

QA 41333

Order 98-8-16



UNITED STATES OF AMERICA
DEPARTMENT OF TRANSPORTATION
OFFICE OF THE SECRETARY
WASHINGTON, D.C.

Issued by the Department of Transportation
on the 23rd day of June, 1998

Joint Application of

AMERICAN INTERNATIONAL AIRWAYS, INC.
and
KITTY HAWK AIRCARGO, INC.

for approval of a transfer of route authority under
49 U.S.C. 41105

Served: August 19, 1998

Docket OST-97-3011 - 2

**ORDER MAKING FITNESS DETERMINATIONS AND
GRANTING *DE FACTO* TRANSFER OF AUTHORITY**

Summary

By this order, we (1) find that Kitty Hawk Aircargo, Inc. ("Kitty Hawk") and American International Airways, Inc. ("AIA") continue to be fit to conduct the air transportation operations for which they hold economic authority; and (2), grant a *de facto* transfer under section 41105 of Title 49 of the United States Code ("the Statute") of the certificate and other economic authorities held by AIA and a related air taxi operator, Kalitta Flying Service, Inc. ("KFS"), to AIA and KFS, respectively, under the ownership of Kitty Hawk, Inc. ("KHI"), the holding company parent of Kitty Hawk.

Applications

On September 3, 1997, in accordance with the provisions of section 204.5 of our rules (14 CFR 204.5) that require air carriers to notify us of substantial changes affecting their operations, Kitty Hawk, located at the Dallas-Ft. Worth International Airport, Texas, and AIA, based in Ypsilanti, Michigan, advised the Department that they proposed to enter into an agreement and plan of merger whereby KHI would acquire all of the outstanding common stock of AIA and four other companies under the sole ownership and control of Mr. Conrad A. Kalitta ("the Kalitta companies").¹ The agreement provides that AIA and the other Kalitta companies would become separate subsidiaries of KHI and would continue to be operated independently of Kitty Hawk until merger plans are finalized. On September 9, the Department asked the two parties to furnish certain information on the forthcoming transaction and on Kitty Hawk's and AIA's continuing fitness.

On October 14, 1997, Kitty Hawk and AIA jointly filed an application with the Department in Docket OST-97-3011 seeking approval under section 41105 of the Statute of the *de facto* transfer of AIA's certificate and other economic authorities to AIA under the ownership of KHI.² A partial response to our information request of September 9 was included with this submission, with the balance of the information filed on October 14 and 31, and on March 23 and April 13, 1998.³

After reviewing all of the documents filed and other information available to us, as more fully discussed below, we find Kitty Hawk and AIA fit and the *de facto* transfer in the public interest.

¹ In addition to AIA, the Kalitta companies include the following: Kalitta Flying Service, Inc. ("KFS"), a Part 298 air taxi operator with authority to operate non-scheduled flights to Canada; American International Travel, Inc. ("AIT"), which arranges travel services for employees of the Kalitta companies; Flight One Logistics, Inc. ("FOL"), a provider of air cargo transport logistics services to shippers; and O.K. Turbines, Inc. ("OK"), which holds Part 298 air taxi authority and provides aircraft maintenance services to AIA and other airlines. In addition, AIA has a 60 percent partnership interest in American International Cargo ("AIC"), which provides freight forwarding services between the Continental U.S. and Hawaii, among the Pacific islands, and to the Pacific rim. The remaining 40 percent interest in AIC is held by Pacific Aviation Logistics, Inc., a California corporation wholly owned by Ms. Beti Ward. The applicants state that the status of AIC is unaffected by KHI's acquisition of the Kalitta companies.

² The applicants also jointly filed an application for an exemption from section 41105 to the extent necessary to allow KHI and AIA to close on the acquisition transaction pending our action on the *de facto* transfer request. By Order 97-11-8, issued on November 6, 1997 (Docket OST-97-3015), we granted the exemption, on condition that Kitty Hawk and AIA remain separate entities until our decision on the *de facto* transfer had been made.

³ This material included copies of the Agreement and Plan of Merger among KHI and the Kalitta companies dated September 22, 1997, KHI's Form S-1 Registration Statement as filed with the Securities and Exchange Commission on September 22, and KHI's SEC Form 10Q for the quarter ended September 30 and its Form 10K for the year ended December 31, 1997.

FITNESS OF KITTY HAWK AND AIA

Pre-Acquisition Ownership

Kitty Hawk

Kitty Hawk, a Delaware corporation located at Dallas-Ft. Worth International Airport, Texas, was found fit in 1989 and issued an interstate all-cargo air transportation certificate under section 41103 of the Statute.⁴ The carrier was also issued, but currently does not utilize, a certificate under section 41102 of the Statute (Order 93-7-15, served July 8, 1993) authorizing it to engage in foreign scheduled air transportation of property and mail between Miami, Florida, and Santo Domingo, Dominican Republic. The carrier conducts cargo charter flights with a fleet of about 34 aircraft -- 22 B-727s, five DC-9s, and seven Convair 600/640s.⁵

Prior to KHI's acquisition of the Kalitta companies, only Mr. M. Tom Christopher, Chairman and Chief Executive Officer of KHI, held a substantial beneficial interest (approximately 64 percent) of KHI's common stock, which is publicly traded.

The Kalitta Companies

The Kalitta companies are incorporated under the laws of the State of Michigan. Prior to their acquisition by KHI, they were owned solely by Mr. Kalitta, who had served as their Chairman and Chief Executive Officer. AIA holds economic authority authorizing it to engage in interstate and foreign scheduled and worldwide charter air transportation of cargo, and interstate scheduled and worldwide charter air transportation of passengers.⁶ The carrier's

⁴ That certificate was originally issued by Order 89-4-15 on April 7, 1989. By Order 89-8-38, dated August 23, 1989, the certificate was reissued and made effective. By Order 92-12-13, dated December 10, 1992, Kitty Hawk's certificate was reissued in the name "Postal Air, Inc.," and by Order 93-1-25 on January 22, 1993, the certificate was reissued again in the name "Kitty Hawk Aircargo, Inc."

