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# Code-Share Agreements: A Developing Trend in U.S. Bilateral Aviation Negotiations

ROBERT F. BARRON II\*

## INTRODUCTION

Consumers who intend to travel internationally in 1996 and who will originate their journey from interior U.S. cities may be surprised to discover that they are flying on an airline other than the one they *thought* they booked. Indeed, in accordance with current government regulation of the airline industry, literally thousands of consumers each day find themselves flying on a carrier different from the one indicated on their airline tickets. This is not an aberration—no last minute flight cancellations; no flight protections on another carrier made in the best interest of the consumer. To the contrary, this is a phenomenon which is largely in the commercial interest of the airlines, and is not only condoned by the United States Department of Transportation (“DOT”),<sup>1</sup> but is quickly becoming a prevalent topic of discussion in both bilateral negotiations between the United States and foreign countries, and in commercial agreements between U.S. and foreign airlines.

The current state of affairs in the airline industry helps provide some insight into DOT’s policies. “Worldwide, airlines have experienced a \$15 billion shortfall over the last four years.”<sup>2</sup> Reports indicate that “from January 1978 through December 1993, cumulative net losses for the major U.S. airlines [alone have] totaled \$9.3 billion.”<sup>3</sup> Consequently, in an industry where the term “survival of the fittest” is now a reality, airlines around the world have begun a race to form global alliances, hoping to find partners with the right synergies to

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\* J.D. Candidate, 1996, Indiana University School of Law—Bloomington; M.B.A., 1990, University of Missouri—St. Louis; B.A., 1979, Indiana University. I would like to thank Professor Don Gjerdingen for his helpful comments in planning this Note. I would also like to thank my parents for a lifetime of inspiration and my three children for bringing a smile to my face at the most challenging of times. Most importantly, I thank my wife, Diane, for her love and immeasurable support throughout the project.

1. The United States Department of Transportation (“DOT”) is the administrative agency which oversees “formal aviation-related functions includ[ing] the following: negotiation of international air transportation rights [and] selection of American air carriers to serve international markets in which capacity is limited by treaty.” Thomas D. Grant, *Foreign Takeovers of United States Airlines: Free Trade Process, Problems, and Progress*, 31 HARV. J. ON LEGIS. 63, 69 (1993); see also 49 U.S.C. §§ 40101(e), 40105 (1994) (outlining policies and procedures the Secretary of Transportation must consider in conducting international aviation negotiations and agreements).

2. Paul S. Dempsey, *Airlines in Turbulence: Strategies for Survival*, 23 TRANSP. L.J. 15, 18 (1995).

3. *Id.* at 18 (citing Julius Maldutis, *Industry Investment Requirements—Looking Beyond 2000*, Address at the 7th International Air Transportation Association High-Level Aviation Symposium (Sept. 6-7, 1993)).

generate profits, and fearful that if they "miss the boat" they will face a certain demise.

When United Airlines purchased "Pan Am's Pacific Division [in 1991,] no non-U.S. airline owned a piece of any large U.S. airline. . . . Today, British Airways owns 24% of USAir, KLM owns 20% of Northwest Airlines, Air Canada owns 24% of Continental and Swissair and Singapore Airlines each owns 5% of Delta."<sup>4</sup> Since U.S. carriers have been struggling financially, they have welcomed the injection of cash from the mergers, while foreign carriers have viewed financial ownership of U.S. carriers as one strategy that will ensure that they will have a U.S. partner capable of providing feeder traffic from "off-line" cities—those which they cannot serve profitably, or are not permitted to serve in their own right under U.S. law. Yet most foreign carriers are unwilling or unable to invest in U.S. carriers which are literally ill-equipped with aging fleets, carry perilously high debt loads, and possess a history of financial losses. Furthermore, U.S. law governing acquisition of U.S. carriers by foreign companies continues to be restrictive, which prohibits further investment.<sup>5</sup> Hence, foreign airlines have rightly concluded that code-share agreements offer them a low cost, but highly effective alternative means of getting their "foot in the door" of the U.S. domestic market.

This Note is organized in four parts. Part I provides an introduction to the manner in which governments grant authority to airlines enabling them to fly between cities. It will also demonstrate the importance of such rights in bilateral negotiations. Part II examines the development of airline computer reservation systems ("CRSs") and discusses the impact they have on the consumer's selection of which airline to fly. Part III takes a critical look at code-shares,<sup>6</sup> and examines the wisdom of DOT's increasing use of code-share rights in bilateral negotiations, and the resulting effect they have on the traveling consumer. Part IV integrates code-share agreements, bilateral negotiations, and CRSs, and demonstrates that code-shares provide only marginal benefits for consumers. Part IV concludes that DOT's growing use of code-shares is nothing more than a means of avoiding taking the final step into a *true* "open skies" policy,<sup>7</sup> which

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4. J.A. Donoghue, *The Players: Impact of Mergers in US Airline Industry*, AIR TRANSP. WORLD, Dec. 1, 1995, at 7.

