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Airline Consolidations and Competition Law—What Next?

*Roger W. Fones**

I. INTRODUCTION

During the last decade, there has been an increase in airline industry consolidation, both within the United States domestically as well as abroad. In the U.S., six of the remaining “legacy” network airlines¹ consolidated into three, and some low cost point-to-point carriers have merged as well. Among legacy carriers, Northwest and Delta merged in 2008, United and Continental in 2010, and most recently, American and US Airways in 2013. In 2011, major low cost carriers Southwest and AirTran also merged. On the international front, Air France and KLM merged in 2004, Lufthansa acquired SN Brussels and Austrian Airlines in 2009, British Airways and Iberia merged in 2011, and Delta acquired forty-nine percent of Virgin Atlantic in 2013. A Wall Street Journal blog speculated that the European airline industry might be poised for its own round of “U.S.-Style” consolidation.²

During that same time period, additional consolidations have been accomplished through joint ventures, alliances, and code sharing, often accompanied by grants of immunity from U.S. antitrust laws by the U.S. Department of Transportation (USDOT). In 2008, USDOT granted statutory antitrust immunity (ATI) to a joint venture and alliance among Delta/Northwest, Air France/KLM, Alitalia, and Czech Airlines to operate jointly between the United States and Europe.³ In 2010, USDOT did the same for American, British Airways, Iberia, Finnair, and Royal Jordanian.⁴ For travel between the United States and Japan, USDOT issued ATI separately for American and JAL to coordinate their service, and for United/Continental to coordinate with All Nippon Airways.⁵ And in 2013, USDOT granted ATI to

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¹ “Legacy” airlines refer to the large, full-service carriers that existed prior to deregulation in the United States.

² Robert Wall, *Europe’s Airlines May Be Ready for New, U.S.-Style Merger Round*, WALL ST. J. (Sept. 17, 2014, 11:26 AM), <http://blogs.wsj.com/corporate-intelligence/2014/09/17/europes-airlines-may-be-ready-for-new-u-s-style-merger-round/>.

³ Alitalia-Linee Aeree Italiane, S.p.A., Docket No. OST-2007-28644 (Dep’t of Transp. May 22, 2008) (final order); see also *infra* Part IV, discussing alliances and code sharing.

⁴ America Airlines, Inc., Docket No. DOT-OST-2008-0252 (Dep’t of Transp. July 20, 2010) (final order).

⁵ U.S.-Japan Alliance Case, Docket No. DOT-OST-2010-0059 (Dep’t of Transp. Nov. 10, 2010) (final order).

Delta, Virgin Atlantic, Air France/KLM and Alitalia to operate jointly between North America and the United Kingdom.⁶

There is no better way to anticipate how the enforcement authorities will treat future consolidations than to understand what they have said and done in the past. Over the years, the major enforcement authorities, particularly in the United States and Europe, have been relatively transparent about their analytical approach to airline consolidations. Moreover, the analytics do not vary much by agency or type of consolidation (e.g., merger, asset acquisition, joint venture). Although this article refers primarily to government enforcement in the United States, other competition authorities, particularly that of the European Union, have applied a similar analytical paradigm for mergers and consolidations in the airline industry and elsewhere.⁷

II. COMPETITIVE ANALYSIS IN THE AIRLINE INDUSTRY

The Antitrust Division of the U.S. Department of Justice (USDOJ) enforces the U.S. antitrust laws in the airline and other industries. Mergers, acquisitions, and other consolidations in the airline industry are governed by the same substantive standards that apply to other industries, principally the standards set forth in section 7 of the Clayton Act.⁸ USDOT also applies the Clayton Act standards when analyzing the competitive effects of proposed international consolidations for ATI applications.⁹

USDOJ's substantive antitrust analysis of proposed airline consolidations follows the general analytical paradigm set forth in the 2010 Horizontal Merger Guidelines (Merger Guidelines) issued jointly by USDOJ and the U.S. Federal Trade Commission.¹⁰ The steps in the review are to: (A) identify the relevant market(s) potentially affected by the transaction; (B) assess pre-and post-merger concentration in each of those markets; (C) evaluate the likely competitive effects of the merger, including (D) the

⁶ Virgin Atlantic Airways Ltd., Docket No. DOT-OST-2013-0068 (Dep't of Transp. Sept. 23, 2013) (final order).