⁵ Kitty Hawk agreed in September 1997 to purchase from AIA for \$51 million 16 B-727 aircraft, of which 15 are in cargo configuration and one is in passenger configuration. Thus far, all but seven of the aircraft are now being operated by Kitty Hawk. AIA has assigned to Kitty Hawk the freight contracts related to the aircraft and will continue to fly them under an operating agreement with Kitty Hawk until the latter company can integrate the aircraft into its operations. AIA, which is using the proceeds to acquire and modify wide-body aircraft and to provide working capital, has the right under certain circumstances to repurchase thirteen of the aircraft.

⁶ In 1967, Mr. Kalitta established Connie Kalitta Services, Inc. ("CKS"), which initially operated small aircraft as an air taxi operator under Part 298. By Orders 84-4-35 (April 11, 1984) and 84-11-45 (September 17, 1984), CKS received certificates authorizing it to engage in interstate all-cargo air transportation and foreign charter cargo air transportation, respectively. CKS subsequently acquired AIA, which had ceased certificated operations following a Chapter 11 filing. After the acquisition, we found AIA fit to resume operations under its own name and under the trade name "Connie Kalitta Flying Service," and reissued AIA's interstate air transportation certificate (Order 89-5-40, dated

flights are performed with a fleet of about 40 aircraft, including 19 DC-8s, seven B-727s, eight L-1011s, and six B-747s.⁷ The company is in the process of acquiring three additional B-747s.

In addition to its scheduled cargo service, AIA operates under contracts with the U.S. Postal Service and the Air Mobility Command. AIA's American International Freight division arranges overnight and second-day air service to 46 U.S. cities for up to a million pounds of cargo each night. The carrier also provides passenger charter service with two L-1011s and two B-747s for tour operators, cruise lines, universities, and for various foreign and domestic air carriers.

Two other Kalitta companies, KFS and OK, hold Part 298 air taxi authority. KFS, based at Ypsilanti, conducts on-demand cargo, passenger, and emergency medical flights to domestic and foreign points with a fleet of about 30 aircraft that can transport from four to eight passengers or from 1,500 to 4,000 pounds of cargo, including Beech 18s and Lear Jets. KFS is designated to provide non-scheduled air transportation between the U.S. and Canada with small aircraft. OK, located at the former Wurtsmith Air Force Base at Oscoda, Michigan, provides aircraft maintenance and engine overhauls for the Kalitta companies and other airline customers. It holds no foreign economic authority.

May 18, 1989), effective for air transportation of property and mail only (Order 91-2-43, dated February 27, 1991). In 1991, the small-aircraft division of CKS was spun off into a separate corporation, named KFS. By Order 93-4-36, dated April 16, 1993, AIA, which had changed its trade name to "Connie Kalitta Services," was found fit to engage in passenger-carrying operations.

In addition, AIA holds the following authorities to engage in foreign air transportation: (1) a five-year experimental certificate to provide cargo air service between Miami and Manaus, Sao Paulo, Recife and Rio de Janeiro, Brazil, via Bogota, Colombia (Order 96-6-12); (2) certificates to engage in cargo air transportation between points in the U.S. and points in Australia, New Zealand, Taiwan, and Hong Kong (Order 95-9-23); between points in the U.S. and points in Costa Rica, Colombia, Belize, El Salvador, Guatemala, Honduras, Nicaragua, and Panama (Order 95-9-23, amended by Order 97-10-8); and between points in the U.S. and Singapore and Indonesia (Order 97-11-2); (3) exemption authority to provide cargo air service between Miami and Quito and Guayaquil, Ecuador, including authority to integrate these services with its existing authority to serve Colombia, and allocation of three narrow-body cargo frequencies (Order 97-8-20); and between the co-terminal points Honolulu and Guam and Jakarta, Indonesia, via the intermediate point Melbourne, Australia (Order 96-7-42); and (4) various statements of authorization for long-term wet-lease service to Aerolineas Argentinas, TACA, NICA, and AVIATECA. In addition, AIA has an application pending before the Department to serve Venezuela (Docket 49577) and has requested that its *de facto* transfer application in Docket OST-97-3011 include this and any other authorities subsequently requested or granted.

⁷ Two additional B-747s are grounded due to their not meeting FAA airworthiness requirements (see discussion under the section "Operating Plans and Financial Condition" below).

Post-Acquisition Ownership

On November 19, 1997, KHI, AIA, *et al.*,⁸ consummated an agreement and plan of merger dated September 22, 1997, whereby, in exchange for the stock in the Kalitta companies, Mr. Kalitta obtained an ownership interest in KHI amounting to approximately 24.4 percent of the shares of KHI then outstanding, while Mr. Christopher's interest decreased to approximately 35.5 percent of KHI.⁹

Management

Kitty Hawk and AIA are continuing to operate as separate entities until the eventual merger of the two carriers. The applicants state that, until that time, no changes in the management of either company are planned, except in the composition of the board of directors of KHI. Following the closing of the acquisition, the KHI board of directors increased from six to seven positions. Three of these seats have been filled by Mr. Kalitta and two individuals chosen by him (Messrs. George W. Kelsey and Philip S. Sauder). The remaining four seats were retained by Mr. Christopher and three other current KHI board members (Messrs. Tilmon J. Reeves, Ted J. Coonfield, and Lewis S. White).¹⁰

Kitty Hawk

Mr. Tom Christopher formed Kitty Hawk in 1988 and now serves as Chairman and Chief Executive Officer of KHI, Kitty Hawk, and AIA. Previously, he owned and operated several air taxi operators, an air freight forwarder, and an aircraft leasing business.

