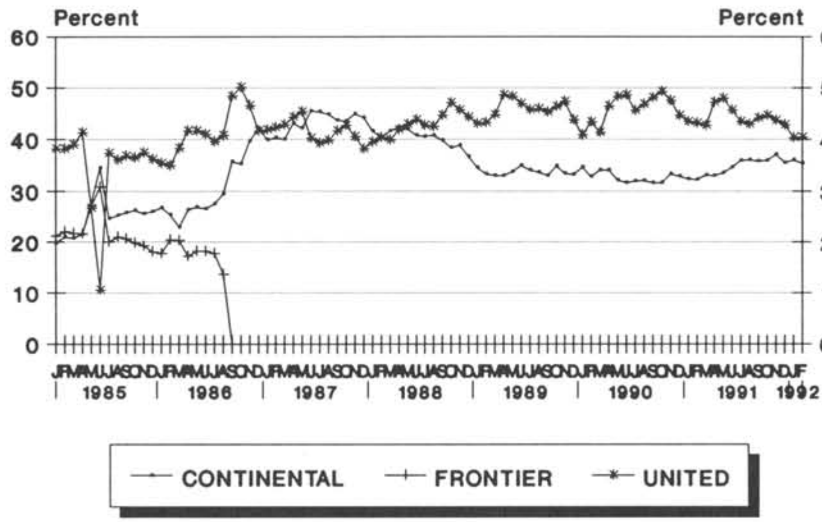
Lorenzo had offered $237 million for People Express the year before but had been rebuffed by Burr.[254] After the Frontier sale to United collapsed, Lorenzo offered $138.4 million for People Express, less than he offered for Frontier.[255] By December 1986, Lorenzo had lowered his offer to $122 million, then to $113.7 million, citing People's deteriorating financial condition.[256] Most of the deal involved an exchange of People Express stock for Texas Air stock, with the number of shares, their value, and the dividend rate reduced by Lorenzo in several steps.[257] Burr would also have to work with his debt holders to reduce annual interest payments by $12.6 million.[258] It was "take it or leave it," and Burr had no choice but to take it, for People Express had no realistic prospects of continuing operations and retaining substantial assets during bankruptcy or of emerging successfully from reorganization.[259] People Express sustained a net loss of $199 million in 1986, and its liabilities exceeded its assets by $135 million.[260] With its subsidiaries, People Express sustained a net loss of approximately $344 million in 1986, of which about $36 million (10 percent) was attributable to the operations of Frontier Airlines.[261] People Express was in such a pathetic economic condition that Lorenzo was able to acquire the company primarily on a stock swap, without a significant outlay of capital, and to unilaterally dictate a lower selling price than originally offered.

Continental sought to merge these carriers and New York Air in a messy overnight consummation on February 1, 1987. These acquisitions, as well as that of Eastern Air Lines, made Texas Air the nation's largest airline, growing from 160 aircraft in 1985 to 636 planes in 1987.[262]

Texas Air bought Frontier's stock for $9.5 million in April 1987. Continental subsequently bought Frontier's stock for $10 million from Texas Air and became the debtor in possession. Frontier transferred 44 aircraft and certain airport and related properties, including gates, to New York Air, a Texas Air subsidiary, for $64 million and an assumption of $49 million of Frontier's indebtedness.[263] Forty-one of these aircraft were then folded into Continental's fleet.

At Continental's direction, Frontier sued United for fraud and return of assets transferred under People's patronage. With a settlement reached with United, Continental possessed most of Frontier's aircraft, as well as three hangars and two concourses (concourses C and D) in Denver. The acqui-

Figure 5.2
Stapleton International Airport Domestic Market Shares, 1985–1990



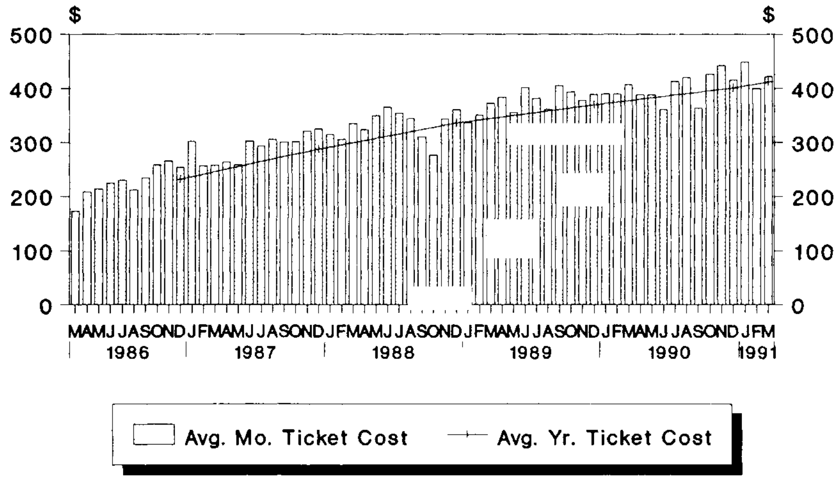

**Frontier ceased operations 8/24/86**
**Continental bought People Express 3/87**

sition would give Continental 236 daily departures from Denver by the end of 1986 (including service to eight additional cities formerly served by Frontier), compared with United's 218 departures.[264] As Texas Air was proud to inform its stockholders, "The Company acquired most all of the assets of Frontier Airlines, Inc., resulting in a strategic strengthening of Continental's Denver hub."[265] For the first time, in December 1986, Continental became the largest carrier at Denver Stapleton, which, as figure 5.2 reveals, is a title it held from June 1987 until May 1988.

After Frontier's demise, United added 51 flights at Denver, significantly increasing its market share from nearly 40 percent when it had agreed to buy Frontier from People in July 1986 to a record 50 percent two months after Frontier's disintegration.[266] Continental's market share skyrocketed from 28 percent to nearly 40 percent during the same period.[267] Denver has become a duopoly—or, perhaps better termed, a "shared monopoly."

In January 1987, Frank Lorenzo called a news conference, speaking from a podium at which he had $5 million in a five-foot-tall pile of cash. This was the amount Continental had allegedly saved consumers a day, or about $2 billion a year. Lorenzo proclaimed that although People Express was no longer, "To borrow from Mark Twain, reports of the death of low fares are exaggerated."[268] Lorenzo said that his commitment to low fares was "not based on altruistic motives" but reflected "Continental's business strategy—to maintain low costs and to use the low-cost structure to keep

Figure 5.3
Stapleton International Airport Average Roundtrip Ticket Price Analysis, 1986–1991




9/88 - New Fares Set
11/88 - Restrictions Increased

fares down."[269] But ticket prices at Denver, which had fallen during 1985 and 1986, began to climb sharply—17.6 percent in 1987 and a record 39.2 percent in 1988.[270] Thus, the demise of Frontier allowed United and Continental to raise ticket prices robustly at Denver. (See figure 5.3.) The destruction of Frontier was essential to that result.

Recent years have been difficult ones for Texas Air.[271] In 1988 it posted the worst losses in the history of the industry—$885.6 million, on revenues of $6.7 billion—surpassing its 1987 record of $718.6 million.[272] In 1989, Eastern went on strike, and Texas Air put the company into bankruptcy. Scandinavian Airline Systems (SAS) purchased a significant equity interest in the airline. To improve its public image, Texas Air was renamed Continental Airline Holdings, and the controversial chairman, Frank Lorenzo, resigned, leaving the company saddled with more than $5 billion in debt.[273] As this book goes to press, Continental is in bankruptcy once again (some call it Chapter 22 bankruptcy).

## POSTMORTEM ON PEOPLE EXPRESS

Several experts have commented on the disintegration of People Express, which dragged Frontier into the abyss of bankruptcy. These observations provide some insight into the strategic mistakes made by Donald Burr and into the predatory behavior of United and Continental.

John W. Teets, chairman and chief executive officer of the Greyhound Corporation, observed, "People Express expanded too fast."[274] Gail H. Ruderman, co-owner of Revere Travel, Inc., provided the travel agents' perspective:

> People has alienated travel agents. . . . It also has been almost impossible to get through to People's reservations center. Even when we can, we cannot count on that reservation being honored when the customer arrives at the airport. Most major carriers oversell flights, but this has been a greater problem with People.[275]

Professor D. Quinn Mills of Harvard, an early admirer of Burr's, once described People Express as "the most interesting company in America today."[276] But he had this to say about the demise of People Express: "Some people are absolutely convinced the management system was at fault. It was unusual, and it looked chaotic."[277]

Alfred Kahn, the former chairman of the Civil Aeronautics Board and architect of deregulation, had once taken credit for the success of People Express, saying: "People Express is clearly the archetypical deregulation success story and the most spectacular of my babies. It is the case that makes me the proudest."[278] His pride was not to last long. When People Express was going down the tubes, Kahn had a different view:

> United, American and other major, full service airlines . . . developed very sophisticated, computerized scheduling programs, which have enabled them to determine how many seats on each flight are likely to go unsold at normal fares but might be filled if they offer a steep discount. . . .
>
> Thus, it appears the People Express model of offering uniform, low fares with no restrictions cannot survive. And I am pessimistic about new companies being able to compete successfully by offering uniform low fares to everybody without discriminating among different travelers and without imposing such restrictions as advance purchase or cancellation penalties.[279]

And finally, from Donald Burr himself, several years after People Express collapsed: "I practiced a number of things that were ideological but not practical. If I were doing it over, I would hire from the outside and amend our compensation terms to attract good people. You couldn't get a chief financial officer for a $1 billion company for $75,000 a year—Burr's salary."[280]

Burr's People Express was like a rocket on the Fourth of July—ascending up and up at a frantic pace, then exploding, and quickly disappearing. It was a wondrous thing to behold. But it was doomed to self-destruction. Although People Express initially enjoyed meteoric growth, there were major flaws in Donald Burr's highly unusual approach.

- The company was grossly undercapitalized, all assets heavily laden with debt. The debt burden crushed what operating profits there were. Like a house of cards, People Express rested on a foundation that was highly delicate.
- People Express lacked measured, timely expansion. It pursued frantic growth without adequate planning or market assessment. Its fleet grew from about 20 aircraft in 1983 to 80 in 1986. It then acquired Frontier, Britt, and PBA.
- People Express had a primitive yield and capacity management system, whereas its competitors were highly sophisticated in managing yield and capacity so as to lure away the low-fare passengers to whom People Express catered. As People Express began to compete in markets dominated by established airlines, the incumbents managed yield by lowering fares on some seats, causing People Express to suffer terribly. Although People Express began the fare wars by offering no-frills discount service, it had insufficient capital to withstand the competitive response.
- A cultlike corporate culture might work in the short term or in small enterprises, but as employee enthusiasm begins to wane or management becomes more impersonal, such a culture becomes difficult to sustain. Twenty-four-hour-a-day industries like airlines often have difficulty keeping labor-management relations on a friendly course. The unusual management philosophy invented by Donald Burr was not adaptable to a company the size that People Express ultimately became.
- Since wages were low, and tasks and hours taxing, employee morale was tied heavily to the success of People Express stock, which they were forced to buy and which soared and plummeted in tandem.
- Many key positions were held by inexperienced managers. Requiring employees to double in other positions sacrificed efficiency. Burr recruited few executives from other airlines and paid corporate officers poorly. They were denied such fundamental productivity-enhancing staff as secretaries. The managerial system was, in a word, chaotic.
- Poor and undependable service alienated passengers and travel agents. Travel agents (on whom most airlines depend for bookings) were appalled by People's no-seat reservations policy, its deliberate overbooking, the insufficient phone lines, its practice of charging customers for meals and checked luggage, and the low commissions. Imposing this no-frills service on Frontier was a marketing disaster and alienated its loyal western customer base.

## NOTES

1. Ennis, *Sky King*, BUS. MONTH, Sept. 1988, at 27, 32.
2. The "Wine of the Week" was one of President Michael Levine's contributions to travel in the Washington–New York–Boston corridor.
3. *At the Controls: Frank Lorenzo Will Pilot a Troubled Continental*, WALL ST. J., July 24, 1987, at 18.
4. R. SERLING, MAVERICK: THE STORY OF ROBERT SIX AND CONTINENTAL AIRLINES 18–19 (1974).
5. *Id.* at 30–33; R. DAVIES, AIRLINES OF THE UNITED STATES SINCE 1914 198 (1972).

6. R. Serling, *supra* note 4, at 36.
7. *Id.* at 37.
8. *Id.* at 81–82.
9. *Id.* at 95, 151–53.
10. *Id.* at 59.
11. *Id.* at 60–61.
12. *Id.* at 98–99.
13. *Id.* at 108.
14. *Id.* at 131.
15. *Id.* at 172.
16. *Id.* at 204–8.
17. *Id.* at 203.
18. *Id.* at 230.
19. M. Murphy, The Airline That Pride Almost Bought: The Struggle to Take over Continental Airlines 5 (1986).
20. *Id.* at 5.
21. *Id.* at 6–7.
22. *Id.* at 8.
23. *Id.* at 8.
24. *Id.* at 9.
25. *Id.* at 11.
26. *Id.* at 11–12.
27. *Id.* at 32–33, 54.
28. Letter from A. L. Feldman to Francisco A. Lorenzo (April 3, 1981).
29. H. Laws & R. Losee, Frontier 2 (monograph, December 2, 1986).
30. *Id.*
31. See J. Cash, Jr., F. McFarlan, J. McKenney, & M. Vitale, Corporate Information Systems Management 18 (1988) [hereinafter cited as Corporate].
32. See *id.* at 17.
33. H. Laws & R. Losee, *supra* note 29.
34. *Id.*
35. See Corporate, *supra* note 31, at 17.
36. Salpukas, *Frontier Files for Bankruptcy,* N.Y. Times, Aug. 29, 1986, at D-1, col. 6.
37. H. Laws & R. Losee, *supra* note 29.
38. See Corporate, *supra* note 31, at 17.
39. H. Laws & R. Losee, *supra* note 29.
40. *Market Shares of Top Three Carriers at 30 Busiest Airports,* Aviation Daily, May 24, 1984, at 138; *CAB Report Details Capacity Changes at Major Hubs,* Aviation Daily, June 21, 1984, at 291.
41. *Texas Air Makes Bid for Frontier,* Aviation Daily, Apr. 5, 1985, at 201.
42. *Frontier Loses $13.8 Million—First Annual Loss Since 1971,* Aviation Daily, Feb. 2, 1984, at 179. In 1982, Frontier had earned a net profit of $17 million. *Id.*
43. Salpukas, *supra* note 36, at D-1, col. 6. *Frontier Negotiates Tentative Contract Concessions,* Aviation Daily, Mar. 30, 1984, at 171.
44. Stapleton International Airport, *Average Airline Fares for Selected U.S. Airports* (1988).

45. *Intelligence,* Aviation Daily, Apr. 16, 1984, at 257.

46. *CAB Gives Frontier Horizon Go-Ahead to Begin Service Today,* Aviation Daily, Jan. 9, 1984, at 34.

47. *Frontier Says Competition at Denver Responsible for Losses,* Aviation Daily, Apr. 30, 1984, at 341.

48. *Record of Certificated Air Carrier Reporting Performance to CAB,* Aviation Daily, Oct. 24, 1984, at 287.

49. *Frontier Auditors Qualify Annual Report,* Aviation Daily, Apr. 3, 1985, at 185.

50. H. Laws & R. Losee, *supra* note 29.

51. Amended Complaint of Frontier Airlines, Inc., In re Frontier (Reorganization Case N. 86-B-8021E, U.S. Bankruptcy Court for the District of Colorado, Jan. 2, 1987) [hereinafter Frontier Bankruptcy Complaint]; *Frontier Begins Down-Sizing Operations,* Aviation Daily, May 15, 1985, at 83. Frontier also sold nine Convair 580s to Metro for $12 million. *Frontier Directors Approve Employee Buyout Plan,* Aviation Daily, July 18, 1985, at 97.

