REDACTED - FILED ON THE PUBLIC RECORD

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

PLAINTIFF UNITED STATES OF AMERICA'S MOTION
TO STRIKE DEFENDANTS' EFFICIENCIES DEFENSE

Pursuant to Fed. R. Civ. P. 16, plaintiff United States of America respectfully moves this Court for an order precluding defendants from offering any evidence at trial pertaining to the alleged efficiencies or other benefits associated with the marketing and code sharing agreement between Northwest Airlines Corp. ("Northwest") and Continental Airlines, Inc. ("Continental"). In support of this motion, plaintiff states as follows:

- The government's case is directed solely at defendant Northwest's acquisition and ownership of a controlling voting interest in its competitor Continental, and did not challenge the separate, stand alone marketing alliance formed by the defendant carriers.

- Defendant Northwest is attempting to misdirect the Court's attention from an analysis of the inevitable anticompetitive effects of its equity holdings in Continental, and to unduly prolong and complicate the trial of this matter, by offering extensive testimony going to the purported benefits of this alliance.
- Decisions of the U.S. Supreme Court and lower federal courts under Section 7 of the

Clayton Act make clear that an efficiencies defense cannot save an otherwise illegal agreement where any such efficiencies can be achieved through alternative means not posing a threat to competition.

! There is no credible basis in this case for finding that the alleged public benefits of the alliance can only be obtained through Northwest's continued ownership of a controlling voting interest in Continental.

  C Northwest's own experience with its KLM Dutch Airlines alliance demonstrates that equity is not necessary for the stability or success of an alliance; indeed,

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  C Continental has recently announced its desire to repurchase Northwest's stock interest and has emphasized that such a transaction would strengthen the carriers' alliance while preventing the harm to Continental caused by Northwest's impending control.

  C Both the government and defendant Continental are in complete agreement that Northwest's sale of its equity interest back to Continental would resolve the competitive concerns raised in this litigation by preserving Continental's independence.

Each of these grounds and the legal support for plaintiff's motion are explained in further detail in the accompanying memorandum of law. In addition, a proposed order precluding defendants from offering any evidence, including any lay or expert testimony, going to the alleged benefits of the Northwest/Continental alliance is attached hereto.

Plaintiff further requests that the Court set an expedited hearing on this motion in order to avoid needless, expensive and time-consuming expert discovery pertaining to these efficiencies issues.

DATED: April 11, 2000

Respectfully submitted,

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STATEMENT OF ISSUE

Whether the Court in a case under Section 7 of the Clayton Act, 15 U.S.C. § 18, should strike an efficiencies defense and all related testimony where the efficiencies are not tied in any way to the challenged transaction.

PRIMARY LEGAL AUTHORITY

Fed. R. Civ. P. 16

United States v. Philadelphia Nat'l Bank, 374 U.S. 321 (1963)

FTC v. University Health, Inc., 938 F.2d 1317 (11th Cir. 1991)

FTC v. Cardinal Health, Inc., 12 F. Supp. 2d 34 (D.D.C. 1998)

MEMORANDUM OF LAW IN SUPPORT OF PLAINTIFF'S
MOTION TO STRIKE DEFENDANTS' EFFICIENCIES DEFENSE

Plaintiff United States of America submits this memorandum in support of its Motion to Strike Defendants' Efficiencies Defense. The government's case squarely presents the issue of whether Northwest Airlines Corp.'s ("Northwest") ability to control Continental Airlines, Inc. ("Continental") by virtue of Northwest's acquisition of a majority of Continental's voting stock will diminish competition between the two carriers to the detriment of American travelers in violation of Section 7 of the Clayton Act, 15 U.S.C. § 18. Defendant Northwest seeks to obfuscate this issue by offering reams of evidence purporting to establish the alleged public benefits of a separate marketing and code share alliance between Northwest and Continental ("the alliance"). But plaintiff has not challenged the alliance under the antitrust laws; therefore, the proffered evidence is not relevant to the merits of the government's case and should be stricken.

The government's case focuses solely on the anticompetitive effect of Northwest's ownership of approximately 51% of the total voting power of Continental. The government did not challenge the broad marketing alliance Northwest and Continental entered into in January 1998, and the defendants have subsequently proceeded to implement a wide-ranging alliance relationship. Nowhere in the answers defendants filed to the government's complaint is there any mention of the alleged benefits of the alliance or any suggestion that such benefits are relevant to their defense of the government's Section 7 claim.

