Testing the Limits of Federal Tolerance: Strategic Alliances in the Airline Industry

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I. Introduction

In the business world, different definitions exist for the term "strategic alliance." This business activity may include minority equity investments, special supply arrangements, combined research and development, joint purchasing, joint production, and joint marketing through co-promotion or co-branding.[1] Strategic alliances are often viewed as synonymous with "joint ventures," which have been defined as "all collaborations, short of a merger, between or among entities that would have been actual or likely potential competitors in a relevant market absent that collaboration."[2] Under any definition, the goal of a strategic alliance is the same - pursuit of strategic objectives by enabling the strategic alliance partners to use their complementary resources efficiently and effectively.[3]

Strategic alliances are becoming a common mechanism for businesses to seek economies of scale, through use of these complementary resources, without an outright merger. In the last decade the number of these alliances increased by about twenty-five percent per year.[4] While the concept of strategic alliances elicits abundant attention from management journals, it attracts little attention in antitrust law review literature.[5] The management journals explain that strategic alliances respond to the increased need for cooperation to maintain profitability in complex tech-

1. William J. Kolasky, Jr., *Antitrust Enforcement Guidelines for Strategic Alliances*, PRAC. L. INST., July/Aug., 1998, at 501.
2. *See* Comment and Hearings on Joint Venture Project, 62 Fed. Reg. 22,945 (Apr. 28, 1997).
3. *See* Kolasky, *supra* note 1, at 501.
4. *Id.*
5. *Id.* at 502.

nologies and global markets.[6] The journals expound five factors that contribute to the increased need for cooperation:

> 1. *Globalization.* Competing in a global economy requires a much larger scale and scope of operations . . . .
> 2. *Increasing economies of scale and scope.* More generally, in more and more industries, the scale and scope of the optimal-sized firm seems to be expanding dramatically due to technological change . . . .
> 3. *Specialization.* At the same time as the economies of scale and scope in individual markets increase, there is increased consciousness of the diseconomies of a large firm trying to do everything itself. The current business school mantra is to concentrate on your core competencies . . . .
> 4. *Complexity.* Many key technologies have grown so complex that few if any companies can master them all, especially considering the risk involved . . . .
> 5. *Pace of technological change.* R&D alliances are frequently a response to the need to move quickly in rapidly changing markets. Alliances are flexible enough to adapt to changing market conditions, have comparatively low entry and exit costs, and can be abandoned if the market, or the technology, takes a different course.
> 6. *Network effects.* In technology-driven markets, network effects make it critical that a firm capture the first mover advantage so that its technology becomes the industry standard . . . .[7]

Additionally, strategic alliances can be a key factor to the reduction of transaction costs, by coordinating firms' interests to limit the chance of opportunism—i.e., where a firm attempts to capture all gains from an investment—and by extinguishing the need to continuously negotiate new deals in response to convoluted and dynamic business decisions.[8] This transaction cost reduction is usually carried out via reciprocity and exclusivity agreements; sometimes, the alliance relationship is further anchored through co-ownership of assets or though mutual equity investments.[9]

Many of the largest attempted strategic alliances occurred in the airline industry, where they were used to surmount obsolescent hurdles to enable airlines to compete internationally.[10] Several obstacles exist for these domestic airlines desiring an alliance with foreign carriers to ensure increased international reach: limitation on foreign ownership, the existence of entrenched local airlines, differing cost structures, and diverse preferences and customs.[11] Although these obstacles exist to dissuade airlines to embark on strategic alliances with foreign carriers, several do-

6. *Id.*
7. *Id.* at 502-03 (emphasis added).
8. *Id.* at 503.
9. *Id.*
10. *Id.*
11. *Id.*

mestic airlines nonetheless initiate these alliances because "customers are demanding integrated services that cross international lines."[12]

While management journals explain the business rationale for strategic alliances, few litigated cases expressly address the issue from a public policy perspective.[13] However, the United States Department of Justice (DOJ) conducted several recent investigations to study the effect, from an antitrust vantage point of strategic alliances in the airline industry.[14] This Note focuses on international and domestic strategic alliances in the airline industry. It focuses on antitrust and overall public policy concerns. Part II of this Note discusses "code-sharing," the prevalent way strategic alliances are accomplished in the airline industry.[15] Part III examines recent federal regulatory analyses of strategic alliances. Part IV theorizes a legal standard for airline strategic alliances and applies that standard to a recent test case.

II. CODE-SHARING

A. DEFINITION

"Code-sharing" is defined by the DOJ to mean "as little as allowing another airline to use its code when it sells seats on your plane on a route in which it cannot compete."[16] However, code-sharing "also can mean as

12. *Id.*

13. *Id.* at 502.

14. Carole A. Shifrin, *Tough Policy Questions: A Deregulation Legacy*, AVIATION WK. & SPACE TECH., Nov. 9, 1998, at 51.

15. In this Note, references to code-sharing alliances, strategic alliances, and joint ventures are meant to be synonymous, although code-sharing is not completely synonymous with strategic alliances or joint ventures. A strategic alliance, in the context of the airline industry, can encompass fusion of frequent flyer programs, sharing of airport lounge space, locating gate space near the alliance partner's gate space for marketing association purposes, and, of course, code-sharing. The synonymous use is mostly because code-sharing is the most significant aspect of an airline strategic alliance or joint venture.

16. Roger W. Fones, *International Code Sharing—An Antitrust Perspective*, 10 AIR & SPACE L. 1, 5 (1995) [hereinafter *International Code Sharing*]. Mr. Fones is the Chief of the Transportation, Energy, and Agriculture Section, Antitrust Division, of the DOJ. *Id.* at n.a1. An example applying the DOJ's code-sharing definition is the planned domestic code-sharing alliance involving Northwest Airlines and Continental Airlines. *See Pilots' Union Urges Intervention to Block 'Virtual Merger' of Northwest, Continental Airlines*, PR NEWSWIRE, Nov. 5, 1998. *See also infra* Part IV.B.2. If the code-sharing alliance is initiated, the two carriers would be allowed to ticket passengers on each others' aircraft as though they were their own. *Id.* Gordon Bethune, Chairman and Chief Executive Officer of Continental Airlines, recently testified before the Antitrust, Business Rights, and Competition Subcommittee of the Senate Committee on the Judiciary; he gave an example of code-sharing and how the Northwest and Continental code-sharing plan would affect the two airlines' customers:

> The creation of new online options for the U.S. consumer is a key benefit of any alliance. Take a market like Madison, Wisconsin. Northwest is currently one of nine airlines flying to Madison. Continental does not fly to Madison at all. Now let's consider destinations like Panama City, Panama or Midland, Texas. The only online option cur-

much as comprehensive integration of marketing and operations that involve joint decisions on price, capacity, schedule, and other competitively sensitive matters."[17] To the DOJ, code-sharing arrangements are basically types of corporate combinations that "fall somewhere between outright merger[s] and traditional arm's length interlining agreements."[18]

B. Benefits and Detriments

The DOJ acknowledges both benefits and detriments of code-sharing.[19] Benefits include pro-competitive aspects that benefit the traveling public: creation of new service, improved existing service, lower costs, and increased efficiency.[20] However, "code sharing can also be a mask for anti-competitive arrangements between actual or potential competitors to allocate markets, limit capacity, raise fares, or foreclose rivals from markets—all to the ultimate injury of consumers."[21] Distinguishing between these benefits and detriments is essential for airlines, aviation policymakers, and antitrust enforcement personnel.[22]

III. Analyses by Regulatory Agencies

A. Department of Transportation Authority

The United States Department of Transportation (DOT) is the federal regulatory body with the power to grant antitrust immunity to code-sharing partners and approve code-sharing agreements.[23] The DOT is granted this authority through 49 U.S.C. sections 41308 and 41309.[24] Section 41309 authorizes the DOT to approve agreements involving international air transportation.[25] To approve such an agreement, the DOT must find that the agreement is not contrary to the public interest and not

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> rently available between Madison and these points is American [Airlines]. Continental does not serve Madison; Northwest does not serve Panama City or Midland. By linking the systems, both airlines now serve these cities and offer online connections between them. Competition and choice have been created.