52. *Frontier Begins Down-Sizing Operations,* Aviation Daily, May 15, 1985, at 83.

53. Levere, *United to Buy Frontier Air from People,* Travel Weekly, July 17, 1986, at 1.

54. *Frontier to Terminate Service to Five Cities in September,* Aviation Daily, July 8, 1985, at 35.

55. *Frontier Directors Approve, supra* note 51, at 97; *Frontier Employees Would Fund Buyout from Several Sources,* Aviation Daily, Aug. 8, 1985, at 217.

56. See Salpukas, *supra* note 36, at D-1, col. 6.

57. *Texas Air to Make Tender Offer for Frontier,* Aviation Daily, Sept. 20, 1985, at 105.

58. *Id.* at 105, 106.

59. *Texas Air Bid for Frontier Called No-Lose Situation,* Aviation Daily, Sept. 23, 1985, at 114.

60. *Id.*

61. *Texas Air, supra* note 57, at 105, 106.

62. "Lorenzo's bid to acquire Frontier had run into opposition by labor because he was viewed as being a union buster." Csongos, *People Express, Frontier Airlines Merger Approved,* United Press International Wire Report (Nov. 21, 1985). Ironically, when Texas Air sold its 800,000 shares to People Express, it made $5.7 million in arbitrage. *Texas Air Withdraws Offer for Frontier,* Aviation Daily, Oct. 11, 1985, at 226.

63. *Texas Air Makes Bid for Frontier,* Aviation Daily, Apr. 5, 1985, at 201, 202.

64. *Id.* at 201; *Texas Air Takeover of Frontier Faces Numerous Obstacles,* Aviation Daily, Sept. 23, 1985, at 114, 115.

65. *Consumer Complaints Filed at DOT,* Aviation Daily, Feb. 3, 1986.

66. As of April 1985, Frontier had 18 unencumbered 737s out of 33 it owned. *Texas Air Makes Bid, supra* note 63, at 201; *Texas Air Bid, supra* note 59, at 114.

67. *A Yankee Preacher in the Pilot's Seat,* Time, Jan. 13, 1986, at 46.

68. *Id.*

69. Byrne, *Donald Burr May Be Ready to Take to the Skies Again,* BUS. WEEK, Jan. 16, 1989, at 74.

70. Burns, *Rapid Expansion Meant Collapse for People Express,* United Press International Wire Report (Dec. 29, 1986).

71. *Yankee Preacher, supra* note 67, at 46.

72. Clayton, *The People at People Express Say 'Bye to a Dream,* CHRISTIAN SCIENCE MONITOR, Jan. 26, 1987, at 16.

73. *Super Savings in the Skies,* TIME, Jan. 13, 1986, at 40, 43.

74. *Yankee Preacher, supra* note 67, at 46.

75. Clayton, *supra* note 72, at 16.

76. *Super Savings, supra* note 73, at 40, 42.

77. Clayton, *supra* note 72, at 16.

78. Thomas, *Again, Burr and Lorenzo Part Company as People's Founder Leaves Texas Air,* WALL ST. J., July 24, 1987, at 1.

79. *Bitter Victories,* INC. (Aug. 1985), at 25.

80. Byrne, *supra* note 69.

81. *Id.*

82. *Super Savings, supra* note 73, at 40, 42.

83. Deposition of Charles W. Thomson In Re Frontier Airlines, Inc., U.S. Bankruptcy Court (D-Colo) No. 86B8021E (Dec. 10, 1986), at 14.

84. Bitter Victories, *supra* note 79.

85. Byrne, *supra* note 69.

86. Clayton, *supra* note 72; Byrne, *supra* note 69.

87. *Super Savings, supra* note 73, at 40, 42.

88. *Yankee Preacher, supra* note 67.

89. *Id.*

90. *Id.*

91. Clayton, *supra* note 72.

92. *Id.*

93. Prokesch, *People Express: A Case Study,* N.Y. TIMES, July 6, 1986, at 3-1, col. 3.

94. Form 10-K Filed by People Express Airlines, Inc., for the Fiscal Year Ending Dec. 31, 1986, with the U.S. Securities and Exchange Commission (Mar. 31, 1987), at 10.

95. *Super Savings, supra* note 73, at 40, 44.

96. See *Bitter Victories, supra* note 79, at 25, 28.

97. Labich, *How Long Can Quilting-Bee Management Work?,* TIME, Nov. 25, 1985, at 136.

98. Deposition of Charles W. Thomson In Re Frontier Airlines, Inc., U.S. Bankruptcy Court (D-Colo) No. 86B8021E (Dec. 10, 1986), at 16.

99. *Bitter Victories, supra* note 79, at 25, 34; *People Express Contracts Out Entire Computer Network,* AVIATION DAILY, Sept. 4, 1985, at 13.

100. Clayton, *supra* note 72.

101. *Id.*

102. *Yankee Preacher, supra* note 67.

103. *Super Savings, supra* note 73, at 40, 45.

104. Clayton, *supra* note 72; Form 10-K Filed by People Express with the U.S. Securities and Exchange Commission, Dec. 31, 1985, at 25.

105. Form 10-K, Filed by Texas Air Corporation with the U.S. Securities and Exchange Commission 35 (for fiscal year ending Dec. 31, 1986); Carley, *Many Travelers Gripe about People Express, Citing Overbooking,* WALL ST. J., May 19, 1986, at 1; Form 10-K Filed by People Express with the U.S. Securities and Exchange Commission, Dec. 31, 1985, at 25.

106. People Express, Inc., Business Plan-Preliminary Draft 5 (Aug. 7, 1986).

107. *Intelligence,* AVIATION DAILY, June 3, 1985, at 177.

108. *Bitter Victories, supra* note 79, at 25, 26.

109. Burns, *supra* note 70.

110. *Super Savings, supra* note 73, at 40, 44; *People Express Seeks Certificate Rights to Six European Countries,* AVIATION DAILY, Apr. 19, 1985, at 282.

111. *Super Savings, supra* note 73, at 40, 45.

112. Salpukas, *The Woes at People Express,* N.Y. TIMES, June 25, 1986, at D-1, col. 3.

113. Clayton, *supra* note 72.

114. *Id.*

115. People Express, Inc., Business Plan-Preliminary Draft 4-5 (Aug. 7, 1986).

116. Salpukas, *supra* note 112.

117. Byrne, *supra* note 69.

118. Clayton, *supra* note 72.

119. *Id.*; Prokesch, *People Express: A Case Study,* N.Y. TIMES, July 6, 1986, at 3-1, col. 3.

120. *Super Savings, supra* note 73, at 40, 44.

121. Burns, *supra* note 70.

122. Byrne, *supra* note 69.

123. *Super Savings, supra* note 73, at 40, 44.

124. *Bitter Victories, supra* note 79, at 25, 32.

125. *Super Savings, supra* note 73, at 40, 44.

126. Britt had enabled him to boost the number of flights from Chicago. *People Express, Inc., Requests Exemption to Acquire Britt,* AVIATION DAILY, Jan. 14, 1986, at 69; *People Express to Acquire Provincetown-Boston Airline,* AVIATION DAILY, Feb. 3, 1986, at 179. Burr's acquisition of Frontier was described by a People Express board member as perhaps "a bridge too far for him." *Yankee Preacher, supra* note 67.

127. *Super Savings, supra* note 73, at 40.

128. *PBA Reviewing People Express Buyout Offer, Seeking Alternatives,* AVIATION DAILY, Mar. 19, 1986, at 426.

129. Prokesch, *Two Dreamers Awake to a Dogfight,* N.Y. TIMES, Mar. 9, 1986, at 3-1.

130. Clayton, *supra* note 72.

131. Form S-2 Filed by People Express with the U.S. Securities and Exchange Commission, Mar. 13, 1986, at 5; see also Form 10-K Filed by People Express with the U.S. Securities and Exchange Commission, Dec. 31, 1985, at 7-8.

132. Based on revenue passenger miles for 1985. *Industry Market Share,* AVIATION DAILY, Feb. 5, 1986.

133. *Frontier Shareholders, DOT Approve People Express-Frontier Purchase,* AVIATION DAILY, Nov. 22, 1985, at 113; Csongos, *supra* note 62.

134. *People Express 1985 Expenses Increase 68.4 Percent,* AVIATION DAILY, Feb. 20, 1986, at 276.
135. *National Carriers Financial,* AVIATION DAILY, Mar. 21, 1986, at 449; *Industry Market Share,* AVIATION DAILY, Mar. 27, 1986, at 480.
136. Labich, *supra* note 97.
137. McCormick, *People Chief Is a Burr in Many Saddles,* ROCKY MOUNTAIN NEWS, Oct. 9, 1985.
138. *Denver Hub Possible for People Express,* AVIATION DAILY, Oct. 11, 1985, at 227.
139. Henry, *People on the Move,* TIME, Oct. 21, 1985, at 64.
140. See CORPORATE, *supra* note 31, at 17. Frontier was then Denver's third-largest airline, with 19 percent of the market (compared with United's 37 percent and Continental's 26 percent). Data for 1985 taken from Stapleton International Airport, Domestic Market Shares (Nov. 1986).
141. *Frontier to Revamp Fare Structure, Marketing Strategy,* AVIATION DAILY, Feb. 11, 1986, at 225.
142. *Super Savings, supra* note 73, at 40, 44.
143. Summary of Testimony of Expert Witness Thomas R. Sandler, In re Frontier Airlines, Inc. (U.S. Bankruptcy Court, District of Colorado, Case No. 86B-8021-E, Dec. 19, 1986), at 2; Frailey, *Retreat from Denver,* U.S. NEWS & WORLD REP., July 21, 1986, at 31; *People Express, Frontier Sign Final Merger Agreement,* AVIATION DAILY, Nov. 26, 1985, at 132.
144. Summary of Testimony of Expert Witness Thomas R. Sandler, In re Frontier Airlines, Inc. (U.S. Bankruptcy Court, District of Colorado, Case No. 86B-8021-E, Dec. 19, 1986), at 2.
145. *Id.*
146. *Domestic News,* United Press International Wire Report (July 10, 1986).
147. Form 10-Q Filed by People Express Inc. with the U.S. Securities and Exchange Commission for the Quarter Ending Sept. 30, 1985 (Nov. 14, 1985), at 29.
148. Deposition of Charles W. Thomson In Re Frontier Airlines, Inc., U.S. Bankruptcy Court (D-Colo) No. 86B8021E (Dec. 10, 1986), at 13 [hereinafter cited as Thomson].
149. Dubroff, *Burr Aims for Frontier 5-Cent Mile,* Denver Post, Jan. 30, 1986.
150. Thomson, *supra* note 148, at 26; *Frontier President Replaced with People Express Appointee,* AVIATION DAILY, Jan. 31, 1986.
151. *United-Frontier Merger Likely to Reduce Denver Flights,* AVIATION DAILY, July 15, 1986, at 141.
152. *Frontier to Revamp, supra* note 141.
153. *Id.*
154. Thomson, *supra* note 148, at 27.
155. *Id.* at 28.
156. See *Frontier Marketing VP Thomas Volz Resigns,* AVIATION DAILY, June 12, 1986, at 412.
157. Thomson, *supra* note 148, at 28.
158. *Frontier to Revamp, supra* note 141; *People Express/Frontier Put High Priority on Cutting Costs,* AVIATION DAILY, Mar. 5, 1986, at 345; *Frontier Predicts Sharp Increase in Summer Traffic,* AVIATION DAILY, May 19, 1986, at 276.

159. *Frontier Predicts, supra* note 158.
160. H. Laws & R. Losee, *supra* note 29.
161. *Frontier Service Changes Bring Carrier into Line with People Express,* Aviation Daily, Mar. 20, 1986, at 438.
162. See Salpukas, *supra* note 112.
163. *Continental Expands Denver Service, Signs Marketing Pact with Regionals,* Aviation Daily, June 12, 1986, at 410.
164. *Frontier Inflight Service Changes Result in Layoffs,* Aviation Daily, Mar. 25, 1986, at 461.
165. See Dubroff, *Frontier's Low Fares Score with Travelers,* Denver Post, Feb. 13, 1986, at 1-D.
166. Weber, *Travel Agents Air Gripes about Frontier's No-Frills,* Rocky Mountain News, Mar. 4, 1986, at 1-B.
167. The industry suffered more than half a billion dollars in operating losses during the first quarter of 1986. *Industry Market Share,* Aviation Daily, June 2, 1986.
168. *Analyst Says First Quarter Losses May Top $625 Million,* Aviation Daily, Apr. 10, 1986, at 63.
169. H. Laws & R. Losee, Frontier 11 (monograph, December 2, 1986).
170. *Frontier Operations Shut Down, Carrier's Future Uncertain,* Aviation Daily, Aug. 26, 1986, at 313.
171. Frontier Bankruptcy Complaint, *supra* note 143, at 3.
172. Levere, *United to Buy Frontier Air from People,* Travel Weekly, July 17, 1986, at 1.
173. Stevenson, *People Express Says It Might Have to Sell Part or All of Airline,* N.Y. Times, June 24, 1986, at A-1, col. 1.
174. Salpukas, *Frontier Files for Bankruptcy,* N.Y. Times, Aug. 29, 1986, at D-1, col. 6.
175. *Frontier Unveils New Premium Coach Service,* Aviation Daily, May 28, 1986, at 325.
176. See *Frontier Gets $50 Million Loan, New Entrant Air Puerto Rico $5.2 Million,* Aviation Daily, June 3, 1986, at 353.
177. *Frontier Holdings Sells Off Last Non-Airline Subsidiary,* Aviation Daily, June 17, 1986, at 437.
178. Form S-2 Filed by People Express with the U.S. Securities and Exchange Commission, Mar. 13, 1986, at 9. There may be some inconsistency in the reports filed by People Express with the Securities and Exchange Commission. For example, People elsewhere indicated that its long-term debt for 1984 was $289 million and for 1985 was $479 million. Form 10-K Filed by People Express Inc. with the U.S. Securities and Exchange Commission for the 1985 Fiscal Year (Mar. 13, 1986), at 39.
179. Burns, *supra* note 70; *National Carriers Financial,* Aviation Daily, Mar. 21, 1986, at 488; Form 10-K Filed by People Express with the U.S. Securities and Exchange Commission, Dec. 31, 1985, at 32.
180. *People Express Posts $47.4 Million Quarterly Operating Loss,* Aviation Daily, May 2, 1986, at 186; Prokesch, *supra* note 119. However, in data files at the Securities and Exchange Commission, People Express reported only a $20-million operating loss and a $35-million net loss for the quarter. Form 10-Q Filed

by People Express Airlines, Inc. with the U.S. Securities and Exchange Commission (May 15, 1986), at 4. Nonetheless, even People's numbers show a rapidly deteriorating condition. Revenue had increased only 12 percent while maintenance expenses had risen 23 percent and operating losses had soared over 300 percent for the same period in 1985. *Id.*

181. *People Express Loses $57 Million in Second Quarter,* AVIATION DAILY, Aug. 14, 1986, at 251.

182. Form 10-Q Filed by People Express Airlines Inc., for the Quarter Ending June 30, 1986, with the U.S. Securities and Exchange Commission (Aug. 15, 1986), at 4. People Express reported a less severe economic picture to the SEC than did media accounts. It said that during the first half of 1986, People Express suffered a net loss of only $80 million and that its working capital fell by $89 million. *Id.* at 6, 12.

183. Salpukas, *supra* note 112.

184. Prokesch, *supra* note 129.

185. Burns, *supra* note 70.

186. *Id.*

187. *Id.*

188. Stevenson, *supra* note 173.

189. Carley, *Many Travelers Gripe about People Express, Citing Overbooking,* WALL ST. J., May 19, 1986, at 1.

190. *Id.* at 1, 12.

