REDACTED -- FILED ON THE PUBLIC RECORD

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

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

PLAINTIFF UNITED STATES OF AMERICA'S
STATEMENT OF FACTS PRECLUDING SUMMARY JUDGMENT

Plaintiff United States of America hereby submits this Statement of Facts Precluding Summary Judgment, in support of its Memorandum in Opposition to Defendant Northwest Airlines' Motion for Summary Judgment. The following facts, supported by admissible evidence, place in dispute Northwest Airlines Corporation's ("Northwest") core contention -- that it cannot influence or control Continental Airlines' ("Continental") competitive business decisions -- and affirm that Northwest's continued holding of the control block of Continental will invariably diminish competition between the two carriers and in the airline industry in general.[1]

[1]Attached to this filing is a cross-index showing which of the following statements of fact dispute, or place in context, Northwest's factual statements.

Northwest's Ownership of 51% of the Voting Power and 14% of the Equity of Continental Will Likely Substantially Lessen Competition Between the Two Airlines

1. Northwest is the fourth largest airline in the United States; Continental Airlines, Inc. ("Continental") is the fifth. Northwest Airlines Corp. Form 10-K, filed March 28, 2000, Vol. 1, Tab 23; Continental Airlines, Inc. Form 8-K, filed January 18, 2000. Vol. 1, Tab 22.[2] Combined, these two carriers have account of over $10 billion per year in domestic revenues. Baker Report at ¶ 19, Vol. 1, Tab 16.

2. Northwest and Continental compete with each other to provide customers better prices on a number of routes in the United States. See Answer of Northwest Airlines Corp. (1/25/99) at ¶2. Northwest serves nearly two thirds of the domestic city pairs served by Continental; **[REDACTED MATERIAL**

] Baker Report at ¶ 20, Vol. 1, Tab 16.

3. Northwest and Continental are each others most significant competition on the "hub-to-hub" city-pair markets -- those routes connecting one of Northwest's hub cities with one of Continental's hub cities, such as Detroit to Houston -- where both Northwest and Continental provide nonstop service. In seven of the nine hub-to-hub routes, Northwest and Continental are the only carriers that offer the nonstop service preferred by business travelers and carry the overwhelming share of the total number of passengers traveling on those routes. Over 2.4 million passengers traveled in these markets in 1998, and the total market revenues exceeded $422 million. Baker Report at ¶ 51, App. D, Vol. 1, Tab 16.

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[2]The citations to this document are found in the accompanying appendices with each document labeled individually.

4. **[REDACTED MATERIAL**

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5. If a system-wide increase by one major airline is not promptly matched by all of the other major airlines, the increase does not go through. At times in the past, either Northwest or Continental has played a pivotal role in preventing such system-wide increases, by refusing to match a price hike proposed by other major carriers. Similarly, in the past, one of these two carriers has been the first to initiate a system-wide fare sale, or has chosen to lengthen the duration, or extend the scope, of a sale proposed by another major airline. Baker Report at ¶ 10, Vol. 1, Tab 16.

6. Even a small increase, of say 2 to 4%, can, taken across the entire systems of all the major airlines, have an enormous negative impact on consumers. **[REDACTED MATERIAL**

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7. Prior to Northwest acquiring stock in Continental, the two airlines also competed on a variety of non-price dimensions that affect the quality of service consumers receive, including the frequency of flights and type of aircraft used on a given route, which routes to enter, and which aircraft to purchase. Baker Report at ¶ 11, Vol. 1, Tab 16.

8. The United States' economic expert, Dr. Jonathon Baker, a former Director of the Bureau of Economics at the Federal Trade Commission, found that as a result of Northwest's purchase of a controlling block of stock in Continental the two airlines no longer compete as aggressively against each other. In short, he found that the likely net effect of Northwest's acquisition is that consumers will pay higher prices and receive worse service, both in the hub-to-hub markets and on a system-wide basis; because of Northwest's acquisition of Continental stock, both carriers are less likely to be the "spoiler" of system-wide price increases or to initiate or extend fare sales. Baker Report at ¶¶ 9-11, Vol. 1, Tab 16.

