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IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF MICHIGAN

UNITED STATES OF AMERICA, Plaintiff, v. NORTHWEST AIRLINES CORP., and CONTINENTAL AIRLINES, INC., Defendants.	Civil Action No. 98-74611 Judge Hood Magistrate Scheer

TRIAL BRIEF OF THE UNITED STATES

James R. Wade
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October 24, 2000

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CONTROLLING OR MOST APPROPRIATE AUTHORITY

Cases

Brown Shoe Co. v. United States, 370 U.S. 294 (1962)
Denver & Rio Grande W. R.R. Co. v. United States, 387 U.S. 485 (1967)
FTC v. Dean Foods Co., 384 U.S. 597 (1966)
FTC v. Proctor & Gamble Co., 386 U.S. 568 (1967)
Times-Picayune Publ'g Co. v. United States, 345 U.S. 594, 612 (1953)
United States v. E. I. du Pont de Nemours & Co., 351 U.S. 377 (1956)
United States v. Falstaff Brewing Co., 410 U.S. 526 (1973)
United States v. General Dynamics Corp., 415 U.S. 486 (1974)
United States v. Marine Bancorporation, Inc., 418 U.S. 602 (1974)
United States v. Penn-Olin Chem. Co., 378 U.S. 158 (1964)
United States v. Philadelphia National Bank, 374 U.S. 321 (1963)

FTC v. Elders Grain, Inc., 868 F.2d 901 (7th Cir. 1989)
FTC v. University Health, Inc., 938 F.2d 1206 (11th Cir. 1991)
Lektro-Vend Corp. v. Vendo Co., 660 F.2d 255 (7th Cir. 1981), *cert. denied* 455 U.S. 921 (1982)

Community Publishers, Inc. v. Donrey Corp., 892 F. Supp. 1146 (W.D. Ark. 1995), *aff'd*, 139 F.3d 1180 (8th Cir. 1998)
FTC v. Cardinal Health, Inc., 12 F. Supp. 2d 34 (D.D.C. 1998)
FTC v. Staples, Inc., 970 F. Supp. 1066 (D.D.C. 1997)
United States v. Ivaco, Inc., 704 F. Supp. 1409, 1415 (W.D. Mich. 1989)
United States v. Rockford Mem'l Corp., 717 F. Supp. 1251 (N.D. Ill. 1989), *aff'd on other grounds*, 898 F.2d 1278 (7th Cir. 1990), *cert. denied*, 498 U.S. 920 (1990)

Statutes

Clayton Act § 7, 15 U.S.C. § 18 (1950)

Other Sources

U.S. Dep't of Justice and Fed'l Trade Comm'n Horizontal Merger Guidelines, §§ 1.1, 2.1, 3, 4 (1992)

H.R.Rep. No. 94-1373, 94th Cong., 2d Sess. 8 (1976)

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INTRODUCTION

On October 23, 1998, the United States filed a complaint alleging that Northwest Airlines Corporation's ("Northwest") proposed acquisition of 51% of the voting rights of Continental Airlines, Inc. ("Continental") and 14% of its equity would diminish competition between the two airlines and likely lead to higher prices and worse service for air transportation in violation of section 7 of the Clayton Act, 15 U.S.C. §18. The United States sought to prohibit Northwest from acquiring or holding the control stock except on terms agreed to by the Plaintiff and the Court. Notwithstanding the government's lawsuit, Northwest proceeded to acquire the controlling block of Continental stock, which it continues to hold today. The United States did not challenge a separate joint marketing agreement the airlines entered into at the same time.

Northwest and Continental are two of the ten largest airlines in the world, and two of the five largest in the United States. They compete with one another to provide airline service between thousands of origin/destination pairs throughout the United States. Combined, their revenues totaled almost $19 billion in 1999. Both are financially sound, profitable airlines.

Northwest and Continental compete with one another on fares and service throughout their systems. If one offers a discount, the other will quickly match. And neither airline will dare increase its fares "systemwide," that is, across its domestic airline network, unless the other does so as well. Where they compete, Northwest and Continental also strive, among other things, to offer better in-flight amenities, on-time performance and ticketing procedures, and a host of other services designed to attract passengers. Indeed, Continental has improved dramatically from "worst to first" in many of these areas, making it a top choice for demanding business travelers.

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Northwest and Continental have been each other's most significant competitor for air service on the nine heavily traveled routes between the cities where they operate their hubs – Detroit, Memphis and Minneapolis for Northwest; and Cleveland, Houston, and Newark for Continental. On seven of these hub-to-hub routes, where over 2.1 million passengers travel on an annual basis generating nearly $385 million in passenger revenues, Northwest and Continental are the only airlines offering the daily nonstop service strongly preferred by business travelers. Unless the Court orders Northwest to divest its controlling Continental stock, millions of consumers will lose the benefits of Continental's competition. Consumers will pay higher prices and receive diminished air transportation service.