191. Byrne, *supra* note 69.

192. Carley, *supra* note 189, at 1, 12.

193. *Consumer Complaints Filed at DOT, Per 100,000 Passengers,* AVIATION DAILY, June 10, 1986.

194. McCormick, *Ordeal in Frustration Makes People the Airline to Avoid,* ROCKY MOUNTAIN NEWS.

195. *People Express,* AVIATION DAILY, June 14, 1985, at 251.

196. Form 10-Q Filed by People Express Inc. with the U.S. Securities and Exchange Commission for the Quarter Ending Sept. 30, 1985 (Nov. 14, 1985), at 22.

197. *People Express Seeks More Financing, Predicts First Quarter Loss,* AVIATION DAILY, Mar. 15, 1985, at 83.

198. *People Express Restructuring Debt Load,* AVIATION DAILY, Mar. 21, 1986, at 451; *People Express Launches Sale of $115 Million in Equipment Certificates,* AVIATION DAILY, Apr. 21, 1986, at 115.

199. Memorandum from R. R. Ferguson to F. Lorenzo (May 5, 1986).

200. *People Express Studying Sale of Part or All of Company,* AVIATION DAILY, June 24, 1986, at 474.

201. *Id.*

202. Levere, *Pilots' Dispute Imperils Plan for United to Buy Frontier,* TRAVEL WEEKLY, Aug. 11, 1986, at 45.

203. Prokesch, *supra* note 119.

204. *People Express,* AVIATION DAILY, June 25, 1986, at 482.

205. *Id.*

206. Levere, *United to Buy Frontier Air from People,* TRAVEL WEEKLY, July 17, 1986, at 1.

207. Russell, *Cliff Hanger; People Sells Off Frontier,* TIME, July 21, 1986, at 49.

208. Levere, *supra* note 202.

209. *Airlines 1986 Earnings Estimate Per Share Projected by Analysts,* AVIATION DAILY, Apr. 23, 1986.

210. Russell, *supra* note 207.

211. People Express, Inc., Business Plan-Preliminary Draft 1 (Aug. 7, 1986).

212. Burns, *supra* note 70.

213. Moran & Levin, *People Planning to Put Frills Back,* ADVERTISING AGE, July 14, 1986, at 74.

214. *Id.*

215. People Express, Inc., Business Plan-Preliminary Draft 5 (Aug. 7, 1986).

216. People Express, Inc., Business Plan-Preliminary Draft 6-7 (Aug. 7, 1986); Form 10-Q Filed by People Express Airlines Inc., for the Quarter Ending June 30, 1986, with the U.S. Securities and Exchange Commission (Aug. 15, 1986), at 13.

217. Burns, *supra* note 70.

218. *United to Buy Frontier from People Express,* AVIATION DAILY, July 11, 1986, at 58.

219. Stapleton International Airport, Domestic Market Shares (July 1986).

220. *People Express Likely to Sell Frontier Assets to Ensure Survival,* AVIATION DAILY, June 25, 1986, at 482.

221. Levere, *supra* note 206.

222. In re Frontier Airlines, Inc. (memorandum opinion and order on motion to approve settlement, Case No. 86 B 8021 E, Mar. 23, 1987), at 4.

223. *Id.* at 5. Most of these assets were ultimately transferred back under an agreement reached in settlement of litigation by Frontier against United. *Id.* at 6.

224. Frailey, *supra* note 143.

225. *United-Frontier Merger to Focus on Failing Company Doctrine,* AVIATION DAILY, July 25, 1986, at 138.

226. *People Express Posts $112.9 Million Quarterly Net Loss,* AVIATION DAILY, Nov. 12, 1986, at 228. Oddly, People's filings with the Securities and Exchange Commission show a less gloomy picture. For the third quarter of 1986, People Express reported a net loss of only $40 million (interest expenses were more than half of that) to the SEC. Form 10-Q Filed by People Express Inc. with the U.S. Securities and Exchange Commission for the Quarter Ending Sept. 30, 1986 (Nov. 14, 1986), at 4. For the first nine months of 1986, People Express reported a net loss of $120 million and a decrease in working capital of $158 million. *Id.* at 5.

227. In re Frontier Airlines, Inc. (memorandum opinion and order on motion to approve settlement, Case No. 86 B 8021 E, Mar. 23, 1987), at 12.

228. *United-Frontier Merger Likely to Reduce Denver Flights,* AVIATION DAILY, July 15, 1986, at 141.

229. *United Directors Approve Frontier Acquisition,* AVIATION DAILY, July 14, 1986, at 66.

230. *Domestic News,* Reuters Wire Service (Aug. 29, 1986).

231. Sing, *Frontier Halts Flights, Cites Large Losses,* LOS ANGELES TIMES, Aug. 25, 1986, at 1-1, col. 6.

232. *United-Frontier Merger, supra* note 228.

233. Salpukas, *supra* note 174; Sing, *supra* note 231.

234. Sing, *supra* note 231; Lassiter & Dubroff, *Petition for Bankruptcy Reveals People Subsidiary Had No Cash,* TRAVEL WEEKLY, Sept. 8, 1986, at 1.

235. *Frontier Operations Shut Down, Carrier's Future Uncertain,* AVIATION DAILY, Aug. 26, 1986, at 313, 314.

236. Pierce, *The Perils of Competition,* TIME, Sept. 8, 1986, at 50.

237. Form 10-K, Filed by Texas Air Corporation with the U.S. Securities and Exchange Commission 35 (for fiscal year ending Dec. 31, 1986).

238. Pierce, *supra* note 236.

239. Lassiter & Dubroff, *supra* note 234.

240. *Reporters, Analysts Applaud United's Frontier Purchase,* FRIENDLY TIMES, Aug. 1986, at 2.

241. *Id.*

242. Lassiter & Dubroff, *supra* note 234.

243. TEXAS AIR, INC., 1987 ANNUAL REPORT 2 (1988).

244. Stevenson, *supra* note 173.

245. Burns, *Judge OKs Settlement of People Express Suit,* United Press International Wire Report (Apr. 25, 1989); *People Express Investors File Suit against Carrier,* AVIATION DAILY, Sept. 25, 1986, at 484.

246. Form 10-K, Filed by Texas Air Corporation with the U.S. Securities and Exchange Commission 22 (for fiscal year ending Dec. 31, 1986).

247. In re Frontier Airlines, Inc. (memorandum opinion and order on motion to approve settlement, Case No. 86 B 8021 E, Mar. 23, 1987), at 4.

248. *Texas Air Lowers People Express Purchase Price by about $25 Million,* AVIATION DAILY, Nov. 4, 1986, at 185. Some sources report the original offer at $122.1 million for People Express. See, e.g., *Texas Air Corp. Seeks to Purchase People Express, Frontier Assets,* AVIATION DAILY, Sept. 16, 1986, at 425.

249. *Texas Air Corp., supra* note 248.

250. *Frontier Employees to Vote on Continental Work Offer,* AVIATION DAILY, Sept. 18, 1986, at 441, 442.

251. *People Express Using Failing Company Doctrine to Speed Merger Okay,* AVIATION DAILY, Oct. 9, 1986, at 50.

252. *Texas Air Debt Load Reaches $5.5 Billion with People Express Purchase,* AVIATION DAILY, Oct. 16, 1986, at 82.

253. *Id.*

254. Moran & Levin, *supra* note 213.

255. *Texas Air Lowers, supra* note 248.

256. Salpukas, *Company News; People's Acquisition Is Voted,* N.Y. TIMES, Dec. 30, 1986, at 4, col. 1; *Texas Air Lowers, supra* note 248; *Texas Air Again Reduces Value of People Express Takeover Offer,* AVIATION DAILY, Dec. 2, 1986.

257. *Texas Air Again Reduces, supra* note 256, at 324.

258. *Texas Air Negotiating to Lower Price for People Express,* AVIATION DAILY, Nov. 3, 1986, at 179.

259. *People Express Requests Confidentiality for Board Proceedings,* AVIATION DAILY, Oct. 17, 1986, at 90.

260. Form 10-K Filed by People Express Airlines, Inc., for the Fiscal Year Ending Dec. 31, 1986, with the U.S. Securities and Exchange Commission (Mar. 31, 1987), at F-1.

261. Form 10-K Filed by People Express Airlines, Inc., for the Fiscal Year End-

ing Dec. 31, 1986, with the U.S. Securities and Exchange Commission (Mar. 31, 1987), at F-12.

262. TEXAS AIR CORPORATION, 1986 ANNUAL REPORT 15 (1987).

263. Form 10-K, Filed by Texas Air Corporation with the U.S. Securities and Exchange Commission 3 (for fiscal year ending Dec. 31, 1986).

264. *Continental Expects to Operate 250 Daily Denver Departures by Yearend,* AVIATION DAILY, Nov. 3, 1986, at 182.

265. TEXAS AIR CORPORATION, 1986 ANNUAL REPORT 2 (1987).

266. Stapleton International Airport, Domestic Market Shares (July & Oct. 1986).

267. *Id.* See Pasxtor & Carley, *People Express Bid by Texas Air Clears a Hurdle,* WALL ST. J., Oct. 2, 1986, at 2, col. 2.

268. Krauss, *Financial,* United Press International Wire Report, Jan. 13, 1987.

269. *Id.*

270. Stapleton International Airport, Average Airline Fares for Selected U.S. Airports (1988).

271. Lorenzo made the helm of Continental a revolving door of executives. For example, Lorenzo ousted Continental President Thomas Plaskett (who had previously served as an executive at American Airlines for 12 years) after only eight months on the job. Thomas, *Frank Lorenzo, Builder of Airlines, Now Faces Task of Running One,* WALL ST. J., July 24, 1987, at 1.

272. Salpukas, *Airlines' Big Gamble on Expansion,* N.Y. TIMES, Feb. 20, 1990, at C1, C5.

273. *Id.* at C5.

274. Prokesch, *supra* note 119.

275. *Id.*

276. *Super Savings, supra* note 73, at 40.

277. Byrne, *supra* note 69.

278. *Super Savings, supra* note 73, at 40, 41.

279. Prokesch, *supra* note 119.

280. Byrne, *supra* note 69.

# 6

# DELTA AIR LINES

*Hubs:* Atlanta, Salt Lake City, Cincinnati
*Mini-hubs:* Dallas/Ft. Worth, Los Angeles, Orlando
*Post-deregulation Merger:* Western (1986)
*Computer Reservations System:* DATAS II, a part of WORLDSPAN
*Rank and Market Share:* 1978—fifth, 10.3%; 1990—third, 13.0%

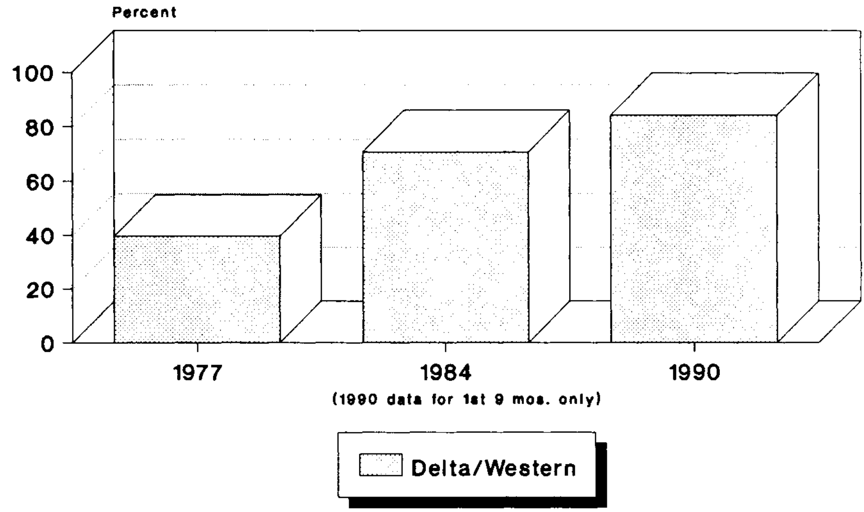
Delta Air Lines began modestly, as a crop-dusting outfit in Monroe, Louisiana, in 1928—the first professional crop duster in the nation.[1] Delta was born and nurtured by C. E. Woolman, who headed the company for 38 years, until his death in 1966.[2] He moved Delta's headquarters to Atlanta in the early 1940s, and that hub became the heart of its operations and, ultimately, the source of most of its management.

Delta vigorously opposed deregulation. During the late 1970s, it was the most litigious of the bunch, taking the CAB to court on nearly every one of the deregulatory initiatives of Alfred Kahn, who was then chairman. Indeed, the litigation branch of the CAB's Office of General Counsel came to be known as the "Delta Wing."

Nonetheless, Delta entered deregulation with a number of strengths. By growing, it had elbowed its way into the "big five." Delta had expanded significantly in the Southeast by acquiring Citizens & Southern Airlines in 1953.[3] It expanded north with its acquisition of Northeast in 1972.[4] And in 1986, Delta joined the stampede to merge by acquiring Western Air Lines, hubbed in Salt Lake City, for $900 million (see figure 6.1).[5]

Because Delta paid its workers well and had never laid any off, it enjoyed relatively amicable labor relations and had few union contracts. That enabled it to enjoy high productivity, excellent service, and high worker

**Figure 6.1**
**Airline Market Share at Salt Lake City**




*Sources:* AVIATION DAILY, Apr. 19, 1985, at 28; Feb. 1, 1990, at 230; Apr. 29, 1990, at 628; Mar. 29, 1991, at 590; and CONSUMER REPORTS.

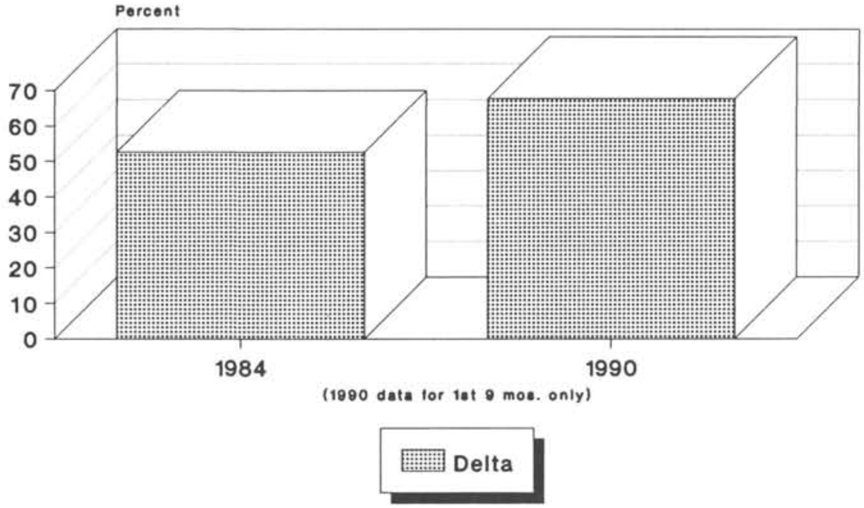
morale with little turnover.[6] Delta's greatest asset of all was its people.[7] While deregulation has brought the industry tremendous labor strife, labor-management relations are relatively peachy at Delta's Atlanta headquarters. In 1986, Delta's workers dug into their pockets and bought their company a jet.

Delta is a conservative company with little debt. Its debt-to-equity ratio in 1988 was 33 percent, compared with an industry median of more than 80 percent.[8] But Delta's salary expenditures are high. In 1988, Continental's average employee earned $29,700, whereas Delta's earned $51,400.[9] When it acquired Western in 1986, Delta immediately raised the salary of all Western employees from their average of $36,500 to Delta levels, without laying off a single employee.[10] As a former Delta executive noted, "A job with Delta is security for life, providing you don't get caught sleeping with one of your employees."[11] Hence, Delta is a bit heavy with employees and is saddled with the largest labor expenditures in the industry.