⁸ The parties to the agreement are KHI, five newly created subsidiaries of KHI (Kitty Hawk-AIA, Inc., Kitty Hawk-AIT, Inc., Kitty Hawk-FOL, Inc., Kitty Hawk-KFS, Inc., and Kitty Hawk-OK, Inc.), Mr. M. Tom Christopher (majority stockholder of KHI), the five Kalitta companies, and Mr. Kalitta. At consummation, the five newly created KHI subsidiaries merged into the five Kalitta companies, which then became wholly owned subsidiaries of KHI.

⁹ Following the acquisition, no other KHI shareholder owns more than 5.1 percent of the company's stock.

¹⁰ Mr. Kelsey, who has practiced law for 27 years, has been a director of AIA since 1995 and has served as its principal outside counsel. He owns Kelsey Law Offices, P.C., located in Ann Arbor, Michigan.

Mr. Sauder has also been a director of AIA since 1995. He is a limited partner of Carlisle Enterprises, L.P., which acquires manufacturers of engineered products, and is the Chairman and Chief Executive Officer of Alpha Technologies, Inc., a manufacturer of instrumentation for the polymer and rubber industries.

Mr. Reeves serves as President of both KHI and Kitty Hawk.

Mr. Coonfield, a director of KHI since 1994, is President of Oregon Wine Designs, Inc., a wine production and marketing company. He also works as a consultant with Performance Consulting Group, a specialist in management consulting for banks and insurance companies.

Mr. White was elected to the board of KHI in 1994. Since 1988, he has been President of L. S. White & Co., which is engaged in business planning, finance, acquisitions and restructurings.

Mr. Tilmon J. Reeves joined Kitty Hawk in 1992 as Vice President, and was named President and Chief Operating Officer of KHI in 1993. He relinquished the latter position upon consummation of the acquisition, and now serves as President of both KHI and Kitty Hawk. Before joining Kitty Hawk, Mr. Reeves was employed as Vice President-Sales of Express One International and Managing Director-Cargo Services for American Airlines.

Mr. Tej Raj has been Kitty Hawk's Director of Operations since 1989. His prior experience includes serving as Chief Pilot for one of Mr. Christopher's air taxi operators, Skyfreighters Corporation, as a pilot for General Aviation, Inc., Kitty Hawk's predecessor, and for Corporate Air, Inc., of Hartford, Connecticut. Mr. Raj is a citizen of India and a permanent resident of the United States. He holds an Airline Transport Pilot Certificate from the FAA.

Mr. Joseph T. Longacre joined Kitty Hawk in 1992 as Chief Inspector for jet operations and now holds the position of Director of Maintenance. Mr. Longacre, who holds an FAA-issued Airframe and Powerplant Mechanic Certificate, has spent a total of 21 years in aircraft maintenance positions. In addition to Kitty Hawk, he has worked for Amerijet International Airlines, the original Midway Airlines, Florida West Airlines, and the original Pan American World Airways.

Mr. Gregory V. Embree is its Director of Quality Control. Over his 19-year aviation career, Mr. Embree has held maintenance and inspection management positions with Interstate Airlines, Pacific Interstate Airlines, Gas Turbine Corporation, Buffalo Airways, and UltraAir. He holds an Airframe and Powerplant Mechanic Certificate issued by the FAA.

Mr. Robert B. Stephens is Kitty Hawk's Chief Pilot. He holds an Airline Transport Pilot Certificate with ratings for DC-8, DC-9, B-727, and B-747 aircraft. During his 26-year career in commercial aviation, Mr. Stephens accumulated over 19,600 hours of flight time as a pilot with Eastern Air Lines, KFS, Private Jet Expeditions, and Atlas Air. He also was employed as Vice President/Director of Operations and Chief Pilot with Private Jet, and as Vice President-Operations with Polar Air Cargo.

AIA

Mr. Kalitta, who had served as Chief Executive Officer of AIA and the other Kalitta companies, assumed the titles of President of AIA and as Vice Chairman of KHI following the acquisition. He retired from his active management roles in April 1998, although he remains a director and stockholder of KHI.

Mr. William L. Gray was named Chief Operating Officer/General Manager in 1995. In early 1998, following the departure of AIA's Vice President of Operations, Mr. Gray took on that assignment, and upon Mr. Kalitta's retirement, was again named Chief Operating Officer of AIA. He holds Airline Transport Pilot and Airframe and Powerplant Mechanic Certificates from the FAA. Prior to joining AIA, he managed the Flight Facility (including an FAA-approved Repair Station) at the Environmental Research Institute of Michigan. He also

worked for ten years for Zantop International Airlines in positions including pilot, check airman, and hazardous materials specialist. He also was employed as Director of Operations for Wolverine Aviation.

Mr. Michael F. Maraone joined AIA as Vice President and Chief Financial Officer in 1993. Previously, he was employed by Jered Brown Brothers, Inc., in several managerial positions including Vice President, Chief Financial Officer, and Controller, and by Arthur Andersen & Co., as an accountant.

Mr. Terry C. Austin joined AIA as its Director of Safety in July 1997. He holds an FAA Air Transport Pilot Certificate and has over 7,800 hours of flight time. Prior to accepting his present position, Mr. Austin was employed as an FAA Air Carrier and General Aviation Operations Inspector. He also served in the U.S. Army Military Intelligence Command and its Directorate of Evaluations and Standards.

Mr. Thomas A. Mealie was employed as AIA's Manager of Quality Assurance in April 1995, subsequently held the positions of Director of Quality Control and Corporate Director of Quality Control, and was named Director of Maintenance in January 1998. Mr. Mealie, who holds an FAA Airframe and Powerplant Mechanic Certificate, also worked for 25 years for Trans World Airlines in positions that ranged from aircraft mechanic to Manager of Technical Quality Assurance for the carrier's entire system.