Now, having proceeded with their alliance without challenge from the government, Northwest is attempting to use the success of that alliance to justify its illegal acquisition of a controlling voting interest in Continental. The only efficiencies asserted by Northwest relate to public benefits stemming from the

alliance, not any cost savings or other alleged efficiencies related to the equity purchase. Northwest seeks to offer expert testimony from three separate witnesses going to these alleged benefits in an attempt to misdirect the Court's attention from an analysis of the inevitable anticompetitive effects of the equity transaction.

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Accordingly, evidence of any "benefits" from the alliance is irrelevant, would needlessly lengthen and complicate the trial of this matter, and should be stricken. Plaintiff requests that the Court rule on this motion expeditiously so that the parties to this case can avoid needless, time-consuming and costly expert discovery on this issue, much of which is currently scheduled to take place in the first two weeks of May.

The grounds supporting the government's motion are:

First, the law is clear that an otherwise illegal and anticompetitive transaction cannot be justified by efficiency arguments where, as in this case, those benefits can be achieved through alternative means not posing any threat to competition.

Second, there is no credible basis for finding that the alleged benefits of the alliance are "linked" to Northwest's continued ownership of a majority voting equity interest in Continental. In fact, Continental has concluded that Northwest's ownership of an equity interest in Continental is actually detrimental to the carriers' ongoing alliance relationship, and thus Continental has attempted to

repurchase the Continental stock currently held by Northwest. This is precisely the circumstance Northwest found itself in just four years ago, when it struggled (and ultimately succeeded) in convincing its alliance partner KLM Dutch Airlines ("KLM") that allowing Northwest to repurchase the equity interest KLM held in Northwest would advance both airlines' interests in enhancing the value of their alliance. Far from endangering the "stability" of the alliance, the divestiture by KLM of its stock interest in Northwest actually led the parties to enter into an enhanced alliance relationship, one which Northwest itself has heralded in its Annual Report as the "Alliance for Life."[1]

Third,

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This is not an adequate basis for an expert opinion, particularly where the prior statements and actions by many of those same executives contradict the very conclusion reached by their experts in this case.

Accordingly, plaintiff requests that this Court issue an order striking any defense premised on the alleged benefits of the alliance, including all expert testimony and/or expert reports relating to that defense. Plaintiff also respectfully requests a hearing on its motion at the Court's earliest convenience.

[1] *See* Northwest Airlines Corp., 1998 Annual Report, NW0282-02187 at 8. (Confidential Appendix, Tab 1) (For the Court's convenience, plaintiff has included copies of all of the documents and deposition testimony referenced in this brief in the accompanying Confidential Appendix.).

I. BACKGROUND

Defendants Northwest and Continental are the fourth and fifth largest domestic air carriers currently serving the United States. Until the stock transaction that led to the filing of this case, Continental was controlled by an investment group managed by financier David Bonderman known as Air Partners, which controlled a block of "supervoting" Continental Class A shares.[2] Air Partners had acquired this controlling interest in Continental at the time the carrier was emerging from bankruptcy in the mid-1990's.

Sometime in 1997, Continental and Northwest began exploring a possible marketing relationship between the two carriers. In particular, the carriers contemplated that a central feature of this marketing alliance would be "code sharing" -- a now common practice where carriers list each others' flights in airline computer reservation systems with their own designator code (typically with a "star" [*] added to indicate that it is a code shared flight). The principal effect of code sharing is to treat code shared flights as online connections in the computer reservations system; *i.e.*, to make it appear that the entire itinerary is operated by one carrier even though it actually involves connections operated by two or more different airlines partnered in the alliance. Online connections are generally preferred by most passengers, and receive preferential listings in the reservations system.

[2]While these shares only amounted to approximately 14% of the overall equity of Continental, they carried with them close to 50% of the total voting power of the company.

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Then in January 1998, Delta Airlines emerged as a potential bidder for Air Partner's controlling interest in Continental, as part of a proposal for a merger with Continental.

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Northwest and Continental ultimately executed an agreement to develop a long-term global alliance in late January 1998. The so-called "Master Alliance Agreement" included provisions for code sharing as well as reciprocal frequent flyer programs and executive lounge access.[4] At about the same time, Northwest entered into an agreement to acquire the controlling block of Continental stock from Air Partners, and Northwest and Continental reached consensus on a "Governance Agreement" temporarily placing certain restrictions on Northwest's ability to vote the Air Partner shares.