Nonetheless, Delta has been blessed with profitability. Before 1990, the only year since the Great Depression in which Delta failed to post a profit was 1983, when it lost $16.1 million.[12] In part, Delta's success lies in its competition.

Its slower southern cousin, Eastern, was traditionally a poor competitor at their common Atlanta hub. Eastern's bankruptcy experience under Frank

**Figure 6.2**
**Airline Market Share at Atlanta**




*Sources:* AVIATION DAILY, Apr. 19, 1985, at 28; Feb. 1, 1990, at 230; Apr. 29, 1990, at 628; Mar. 29, 1991, at 590; and CONSUMER REPORTS.

Lorenzo ultimately benefited Delta. Because of Delta's superior service, most businesspeople prefer to fly Delta. (See figure 6.2.)

Delta is, however, a sluggish price innovator.[13] Higher prices tend to cover its higher costs. With its shared monopoly in Atlanta, passengers who board or depart there recently paid 22¢ a mile, whereas other Delta passengers paid 13¢ a mile.[14]

Above all, Delta is conservative. Tradition is the bedrock of its management philosophy.[15] Delta still holds its annual stockholders' meeting in Monroe, Louisiana, the city in which it was founded.

Delta's headquarters at Atlanta's Hartsfield International Airport was traditionally austere. Although newer facilities have been built at Hartsfield, Delta still has linoleum floors in all offices except those of the assistant vice presidents and higher officers. Indeed, if a lower-ranking officer takes over a carpeted office, the carpet is ripped out and replaced with linoleum.[16]

One analyst noted, "Tradition . . . still shapes the basic approach of Delta's management."[17] Conservative management has led it to follow the pack, so to speak, in buying aircraft, in offering pricing discounts, in adopting two-tier wages, in developing a frequent-flyer program and computer reservations system, and in acquiring other carriers. Delta acquired Western Airlines when it saw the industry charging toward acquisitions. It jumped into the computer reservations system (CRS) business by buying DATAS II for $130 million three years after American pioneered the industry with SABRE.[18] By 1989, DATAS II had only about 5 percent of the national CRS market.[19] A Delta critic charged, "The corporate culture at Delta does not honor innovation; it honors loyalty to tradition."[20]

Since the death of C. E. Woolman in 1966, it has been said that Delta's management has been dominated by "good old boys," mostly Georgia Tech graduates. Promotion from within has created a bureaucratic culture at Delta, one with inbred management.[21] However, Delta picked up 4 of Western's 16 officers in the merger, which strengthened its marketing team. Delta also stole away the "Official Airline of Walt Disney World" title from Eastern and expanded operations in Orlando.[22] If indeed the good old boys run Delta, they know what they are doing.

"Buster Tom" Beebe served as chairman of Delta between 1970 and 1980.[23] His protégé, Ronald W. Allen, became president and chief operating officer in 1983.[24] Allen is clean-cut, tall, and athletic.[25] One critic described him as lacking "the breadth of background and the experience to be a successful competitor in this environment where airlines continue to fumble through the chaos created by the Airline Deregulation Act of 1978."[26] Nonetheless, the disintegration of Eastern has been a tremendous boon for Delta, and Delta is among the three airlines most analysts agree will survive the market Darwinism unleashed by deregulation. When asked about Delta's good-old-boy management style, Allen said, "Being nice to our workers, paying them well, that's not good ol' boy, it's modern and enlightened."[27]

Delta's weaknesses include "higher labor costs, a weaker computer reservations system and a slower start on international service than its major rivals."[28] Nonetheless, it has a dedicated labor force, a relatively high level of service, and loyal customers. With its acquisition of Western, it became an airline with a national presence. Delta's development of a hub at Cincinnati has been profitable. It is also enthusiastically expanding in the transatlantic market. It acquired most of Pan American's transatlantic and European operations in 1991. And with 517 aircraft on order or option, Delta is poised to grow if the economy is strong.[29]

## NOTES

1. S. Davis, Delta Air Lines: Debunking the Myth 134 (1988); R. Davies, Airlines of the United States since 1914 117 (1972).
2. S. Davis, *supra* note 1, at 2, 134.
3. *Id.* at 131.
4. R. Davies, *supra* note 1, at 566.
5. S. Davis, *supra* note 1, at 153.
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7. *Id.* at 39.
8. Banks, *Is Delta Too Nice for Its Own Good?*, FORBES, Nov. 28, 1988, at 91, 94.
9. *Id.* at 94.
10. S. DAVIS, *supra* note 1, at 19.
11. *Id.* at 81.
12. *Id.* at 43.
13. *Id.* at 17.
14. *Id.* at 119.
15. Salpukas, *Delta a Favorite in Airline Stocks*, N.Y. TIMES, Oct. 11, 1988.
16. S. DAVIS, *supra* note 1, at 2.
17. Salpukas, *supra* note 15.
18. S. DAVIS, *supra* note 1, at 17, 47.
19. Salpukas, *supra* note 15.
20. S. DAVIS, *supra* note 1, at 32.
21. *Id.* at 43, 167, 173.
22. Banks, *supra* note 8, at 94.
23. S. DAVIS, *supra* note 1, at 3, 45, 140.
24. *Id.* at 148, 154.
25. *See id.* at 133.
26. *Id.* at 3.
27. Banks, *supra* note 8, at 94.
28. Salpukas, *Airlines' Big Gamble on Expansion*, N.Y. TIMES, Feb. 20, 1990, at C1, C5.
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# 7

# EASTERN AIRLINES

*Hub:* Atlanta

*Post-deregulation Acquisition:* Braniff's Latin American Routes (1983)

*Computer Reservations System:* System One (now owned by Texas Air, renamed Continental Airline Holdings)

*Rank and Market Share:* 1978—fourth, 11.1%; 1990—ninth, 4.5% (ceased operations in 1991)

Eastern Airlines, founded in 1928, was the first major carrier to fly the north-south routes along the East Coast. This gave it strong presence in Atlanta and Miami and beyond to the Caribbean. Eastern pioneered the Washington–New York–Boston shuttle, a major innovation.[1]

Before Lorenzo devoured it in 1986, Eastern was the pilots' airline, a company headed by a long line of aviation heros. "Captain Eddie" Rickenbacker, the World War I flying ace (only Sergeant Alvin York earned as much public adoration),[2] reputedly knew all its fliers by name.[3] Rickenbacker became general manager of Eastern in 1935. In 1938, he and several friends bought the airline for $3.5 million from General Motors.[4] That year, Rickenbacker took it off federal subsidy.[5]

Almost single-handedly, Rickenbacker made Eastern one of the "big four," despite the absence of a transcontinental or transoceanic route.[6] He was a colorful and dominant leader. The Eastern "family" was a close one, cultivated by management to take pride in the airline. It was christened "The Wings of Man."

Although among the most profitable of airlines in the late 1940s, Eastern endured a roller-coaster ride that placed the company near bankruptcy by the early 1960s.[7] Employee morale during this period has been compared to that of "a football team with a twenty-five game losing streak."[8] Competing head to head in the Atlanta hub with healthier Delta was an uphill battle. Delta could charge more, pay labor more, and still turn a profit with largely nonunionized workers while Eastern paid labor less, had poor labor-management relations, and was anemic in the 1980s.

But Eastern was growing nonetheless. In 1969, Eastern carried 21.6 million passengers, had a fleet of slightly more than 200 aircraft, and employed 31,900 employees. By 1985, the company carried 41.7 million passengers—more than any other airline in the free world—with a fleet of 289 aircraft and 41,100 employees.[9] Indeed, Eastern ranked first or second in the number of passengers from 1976 to 1985.[10]

Colonel Frank Borman, the Apollo astronaut, was faced with a number of challenges when he took the reigns of Eastern in 1975.[11] Borman also took a gamble with the first U.S. airline purchase of the new Airbus aircraft, manufactured in Europe by a consortium of European governments. Airbus was eager to penetrate the U.S. market and offered Eastern a sweetheart deal with generous financing. For his part, Borman was interested in refurbishing his fleet with modern, fuel-efficient equipment. Had fuel prices continued to ascend, the major purchase might have given Eastern a competitive advantage over its rivals. But in the 1980s, they fell.

The 1970s were, on balance, profitable years for Eastern. Over the decade it enjoyed an operating profit of more than half a billion dollars and earned $58.8 million in net income.[12] The 1980s were a bit worse. Between 1980 and 1985, Eastern earned $244.3 billion in operating profit but lost $380 million in net income, although later years showed some improvement.[13] But interest expenses, levied to finance Eastern's new planes and its tenacious debt, were crushing its profits.

The ailing bottom line required a confrontation with labor over wages. Eastern workers, for their part, could not understand why Eastern didn't make a profit when rival Delta, with higher labor costs, turned a profit in all years except 1983. Surely, Eastern's inferior management was to blame. Nevertheless, Eastern's employees surrendered $1.14 billion in concessions between 1979 and 1988.[14] Eastern enjoyed the lowest labor costs in the industry, with only nonunion Continental having lower wages.[15]

Borman traded wage concessions for equity in the company, and the unions soon sat on Eastern's board of directors, holding four seats and 30 percent of the stock. Charlie Bryan, the tenacious leader of the machinists union, took a seat on Eastern's board and badgered poor Borman relentlessly.[16]

In 1985, Borman informed the unions that he intended unilaterally to impose a continuation of the 1984 wage cuts. The unions voted to strike in February 1986, by margins of over 90 percent. Borman threatened that if the unions did not accede to his demands, he would sell or liquidate the company. All the unions except the machinists capitulated. But on the evening of February 24, 1986, when Borman threatened to sell Eastern to the dreaded Frank Lorenzo, the destroyer of unions, the machinists too agreed to a wide range of concessions, with one condition: that the board of directors replace Borman with a chairman "acceptable to the employee groups."[17] Borman was outraged. Within hours, he had persuaded the board to sell the company to Lorenzo's Texas Air.

Texas Air paid $615 million, or $10 a share, for Eastern. Eastern paid a $20-million inducement to Texas Air to make an offer to buy the airline; Eastern financed Texas Air's purchase with $110 million of its cash and $230 million in preferred stock. Thus, of the $615 million Texas Air ostensibly paid for Eastern, $374 million (or about 61 percent) was paid for by Eastern itself.[18] Five weeks before the deal, Eastern's top management had given itself "golden parachutes" totaling $7.3 million. Colonel Borman's fee for assisting the Texas Air purchase exceeded $1 million.[19] Borman became a director and vice chairman of Texas Air.[20]

The pilots summarized their view of working for Frank Lorenzo in these terms:

> Texas Air is the best example of the worst abuses of deregulation. Under the guise of airline building, Texas Air has gotten control of ten airlines and driven the two survivors, Continental and Eastern, into bankruptcy. This manipulation of the intent of deregulation has protected Lorenzo's financial empire and forced his repressive work ethic upon the remaining employees. Texas Air has a record of reduced competition, reduced jobs, reduced compensation, reduced benefits, reduced service, reduced maintenance, reduced safety margins, reduced pilot quality, and reduced communities served. The major increases Texas Air are responsible for are compensation for its top executives (Lorenzo's 1988 salary was reportedly over $1.25 million) and consumer complaints at a level unequaled in the airline industry.[21]

The pilots were not alone in their disdain for Texas Air. *Fortune* magazine ranked the company as one of the five least-admired corporations in the United States, the least-admired transportation firm in the nation, and one of the ten worst U.S. corporations at providing rewards for shareholders.[22] Between 1971 and 1989, under Lorenzo's control, Texas Air's four airlines (Texas International, Continental, New York Air, and Eastern) suffered net income losses totaling nearly $2.3 billion.[23]

Under Lorenzo's tutelage, between 1986 and 1988, Eastern lost $85.5 million in operating profit and nearly $648 million in net income.[24] Eastern was radically downsized. Between 1986 and 1988, the work force was reduced from 42,000 to 29,000, and its newly established Kansas City hub was abandoned. Eastern, which had been the airline that served the most passengers in the free world, was now the sixth largest. Still, Eastern was the pilots' airline, one traditionally run by men with an aviation background, and it remained proud.

Lorenzo changed all that. His stripping the company of assets and demanding wage reductions created "an intense, highly personal anger, a feeling that [employees'] self-respect, honor and dignity" had been "undercut by a management obsessed with pinching pennies and controlling every aspect of their working lives."[25] As the psychologist Linda Little said:

I sat with Eastern management and talked to them about the process of bonding with an infant, that within the first hours and weeks the mother makes contact and the infant knows that this is a safe place to be. But Eastern management came in and rather than saying to its employees, "We want your advice, we want your help, we want to work with you, to bond with you," they came in and said, "You've got to change, you are bad, you are wrong." They did everything a bad mother would do.[26]

On taking over Eastern, Lorenzo put into place much of the same management team that had led Continental into bankruptcy.

| **Continental** | **Eastern** |
|---|---|
| *IAM Strike:* Aug. 13, 1983 | *IAM Strike:* Mar. 4, 1989 |
| *Bankruptcy:* Sept. 24, 1983 | *Bankruptcy:* Mar. 9, 1989 |
| *Frank Lorenzo:* Board Chairman, President | *Frank Lorenzo:* Board Chairman |
| *Phil Bakes:* Director, Exec. VP | *Phil Bakes:* Director, President, CEO |
| *Tom Matthews:* Sr. VP Employee Relations, Chief Labor Negotiator | *Tom Matthews:* Sr. VP Human Resources, Chief Labor Neg. |
| *Barry P. Simon:* VP, Gen. Counsel, Secretary | *Barry P. Simon:* Sr. VP Legal Affairs, Gen. Counsel, Sec'y |
| *Gary H. Lanter:* Various positions | *Gary H. Lanter,* VP Properties and Purchasing |
| *Mickey Foret:* VP, Treasurer | *Mickey Foret:* Director, Past VP Finance, CFO |
| *Lindsay E. Fox:* Past Chairman Int'l Advisory Board | *Lindsay E. Fox:* Director |
| *James W. Wilson:* Director | *James W. Wilson:* Director |
| *Carl R. Pohlad:* Director | *Carl R. Pohlad:* Director |
| *John Adams:* Sr VP Personnel | *John Adams:* Past VP Human Res. |
| *Donald Breeding:* VP Flight Ops | *Donald Breeding:* Past VP Flight Operations |
| *Robert D. Snedeker:* Director, Sec./Treas. (Jet Cap), Director, Sr. VP, Treasurer (TAC) | *Robert D. Snedeker:* Director (EAL), Sec./Treas. (Jet Cap), Director, Sr. VP, Treasurer (TAC)[27] |

These interlocking directorates allowed Texas Air and its subsidiaries to strip Eastern of its assets for only a fraction of their worth. As the bankruptcy examiner Shapiro concluded:

The history uncovered in the course of the investigation reveals a host of transactions where Eastern apparently suffered from conflicts of interest on the part of Texas Air and the interlocking officers and directors it has put in place. Indeed, there are indications that from time to time Texas Air's officers entertained the notion to "Cherry pick" Eastern assets to the benefit of Continental.[28]

Examiner Shapiro found that such self-dealing resulted in the following amounts owed by Texas Air to Eastern for the following reasons:

**Texas Air's Acquisition of Eastern** **$61 million**

Eastern paid Texas Air a $20 million inducement fee and funded approximately $109 million of the total cash paid by Texas Air to Eastern's shareholders. Texas Air in turn paid Eastern approximately $68 million to purchase previously unissued Eastern stock. Thus, the acquisition of itself by Eastern cost Eastern a net amount of $61 million in cash. This payment of cash by Eastern directly benefited Texas Air by reducing the cash it had to pay for the acquisition, and it is doubtful that Eastern received any benefit from making this payment; . . . there is no clear evidence even that the acquisition by Texas Air was anything other than harmful to Eastern economically.[29]

**Eastern's $16 Million Receivable from Texas Air** **$5 million**

Apparently in order to improve the appearance of Eastern's financial statements, approximately $16 million in expenses paid by Eastern in connection with the acquisition were recorded as a receivable from Texas Air based upon its undertaking to reimburse Eastern. . . . [N]o effort was made to collect until the matter became the subject of adverse attention in litigation. . . . At that time . . . Texas Air paid the receivable without interest. At the rate being paid by Eastern to borrow money at the time, this two-year forbearance cost Eastern approximately $5 million. . . . [A] controlling stockholder's failure to pay a substantial receivable (and officers' and directors' failure to make any collection effort) in a time of financial need would appear to be an appropriate subject for a claim of breach of fiduciary duty.[30]

**Management Fees Paid by Eastern to Texas Air** **$1.4 million**

Eastern paid Texas Air a management fee of $500,000 per month from January 1, 1987 until filing for bankruptcy in March 1989, when the fee was reduced to $250,000 per month. . . .