In its defense, Northwest will tell the Court that this evidence of competition between Northwest and Continental is for the most part irrelevant. Instead, Northwest will urge the Court to accept its defenses – defenses that no Court has ever found to excuse an anticompetitive acquisition. First, Northwest will argue that its retention and ultimate exercise of what is now approximately 58% voting control over Continental is justified by the alleged consumer benefits of another transaction – the carriers' contemporaneous but contractually separate marketing alliance (the "efficiencies defense"). The evidence will show, however, that Northwest's ownership of voting control over its competitor is not necessary to the success of their alliance. Consumers need not face the higher prices and reduced service that will result from Northwest's control over Continental in order to get the claimed alliance benefits. Second, Northwest will point to a series of lengthy, complex, contractual agreements (the "governance agreements") that it entered with Continental to temporarily protect Continental's minority shareholders

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(shareholders now holding 85% of the equity but less than 42% of the total voting power of Continental) from Northwest's using its voting power to benefit itself at their expense. Northwest will claim that the temporary governance agreements not only protect Continental's minority shareholders, but, by fortunate coincidence, also fully protect consumers' interest in competition (the "governance defense"). The evidence will show, however, that the governance agreements are an inadequate substitute for true structural independence between these important competitors. Northwest acquired the controlling interest in Continental on terms that will allow Northwest to fully exercise that control – that's what it bought, that's what it wanted, and that's what it has refused to give up. And the consequences of that choice is what the case is about – the competitive harm consumers will suffer.

I. FACTUAL BACKGROUND

A. NORTHWEST AIRLINES

Northwest is the fourth largest airline in the United States, reporting total 1999 revenues of $10.3 billion. Northwest offers service between and among 150 cities worldwide. Indeed, Northwest can fly a passenger from almost any sizeable city in the United States to any other. Like most every other major U.S. airline, Northwest operates its domestic flights out of "hub airports." Northwest's hubs are located in Detroit, Minneapolis/St. Paul, and Memphis, and in each hub city Northwest is by far the largest carrier. Domestically, Northwest has marketing

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alliance relationships with Alaska Airlines, America West Airlines, and Hawaiian Airlines.[1] Internationally, Northwest has a comprehensive partnership with KLM Royal Dutch Airlines ("KLM") of the Netherlands, and it has the largest presence of any U.S. airline in Asia, operating hubs in Tokyo and Osaka, Japan.

B. CONTINENTAL AIRLINES

Continental is the fifth largest U.S. air carrier, serving 125 cities nationwide. In 1999, Continental had total revenues of $8.6 billion. Continental operates its domestic service out of hub airports located in Newark, Houston (George Bush Intercontinental Airport or "IAH"), and Cleveland, and like Northwest is the dominant carrier in each of its hubs. Like Northwest, Continental can fly a passenger from almost any major city in the United States to any other. Continental has been improving steadily in profitability since it emerged from bankruptcy in 1993, and it now consistently ranks at or near the top of airline customer approval polls. Continental currently has a domestic marketing alliance with America West Airlines that encompasses numerous city pairs. Internationally, Continental has alliance partnerships with Air France, Alitalia, and Virgin Atlantic, among others.

C. THE CHALLENGED TRANSACTION

On January 25, 1998, Northwest agreed with Air Partners L.P., and certain affiliates ("Air

[1] Airline marketing alliances are common in the industry and usually involve "codesharing," an arrangement to put their codes (airline names and flight numbers) on each other's flights in the computer reservation systems that travel agents and others use to sell and reserve seats on flights for their customers.

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Partners"), to purchase Air Partners' shares of Continental Class A stock. Because the Class A shares have supervoting rights,[2] the stake Air Partners proposed to transfer to Northwest represented at that time more than 50% of the outstanding voting power, but only 14% of the equity of Continental. At the same time, Northwest and Continental also agreed to enter a marketing alliance, where the two airlines codeshare, engage in joint marketing activities, and coordinate other aspects of their service. Northwest also entered into a governance agreement which was ostensibly designed to protect Continental's minority shareholders, and in which Northwest relinquished for six years certain prerogatives of its voting control over Continental. Under the governance agreement, Northwest agreed to place its Continental stock in a voting trust but retained the right to vote the stock to block certain important strategic decisions facing Continental, including mergers, acquisitions of other airlines, and reorganizations, among other things. The governance agreement is set to expire in November, 2004, just over four years from now.

[REDACTED][3] and an extensive investigation ensued, during which the Government expressed serious concerns about the competitive effects of Northwest owning control of its competitor, Continental. Although the Continental Board had

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[2]Continental's Class A shares carry ten votes per share, while Class B shares carry only one vote per share.

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already rejected a Delta merger proposal, Northwest argued that it was compelled to purchase the control block to prevent Delta Airlines from purchasing the stock and disrupting the Northwest/Continental alliance. The government proposed several alternatives that would preserve any consumer benefits from the alliance, but would result in little, if any, competitive harm. Under one such proposal, Northwest would purchase the controlling block of Continental stock subject to a requirement that it divest that stock over an appropriate negotiated time frame. This proposal was designed to solve Northwest's alleged "Delta threat," as well as to give Northwest time to get the alliance up and running. Northwest rejected the proposal as a nonstarter. The government then filed this suit on October 23, 1998.

In November, 1998, after this lawsuit was filed, but before Northwest purchased the controlling block of Continental stock, Northwest renegotiated certain aspects of its deal with Air Partners in part to account for changes in the prevailing price of Continental and Northwest stock. In addition, Northwest and Continental modified their governance agreements slightly and executed a "Supplemental Agreement" covering the four years following expiration of the governance agreements. During the four year supplemental period, Northwest will freely exercise 20% of the voting power of Continental on all matters, making Northwest the single largest voting shareholder in Continental. Northwest may also nominate, solicit support for, and vote in favor of its own representatives on Continental's Board of Directors. At the end of the fourth year, all meaningful remaining limitations on Northwest's powers expire, and it will be free to fully exercise its majority voting control over Continental. On November 20, 1998, Northwest consummated the renegotiated transaction with Air Partners, and the government amended its

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complaint accordingly.