Aviation Agreements: Hearings on International Aviation Agreements and Anti-Trust Immunity Before the Subcomm. on Antitrust, Business Rights, and Competition of the Senate Comm. on the Judiciary, 1998 WL 11516012, at *3 (1998) (written testimony of Gordon Bethune, Chairman and Chief Executive Officer of Continental Airlines, Inc.) [hereinafter *Aviation Agreements*].

17. *International Code Sharing, supra* note 16, at 5.

18. *Id.*

19. *Id.*

20. *See Aviation Agreements, supra* note 16, at *3.

21. *See International Code Sharing, supra* note 16, at 5.

22. *Id.*

23. *See* Joint Applic. of United Air Lines, Inc. and Air Canada, Ltd.: Dep't of Transp. Order No. 97-9-21, at 1 (Sept. 19, 1997) [hereinafter UAL/AC Joint Applic.].

24. *See* 49 U.S.C. §§ 41308 & 41309 (1998).

25. *Id.* at § 41309.

otherwise in violation of the statute.[26] The DOT is precluded from approving an agreement that substantially reduces or eliminates competition unless the agreement is necessary to meet a serious transportation need or to achieve important public benefits and the Department finds that those needs or benefits cannot be obtained by any reasonably available alternative that is materially less anti-competitive.[27] Public benefits can include international comity and foreign policy considerations.[28] Section 41308 authorizes the DOT to grant antitrust immunity to an agreement approved under section 41309 if it finds that immunity is required by the public interest.[29] Unless an approved agreement substantially reduces or eliminates competition, the DOT usually withholds antitrust immunity as being unnecessary.[30] However, if there is a strong showing on the record that antitrust immunity is required by the public interest and that parties will not proceed without it, the Department may nonetheless grant immunity to permit the transaction to go forward.[31]

B. Department of Transportation and Department of Justice Authority[32]

1. *Authority and Code-Sharing Nature*

The DOJ is empowered to enjoin an agreement or arrangement not given DOT approval or antitrust immunity pursuant to Section 15 of the Clayton Act, as amended.[33] The DOJ may also file suit pursuant to Section 4 of the Sherman Act[34] to prevent and restrain violations of Section 7 of the Clayton Act, as amended,[35] and Section 1 of the Sherman Act.[36]

26. *Id.*

27. *Id.*

28. *See* Joint Applic. of American Airlines, Inc. and British Airways PLC: Dep't of Transp. Order No. 97-3-34, at 1 (Mar. 21, 1997) [hereinafter AA/BA Joint Applic.].

29. *See* 49 U.S.C. § 41308 (1998).

30. *See* AA/BA Joint Applic., *supra* note 28, at 1.

31. *Id.*

32. DOT authority is mentioned again in Part III.B. because both the DOJ and the DOT use the open skies analysis discussed in Part III.B.4.

33. *See* 15 U.S.C. § 25 (1998).

34. *See id.* at § 4.

35. *See id.* at § 18. The amended Section 7 of the Clayton act would govern where an airline strategic alliance crosses over into equity ownership. *See id.* It provides:

> No person engaged in commerce or in any activity affecting commerce shall acquire, directly or indirectly, the whole or any part of the stock or other share capital and no person subject to the jurisdiction of the Federal Trade Commission shall acquire the whole or any part of the assets of another person engaged also in commerce or in any activity affecting commerce, where in any line of commerce or in any activity affecting 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.

Id. *See* United States v. Penn-Olin Chemical Co., 378 U.S. 158, 167 (1964) (holding that Section 7 of the Clayton Act applies to joint ventures). A strategic alliance crossover into equity ownership has been alleged in a filed DOJ complaint attempting to enjoin Northwest Airlines' pro-

If a code-share arrangement simulates a merger, the DOJ "will analyze it that way."[37] A significant factor the Department intends to study is whether code-sharing partners are true or potential horizontal competitors and, if they are, in what city pairs.[38] Here, from an antitrust viewpoint, the DOJ is concerned about the situation where only a few airlines compete on a city pair in which the strategic partners enter into a code-sharing agreement.[39] The Department recognizes that most code-sharing agreements, typically governing a domestic and a foreign carrier, have raised few horizontal concerns because the code-sharing partners are not direct competitors and likely will not become direct competitors in the near future.[40]

2. Hub-to-Hub Markets

Despite the DOJ's recognition that few horizontal concerns arise in code-sharing, it has also stated that there are "numerous situations in

posed purchase of controlling shares in Continental Airlines. *See* United States v. Northwest Airlines Corp., No. 98-74611 (E.D. Mich. filed Oct. 23, 1998), at 3 (obtained at <http://www.usdoj.gov/atr/cases/f2000/2023.htm>) [hereinafter U.S. v. Northwest]. *See infra* Part IV.B.2.

36. *See* 15 U.S.C.A. § 1 (West 1998). Section 1 of the Sherman Act is the primary arsenal the DOJ has in blocking future code-sharing relationships if it chooses to do so. The provision, which does not require equity ownership, provides:

> Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is hereby declared to be illegal. Every person who shall make any contract or engage in any combination or conspiracy hereby declared to be illegal shall be deemed guilty of a felony, and, on conviction thereof, shall be punished by fine . . . .

Id. See Pan Am. World Airways, Inc. v. United States, 371 U.S. 296, 306 (1963) (holding that joint ventures may be combinations in violation of the Sherman Act). The DOJ has cited Section 1 of the Sherman Act in its attempt to enjoin the Northwest Airlines/Continental Airlines equity/code-sharing agreement discussed above. *See U.S. v. Northwest, supra* note 35, at 3. *See infra* Part IV.B.2. Recall, the Northwest/Continental transaction could not be granted approval or antitrust immunity under sections 41309 or 41308, as those provisions only apply to international agreements.

37. *See International Code Sharing, supra* note 16, at 5.

38. *See* U.S. v. Northwest, *supra* note 35, at 7. "Horizontal alliances" in the airline industry, according to Gordon Bethune of Continental Airlines, are alliances which offer code-sharing between alliance partners with overlapping service or routes. *See Aviation Agreements, supra* note 16, at *4. Bethune states that horizontal alliances are characterized by: "[r]eduction of competition without substantial consumer benefits," "[l]arge combined market shares," "[r]egional domination," "[c]ontrol of the largest or most important gateways," and "[c]losure of key gateways to expansion or competition." *Id.* at *4-*5. A "city pair" is an airline route that serves two cities, usually on a nonstop basis. For example, a route from Dallas-Fort Worth (DFW) to Minneapolis-St. Paul (MSP), including a route from MSP to DFW, would constitute a city pair.

39. *See International Code Sharing, supra* note 16, at 5. "Any time two of very few airlines on a city pair act jointly, whether in a domestic U.S. market or an international city pair, we are concerned about the effect on competition." *Id.*

40. *See* U.S. v. Northwest, *supra* note 35, at 6.

which potential code-share partners are, at least to some extent, actual or potential competitors."[41] Primarily, the DOJ is troubled by the situation in which code-sharing partners have a hub at one or both of the endpoints of any given route.[42] To the Department, "the most serious threat to competition is presented when two carriers enter a code-share or other joint marketing agreement that includes a hub-to-hub market."[43] If hub-to-hub routes are covered in a code-share alliance, and antitrust immunity is not granted by the DOT,[44] the DOJ considers the possibility that competitive harm will occur to competing airlines on these routes.[45] In this consideration, the DOJ ascertains whether both airlines have flight operations in the market, as well as the extent to which pricing, capacity, and scheduling decisions remain autonomous.[46] If autonomy is not achieved by the code-share agreement, the DOJ searches for evidence that, absent the agreement, one of the alliance partners would not likely enter a market or, is likely to exit that market if the agreement were not established.[47] Concurrent with this examination, the DOJ will inquire

41. *See International Code Sharing*, *supra* note 16, at 6.