The evidence raises questions . . . as to whether the value of the services received by Eastern, or the cost incurred by Texas Air in providing those services, are equivalent to the fee paid by Eastern. Further, although Eastern initially was charged a greater fee than Continental because it was a larger carrier, Eastern continued to pay more after Continental had surpassed it in size in the latter part of 1987, and there is no clearly sufficient justification for its having been required to do so.[31]

**Continental-Eastern Sales, Inc.** **$1 to $3 million**

Continental-Eastern Sales, Inc., ("CESI") was formed in December 1986 to combine the sales forces and City Ticket Office ("CTO") operations of Continental and Eastern. . . . Eastern contributed substantially greater numbers of experienced sales personnel, sales offices and CTO's without an equivalent corresponding contribution from Continental. . . . CESI maintained excessive accounts receivable from Continental which improved Continental's cash flow position, at times at Eastern's direct expense.[32]

**Aircraft Transactions by Eastern with Continental — $5.7 to $11.5 million**

Eastern did not receive fair value for its lease and eventual sale of [six] A300s to Continental. . . . Further, the restructuring of the lease agreement appears to have remedied Continental's cash-flow problems to Eastern's detriment.[33]

**People Express Notes Purchased by Eastern from Texas Air — $8 to $11 million**

In March 1987, Eastern acquired unsecured People Express notes due 2001 with a face value of $30 million from Texas Air for approximately $26 million in cash. This acquisition was approved by the Board of Directors of Eastern under circumstances warranting an inference that Eastern's management and the common directors made material omissions and misrepresentations. In addition, the price that Eastern paid appears excessive.[34]

**Sale of Newark Gates Lease from Eastern to Continental — $10 to $14 million**

Eastern assigned its lease of sixteen gates at Newark International Airport to Continental in exchange for an $11 million note and a sublease of five gates. . . . Before the transaction Eastern's Newark gates were valued [at between $1.875 and $2.03] per gate. . . . The evidence concerning the transaction suggests something less than arm's-length negotiations.[35]

**Texas Air Fuel Management Arrangement with Eastern — $18.8 million**

[Eastern paid a one-cent-per-gallon fee to a Texas Air subsidiary, TAC FMI, for aviation fuel.] The cost savings Eastern has realized from TAC FMI's activities appear to be less than the fees Eastern has paid.[36]

**Eastern's Sale of System One to Texas Air — $150 to $250 million**

In February 1986, Merrill Lynch valued [Eastern's computer reservation system] SODA at $200–$250 million. . . .

On March 3, 1987 Eastern's Board unanimously approved the sale [of SODA to Texas Air] for a $100 million, 6 percent convertible subordinated Texas Air note due in 2012. . . .

[It is reasonable to contend that Eastern sold SODA . . . for less than fair value, by an amount in the range between $150 to $250 million.][37]

**Bar Harbor Airways Transactions — $10.6 to $12.4 million**

The evidence suggests that Eastern provided disproportionate financial support for a commuter that was virtually controlled and operated by Continental and from which Continental received substantial benefits, and that it did so under unfavorable financial terms.[38]

**Eastern's Deposit of Cash Collateral for Texas Air's Guarantee in Connection with $200 million Private Placement** **$5 to $7 million**

Texas air treated Eastern less favorable in connection with this guarantee than it had treated Continental in an analogous situation.[39]

**Eastern's Payment of Cash Dividends on Preferred Stock Guaranteed by Texas Air** **$8 million**

[T]he last cash dividend payment of approximately $6.7 million on the merger preferred occurred just days before Eastern declared bankruptcy, at a time when Eastern's borrowing cost was practically infinite because of its poor financial condition, and therefore should not have not been made.[40]

**Total** **$284.5 to $403.1 million**[41]

Lorenzo demanded concessions from the machinists unions. But labor insisted that wages were not the cause of Eastern's economic problems; the rape of Eastern's assets by Texas Air was. A machinists strike in March 1989, followed by the decision of the pilots and flight attendants to honor the picket line, shut down Eastern. Lorenzo responded by throwing the company into Chapter 11 bankruptcy reorganization and selling off its most promising assets: the Boston–New York–Washington shuttle (landing slots and 21 aircraft) to Donald Trump for $365 million; the Philadelphia mini-hub, slots at LaGuardia and Washington National, and Philadelphia-Canada routes to Midway Airlines for $207 million; and the Latin American and Miami-Europe routes to American Airlines for $349 million.[42] Sixty-one aircraft were sold, and 23 aircraft were leased. Asset sales totaled nearly $1.5 billion.[43] Under Lorenzo, Eastern's assets were depleted by more than $1 billion; its capacity was reduced by more than 15 percent; and its employees were cut by more than 30 percent.[44] A much demoralized and downsized Eastern resumed operations from its Atlanta hub in 1989. In 1990, the creditors in Eastern's bankruptcy proceeding insisted that Frank Lorenzo and his lieutenant, Phil Bakes, be removed from the controls of Eastern, and the court appointed Martin Shugrue, a former Pan Am and Continental executive, as trustee to operate Eastern. Lorenzo and Bakes are the only people in history to have bankrupted two airlines (Continental and Eastern).

Chapter 11 bankruptcy was much more difficult than anticipated. As one source noted:

> While its pilots and flight attendants have called off their strike [but the machinists have not], the airline's passenger loads have been low and, under pressure from unsecured creditors, Eastern's management has scaled back its plan to rebuild the carrier.
>
> The goal now is to be about two-thirds its former size, compared with more

than 80 percent [in the fall of 1989]. Eastern lost $852.3 million [in 1989] and expects to lose $155 million in the first six months of 1990.[45]

Examiner Shapiro's findings of self-dealing, quoted above, forced Texas Air to promise a contribution of $280 million to settle possible claims that it had underpaid for Eastern's assets, a promise it later withdrew.[46]

Lorenzo was the central figure who galvanized the unions. One commentator summarized his impact on the airline industry and the American corporate scene:

> The ruthlessness of Lorenzo, although it would have been enough to set the old muckrakers scavenging to expose him, allowing him no place of hiding, is not really the moral of the abysmal story. It is more important that he represents in a particularly comprehensive way the atmosphere of greed and reckless manipulation, of sham financial transactions, that has grown in the past eight years of Reaganism, at the expense of productive commercial and industrial leadership. The reason Lorenzo has not been called to account, except by the union, is that he represents practices that are so common and tolerated.
>
> The destruction of a great airline is in part the destruction of the pride of its work force at all levels, and its loyalty to the company. As Robert Reich . . . said . . . "If companies are run on the principle of financial management, reducing wages, going deeply into debt, moving pieces of the company around like they were pieces of a Monopoly game, workers are not going to feel loyal. . . ." But disloyal to partners and his own management, Lorenzo does not prize loyalty in his own employees. He relies on discipline by terror.[47]

For a time, there was speculation that Eastern's flight operations and aircraft would be folded into nonunion Continental.[48] In early 1991, Eastern Airlines ceased operations, and its properties were placed on the auction block for liquidation. American Airlines purchased the Latin American routes Eastern had earlier bought from Braniff.

## NOTES

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2. R. SERLING, FROM THE CAPTAIN TO THE COLONEL 92 (1980).
3. Solis and de Cordoba, *Eastern Strike Bares Long-Festering Anger over Sense of Betrayal,* WALL ST. J., Mar. 17, 1989, at 1.
4. R. DAVIES, AIRLINES OF THE UNITED STATES SINCE 1914 196 (1972); R. SERLING, *supra* note 2, at 116, 143.
5. R. SERLING, *supra* note 2, at 151.
6. R DAVIES, *supra* note 4, at 533.
7. *Id.* at 393.
8. *Id.* at 393.
9. EASTERN PILOTS, EASTERN AIR LINES: AN AIRLINE IN CRISIS 3.2 (1990).

10. *Id.* at 3.3.
11. R. DAVIES, *supra* note 4, at 473.
12. See EASTERN PILOTS, *supra* note 9, 3.2.
13. *Id.*
14. *Id.* at 2.94.
15. *Id.* at 2.93.
16. *See* S. DAVIS, DELTA AIR LINES: DEBUNKING THE MYTH 12 (1988).
17. Fairlie, *Air Sickness,* NEW REPUBLIC, June 5, 1989.
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19. *Id.*
20. *Id.*
21. *Id.* at 10.
22. *America's Most Admired Corporations,* FORTUNE, Jan. 29, 1990.
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27. EASTERN PILOTS, *supra* note 9, 5.2.
28. In the Matter of Ionosphere Clubs, Inc, U.S. District Court for the Southern District of New York, Chapter 11 Case Nos. 89 B 10448 and 89 B 10449.
29. *Id.* at 80.
30. *Id.* at 81, 82.
31. *Id.* at 82–83.
32. *Id.* at 83–84.
33. *Id.* at 84–85.
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35. *Id.* at 86.
36. *Id.* at 88.
37. *Id.* at 88–91.
38. *Id.* at 92.
39. *Id.* at 94.
40. *Id.* at 96.
41. *Id.* at 97.
42. EASTERN PILOTS, *supra* note 9, 7.15.
43. *Id.*
44. *Id.* at 3.
45. Salpukas, *Airlines' Big Gamble on Expansion,* N.Y. TIMES, Feb. 20, 1990, at C1, C5.
46. Lowenstein, *Eastern Veers into Texas Air's Flight Path,* WALL ST. J., Mar. 9, 1990, at C1.
47. Fairlie, *supra* note 17.
48. Lowenstein, *supra* note 46, at C2.

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# 8

# NORTHWEST AIRLINES

*Hubs:* Minneapolis/St. Paul, Detroit, and Memphis

*Mini-hubs:* Milwaukee, Tokyo, Seoul

*Post-deregulation Merger:* Republic (1986), which is the merged product of North Central, Southern, and Hughes Airwest

*Computer Reservations System:* an interest in PARS, renamed WORLDSPAN

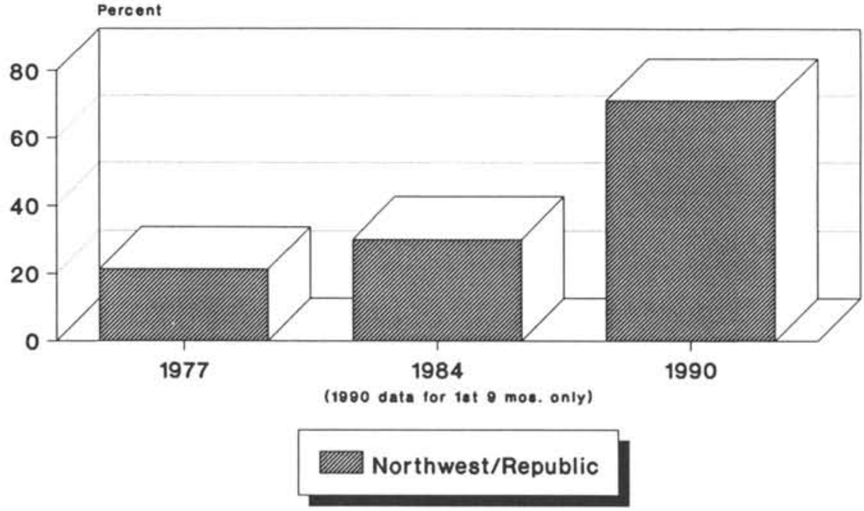
*Rank and Market Share:* 1978—eighth, 3.1%; 1990—fourth, 11.6%

Born in 1926, Northwest "Orient" broke into international aviation with North Pacific route service on July 15, 1947, the first airline to serve the market.[1] For many years, it carried more passengers in the North Pacific than any other U.S. airline.[2] More recently, it acquired transatlantic authority, now funneling much of that through Boston.[3] With the acquisition of Republic in 1986, Northwest gained a death grip on its Minneapolis/St. Paul hub and a stranglehold on Detroit, as well as domestic feed for its international operations. It intends to keep its prominent position in the Pacific (the fastest-growing and most lucrative market in the world), where its traffic is growing 19 percent compounded annually.[4] However, many new carriers are entering the transpacific market. (See figures 8.1 and 8.2.)

The annual report lists several "firsts" for Northwest:

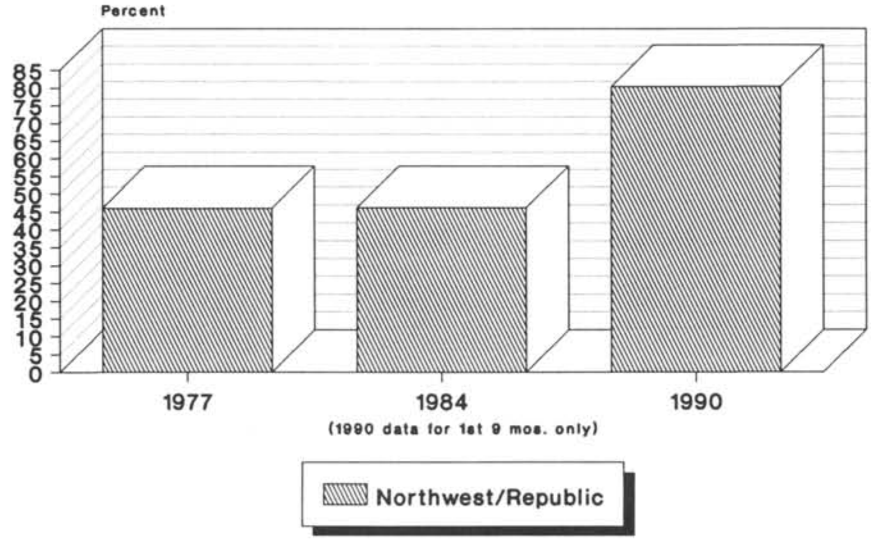
- The first airline to provide regularly scheduled service between Japan and the United States.
- The first airline to serve Seoul from the United States and the first to Shanghai and Manila on a North Pacific routing.
- The first U.S. airline to serve Osaka, Okinawa, and Taipei.

Figure 8.1
Airline Market Share at Detroit




*Sources:* AVIATION DAILY, Apr. 19, 1985, at 28; Feb. 1, 1990, at 230; Apr. 29, 1990, at 628; Mar. 29, 1991, at 590; and CONSUMER REPORTS.

Figure 8.2
Airline Market Share at Minneapolis/St. Paul




*Sources:* AVIATION DAILY, Apr. 19, 1985, at 28; Feb. 1, 1990, at 230; Apr. 29, 1990, at 628; Mar. 29, 1991, at 590; and CONSUMER REPORTS.