Mr. Mark J. Guyon joined AIA in 1993 and was named Corporate Director-Quality Control in January 1998. His previous aviation maintenance experience was obtained over an 11-year period with Rosenbalm Aviation as Assistant Director of Maintenance and Manager of Maintenance Control, CKS as Manager of Maintenance Control, Flagship Express as Director of Maintenance and Assistant Director of Quality Control, and Buffalo Airways as Chief Inspector. He holds an Airframe and Powerplant Mechanic Certificate from the FAA.

Mr. Donald E. Joffrion has been AIA's Chief Pilot since 1995. He holds an FAA Airline Transport Pilot Certificate and has logged over 20,000 hours of flight time. Before joining AIA, Mr. Joffrion spent 23 years employed with three certificated air carriers. He worked as a pilot and check airman with Southern Air Transport and Zantop International Airlines, and as Director of Operations for Trans Continental Airlines.

Based on the experience and background of Kitty Hawk's and AIA's key personnel and the fact that they have been managing the carriers' ongoing operations, we conclude that Kitty Hawk and AIA will continue to have the management skills and technical ability needed to continue conducting their certificated operations.¹¹

¹¹ The FAA also evaluates certain of the carriers' key personnel with respect to the minimum qualifications for those positions as prescribed in the Federal Aviation Regulations. The FAA's evaluation of these key personnel provides an added practical and in-person test of the skills and technical ability of these individuals.

Operating Plans and Financial Condition

Kitty Hawk

Kitty Hawk has experienced profitable operations for the last six years. The carrier reported a net income of \$4.1 million for calendar year 1996 and \$9.0 million for 1997. As of December 31, 1997, Kitty Hawk's balance sheet showed current assets of \$35.6 million and current liabilities of \$29.6 million, for a current ratio of 1.20:1, long-term debt of \$45.9 million, and stockholders' equity of \$32.9 million.

The Kalitta Companies

For the years 1992 through 1995, the Kalitta companies achieved significant operating and net profits. However, for calendar year 1996, they reported a combined operating profit of \$21.5 million, but a net loss of \$17,000, which nevertheless represented a considerable recovery from a net loss of \$5.6 million for the first six months of 1996. The situation deteriorated sharply in the first half of 1997, for which period the Kalitta companies recorded a combined operating loss of \$19.4 million and a net loss of \$30.9 million. The Kalitta companies attribute this performance to a number of factors -- abnormally high engine overhaul expenses following the FAA's issuance of new airworthiness directives, the voluntary grounding of two B-747s that when fully loaded did not meet FAA cargo door safety standards (resulting in an estimated \$46 million in lost revenues over 18 months), start-up costs associated with the company's new passenger charter business, additional flight crew training expenses, delays in acquiring aircraft, and lower military charter revenues.

As of June 30, 1997, the consolidated balance sheet for the Kalitta companies indicated current assets of \$105.4 million, current liabilities of \$327.8 million¹² (current ratio of 0.32 to 1), no long term debt, and stockholders' equity of \$35.5 million.

The Form 41 data filed with the Department for AIA itself for the third quarter of 1997 show that its operating profit of \$6.7 was reduced to a net loss of \$2.5 million. In the fourth quarter, AIA experienced an operating loss of \$5.2 million and a net loss of \$7.9 million. The carrier's balance sheet (Schedule B-1) as of September 30, 1997, revealed a worsening financial condition:- current assets of \$76.7 million, current liabilities of \$341.9 million (current ratio of 0.22 to 1) and stockholders' equity of \$7.6 million. By year-end 1997, AIA's current assets were reported to the Department at \$79.2 million (cash at -\$1.2 million), current liabilities at \$357.8 million (current ratio still at 0.22 to 1), no long-term debt, and a stockholders' deficit of \$7.9 million (including a retained earnings deficit of \$5.2 million).

¹² This current liabilities balance includes a total of \$245.3 million of long-term debt and notes payable that have been reclassified as current by the lenders because AIA is in default under certain restrictive loan agreements, including defaults arising from failure to make certain principal payments. Virtually all of the Kalitta companies' debt has been personally guaranteed by Mr. Kalitta.

Combined Position

KHI believes that Kitty Hawk's and AIA's established market positions, the size and variety of their fleets, and their reputation for reliable service will provide a solid foundation for their forthcoming merger. KHI expects to utilize more of the two carriers' own aircraft, rather than those of third parties, for the charter flights they arrange. KHI also expects to achieve significant cost savings by integrating the carriers' fleets, better matching aircraft capabilities with customer needs, consolidating duplicative ground facilities, increasing AIA's crew utilization, reducing Kitty Hawk's parts inventory and its reliance on outside maintenance services, and lowering aircraft insurance premiums. KHI also expects that the carriers will be able to expand their charter business and increase the maintenance services provided for third parties. In addition, new financial accounting systems have been incorporated in all of the KHI companies to enhance cost control and facilitate the timely production of accurate financial data.

AIA states that several of the problems that negatively affected its profitability in 1996 and 1997 either will not recur or will have a reduced impact in the future, particularly extraordinary engine overhaul expenses and passenger service start-up expenses. In addition, AIA expects to provide military passenger-cargo charters in lieu of the reduced number of military cargo-only charters available. AIA further expects operating profits will improve in 1998 particularly after the three B-747 aircraft being acquired are modified and integrated into the fleet later in the year. KHI has stated that, in the future, the focus for the Kalitta companies will be more on meeting profit goals than on expansion and increased revenues, as in the past.

