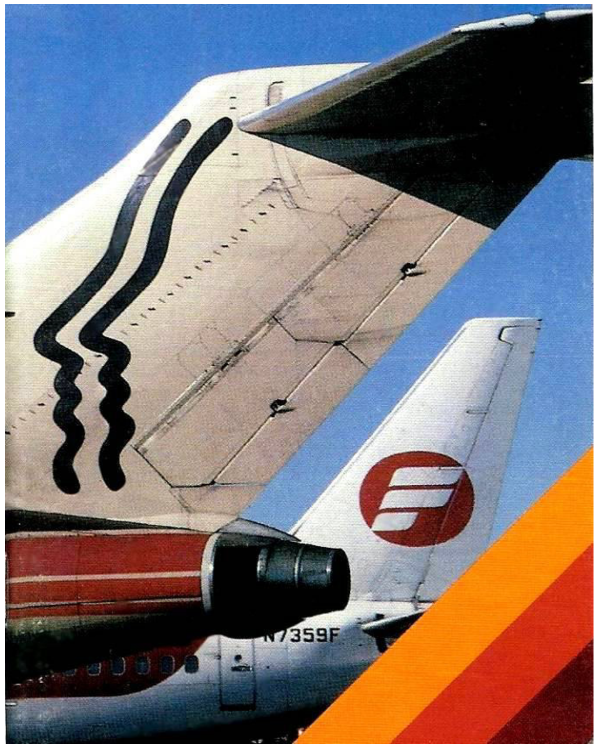

FRONTIER AIRLINES ACQUISITION BY PEOPLE EXPRESS

By Gregory R Stearns

The advancement of Frontier's route transformation was a necessity following the Deregulation Act of 1978, and continued as planned into the 1980s. Smaller cities were phased out, and subsidy reduction was on an overall schedule that was to conclude with a planned termination date of early 1983. As this process continued, the Denver hub, and particularly Frontier, experienced a build up of competition into its market territory which slowly began to erode its revenue base. In addition to this, alternate hub competition was prevalent in increasing numbers, further swiping at the operational revenue based bottom line. As these factors continued to develop, Frontier's parent, RKO General of Ohio, began a series of meetings where such factors and Frontier's position and future business model were discussed.

Toward the end of 1983, it was becoming increasingly obvious that an operational net loss for the year would occur. It was later in the year that RKO began their respective discussions on Frontier's position, and solicited the services of Merrill Lynch to help them evaluate some options which may have been available. Remember, at this point the Frontier Horizon unit of Frontier Holdings was only a few months away, and the wide diversification which was to include Frontier Services and other products that had been expanded outwardly were also present. But the worsening condition of Frontier Airlines, which was the primary unit of the holding company, severely needed to be addressed as their competitive position worsened.

With the assistance of Merrill Lynch, RKO held discussions with several other airlines in this period, to see what merger possibilities might exist. It is of particular relevance to note that discussions were held with Texas Air, parent of Continental, during this time as well. It was a scant few months since the Chapter 11 re-organization of Continental, and the tone or seriousness of these discussions concerning a merger was described to me in an off the record talk as "quite preliminary." But a few months into 1984, RKO terminated Merrill Lynch's services. After only six months on the job, their services were ended and an initial plan was formulated by RKO to begin a sale of the company.

Following this action, the Frontier Board of Directors formed a committee consisting of seven members that were tasked to study, review, and recommend action based on some of the findings of the Merrill Lynch report. There were a number of discussions and meetings that took place in the ensuing months, and one of the things that was hotly conferred about was the short term future, as Frontier Holdings had announced a loss of more than 13 million for 1983. As a result of this, Kidder, Peabody & Co. (KPC) was retained as a financial adviser to Frontier Holdings, and was closely in contact with the seven committee members. They reported their findings in the late Summer of 1984, and I was graciously supplied a copy of what the committee was studying/recommending by one of its members, and it was mostly laid out as follows:

1. Pursuance of a new business plan/model would take place, and discontinuance of ancillary activities was going to be a necessity.
2. No new Frontier hubs should be established (the studies on the initial investment allocation required a HUGE amount of investment capital...the amounts were simply too cost prohibitive.)
3. A significant sale of assets, mainly aircraft, was not yet in the company's interest.
4. Consideration of cash offers to stockholders at a starting price range of $16 a share would be explored (taking into account many other factors in association with this.)
5. A liquidation of Frontier Holdings, which had been openly discussed, was not to be pursued at present.
6. No reasonable merger possibilities existed which could be pursued or acted upon presently.