5. Even though DOT relaxed the limit on total equity that a foreign carrier can hold in allowing KLM Royal Dutch Airlines to effectively purchase 49% of Northwest Airlines, this controlling statute still restricts foreign ownership to a maximum of 25% of the U.S. airline's voting equity stock. 49 U.S.C. § 40102(a)(15)(C) (1994) (defining a corporation as a citizen if 75% of its voting interest is controlled by individual U.S. citizens); Seth M. Warner, Comment, *Liberalize Open Skies: Foreign Investment and Cabotage Restrictions Keep Noncitizens in Second Class*, 43 AM. U. L. REV. 277, 309 nn.231-32 (1993) (discussing earlier version of the statute).

6. In general, "[c]odesharing is the practice by which [two or more] airlines connect flight legs into a longer route under one computer designator code and charge a single fare for the combined flights." Warner, *supra* note 5, at 281 n.29.

7. Order Requesting Comments, 57 Fed. Reg. 19,323 (1992). This initiative was introduced in 1992 by former Secretary of Transportation, Andrew H. Card, Jr., announcing that the United States was willing to negotiate open skies agreements with European countries which would grant U.S. air carriers free access to their markets on a reciprocal basis.

it does at the public's expense. Finally, this Note concludes that federal guidelines on disclosure of code-share agreements are inadequate, and suggests that DOT discontinue its use of code-shares as a substitute for a true open skies policy.

### I. REGULATION OF INTERNATIONAL AIR TRAFFIC RIGHTS

The legal framework for international aviation was first established at the Paris Peace Conference of 1919, which produced the Convention for the Regulation of Aerial Navigation.<sup>8</sup> The Paris Convention "established the principle that every nation has 'complete and exclusive sovereignty over the airspace above its territory.'"<sup>9</sup> In 1944, in response to numerous political, economic, and technical problems which developed as international air travel grew, the United States sponsored the Chicago International Aviation Convention<sup>10</sup> at which it proposed that all airlines have virtually unrestricted traffic rights on international routes. The U.S. negotiators called for multilateral recognition of five "freedoms of the air."

The five freedoms are universally applicable working rules for bilateral air transportation relations [today]. They are:

1) A civil aircraft has the right to fly over the territory of another country without landing, provided the overflown country is notified in advance and approval is given.

2) A civil aircraft of one country has the right to land in another country for technical reasons, such as refueling or maintenance, without offering any commercial service to or from that point.

3) An airline has the right to carry traffic from its country of registry to another country.

4) An airline has the right to carry traffic from another country to its own country of registry.

5) An airline has the right to carry traffic between two countries outside its own country of registry as long as the flight originates or terminates in its own country of registry.<sup>11</sup>

The United States also insisted that the determination of capacities, frequencies, and fares could be appropriately dictated by market forces.

Great Britain opposed the Americans' proposal and instead urged "the creation of an 'International Air Authority' to coordinate air transport, apportion the

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8. Convention Relating to the Regulation of Aerial Navigation, Oct. 13, 1919, art. 1, 11 L.N.T.S. 173, 190 [hereinafter Paris Convention].

9. Warner, *supra* note 5, at 279 (quoting Paris Convention, *supra* note 8, 11 L.N.T.S. at 190).

10. Convention on International Civil Aviation, Dec. 7, 1944, art. 1, 61 Stat. 1180, 1180, 15 U.N.T.S. 295, 296 [hereinafter Chicago Convention].

11. Paul S. Dempsey, *Turbulence in the "Open Skies": The Deregulation of International Air Transport*, 15 TRANSP. L.J. 305, 312 n.13 (1987).

world's air routes, and make decisions on frequencies and tariffs in accordance with agreed criteria designed to 'avoid wasteful competition.'"<sup>12</sup>

Ultimately the participants rejected both of these proposals. Although a majority of the nations attending the Chicago Conference later adopted the first two freedoms, there was an insurmountable disagreement regarding the degree to which capacity under fifth freedom rights should be regulated. Many European nations feared that a system which granted multilateral fifth freedom rights without adequate controls on capacity or frequency would confer on U.S. carriers "unlimited access to the European carriers' most valuable traffic."<sup>13</sup> Similarly, they were unwilling to allow an international regulatory body to formulate and dictate international air transport at the expense of their sovereignty, and consequently rejected the British proposal.<sup>14</sup>

Even though attending nations at the Chicago Conference failed to reach an agreement on a multilateral exchange of traffic rights, they succeeded in establishing the International Civil Aviation Organization ("ICAO").<sup>15</sup> They formed ICAO initially in order to develop uniform *technical* standards relating to international airlines. Subsequently, participating nations have expanded ICAO's jurisdiction to include international *operating* standards, airworthiness certification, registration of aircraft, and "[t]oday ICAO is one of the largest and most successful specialized agencies in the United Nations family, with 156 member nations."<sup>16</sup>

Another result of the Chicago Convention was that participants reinforced the legal principle first developed at the Paris Convention—that each state maintains exclusive sovereignty over the airspace above its territory. Given this fact and because they did not reach a multilateral solution, a nation that wanted its carrier(s) to operate international services would be required to enter into direct, bilateral negotiations with foreign governments to negotiate the parameters of international airline operations between the two countries.<sup>17</sup> The language in Article 6 of the Chicago Convention set the stage for bilateral negotiations by stating that "[n]o scheduled international air service may be operated over or into the territory of a contracting State, except with the special permission or other

12. Bruce Stockfish, *Opening Closed Skies: The Prospects for Further Liberalization of Trade in International Air Transport Services*, 57 J. AIR L. & COM. 599, 604 (1992) (citing ANDREAS F. LOWENFELD, *AVIATION LAW: CASES AND MATERIALS* 2-8 (1981)).