In January 1999, Northwest and Continental began implementing their alliance, which quickly proved highly profitable for both carriers. Indeed, the alliance will generate incremental revenues for each carrier exceeding $140 million in this year alone. In light of this undeniable success, Continental has offered to buy its stock back from Northwest and further strengthen the alliance by extending its term to 25 years, adding a provision for large liquidated damages if either party breaches the alliance agreement, and allowing Northwest, if it chooses, to prevent Continental from merging with another airline. Northwest, however, adamantly refuses to sell, and continues to hold that controlling block of Continental stock as the trial of this matter begins.

II. LEGAL OVERVIEW

Section 7 of the Clayton Act (as amended) clearly applies to partial acquisitions, explicitly preventing one company from purchasing part of a competitor's stock, where, in the words of the statute, the acquisition *may* substantially lessen competition.[4] Section 7 reads in pertinent part:

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[4]Although this case involves acquisition of voting control, there is no such requirement under section 7. In a case involving ownership of a 20% voting interest in a competitor, the Supreme Court instructed:

> It is not the possibility of control that may prejudice appellants and the public interest, but simply the fact that with [the acquirer] holding 20% of [the acquired company's] stock *there is likely to be immediate and continuing cooperation between the companies*, cooperation which appellants claim will be to their detriment and which the Government concedes may be against the public interest. If appellants are correct, and if such an alliance would in fact be against the public interest, then § 7 of the Clayton Act requires that it be stopped in its incipiency.

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> No person . . . shall acquire, directly or indirectly, the whole or any part of the stock . . . of another person . . ., where in any line of commerce . . . in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly.

15 U.S.C. § 18. The "delphic language" of section 7 "was designed to cope with monopolistic tendencies *in their incipiency* and well before they have attained such effects as would justify a Sherman Act proceeding." *Cargill, Inc. v. Monfort of Colorado, Inc.*, 479 U.S. 104, 124 (Stevens, J, dissenting) (1986) (emphasis added) (citations and quotations omitted).

The Court's inquiry under section 7 is predictive in nature. The government need not show that an actual restraint has occurred, only that it may occur in the future. *FTC v. Proctor & Gamble Co.*, 386 U.S. 568, 577 (1967); *Lektro-Vend Corp. v. Vendo Co.*, 660 F.2d 255, 274 (7th Cir. 1981). "It is the probable effect of the merger upon the future as well as the present which the Clayton Act commands the courts . . . to examine." *Brown Shoe Co. v. United States*, 370 U.S. 294, 333 (1962). "[T]he mere nonoccurrence of a substantial lessening of competition in the interval between acquisition and trial does not mean that no substantial lessening will develop thereafter; the essential question remains whether the probability of such *future* impact exists at the time of trial." *United States v. General Dynamics Corp.*, 415 U.S. 486, 505 (1974) (emphasis in original). Thus, "the court should remember that the mandate of the Congress is in terms of the probability of a lessening of substantial competition, not in terms of tangible present restraint." *United States v. Penn-Olin Chem. Co.*, 378 U.S. 158, 177 (1964). Moreover, evidence of postacquisiton, but pretrial behavior is not necessarily probative. "If a demonstration that no

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Denver & Rio Grande v. United States, 387 U.S. 485, 504 (1967) (emphasis added) (citations omitted).

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anticompetitive effect had occurred at the time of trial . . . constituted a permissible defense to a §7 divestiture suit, violators could stave off such actions merely by refraining from aggressive or anticompetitive behavior when such a suit was threatened or pending." *United States v. General Dynamics Corp.*, 415 U.S. at 504-505.

The government need not demonstrate the predicted anticompetitive effect with certainty or, indeed, "even a high probability." *FTC v. Elders Grain, Inc.*, 868 F.2d 901, 906 (7th Cir. 1989). The proper standard of proof is a "reasonable probability" of substantially lessened competition. *FTC v. Proctor & Gamble Co.*, 386 U.S. at 577. *See also Hospital Corp. of Am. v. FTC*, 807 F.2d 1381, 1389 (7th Cir. 1986) ("All that is necessary is that the merger create an appreciable danger of [higher prices] in the future. A predictive judgment, necessarily probabilistic and judgmental rather than demonstrable . . . is called for."); *Crouse-Hinds Co. v. Internorth, Inc.*, 518 F. Supp. 416, 422 (N.D.N.Y. 1980). Such effects may include not only a rise in prices, but a decline in quality.[5]

III. KEY ISSUES FOR TRIAL

A. THE EQUITY ACQUISITION VIOLATES SECTION 7 OF THE CLAYTON ACT

Section 7 of the Clayton Act bars acquisitions "where in any line of commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly." 15 U.S.C. § 18. The ultimate question in any section 7 case is whether a proposed acquisition may have anticompetitive effects. The answer to this question

[5] *See, e.g., United States v. Philadelphia Nat'l Bank*, 374 U.S. 321, 368-69 (1973).

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depends upon (i) the "line of commerce," or product market, affected by the transaction; (ii) the "section of the country," or geographic market, where the acquisition will have its likely effect; and (iii) the transaction's probable effect on competition in the relevant market.[6]

1. The Relevant Product Markets are Scheduled Airline Service and Scheduled Airline Service for Business Travelers

The relevant product market defines the product boundaries within which competition meaningfully exists,[7] and includes those products or services that are reasonably interchangeable by consumers for the same purpose.[8] Not every product that competes for a customer's dollar is included in a properly defined product market:

> For every product, substitutes exist. But a relevant market cannot meaningfully encompass that infinite range. The circle must be drawn narrowly to exclude any other product to which, within reasonable variations in price, only a limited number of buyers will turn . . . .[9]

Thus, the pivotal question in product market definition is whether an increase in price for one product would cause enough buyers to turn to other products so as to make the price increase unprofitable.[10] In the airline industry, the product consumers purchase is scheduled air travel between an origin and destination. The evidence will show that travelers are not likely to turn to

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[6]*See, e.g., United States v. Marine Bancorporation, Inc.*, 418 U.S. 602, 619-25 (1974).