KPC worked closely with the committee and helped draft some of the aforementioned recommendations. At a special meeting in August of 1984, where these items were discussed and laid out, one additional item was talked about A proposal by Travis Reed, which was a draft presented to board members. The plan was a proposed acquisition by himself and a group of investors which had made initial contact with RKO a few weeks before.

As far as Frontier was concerned, they had already committed to an operational reduction of costs, which was forthcoming in late October with the "84-10" cutback. The airline was pulling out of more than 20 cities, and the reduction was reflective of a cost cutting measure designed to both utilize higher frequency scheduling and unit cost reduction. The cutbacks were going to utilize the same amount of block hours, but remove inefficient station models, therefore reducing the overall system cost. In my Frontier book, I used the Denver-Detroit model as an example of the problem Frontier was in with pricing on the longer route models, and this was the basis for why Frontier Horizon had come to be in the first place. There was NO WAY to profitably operate these pairs with Frontier Airlines as it existed at this particular time. United was reducing the company's traffic and Continental reducing their fares. But barely a month after the new 84-10 system was in place, Glen Ryland was replaced, which had a few negative effects that were somewhat unseen.

Ryland had come to Frontier with Al Feldman more than a decade before, and had been more or less the leader of the financial side of the company. When the "84-10" reduction was implemented, it was he who had signed off on the company changes, then was replaced. The architecture and vision of what the short term future at Frontier would hold was now in the hands of someone else, and unfortunately this series of events would continue moving forward, witb a few damaging effects. In addition, Ryland had a working relationship with some of Frontier's lead lenders, and his dismissal now put an "unknown quantity" at the helm. Though Hank Lund wasn't a total stranger, he was a marketing man by background and wasn't involved in the financial circles Ryland had been. I inquired to some of the folks with knowledge of the situation why an outside, totally new face wasn't brought into the mold at this time, but the leading candidate that was favored was an officer with RKO and their lawyers advised against taking this action, citing a conflict of interest.

In October, at a special meeting of the Board of Directors in Denver (the same one where Glen Ryland was fired and Hank Lund was appointed president) Travis Reed made a thorough presentation of the proposal he previously had supplied. The notable part of the presentation was that Reed and his financial backers, First Securities Investment Corporation (FSIC), were proposing to operate the carrier in a high frequency, scaled down model and was intending to sell 30 aircraft in order to finance this. The Frontier board did confer with their outside counsel, who advised them to reject the proposal mostly because of the legal contingencies that the proposed aircraft sale created.

In November, the board recognized that a further transformation of the company cost structure was necessary, and began negotiating with the unions on new work rules and pay structures. In addition, the initial ESOP agreement was entered into, and the new work rules and wage rates were the start of the employees investment in the new ESOP plan. It was concurrent with this that a large study was concluded which was a top to bottom analysis of the benefits of a merger of Western Airlines. Members of the Frontier finance department had concluded making a recommendation to further pursue such a course, and the study showed all asset to debt ratios, long term commitments, long term debt structures, and aircraft lease commitments. Though both companies had similar interest in pursuing discussions further, the upcoming 1984 financials derailed talks, and forced the Frontier management corps to move forward into what was going to be an extremely difficult 1985.