42. Edward H. Phillips, *U.S. Antitrust Suit Targets Northwest/Continental*, AVIATION WK. & SPACE TECH., Nov. 2, 1998, at 48. *See also* U.S. v. Northwest, *supra* note 35, at 12. A "hub" is a primary operations location for any given airline. The term was derived after deregulation of the airline industry in 1978, which gave birth to a number of airlines operating on a "hub-and-spoke" system. For example, American Airlines has as its primary hubs Dallas-Fort Worth International (headquarters), Chicago O'Hare International, New York Kennedy International, and Miami International airports. Between these hub airports, a large concentration of American flights can be found. Using part of the Bethune example in footnote 14 above, assume a passenger wishes to travel from Dallas-Fort Worth to Madison, Wisconsin. This passenger will have to fly into Chicago O'Hare, whereby he or she will likely catch American's commuter subsidiary, American Eagle, for a flight into Madison. The flight from Dallas-Fort Worth to Chicago was a hub-to-hub flight, whereas the flight from Chicago to Madison was a "spoke" flight.

43. *See International Code Sharing*, *supra* note 16, at 6. To illustrate this situation, consider American Airlines again with its proposed domestic strategic alliance partner US Airways (USAir). *See* Katie Fairbank, *Allies in the Air*, HOUS. CHRON., Apr. 25, 1998, at B1. One of USAir's primary hubs is Pittsburgh. With the American-USAir code-sharing arrangement, the DOJ would be concerned, for example, about code-sharing from Pittsburgh to Dallas-Fort Worth and Dallas-Fort Worth to Pittsburgh. Because American and USAir would control a large number of the flights between these cities, and arguably *all* of the nonstop flights, the two carriers, the DOJ would assert, could potentially stifle competition on that route, precluding entry by other carriers or perhaps driving other carriers out of that market.

44. *See supra* Part III.A.

45. *See* U.S. v. Northwest, *supra* note 35, at 9.

46. *Id.* at 11. The DOJ defines "autonomous" to mean more than just maintaining the legal right for each code-share partner to act alone. *See International Code Sharing*, *supra* note 16, at 8. The DOJ states that the code-share agreement must be structured more like a traditional interline pact, where there would be less likelihood of competitive harm. *Id.* In achieving this autonomy, the DOJ contemplates that the agreement should "give[ ] each carrier the strongest possible incentive to sell seats on the flights it operates, rather than on those of its code-share partner . . . ." *Id.*

47. *See* U.S. v. Northwest, *supra* note 35, at 9.

whether the alliance partners' collective cooperation on the hub-to-hub market is "necessary to achieve significant pro-competitive efficiencies" for service to cities beyond the hub cities which are served and benefited by the code-share mechanism.[48] However, the DOJ emphasized that "[t]he evidence that such efficiencies outweigh the potential competitive harm in the hub-to-hub market must be clear."[49]

3. *"Open Skies" Bilateral*

a. DOT/DOJ Open Skies Policy[50]

The hub-to-hub market and interline passenger analyses are only the initial competitive studies the DOJ undertakes to ascertain whether code-sharing alliances violate the antitrust laws.[51] Another factor considered is whether a hub-to-hub market adheres to an "open skies" bilateral.[52] "Open skies" contemplates the possibility of non-hub carrier entry into the market in which the code-share partners serve.[53] The DOJ examines the likelihood of such entry if the alliance partners strive to increase fares or limit service.[54] The DOT recently discussed open skies in its own parlance:

> International traffic rights are essentially unrestricted in an open-skies agreement. Agreements permit United States carriers to serve from points behind the United States and intermediate points, to any point or points in the partner's territory and to points beyond that country. Similarly, it would permit partner's flag carriers to serve from points behind their homeland, via the homeland and intermediate points, to a point or points in the United States and beyond.[55]

Open skies issues often surface in the realm of international travel; for example, international gateway-to-gateway city pairs are often governed by restrictive bilateral agreements, the antithesis of open skies,

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48. *See International Code Sharing*, *supra* note 16, at 8. To see how beyond-hub cities are benefited by code-sharing, see *supra* note 16 and accompanying text. In other words, if hub-to-hub code-sharing is essential to achieve the efficiencies associated with an airline using its alliance partner to help extend its service reach for its customers, the DOJ might allow such cooperation even on hub-to-hub routes.

49. *Id.*

50. Both the DOT and the DOJ utilize the open skies analysis. The DOT uses the doctrine in its consideration of whether to grant approval and antitrust immunity under sections 41309 and 41308. The DOJ, on the other hand, uses the doctrine in its antitrust assessment. Despite the different uses, the basic analysis is the same.

51. *Id.* at 6.

52. *Id.*

53. *See* AA/BA JOINT APPLIC., *supra* note 28, at 5.

54. *See International Code Sharing*, *supra* note 16, at 6.

55. United States Department of Transportation—Office of the Assistant Sec. for Aviation and Int'l Affairs, *U.S. Open Skies Agreements*, (Dec. 4, 1998), at 1, <http://ostpxweb.dot.gov/aviation/IntAv/OpenSky.htm> [hereinafter *Open Skies*].

which limit entry into a country to only certain foreign carriers and limit the frequency of that entry.[56] In response to carriers opposing the joint application of American Airlines and British Airways for approval and antitrust immunity for the proposed code-sharing alliance,[57] the DOT stated:

> Under our established policy and practice, we will not grant approval and antitrust immunity without an Open-Skies agreement . . . . We reaffirm that policy and practice here. We are unwilling to approve and immunize an alliance if other airlines are unable to provide effective competition to the alliance partners. This policy is directly relevant here, for U.S. airlines have had little or no opportunity to enter or expand service at London's Heathrow airport, British Airways' hub, due to policies applied by the United Kingdom. Obviously, we could not grant approval and immunity for the Joint Applicants' alliance unless other U.S. airlines could compete effectively in the markets affected by the Alliance, since otherwise the Alliance would not be in the public interest.[58]

The DOT and DOJ thus assert that a liberal bilateral reduces antitrust concerns that might otherwise flow from an international code-sharing agreement.[59] While a liberal bilateral does diminish antitrust concerns,

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56. *See International Code Sharing, supra* note 16, at 8. A "gateway-to-gateway" city pair is essentially a city pair which serves two markets that are the launching points for international service to countries. For example, a flight from Washington Dulles International to London Heathrow International would be a gateway-to-gateway market, because the airports serve as launching points for their respective countries. "Bilateral agreements" are agreements transportation agencies of two different countries enter into whereby the number of foreign carriers entering into any given country's domestic market is limited by certain carriers and a certain number of flights per a specific time period. *See e.g., Aviation Agreements, supra* note 16, at 6 (discussing American Airlines' request for antitrust immunity from its proposed code-sharing alliance with British Airways).

57. *See* AA/BA JOINT APPLIC., *supra* note 28, at 2.

58. *Id.*

59. *Id.* at 4. Besides the open skies elements discussed earlier, the other elements include:

(1) no limits on the number of airlines that may be designated by either country;

(2) unrestricted capacity and frequencies on all routes;

(3) full fifth-freedom (local international traffic) and sixth-freedom (traffic from behind home country to other party) rights, unlimited "change of gauge" (change of aircraft type at any points on the route), coterminalization, and substantial routing flexibility;

(4) a double-disapproval pricing provision on all routes, including fifth/sixth freedom markets (both countries must agree to disapprove a fare to prevent it from taking effect);

(5) liberal charter arrangements (the least restrictive charter regulations of the two governments would apply regardless of the origin of the flight);

(6) open code-sharing opportunities;

(7) the right to convert earnings and remit them in hard currency promptly and without restrictions;

(8) the right of airlines to perform ground handling of their own passengers and cargo;

(9) procompetitive doing-business provisions, including commercial opportunities, user charges, fair competition, and intermodal rights;

the DOJ notes that all code-sharing agreements are different with different impacts on competitors and consumers. In other words, the DOJ "examine[s] all of the facts and circumstances surrounding each code-share agreement and make[s] [its] competitive assessment on a case-by-case basis."[60]

b. DOT/DOJ Open Skies Policy Applied - Oneworld Alliance[61]

On January 10, 1997, Great Britain-based British Airways and Ft. Worth-based American Airlines filed a Joint Application with the DOT for a grant of approval and antitrust immunity to a sweeping strategic alliance.[62] This alliance, recently named "Oneworld,"[63] is, in its most modest form, a cooperative agreement whereby the two carriers will code-share on beyond-gateway markets, fuse frequent-flier programs, and share airport lounges.[64] The strategic alliance's not-so-modest form is largely unknown because the details of the agreement are confidential between the carriers; however, industry experts speculate that the linkup agreement could involve much more than the above-referenced provisions: joint determination of pricing and scheduling, coordinated consideration of aircraft utilization for specific routes, and dual assessment of travel agent commissions.[65] Moreover, a pooling of revenues from British-American operations is also mentioned as a possible agreement provision.[66]

The DOT concluded, via an order issued on March 21, 1997, that it was in the "public interest" to commence *processing* the AA/BA alliance

(10) an explicit commitment for nondiscriminatory operation of, and access for, computer reservations systems; and

(11) U.S. model provisions on safety and security.

