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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

PLAINTIFF UNITED STATES OF AMERICA'S REPLY MEMORANDUM IN SUPPORT OF ITS MOTION TO STRIKE DEFENDANTS' EFFICIENCIES DEFENSE

Plaintiff United States of America submits this reply memorandum in further support of its Motion to Strike Defendants' Efficiencies Defense filed April 7, 2000. In that motion, we asked the Court to exclude evidence of alleged benefits from a collateral contract between Northwest and Continental -- the marketing "alliance" -- pointing out that Northwest has not shown that any alliance benefits (that is, efficiencies) were unachievable but for its ownership of a controlling interest in Continental.

Defendant Northwest has responded by burdening the record with an avalanche of paper that serves only to obfuscate the simple issue we have placed before the Court.[1] A prime example is Northwest's invocation of the so-called "governance safeguards" that Northwest repeatedly

[1]Northwest responded both by opposing the motion to strike and filing what they have styled a "Motion For Partial Summary Judgment Regarding The Equity-Alliance Linkage." The United States will respond separately to the partial summary judgment motion within the time allotted under the Local Rules.

asks this Court to rely upon to ensure Continental's "independence" from Northwest in the face of Northwest's ownership of 51% of the voting power of Continental. (Defendant Northwest Airlines' Memorandum In Opposition To Plaintiff's Motion To Strike, at 4, 11, 16-17 (hereinafter "Northwest Opp. Mem.")). Although the United States vigorously disputes Northwest's characterization of the law and evidence on this issue, the governance issue is not raised in this motion.[2] Northwest also argues that the United States has failed to show actual harm stemming from the equity transaction. (Northwest Opp. Mem. at 5, 12). That argument is likewise based on a misconception of the applicable law and a distortion of the factual record, but again is completely irrelevant to the instant motion.[3]

On the actual merits of our motion, Northwest's arguments are unpersuasive. Taken in the light most favorable to Northwest, the evidence we seek to exclude would show only that the equity transaction plus the alliance, taken together, produce consumer benefits. But for that evidence to be at all relevant in this lawsuit, Northwest must show that the benefits would be unachievable if Northwest sold the equity. This they simply cannot do.

Northwest argues that the equity transaction was "an absolute prerequisite" to the formation of the alliance. (Northwest Opp. Mem. at 8). However, even conceding for purposes of the instant motion this is true (which it is not), and even conceding that this is relevant (which it

[2]The government will clarify the record on this point at the appropriate juncture.

[3]Section 7 does not require the government to prove that prices have in fact risen; rather, only that there is a "reasonable probability" of substantially lessened competition. *FTC v. Proctor & Gamble Co.*, 386 U.S. 568, 577 (1967); *see also* Memorandum of Law In Support of Plaintiff's Motion to Strike at 8-9 and cases cited therein (hereinafter "U.S. Mem.").

may not be), Northwest cannot meet its burden of showing that the alliance benefits are unobtainable without Northwest's *continued* ownership of voting control over Continental.

The overwhelming weight of the evidence confirms that Northwest's continued ownership of a controlling block of Continental stock is not necessary for the success of the alliance.

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(*See* Master Alliance, ¶ 2(b) and Exhibit C thereto, ¶ 16(b)).

Significantly, Defendant Continental has clearly and publicly taken the position that the sale of Northwest's equity stake in Continental back to Continental would serve to *strengthen* the alliance, thereby preserving any attendant benefits to American consumers while simultaneously eliminating the competitive harm by restoring Continental's true independence. (*See* U.S. Mem. at 15-17). Continental's decision to enter into an alliance with Northwest was in no way dependent upon Northwest's perpetual ownership of Air Partners' control block of Continental stock. Continental has recently made a formal offer to Northwest to repurchase the stock and to agree to various contractual provisions designed to further secure each carriers' commitment to their ongoing alliance. (*See* U.S. Mem. at 16-17).

The alliance has been financially lucrative for both Northwest and Continental; it simply makes no economic sense for Continental to risk that relationship and thereby place the

substantial revenues generated by the alliance in jeopardy. On the other hand, it seems perfectly logical for Continental to want to ensure its own corporate autonomy, and to eliminate Northwest's ownership of a supervoting block of stock which undermines Continental's competitive independence.

As compelling as this evidence may be, Northwest and its senior executives have also confirmed by their prior words and actions that equity is not an essential element to a successful alliance. In fact, Continental's attempt to negotiate a repurchase of its stock from Northwest is exactly the same approach Northwest advocated and eventually succeeded in enacting to strengthen its alliance with another carrier -- KLM.