- The first U.S. airline to hire Japanese employees.
- The first airline to operate the new-technology Boeing 747-400 and the first to fly it on the 6,800-mile New York–Tokyo route.[5]

Northwest is a blend of several former local service airlines that merged after deregulation to form Republic—North Central, Southern, and Hughes Airwest. North Central merged with Southern to form Republic in 1979, then acquired Hughes Airwest the following year for $45 million.[6] With its $884-million acquisition of Republic, Northwest became an amalgamation of aircraft, hubs, labor, and management styles. The merger caused its problems:

> Merging two companies of similar size but totally different management styles which previously competed tooth and nail has been fraught with practical difficulties. Those problems have resulted in one of the worst on-time performance records in the industry, and thousands of complaints from irate passengers suffering from delayed or cancelled flights, and mishandled baggage.[7]

Service problems in the 1980s led many of its passengers to dub it "Northworst."[8] The merger also festered labor sores as 16,400 Republic workers joined 17,500 Northwest employees in a long and difficult blending of seniority lists.[9] As Chairman and CEO Stephen Rothmeier said: "The resulting culture is neither Northwest nor Republic. Clearly, that doesn't come easily."[10] But Republic gave Northwest several significant assets: small aircraft to provide domestic feed for its international routes and, again, a stranglehold on several domestic hubs.

With the leveraged buyout in 1989 by Alfred Checchi, Northwest has been saddled with more than $3 billion in debt to pay for his acquisition. Checchi and his partners invested only $40 million of their own, for which they received half the common stock of Wings Holdings, Inc., established as the holding company. In the process, Northwest's debt-to-equity ratio rose from 0.42/1 to 5.85/1. Much of the LBO was financed by KLM Royal Dutch Airlines, which began pooling operations with Northwest from Minneapolis to Amsterdam. In an unprecedented move by the U.S. Department of Transportation in 1991, KLM was allowed to retain a 49 percent equity and debt interest in Northwest (traditionally, foreign ownership has been limited to 25 percent, the statutory standard for voting control).

Significant aircraft orders (229 aircraft will be delivered during the 1990s) have also laden the company with debt. This, of course, would make the airline vulnerable during a long economic downturn.[11] Because the airline is privately held, its true financial condition has been obfuscated.

Neither Checchi nor the man he installed as president, Frederic V. Malek, have airline experience. Both spent much of their careers in the Mariott Hotel chain.[12]

Although not well loved by many passengers, for whom Northwest is their only choice and who grumble about the ticket prices and domestic service, before 1990 Northwest had been consistently profitable each year after 1949.[13]

## NOTES

1. R. Davies, Airlines of the United States since 1914 555 (1972). Northwest Airlines incorporated in 1934 to replace Northwest Airways. That year, it also purchased the Chicago-Fargo route from Hanford's Tri-State Airlines. *Id.* at 197.
2. NWA Inc., Annual Report 1 (1988).
3. *Northwest Shaping Strategy,* Airline Bus., June 1988, at 16.
4. *Id.; Northwest Changes Direction,* Flight International, June 11, 1988, at 33.
5. NWA Inc., Annual Report 8 (1988).
6. P. Dempsey, Law & Foreign Policy in International Aviation 146 (1987).
7. *Northwest Labour Pains,* Airline Bus., June 1988, at 19.
8. Reiff, *Being Down So Long It Looks Like Up to Me,* Forbes, June 13, 1988, at 96.
9. Salpukas, *Northwest Air Turns the Corner,* N.Y. Times, Jan. 7, 1989, at 36, 37.
10. Donoghue, *Northwest: Rough Ride to a Competitive Fortress,* Air Transport World, Oct. 1988, at 28, 31.
11. *Id.* at C5.
12. *Id.*
13. *See* NWA Inc, Annual Report 4 (1988.

# 9

# PAN AMERICAN WORLD AIRWAYS

*Hub:* New York Kennedy

*Mini-hub:* Miami

*Post-deregulation Merger:* National (1979); Texas Air, Boston–New York–Washington Shuttle (1986)

*Computer Reservations System:* None

*Rank and Market Share:* 1978—fifth, 9.3%; 1990—eighth, 6.9% (ceased operations in 1991)

In the mid-1920s, Dr. Peter Paul Von Bauer, the managing director of Sociedad Colombo-Alemana de Transportes Aereos (SCADTA), flew a delegation from Barranquilla to Key West via Central America and Cuba in two flying boats, supplied by Kondor Synidkat of Berlin. Von Bauer went to Washington to negotiate landing rights in Florida and the Canal Zone. The idea of a German-sponsored airline based only a few hours' flight from the United States caused concern in Washington. Von Bauer's request was denied by the State Department,[1] which would give full support only to a U.S.-controlled airline.[2]

The following year, a group of "gentlemen flier" Yale classmates led by Juan Trippe, who had operated Long Island Airways in 1923, exhibited an interest in an air route in the Caribbean.[3] After losing out on a New York–Boston airmail contract to Colonial Air Transport, they formed a temporary alignment with their rival but soon became frustrated at the reluctance of the New England company to extend its ambitions south of New York. So Trippe and his friends looked southward at the broad horizons and the potential of an airline market in Latin America.[4] Trippe's group formed the Aviation Corporation of America on June 2, 1927, and six days later, Trippe formed Southern Air Lines Inc., later to become New York Airways.[5] On July 16, 1927, J. K. Montgomery, who was earlier influenced by Von Bauer and his group, Pan American, won the coveted mail contract for the Key West–Havana route.[6] On October 11, 1927, the Reed Chambers-Ed Hoyt group reincorporated Southeastern Air Lines Inc. as Atlantic, Gulf and Caribbean Airways.[7] These three separate financial groups competed for the high stakes of Latin American air routes.[8]

In 1927, President Calvin Coolidge recommended a comprehensive system of airmail services to South America. That year, Congress passed the Foreign Air Mail Act, and the postmaster general advertised for bids on a wide-ranging network of mail routes throughout Latin America.[9]

The three groups—Trippe's New York Airways, Montgomery's Pan American, and the Chambers-Hoyt group—merged on June 23, 1928, forming the Aviation Corporation of the Americas.[10] Forty percent of the new company's stock was held each by Trippe's and Hoyt's groups and 20 percent by Montgomery's group.[11] On June 27, 1928, the Aviation Corporation of the Americas formed Pan American Airways Inc. as the operating subsidiary.[12]

The new Pan American Airways Inc. was awarded every foreign airmail route for which bids were invited. Pan American precisely fit the concept of a U.S. "chosen instrument" for overseas airmail service.[13]

With Charles Lindbergh as its technical adviser, Pan American began passenger service in January 1928.[14] By 1930, after taking on W. R. Grace and Co., an international trading company, as a partner, Pan American quickly swallowed the air routes of Latin America.[15] However, none of this could have occurred without a special relationship with the State Department.[16]

Pan American merged with its competition—New York, Rio & Buenos Aires Line (NYRBA)—in South America.[17] The acquisition of NYRBA sealed Pan American's monopoly of the foreign air transportation in Latin America. All that was left to complete the circuit of Latin America was the Venezuelan overhang.[18]

In 1931, General Gomez granted rights to open service between Maracaibo and Port of Spain, thus enabling the airline to fly a ring around the Caribbean. Pan American was now the world's largest international airline, operating 21,000 miles of routes through 29 countries in the Western Hemisphere. In contrast, the entire domestic route system of the United States, operated by more than a dozen carriers, was 30,451 miles.[19]

During the depression, Pan American continued to expand.[20] As Pan American looked forward to spanning the globe, the fears of engine failure over jungles and oceans haunted both the passengers and the pilots flying the aircraft. To alleviate those fears, Pan American constantly improved the navigation and safety of its aircraft.[21]

In 1931, Pan American carried 820,000 pounds of mail and cargo and

45,000 passengers and flew 12,479,000 passenger miles. That year it showed its first profit of $105,000 on revenues of $7.9 million, after a loss of $700,000 in its first two and a half years of operation.[22] Postmaster General Brown convinced Trippe to give up the domestic field, so Trippe did as instructed and sold New York Airways to Eastern Air Transport.[23]

In the mid-1930s, retired Postmaster General Brown was charged with conspiracy and collusion in the awarding of airmail contracts.[24] The postmaster general canceled the domestic airmail contracts, and the army was directed to fly the mail. A spate of crashes revealed that the army was incompetent to carry the mail; consequently, the domestic mail routes were reopened for bidding.[25]

Even though Pan American was not a part of the domestic mail route system, it did catch heat in Washington for possible illegalities involved in the awards of Pan American's foreign airmail route contracts.[26] Fortunately for Pan American, foreign communication links were a necessity, and the U.S. military could not realistically hope to cross foreign territories on a daily basis. Thus, Pan American kept its foreign airmail contracts, but some had to be modified.[27]

On the completion of the first passenger flight across the Pacific, in October 1936, Trippe sent the following message to President Franklin Roosevelt from the cockpit of the *China Clipper:* "We are glad to inform you that this first flight was made during your administration by an American company with [an] aircraft built in [the] U.S. and in charge [an] American captain and his five flight officers."[28] Trippe was a consummate diplomat, stroking domestic politicians and negotiating his own "treaties" with other governments.[29] Pan Am was sometimes referred to as "the other State Department."[30] However, Japan's movements suggested that a war was brewing, and Japan opposed an American airline flying over or too near to its territory.[31]

While Pan American was conquering the Pacific, it also had its eyes on conquering the Atlantic.[32] In the late 1930s, Pan American and Imperial Airlines obtained a 15-year permit to operate over the Atlantic. Trippe obtained this authority with the recommendation of the British director of civil aviation, without actually being chosen by his own government.[33] This reciprocal agreement gave both airlines the authority to fly between the United States and Britain via Newfoundland and Bermuda.[34]

As of January 1, 1939, Pan American served 54,072 route miles in 47 countries with 126 aircraft, 145 ground radio stations, and 5,000 employees. That year, Pan Am began the world's first regularly scheduled transatlantic airplane passenger service. Pan American and its subsidiaries constituted, by far, the largest airline operation in the world.[35] At this time, however, the company was in poor financial shape, losing heavily in the Pacific and investing heavily in the Atlantic with no return as yet. Large loans had been needed, resulting in a board heavy with bankers.[36]

World War II broke out, and Pan American's passenger load boomed.[37] In the first two weeks of the war, 10,000 Americans in Europe wanted to fly home. Mail loads increased to a staggering amount. Profits soared, and Pan American purchased six more Boeings, making twelve in all.[38]

During the war, over half of Pan American's system was converted to military use.[39] Trippe was offered a job as the general of the U.S. Army Air Corps, but declined.[40]

Before World War II, the international air commerce of the United States was almost exclusively the domain of Pan American and its affiliate, Pan American–Grace Airways. The authority for these carriers to fly to Europe, Asia, the Caribbean, and South America had been granted by private agreements between the airlines and the governments of the foreign nations to which they flew. As the war wound down, the CAB announced that treaties henceforth would be negotiated by the CAB and the U.S. Department of State and not by individual airlines.[41]

By 1945, Pan American had 13 terminal cities: Boston, New York, Philadelphia, Baltimore-Washington, Miami, Seattle, San Francisco, Los Angeles, Detroit, Chicago, New Orleans, and Houston. Trippe proposed to link them with high-speed, nonstop service.[42] The only real competition Trippe feared was foreign competition.[43] In 1947, Pan Am began the first round-the-world service but was prohibited from providing the New York-San Francisco domestic link.

Pan American's proposal for routes inside the United States was opposed by all 17 domestic airlines.[44] Pan American upgraded its fleet with larger and more powerful aircraft in anticipation that the CAB might grant Pan American its domestic express route applications.[45] The CAB, however, did not allow Pan American to provide domestic U.S. operations due to the harm anticipated to the other domestic airlines.[46]

Pan American eventually purchased American Overseas Airlines from its parent, American Airlines. The CAB denied the merger, but the CAB's decision was reversed by President Harry Truman. As a result, Pan American secured access to Paris and Rome.[47]

Before the first jets flew,[48] a civil antitrust suit brought by the Department of Justice complained that Panagra, Pan American, and W. R. Grace and Co. were engaged in a conspiracy to monopolize air commerce between the United States and South America. In 1956, Pan American served 111 cities while TWA served only 26. In 1959, Pan Am became the first airline to offer scheduled turbojet service. Although 14 U.S. airlines now operated overseas, Pan American flew 54.4 percent of all overseas route mileage flown by U.S. airlines and carried about 59 percent of the passengers and 60 percent of the air freight. Pan American's capital investment amounted to 67 percent of the international industry total, while TWA's capital investment was only 11 percent.[49] Pan American was the largest

U.S. company engaged in air transportation in terms of assets. No statistics adequately reflected Pan American's economic power, for it owned or controlled 49 affiliated companies, of which 12 were airlines.[50] Trippe was sitting on top of a billion-dollar conglomerate in the 1960s with hotels, missile ranges, business jets, a midtown Manhattan office building, and the mightiest international airline in the world.[51]

By 1964, Pan American was flying to Europe 214 times a week, up from 170 flights in 1958 in propeller planes carrying half as many people. In 1965, there were 258 flights a week to Europe and 152 across the Pacific. By 1966, traffic had risen another 25 percent. The planes now touched down in 118 cities, and the net profit was $132 million.[52]

By now Pan American was so vast that Trippe had become a difficult individual to see. Trippe's subordinates would sometimes wait days, even weeks, before seeing him. Trippe ruled absolutely. Trippe was a hard worker, who worked long hours straight through, and he expected the same out of his executives. When he took a lunch, it was not a social occasion. A social occasion to Trippe was his annual Christmas party, for one social event was enough.[53] Trippe lacked a sense of time, a consideration of others and their schedules.[54] Pan American employees grumbled about low pay, except for the pilots.[55] Pan American was like a government service. The company appealed to those who liked to give public service and to those who were attracted by the glamor of the airline business and who believed that they were building and serving.[56]

Trippe boldly placed orders for 25 DC-8s and 20 707s, ushering in the jet age in international aviation.[57] By the late 1960s, Trippe was looking forward to supersonic air transport; but more so, he was looking toward the development of a new aircraft by Boeing—the 747.[58] Pan Am had always challenged the manufacturers to produce long-range equipment.[59] Indeed, it was Trippe's vision that persuaded Boeing to launch the B-747; he placed an order for 25 in 1966.[60] Thus came the dawn of widebodied aircraft.

At a stockholders' meeting in 1968, Trippe announced his successor, Harold Gray. By then, Pan American had 40,000 employees. Its fleet numbered 143 multi-engined jets, with a billion and a half dollars' worth of planes on order. Pan Am still had hotels, business jets, airports, and a midtown skyscraper.[61]

As Trippe departed, Pan American began to lose money. In 1969, Pan American lost $26 million, and in 1970, $49 million. Trippe shouldered part of the blame as the press claimed he had bailed out when he foresaw these losses coming.[62] Throughout the 1960s, overseas air traffic had increased at nearly 25 percent per year. Market projections pointed to continued growth.[63] Unfortunately, traffic stagnated. A two-year recession hit at the beginning of the 1970s, which led to acres of empty seats. Thirteen domestic and foreign airlines competed across the Pacific, 23 in Central and South America, and 29 across the North Atlantic. Pan American's share of overseas traffic dropped sharply.[64]

The ruinous competition Trippe had predicted had at last emerged. Unanticipated increases in labor and maintenance expenses and higher fuel costs also contributed to Pan American's financial woes.[65]

A few domestic routes might have offset all this. Though Pan American continued to apply for domestic routes from time to time, none were ever awarded. On top of the recession, the increased competition, and the unfavorable CAB decisions rode Pan American's monumental debt due to the purchase of new 747s and the cost of a new Kennedy Airport terminal building, which amounted to nearly a billion dollars borrowed at then near-usurious rates of 11 percent.[66] As a result of all this, Gray laid off 2,000 employees.[67] Gray had the extremely orderly mind typical of an engineer, but he was raw in public relations. Gray lasted only 18 months and was succeeded by Najeeb Halaby.[68]

Pan American continued to lose money through the 1970s. Halaby, in panic, began firing executives and bringing in new executives who were inexperienced in the airline business.[69]

The president and chief operating officer under Halaby, William Seawell, was promoted to chairman and replaced Halaby. Seawell began to reduce the tariff structure, to abandon unprofitable routes such as the Caribbean, and to cut the personnel roster almost in half. Contradicting Seawell's moves was the Mideast oil embargo, which caused fuel prices to skyrocket. Seawell traded off routes with TWA, abandoning Paris and Rome but gaining exclusivity in Germany and the Pacific.[70] Pan American continued to lose money. At last, Seawell considered declaring bankruptcy.[71]

Pan American lost money for eight consecutive years, until 1977, when it finally showed a profit. Seawell's business tactics had turned the situation around, and he temporarily saved the airline.[72]

In 1979, President Jimmy Carter approved Pan American's $308-million acquisition of National Airlines, which served the entire U.S. East Coast and the West Coast via a southern transcontinental route. Frank Lorenzo had secretly begun buying the stock at $26 a share and ultimately walked off with $47 million in arbitrage.[73] Pan Am offered $41 a share, but after Eastern's Frank Borman entered the bidding war, the price was bid up to $50 a share, which is what Pan Am paid.[74] By the 1980s, Pan American at long last had a domestic artery to pump traffic into its international system, but the prize was too late in coming.