9. Now that Northwest owns voting control of Continental, Continental will have an incentive to act to favor the interests of Northwest when confronted with competitive decisions. Continental's management make a multitude of competitive decisions everyday, on subjects ranging from fare changes, sales, pricing strategies, service frequency, network or hub expansion and aircraft purchases. Rock Report at ¶ 103, Vol. 1, Tab 20. Any of these competitive decisions may now be altered given the awareness on the part of

Continental's managers that Northwest does now, or will soon, control the outcome of many of Continental's strategic decisions, and will soon control their fates as well. Hence, Continental's management is now likely to take into account the effects of their actions on Northwest's profits in a way they did not prior to the acquisition. *Id*.; Baker Report at ¶¶ 11, 17, Vol. 1, Tab 16.

10. Indeed, Gordon Bethune, CEO of Continental, stated **[REDACTED MATERIAL**

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11. Furthermore, as a result of Northwest's acquisition of 14% of the equity of Continental, Northwest will compete less vigorously with Continental. As a consequence of its stock ownership, Northwest is now entitled to 14% of Continental's profits. As Dr. Baker noted, Northwest's managers will now take into account the effects of their actions on Continental's profits when deciding how and when to compete against Continental; as a result "Northwest's incentive to compete with Continental will now be muted." Baker Report at ¶ 16, Vol. 1, Tab 16.

Northwest Purchased Air Partners' Shares of Continental Stock for Strategic Business Purposes -- Not "Solely" as an Investment

12. **[REDACTED MATERIAL**

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13. **[REDACTED MATERIAL**

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14. **[REDACTED MATERIAL**

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15. **[REDACTED MATERIAL**

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16. **[REDACTED MATERIAL**

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17. **[REDACTED MATERIAL**

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18. **[REDACTED MATERIAL**

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19. Northwest told the Securities and Exchange Commission ("SEC") that although it had eventually entered into an agreement with Continental restricting some of its shareholder rights, Northwest's intent when it began negotiations with Air Partners was to obtain "control of [Continental], including the power to elect a majority of [Continental's] Board of Directors . . . and the power to vote a majority of the outstanding voting power of [Continental's] stock with respect to mergers or other business combinations involving

[Continental].” Northwest Airlines Corp., Form 13D, filed February 4, 1998, Vol. 1, Tab 24.

20. When Northwest negotiated its agreement with Air Partners (the “Investment Agreement”), Northwest expressly conditioned its purchase of Air Partners’ shares on obtaining “no less than 50.1% of the aggregate Fully Diluted Voting Power of all holders of [Continental] stock.” Investment Agreement (as amended on Feb. 27, 1998 and Nov. 20, 1998) § 5(c), Vol. 2, Tab 52. (Hereinafter, “Investment Agreement). Northwest agreed that it would “use its best efforts” to purchase sufficient stock prior to closing to constitute at least 50.1% of the voting power of Continental. Investment Agreement §4.1(e), Vol. 2, Tab. 52.

21. On January 25, 1998, Northwest formally entered into the Investment Agreement with Air Partners to purchase Class A shares of Continental stock that represented approximately 51% of the voting power of Continental, but only 14% of the equity of the company. <u>See</u> Investment Agreement § 3.2(d), Vol. 2, Tab 52.

22. Northwest paid Air Partners **[REDACTED MATERIAL**

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23. After entering into the Investment Agreement with Air Partners in January 1998, Northwest learned that the acquisition of Air Partners’ shares might not give Northwest the absolute control over critical Continental decisions that it desired. Consequently, on March 2, 1998, Northwest entered an agreement with the Barlow Investors group to

purchase additional Class A shares of Continental to make certain that Northwest would hold over 50% of the voting power of Continental on a fully diluted voting basis. Northwest Airlines Corp., Form 13D, filed March 5, 1998, Vol. 1, Tab 25.

24. Northwest consummated its acquisition of Air Partners' and Barlow's shares of Continental stock on November 20, 1998. Northwest Airlines Corp. Press Release (11/20/98), Vol. 2, Tab 56.

25. **[REDACTED MATERIAL**

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26. Northwest is now, **[REDACTED MATERIAL]** the single largest shareholder of Continental. **[REDACTED MATERIAL]**

Northwest Acquired and Retains the Ability to Influence and Control Continental's Most Strategic Decisions in Years 1-6

27. On the same date that Northwest entered into the Investment Agreement with Air Partners, Northwest also entered into an alliance with Continental and an agreement (the "Governance Agreement") which placed some limits on Northwest's ability to vote its stock. On March 2, 1998, Northwest and Continental agreed to amend the Governance Agreement to permit Northwest to purchase the Barlow shares without violating the Governance Agreement. See generally, Governance Agreement, dated Jan. 25, 1998, Vol.