Just after the first of the year, news leaks began to surface about the massive loss which was going to be reported for 1984. The board, ownership, and management supported the new ESOP, but could already see that losses were going to exceed the "hemorrhage limit" in the text of the agreement with the employee groups, thus giving RKO the option to terminate the agreement completely, should it choose to do so. Concurrent with this, the Board began to receive several inquiries from other interested parties, and the management corps themselves were having to deal with their lead lenders pulling their credit line and applying encumbrances to a portion of the fleet, as per some of the agreements in their debt structure. This action alone was going to necessitate some extraordinary actions moving forward, and a sizable portion of the company's long term debt structure was going to need to be retired. The ownership faction made the decision to sell the five MD-80's to begin to accomplish this, as the debt and financial condition needed immediate improvement if they could interest any outside parties in a purchase. "That particular piece of the business wasn't as important", one RKO officer told me, and re-iterated "We never deviated from selling the company", once losses and negative publicity began piling up at an alarming rate. Holding companys aren't in the business of losing money, so I understood their position.

In early February 1985, Joseph Frates made initial inquiry to Frontier Holdings, and was supposedly prepared to make a cash offer of $16 a share for Frontier. I was told the Board of Directors was "quite interested" in pursuing further discussions with the Frates people, but they had been insistent from the start of the talks that they be granted an exclusive option to purchase the outstanding stock. The Board refused this request, mostly because they were largely unconvinced that the Frates people had the necessary financing immediately available. In turn, the Frates financiers had stipulated they would only proceed with an exclusive option available, and thus, any prospective deal never materialized.

Later in the same month, the Frontier Union Coalition (the employees) had appointed an ESOP specialist, Brian Freeman, to present their own plans for a full employee buyout of the company. While the proposal was in line with the terms laid out in the agreement with RKO, Freeman had attempted to obtain financing but ultimately was unable to do so. Key to his failure to do so was that there were disagreements over the company's financial projections moving forward. Thus, nothing specifically came of this arrangement concerning future ownership.

On February 21 and 22 of 1985, Hank Lund concluded a series of meetings with representatives of United where an agreement in principle on a sale of 25 737's was entered into. The agreement which resulted from these meetings included language which would see Frontier inform United by April 1 of their intentions, and also included a figure of $265 million as the purchase price for the aircraft. A "need to know" restriction was included as well, and the framework was now laid for the significant asset sales that were to permeate the 1985 period.

Three days following this, on February 25, a select few United officers (who were "in the know" concerning the 737 deal with Frontier) drafted a confidential, internal memo outlining the aircraft deal and detailed the terms of Frontier's fleet structure, that 29 aircraft were owned outright and two were safe harbored. In addition, they observed that "The outcome isn't as certain as Lund would like to believe", and further observed that "management wants to run a larger airline than the banks will likely go along with", and had their legal team ready if the Frontier IAM instigated legal action to block a potential sale. It was clear that United's upper management were closely eyeing the Frontier situation, especially since they were in the middle of a potential asset deal.

In lengthy discussions with one board member, he stated to me that dealing with Hank Lund and the unions "wasn't much fun," in reference to the unfortunate situation that the financial picture had created. RKO and its officers very much wanted to see Frontier succeed, but the realities of the new marketplace had carved out an arduous situation for all involved. The sale of the MD-80s was the catalyst that positioned the company for a potential sale, and RKO was sure they'd find a suitor soon after. After having the agreement in principle for the airplanes in hand, Gerald O'Neil received yet another inquiry in early March, which arrived in the form of two different offer sheets addressed to the Frontier Board of Directors.

The offers came from the Texas Air Corporation, but neither purchase offer came close to the par value of Frontier stock Though the offers were drafted with language that made them payable in cash and notes, Frank Lorenzo communicated his intentions personally to Mr. O'Neil and indicated a willingness to pursue the matter further if RKO elected to do so. Lorenzo had made initial inquiries to the Frontier board back in the summer of 1984, and continued efforts well into the fall, but how much communication each party had at that time became unknown because I received conflicting information on exactly how many offers and how frequent the communication was between Texas Air and RKO in this time period. In addition, a news leak in the business circles found its way straight to the Wall Street Journal, and a subsequent headline hit the business press proclaiming "TEXAS AIR IS SAID TO BE NEGOTIATING TO BUY FRONTIER". In reality, that portion didn't matter much, only because the majority of the RKO officers were quite turned off by the way Frank Loreuzo did business. A normal course of exercising a purchase agreement would be for a purchasing company to work with the stockholder, draft a sales statement/press release, and clearly communicate what the intentions are with respect to financial agreements. With Frank Lorenzo, RKO officers were reading statements in the news media and were left to try and interpret these into what Texas Air might be doing. After one lengthy phone conversation with Lorenzo on April 14, 1985, (the last day of the Masters golf tournament, which he was watching on TV), one RKO director immediately phoned Gerry O'Neil and exasperatedly stated "why are we doing business with this guy!"