13. Dempsey, *supra* note 11, at 312 n.9.

14. *Id.* at 313.

15. Article 44 of the Chicago Convention states that:

The aims and objectives of the Organization are to develop the principles and techniques of air navigation and to foster the planning and development of international air transport so as to . . .

(d) Meet the needs of the peoples of the world for safe, regular, efficient and economical transport;

(e) Prevent economic waste by unreasonable competition;

(f) Insure that the rights of contracting States are fully respected and that every contracting State has a fair opportunity to operate international airlines.

Chicago Convention, *supra* note 10, 61 Stat. at 1192-93, 15 U.N.T.S. at 326.

16. Dempsey, *supra* note 11, at 313.

17. *Id.* at 314.

authorization of that State.”<sup>18</sup> Accordingly, the Chicago Convention set the framework for the exchange of bilateral air traffic rights which began shortly thereafter, and continues to this day.

To illustrate a simplistic bilateral agreement, consider the factors involved in the development of a bilateral agreement between Argentina and Australia which occurred in 1988.<sup>19</sup> Both countries had long designated a single, government-owned international airline, and both owned and operated Boeing 747 aircraft. Aerolineas Argentinas believed that a market existed which would initially support a weekly service between the two countries, and which could later be expanded once the market was further developed. It also aspired to use Australia as a stepping-stone into the lucrative Asian market. On the other side, Qantas viewed the route as the only gap in its worldwide route structure. It already operated extensive services into Asia, Europe, and North America and although it recognized South America as a small market at the outset, it saw significant strategic potential in the long term.

With no bilateral agreement in place, travelers coming from the South Pacific ordinarily traveled north to Los Angeles or San Francisco, then south to Argentina. The most direct route at the time from Sydney, Australia to Buenos Aires, Argentina required a journey of fifty-five hours (elapsed time).<sup>20</sup> Aerolineas Argentinas proposed a new route (one no commercial airline had ever flown) which traversed the South Pole and reduced the elapsed travel time to approximately twenty-five hours, which included a technical refueling stop in southern Argentina.

With no one to oppose the agreement and strong mutual goals, the respective governments easily reached a bilateral agreement providing for the operation of one weekly Boeing 747 service for each carrier. The bilateral agreement designated the precise type of aircraft that could be flown or substituted, the number of seats allotted, the exclusive names of the carriers that could operate, and specified that the origin and destination would be the two primary cities, Sydney and Buenos Aires. It also stipulated that subject to a separate commercial agreement between the two national carriers, one carrier could choose not to operate, but could instead negotiate a seat purchase agreement with the operating carrier. In the subsequent commercial agreement Qantas agreed not to operate in exchange for the ability to sell, as its own, an allocation of fifty seats per flight. In exchange, Aerolineas Argentinas received the right to exercise Qantas's weekly flight allocation, which it only exercised during the peak travel months of December to February each year. In the seven years since the bilateral was signed, Qantas has never operated its own aircraft on the route.

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18. Chicago Convention, *supra* note 10, 61 Stat. at 1182, 15 U.N.T.S. at 300.

19. This author participated in developing and implementing a commercial agreement between Qantas Airways, the airline of Australia, and Aerolineas Argentinas, the designated international flag carrier of Argentina. The commercial agreement was provided for in the bilateral agreement between the two countries.

20. Elapsed time includes the total number of hours it takes to fly the originating flight from Australia to the west coast of the United States, the layover time on the west coast, the time for the final flight to Argentina, and the time required for intermediate stops, if any.

Even a relatively simple bilateral agreement such as this contained some of the complexities that exist in nearly all bilateral agreements. The bilateral agreement granted "beyond" traffic rights to the designated Australian carrier, permitting it to carry passengers beyond Argentina to two additional points in South America, in exchange for the Argentine carrier's right to travel to one point in New Zealand and one additional point in Australia. However, if for example, Qantas chose to exercise its right to fly its aircraft to Buenos Aires, then on to Rio de Janeiro, Brazil, it still could not do so without first negotiating a separate bilateral agreement between Australia and Brazil which granted it that same right. So while the competitive position of air carriers operating internationally continues to be determined by terms negotiated under bilateral treaties as propounded at the Chicago Convention, a government must often negotiate multilateral agreements to achieve its desired air traffic rights.

In addition to the five freedoms of the air which were postulated at the Chicago Convention, scholars and negotiators now recognize sixth, seventh, and eighth freedoms.

The sixth freedom grants the right to carry traffic from the grantor country to the home country and then carry that same traffic, under a different flight number to a third country. . . . The seventh freedom grants the right to carry traffic from the grantor country to a third country without stopping at the home country [and] the eighth freedom grants carriage rights now restricted by cabotage law.<sup>21</sup>

Cabotage is a term which is unfamiliar to the traveling public, but which has an enormous impact on the airlines which operate in and out of the United States. Although the term originated centuries ago in relation to maritime rights, the airline industry uses "cabotage" to describe the prohibition of foreign carriers from carrying domestic traffic, thereby preserving the state's<sup>22</sup> sovereignty. Although under the Paris Convention states could bilaterally grant cabotage rights to one another, the cabotage provision composed at the Chicago Convention eliminated a contracting state's right to grant *exclusive* cabotage privileges to another state.<sup>23</sup> Cabotage is particularly significant to the United States because the United States—"by far the world's largest and potentially most lucrative domestic aviation market under a single sovereignty—restricts cabotage quite unbendingly; no foreign air carrier may provide domestic air service in the United States."<sup>24</sup> Consider the following hypothetical facts:

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21. F. Allen Bliss, Note, *Rethinking Restrictions on Cabotage: Moving to Free Trade in Passenger Aviation*, 17 SUFFOLK TRANSNAT'L L.J. 382, 388 n.25 (1994).