After the Airline Deregulation Act of 1978, Pan American faced greater competition, greater than any Trippe had conceived in his wildest dreams, when domestic and foreign carriers began to fly the routes that Pan American had once had all to itself.[75] And National's domestic feed was not all Pan Am had hoped. Pan Am's economic problems continued throughout the 1980s, causing it to cannibalize its assets—the Manhattan headquarters building (sold to Metropolitan Life Insurance Company for $400 million in July 1980, then the largest real estate transaction for a single building in history),[76] Intercontinental Hotels (sold to Grand Metropolitan of London for $500 million), its transpacific routes and corresponding aircraft including all the 747SPs (sold to United Airlines in 1985 for $750 million), queues for new Airbus aircraft (16 A320s and options for 34 more sold to Braniff in 1988 for $115 million), and its contract services unit, Pan Am World Services (sold to Johnson Controls in 1989 for $165 million).[77] Yet the losses continued. During the 1980s, Pan Am had two barely profitable years.[78] But it lost $73 million in 1988 and $337 million in 1989.[79] In the 1990s, it sold its intra-German Berlin operations to Lufthansa and its London Heathrow and beyond rights to United Airlines.

Pan Am was able to pick up from Texas Air valuable landing slots and gates in Boston, New York, and Washington to run a shuttle in competition with Eastern. The Justice Department had insisted on divestiture as a condition of approval of the Texas Air acquisition of Eastern.[80] Pan Am sold the shuttle and its remaining European routes to Delta in 1991.

Pan Am's problems were summarized as follows:

> Pan American World Airways has survived on money raised by selling assets, but there is general agreement that the carrier will end up slowly liquidating itself unless it can link up with another major airline. . . .
>
> Thomas G. Plaskett, chairman and chief executive, acknowledges that the carrier has no future unless it can link up with a strong airline. Talks between Pan Am management and each of the major carriers have taken place from time to time. Pan Am's international routes, particularly its operations out of Heathrow Airport in London, are especially attractive. But no carrier has been willing to take on the enormous task of renewing Pan Am's aging fleet and integrating its unionized workers with its own employees.[81]

Pan Am entered Chapter 11 bankruptcy in early 1991, and ceased operations late that year. United purchased its Latin American routes in a bankruptcy auction for $315 million. The loss of this pioneer of global aviation was a profound national tragedy. The demise of Pan Am is of the same magnitude as if Ford Motor Company produced its last car, for Henry Ford had the same impact on automotive manufacturing that Juan Trippe had on international aviation. Both were brilliant innovators in their respective industries. As R. E. G. Davies eloquently wrote:

> During the 60 years of its brilliant history, [Pan Am] pioneered transocean and intercontinental air routes, it sponsored airplane types which were in the van of technical progress, and as the Chosen Instrument of commercial aviation policy overseas, it became a powerful political force. Without Pan American the course of air transport, even some nations' destinies, would have been different.[82]

## NOTES

1. R. DAVIES, AIRLINES OF THE UNITED STATES SINCE 1914 210–11 (1972).
2. *Id.* at 211.
3. *Id.* at 211; Carlson, *Juan Trippe Took World Travel into Skies,* WALL ST. J., June 13, 1989, at B2.
4. R. DAVIES, *supra* note 1, at 211. Another investment group was also looking for an airline route in Latin America. This group, led by Eddie Rickenbacker and Reed Chambers, had organized Florida Airways early in 1926 and operated a route between Atlanta and Miami with the objective of obtaining a Havana route. Because it did not have a good northern connection, Florida Airways fell into bankruptcy. *Id.* at 211.
5. *Id.* at 212.
6. *Id.* at 212.
7. *Id.* at 212.
8. *Id.* at 212.
9. *Id.* at 213.
10. *Id.* at 213.
11. *Id.* at 213.
12. *Id.* at 214.
13. *Id.* at 214.
14. M. BENDER & S. ALTSCHUL, THE CHOSEN INSTRUMENT: THE RISE AND FALL OF AN AMERICAN ENTREPRENEUR 102 (1982); Carlson, *supra* note 3, at B2.
15. Braniff acquired Pan American–Grace Airways in 1967. R. DAVIES, *supra* note 1, at 562.
16. M. BENDER & S. ALTSCHUL, *supra* note 14, at 123. By the summer of 1929, Pan American owned a dozen and a half planes, mostly Sikorsky S-38 amphibians and Fokker-10 land planes. *Id.* at 170.
17. *Id.* at 174–75.
18. *Id.* at 176.
19. *Id.* at 176.
20. *Id.* at 181.
21. *Id.* at 182–83.
22. *Id.* at 190.
23. *Id.* at 191.
24. *Id.* at 215.
25. *Id.* at 219–20.
26. *Id.* at 221–23.
27. *Id.* at 221–23.
28. Carlson, *supra* note 3, at B2.
29. *Id.* at B2. P. DEMPSEY, LAW & FOREIGN POLICY IN INTERNATIONAL AVIATION 18, 48 (1987); A. SAMPSON, EMPIRES OF THE SKY 44, 46 (1984).
30. Carlson, *supra* note 3, at B2.
31. M. BENDER & S. ALTSCHUL, *supra* note 14, at 230.
32. *Id.* at 258.
33. *Id.* at 261.
34. *Id.* at 260–61. However, actual commercial flights on these routes over the Atlantic were delayed. During the next year and a half, transatlantic bargaining

took on a vicious character. The contract between Pan American and Imperial was signed on January 25, 1936. The French and the German air officials saw the Pan American and Imperial agreement as an effort to freeze their airlines out of the North Atlantic. *Id.* at 262. So Trippe signed an agreement with Air France in February 1936 for operation of a North Atlantic service between New York and Paris. *Id.* at 262. But because of Hitler's decision to rearm and unleash his anti-Semitic campaign, the United States acceded only to permits for experimental flights of German aircraft. *Id.* at 263. In June 1937, commercial air service between Port Washington and Hamilton, Bermuda, was inaugurated at last. *Id.* at 265.

35. R. DALY, AN AMERICAN SAGA: JUAN TRIPPE AND HIS PAN AM EMPIRE 231 (1980).

36. *Id.* at 232.

37. In 1939, Sonny Whitney temporarily deposed Trippe. *Id.* at 238. Whitney soon tired of the chief executive role and was also aware that he lacked both the knowledge and the dynamism to run a company the size of Pan American. Whitney voluntarily resigned his position back over to Trippe in January 1940. *Id.* at 253. Trippe held a few grudges and promoted those who had previously supported him and demoted those who had not. *Id.* at 253–55.

38. *Id.* at 252.

39. *Id.* at 335.

40. *Id.* at 336.

41. P. DEMPSEY, *supra* note 29, 18–19.

42. R. DALY, *supra* note 35, at 358.

43. His principal postwar job was to reestablish his company's "chosen instrument" status, no matter what the cost. *Id.* at 346.

44. *Id.* at 359.

45. *Id.* at 359. Pan American sometimes engaged in unethical competition with the other airlines in some foreign ports, such as extinguishing the landing lights so that the competitor aircraft could not land. Pan American would also charge its competitors exorbitant landing fees or demand that permission to land be obtained from Pan American's division headquarters in Miami far in advance of the scheduled flights, so far in advance that it became practically impossible for competitors to provide flexible schedules or to change them to meet passenger demand. *Id.* at 372. Trippe denied responsibility for these actions and shifted the possible blame to his divisions, which were run as personal fiefdoms by the men in charge. *Id.* at 372. The late 1940s was a time of depression in the airline business, which brought about merger fever. *Id.* at 384–85. Trippe and Howard Hughes met to discuss the possible merger of TWA with Pan American. This merger never took place. *Id.* at 384–85.

46. *Id.* at 386.

47. *Id.* at 385–86.

48. By 1955, airlines were lining up to buy turboprops like the Lockheed Electras and British Viscounts. Pan American avoided this stepping-stone in converting to jets. *Id.* at 401. Once delivered in 1958, the jets were an immediate success. During the first quarter of 1959, 33,400 passengers were carried on Pan American's jets, with a 90.8 percent seat occupancy, an all-time high. *Id.* at 413–14. During the first five years of the jet age, overseas traffic doubled. *Id.* at 414.

49. *Id.* at 420–21.

50. See P. DEMPSEY, *supra* note 29, at 180; R. DALY, *supra* note 35, at 421. No antitrust proceedings were ever initiated as a result of these hearings, but Pan American bore the scars on its reputation for some time. *Id.* at 421. Pan American purchased a hotel chain, Intercontinental Hotels, sprinkled across 37 countries on five continents. *Id.* at 426–27. Intercontinental had been established in 1946 at the insistence of the U.S. government. R. DAVIES, *supra* note 1, at 562.

51. R. DALY, *supra* note 35.

52. *Id.* at 427.

53. *Id.* at 428.

54. M. BENDER & S. ALTSCHUL, *supra* note 14, at 463.

55. *Id.* at 463.

56. *Id.* at 464.

57. R. DAVIES, PAN AM 78 (1987).

58. R. DALY, *supra* note 35, at 430–32.

59. R. DAVIES, *supra* note 1, at 358.

60. R. DAVIES, *supra* note 57, at 79.

61. R. DALY, *supra* note 35, at 441.

62. *Id.* at 442.

63. *Id.* at 443.

64. *Id.* at 443–44.

65. *Id.* at 444.

66. *Id.* at 444.

67. *Id.* at 444.

68. *Id.* at 444–45.

69. *Id.* at 446–47.

70. P. DEMPSEY, *supra* note 29, at 20–21.

71. R. DALY, *supra* note 35, at 447.

72. *Id.* at 447.

73. P. DEMPSEY, *supra* note 29, at 146.

74. *Aviation Daily Reports on the Decade of the Eighties,* AVIATION DAILY, Jan. 2, 1990, at five.

75. M. BENDER & S. ALTSCHUL, *supra* note 14, at 524.

76. *Id.*

77. *Id.* Nomani, *Ailing Pan Am Still Relying on Asset Sales,* WALL ST. J., Mar. 12, 1990, at A4, col. 2; R. DAVIES, *supra* note 57, at 84.

78. Reed, *Pan Am Hopes Miami Strategy Will End Era of Crisis,* CHICAGO TRIBUNE, Dec. 3, 1989, at 7-22C, col. 5.

79. *Id.*

80. P. DEMPSEY, *supra* note 29, at 147.

81. Salpukas, *Airlines' Big Gamble On Expansion,* N.Y. TIMES, Feb. 20, 1990, at C1, C5.

82. R. DAVIES, *supra* note 57, at 1.

# 10

# TRANS WORLD AIRLINES

*Hubs:* St. Louis, New York Kennedy

*Post-deregulation Merger:* Ozark (1986)

*Computer Reservations System:* an interest in PARS, renamed WORLDSPAN

*Rank and Market Share:* 1978—third, 11.9%; 1990—seventh, 7.1%

Trans World Airlines (TWA) was formed in 1930 with the merger of Transcontinental Air Transport (TAT) and part of the Western Air Express System (WAE) into what was originally named Transcontinental and Western Air.[1] TWA flew the central mail route from New York to Los Angeles via St. Louis and Kansas City.

By 1938, TWA had slightly more than 1,100 employees, more than half of whom were based in Kansas City, the core of the airline's technical operations. Jack Frye, TWA's president, continuously focused TWA's energies on customer service and technological development in airline safety and navigation.

Even though the DC-3 was the state-of-the-art plane in the late 1930s, Frye realized that the DC-3's limitations in altitude and speed capabilities restricted airline growth.[2] The development of the 307 Stratoliner by Boeing attracted Frye's attention, but Frye was outvoted on buying the aircraft by John Hertz and the Hertz-dominated board of directors. The Hertz-Frye feud threatened to erupt into a full-scale battle for control of TWA's destiny, and it was a war in which Frye was sadly outmanned. Frye was essentially the heart and soul of TWA, but John Hertz was TWA's financial source. Frye's position was weakened in 1937 because for all his service innovations and commitment to technical excellence, the airline had suffered significant losses.

At a directors' meeting at Hertz's home early in 1939, an argument broke out over the type of propellers to be installed on all TWA aircraft. Hertz opposed the propeller installation, and the meeting was quickly adjourned so that Hertz and his friends could attend the horse races. Frye left the meeting furious at Hertz's lack of business concern, and he decided to do something about it. Flying to Los Angeles to meet with Howard Hughes, Frye was to shape TWA's destiny for the next 20 years.

Frye and Hughes had known each other for quite some time. The two were not the best of friends, but aviation was a common interest. Frye explained that he wanted to quit TWA and go to work for Hughes when Hughes bought the airline Pacific Air Transport. Frye told Hughes that he simply would not work for Hertz any more.

Hughes then offered to buy TWA. By the end of January 1939, Hughes had acquired about the same amount of TWA stock as Hertz and the Lehman brothers. Hertz and the Lehman brothers soon sold out to Hughes, and shortly thereafter, Hughes owned around 78 percent of the TWA stock. With controlling interest in TWA, Hughes provided the company with nearly unlimited financial resources.[3]

Howard Hughes had inherited his father's Hughes Tool Company at an early age. It provided the revenue for his diverse ventures. In 1925, Hughes moved to Hollywood. After producing a series of movies, he began production of an epic on the First World War airmen, a movie entitled *Hell's Angels*. Hughes had always been fascinated by airplanes, and by 1928, he was an expert pilot. Hughes observed with awe as the classic planes soared through their aerial scenes for his silent film.[4]

In 1932, after the success of his latest movie, *Scarface,* Hughes thought of making another aerial film. But before that movie idea developed into reality, he had another grand idea. It was typical of Hughes throughout his life to focus all his attention and energy in one field only to abandon it suddenly in favor of another.

Hughes's new goal and obsession was to purchase a small airplane and to remodel and make it the fastest plane in the world. Hiring a crew of airplane mechanics and designers, Hughes established the Hughes Aircraft Company, which would later become one of the nation's largest and most powerful defense contractors.

For years, airplanes were Hughes's hobby. By the summer of 1932, aviation had become the focus of his mental and financial energies. During this period, American aircraft manufacturers were obsessed with conquering time and distance by designing more powerful and faster airplanes. Hughes was caught up in this craze and entered all sorts of flying shows and contests where he broke records in speed and distances traveled, including a transcontinental flight followed by an around-the-world flight.