2, Tab 48; the First Amendment to the Governance Agreement, dated Mar. 2, 1998, Vol. 2, Tab 49.

28. After the United States filed this lawsuit challenging Northwest's purchase of control of Continental, Northwest and Continental again changed the Governance Agreement. (The "Second Amendment to the Governance Agreement" or "Second Amendment"). Northwest also entered into a "Supplemental Agreement" with Continental which imposes fewer restrictions on Northwest than the amended Governance Agreement and covers the four years after the Governance Agreement expires. See generally, Second Amendment to the Governance Agreement, dated Nov. 20, 1998, Vol. 2, Tab 50; Supplemental Agreement, dated Nov. 20, 1998, Vol. 2, Tab 51.

29. At the same time it entered these additional agreements with Northwest, Continental also instituted a shareholders rights agreement ("the Rights Agreement"), **[REDACTED MATERIAL]** The Rights Agreement limits the ability of persons to purchase amounts of Continental stock above a certain threshold. However, Northwest's current share of voting power does not violate the Rights Agreement. Northwest's ownership interest would trigger the provisions of the Rights Agreement if 1) Northwest violates any of the governance arrangements, and 2) it attempts to purchase additional stock. **[REDACTED MATERIAL]** see generally, TP 118503-506, Vol. 2, Tab 47. Thus, contrary to what Northwest suggests in its brief, the Rights Agreement would only act as a deterrent to Northwest breaching any of the governance arrangement if Northwest were also interested in purchasing additional

shares of Continental. But as Northwest already owns voting control of Continental, and the attendant ability to influence Continental, Northwest has no need to purchase additional shares of stock. [REDACTED MATERIAL] Thus, in reality, all the Rights Agreement does is to ensure that no other shareholder will have greater voting power than Northwest during the term of the various governance agreements.[3] See generally, Rights Agreement, dated Nov. 20, 1998, Vol. 2, Tab 53.

30. **[REDACTED MATERIAL**

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31. **[REDACTED MATERIAL**

[3]Hereinafter, the Governance Agreement and its amendments, the Supplemental Agreement, and the Rights Agreement, will collectively be referred to as the "governance arrangements."

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32. During the first six years covered by the governance arrangements, Northwest expressly retains the right to vote its control block with respect to some of the most strategic issues facing Continental, including a "merger, reorganization, share exchange, consolidation, business combination, recapitalization, liquidation, dissolution or similar transaction," and large issuances of stock. Governance Agreement at §1.04, Vol. 2, Tab 48. **[REDACTED MATERIAL**

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33. **[REDACTED MATERIAL**

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34. These strategic decisions, for which Northwest can control the outcome given its retained voting rights, are periodically considered or made by an airline like Continental. For example:

- Continental has radically restructured itself (indeed, has actually entered bankruptcy) two times in the past 15 years. **[REDACTED MATERIAL]**
- **[REDACTED MATERIAL]**
- Since Continental is highly leveraged, it is not unlikely that in the event of a turn in the economy the company might seek to recapitalize by issuing stock.

Rock Report at ¶¶ 150-51, Vol. 1, Tab 20; see generally, **[REDACTED MATERIAL]**

35. Even a large minority shareholder can exert control or influence. **[REDACTED MATERIAL]**

36. In addition to its influence over Continental arising from its ability to block certain strategic decisions, **[REDACTED MATERIAL**

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37. During the first six years it owns Continental's stock, Northwest is also free to signal its displeasure with the actions of Continental's management by refraining to vote its shares in favor of election of the management representatives to Continental's board, or by inducing a proxy fight by publicly stating its disappointment or dissatisfaction with the results of its alliance with Continental. Rock Report at ¶¶166-179, 189-90, Vol. 1, Tab 20.

38. Although under the governance arrangements, Northwest has no right to designate a director to Continental's Board during the first six years, the governance arrangements create a substitute for board representation by explicitly permitting Northwest to engage in

"periodic discussions with directors, officers and employees of [Continental] regarding the Company's business" so long as the matters discussed do not "include matters that, under applicable antitrust laws, could not be discussed among competitors." Second Amendment to the Governance Agreement, dated Nov. 20, 1998, at ¶ 7, Vol. 2, Tab 50.