22. "State" as used by the Chicago Convention refers to sovereign nations.

23. Article seven of the Chicago Convention, the cabotage provision, states that:

Each contracting State shall have the right to refuse permission to the aircraft of other contracting States to take on its territory passengers, mail and cargo carried for remuneration or hire and destined for another point in its territory. Each contracting State undertakes not to enter into any arrangements which specifically grant any such privilege on an exclusive basis to any other State or an airline of any other State, and not to obtain such exclusive privilege from any other State.

Chicago Convention, *supra* note 10, 61 Stat. at 1182, 15 U.N.T.S. at 300.

24. Grant, *supra* note 1, at 75.

Germany has negotiated a bilateral agreement with the United States whereby Lufthansa German Airlines has been granted traffic rights to operate from Frankfurt to New York, Chicago, and Atlanta. Because of the prohibition on cabotage, Lufthansa cannot compete with U.S. carriers by operating its flights between New York and Chicago, carrying passengers that are traveling only between those cities. Unless there is sufficient demand to independently operate services to each of those cities on some regular basis, Lufthansa may be interested in flying from Frankfurt to New York where it would discharge passengers, then continue on to Chicago. But again it would only be allowed to carry passengers that originated in Frankfurt. In all probability the economics of operating such a service would be prohibitive. But even if the carrier decided to operate such a service it would be forced to deny carriage to an American traveler standing at the gate wishing to purchase a ticket to fly from New York to Chicago—under cabotage they cannot make exceptions. Because of cabotage restrictions and the limits on investment in U.S. airlines, code-shares have become a key factor in global alliance strategies.

## II. COMPUTER RESERVATION SYSTEMS

In today's computer age it comes as no surprise that CRSs have played an integral role in the airline industry. As airlines expanded their route structures over time, they found it uneconomical and impractical to distribute their product through their own sales and ticket offices, and third party specialists (travel agents) emerged to fill that need. Today travel agencies are the principal distribution channel for airlines and they avail themselves of airline products through CRSs. "CRSs are massive databases that allow the user, typically a travel agent, to check flight availability and fare information instantaneously, to make airline ticket reservations, and to print out tickets and boarding passes for listed airlines."<sup>25</sup> The productivity of an automated travel agency is far greater than that of its non-computerized counterparts which must phone each individual airline to check fares and flight availability. Since the late 1980s, "95 percent of all domestic travel agencies used CRSs and travel agents booked 92 percent of the domestic airline sales through them."<sup>26</sup>

### *A. U.S. Carriers' Dominance of the CRS Industry*

Because of intense competition in the airline industry, frequent changes in pricing and schedules, and the growing dependence on travel agencies for product distribution, airlines recognized the need to develop CRSs as an efficient means of placing their products in the hands of their new "sales force"—travel agencies. "United Airlines and American Airlines, which led the industry in the

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25. Note, *The Legal and Regulatory Implications of Airline Computer Reservation Systems*, 103 HARV. L. REV. 1930, 1931 (1990).

26. Marj P. Leaming, Note, *Enlightened Regulation of Computerized Reservations Systems Requires a Conscious Balance Between Consumer Protection and Profitable Airline Marketing*, 21 TRANSP. L.J. 469, 472 (1993).



development of CRS technology, each spent over \$100 million to develop their respective systems."<sup>27</sup> Initially CRSs were leased to travel agents for nominal fees, and other airlines were permitted to list their flights at no charge. At that time the vendor airlines were content with the incremental revenues they gained from their respective CRSs. In fact, the vendor airlines were receiving "substantial revenue from additional airline business they received through 'biasing' the system" through "displaying flight information in a way that favor[ed] the vendor airline."<sup>28</sup>

In the late 1970s and early 1980s the vendor airlines recognized the income-producing potential of the CRS and reformulated their strategies. United and American began signing "cohost contracts" with other airlines wherein the subscribing airlines were given preferential treatment in the CRS in exchange for a "booking fee." The fee was paid on every flight segment booked through the CRS by any airline or travel agent. "Beginning in 1981, vendor airlines began entering into individually negotiated contracts with each airline, and booking fees rose from \$0.25 per booking up to \$3.00 per booking."<sup>29</sup>

Today there are four CRSs which are wholly or partially owned by U.S. airlines: (1) SABRE, which is wholly owned by American Airlines and is installed in approximately 22,000 travel agencies; (2) APOLLO, in which United Airlines holds a majority ownership position and a myriad of other carriers hold minority positions, is located in 25,000 agency locations; (3) System One, originally developed by now defunct Eastern Airlines and later acquired by Continental Airlines, is installed in roughly 7,500 locations; (4) and Worldspan, which was a merger of Trans World Airlines' PARS system and Delta's DATAS II system, is installed in over 10,000 travel agency sites.<sup>30</sup> The CRSs have produced significant revenue for the airlines—in 1991 revenue earned by three of the CRSs was reported as \$655 million for SABRE, \$475 million for APOLLO, and \$378 million for System One.<sup>31</sup> Income is generated through three primary channels: installation and leasing fees from travel agency subscribers for use of terminals and related equipment, segment booking fees paid by subscribing airlines, and incremental revenue generated by owning the CRS.<sup>32</sup>