See Open Skies, *supra* note 55, at 1-2.

60. *See International Code Sharing*, *supra* note 16, at 8.

61. Although both agencies examine the open skies policy, discussion of the AA/BA proposed alliance here is limited to the DOT's consideration of that policy. This limitation to DOT discussion is logical because a DOT granting of approval and antitrust immunity under sections 41309 and 41308 would mute the DOJ's consideration of the antitrust aspects of the alliance. However, the DOJ does provide antitrust input to the DOT in the latter's assessment of whether to grant approval and antitrust immunity. *See* AA/BA JOINT APPLIC., *supra* note 28, at 6.

62. *See* AA/BA JOINT APPLIC., *supra* note 28, at 1.

63. *See* Charles Goldsmith, *British Airways, American Air Face Foes Even on Gradual Phase-In of Union*, WALL ST. J., Nov. 2, 1998, at 23A.

64. *Id.*

65. *Airline Joint Agreement Antitrust Implications: Hearings on The Antitrust Implications of the Proposed British Airways-American Airlines Alliance Before the Subcomm. on Antitrust, Business Rights, and Competition of the Senate Comm. on the Judiciary*, 1997 WL 10569895, at 3 (1997) (testimony of Barry P. Simon, Senior Vice President, International of Continental Airlines, Inc.) [hereinafter *Airline Joint Agreement*].

66. *Id.*

agreement even though open skies negotiations were (and are) ongoing between the DOT and the British government.[67] Although the Order initially appeared to be a departure from the DOT's long-held policy of open skies prior to approval of international strategic alliance agreements, the Department quickly noted that it was not ruling on the merits of the application.[68] The Order provided, "[T]his *procedural decision* reflects no change in our substantive policy, which we reaffirm here, i.e., that the completion of an Open-Skies agreement is one necessary precondition to any decision to grant approval and immunity, even tentatively, to a proposed alliance, which must also be found to be pro-competitive."[69] Nevertheless, the DOT determined that, since the "application [would] be difficult to process in a timely manner," processing of the AA/BA agreement should begin "to avoid undue delay in providing the substantial public benefits of implementing an Open-Skies regime."[70] The Department determined that it would ultimately reach a decision as to whether the application is both pro-competitive and in the interests of United States consumers after both de jure and de facto open skies with Great Britain is achieved.[71]

Currently, an Open Skies agreement does not exist between the DOT and Great Britain/European Union officials.[72] American Airlines and British Airways officials now claim their companies are entitled to go forward with their strategic alliance under existing treaties.[73] However, DOT officials made it clear that they are hesitant to approve even modest continued cooperation between carriers without a new liberalized Open Skies agreement.[74] Because American Airlines and United Airlines are the only United States carriers currently allowed to utilize "London's coveted Heathrow Airport," the DOT continues to deny outright approval and antitrust immunity to the AA/BA strategic alliance until other United States carriers are guaranteed access to Heathrow.[75] The major stumbling-block in the consummation of the strategic alliance appears to be British Airways' unwillingness to surrender 267 weekly Heathrow Air-

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67. *See* AA/BA JOINT APPLIC., *supra* note 28, at 5.

68. *Id.* at 6.

69. *Id.* at 5 (emphasis added).

70. *Id.*

71. *Id.* The DOT emphasized that the processing of the agreement was necessary to make sure that open skies are achieved beyond just paper when they occur—that open skies exist *in fact*. *See id.* at 4.

72. *See* Goldsmith, *supra* note 63, at 23A. United States-Great Britain talks on a liberalized open skies agreement broke off in early October, 1998, when American negotiators broke off discussion due to the British government's alleged unwillingness to liberalize existing air service treaties. *Id.*

73. *See id.*

74. *Id.*

75. *Id.*

port slots to rival carriers, a condition imposed by European Union regulators.[76] Stating that the surrender of slots was not "acceptable to us commercially," British Airways officials now favor a gradual phase-in of Oneworld in the next four or five years.[77] While one market analyst praised the carrier for its protective stance in light of "economic uncertainties" in Great Britain, he warned that other strategic alliances will only grow stronger and build more customer loyalty while the Oneworld alliance "proceeds at less than full speed."[78]

IV. Predicted Analysis by Courts

A. Definitions and Exertion of Market Power

While litigation involving airline strategic alliances is rare to nonexistent, code-sharing agreements could potentially be analyzed, if challenged by the DOJ, under the same tests used by courts for joint ventures and horizontal agreements.[79] Therefore, the formation and operation of strategic alliances may be assessed under a test drawn from Section 1 of the Sherman Act or Section 7 of the Clayton Act, as amended.[80] The first step in this test "is to determine whether an alliance is facially anti-competitive."[81] If the arrangement is more substantive than the "strategic alliance" label, and the venture's only purpose is to restrict output or fix prices, then it is treated as *per se* unlawful.[82] However, because a strategic alliance will rarely be *facially* anti-competitive, the second step requires evaluation under the "rule of reason" test.[83] "The rule of reason looks at the anti-competitive effects of the alliance and balances those effects against the pro-competitive and efficiency justifications."[84] Under this test, the agency has the initial burden of showing the arrangement has lessened, or is likely to lessen competition.[85] This burden is satisfied

76. *Id.*

77. *Id.*

78. *Id.* The other alliances that "will only grow stronger and build customer loyalty" include: the "Star Alliance," which includes United Airlines, Lufthansa, Thai International, Air Canada, Varig, and SAS; Delta Airlines' alliance with Austrian, Sabena, Belgian, and Swissair; Northwest's alliance with KLM Royal Dutch, which also has an agreement with Alitalia; and Continental's alliance with Air France, Alitalia, and Virgin Atlantic. *See* Tom Belden, *Airline Alliances Can Lead to Higher Travel Costs*, Seattle Times, Feb. 22, 1998, at K11.

79. *See* Kolasky, *supra* note 1, at 506. Recall that strategic alliances and joint ventures are often synonymous.

80. Michael S. McFalls, *The Role and Assessment of Classical Market Power in Joint Venture Analysis*, 66 Antitrust L. J. 651, 653 (1998).

81. *See* Kolasky, *supra* note 1, at 506.

82. *Id.*

83. *Id.*

84. *Id.*

85. *See* NCAA v. Board of Regents, 468 U.S. 85 (1994); F.T.C. v. Indiana Fed'n of Dentists, 476 U.S. 447 (1986).

by the agency if it shows either proof that the alliance will originate or promote the exertion of market power, or proof of anti-competitive effects such as contraction of output.[86] If the agency meets this showing, the burden then shifts to the challenged alliance partners to prove the pro-competitive benefits of the alliance.[87] If the alliance partners demonstrate that the alliance arrangement has pro-competitive benefits, then the burden shifts again to the agency to establish that "the alliance is not reasonably necessary to achieve the pro-competitive benefits."[88]

Administrative agencies, like the DOJ, usually approach their initial burden by attempting to show that the strategic alliance, or joint venture, promotes exertion of market power.[89] The Supreme Court defined "market power" as the ability to increase prices "above the levels that would be charged in a competitive market."[90] Due to the variety of horizontal arrangements that fall between outright mergers and strategic alliances, market power analysis in the joint venture context is often a difficult undertaking.[91] Even when joint ventures are restricted to one function, the joint venture agreement's terms and operation may vary significantly from one context to the next.[92] Therefore, assessment of the market power of airline strategic alliances, which is restricted to the one broad function of coordination of air services, often depends on the terms of the agreement that solidifies the strategic alliance.[93]

86. *See* Capital Imaging Assoc. v. Mohawk Valley Med. Assoc., 996 F.2d 537, 546 (2d Cir. 1993).