In connection with the acquisition, KHI undertook a public offering of its common stock, from which it received proceeds of \$38.3 million, and a sale of KHI senior secured notes, from which it received proceeds of \$329.1 million. In addition, KHI obtained a \$45.9 million term loan (the proceeds of which paid most of the \$51 million purchase price for the 16 727s acquired from AIA), and a new \$100 million revolving credit facility. Of the approximately \$413 million in proceeds from all the transactions (except the credit facility), \$329.8 million was used to repay or refinance existing AIA and Kitty Hawk indebtedness, \$56 million went toward the purchase and modification of two B-747s, \$20 million went to pay the cash portion of the purchase price, and \$6 million was allotted to working capital.

According to KHI's SEC Form 10K for calendar year 1997, which reflects the outcome of the AIA acquisition and the allocation of the proceeds from KHI's stock and securities sales, the consolidated companies had current assets of \$277.3 million (including a cash balance of \$17.9 million), current liabilities of \$166.3 million (yielding a current asset ratio of 1.67:1), long-term debt of \$392.2 million, and stockholders' equity of \$174.9 million (including retained earnings of \$44.2 million). Consolidated operating income for 1997 was reported at \$36.6 million, and net income at \$17.9 million from revenues of \$137.3 million.

In addition, KHI has a \$100 million credit facility with Wells Fargo Bank (Texas), N.A., which is subject to a current borrowing base limit of approximately \$59 million, of which \$15 million was outstanding as of March 31, 1998. KHI believes the credit line, the carriers' cash flow, and the proceeds of the stock and note offerings will be sufficient to meet working capital and capital expenditure needs for at least the next 12 months.

While KHI's post-acquisition financial condition appears to be positive, there are a number of challenges that the company will face over the next few years which could significantly affect its profitability. Although the proceeds of the \$40 million stock offering and the \$340 million KHI senior note offering has enabled about \$328.7 million of AIA's and KHI's existing debt to be discharged and the B-747s to be acquired and modified, KHI has still been left with substantial debt that will restrict its ability to respond flexibly to expansion opportunities and to economic changes.

A significant KHI challenge concerns the expensive modifications that will need to be undertaken to bring its fleet in compliance with FAA airworthiness and noise standards. According to recent FAA information, about half of Kitty Hawk's and AIA's jet aircraft meet the Stage III noise standards. The cost of retrofitting the rest of the jet fleet, which must be accomplished by January 1, 2000, has been estimated by KHI at about \$100 million, not including the cost of aircraft downtime.¹³

Moreover, the FAA's recent requirement that B-747 operators must undertake certain wiring and other inspections and modifications stemming from concerns about the safety of older B-747 center fuel tanks will have an as yet unknown financial impact on AIA. Some of the work on this project must be completed this year, and additional costly modifications may be necessary in the future.

With regard to the two previously mentioned B-747s that AIA had grounded in 1996 due to FAA restrictions on its load levels,¹⁴ KHI states that an engineering redesign has been identified which, if acceptable to the FAA, could enable one of the B-747s to be returned to service with the capacity to carry 160,000 pounds, or about 73 percent of full capacity. A resolution is still being sought for the structural problems of the second aircraft.

¹³ KHI has indicated that 20 of the B-727's belonging to AIA and Kitty Hawk will need to undergo Stage III retrofitting before the deadline in the year 2000, at an expected cost of about \$36 million, not counting downtime. In addition, 14 of AIA's DC-8 aircraft which do not meet the Stage III requirements may be phased out to avoid the retrofit expense, which is estimated at about \$50 million, not including downtime.

¹⁴ The FAA issued an Airworthiness Directive in January 1996 restricting cargo loads on these two B-747s to no more than 120,000 pounds (55 percent of maximum capacity) due to concerns about the safety of the cargo door and the surrounding cargo floor area. The aircraft were modified for cargo transport by GATX-Airlog Company, against whom AIA has instituted litigation to recover repair expenses and lost revenue. Mr. Kalitta has agreed to cover AIA's legal costs in exchange for the right to reimbursement from any recoveries obtained from GATX.

In addition, the FAA states that it is preparing an Airworthiness Directive that will affect 28 of KHI's 29 B-727s, seven of which are operated by AIA and 21 by Kitty Hawk. After certain B-727s were converted for cargo use according to one particular engineering design, the FAA determined that the cargo floor structures and certain cargo-handling system components did not meet required strength standards. The FAA is proposing to direct all operators of such B-727 freighters to limit the weight of each cargo container or pallet to 4,800 pounds, or 60 percent of the current maximum of 8,000 pounds, until the structures meet FAA standards. KHI notes that an alternative solution, that would enable the aircraft to safely carry up to 6,000 pounds after only minor modifications, would not result in an undue financial burden.

In consideration of the above, we conclude that KHI has a plausible plan for combining the operations of Kitty Hawk and AIA and that it has obtained sufficient capital, for the present, to support the continued certificated operations of the two carriers without imposing undue risks on the public or their funds.

Safety and Compliance Disposition

Kitty Hawk

We have reviewed our records, including those of the FAA, with respect to any evidence of Kitty Hawk compliance problems or consumer complaints. FAA records indicate that Kitty Hawk has had two accidents and five incidents over the past seven years. One of the accidents, a midair collision between a Kitty Hawk non-revenue flight and another aircraft, occurred after the Kitty Hawk aircraft was cleared to land in Ft. Worth in November 1991. No one was injured, but the aircraft received substantial damage. The cause was attributed to the failure of the pilots of both aircraft to observe and avoid each other. The second accident, which occurred on a non-revenue flight on November 21, 1997, involved improperly secured cargo. When the flight lifted off from Syracuse, unsecured ballast (empty cargo pallets) shifted to the rear of the cargo compartment. The crew aborted the takeoff, noted that there was some damage in the tail section, but decided to tie down the ballast and depart; the flight landed successfully in Ypsilanti. The pilot-in-command was later cited for not performing an adequate pre-flight inspection of the aircraft. The five incidents, which occurred over the period August 1992-July 1996, involved one hard landing and four engine or system malfunctions. Other than the action against the pilot mentioned above, no enforcement actions were taken by the FAA as a result of any of these events.