[7]*United States v. Continental Can Co.*, 378 U.S. 441, 449 (1964).

[8]*United States v. E. I. du Pont de Nemours & Co.*, 351 U.S. 377, 395 (1956)

[9]*Times-Picayune Publ'g Co. v. United States*, 345 U.S. 594, 612 (1953); *United States v. Ivaco, Inc.*, 704 F. Supp. 1409, 1415 (W.D. Mich. 1989) ("The court need not consider every conceivable, but economically unrealistic, substitute for a particular product").

[10]*United States v. Archer-Daniels-Midland, Co.*, 866 F.2d 242, 248 (8th Cir. 1988); DOJ and FTC Merger Guidelines §§ 1.1, 2.1.

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other transportation services, such as driving or chartering a plane, so as to render a price increase on tickets for travel between an origin and destination (referred to as a “city pair” in the airline industry) unprofitable. Thus, scheduled airline service is a relevant product market for this case.

The evidence will also show that business travelers demand flexibility and convenience in their air travel services and, consequently, are willing to pay a higher price for tickets that have limited or no restrictions. Business travelers need the ability to purchase or change tickets at the last minute. They also value their time very highly, preferring nonstop service to the risk and delay associated with connecting service. Business travelers would not switch to more restricted tickets in the event of a price increase, nor are they likely to switch to connecting service. Thus, scheduled airline service for business passengers is also a relevant product market.

2. <u>The Relevant Geographic Market Is Domestic City Pairs</u>

The relevant geographic market is the "area in which the seller operates, and to which the purchaser can practically turn for supplies."[11] "The purpose in determining the appropriate geographic market is to identify the relevant competitors who constrain the merging firms from exercising market power."[12] If consumers in a given geographic area do not consider products from outside that area as practical, good alternatives, then that geographic area is a relevant geographic market.[13]

In this case, the relevant geographic markets are domestic city pairs. Most passengers

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[11] *United States v. Philadelphia Nat’l Bank*, 374 U.S. 321, 359 (1963) (emphasis omitted).

[12] *United States v. Rockford Mem’l Corp.*, 717 F. Supp. 1251, 1261 (N.D. Ill. 1989).

[13] *Hospital Corp. of Am. v. FTC*, 807 F.2d at 1388.

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who wish to travel from one city to another would not respond to a small fare increase by traveling instead to different city. Thus, if the price of the Detroit-Houston flight rises, passengers generally, and business passengers in particular, would not take a trip from Detroit to Los Angeles instead.

B. NORTHWEST'S OWNERSHIP OF CONTINENTAL WILL HARM CONSUMERS IN HUB-TO-HUB CITY-PAIRS AS WELL AS ALL CITY-PAIRS SYSTEMWIDE

1. Hub-to-Hub Effects

Northwest and Continental are both "hub and spoke" carriers. In other words, they focus their operations around a small number of "hub" airports out of which they offer service to many "spoke" cities. Passengers originating from a spoke city must generally pass through a hub in order to reach another spoke city. While hub and spoke carriers like Northwest and Continental offer many nonstop flights from their hubs, these carriers rarely offer nonstop service directly between spoke cities.

Northwest operates domestic hubs in Minneapolis, Detroit and Memphis. Continental's hubs are in Houston, Cleveland and Newark. Almost two and a half million passengers annually travel on the nine city-pair markets connecting a Northwest hub and a Continental hub, generating more than $420 million in revenues.[14] These markets are highly concentrated. In most of them, Northwest and Continental combined have over an 80% market share, and are clearly each others' most significant competitor. In seven of them, Northwest and Continental are the only providers

[14] Those markets are as follows: Detroit-New York; Detroit-Houston; Detroit-Cleveland; Minneapolis-New York; Minneapolis-Houston; Minneapolis-Cleveland; Memphis-New York; Memphis-Houston; and Memphis-Cleveland.

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of daily nonstop service, the distinct service preference for business travelers. Northwest's acquisition of the controlling interest in Continental will substantially eliminate competition in these heavily traveled hub-to-hub markets, resulting in higher prices and worse service for consumers.

2. Systemwide Effects

Both Northwest and Continental have extensive domestic networks that span the United States. They both provide service between most U.S. cities. Only a limited number of other airlines have such broad networks (generally referred to as the "major airlines").[15] The major airlines compete across the vast number of domestic markets where their systems overlap, responding to each other's price and service. If one airline initiates a nationwide sale, the others quickly follow. Similarly, if one improves or promotes a particular aspect of its service, the other major airlines respond competitively. Continental in recent years has distinguished itself in offering high quality service, and has focused its efforts on attracting business passengers.

From time to time the major airlines attempt to increase their prices systemwide (*e.g.*, raise their business fares by 5% to all the cities they fly to in the United States). But, they have found that it is unprofitable to maintain a price increase if even one of the other major airlines decides not to follow. Thus, if one major airline raises its fares systemwide, it will withdraw that fare increase within a few days unless all the others have raised their fares to match. There are

[15] Major airlines at most include United Airlines, Delta Airlines, American Airlines, Northwest, Continental, US Airways and TWA. TWA has a somewhat more limited scope than the others and United and US Airways have recently proposed to merge, spinning off some of US Airways' assets to a new regional airline. Southwest Airlines does not have a national hub and spoke network. It only flies point to point.