87. *See* Kolasky, *supra* note 1, at 506.

88. *Id.* Courts may examine specific restraints included in the alliance even though the alliance passes overall judicial scrutiny. *Id.* (citing United States v. Addyston Pipe & Steel Co., 85 F. 271 (6th Cir. 1898)). "Under this doctrine, a restraint will be upheld if it 'is reasonabl[y] necessary . . . to the legitimate ends of the existing partnership.'" *Id.* (quoting United States v. Addyston Pipe & Steel Co., 85 F. 271, 281 (6th Cir. 1898)). "If an individual restraint does not withstand scrutiny, the court may approve the alliance subject to removal or modification of the unlawful restraint." *See* Kolasky, *supra* note 1, at 506.

89. *See* McFalls, *supra* note 80, at 657.

90. Jefferson Parish Hosp. Dist. No. 2 v. Hyde, 466 U.S. 2, 27 (1984). The DOJ has defined "market power" in its Merger Guidelines written in conjunction with the Federal Trade Commission:

> [T]he Guidelines focus on the one potential source of gain that is of concern under the antitrust laws: market power. The unifying theme of the Guidelines is that mergers should not be permitted to create or enhance market power or to facilitate its exercise. *Market power to a seller is the ability profitably to maintain prices above competitive levels for a significant period of time.*

United States Department of Justice and the Federal Trade Commission (FTC) Revision to the Horizontal Merger Guidelines § 0.1 (Apr. 8, 1997) (emphasis added) [hereinafter Merger Guidelines].

91. *See* McFalls, *supra* note 80, at 653.

92. *Id.*

93. *Id.* The terms of the strategic alliance agreement, however, must always be checked against the circumstances at hand. *See id.* For example, the terms in the strategic alliance agreement might be innocuous, in antitrust terms, on their face and at the time of inception. How-

B. Joint Venture Standard and Predicted Analysis in the Airline Strategic Alliance Context

1. *Joint Venture Standard*

Because the formation of joint ventures or strategic alliances among actual competitors raise issues similar to those examined in conventional merger analysis, merger analysis can predict the effects of these transactions—"transactions in which the [alliance partners] contribute all of their productive assets in the relevant market to the collaboration and jointly determine output and price, even when the ventures are of limited duration and the [alliance partners] retain a legal right to withdraw from the collaboration."[94] A groundbreaking case for examination of a joint venture using the merger analysis occurred in *United States v. Ivaco*, where the district court enjoined a joint venture between the two leading manufacturers of automatic railroad tampers.[95] Under the joint venture agreement, the two companies would have shared equal ownership and control of their merged automatic tamper and railway maintenance businesses.[96]

The court initially determined that the inquiry of whether the transaction would harm competition does not change significantly when the transaction is termed a "joint venture" versus an outright merger.[97] Continuing its analysis, the court defined the relevant product market as automatic tampers. It did so despite the defendants' argument that the market consisted either of a cluster of tamper markets or of entirely separate tamper markets.[98] The defendants were making this cluster argument to attempt to illustrate low entry barriers, whereby potential future competitors would not be deterred from entering the allegedly non-monopolistic market.[99] The court noted, however, that the defendants' argument was inconsistent with their assertion that the joint venture was necessary to compete in the continuous action tamper market.[100] Once the relevant market was pinpointed, the court applied what was essentially the "rule of reason" test, and held that the government had made a

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ever, the terms might cause enhanced antitrust problems given changing circumstances in the given industry. This is particularly relevant in the dynamic airline industry, an industry which has undergone significant change on a yearly basis since deregulation of the industry in 1978.

94. *Id.* at 664-65. In a sense, airlines would be contributing "all of their productive assets" in a strategic alliance agreement, because they would be co-marketing and co-promoting one another's service—flights, reservation services, frequent flyer programs, etc.—which would essentially be tantamount to utilization of the other alliance partner's productive assets.

95. United States v. Ivaco, 704 F. Supp. 1409 (W.D. Mich. 1989).

96. *Id.* at 1412.

97. *Id.* at 1414.

98. *Id.* at 1417.

99. *Id.*

100. *Id.*

prima facie case of illegality because the statistical device offered by the government demonstrated the creation or enhancement of market power.[101] The statistical index utilized, the Herfindahl-Hirschman Index (HHI),[102] provided that the HHI in the relevant market would increase from 3549 to 5809 if the joint venture were approved.[103] To support this showing, the government offered comprehensive evidence illustrating the defendants' previous lively competition, whereby they proactively responded to each other's price adjustments.[104] The court emphasized the government's showing that this competition would cease with the joint venture's initiation.[105]

To rebut the government's prima facie showing of illegality, the defendants asserted two main allegations.[106] First, they argued that they were faltering companies in a declining market.[107] The court rejected the argument by holding that, even if one of the firms did have to exit the market, the result would be more "natural" because it would result from competition rather than the result of the combination of the two largest competitors in the relevant market.[108] Next, the defendants argued that

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101. *Id.* While the court discussed anticompetitive effects later in the opinion, which could have been used alone to meet the government's burden, it stressed the government's evidence of market power exertion.

102. The HHI Analysis has been used by courts to examine horizontal mergers in which parties integrate their productive capacities in a relevant market into a single firm. *See* McFalls, *supra* note 80, at 654, 663. The calculation "squares the market shares of all firms in the relevant market to arrive at a statistical measure of concentration, thereby giving greater weight to the market shares of larger firms." *Id.* A firm's "market share" represents the percent of sales or capacity that firm controls in a relevant market. *Id.* at 661. The HHI seeks to reflect the probability of oligopolistic organization in the post-merger market. *Id.* at 663. In measuring the HHI, the governmental agency—typically the DOJ or the FTC—will first calculate the HHI for the relevant market before the merger. *See* Merger Guidelines, *supra* note 90, at § 1.51. Then, the agencies calculate the post-merger HHI by integrating the market shares of the merging firms and squaring the result. *Id.* Finally, the pre-merger HHI is compared with the post-merger HHI to ascertain the likely competitive effects of the merger. *Id.* If the HHI numbers fall within certain specific ranges set out in the Horizontal Merger Guidelines, the agencies are not likely to challenge the transaction. *Id.* However, if the HHI differences fall outside of their safe harbor values, they create a presumption that the merger is "likely to create or enhance market power or facilitate its exercise." *Id.* Sections 2 through 5 of the Merger Guidelines provide factors that, if shown, may overcome the presumption of market power. *See generally* Merger Guidelines, *supra* note 90, at §§ 2-5. Among these factors are: whether the transaction will promote greater cooperation among firms in the post-merger market, whether the merging entities would be predisposed to raising prices through agreed output limitation, whether entry by new firms would be likely and adequate to discourage joint price increases, and whether the transaction will produce efficiencies from which consumers will benefit. *Id.*

103. Ivaco, 704 F. Supp. at 1419.

104. *Id.*

105. *Id.*

106. *Id.* at 1425.