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27. Larry G. Locke, Note, *Flying the Unfriendly Skies: The Legal Fallout over the Use of Computerized Reservation Systems as a Competitive Weapon in the Airline Industry*, 2 HARV. J.L. & TECH. 219, 220 (1989); see also Notice for Advance Comments, 48 Fed. Reg. 41,171, 41,173 (1983) (discussing the expenditure of money by airlines for development of this technology).

28. *In re Air Passenger Computer Reservations Sys. Antitrust Litig.*, 694 F. Supp. 1443, 1450 (C.D. Cal. 1988), *aff'd sub nom. Alaska Airlines, Inc. v. United Airlines, Inc.*, 948 F.2d 536 (9th Cir. 1991), *cert. denied*, 503 U.S. 977 (1992).

29. *Id.* This practice continued unabated until 1984 when the Civil Aeronautics Board ("CAB") established new rules requiring CRS vendors to charge subscribing carriers similar fees for similar services, and to provide unbiased displays. However the new rules did not regulate booking fees. See 14 C.F.R. §§ 255, .9(b)(1), .10(a) (1996).

30. Leaming, *supra* note 26, at 473-74.

31. *Id.* at 472-74.

32. Many industry analysts have theorized that there is a "halo effect" by which travel agents are more apt to book the airline whose system they are using. See, e.g., Note, *supra*, note 25, at 1932 n.14. Travel agents are not likely to forget which system they are using as they

The airlines possess inordinate control over travel agencies' booking practices thereby impacting consumer preferences, especially United and American Airlines which have "dominated the CRS market with a combined share of [as much as] 77 percent of national CRS rentals."<sup>33</sup> As vendor airlines with control over the mainframes, they have access to reports which indicate the percentages of a travel agency's bookings that were sold on the vendor airline and on competing airlines. Vendor airlines can use the data as a coercive marketing tool directly when establishing lease prices and override commissions, or indirectly by controlling the level of assistance provided to the travel agency, such as by flexing ticketing deadline rules or clearing a valued agency client from a wait list.

CRS lease contracts have resulted in substantial litigation. In general, CRS vendors require travel agents to sign contracts for five years. These contracts often contain minimum use provisions that require the travel agent to book at least half of its flights on that specific CRS and typically contain strict liquidated damages clauses that discourage travel agents from switching to a competing system before the expiration of the contract. By virtue of aggressive sales tactics by system vendors, a travel agent wishing to terminate the lease often faces stipulated damages amounting to several years of lease rentals. For example, in *United Airlines v. Austin Travel Corp.*,<sup>34</sup> System One persuaded the Long Island travel agency to convert from APOLLO to its system, "agree[ing] to defend [the] travel agents in suits brought by United and to indemnify [them] for any damages from breaching their lease[. . .] System One . . . challenged the United leases as agreements restraining trade and monopolizing the CRS market in violation of sections 1 and 2 of the Sherman Act."<sup>35</sup> The court awarded United over \$400,000 and "found United innocent of monopolization because Apollo accounted for only 8% of revenues generated by CRS bookings in the Long Island area."<sup>36</sup>

Two other theories have also been advanced to show that CRS vendors have violated the Sherman Antitrust Act.<sup>37</sup> "The first theory was that defendants' CRSs are essential facilities for the distribution of air travel and thus should be controlled by the essential facilities doctrine."<sup>38</sup> "The [second] theory was that defendants had monopolized . . . national and local air transportation markets and the various markets for CRS service."<sup>39</sup> A detailed discussion of antitrust law is beyond the scope of this Note, but it is essential to recognize that all of the

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generally receive training unique to that system. Each system also has a unique look—APOLLO, for example, is sky blue and easily recognizable.

33. Joseph F. Brodley & Ching-to Albert Ma, *Contract Penalties, Monopolizing Strategies, and Antitrust Policy*, 45 STAN. L. REV. 1161, 1189 (1993).

34. 867 F.2d 737, 739 (2d Cir. 1989).

35. Brodley & Ma, *supra* note 33, at 1189-90.

36. Jerome Ellig, *Computer Reservation Systems, Creative Destruction, and Consumer Welfare: Some Unsettled Issues*, 19 TRANSP. L.J. 287, 292 (1991).

37. 15 U.S.C. §§ 1-40 (1994).

38. Locke, *supra* note 27, at 227 (citing *In re Air Passenger Computer Reservations Sys. Antitrust Litig.*, 694 F. Supp. 1443, 1451 (C.D. Cal. 1988), *aff'd sub nom. Alaska Airlines, Inc. v. United Airlines, Inc.*, 948 F.2d 536 (9th Cir. 1991), *cert. denied*, 503 U.S. 977 (1992)).