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many reasons why one airline may not want to raise prices, even though the rest of the industry does, including, for example, a situation where one airline is facing (or just emerging from) a labor slowdown or strike, or is experiencing lower systemwide demand for its flights, or has short-term cash-flow problems. By refusing to match, Northwest and Continental have, at differing times in the past, each prevented price increases that the rest of the industry has tried to impose. Indeed just before this suit was filed, Northwest had frequently refused to match systemwide increases, including some increases that Continental initiated. As a result of Northwest's ownership of Continental, however, the two carriers' interests are more closely aligned, making it less likely that either will be the one "spoiler" that blocks a nationwide price increase. Fewer potential spoilers will lead to higher prices for consumers – a successful systemwide fare increase of only 1% would cost American consumers more than a half a billion dollars a year.

C. ENTRY BY OTHER CARRIERS IS UNLIKELY TO OCCUR AT A RATE AND SCALE SUFFICIENT TO REMEDY THE COMPETITIVE HARM CAUSED BY NORTHWEST'S OWNERSHIP OF CONTINENTAL

In a section 7 case, once the Government establishes an increase in concentration in a relevant market, or as in this case, in numerous relevant markets, the burden shifts to the defendants to rebut that *prima facie* case with evidence showing that despite the increase in concentration, the transaction is not likely to substantially lessen competition in <u>any</u> of the relevant markets. One way defendants can rebut the presumption is to show that a new firm is likely to enter each adversely affected city pair in response to a price increase. Specifically, to meet their burden of rebutting the presumption in this manner, defendants must show that the

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entry will be timely, likely and sufficient to prevent the exercise of market power.[16]

If there are barriers preventing new companies from entering the relevant markets, then the concentration in those markets becomes all the "more threatening, since there is little chance that other firms (new or old) would be able, in the face of anticompetitive practices, to spur competition." *University Health*, 938 F.2d at 1219. Thus, where there are significant barriers to entry, defendants will be unlikely to rebut the presumption of illegality. *Id*.

Here, the evidence will show that there are several such barriers. Established network carriers are unlikely to challenge each other at their hubs. The economic reality of the hub-and-spoke system makes it unlikely that another major airline will add nonstop service between Northwest's and Continental's hub cities.[17] Major carrier entry into another's hub-to-hub route occurs on average once every 32 years and is successful less than 25% of the time.

Entry by non-major airlines in the event of a price increase is also unlikely. The history of the airline industry is filled with failed attempts by new carriers to challenge established network carriers such as Northwest and Continental. New carrier entry is also rare (once every 13 years) and risky (successful only 32% of the time). The costs of new entry are substantial, and many of

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[16]*See, e.g., FTC v. University Health, Inc.*, 938 F.2d 1206, 1218 (11th Cir. 1991)*; United States v. United Tote, Inc.*, 768 F. Supp. 1064, 1071-72 (D. Del. 1991); *Ivaco*, 704 F. Supp. at 1420; U.S. Dep't of Justice and Fed'l Trade Comm'n Horizontal Merger Guidelines, § 3 (1992), *reprinted in* 4 Trade Reg. Rep. (CCH) ¶ 13,104.

[17] When evaluating traffic flows, the major airlines have determined that it is almost never profitable to add a new domestic flight unless it begins or ends at that airline's own hub. Because neither Northwest nor Continental's hubs are located in the same airport with another major airline's hub, no major airline is likely to add any new flights between Northwest and Continental's hubs.

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the costs are "sunk," meaning they cannot be recovered if the entry effort fails. If sunk costs are required for entry, and there is a significant risk that entry will fail, the sunk costs are an entry barrier. An important reason new entry does not occur in hub cities such as Detroit and Minneapolis in response to high fares or poor service is that the high fares that persist before entry will not remain after entry. Because entry requires that sunk costs be put at risk and any entrant will reasonably expect an aggressive price response from the incumbent hub carrier, the new entrant will be unlikely to attempt entry in the hub-to-hub markets in the first place.

Moreover, entry on a nationwide scale comparable to the major airlines is an enormous undertaking, indeed almost inconceivable at this stage in the industry's development. Continental alone has over 500 airplanes, facilities at over 130 U.S. airports and more than 50,000 employees. In short, if Northwest retains control of Continental, entry will not protect consumers from the price increases or service decreases that will result.

D. THE TEMPORARY GOVERNANCE AGREEMENTS DO NOT REMEDY THE ANTICOMPETITIVE HARM CAUSED BY THE ACQUISITION

Once the Court is convinced that a transaction violates Section 7, all doubts as to the remedy must be resolved against the defendants. *United States v. E.I. du Pont de Nemours & Co.,* 366 U.S. 316, 334 (1961). The Supreme Court has instructed trial courts that the relief they fashion in an "an antitrust case must be 'effective to redress the violations' and 'to restore competition.'" *Ford Motor Co. v. United States,* 405 U.S. 562, 573 (1972) (citations omitted). In this case, the appropriate remedy is restoration of the status quo ante – divestiture by Northwest of its controlling block of Continental stock. Indeed, the Supreme Court has emphasized that the appropriate remedy for an anticompetitive acquisition is divestiture because it does not require

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constant judicial or administrative oversight.