107. *Id.*

108. *Id.*

the collaboration would allow development of innovative products.[109] The court agreed that the joint venture *might* have been the most financially attractive scheme for innovation; however, it held that less restrictive schemes were available, such as a vertical joint venture with large railroad customers.[110] Finally, the court expressed doubt that the cost savings from the joint venture would have been adequate enough to fund the innovation of new machinery without concurrently increasing prices on current products.[111]

The *Ivaco* court apparently focused on the agreement in reaching its decision, the terms of which would certainly have ended all output and price competition between the parties in the relevant market.[112] Moreover, the court found that the possible anti-competitive effects of the joint venture were basically the same effects that would have resulted from the parties' outright merger.[113] The key to the court's holding appears to be the assignment of a sole post-joint venture market share, which was focused upon to ascertain the potential market power of the joint venture in the relevant market.[114] Holding that the defendants failed to rebut the government's evidence of market power exertion, or potential anti-competitive effects,[115] the court granted a preliminary injunction to stop the joint venture's consummation.[116]

2. *Joint Venture Predicted Analysis in the Airline Strategic Alliance*

a. DOJ's Complaint

i. Investment Agreement

On October 23, 1998, the DOJ, alluding to consumer harm through diminished competition and increased airfares, filed an antitrust lawsuit under Section 7 of the Clayton Act and Section 1 of the Sherman Act which seeks to permanently enjoin Northwest Airlines' proposed acquisition of an equity stake in competitor Continental Airlines.[117] The "Investment Agreement"[118] provides for Northwest's purchase of Continental's Class A voting stock, constituting 14 percent of the total outstanding equity of Continental, and 51 percent of the voting rights cur-

109. *Id.* at 1425-26.

110. *Id.*

111. *Id.* at 1426.

112. *See* McFalls, *supra* note 80, at 666.

113. *Id.*

114. *Id.*

115. Again, while discussion of anticompetitive effects was secondary to the market power analysis in the court's reasoning, proof of anticompetitve effects will alone suffice to make a prima facie case of an antitrust violation.

116. *Id.*

117. *See* Phillips, *supra* note 42, at 48.

118. This is DOJ terminology.

rently held by Air Partners, L.P. (Air Partners).[119] By the terms of the Investment Agreement, the owners of Air Partners exchange their interests for stock and cash in a newly-formed holding company, Coulco, Inc., that immediately merge into Northwest.[120] As a result, Northwest gains voting control of Continental.[121] The Investment Agreement further grants the former Air Partners owners almost five percent of Northwest's voting shares and the right to designate, through Coulco, one person to sit on Northwest's board.[122] The Coulco designee, according to the Investment Agreement, must be acceptable to Northwest.[123]

ii. Other Agreements

Concurrent with the execution of the Investment Agreement, Northwest and Continental entered into a "Governance Agreement,"[124] setting forth "how Northwest would exercise its control over Continental during the next six years . . . ."[125] The Governance Agreement provides that Continental stock purchased by Northwest will be placed in a voting trust for six years with Northwest selecting the trustee.[126] Additionally, the Governance Agreement grants Northwest various means to exercise control of Continental, including: the voting power to affect the future competitiveness of Continental, including a vote on major corporate transactions; the power to designate the appointment of one director to the Continental board and the ability to influence the selection of others; and the ability to otherwise exercise control for all other Continental shareholder matters through the Northwest-appointed trustee.[127] The DOJ emphasized that the expiration of the Governance Agreement in six years, which terminates the voting trust, would give Northwest even more

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119. U.S. v. Northwest, *supra* note 35, at 4.

120. *Id.*

121. *Id.*

122. *Id.*

123. *Id.* Notably, the Investment Agreement named James Coulter and William S. Price, former Air Partners owners, as acceptable designees to the Northwest board. *Id.* The DOJ noted:

> [The] [c]onsummation of the Proposed Acquisition is likely to create interlocking directors on the boards of directors of Northwest and Continental. William S. Price currently sits on the Continental board and, if he is elected to the Northwest board, the two airlines will have a common director. In addition to Price, three other individuals affiliated with Air Partners currently sit on the Continental board . . . . If Coulter, Price, or any other person affiliated with Air Partners is designated to the Northwest board, the Air Partners owners will have representatives on the boards of both Northwest and Continental.

Id. at 4-5.

124. This is DOJ terminology.

125. U.S. v. Northwest, *supra* note 35, at 5.

126. *Id.*

127. *Id.* at 5-6.

power to control Continental's operations.[128]

Along with the Investment and Governance Agreements, the two carriers entered into an "Alliance Agreement,"[129] which governs a system-wide joint marketing of Northwest's and Continental's services.[130] While the DOJ noted the commonness of these types of alliance agreements between domestic and international carriers, it stated, "[s]ubstantial equity ownership between alliance partners is uncommon; few, if any, have involved a majority interest."[131] The DOJ did recognize, however, the mutual exclusivity of the Alliance Agreement and the other agreements—it was not contingent upon the consummation of the other agreements.[132]

iii. Relevant Markets

Like the *Ivaco* court's decision, the DOJ's complaint focused on defining the relevant product markets involved in the Northwest and Continental transaction.[133] The DOJ asserted two relevant product markets to consider, as well as a relevant geographic market.[134] The first relevant product market, according to the DOJ, was *scheduled airline passenger service*. Considering the large number of passengers who wish to travel by air in the United States, the DOJ reasoned that no other mode of transportation would substitute for scheduled airline passenger service in response to a significant increase in airfares.[135] Therefore, the DOJ asserted that "[s]cheduled airline passenger service . . . constitutes a line of commerce and a relevant product market within the meaning of Section 7 of the Clayton Act, and within the meaning of Section 1 of the Sherman Act."[136] Turning to the second relevant product market, the DOJ declared that *nonstop scheduled airline passenger service* constituted "a line of commerce and a relevant product market within the meaning of Section 7 of the Clayton Act, and within the meaning of Section 1 of the Sherman Act."[137] To support this claim, the DOJ stated that few passengers flying nonstop between United States cities would choose connecting service—i.e., service with one or more stops en route—over nonstop service as a result of notable increases in airfares for nonstop scheduled air-

128. *Id.* at 6.
129. This is DOJ terminology.
130. U.S. v. Northwest, *supra* note 35, at 6.
131. *Id.*
132. *Id.*
133. *Id.* at 6-7. *See supra* note 107 and accompanying text for a further discussion of the *Ivaco* court's focus on defining the relevant product market.
134. *Id.*
135. *Id.*
136. *Id.*
137. *Id.* at 7.

line passenger service.[138] Finally, discussing the relevant geographic market, the DOJ contended that few passengers wishing to fly between specific cities in the United States would switch to flights between other airports or cities in response to a significant increase in airfares.[139] In other words, the DOJ claimed that many passengers will continue to fly *out of* an airport convenient to their homes despite fare increases on routes out of the convenient airport; conversely, travelers will, for the most part, continue to fly *into* airports convenient to their destination locations despite fare increases on routes into the airport convenient to their destination.[140] Therefore, the DOJ determined that *city pairs* constitute a section of the country and a relevant geographic market under Section 7 of the Clayton Act and Section 1 of the Sherman Act.[141]

iv. Concentration and Entry

After defining the relevant markets, the DOJ focused next on the creation of market power through the concentration of Northwest-Continental service, including the likelihood of new carrier or new service entry resulting from such concentration.[142] Primarily, the DOJ pinpointed seven hub-to-hub markets in which Northwest and Continental "together dominate the market for *nonstop service* and for all *scheduled airline passenger service*."[143] The market shares in each of the seven hub-to-hub city pairs are:[144]

Route	Northwest Share of Nonstop Flights	Continental Share of Nonstop Flights	Combined Share of Nonstop Flights
Detroit-Cleveland	54%	40%	94%
Detroit-New York	70%	17%	87%
Detroit-Houston	36%	64%	100%
Cleveland-Minneapolis	53%	47%	100%
Minneapolis-New York	80%	20%	100%
Houston-Minneapolis	42%	58%	100%
Houston-Memphis	39%	61%	100%

138. *Id.*

139. *Id.*

140. For example, Houston-based travelers are unlikely to drive four hours to Dallas to catch a flight as a result of fare increases at Houston's Bush Intercontinental Airport; conversely, Houston-bound passengers will likely fly into Houston instead of Dallas despite fare increases on routes into Houston.

141. U.S. v. Northwest, *supra* note 35, at 7.

142. *Id.* at 7-8. Defining this concentration, the DOJ stated that "Northwest and Continental compete for passengers in thousands of city-pair markets." *Id.* at 7.