The government commenced this action on October 23, 1998, alleging that Northwest's acquisition of a controlling voting interest in Continental would diminish competition between the two airlines in violation of Section 7 of the Clayton Act, 15 U.S.C. § 18, and Section 1 of the Sherman Act,

[3]Continental's stock buyback plan would eliminate the supervoting block previously owned by Bonderman and, in the judgment of Continental's management, be the best strategy for ensuring the long-term stability and independence of the company.

[4]Master Alliance Agreement, 102 DOC 01480-94 (Confidential Appendix, Tab 2).

15 U.S.C. § 1. Subsequently, Northwest consummated its acquisition of the Air Partners stock, and modified its governance arrangement with Continental, purportedly to address the government's concerns with the transaction. The government filed an amended complaint on December 18, 1998, alleging that Northwest's ownership of a controlling voting interest in its competitor Continental would diminish competition between them in violation of the antitrust laws.

Northwest and Continental implemented code sharing pursuant to their alliance agreement beginning in January 1999, and have engaged in various joint marketing activities in support of the alliance. Both Northwest and Continental have publicly proclaimed the success of the alliance,

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[5]

Since the filing of the amended complaint, the parties have engaged in extensive factual discovery leading up to the exchange of opening expert reports in January 2000. At that juncture, defendants proffered expert reports containing voluminous statistical analyses and opinions going to the alleged benefits of the Northwest/Continental alliance.

[5] *See* NW0324-02198; CO 200095 (Confidential Appendix, Tab 3).

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[6]

[6] **REDACTED TEXT**

Thus, while Northwest estimates that it secured additional revenues of approximately **REDACTED** in the first year of the alliance, these are not the benefits the law cares about.

As demonstrated below, there is no basis for finding that Northwest's ownership of a

controlling interest in Continental is necessary for the carriers to continue to realize the benefits of their marketing alliance. Typically, marketing alliances in the airline industry are made without any carrier taking an equity stake in the other, much less a controlling stake like Northwest has. Even assuming, *arguendo*, that Northwest needed to acquire the stock at the time to enter into the alliance with Continental, there is no credible evidence to suggest that Northwest needs to continue holding the stock for the alliance to continue -- to the contrary, Continental's position is that the sale of the stock back to Continental would in fact strengthen the alliance. Thus, the government and defendant Continental are in complete agreement on an acceptable solution to the concerns raised in this litigation; only Northwest's recalcitrance stands in the way of a prompt and appropriate resolution. In any event, Northwest should not be permitted to raise irrelevant and immaterial arguments at the trial of this matter.

II. ARGUMENT

A. NORTHWEST CANNOT RELY ON AN EFFICIENCIES DEFENSE TO SAVE AN OTHERWISE ILLEGAL TRANSACTION

1. The Incipiency Standard of Section 7

Section 7 of the Clayton Act (as amended) was intended to stop one company from purchasing all or part of a competitor's stock or assets where, in the words of the statute, the acquisition *may* substantially lessen competition. Section 7 reads in pertinent part:

> 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 (1986) (emphasis added) (citations and quotations omitted).

The fact that section 7 is an "incipiency" statute leads to two important points. First, section 7 is predictive. The government need not show that an actual restraint has occurred, only that it "may" occur. *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). Second, section 7 only requires a showing that an acquisition "may" have a substantial anticompetitive effect -- the government is not required to demonstrate 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 America 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 probalistic and judgmental rather than demonstrable . . . is called for."); *Crouse-Hinds Co. v. Internorth, Inc.*, 518 F. Supp. 416, 422 (N.D.N.Y. 1980).

2. The Legal Framework For Evaluating Efficiencies Under Section 7

To rebut the argument that a stock purchase or combination violated section 7, defendants have traditionally argued that their combinations were justified, in spite of some competitive harm, because the combinations generated huge societal benefits or competitive efficiencies overall. When the United

States Supreme Court first considered this argument in light of the clear statutory language and legislative history of section 7, the Court found it lacking and rejected an efficiency defense. The Court instructed,

> We are clear, however, that a merger the effect of which "may be substantially to lessen competition" is not saved because, on some ultimate reckoning of social or economic debits and credits, it may be deemed beneficial. A value choice of such magnitude is beyond the ordinary limits of judicial competence, and in any event has been made for us already, by Congress when it enacted the amended § 7. Congress determined to preserve our traditionally competitive economy.

United States v. Philadelphia Nat'l Bank, 374 U.S. 321, 371 (1963); *see also Proctor & Gamble*, 386 U.S. at 580.