Northwest instead proffers its private, temporary corporate agreements with Continental as an adequate remedy, arguing that they are sufficient to protect consumers – at least for now. But it is beyond dispute that this “remedy”expires in 2008, and Northwest will have *total control* over Continental. Northwest’s future control of Continental is not speculative; it is a legal and contractual certainty. At best, Northwest has created a temporary delay in the inevitable anticompetitive effects of its acquisition. Courts are not permitted to defer consideration of an acquisition that is reasonably likely to harm competition in the future until the harm ripens into an actual restraint. *See United States v. Penn-Olin Chem. Co.*, 378 U.S. at 177 (the "mandate" of section 7 is to predict effects on competition in terms of "probability. . . not in terms of tangible *present* restraint") (emphasis added); *see also FTC v. Dean Foods Co.*, 384 U.S. 597, 606, n. 5 (1966) (delay may diminish government's ability to secure effective relief). Permitting defendants to thwart enforcement of section 7 with illusory contractual time delays would "create a large loophole in a statute designed to close a loophole." *United States v. Philadelphia Nat’l Bank*, 374 U.S. 321, 343 (1963); *Penn-Olin*, 378 U.S. at 168.

Even in the interim, the governance agreements are an inadequate remedy. In 2004, Northwest will have unfettered control over 20% of Continental’s voting stock, giving it *de facto* control of Continental. Continental executives are keenly aware that their fates will be controlled by Northwest in just four years. That knowledge will affect their decisions more and more as

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2004 approaches.[18] As private corporations, neither Northwest or Continental owes any duty to consumers; they can be expected to act in their own pecuniary interests rather than in the interests of vigorous competition. Northwest and Continental are free to ignore these agreements at any time it serves their own interests, and Northwest's stock ownership makes it more likely that collusive conduct between the two competitors may escape antitrust scrutiny.

The only time the Supreme Court faced the issue of whether a "voting trust" arrangement sufficiently ameliorated the competitive harm of a particular stock acquisition, it unambiguously rejected it as a matter of principle.[19] Courts are understandably loathe to rely on "behavioral rules" as a substitute for divestiture, even where the rules are court-ordered. And where such rules are no more than private promises or agreements to compete, courts have repeatedly rejected them as

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[18]Northwest also has control over the most important corporate decisions Continental can make *today*. Northwest can vote all its shares without restriction on many important issues such as mergers, consolidation, business combinations, liquidation and large stock issuances.

[19] *du Pont*, 366 U.S. at 334. ("[T]he public is entitled to the surer, cleaner remedy of divestiture," rather than non-structural injunctive relief requiring continuing oversight.); *see also California v. American Stores Co.*, 495 U.S. 271, 285 (1990) ("divestiture is the remedy best suited to redress the ills of an anticompetitive merger"); *Ford Motor*, 405 U.S. at 573 ("divestiture is particularly appropriate where asset or stock acquisitions violate the antitrust laws"). In *du Pont*, the Supreme Court rejected defendant's claim that certain court-supervised ancillary remedial provisions added enough protection against anticompetitive conduct to make the decree effective. The ancillary clauses in *du Pont* (*e.g.*, those barring du Pont from influencing the selection of GM officers or directors and prohibiting preferential trade relationships between du Pont and GM) are not unlike Section 1.04(a) in the Northwest/Continental Governance Agreement. The Court found that enforcing such a decree likely would be cumbersome and time-consuming; that framing an injunction to address adequately all possible means of improper influence would be impossible; and that policing the ancillary provisions "would probably involve the courts and the Government in regulation of private business affairs more deeply than administration of a simple order of divestiture." 366 U.S. at 334.

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a remedy to an otherwise anticompetitive transaction.[20]

Northwest has argued that the government is asking the Court to speculate about the future, but in fact it is Northwest that invites the Court to speculate. Over the next few weeks, Northwest will have its opportunity to show that the transaction will not lessen competition as the government contends. Northwest can dispute the government's definition of the relevant market, as well as the government's evidence demonstrating that fares typically increase as the number of airlines serving a route decreases. Northwest can offer evidence that entry into the markets at issue is easy and likely. If Northwest persuades the Court on <u>any</u> of these issues, Northwest should prevail. But Northwest must harbor suspicion about its ability to prevail on these core issues, because Northwest argues instead that <u>even</u> if the weight of the evidence on these issues is decidedly against Northwest today, the Court should not rule against Northwest because, in four years, the dispositive facts <u>may</u> change. That is speculation.

What is not speculation is that if the Court waits, as Northwest suggests, until control is

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[20]*DuPont* 366 U.S. at 332, *See also Community Publishers, Inc. v. Donrey Corp.*, 892 F. Supp. 1146 (W.D. Ark. 1995), *aff'd*, 139 F.3d 1180 (8th Cir. 1998);*University Health,* 938 F.2d at 1224, *Ivaco*; 704 F. Supp. at 1426, 1429. In *Community Publishers*, the court considered an antitrust challenge to the acquisition of a local newspaper by a larger competitor, which was owned by the same family that owned other competing newspapers. In that case, the court stated:

> While the court was impressed with the sincerity and honesty of Mr. Jack Stephens and every other witness from his organization who testified, the court is still left with the gnawing feeling that it is inevitable that someday, maybe sooner rather than later, the newspapers will be operated as one and the Northwest Arkansas Times will disappear from the scene just as two other venerable hometown papers . . . have disappeared under the Stephens family ownership. It simply makes economic sense, and humans, being the type of animal they are, almost always act in their own best interests.

Community Publishers, 892 F. Supp. at 1168 n.17.