FAA records reveal five open enforcement cases involving alleged violations by Kitty Hawk of regulations concerning employee drug testing procedures and maintenance and airworthiness requirements. The FAA states that these cases, which may involve the imposition of civil penalties, will not be resolved for some time, but that, in the meantime, the deficiencies which gave rise to these actions have been corrected. The FAA states that it is satisfied with Kitty Hawk's compliance disposition but that it is concerned about the company's ability to integrate the 16 additional B-727s into its operation. The FAA notes that this fleet expansion will require the carrier to hire approximately 150 new flight crewmembers, which will place a

strain on its flight and training operations, as well as new maintenance personnel. FAA further states, however, that it has and will continue to closely monitor Kitty Hawk's operations for any indication of unsafe or non-compliant tendencies.

The Department's records on consumer complaints contain no references to any complaints against Kitty Hawk over the past three years. The Department's Bureau of Transportation Statistics states that Kitty Hawk has periodically exhibited unacceptable compliance with our Form 41 filing requirements. Currently, however, the company has no outstanding reports.

The Kalitta Companies

According to FAA and NTSB records, AIA has been involved in a number of accidents and incidents over the past seven years, although there is no record of any fatalities. Two accidents, in 1991 and 1992, were the result of the pilot's landing too far down a wet runway and hydroplaning. Another in 1992 involved an encounter with severe turbulence, and one in 1994 resulted in a crew member experiencing severe oxygen deprivation because maintenance personnel had failed to reinstall (and the flight crew had failed to observe) an emergency door removed for repairs, making it impossible to pressurize the cabin.

NTSB files also contain information on an accident that occurred in 1993 while an AIA flight was attempting to land at Guantanamo Bay. The aircraft stalled and crashed into the water after the pilot lost control of the angle of descent and airspeed. Serious injuries to the three crew resulted. The accident was attributed to the fatigue of the pilot and other crew. In addition, in 1996, the cargo on an AIA flight shifted causing punctures in the pressure bulkhead and a resultant loss of pressure for a 15-minute period. The company's maintenance personnel were faulted for failing to adequately secure the cargo, and the flight crew was cited for failure to detect the problem in the preflight inspection.

Based on inspections of AIA conducted during 1995 and 1996, the FAA found that the carrier appeared to have violated a number of regulations governing such areas as pilot training, weight and balance procedures, operations and maintenance manual procedures, and contract maintenance. The FAA and AIA entered into a consent agreement in January 1997 under which AIA agreed to make changes in certain company policies and procedures to resolve the discrepancies uncovered in the inspections as well as those found in earlier enforcement actions that remained open.¹⁵ AIA agreed to pay a civil penalty of \$450,000, although one-third of this amount was to be forgiven if AIA complied with all the provisions of the consent order.

¹⁵ The carrier agreed to make changes, according to a specified timetable, including employing additional operations, maintenance, and quality assurance personnel; revising training programs and recordkeeping systems; improving the flight and duty time tracking system; arranging for the reevaluation of all check airmen; and expanding the reliability department to include monitoring of the effectiveness of the inspection and maintenance programs carried out by AIA or its contractors.

In order to verify AIA's compliance with the terms of the January consent order, FAA inspectors conducted a base inspection of the carrier in September 1997 during which several discrepancies were discovered. All together, since the consent order was signed, the FAA has instituted about 14 new enforcement actions in which civil penalties have been proposed for alleged violations by AIA of regulations governing hazardous materials handling, equipment operability, maintenance, center-of-gravity calculations, flight and duty time, and crew qualifications. The FAA concludes that the recent enforcement actions do not place AIA in violation of the terms of the consent order (in fact, that enforcement case was closed in early January 1998), and that it has found no other reason to conduct any large-scale inspection of the carrier's operations.

The FAA's compliance and safety records on KFS revealed that the air taxi operator has not been the subject of any FAA enforcement actions involving operational or airworthiness matters or civil penalties. However, the carrier has had three non-fatal accidents and two incidents over the past five years.¹⁶

FAA records on the other Kalitta air taxi operator, O.K. Turbines, indicates no recent enforcement actions and no accidents or incidents. The company has a fleet of three HFB-320 aircraft.

No consumer complaints were found in the Department's files naming any of the Kalitta companies. The Bureau of Transportation Statistics reports that AIA's Form 41 reports have been submitted in an overall timely manner.

In conclusion, our records show that both carriers, but particularly AIA, have had compliance difficulties. Kitty Hawk has been warned by the Department of possible enforcement action because of its long-running failure to file its Form 41 reports in a timely manner. AIA, on the other hand, has exhibited FAA compliance and safety deficiencies for some time.

¹⁶ A KFS cargo flight that crashed in Baltimore in December 1992, killing the pilot, was caused when unsecured cargo shifted to the rear. The investigation concluded that the pilot had failed to perform an adequate preflight inspection, then failed to maintain adequate speed, which led to a stall and the subsequent crash. In June 1994 at Detroit, a KFS non-revenue flight experienced a loss of fuel pressure in one engine. Despite the fact that the aircraft stalled, crashed, and burned, no injuries were sustained in this accident, which was attributed to improper fuel system maintenance. In October 1994, in Holland, Michigan, a pilot of a non-revenue flight landed both short and not properly aligned with the runway, damaging the left landing gear. The pilot returned to the KFS base, where the left gear collapsed upon landing. The pilot was faulted for his poor landing at Holland. The two KFS incidents, which happened in May 1994 and June 1995, involved (1) a deviation by the pilot of a cargo flight from his assigned flight level, which was written up as a violation by the FAA; and (2) a loss of control on a runway by a pilot undergoing a re-examination by a supervising pilot, who was cited by the FAA for inadequate supervision.