At this time period, RKO was forced into advancing all options with respect to Frontier. One course of action which had to be ready, should things become far more dire than forecast, was a liquidation plan. The values and financial figures needed to be present for company valuation if nothing else, but this action incensed Hank Lund and he offered to resign at this point. I had several discussions with board members and RKO directors concerning this action, and each was clear with me that this action was an ownership protection that was necessary considering the bleak financial picture. How close Frontier was to ACTUALLY liquidating was the logical next question. One source told me "I'm not commenting on that," while another stated "It's NEVER close until the deal is DONE." Either way, Gerry O'Neil replaced Hank Lund with Joseph O'Gorman, and Frontier's ownership questions motored into the summer of 1985, where the aircraft sale to United officially took place.

On May 13, the Frontier board received a letter from Texas Air which upped their original purchase price to S19 dollars a share. The board again had to meet to discuss this offer, but instead decided to move on a sale of 25 aircraft to United Airlines instead, which would immediately provide additional operating capital and transform the Frontier business model moving forward. Since the unions had failed to obtain acquisition financing by this point, there wasn't much left to do with respect to a company ESOP/purchase. But RKO instead made a revised deal, where wage levels which were agreed upon previously would stay in place in exchange for an option to purchase outstanding stock for $17 a share. The Frontier board subsequently met on July 16, and received an opinion from KPC that the $17 a share price was fair with respect to this arrangement.

The resulting deal, referred to as the "Union Merger Agreement," would see RKO voting its shares in favor of a union acquisition pursuant to a few conditions that were set forth. Both sides were confident a deal would come to fruition, but three weeks later Frank Lorenzo initiated another telephone conversation with Gerry O'Neil and was discussing another acquisition plan that was to exceed $17 a share. O'Neil called the board and reported this, and now all parties had to decide which course was best for all parties involved. Concurrent with this, Joseph O'Gorman met with Frank Lorenzo in Denver on September 16, whereby Lorenzo made an offer for some of Frontier's assets at Stapleton Airport. The next day in a private meeting, the board and O'Gorman concluded they were unable to make a decision on the offer, as neither party had evaluation numbers necessary to negotiate a transaction.

The following day, Lorenzo informed the board and RKO that he was delivering a tender offer for Frontier Airlines, or more specifically, Frontier Holdings. Through a subsidiary named FHI Acquisitions, Lorenzo was intending on a purchase of shares at $20 per share, which was far in excess of the $17 proposed by the employee group. It is interesting to note that at this particular point, Texas Air already controlled more than 5% of the voting stock through Cede & Co., who was a nominee for the Deposit Trust Co. who had the shares on behalf of Goldman Sachs who was a nominee for the Texas Air Corporation (In reality, Frank Lorenzo.) The board was now forced to meet around a week later and consider, with legal and financial staffers in New York City, the terms of the Texas Air offer. It was at this time that an important tennis match was taking place in Monterey, California, between Donald Burr and an attorney who had previously done work with Frontier.

Sitting on the table adjacent to the court, the Wall Street Journal was open with an article detailing the ownership and financial woes Frontier was experiencing. Donald Burr, who was the head of People Express, had taken note of this and by lunchtime was interested in entering the fray. Burr had been quite a success with People Express in the post deregulation marketplace, and one People Express officer told me that "we were looking to get people from Boston to Bozeman." This approach, possibly ahead of its time, was a driving force in getting the PEX people not only involved in a possible purchase of Frontier, but could position the unions to thwart Frank Lorenzo in his attempts at an acquisition.