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unambiguous, it will be too late for effective relief. Divestiture of the stock at that time will not restore Continental as an independent, viable competitor. It will no longer have the management, strategic direction, assets or operations it has today. With Northwest's increasing influence and control, Continental will, perhaps imperceptibly at first, but inexorably increasing as time goes on, begin its competitive transformation into little more than a Northwest subsidiary.[21]

E. NORTHWEST CANNOT CARRY ITS BURDEN TO ESTABLISH AN EFFICIENCIES DEFENSE

This case is, and always has been, about the competitive harm caused by Northwest's ownership of a controlling interest in Continental. Northwest is attempting to change that focus to the carriers' separate alliance transaction. Northwest wants to introduce evidence of allegedly procompetitive benefits of the alliance and ask the Court to weigh those benefits against the anticompetitive harm caused by Northwest's ownership of control over Continental. Such

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[21]Congress recognized this precise problem in passing the Hart-Scott-Rodino Antitrust Improvements Act:

> During the course of the post-merger litigation, the acquired firm's assets, technology, marketing systems, and trademarks are replaced, transferred, sold off, or combined with those of the acquiring firm. Similarly, its personnel and management are shifted, retrained, or simply discharged. In these ways the acquiring and acquired firms are, in effect, irreversibly 'scrambled' together. The independent identity of the acquired firm disappears. 'Unscrambling' the merger and restoring the acquired firm to its former status as an independent competitor is difficult at best, and frequently impossible.

H.R. Rep. No. 94-1373, 94th Cong., 2d Sess. 8 (1976); *accord* S. Rep. No. 94-803, at 61 (1976).

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evidence constitutes an efficiencies defense,[22] and it is Northwest's burden to prove.[23]

1. Efficiencies Must Be "Merger-Specific" to Constitute A Defense Under Section 7 of the Clayton Act

To sustain an efficiencies defense, a defendant must prove (1) that there are cognizable efficiencies; that is, efficiencies that benefit the public by, for example, lowering costs, improving quality or enhancing service; and (2) that the efficiencies are "merger-specific," that is, they result from the transaction and cannot be obtained by less competitively harmful means. The efficiencies defense is subject to a "very rigorous standard;" and the burden of meeting that exacting standard falls squarely on the defendant. *United States v. Rockford Mem'l Corp.*, 717 F. Supp. 1251, 1289 (7th Cir.), *cert. denied*, 498 U.S. 920 (1990). Self-serving statements by defendants' executives alone are insufficient to carry the burden of proof on an efficiencies defense.[24]

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[22]The Supreme Court rejected an efficiencies defense in *United States v. Philadelphia Nat'l Bank*, 374 U.S. 321, 371 (1963), stating that an otherwise anticompetitive merger would not be saved because, "on some ultimate reckoning of social or economic debits and credits, it may be deemed beneficial." *See also FTC v. Proctor & Gamble Co.,* 386 U.S. 568, 580 (1967).

[23]*See FTC v. University Health, Inc.*, 938 F.2d 1206, 1223 (11th Cir. 1991) (holding that a defendant must prove the efficiencies); *FTC v. Staples, Inc.,* 970 F. Supp. 1066 (D.D.C. 1997) (same); U.S. Department of Justice and Federal Trade Commission, Horizontal Merger Guidelines § 4, at 31 (rev. Apr. 8, 1997) ("merging firms must substantiate efficiency claims so that the Agency can verify by reasonable means the likelihood and magnitude of each asserted efficiency, how and when each would be achieved (and any costs of doing so), how each would enhance the merged firms' ability and incentives to compete, and why each would be merger-specific.").

[24]*University Health,* 938 F. 2d at 1222-23 (holding that a defendant cannot carry its burden "based solely on speculative, self-serving assertions."). *See United States v. Falstaff Brewing Co.,* 410 U.S. 526, 570 (Marshall, J, concurring) (1973) (subjective statements of future intent should not outweigh strong evidence to the contrary); *FTC v. Atlantic Richfield Co.,* 549 F. 2d 289, 297 (4th Cir. 1977) (finding it was error for the lower court to rely on management's subjective statements when objective evidence strongly points otherwise).

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Courts have repeatedly rejected efficiencies defenses where defendants have not met their burden of proving the efficiencies were specific to the transaction. *See FTC v. University Health, Inc.*, 938 F.2d at 1222 n.30 (stating that courts should require "proof that the efficiencies to be gained by the acquisition cannot be secured by means that inflict less damage to competition"); *FTC v. Cardinal Health, Inc.*, 12 F. Supp. 2d 34, 61-62 (D.D.C. 1998) ("efficiencies, no matter how great, should not be considered if they could also be accomplished without a merger"); *United States v. Ivaco, Inc*., 704 F. Supp. 1409, 1425-26 (W.D. Mich. 1989) (finding the efficiency argument unpersuasive because defendants failed to consider a number of alternative transactions, and failed to explain why such alternatives were impractical); *Rockford Mem'l Corp.*, 717 F. Supp. at 1289 ("Efficiencies benefitting the [combined] entity, but obtainable by means independent of the [combination], are not relevant for § 7 purposes."), *aff'd on other grounds*, 898 F.2d 1278 (7th Cir.); *Staples, Inc.,* 970 F. Supp. at 1088-90 (holding that many of the claimed cost savings were not specific to the combination since they could have been achieved if the firms remained independent); *United States v. Mercy Health Servs.*, 902 F. Supp. 968, 987-88 (N.D. Iowa 1995) (rejecting many of the claimed efficiencies on the grounds they could be realized without the combination), *vacated as moot*, 107 F.3d 632 (8th Cir. 1997); *Philadelphia Nat'l Bank*, 374 U.S. at 370-71 (holding that the advantages of an acquisition did not justify the acquisition where an alternative – internal expansion – was available). No cases suggest that the Sixth Circuit does not follow this well-settled rule.