143. *Id.* at 8 (emphasis added). Referencing the table above, Northwest operates hubs at Detroit, Minneapolis/St. Paul, and Memphis, whereas Continental operates hubs at Newark, Cleveland, and Houston. *Id.* at 7-8. For a further discussion of the hub-and-spoke system, see *supra* note 42.

144. *Id.* at 8.

Additionally, the DOJ noted two other hub-to-hub markets, Memphis-Newark and Cleveland-Memphis, in which Northwest has a nonstop monopoly.[145] These routes are of particular concern to the DOJ, because Continental, the only carrier with Newark and Cleveland hubs, is the most likely entrant to challenge the Northwest nonstop monopoly on these two routes.[146]

Besides an analysis of Continental's likelihood of entry, the DOJ discussed new entry by other carriers, stating that "[e]ffective new entry for the provision of nonstop service in the hub-to-hub markets is unlikely by any carrier without a hub at one of the endpoints of the city pair."[147] The DOJ reasoned that new carrier entry was not likely because Northwest and Continental have significant cost advantages over a non-hub airline, thereby making the time-consuming and costly establishment of a non-hub airline unlikely as a response to Northwest-Continental increased airfares in the hub-to-hub markets.[148] Despite the DOJ's emphasis on the "virtual duopoly" created by the hub-to-hub routes, the Department did not ignore the large number of Northwest/Continental passengers traveling on connecting flights in a plethora of city pair markets: "Because of the light traffic on these routes and the short flights to the Northwest or Continental hubs, carriers with more distant hubs are unlikely to initiate or expand competitive service to these destinations from their hubs in response to significant fare increases."[149]

v. Anti-Competitive Effects

While the DOJ's "concentration and entry" argument was intended to demonstrate the transaction's potential to exert market power, the Department's final argument addressed the anti-competitive effects of the Northwest/Continental strategic alliance.[150] First, to further its "anti-competitive effects" argument, the DOJ asserted that Northwest's acquisition of controlling interest in Continental will diminish Continental's incentive to aggressively compete with Northwest; moreover, Northwest's 14 percent equity stake in Continental's profits will reduce Northwest's incentive to aggressively compete with Continental.[151] Next, the DOJ stated that Northwest's controlling interest in Continental would de-

145. *Id.*
146. *Id.* at 9.
147. *Id.*
148. *Id.* The DOJ also emphasized that new entry was burdened by other factors, including problems gaining access to gate facilities, the lure of frequent flyer passengers to the established hub airlines, and the risk of contentious responses to new entry by the dominant incumbent airline in the given market. *Id.*
149. *Id.*
150. *Id.* at 10.
151. *Id.*

crease actual competition in the seven hub-to-hub markets and other concentrated markets.[152] Furthermore, the DOJ pointed to the diminished probability of Continental's entry into nonstop Memphis-Cleveland and Memphis-Newark service, as well as lessened competition in other markets where the carriers are among the few likely providers of scheduled service, as evidence of the anti-competitive effects of the transaction.[153] Consequently, the DOJ declared, airfares will likely increase and service will likely decrease in these city pairs.[154] The Department also alluded to the possibility that the equity control could deter Continental from initiating nonstop service from its Cleveland hub due to its close proximity to Northwest's Detroit hub.[155] Finally, the DOJ considered the Governance Agreement in light of the anti-competitive effects of the transaction.[156] The DOJ was adamant in its claim that "no private agreement can alter the fact that Northwest still owns Continental, and Continental will not compete vigorously with its owner during the term of the Governance Agreement."[157] Although the Governance Agreement purported to limit Northwest's control of Continental, the DOJ contended that Northwest still retains direct control over strategic decisions made by Continental.[158] The DOJ stated that, even assuming the Governance Agreement dilutes Northwest's immediate control of Continental, its expiration in six years would essentially erase any limitation placed on Northwest's perpetual control of Continental.[159]

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152. *Id.*

153. *Id.*

154. *Id.*

155. *Id.* Many passengers living midway between Cleveland and Detroit often drive to the city in which they can get a cheaper airfare. In this instance, the DOJ is concerned that Northwest's equity control will effectively tend to lure those customers to Detroit, Northwest's hub, and away from Cleveland, Continental's hub. The presupposition of this Detroit/Cleveland scenario is essential to the "relevant geographic market" analysis.

156. *Id.*

157. *Id.*

158. *Id.*

159. *Id.* Continental's Executive Vice President and General Counsel, Jeff Smisek, recently noted that he was disappointed with the DOJ's decision to file the antitrust lawsuit because the carriers have "'structured the transaction to ensure Continental's independence and preserve competition.'" *See* Phillips, *supra* note 42, at 48. Douglas M. Steenland, Northwest's Executive Vice President and General Counsel, also noted that, under the carriers' agreements, Continental would "'retain total, independent control of its own operations,'" which include route planning, pricing decisions, and aircraft purchases. *Id.* The carriers also engaged in negotiations with the DOJ in an attempt to settle the case. *Id.* However, Northwest and Continental rejected to key conditions sought by the DOJ: the reduction of Northwest's voting stake from 51 percent to 15 percent within two years along with an agreement from Northwest not to use its 51 percent in the meantime to block a merger between Continental and another airline. *Id.*

b. Predicted Analysis of the DOJ's Complaint

Because the formation of the Northwest/Continental strategic alliance with equity exchange potentially raises issues similar to those examined in conventional merger analysis, the United States District Court for the Eastern District of Michigan will likely follow the *Ivaco* court's lead in examining the transaction under merger theories. While Northwest and Continental are not the two leading producers of airline service in the United States market, unlike the manufacturers in *Ivaco*, the court will likely recognize the two carriers' significant combined impact in the domestic airline market.[160] Analyzing Northwest's and Continental's Investment and Governance Agreements, the court could analogize them with the defendants' agreement in *Ivaco*, whereby the two companies would have shared equal ownership and control of their merged businesses. However, unlike the *Ivaco* defendants, Northwest and Continental would retain control of their respective businesses, at least in theory. In any event, the district court will probably determine that the Northwest/Continental transaction must be examined with regard to its effect on competition, despite its label as a "strategic alliance" instead of an outright merger.

The next key inquiry the district court could undertake might be an analysis of the relevant product markets. Northwest and Continental will possibly attempt to define the relevant product market more broadly than the DOJ. For example, instead of arguing for "scheduled airline passenger service" being the relevant product market, the carriers could argue that *transportation in general* is the relevant product market. Under this assertion, the carriers could claim that travelers would, in fact, discontinue air travel in exchange for another mode of transportation if air travel becomes too expensive. Answering the DOJ's argument that nonstop scheduled airline passenger service is a relevant product market, Northwest and Continental might attempt to show that passengers often forego nonstop service for cheaper connecting service. To demonstrate low entry barriers, the carriers may offer evidence that more dominant carriers could enter any given market to effectively compete with Northwest or Continental service. Moreover, the carriers will undoubtedly stress the overall competitive nature of the airline industry after deregulation in 1978. Regarding the DOJ's claim that city pairs constitute a relevant geographic market within the meaning of the antitrust laws, the carriers could offer proof that passengers would drive a minimal distance

160. In fact, Northwest and Continental are the fifth and sixth largest carriers, respectively, based on revenue. *See* Michael Meyer, *Now, It's Spring Fever In the Skies—Airline Mergers: Better Service at a Cost?*, NEWSWEEK, May 4, 1998, at 49.

in order to attain cheaper fares at another airport.[161]

Northwest and Continental, like the *Ivaco* defendants, will likely argue the necessity of their joint venture. To further this argument, the carriers would attempt to show that the joint venture allows each of them to serve markets that could not be served without the transaction.[162] This argument, however, is not likely to benefit the carriers to a large extent, because the DOJ was *much more critical* of the equity ownership and control aspects of the transaction furthered by the Investment and Governance Agreements, respectively; however, this criticism did not extend, for the most part, to the code-sharing provisions furthered by the Alliance Agreement.[163]

While the Complaint does not specifically mention the DOJ's utilization of the HHI analysis to demonstrate market power, the Department will likely use that method to illustrate Northwest's and Continental's exertion of market power in whatever market the court determines to be the relevant product market. It might be assumed that the DOJ already performed an HHI analysis and determined the transaction to fall outside of the Merger Guidelines' safe harbor.[164] If the relevant product markets are defined by the district court in favor of the DOJ and it is able to demonstrate through the HHI statistical index that the Northwest and Continental transaction, as to those markets, is "likely to create or enhance market power or facilitate its exercise," the district court may hold that the DOJ has made a prima facie case that the Investment Agreement

161. For example, Northwest and Continental could offer Denver International Airport (DIA) as an example. When DIA was opened, many passengers living in the Denver metropolitan area favored the use of Colorado Springs' airport due to the significant cost savings compared with service out of DIA. Even travelers living closer to DIA would often drive a few extra miles to Colorado Springs to get cheaper airfares.