39. *Id.*

antitrust challenges were rejected by the courts. In *Air Passenger*, the court opined that American Airlines could not have monopolized the market for air transportation when it had never had more than a fourteen percent share of the total air transportation market. Similarly, the court stated that given the existence of competing CRSs in the marketplace which serve as substitutes, American's ability to weaken competition in the air transportation market is constrained.<sup>40</sup>

In sum, CRSs have given proprietary airlines significant profits, but perhaps more importantly, enormous and unfettered control over travel agencies and, therefore, consumer choice. The significance of CRSs as they relate to code-share agreements will be discussed further in Part IV of this Note.

### III. THE EMERGENCE OF CODE-SHARE AGREEMENTS IN COMMERCIAL AVIATION

Code-sharing arrangements have existed in the U.S. domestic airline industry since the 1960s. Because of the excessive cost of operating jet aircraft on routes with limited travel, Allegheny Airlines (later renamed USAir) first formed agreements with commuter carriers<sup>41</sup> to provide service on those feeder routes under the "AL" (Allegheny's) flight designator code. The strategy enabled Allegheny to withdraw its own higher cost aircraft and crews yet still connect passengers to its principal flights. Furthermore, it afforded Allegheny the opportunity to maintain its presence in many small communities, since the commuter carriers often painted their aircraft in the colors and with the logo of the major carrier. The strategy proved successful and it slowly gained popularity among other major airlines and regional feeder carriers.

"Between 1984 and 1989, the number of U.S. domestic code-sharing partnerships increased from only a few to fifty-seven."<sup>42</sup> This prompted DOT to adopt a policy concerning code-shares. DOT officials considered code-share arrangements negotiated between U.S. carriers "private business deals"<sup>43</sup> and as such did not require prior government approval. This also held true for international code-shares, provided that the foreign airlines had the underlying route authority.<sup>44</sup> However, as the number of code-share arrangements grew, DOT recognized the potential for deception of the public. Finally in 1985, DOT promulgated a policy on airline designator code-sharing which states that "the

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40. *Air Passenger*, 694 F. Supp. at 1455-56.

41. Commuter carriers usually operated turboprop planes of small capacity (in the range of 15 to 30 seats) with a high number of frequent flights between cities. These planes were especially economical to operate on short haul flights of approximately one hour. The pilots tended to be lower paid, with fewer flight hours than pilots at "major airlines," and the flights were permitted to operate without flight attendants. See generally Dempsey, *supra*, note 2, at 38.

42. Carolyn Hadrovic, *Airline Globalization: A Canadian Perspective*, 19 TRANSP. L.J. 193, 196 (1990).

43. See Joan M. Feldman, *U.S. Inconsistencies Cloud International Code-Sharing*, AIR TRANSPORT WORLD, Apr. 1988, at 20, 21.

44. Hadrovic, *supra* note 42, at 197 (citing DOT, OUTLINE OF CODE-SHARING DEVELOPMENTS (1988)).

use of a single air carrier designator code by two or more air carriers [is] in violation of section 411 of the Act unless . . . the air carriers give reasonable and timely notice of the existence of such code-sharing arrangements."<sup>45</sup>

Since this policy has remained unchanged for over ten years, DOT is apparently satisfied that this regulation is sufficient to fulfill the Department's stated purpose which includes "recommend[ing] to the President and the Congress for approval national transportation policies and programs . . . with full and appropriate consideration of the needs of the *public* . . ."<sup>46</sup> Yet many scholars and industry analysts believe that in the domestic market:

Regional and commuter airlines have come under the domination of megacarriers through 'code-sharing' programs, which represent a nadir in industry ethics, already at an all time low. . . . [This prompted] one commuter [airline] official [to state that] '[t]he only thing worse than a code-sharing agreement for passengers is no code-sharing agreement for the commuter airline."<sup>47</sup>

#### IV. CODE-SHARE PROVISIONS IN BILATERALS: QUESTIONING DOT POLICIES

In recent years there has been an explosion in the number of code-share agreements. In 1995, the Director-General of the International Air Transport Association proclaimed, "There are now more than 400 [airline] alliances worldwide . . . [and o]ne hundred thirty-three of them involve inter-continental links and codesharing."<sup>48</sup> Proponents claim that consumers actually receive benefits from code-shares. One commentator noted:

Code-shares provid[e] passage under the name of a single airline and through the ticketing and airfare arrangements of that airline, even though passengers must switch airlines *en route*. [He declared that] without code-sharing, a passenger who needed to switch airlines to go from point A to point C

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45. 14 C.F.R. § 399.88 (1996). The policy sets minimum disclosure requirements which require air carriers to:

- (1) Identify, with an asterisk or other means, each flight in which the airline code is different from the code of the carrier actually providing the service, in written or electronic schedule information provided by the air carrier to the public, the Official Airline Guide and . . . computer reservations system vendors;
- (2) Provide information in any direct oral communication with a consumer concerning a code-sharing flight sufficient to alert the consumer that the flight will occur on an airline different from the carrier whose code is used and identify the carrier(s) actually providing the service; and
- (3) Provide frequent, periodic notice in advertising media that can reasonably be expected to convey to potential passengers and travel agents the existence of a code-sharing relationship and the identities of the carriers actually providing the service.

*Id.*

46. Theodore P. Harris, *The Disaster of Deregulation*, 20 *TRANSP. L.J.* 87, 93 (1991) (citing DOT, *DECLARATION OF PURPOSE* (1966)) (emphasis added).