Northwest bears a particularly heavy burden in proving its efficiencies are transaction-specific in the situation presented here. Northwest is not claiming that any efficiencies flow

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directly from the transaction challenged by the government – its acquisition of the controlling interest in Continental. Rather, it relies on the alleged benefits from its contemporaneous, but contractually separate (and unchallenged) alliance agreement with Continental to justify the harm from its controlling stock acquisition. Northwest must prove, with more than its executives self-serving statements, that the alliance benefits cannot reasonably be achieved unless Northwest purchased, held and ultimately exercises full control over Continental. Northwest will not be able to meet that burden.

2. The History of Airline Alliance Agreements, Including Northwest's Own Prior Conduct, Is Compelling Evidence That Control Is Not Necessary For the Public to Receive Alliance Benefits

The evidence, including Northwest's own prior words, experience and conduct, will show that the alleged benefits of the alliance are not "linked" to Northwest's continued ownership of voting control of Continental; the evidence will further show that consumers can continue to receive any benefits the alliance offers after divestiture of the control stock.

- The contract that creates the alliance between Northwest and Continental is not contingent in any way on Northwest's ownership of Continental stock;
- Northwest proceeded with the alliance in the face of the lawsuit seeking the stock divestiture;
- Only a small minority of the numerous past and present airline marketing alliances involve any equity ownership between partners at all and almost none involves control;
- The Northwest/KLM alliance is very successful and its history demonstrates that as little as 19% ownership of one alliance partner by another was not only unnecessary, but enough to be counterproductive to the alliance relationship;
  - In a July19, 1996 letter, John Dasburg, President of Northwest, clearly stated Northwest's position on the role of equity in an alliance to KLM's

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President:

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– KLM offered Northwest [REDACTED

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- After September 1997, Northwest repurchased KLM's shares. At the same time, Northwest and KLM entered into an "Enhanced Alliance Implementation Agreement" in which both parties agreed to expand and improve upon their alliance relationship. Northwest's 1998 Annual Report proclaims that this new agreement, executed only <u>after</u> KLM had agreed to divest its stake in Northwest, "made the alliance between them virtually permanent."

- Continental has no means, other than the alliance agreement itself, to prevent Northwest from breaching or terminating the alliance;

- Northwest has a successful alliance agreement with Alaska Airlines that does not involve equity;

- Continental and America West have continued to invest in and reap profits from their alliance even though significant equity links between the two have ended;

- The Northwest/Continental alliance has already proven highly profitable to each carrier, more than covering the initial investments each made to implement the alliance.

3. Northwest Has Rejected Less Anticompetitive Alternatives

Northwest has already urged the Court to not consider any of the above evidence, and will likely continue to do so. It will argue that this alliance is "different" and that the otherwise obvious alternative, an alliance without controlling equity, "does not meet our objectives." Northwest's stated justifications for why it needs to maintain the controlling equity have evolved over time. Northwest first explained that "[w]ith that 'control block' in play, neither Northwest nor Continental could take the risk that the stock could be sold to another airline or to a third party who would not support the codeshare arrangement." August 25, 1998 Presentation to the Department of Justice by Northwest and Continental. But then the government offered to allow the purchase of the stock if Northwest agreed to gradually divest it over a negotiated period of time. The "negotiated period of time" for divestiture would clearly have solved any "Delta problem," and would also have provided sufficient time for Northwest and Continental to ensure that their alliance was operating smoothly and profitably. Northwest summarily rejected the proposal, offering no explanation as to why it was not a viable alternative.

The government filed this suit on October 23, 1998. Northwest proceeded to renegotiate its investment agreement with Air Partners, as well as its governance agreement with Continental, but closed its eyes to any alternative to buying and retaining the controlling block of Continental stock. Northwest did not consider buying the stock and divesting it over a period of time; it did

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<u>not</u> consider buying it and converting it to nonvoting stock (as Northwest had proposed to KLM when the shoe was on the other foot); and it did not consider buying and selling the stock back to Continental, which had always been willing and eager to purchase the stock in order to stabilize its common stock structure by eliminating this supervoting stock.

Even after it acquired the stock, and even after the alliance was successfully established, Northwest has kept its eyes closed to alternatives. Continental has made formal proposals to Northwest which would allow Continental to repurchase the supervoting stock and retire it, while at the same time providing Northwest with significant contractual measures designed to further strengthen the parties' alliance. Indeed, Continental has indicated its willingness to extend the term of the carriers' alliance agreement to 25 years and to provide for a significant breakup fee in the event of a breach of the agreement by either party. Northwest refuses to even consider such a proposal. Instead, Northwest's only apparent remaining rationale has degenerated into "we need the stock to maintain the alliance because we say so." This is simply not sufficient to meet Northwest's efficiencies burden. The law demands far more before subjecting consumers to an anticompetitive transaction.

CONCLUSION

Northwest's acquisition and continued holding of a controlling interest in Continental has

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a reasonable probability of substantially reducing competition in the airline industry in violation of section 7 of the Clayton Act. Accordingly, the Court should order Northwest to divest its controlling block of Continental stock.

DATED: October 24, 2000

Respectfully submitted,

"/s/"

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CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing REDACTED TRIAL BRIEF OF THE UNITED STATES AND MOTION TO FILE A REDACTED TRIAL BRIEF IN EXCESS OF TWENTY PAGES were served by hand this 24th day of October, 2000 upon each of the parties listed below:

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