39. Northwest claims this provision of the Second Amendment sufficiently restrains Northwest from discussing matters that might influence Continental's management or disrupt competition between the two carriers. However, the provision leaves to the parties the determination as to which issues regarding "the Company's business" would be prohibited. For example, **[REDACTED MATERIAL**

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40. Northwest has the ability, under the governance arrangements, to seek to influence the Continental's Board or management on matters relating to "the performance of the

Alliance Agreement and the subsequent negotiations and agreements contemplated thereby." Governance Agreement, §1.04(a), Vol. 2, Tab 48; Second Amendment to the Governance Agreement, ¶ 7, Vol. 2, Tab 50.

41. Northwest's right to speak to the Board and management regarding issues relating to the alliance gives Northwest a vast opportunity to influence Continental's day-to-day decision making. See Rock Report at ¶¶ 180-81, Vol. 1, Tab 20. According to **[REDACTED MATERIAL**

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42. **[REDACTED MATERIAL**

] *Copperweld* immunized from the antitrust laws anticompetitive agreements between a parent corporation and its wholly-owned subsidiary. Courts have applied this doctrine to agreements between parent corporations (like Northwest) and partially-owned subsidiaries (like Continental).

Northwest Ability to Control and Influence Continental Increases in Years 7-10

43. During the time period covered by the Supplemental Agreement (from 2004 to 2008), Northwest will have an even greater ability to vote its shares as it wishes, thereby increasing it ability to control and influence Continental. **[REDACTED MATERIAL**

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44. **[REDACTED MATERIAL**

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45. During the period covered by the Supplemental Agreement:

- **[REDACTED MATERIAL**

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- Northwest can freely vote shares representing 20% of the voting power of Continental on any shareholder issue, including compensation of management. See Supplemental Agreement, dated Nov. 20, 1998, at § 5, Vol. 2, Tab 51.

- Northwest can purchase additional shares of Continental and force the directors to consider a merger between the two companies. Rock Report at ¶ 96, Vol. 1, Tab. 20.
- There is no longer even a contractual facade purporting to restrict Northwest's ability to seek to influence Continental's board and management. See generally, Supplemental Agreement, dated Nov. 20, 1998, Vol. 2, Tab 51; see Rock Report at ¶ 140, Vol. 1, Tab 20.
- Northwest can engage in proxy solicitations and encourage proxy fights. Rock Report at ¶¶ 118-137, Vol. 1, Tab 20.
- Northwest can nominate persons to Continental's Board of Directors. See generally, Supplemental Agreement, Vol. 2, Tab 51.

46. With its ability to vote shares representing 20% of the voting power of Continental, Northwest will have a substantial tool to influence Continental. **[REDACTED MATERIAL**

] Northwest apparently shares this belief, as its own Board implemented a shareholders rights plan that limited the ownership of voting power of any of Northwest's shareholders to 19%. NW 00280235-42, Vol. 2, Tab 33.

47. Even though Northwest has reserved for itself ample means under the governance arrangements to exercise direct control and influence over Continental during the time

when the governance arrangements are in effect, it need not even resort to any of these measures to hold sway over Continental's management. Continental's management is aware of the tools at Northwest's disposal, and that Northwest will ultimately have absolute control of the company. That knowledge, in and of itself, will influence Continental to compete less aggressively with Northwest. Rock Report at ¶ 191, Vol. 1, Tab 20.

48. The Supplemental Agreement ends, or does not even come into effect, if Northwest and Continental terminate the Alliance. In that case, Northwest will be free to exercise its 51% of the voting power any way it chooses. When the Supplemental Agreement terminates, Northwest will have absolute voting control of Continental -- it can replace Continental's management at will and can dictate the competitive direction of the company. See Rock Report at ¶107, Vol. 1, Tab 20; Fox Dep. (5/19/00) at 58-59, Vol. 1, Tab 6. At that time, the only restraint on Northwest's ability to take any action it pleases with respect to Continental is that Northwest has agreed to ensure that Continental's board include at least five independent directors and that those directors approve any material transaction between Northwest and Continental, such as Northwest acquiring planes from Continental. After the Supplemental Agreement expires, the independent directors do not need to constitute a majority of the board; moreover, Northwest can elect 100% of the board, including the persons designated to serve as independent directors. See generally, Supplemental Agreement, Vol. 2, Tab 51; Rock Report at ¶ 108-110, Vol. 1, Tab 20.