47. *Id.*

48. *IATA Director General Predicts Record Profits for 1995*, *WORLD AIRLINE NEWS*, Nov. 13, 1995, available in *DIALOG*, IAC-NEWS database.

through point B would require separate ticketing, billing, scheduling, and baggage check-in.<sup>49</sup>

Yet these benefits are overstated. Nearly all airlines have multilateral interline agreements which allow a passenger to purchase a single ticket (with multiple coupons) from a local travel agent. The ticket will provide for round trip travel on all flights, and the consumer is billed at one fare which often includes a fare on a domestic route that is subsidized by an international airline. Additionally, baggage can be "interlined," that is, checked from the originating U.S. domestic city to the final, international destination.

A simple hypothetical can illustrate the pros and cons of such a trip with and without a code-share. Assume the passenger lives in Atlanta, Georgia, and wishes to travel to Rio de Janeiro, Brazil, but there is no code-share. If Delta has an interline agreement with Varig Brazilian Airlines, passengers can purchase a single ticket from a local travel agency and check their baggage with Delta at the Atlanta airport (through to Rio de Janeiro). They will fly to Miami on Delta and then walk to the Varig counter or gate. They later board a Varig plane for the flight to Rio. On the other hand, if a code-share is established between the two airlines, the travel agent may tell them that there are two carriers operating between Atlanta and Rio: Delta and Varig. The passengers may choose Delta, the hometown airline. In essence, the trip will be the same except for the confusion that is inherent in code-shares, that is upon arriving in Miami the passengers may be confused about where to go for the flight to Rio, or may be completely unaware that they will be flying on Varig.<sup>50</sup>

The one significant benefit that consumers would undoubtedly desire from a code-share is lower airfares, but surprisingly "carriers with code-sharing arrangements charge [on average] 8% higher fares."<sup>51</sup>

#### *A. An Explosion of Code-Share Agreements Between the United States and Foreign Airlines*

Last year DOT approved a plan that increased a British Airways-USAir "code-share network from 66 USAir cities . . . to 138. . . . The deal also . . . extend[ed] the code share to five new BA [British Airways] gateways: Atlanta, Chicago, Dallas/Fort Worth, Houston and Seattle."<sup>52</sup> And although American Airlines has often expressed public opposition to the United States' increasingly code-share based policy, it has been vigorously signing them since 1988. In November 1995, American announced that it would be "put[ting] its AA computer reservations system designator on four weekly Qantas flights between Los Angeles and both Auckland and Melbourne, [providing American with] code-shares on 24 weekly Qantas flights between Sydney and Los Angeles. Qantas puts its QF code on

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49. Grant, *supra* note 1, at 80 n.48.

50. Passengers may or may not be required to check-in with the international carrier depending upon the level of efficiency achieved between the two code-sharing airline partners.

51. Dempsey, *supra* note 2, at 36 (citing PAUL S. DEMPSEY ET. AL., 1 Aviation Law and Regulation §5.05 (1993)).

52. Bill Poling, *U.S.-U.K. Deal Expands Code Shares, Adds Third Chicago-London Airline*, TRAVEL WEEKLY, June 8, 1995, at 1.

American flights between Los Angeles and Boston, Chicago, New York Kennedy [airport] and Washington Dulles [airport].”<sup>53</sup> In other words, when travel agents look for flight availability in their CRSs, they can offer consumers one of American Airlines’ twenty-four weekly “flights” from the United States to Australia, even though no American plane ever touches down on the Australian continent.

In reality, the *real* benefits derived from code-share agreements accrue to the airlines through enhanced product positioning in CRS displays, greater access in previously restricted markets (especially for foreign carriers), and potentially greater profits.

Under DOT regulations,

In ordering the [flight] information contained in an integrated display, [CRSs] shall not use any factors directly or indirectly relating to carrier identity. [Furthermore s]ystems may order the display of [flight] information on the basis of any service criteria that do not reflect carrier identity and that are consistently applied to all carriers . . . .<sup>54</sup>

These restrictions have not prevented CRS airline owners from providing themselves with significant display preferences for their own services in connection with code-share arrangements. Code-share flights are commonly listed twice, which results in superior listings on computer screens in travel agencies throughout the country.<sup>55</sup> In the American/Qantas code-share mentioned above, two flights would appear in the computer as operating from Chicago to Sydney, one with American’s “AA” flight designator and one with Qantas’ “QF.” Even though the “American” flight must be marked with an asterisk, the code-share flight has gained a competitive advantage over other connecting carriers which will be moved to an inferior position on the screen or to a subsequent page, even though they may offer a superior connection than American.

[M]ost airline ticket sales are made by travel agents from the first page of the computer reservations screen—it is widely acknowledged that more than 70% of all flights are sold from the first page of the screen. By relegating competitive service offerings to inferior display [in CRSs] . . . these practices deceive consumers and damage competing airlines . . . .<sup>56</sup>

Although DOT has been the chief proponent of international code-share agreements it appears to be operating in the dark:

Both Congress’s General Accounting Office and Gellman Research Assoc. studied code sharing in 1994 and concluded that DOT is at a huge disadvantage in assessing whether the deals enhance or reduce competition; gain access or boost traffic for U.S. carriers, or simply shift it; make or lose money and for whom.<sup>57</sup>

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53. *American Airlines and Qantas to Expand Their Cooperative Services*, WORLD AIRLINE NEWS, Nov. 6, 1995, available in DIALOG, IAC-NEWS database.