While lower federal courts have recently appeared more willing to consider efficiencies arguments in a section 7 case, no federal court has found an otherwise anticompetitive transaction legal under section 7 because of substantial efficiencies or societal benefits allegedly to be gained from the deal. In those cases where efficiencies claims have been advanced, courts have imposed strict requirements that defendants must satisfy in order for their efficiencies to even be considered. Two such requirements stand out:

- First, efficiencies cannot be used to justify a combination that is anticompetitive where those efficiencies can be achieved through other means that are not as competitively harmful.[7]

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[7] *FTC v. University Health, Inc.,* 938 F.2d 1206, 1222 n.30 (11th Cir. 1991) (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. Rockford Mem. Corp.*, 717 F. Supp, 1251, 1289 (N.D. Ill. 1989) ("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.), *cert. denied*, 498 U.S. 920 (1990); *FTC v. Staples, Inc.,* 970 F. Supp. 1066, 1088-90 (D.D.C. 1997) (holding that many of the claimed cost savings were not specific to the combination

< Second, the efficiencies defense is one for which defendants must carry the burden of proof by clear and convincing evidence.[8] As a matter of law, self-serving statements by defendants' executives alone are insufficient to carry that burden.[9]

Thus, Northwest must establish, with more than the self-serving testimony of its executives (and expert opinions premised solely on that self-serving testimony), that any efficiencies are unobtainable through alternative means. Because, as discussed more fully below, alliance-generated efficiencies will continue once Northwest sells its controlling interest in Continental, Northwest cannot prove that holding the Continental stock, with its attendant harm, is necessary to attain any of the purported alliance benefits. Therefore, Northwest's attempt to present evidence of alleged "benefits" of the alliance is legally deficient and should be rejected.

B. ANY ALLEGED BENEFITS OF THE ALLIANCE ARE NOT LINKED TO NORTHWEST'S OWNERSHIP OF VOTING CONTROL OVER CONTINENTAL

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since they could have been achieved if the firms remained independent); *United States v. Mercy Health Svcs.*, 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); *see also 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).

[8]*University Health*, 938 F.2d at 1223 (holding that a defendant must prove the efficiencies); *Staples*, 970 F. Supp. at 1088 (holding that defendants have the burden of proof); *Rockford Mem. Corp.*, 717 F. Supp. at 1289 (stating that the efficiencies defense is subject to a "very rigorous standard"; it must be proved with "clear and convincing evidence"); 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.").

[9]*University Health*, 938 F.2d at 1222-23 (holding that a defendant cannot carry its burden "based solely on speculative, self-serving assertions.").

1. The Northwest/KLM Experience Demonstrates That Equity Is Not Necessary For A Successful Alliance

The most compelling evidence on the issue of whether the performance of the Northwest/Continental alliance is linked to Northwest's equity stake in Continental comes directly from Northwest's own experience. Previously,

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In fact, the record relating to Northwest's relationship with KLM powerfully illustrates the very point Northwest now seeks to deny in this case -- that any alleged benefits of a marketing and code sharing alliance are not premised on the existence or continuation of equity shareholding by one alliance partner in another.

KLM was one of a number of investors that purchased a stake in Northwest during a leveraged buyout of the carrier in 1989. By 1992, KLM owned approximately 19% of Northwest's outstanding common stock, had an option for an additional 4.6%, and had the right to appoint three directors to Northwest's fourteen member Board of Directors. Northwest and KLM were also partners in a joint venture alliance which included extensive code sharing on the carriers' routes.

Despite what both Northwest and KLM proclaimed was a successful alliance, KLM's equity stake in Northwest increasingly became a source of conflict between the alliance partners. In particular, Northwest's management became convinced that KLM intended to acquire additional shares of Northwest in order to acquire control over the carrier. Eventually, this fear of "creeping control" by KLM led Northwest to adopt a "poison pill" rights plan effectively freezing KLM's ownership at existing levels. Litigation between the two alliance partners ensued.

The conflict caused by KLM's equity stake in Northwest ultimately threatened the stability of the carriers' marketing alliance.

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Ultimately, Northwest prevailed and, in 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. *See* NW 00230517-572 (Confidential Appendix, Tab 5). Northwest's 1998 Annual Report proclaims that this new agreement, executed only after KLM had agreed to divest its stake in Northwest, "**made the alliance between them virtually permanent**." Northwest Airlines Corp. 1998 Annual Report, NW0282-02187-02260, at 8 (emphasis added) (Confidential Appendix, Tab 1). Today, the Northwest/KLM alliance continues without any equity holdings by one partner in the other, and Northwest continues to tout its apparent success. The very same resolution has now presented itself in this litigation by virtue of Continental's offer to repurchase its shares from Northwest.