While the carriers' compliance histories are troubling, their shortcomings are not so critical as to warrant a finding that they are not fit. We are encouraged by their having demonstrated a more positive attitude and taken steps to correct their deficiencies. Kitty Hawk is now current with its Form 41 reporting and the FAA is satisfied with AIA's compliance with the terms of the consent order. Moreover, since Kitty Hawk is a generally disciplined company that has maintained a relatively good FAA compliance and safety record, we are hopeful that its management will bring about further improvement in AIA's compliance disposition. Nevertheless, because they are undergoing a period of cultural adjustment following the acquisition, and because of uncertainties about the future use of and modifications to certain aircraft in their fleets, we intend to monitor Kitty Hawk's and AIA's compliance and safety for the foreseeable future.

Citizenship

49 U.S.C. 41102 requires that certificates to engage in air transportation be held only by citizens of the United States as defined in 49 U.S.C. 40102(a)(15). That section specifies that the president and two-thirds of the board of directors and other managing officers be U.S. citizens and that at least 75 percent of the outstanding voting stock be owned by U.S. citizens. We have also interpreted the statute to mean that, as a factual matter, the carrier must actually be controlled by U.S. citizens.

Kitty Hawk is a corporation organized under the laws of the State of Delaware, and AIA and KFS are corporations organized under the laws of the State of Michigan. They are wholly owned by KHI, a Delaware corporation whose stock is publicly traded. Approximately 60 percent of its voting stock is owned by Messrs. Tom Christopher and Conrad Kalitta, both of whom are U.S. citizens. Dresdner Bank AG/RCM Capital Management, L.L.C., a German entity, beneficially holds 5.1 percent of KHI's voting stock. All other KHI stockholders now own less than three percent each. Moreover, KHI's certificate of incorporation and bylaws contain provisions which limit the aggregate voting power of any non-U.S.-citizen stockholders to 22.5 percent of the votes taken on any matter, and prohibit non-U.S. citizens from serving as directors or officers of the company.¹⁷ KHI has declared that it remains a U.S. citizen and has affirmed that those owning at least 75 percent of its stock, all of the members of its board of directors, and all of its key personnel as well as those of Kitty Hawk, AIA and KFS are U.S. citizens, except Mr. Tej Raj, Kitty Hawk's Director of Operations, who is a citizen of India. We have found nothing in the record that would lead us to conclude that control of KHI is not with citizens of the United States.

In view of the foregoing, we conclude that Kitty Hawk, AIA and KFS are U.S. citizens and that Kitty Hawk and AIA continue to be fit, willing, and able to provide the interstate and foreign air transportation service for which they hold authority.

¹⁷ KHI SEC S-1 Registration Statement, p. 16.

DE FACTO TRANSFER

The applicants observed that, since the stock acquisition did not involve a combining of the two carriers but merely a change in ownership of AIA and KFS -- an event, with respect to AIA, which the Department would normally address under its continuing fitness rules -- no actual transfer of economic authority was taking place in connection with this proceeding. Nevertheless, in view of the Department's past rulings that, when two or more carriers each with international route authority come under common control, a *de facto* transfer of authority has taken place under section 41105 of the Statute,¹⁸ Kitty Hawk and AIA have requested the Department's approval of KHI's acquisition of AIA and KFS.

Public Interest

The Department must examine such transactions under section 41105 of the Statute to determine whether the transfer is consistent with the public interest. The primary decisional criteria in determining the public interest are whether the certificate transfer would conflict with important international aviation policy objectives and whether the surviving entities are U.S. citizens and whether they will be fit to hold the authority.¹⁹ Moreover, section 41105(b) requires the Secretary to analyze the impact of the transaction on the viability of the carrier applicants, competition in the domestic airline industry, and the trade position of the United States in the international air transportation market.

The applicants argue that the linking of Kitty Hawk, AIA, and KFS under KHI can only improve the carriers' viability, since each will benefit from the strengths of the others. Moreover, the enhancement of AIA's financial condition by the \$380 million additional investment raised in the KHI public stock and senior note offerings will enable the carriers to compete more effectively and thereby enhance competition in the airline industry.²⁰

Thus, the only remaining factor to be considered is whether the transfer would adversely affect the trade position of the United States in the international air transportation market. The applicants point out that the Department historically has found transactions of the type at issue here to be in the public interest unless they were determined to conflict with our international

¹⁸ "A stock acquisition resulting in common control of two carriers having international route authority constitutes a *de facto* certificate transfer subject to section 401(h)." [Former section 401(h) of the Federal Aviation Act was recodified as section 41105 of the Statute.] *Federal Express Corporation and The Flying Tiger Line, Inc.*, Order 89-3-21 at 2, note 2. Also see, *AMR Eagle, Inc. and Executive Air Charter, Inc.*, Order 90-2-1, January 24, 1990; and *Texas Air-TWA Acquisition Case*, Order 85-8-25, August 9, 1985, at 5-6.

¹⁹ See, *Federal Express*, Order 89-3-21 at 7.

²⁰ The issue of whether the *de facto* transfer will affect competition in the domestic airline industry has also been reviewed by the Department of Justice, which has decided that the acquisition will not have any serious adverse effects on domestic airline competition that would require further examination.

aviation policies.²¹ Kitty Hawk and AIA assert that the *de facto* transfer of AIA's and KFS's economic authorities would not be counter to U.S. international aviation objectives since the three carriers share no foreign route authorities, and none of the carriers will terminate or reduce any currently provided service as a result of the acquisition.

