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SYNTHETIC MERGERS AND AIRLINE  
CONSOLIDATION

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# THE DLC OR SYNTHETIC MERGER STRUCTURE AND AIRLINE CONSOLIDATION

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## INTRODUCTION

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It is generally held that the airline industry is fragmented and should consolidate. Various reasons have been suggested to explain the lack of consolidation to date; this paper focuses on just one of those: the foreign ownership restrictions contained in the bilateral system governing the airline industry.

This paper should be read in conjunction with the companion paper providing further detailed explanations of the DLC structure.

## THE PROBLEM

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Consolidation can take place in two ways: organically, where one group gains market share over time from another group, which reduces capacity or exits the business; and by mergers and acquisitions. In normal industry environments both trends occur together and may be mutually supportive: the big get bigger.

The extent to which an industry can consolidate without mergers and acquisitions activity will depend on a range of factors: for example, the extent to which certain businesses develop a competitive advantage over others and the availability of capital, including state aids, to support the weaker

businesses. In the airline industry, organic consolidation has been slow.

Much attention has focused on merger and acquisitions as providing a route forward, though the factors which make organic consolidation slow can also make mergers and acquisitions difficult to achieve.

In the case of the airline industry, consolidation by mergers and acquisition is additionally complicated by the bilateral regime which typically requires that an airline is “substantially owned and effectively controlled” by nationals of the designating country. Of course, in a normal merger or acquisition, both ownership and control change and, in a cross-border transaction, typically one entity would lose its nationality, potentially putting at risk the route rights of one merger partner. Hence cross-border mergers in the airline industry have been considered to be ruled out.

As has been well reported, this has in part explained the prevalence in the airline industry of alliances and minority stakes. Neither of these provides an adequate solution. In the absence of a change to the regulatory environment, the task remains to

find ways which allow the airline industry to consolidate and so adapt more properly to the modern world.

## A SOLUTION

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A potential solution exists to allow normal merger and acquisition activity to take place in the airline industry. It involves using a type of structure first adopted by Royal Dutch/Shell and Unilever in the early decades of the last century. This structure is typically referred to as a Dual Listed Company (“DLC”) or synthetic merger structure.

DLCs have been steadily growing in use over recent years for a variety of reasons, not least the increase in cross-border merger activity since the 1980s. Yet their relative rarity and apparent complexity mean that the structure is not widely recognised as the potential tool that it is. It is the aim of this paper to highlight the scale of this opportunity and to explain briefly how this type of structure can offer a potential solution.

## WHY A DLC?

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A DLC is a hybrid structure. It enables all the normal business benefits of consolidation to take place yet it preserves intact the two merging companies, together with their respective listings. A general introduction to DLCs and a detailed description of the Rio Tinto DLC are provided in a companion paper to this paper.

Immediately the advantage of the DLC over normal unitary structures can be seen. If the merging airlines complied with the bilateral requirements on nationality before the merger, since no change takes place in the ownership of the companies as a result of the merger, then the two companies should continue to enjoy national status after the merger.

In a DLC, the two merging entities remain. They can keep their original names; they will continue to operate a head office which will be in the country of listing. The identity of the shareholders in the merging entities will be unaffected by the merger. The operations of the two merging entities remain held in separate legal structures – the same ones as before the merger. In many ways, the DLC structure creates considerable flexibility to present the merger as preserving intact the original entities, and this makes it a structure which is least likely to offend the nationality requirements of the bilateral system.

At the same time, there is nothing inherent in the structure which means that the normal business benefits of a merger can not be obtained; indeed in this regards a DLC is just the same as a normal, unitary merger. So cost saving and revenue benefits, to the extent they would be available in a unitary merger, would be equally available in a DLC merger. With a DLC you can have the best of both worlds.

## HOW WOULD IT WORK?

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There are two steps to constructing a cross-border merger of two (or more) listed airlines using a DLC structure:

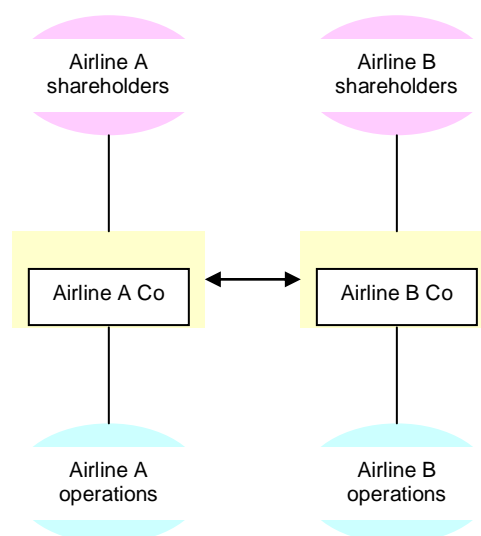
Step 1. Establish mechanisms for maintaining the nationality of the listed parent companies, if not already in place