2. Continental Does Not Believe That Equity Is Necessary For The Northwest/Continental Alliance To Succeed

The lessons learned by Northwest during the Northwest/KLM alliance apparently also ring true with Continental's management.

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More recently, Continental has offered to repurchase all of the Continental stock currently owned by Northwest in a transaction that Continental believes will strengthen the NW/CO alliance, and that the United States believes would eliminate the harm to competition at the center of this case.

Both the sworn testimony of Continental's witnesses and the company's actual experience confirm what Northwest learned in connection with the Northwest/KLM alliance -- that equity is not an essential ingredient to a successful airline alliance.

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Even more striking, however, are the public statements made by Continental in recent months. These statements make it absolutely clear not only that Continental believes that Northwest's continued

ownership of a controlling voting interest in Continental is unrelated to the

performance of the carriers' marketing alliance, but that Northwest's equity stake in its competitor may actually be *detrimental* to Continental's competitiveness.

In January of this year, Mr. Bethune publicly expressed Continental's desire to repurchase the supervoting shares currently owned by Northwest, while noting that "[t]he alliance between Continental and Northwest is beneficial to both carriers, and any transaction would be designed to preserve and strengthen the benefits of the alliance." Minneapolis-St. Paul Star Tribune, January 19, 2000, at 1D (Confidential Appendix, Tab 8). Further explaining the reason for Continental's desire to repurchase the stock, Bethune stated:

> We'd like to remove the cloud of uncertainty [caused by Northwest's ownership of Continental stock] . . . . We don't think we need it; it has a downside for our employees**,** and we think both airlines' shares would appreciate without it.

Saint Paul Pioneer Press, January 19, 2000, 2000 WL 10324559, at *3 (Confidential Appendix, Tab 9). Similarly, in an Airline Financial News report, Bethune is quoted as stating, "[t]his stock ownership is not a necessary ingredient. Actually it has more downsides than it does upsides in things like investor confidence and employee confidence." Airline Financial News, January 24, 2000, 2000 WL 8773315 at *3 (Confidential Appendix, Tab 10).

The testimony from Continental's top executives goes directly to the heart of the issue presented in this motion and confirms the lack of any justification for a time-consuming analysis of the purported benefits of the Northwest/Continental alliance as part of the trial of this case.

3. Northwest's Experts Have No Basis For Asserting That The Alliance Benefits Are Linked To Equity Ownership

Balanced against all of the foregoing evidence concerning Northwest's past experience and

Continental's views on the role of equity in stabilizing an alliance are the unfounded and conclusory statements made by Northwest's experts in their expert reports.

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In the face of all of the contrary evidence, these so-called expert opinions lack any probative value and should be stricken.

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[10] It would be economically irrational for Northwest to sacrifice annual benefits in the range of **REDACTED** simply because it no longer holds a controlling stake in its alliance partner.[11] Such a course of action would also be inconsistent with the history of Northwest's involvement in its alliance with KLM.

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[10] **REDACTED TEXT**

[11] **REDACTED TEXT**

REDACTED TEXT Continental has made it clear, however, that it is prepared to acquire that block of stock from Northwest and then retire it, thus eliminating the feature of its capital structure that made Continental vulnerable to a takeover.

In short, while these experts' single-minded reliance on the self-serving deposition testimony of Northwest's own executives is understandable given the contrary factual evidence discussed above, it does not provide an adequate basis for an expert opinion. Accordingly, expert testimony relating to the alleged benefits of the alliance, and any analytical or empirical analysis thereof, should not be permitted at trial.

III. CONCLUSION

For all of the foregoing reasons, the Court should enter an order precluding defendants from offering any evidence at trial pertaining to the alleged efficiencies or other benefits associated with the Northwest/Continental alliance, and the Court should so direct at this time in order to avoid the lengthy and time-consuming discovery that would otherwise ensue.

DATED: April 11, 2000

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CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing PLAINTIFF UNITED STATES OF AMERICA'S MOTION TO STRIKE DEFENDANTS' EFFICIENCIES DEFENSE AND MEMORANDUM OF LAW IN SUPPORT THEREOF were served by hand and/or first-class U.S. mail, postage prepaid, this 11th day of April, 2000 upon each of the parties listed below:

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