49. The terms of the governance arrangements, the Investment Agreement and all the applicable amendments interrelate. These agreements collectively are several hundred pages long and must be read in tandem with each other to grasp the full meaning of their terms. **[REDACTED MATERIAL**

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Thus, even if Continental were to try to enforce a provision of the governance arrangements, Northwest might likely disagree with Continental's interpretation of the restrictions on Northwest. See Rock Dep. (5/9/00) at 130-133, Vol. 1, Tab 8.

50. **[REDACTED MATERIAL**

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Continental Clearly Recognizes that
Northwest has Purchased Voting Control of Continental

51. **[REDACTED MATERIAL**

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52. **[REDACTED MATERIAL**

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53. **[REDACTED MATERIAL**

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54. **[REDACTED MATERIAL**

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55. **[REDACTED MATERIAL**

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56. **[REDACTED MATERIAL**

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57. These statements confirm the opinion offered by the government's governance expert, Edward Rock, a professor of corporate law and expert on corporate governance issues. Professor Rock testified that the period covered by the governance arrangements is essentially a "test period during which Continental management can prove itself to be a valuable partner to Northwest." Rock Report at ¶¶ 100-102, Vol. 1, Tab 20.

58. Since Northwest acquired the control block, Continental has attempted to buy the controlling shares back from Northwest. Northwest has refused to sell back the shares. Continental Airlines, Inc. Form 8-K, filed January 18, 2000, Vol. 1, Tab 22; **[REDACTED MATERIAL]**

Northwest's Own Prior Statements and Conduct Confirm that Private Agreements do not Prevent Influence and Control by a Shareholder

59. **[REDACTED MATERIAL**

] However, to qualify to be an independent director, the Governance and Supplemental Agreements require only that the person be "independent" (an undefined term) of, and has not served as an officer, employee, consultant or advisor of, Northwest or Continental in the previous three years. Thus, for example, nothing in the governance arrangements would prohibit a relative, best friend, best friend or business partner of one of Northwest's executives from being selected as an independent director of Continental. Governance Agreement, at § 2.01(a), Vol. 2, Tab 48; Supplemental Agreement, at § 28, Vol. 2, Tab 51; **[REDACTED MATERIAL]**

60. **[REDACTED MATERIAL**

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61. Even though Northwest insists its adherence to the terms of the governance arrangements will adequately restrict Northwest's ability to influence and control Continental, **[REDACTED MATERIAL**

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62. **[REDACTED MATERIAL**

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63. With respect to KLM's ownership of Northwest, Northwest took the position that even a 19% voting stake (and no board members) presented too much ability to control or influence on the part of a shareholder. **[REDACTED MATERIAL**

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64. Finally, in its brief, Northwest suggests that both the Securities and Exchange Commission and the Department of Transportation ("DOT") affirmatively concluded that, as a result of the governance arrangements, Northwest does not have enough control over Continental for either agency to take enforcement action. However, neither the SEC nor the DOT reviewed Northwest's ownership of Continental with an eye toward determining whether it violated the antitrust laws. The "control" issue before the SEC did not relate to questions of anticompetitive conduct or influence, but rather to whether Northwest, as a majority shareholder of Continental, may use an alternate form of accounting. <u>See generally</u> NW0315-00554-571, Vol. 2, Tab 44. Likewise, the DOT was not charged with conducting an antitrust review of the transaction; the DOT considered whether Northwest's acquisition of an ownership interest in Continental constituted a *de facto* transfer of international route authorities held by Continental to Northwest. Contrary to what Northwest suggests, the DOT made no formal finding, deciding instead to *defer* making any determination pending the outcome of this lawsuit. <u>See</u> <u>Re: Agreement</u>

Between Northwest Airlines, Inc. and Continental Airlines, Inc., Order 98-12-12, at 2 (Department of Transportation Dec. 10, 1998), Vol. 2, Tab 54.

DATED: July 28, 2000

Respectfully submitted,

"/s/"

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