On October 2, at a second meeting with the board of directors, discussion ensued concerning the Lorenzo offers and at the end of a long day, the board concluded they were unable to take a position with respect to Texas Air's acquisition plans. Concurrent with this, just days later, Frontier management reached an agreement in principle with PEX representatives on a proposed purchase. The RKO directors, receiving info on the talks, were somewhat unenthused by this development. An RKO director, who was present in New York during these talks, told me that offers began to waft in at values FAR in excess of company value. This meant that viability was now a question moving forward, and one director told Gerry O'Neil point blank that PEX was "making offers for more than the company was worth." One response from a dumbfounded director was "It was interesting People Express got into the fray." Most directors couldn't believe this situation, and a few days later, Texas Air upped their purchase price to $22 a share.

On October 8, the Frontier situation was now at a crossroads. Either RKO and the board could approve the Texas Air purchase, and face a "kicking and screaming" union contingent, or revisit PEX on an alternative. PEX came back with $24 a share, and if the RKO directors weren't short of breath before, they were about to have a full on heart attack. It was difficult to imagine PEX absorbing and surviving this kind of cost burden, and many in the director circles made this fact known. Hoadley Dean, longtime legacy director at Frontier, was a dissenting vote on the PEX acquisition and refused to sign the Agreement of Merger. He had been vocal early on in the process concerning Frontier ownership, and even called one employee on the phone one evening in the fall of 1985 and emotionally exclaimed "Its a shame what's happening to Frontier Airlines!" What he was proposing instead was reengaging Texas Air to potentially merge Frontier into Continental, as he felt this was a much stronger action for the future. A few other directors were similarly concerned as he, with respect to PEX, but it didn't matter in the end because options were limited and each signed and agreed to the document which transferred ownership to People Express. At the 11th hour of the deal being made, a member of the board independently contacted representatives of both Western and Delta Airlines, but neither was able or willing to get involved, absent any hard data or credible future projections with respect to Frontier's finances. As hotly contested as this situation was, the Lorenzo presence was simply too touchy an issue to approach with any degree of reason.

In my discussions with the directors, financiers, lawyers and officers who were involved in this deal, many really couldn't understand why there was such adverse negativity towards a deal with Texas Air, which would have been the catalyst to a merger with Continental. I understood their plight, as they had no exposure to the union positions or attitudes that prevailed after Lorenzo had executed the reorganization of Continental. From their point of view, a deal with Continental could be sensibly completed, while this PEX deal looked destined to fail. I'm aware that a Frontier-Continental deal at this point would have had numerous challenges, and been extremely difficult from the union's standpoint, but the majority of these men, having no exposure to the inner workings of the airline world, were unable to see this, again by no fault of their own.

The 1985 annual report to stockholders partially summed up a good portion of the transaction, but still didn't tell the whole saga. I was surprised to see the stock breakdowns, financial shortages, and terms of the People Express deal. While it was going to preserve the Frontier name for the time being, it was going to dreadfully strain the PEX business model moving ahead. Following the completion of the deal in New York, an RKO financier turned to Gerry O'Neil and said "I don't think they made a good deal." The windfall on the sale was obvious, but keeping a viable company for all parties involved moving forward was clearly not what this transaction engendered.

In Denver around a month later, Burr gave a large presentation in Hangar 2 on Smith Road, and spoke about what the future looked to be with respect to growth and service. At the conclusion of his well communicated pitch, several employees were anxious to begin investments and jump on the Burr Bandwagon. There's no doubt Mr. Burr had the gift of engendering spirit, but his real failing was the financial reality the Frontier purchase put him and his officers in. People's COO had approached many separately concerning this, but without convincing Burr, he was at a dead end. I think most know how the final chapter of this ended eight months later, and a great anecdote happened prior to all of that at Burr's hangar presentation. Following the presentation, some employees were making small talk and asking questions of a few of the PEX officers who were present. One wife of an employee, who had listened to the spiel, innocently asked a People Express attorney what would happen if they "ran out of money"?

"People Express isn't going to run out of money," the attorney said with a matter of fact tone. "That'll NEVER happen..."

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Gregory R. Stearns is the author of "Frontier Airlines: A History of the Former Frontier Airlines 1950 - 1986". His father was a pilot and his mother a flight attendant for Frontier Airlines. This essay is reprinted with his kind permission.