162. *See Aviation Agreements, supra* note 16, at *3 (demonstrating how integration of service allows carriers to extend their market service beyond what was possible without the integration arrangement).

163. *See supra* text accompanying note 140.

164. This assumption is present because, if the HHI calculation was within the Merger Guidelines' safe harbor, the DOJ would not have brought suit to enjoin the transaction. Referring to the table in Part IV.B.2.a.iv., recalling that the HHI is calculated by squaring the relative market shares, the applicable HHI values would be:

Route	Northwest HHI of Nonstop Flights	Continental HHI of Nonstop Flights	HHI Total Without Alliance	HHI Total With Alliance
Detroit-Cleveland	2916	1600	4516	8836
Detroit-New York	4900	289	5189	7569
Detroit-Houston	1296	4096	5392	10000
Cleveland-Minneapolis	2809	2209	5018	10000
Minneapolis-Newark	6400	400	6800	10000
Houston-Minneapolis	1764	3364	5128	10000
Houston-Memphis	1521	3721	5242	10000

Note that the HHI increases are much more drastic here than the defendants' HHIs in *Ivaco*, indicating that a finding of market power in the Northwest/Continental transaction is likely.

is illegal.[165] To support such a prima facie ruling, the DOJ, like the government agency in *Ivaco*, may attempt to supplement the HHI index with evidence of Northwest's and Continental's engaging competition before the consummation of the Investment and Governance Agreements. Undoubtedly, the DOJ will focus on the seven Northwest-Continental hub markets outlined in the Part IV.B.2.a.iv. table to illustrate the previous engaging competition. In its complaint, the DOJ stresses that this competition will cease with the active execution of the Investment and Governance Agreements. If the district court is persuaded by this argument, it is even more likely to hold that the Investment and Governance Agreements are *per se* illegal.

If the Investment and Governance Agreements are held by the district court to be *per se* illegal, Northwest and Continental might look to the *Ivaco* defendants' arguments to understand what assertions *will not* rebut the DOJ's prima facie showing of illegality and what assertions *might* rebut such a showing. Obviously, the carriers would claim they are faltering airlines in a declining market.[166] Even assuming the carriers are faltering airlines in a declining market, the district court might allow a natural failure versus the allowance of the virtual combination of the fifth and sixth largest carriers. Northwest's and Continental's better argument is found in the innovation, or creation of efficiencies, that could result from the transaction. Like the *Ivaco* defendants' "development of innovative products" argument, the carriers could show that pro-competitive benefits are found in the expansion of service for customers in general.[167]

165. Northwest and Continental may attempt to challenge the HHI's viability with reference to the mitigating factors in sections 2-5 of the Merger Guidelines. The carriers might be able to show greater cooperation among airlines after consummation of the agreements by demonstrating, for example, other airlines' increased desire to interline passengers through either Northwest or Continental with the combined networks. However, the issue regarding the DOJ's main challenge being the Investment Agreement arises again, because this improved route structure would be the result of code-sharing—not the equity exchange. While the Northwest/Continental agreements do not provide for pricing or output collusion expressly, this argument on the carriers' behalf will likely not overcome the HHI's demonstration of market power because the Merger Guidelines require the lack of a *predisposition* to raise prices or limit output. The *lack* of such a predisposition might be difficult for the carriers to show. Perhaps the carriers' strongest argument to overcome the presumption of market power created by the HHI analysis would be the creation of expanded service that benefits consumers as a result of the Alliance Agreement; again, however, this argument does not support the Investment and Governance Agreements' viability.

166. However the market is defined, airline profits have not been declining. On the contrary, "[a]irline profits are at record highs." *See* Meyer, *supra* note 160, at 49.

167. For example, see the example of expanded service in *Aviation Agreements*, *supra* note 16, at *3. Allowing a Northwest customer to fly from Madison, Wisconsin to Panama City, Panama under one integrated service provides procompetitive benefits for passengers flying out of Madison. Now, American Airlines has a competitor in this market, and Madison consumers will benefit from this competition. Alternatively, if a Continental customer is allowed to fly from Panama City, Panama to Madison, Wisconsin under one integrated service, procompetitive ben-

While this argument is certainly compelling, the district court, like the *Ivaco* court, could determine that a less restrictive scheme was available for the creation of these pro-competitive benefits. The court could rule that this less restrictive scheme is found in the enactment of the Alliance Agreement alone. After all, as stipulated by the DOJ, the Alliance Agreement is a stand-alone agreement that is not dependent on the execution of the Investment or Governance Agreement. Therefore, the court could decide the case in a way to benefit consumers and further competition, while still holding the Investment and Governance Agreements in violation of the antitrust laws.

The district court might hold, consistent with the court's ruling in *Ivaco*, that allowance of the Investment and Governance Agreements essentially end significant output and price competition between Northwest and Continental in the relevant product market, if the relevant product market is defined as provided in the DOJ Complaint. The court could declare that application of the Investment and Governance Agreements is tantamount to an outright merger of Northwest and Continental. If convinced of the carriers' concentration of service that precludes new entry and the existence of anti-competitive effects, the district court could block Northwest Airlines' acquisition of a controlling stake in Continental Airlines.

V. Conclusion

International and domestic airlines will likely continue to strategically ally themselves to the extent allowed by the federal government. The potential for economies of scale and increased service reach resulting from these cooperative agreements are the motivating force behind the trend. While the regulatory threshold governing these alliances is ambiguous at best, the DOT and the DOJ have certainly provided indicators of when these alliances will be challenged on public interest or antitrust grounds.

Future foreign-domestic alliance partners should look to the DOT's regulatory power for guidance. For international airline strategic alliances, the DOT's focus remains achievement of open skies as a prerequisite for the granting of approval and antitrust immunity via 49 U.S.C. §§ 41309 and 41308. Once open skies is achieved, these agreements will likely be approved and granted immunity from a DOJ antitrust inquiry. Likely, open skies between Great Britain and the United States will be

efits for Panama City passengers, who might be American citizens traveling from Panama on business, are created through the new competition with American. To reiterate again, however, this Northwest and Continental argument assumes the need for the Investment and Governance Agreements to make this integration possible, and that assumption is, at best, questionable.

achieved and the Oneworld Alliance will be approved and granted antitrust immunity by the DOT. British Airways and American Airlines, along with the government regulators on both sides of the Atlantic, realize that other alliances will be strengthened only to the detriment of Oneworld the longer open skies is withheld. The Oneworld airlines especially will not want to be placed at a competitive disadvantage as other worldwide airline strategic alliances thrive.

Because domestic partnerships are not given DOT immunity protection, a domestic airline should closely monitor the DOJ's regulatory power to block such domestic linkups before engaging in or broadening an alliance with another domestic airline. Apparently, equity ownership is the line of demarcation for the DOJ in ascertaining the antitrust nature of domestic airline strategic alliances. Airlines seemingly have free reign to engage in a broad array of coordinated activities *short of* equity ownership. Northwest Airlines and Continental Airlines have transgressed the DOJ's antitrust tolerance by coupling an equity exchange with a marketing alliance agreement. The Eastern District of Michigan must now decide whether the DOJ's tolerance threshold is proper for analysis under the antitrust laws.