With KLM, Northwest chafed under the significant influence and threat of control caused by their alliance partner's ownership of Northwest stock amounting to just 19% of Northwest's total voting power, arguing at every opportunity that such a relationship was harmful to their alliance. Yet, here Northwest argues that it needs absolute voting control over Continental to "stabilize" the carriers' alliance. Try as they might to distinguish and downplay their past actions, Northwest's experience with the KLM alliance confirms the fundamental premise behind plaintiff's motion to strike.

Northwest maintains that the Northwest-KLM alliance was "unstable, precisely because it lacked the safeguards against influence and control that make Continental's autonomy from Northwest 'absolute.'" (Northwest Opp. Mem. at 20).

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And, in any event, this

argument entirely misses the point of the KLM experience: ownership of equity is unnecessary to achieve the benefits of a marketing and code sharing alliance. At Northwest's insistence, KLM divested its Northwest stock, and the two carriers implemented an amended contractual relationship which improved their alliance relationship.[4] Northwest has publicly pronounced that the new contractual agreement with KLM has "made the alliance between them virtually permanent." Northwest Airlines Corp. 1998 Annual Report, NW0282-02187-02260, at 8. (Tab 1 to the Confidential Appendix which accompanied the government's opening motion).

Northwest further contends that the profit pooling mechanism between it and KLM somehow equates to a form of "equity" that secures the existing alliance between those carriers. (Northwest Opp. Mem. at 20). This assertion can not save the equity arrangement here because all airline code sharing alliances contain mechanisms for allocating revenues as a means of compensating each alliance partner for providing service. Moreover, the existence of a profit pool does not preclude any airline from taking over Northwest or KLM, nor does it compel either partner to remain in the alliance. Instead, what keeps the carriers in the alliance are the profits themselves -- precisely the reason Continental says it will remain in the alliance with Northwest even after it buys back its equity. Thus, the existence of a profit pooling arrangement certainly does not provide a meaningful basis for distinguishing the KLM experience.

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[4] **REDACTED TEXT**

Letter from John Dasburg to Pieter Buow of 7/16/96, NW0189-02442-43, at 1-2 (emphasis added)(Confidential Appendix, Tab 4).

Finally, Northwest couches an argument in its "facts" section that a takeover of KLM is "unlikely" because KLM is protected by Dutch and European antitrust laws. (Northwest Opp. Mem. at 7). This observation is completely illogical and miscomprehends the relevance of the KLM experience. It was KLM that held equity in Northwest, a U.S. corporation. The Dutch and European laws, which did not protect Northwest from becoming a takeover target, therefore did nothing to protect KLM's interest in that regard. Thus, Northwest was in the same position as to KLM that Continental is with respect to Northwest: equity is not necessary to make the alliance successful or to ensure the stability of the alliance.

In the end, all that Northwest is left with is the argument that the Court must save it from itself.

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(Northwest Opp. Mem. at 9). In other words, Northwest would have this Court believe that Northwest would consider voluntarily walking away from an alliance that, in its first year of operations, **REDACTED TEXT** and all because of a perceived threat that Continental might be taken over by one of Northwest's competitors. (*See* U.S. Mem. at 6). In any real world sense, this testimony does not seem credible given

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In short, Mr. Dasburg is presumably a savvy businessman who would not "cut off his nose to spite his face."

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CONCLUSION

Continental has offered to repurchase the controlling block of stock from Northwest and restructure its alliance relationship with Northwest to address any possible concerns about the stability of that alliance. Divestiture of Northwest's holdings back to Continental would resolve this case -- protecting the public interest in competition. While Northwest may continue to resist this option precisely because it does not want to give up its ability to control its competitor Continental, there is no basis for finding that the alleged efficiencies associated with the alliance are linked to Northwest's continued ownership of voting control over Continental.

For all of the foregoing reasons, and those stated in the government's opening motion and accompanying memorandum, plaintiff's motion to strike should be granted.

DATED: May 26, 2000

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing PLAINTIFF UNITED STATES OF AMERICA'S MOTION FOR LEAVE TO FILE A REPLY MEMORANDUM IN EXCESS OF FIVE PAGES and REPLY MEMORANDUM IN SUPPORT OF ITS MOTION TO STRIKE DEFENDANTS' EFFICIENCIES DEFENSE were served by hand and/or first-class U.S. mail, postage prepaid, this 26th day of May, 2000 upon each of the parties listed below:

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