At TWA, Jack Frye and Howard Hughes worked as a team. The two men were united at first by a piece of machinery, the Boeing 307 Stratoliner, an aircraft that was to remain a significant force in the airline's development. Although TWA had some financial troubles, it was achieving a reputation for technical excellence, safety, and good service—characteristics that dominated the airline until the 1980s.[5]

In 1944, the airline applied to the CAB for a round-the-world route serving more than 20 countries. This postwar expansion plan was larger than that of any other carrier. Frye's optimism was both his own and that of Howard Hughes, who had a keen interest in global flight. During the war, Hughes suggested to Frye that the airline change its name while retaining its initials. In 1945, TWA registered the name Trans World Airlines, but it was not until 1950 that the name change became official.[6]

Coming out of the war, TWA sponsored the development of the Constellation, Lockheed's challenge to Douglas's supremacy. The Constellation's pressurized cabin was more advanced than that of the Boeing 307, and the plane was 80 mph faster than the unpressurized Douglas DC-4. The new Constellations, with their four engines, improved comfort, speed, and reliability and were more profitable with their longer ranges between stops.[7]

Throughout the 1930s, Pan American Airways had held a monopoly over all U.S. international air routes. On June 1, 1945, the CAB announced that both American Export and TWA could compete with Pan American in the North Atlantic.[8] American Export was authorized to serve all of Europe north of the 50th parallel. The rest of Europe was divided between TWA and Pan American.[9]

In 1946, the pilots went on strike and Jack Frye retired, leaving Hughes to run the show for a while.[10] Hughes's participation was successful in major policy decision making during the presidency of Ralph Damon, who had joined Hughes from American Airlines in 1949.[11] Like Jack Frye, Damon was Hughes's working companion and TWA's president until January 1956. Damon's untimely death in 1956 hurt TWA when the vital decisions that were required in ordering the big jet airliners, which were to be the backbone of TWA's fleet for the next 10 years, had to be made without his guidance. In addition to the loss of Damon's help, the industry was beginning to suffer from a minor economic recession in 1958–59.[12]

During this period, Hughes became more of a recluse, seeking privacy to the extent that the next TWA president, Carter Burgess, never met Hughes.[13] Hughes lost control of TWA in 1960.[14] But in 1969 he acquired Airwest, renaming it Hughes Airwest (subsequently acquired by Republic, which itself was absorbed by Northwest).

With the departure of Hughes, Charles Tillinghast directed the airline's fortunes for nearly 16 years, first as president, then as chief executive officer and board chairman.[15] In 1967, in an effort to balance the seasonal fluctuations of air travel, TWA diversified vertically and merged with Hilton International Hotels.[16]

Following Pan American's lead in placing the first Boeing 747 into flight on January 22, 1970, TWA opened transcontinental Boeing 747 service from New York to Los Angeles on February 25, 1970.[17] TWA and Pan Am tried to merge twice in the 1970s, but these negotiations wound up instead in an exchange of routes.[18] TWA surrendered its Pacific routes, thus getting rid of the money-losing around-the-world service it had begun in 1968. TWA also abandoned service at Frankfurt, Hong Kong, Bombay, and Bangkok. Pan Am agreed to pull out of Paris, Barcelona, Nice, Vienna, and Casablanca, in addition to dropping its London service out of Chicago, Los Angeles, and Philadelphia. The CAB authorized the route swap for a two-year period.[19] When the agreement expired, TWA restored service only to Frankfurt. TWA purchased the Barcelona route from Pan Am because it linked up well with its Madrid service. However, TWA eventually abandoned service at the African points of Kenya, Tanzania, and Uganda because it proved economically unfeasible. During this period, TWA was contracting while struggling with heavy equipment commitments.[20]

The 45-day strike of flight attendants in 1973 was a tragedy, showing the gradual deterioration in company and attendant relations, although TWA had been one of the first carriers to employ married women as flight attendants in 1938.[21] By 1975, TWA's domestic operations were suffering from built-in deficiencies. Not having enough of the right airplanes was one of them. TWA's domestic system was the most embattled in the industry because it had no monopoly markets. TWA enjoyed a booming international market. Unfortunately, its inherent domestic vulnerability was a problem.

The resolution was simple but long term. TWA established a long-range schedule-planning department. The plan was twofold. First, TWA wanted to make St. Louis the hub around which most of its domestic system revolved. Second, TWA wanted to develop New York Kennedy Airport as a second major hub, one that would link the domestic system with the international routes. The latter would become a reality several years later, when Pan Am acquired National and sold TWA its JFK terminal directly adjacent to TWA's international terminal.

TWA fought deregulation when it was first proposed, as did most of the airlines.[22] After deregulation, TWA became a leaner carrier by reducing the number of employees and by trimming its fleet.[23] Labor relations at TWA deteriorated due to the resulting employee layoffs. Labor-management relations at TWA have generally been acrimonious since.

Not only did the airline shrink, but the company shed itself of nonairline operations as well. In the late 1970s, Ed Smart was chairman of TWA, which owned the profitable Hilton International and Canteen corporations. They had been acquired to provide a more balanced revenue flow to offset the highly seasonal fluctuating peaks and valleys of the airline's operations. Smart decided to form a holding company, Trans World Corporation, with the airline and the other two companies as subsidiaries. In part, this may have been motivated by the desire to get the Hilton and Canteen profits off TWA's books so that labor would concede more in wage cuts. TWA was given notes for its Hilton and Canteen investments for a fraction of their worth. Rather than expanding the airline's operations, Trans World Corporation acquired other nonairline ventures, including Century 21 real estate and Spartan Foods. So rather than grow, TWA lost market share to the other airlines.

During this period, the board of directors of both TWA and Trans World Corporation were substantially identical. Smart made sure they received generous stock options, even when their main subsidiary, TWA, was losing money and when its employees were surrendering wages and benefits. Ultimately, to fend off corporate raids, one of which was led by Donald Trump, Trans World Corporation spun off its subsidiaries (Hilton International, Century 21, Canteen Corporation, and Trans World Services), leaving TWA, which had provided the capital for the acquisition of the other subsidiaries, dangling in the wind. But soon TWA was to be taken by a corporate raider extraordinaire—Carl Icahn.

In the mid-1980s, TWA became a target of Frank Lorenzo and then Carl Icahn. The pilots surrendered generous wage concessions to Icahn to avoid the dreaded union-buster Lorenzo. The TWA board of directors seemed most concerned that they retain their lifetime term passes on TWA.

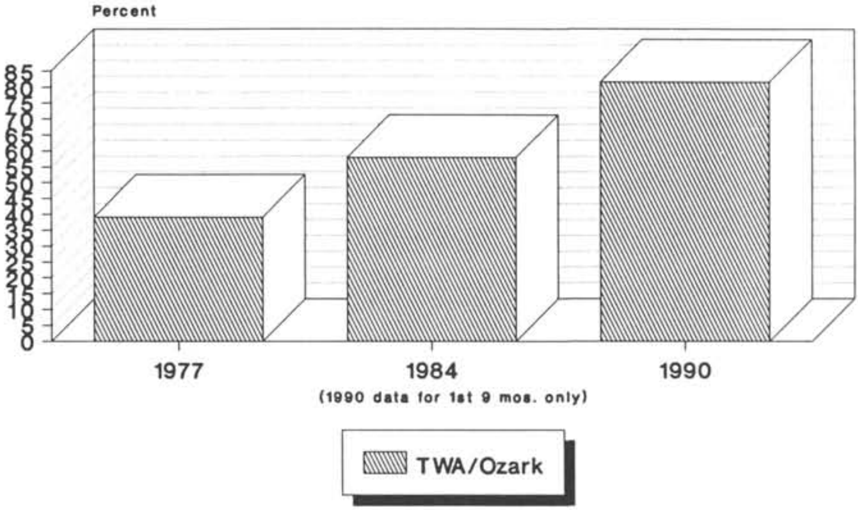
After acquiring TWA, Icahn did three major things. First, he executed the existing plan to acquire Ozark, which gave TWA market dominance in St. Louis. As figure 10.1 reveals, TWA's market share at Lambert International Airport soared.

Second, Icahn effectively crushed the flight attendants union when it struck. In demanding wage concessions, he told the flight attendants that whereas the machinists are "bread winners . . . you girls are second incomes."[24] Finally, he took the company private and so highly leveraged the airline (with $2.6 billion in debt) to pursue leveraged buyouts of nonairline ventures (including Texaco Inc. and USX Corporation) that TWA had a negative net worth, had the oldest fleet of aircraft in the industry, and was not reinvesting its profits. Prodded by labor, Icahn placed $3 billion in orders for new aircraft in the late 1980s, although the first planes were not scheduled to roll off the assembly line until 1994.[25]

In 1990, Icahn offered to buy a number of narrowbodied aircraft if the pilots would surrender another $80 million in concessions. In the shadow of his sale and then lease of eight L-1011s and three B-747s, Icahn threatened to cannibalize more aircraft if the pilots didn't succumb to his demands. He had already sold the Chicago-London route, gates, and landing slots to American.

The pilots, whose contract did not expire until 1992, estimated the cuts

**Figure 10.1**
**Airline Market Share at St. Louis**




*Sources:* AVIATION DAILY, Apr. 19, 1985, at 28; Feb. 1, 1990, at 230; Apr. 29, 1990, at 628; Mar. 29, 1991, at 590; and CONSUMER REPORTS.

at between 30 percent and 40 percent of their salaries, which would put them near the bottom of the industry, slightly above nonunion Continental. Kent Scott, head of the TWA pilots union, said: "There is only one word that describes the tactics being used here, extortion. You and I are being asked to pay protection money to keep our airline intact and keep it from being scattered into the winds."[26] Scott said that Icahn chose "to squander the $1.5 billion in total concessions that TWA's labor group gave him by crippling the company with debt in his privitization transaction of 1988."[27] In response, TWA announced that it was selling two B-747s and selling and leasing back six B-767s.[28] The fleet was shrinking rapidly. In 1991, TWA sold to American Airlines several of its primary transatlantic routes to London Heathrow Airport.

Thus, with Hughes, Frye, and Tillinghast, TWA has consistently been bled of its capital and resources to finance nonairline ventures, and this once magnificent international airline has consequently lost market share to its rivals. All the while, employee morale has disintegrated. As a senior TWA pilot recently observed:

> The entire physical plant of what is still TWA is deteriorating at a rate never even approached in the past. I'm not talking about the aircraft . . . everyone knows we have the oldest fleet in the industry . . . I'm speaking about the rest of the company. Have you walked through the terminals in New York or St. Louis lately? The latest Business Week mentions that the president of US Air inspects and makes

notes of the carpet and upholstery as he walks through his terminals when he travels. If he were with us he would need a full time stenographer to keep track of the notes! . . . Employee morale and pride is non-existent and most of us have been here a lot longer than some of the management and can remember when we were proud to say we worked for TWA. Now when asked if I fly for an airline, I usually respond in my N.Y. smart alec way, "no, I'm with TWA." . . .

Management should be thankful that the ontime performance does not include mechanical delays or we would be the joke of the industry in yet another category! Doesn't anyone back there know what is going on and try to tell who ever is supposedly steering this drifting carcass of what had once been a decent airline that we are sinking rapidly and that we need some help? We used to have excellent maintenance and I really believe that the people are still outstanding for the most part, but we need parts and planes if we are going to survive. . . .

Doesn't anyone at [TWA's headquarters at] Mt. Kisco understand that there are a lot of good people out here, wanting and trying to do a decent job but are fed up with all the lies and misdirection that is going on. Make no mistake about it . . . despite what comes out of the office of the president, TWA is not close to being a premier airline and will not be a survivor the way we are going. . . .

Have you looked at the old planes; have you looked at the paint jobs on most of the Ozark fleet? Even Earl Schieb would be embarrassed. . . . I close with a simple question that has been going around the airline: "Do you know why people are still flying TWA? Because they are born faster than we can piss them off."[29]

The pilot was referring to the low esteem in which TWA is held by its passengers. Recently, TWA has ranked among the major airlines with the highest level of consumer complaints per 100,000 passengers.[30] As this book goes to press, TWA entered Chapter 11 bankruptcy.

## NOTES

1. R. Davies, Airlines of the United States since 1914 89 (1972).

2. *Id.* at 93. TWA's original transcontinental mail route stretched from New York to Los Angeles, connecting 12 intermediate cities: Philadelphia, Harrisburg, Pittsburgh, Columbus, Dayton, Indianapolis, St. Louis, Kansas City, Wichita, Amarillo, Albuquerque, and Winslow.

3. *Id.* Howard Robard Hughes was born on Christmas Eve of 1905. Hughes's early life was transient and unsettled as his father followed the oil rush from one strike to the next. In 1909, Howard Hughes, Sr., designed and patented a revolutionary drill bit, which was later to make Howard Hughes, Sr., and Howard Hughes, Jr., incredibly wealthy by forming what was to become the financial foundation for the Hughes Tool Company, later to be renamed Toolco.

4. *Hell's Angels* was modified by adding sound and was a box office hit. Hughes became a popular man in the glamorous society of Hollywood. However, no matter how popular Hughes became, he still remained shy, uncomfortable around strangers, and eccentric. And what was worse, the phobias instilled by his mother were maturing within, compounded by the compulsive striving for perfection in all his projects.

5. *Id.* at 368.

6. R. Serling, From the Captain to the Colonel at 115 (1980).

7. R. Davies, *supra* note 1, at 291. Up until 1940, the DC-3 was the standard aircraft. On March 1, 1946, TWA placed the Lockheed Constellation on the transcontinental route from New York to Los Angeles, the first civil airline to challenge Douglas's supremacy. *Id.* at 283–29. TWA developed its Super Constellation on September 10, 1952. *Id.* at 332–33.

8. P. Dempsey, Law & Foreign Policy in International Aviation 19 (1987).

9. R. Davies, *supra* note 1, at 366–67. Both TWA and Pan Am were granted onward rights to India. TWA was granted a southern route via Cairo to Bombay. Pan Am was granted the route via Istanbul to Karachi and Calcutta. American Export and Pan Am were given the right to fly to London. TWA was given the right to fly to Paris. P. Dempsey, *supra* note 8, 18–23.

10. R. Davies, *supra* note 1, at 368. Hughes emerged from World War II with a magnificent route award that gave TWA the distinction of being the only airline with both transcontinental and transatlantic traffic rights. *Id.* at 535.

11. *Id.* at 535.

12. *Id.* at 536.

13. *Id.* at 536.

14. *Id.* at 537. After Howard Hughes departed, TWA appointed two new leaders, Ernest Breech and Charles Tillinghast. One of Breech and Tillinghast's first decisions was to file an antitrust suit against Hughes Tool Company, Toolco, on June 30, 1961. *Id.* at 537.

15. R. Serling, *supra* note 6, at 311.

16. *Id.* at 316; R. Davies, *supra* note 1, at 563.

17. R. Davies, *supra* note 1, at 573; R. Serling, *supra* note 6, at 311.

18. P. Dempsey, *supra* note 8, 20–21.

19. CAB Order 75-1-133 (1975).

20. R. Serling, *supra* note 6, at 318.

21. *Id.* at 320.

22. *Id.* at 323.

23. *Id.* at 323.

24. *Supreme Court Upholds Rulings for Management over Unions,* Aviation Daily, Jan. 17, 1990, at 115.

25. Salpukas, *Airlines' Big Gamble on Expansion,* N.Y. Times, Feb. 20, 1990, at C1, C5.

26. See *TWA Chairman Offers Pilots New Aircraft for Concessions,* Aviation Daily, Feb. 16, 1990, at 334.

27. *TWA Pilots Call Aircraft Sale a Major Step toward Liquidation,* Aviation Daily, Feb. 27, 1990, at 400.

28. *Id.*

29. For obvious reasons, the identity of the pilot will not be disclosed.

30. See *Rankings of U.S. Carriers Consumer Complaints Per 100,000 Passengers,* Aviation Daily, Mar. 8, 1990, at 474; and *Consumer Complaints against U.S. Carriers Reported to DOT, By Category,* Aviation Daily, Jan. 10, 1990, at 70.