Decision

After carefully examining the applicants' pleadings and other information available to us, we find that the proposed transaction warrants approval under the decisional criteria of section 41105. Based on our review of the ownership and management of Kitty Hawk, AIA and KFS, we have concluded that they are U.S. citizens. Moreover, based on our examination of the continuing fitness of AIA and Kitty Hawk, we have concluded that the two carriers are fit, willing, and able to engage in the air transportation authorized by their respective economic authorities. We find that approval of the *de facto* transfer will result in a transaction that will improve the viability of AIA's, KFS's and Kitty Hawk's operations and financial condition, enabling them to be more effective competitors and thereby enhance domestic competition in the airline industry. Furthermore, we note that the Department of Justice has found no anticompetitive implications in the proposed transaction warranting a further review under the Hart-Scott-Rodino Antitrust Improvements Act.

Finally, based on the record in this case, we find that the proposed acquisition will not conflict with any U.S. international aviation policy objectives and will have no material effect on the trade position of the United States in the international air transportation market.

Therefore, we conclude that approval of the *de facto* transfer of AIA's and KFS's certificate and economic authorities to AIA and KFS under the ownership of KHI is in the public interest.²²

ACCORDINGLY,

1. We find that American International Airways, Inc., and Kitty Hawk Aircargo, Inc., continue to be fit, willing, and able to engage in the interstate and foreign air transportation for which they hold authority.
2. We grant the request of American International Airways, Inc., and Kitty Hawk Aircargo, Inc., for approval under 49 U.S.C. section 41105 of the *de facto* transfer of the certificate and other economic authorities held by American International Airways, Inc., and Kalitta Flying Service, Inc., as described in the text of this order, to American International Airways, Inc., and Kalitta Flying Service, Inc., respectively, under the ownership of Kitty Hawk, Inc.

²¹ See, *Federal Express*, supra, at 7.

²² The *de facto* transfer of a foreign certificate is subject to Presidential review under 49 U.S.C. 41307.

4. Unless disapproved by the President of the United States under 49 U.S.C. 41307, this order shall become effective on the 61st day after its submission for section 41307 review or upon the date of receipt of advice from the President or his designee under Executive Order 12597 and implementing regulations that he or she does not intend to disapprove the Department's order under that section, whichever occurs earlier.²³

5. We will serve a copy of this order on the persons listed in Attachment A.

By:

CHARLES A. HUNNICUTT
Assistant Secretary for Aviation
and International Affairs

(SEAL)

*An electronic version of this document is available on the World Wide Web at:
<http://dms.dot.gov>*

²³ This order was submitted for Section 41307 review on June 23, 1998. On August 4, 1998, we received notification that the President's designee, under Executive Order 12597 and implementing regulations, did not intend to disapprove the Department's order.

**SERVICE LIST FOR AMERICAN INTERNATIONAL AIRWAYS, INC.,
AND KITTY HAWK AIRCARGO, INC.**

Mr M Tom Christopher
CEO Kitty Hawk, Inc.
Box 612787
DFW Intl Airport TX 75261

Mr Robert P Silverberg
Bagileo Silverberg & Goldman
Counsel - Kitty Hawk Aircargo Inc
1101 30th St NW Ste 120
Washington DC 20007

Mr Mark W Atwood
Ms Kelly A O'Connor
Sher & Blackwell
Counsel - Amer Intl Airways Inc
1850 M St NW Ste 900
Washington DC 20036

Mr Richard G Roberts
Flight Stds District Office
Federal Aviation Admin
Willow Run Airport - East Side
8800 Beck Rd
Belleville MI 48111

Mr David E Hanley
Mgr Flight Stds Div AGL-200
Federal Aviation Admin
2300 E Devon Ave
Des Plaines IL 60018

Mr Alan G Sumberg
Asst Chief Counsel AGL-7
Federal Aviation Admin
2300 E Devon Ave
Des Plaines IL 60018

Mr Gregory S Lander
Flight Stds District Office
Federal Aviation Admin
DFW Bus Ctr Ste 400
2150 Northbound Access Rd
Dallas TX 75261

Mr Thomas E Stuckey
Mgr Flight Stds Div ASW-200
Federal Aviation Admin
2601 Beacham Blvd
Ft Worth TX 76137-4298

Ms Lynette Word
Asst Chief Counsel ASW-7
Federal Aviation Admin
2601 Beacham Blvd
Ft Worth TX 76137-4298

Mr Marshall Widick
Klimist McKnight et al
Counsel - Teamsters Local #747
400 Galleria Officentre #117
Southfield MI 48034-8464

Amer Assoc of Airport Execs
4224 King St
Alexandria VA 22302

Mr Richard A Nelson
Official Airline Guides
2000 Clearwater Dr
Oak Brook IL 60521

Mr Jim Zammar
Dir of Revenue Accounting
Air Transport Assoc
1301 Pennsylv Ave NW Ste 1100
Washington DC 20004

Mr Allan Muten
Asst Treasurer
Airlines Reporting Corp
1530 Wilson Blvd Ste 800
Arlington VA 22209-2448

Mr Ray Benning
Dir Airline Div
Intl Brotherhood of Teamsters
6242 Westchester Pkwy Ste 250
Los Angeles CA 90045

Mr Quentin J Smith Jr
Mgr Air Transportation Div.
Office of Flight Stds AFS-200
Federal Aviation Admin
800 Independence Ave SW
Washington DC 20591

Mr Louis Cusimano
Mgr Certification Program Office
Office of Flight Stds AFS-900
Federal Aviation Admin
PO Box 20267
Washington DC 20041

Mr John H Cassidy
Dep Chief Counsel AGC-2
Federal Aviation Admin
800 Independence Ave SW
Washington DC 20591

Mr Tim Carmody
Dir Office of Airline Information
Dept of Transportation K-25
400 Seventh St SW
Washington DC 20590