54. 14 C.F.R. § 255.4(b) (1996).

55. Dempsey, *supra* note 2, at 63.

56. *Id.* at 64.

57. Joan M. Feldman, *Alliances: Are We Making Money Yet?*, AIR TRANSP. WORLD, Oct. 1995, at 25, 26.

Even given this scarcity of factual information, Democratic Senator Wendell H. Ford of Kentucky, Senate Aviation Subcommittee Chairman, stated that Transportation Secretary Federico Peña "already ha[s] approved 77 code-sharing agreements, 61.6% of such agreements ever presented to DOT for approval, and that prior to a Virgin-Delta request [which was approved in 1995], Peña had not turned down a request for a code-sharing agreement."<sup>58</sup> Every U.S. carrier has strategically used code-shares not to enhance services, but to eliminate international services on unprofitable routes. For example, in 1994 Delta Airlines cut four trans-Atlantic routes and removed thirteen Airbus A-310 aircraft from its fleet, replacing those services with code-shares with foreign airlines.<sup>59</sup> And while U.S. carriers have been unwilling or unable to share data with DOT, many foreign carriers have publicly expressed satisfaction with their ability to increase access to U.S. markets and profits. As Lufthansa German Airlines' Senior Vice President-Americas, Frederick Reid, has stated: "We can measure the benefits precisely, though we're not giving them to DOT. [We've] made a significant number of tens of millions of dollars. The return on investment has a better margin than anything I've ever been involved in."<sup>60</sup> It is noteworthy that Lufthansa has been able to achieve this performance entirely through code-sharing in the absence of any equity investment in U.S. carriers.

### *B. Changing the Direction of DOT Policy*

Code-shares came into being because of the U.S. policy which denies cabotage rights to foreign airlines. U.S. airline executives claim that "[g]ranting cabotage rights to foreign air carriers may impair national security, cause U.S. airlines to lose their competitive advantage in the U.S. market, push some airlines into bankruptcy, and result in the loss of American jobs to foreigners."<sup>61</sup> Yet these arguments are ill-founded. First, cabotage rights will not weaken national security since the President or his designee has the authority to revoke or suspend such rights in the event of a national emergency.<sup>62</sup> Secondly, the U.S. airline industry has already experienced a tremendous fallout, and although all carriers currently operating are not on solid ground financially, the domestic market is already highly competitive. Finally, as discussed above, U.S. airlines have successfully used code-shares to reduce services, and therefore staff. On the contrary, it is doubtful that the grant of cabotage rights to foreign carriers would create significant harm to U.S. carriers, since "[f]ew foreign airlines would volunteer for a bare-knuckled fight with United and American for control of the

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58. Douglas W. Nelms, *Delta Presents Its Case: After \$1 Billion in Losses, the U.S. Carrier Is Changing Its European Marketing Strategy with a Major Advertising Campaign*, AIR TRANSP. WORLD, Dec. 1, 1994, at 59, 63.

59. Bridget O'Brian, *Delta Air to Drop Four of Its Routes, Remove 13 Fleets*, WALL ST. J., June 15, 1994, at A5.

60. Feldman, *supra* note 57, at 25, 32.

61. Warner, *supra* note 5, at 316-17.

62. See 50 U.S.C. § 2170 (1994) (providing authority to review certain mergers, acquisitions, and takeovers).

Chicago hub.”<sup>63</sup> On the positive side, granting cabotage rights to foreign airlines will create new job opportunities for Americans to assist in operating and managing the newly-established domestic services. Americans will also benefit from increased competition on domestic routes which will insure that prices remain competitive, and may even cause U.S. carriers to upgrade in-flight services to the superior level of many foreign carriers. “Cabotage is . . . likely to result in niche marketing, and maybe a little dumping. And if foreign carriers dump cheap seats on the deregulated U.S. market while enjoying protected markets at home, the U.S. consumer may benefit . . .”<sup>64</sup>

#### CONCLUSION

The overwhelming use of code-share agreements by DOT in bilateral aviation agreements constitutes a fraud on consumers. Although “bare-bones” regulations are in place to inform consumers of code-shares, in practice the traveling public has a very low level of awareness or understanding concerning them. Moreover, while DOT has generally been quick to approve any code-share proposal put forth, it has done so with very little factual knowledge. Today’s aviation industry functions in a global marketplace. Bilateral agreements are antiquated and significantly inhibit growth in the global marketplace. The United States must be the leader in international aviation. DOT should abandon its policy of negotiating code-share agreements and replace it with an aggressive policy of ending the prohibition on cabotage. Concededly, the United States must endeavor to trade cabotage rights for rights of similar value. In dealing with small foreign countries with limited domestic travel, DOT will have to negotiate regional agreements with several countries. It is time for DOT to consider what is in the interest of American consumers—both code-shares and cabotage restrictions must gradually be eliminated. American carriers will adapt and will continue to be at the forefront of international aviation.

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63. Bill Poling, *Foreign Aid for U.S. Airline Industry?*, TRAVEL WEEKLY, Feb. 28, 1991, at 31, 31.

64. *Id.*