Step 2. Implement a DLC merger, maintaining the national ownership achieved in 1. above through to the sensitive operations of each airline

Step 1. The first step is not a new one. All listed airlines must have a mechanism for ensuring that, given the otherwise free trading in its stock, a majority of its shares remain in the hands of nationals. In many cases this is achieved by the simple expedient of the government owning a majority of the shares. Where registered shares are the norm, there are well-proven mechanisms such as that used by British Airways to monitor the nationality of its shareholders and tools with which to respond if the foreign ownership of shares exceeds a safe level. Where bearer shares are the norm, as is often the case in Continental Europe, more imaginative solutions have been adopted, such as the unique convertible instrument held by the Dutch state in KLM, giving the state a right to subscribe for a majority of KLM's shares if its route rights were threatened, a device which remained in place to protect KLM after the merger with Air France.

## ILLUSTRATION OF AIRLINE DLC

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Step 2. To implement a merger, the merging airlines would enter into a contract (there would be certain additional legal steps); the effect of the contract would be to enable the two businesses to be run in such a way that the normal business benefits of a merger could be secured. The way this is achieved is that instead of the shareholders in the merging airlines exchanging their shares for shares in another company (ignoring for these purposes a cash offer), the shares in one airline are made to mirror the shares in the other airline, so that the effect is the same as that of a normal unitary merger, in other words to achieve a merger synthetically.

As has been noted, there are two aspects to the nationality tests: ownership and control. These two concepts need to be tested against the synthetic arrangement.

*Ownership.* The ownership of the two airlines is unchanged by the DLC merger. The

investors who owned the shares in airline A before the merger are exactly the same immediately after the merger, and as a result of Step 1 they are known to be majority nationals of the designating state.

Of course, the economic position of shareholders after the merger is different to that before. After the merger shareholders in airline A own an interest in a company that has agreed to reward its shareholders in exactly the same manner as its merger partner. The financial fortunes of the two airlines are independent of each other (except to the extent of any other arrangements put in place as a result of the merger, such as procurement pooling or joint marketing, arrangements which could be implemented outside a merger), but the rewards of the shareholders are permanently linked by agreement.

*Control.* In modern-day DLC structures, especially since Rio Tinto, the votes of shareholders in a merged DLC group are cast on a pooled basis, as if shareholders were all voting together in a single company. This is a democratic approach, consistent with today's standards of corporate governance.

Since the effect of pooling is to remove the effect of there being two separate companies, the nationality protection offered by the DLC appears at first to be lost, as the control of a DLC would rest with the majority of shareholders of the merged entity, which plainly can not be of the same nationality in a cross-border airline merger as the majority in each prior to the merger.

Fortunately, the DLC structure has an in-built mechanism for protecting the rights of the shareholders of each company taken separately, with the vote pooling system put to one side and general meetings conducted just as they would have been for each company as if the merger had never taken place. This device is referred to by the type of resolution which is put to shareholders in this manner: "class rights" matters.

Now it can be seen how the nationality enshrined at the shareholder level on an individual company basis is preserved through the voting mechanism via class rights matters, so that control of the airline's affairs, at least insofar as they are relevant to the retaining of route rights (the class rights matters), continues in the hands of each airline's nationals.

In practice this would mean that each airline in its corporate constitution would identify a list of matters which were considered sensitive to the protection of the airline's route rights. These would be matters which would be decided upon directly by each company's shareholders voting separately, each group being majority nationals. This list would include the nomination of directors (being nationals) to a board of a separate airline company which would have responsibility for the conduct of affairs where sovereignty was critical.

Control of sensitive airline operations would be exercised via that separate subsidiary; the board of that company would be elected

directly by the shareholders of each parent company separately (and not by the boards of the listed parents). In this fashion, control is streamed up to that airline's nationals (directors and shareholders), complying with the nationality requirements of the bilaterals.

#### ADVANTAGES OF THE DLC

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What, in summary, are the advantages of the DLC as regards airline mergers and the problem of the bilaterals?

1. DLCs retain the two merging companies separately, each with their own corporate and national identity, together, as appropriate, with the characteristic features of identity, such as name and head office location.

2. DLCs do not alter the ownership of an airline in a merger, thus satisfying the ownership test, though they do alter the economic entitlements of shareholders in virtue of their holding shares in each airline

3. DLCs have a special voting procedure which allows sensitive matters to remain under the sovereignty of each airline's nationals, thus satisfying the control test

4. DLCs bring ALL the business and financial benefits of a normal merger, unlike alliances and other arrangements used to date to avoid the loss of route rights

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