⁷ See, e.g., 2004 O.J. (C 31) 5 [hereinafter EU Guidelines].

⁸ 15 U.S.C. § 18 (2014) ("No person 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 one or more persons engaged 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, of such stocks or assets, or of the use of such stock by the voting or granting of proxies or otherwise, may be substantially to lessen competition, or to tend to create a monopoly.").

⁹ "The intended commercial effects of the ATI Applicants' respective joint venture agreements are similar to those resulting from a merger. As part of our overall analysis, we apply the Clayton Act test, which is used to predict the competitive effects of a proposed merger." U.S.-Japan Alliance Case, *supra* note 5, at 3.

¹⁰ U.S. DEP'T OF JUSTICE & F.T.C., HORIZONTAL MERGER GUIDELINES (2010), available at <http://www.justice.gov/atr/public/guidelines/hmg-2010.pdf> [hereinafter Merger Guidelines].

likelihood of new entry; and finally to (E) consider any merger-specific efficiencies of the transaction that might offset any competitive harm. There also may be “failing firm” issues to consider, which might permit an otherwise anticompetitive consolidation to proceed.¹¹

A. Relevant Markets

The first step in merger analysis under competition laws is to define the “relevant market” (or markets) affected by consolidation. The U.S. Supreme Court has held that defining a relevant market is necessary because any effect of the consolidation on competition can be determined only with respect to a relevant market.¹² USDOJ methodology for defining relevant markets uses the hypothetical monopolist test as set forth in the Merger Guidelines.¹³ Following Section 7 of the Clayton Act, the Guidelines refer to defining both a product market (“line of commerce”) and a geographic market (“section of the country”).¹⁴ These two concepts tend to converge in the airline industry, however, with USDOJ normally concluding that air travel between any given origin city and destination city (i.e., a “city pair”) is the appropriate relevant market for analyzing airline mergers. USDOJ reasons that a passenger who wants to fly from Washington, D.C. to San Francisco for a business meeting or a vacation will not view a flight from Washington, D.C., to Minneapolis as a reasonable substitute if fares to San Francisco increase. The courts and USDOT are generally in accord.¹⁵

1. City or Airport Pairs

While USDOJ typically views city pairs as the appropriate relevant markets in the airline industry, issues sometimes arise when multiple airports serve a single metropolitan area, as is the case in Washington D.C., New York City, Tokyo, and London. The question then becomes whether a hypothetical monopolist of flights from one airport, for instance, Washington Dulles

¹¹ See *infra* Part II.F.

¹² *United States v. E.I. du Pont de Nemours & Co.*, 353 U.S. 586, 593 (1957).

¹³ The hypothetical monopolist test posits a monopoly supplier of a group of products or services in a candidate relevant market and asks whether it could profitably implement a “small but significant and non-transitory increase in price” (SSNIP). The smallest group of products or services that satisfies the hypothetical monopolist test constitutes a relevant product or service market. Merger Guidelines, *supra* note 10, at § 4.1.

¹⁴ See *supra* note 8.

¹⁵ See, e.g., *Malaney v. UAL Corp.*, 434 F. App’x 620, 621 (9th Cir. 2011) (“national market in air travel” improper; flights from San Francisco to Newark are not interchangeable with flights from Seattle to Miami); *America Airlines, Inc.*, Docket No. DOT-OST-2008-0252, 18 (Dep’t of Transp. Feb. 13, 2010) (show cause order) (“[R]elevant markets in the airline industry are transportation between city pairs. Demand is specific to city pairs; if the price of travel in City Pair A increases by a significant amount, consumers would not generally consider substituting travel in City Pair B.”).

International Airport, could raise fares without losing a significant number of passengers to alternate airports, such as Ronald Reagan Washington National Airport (Washington National) or Baltimore/Washington International Thurgood Marshall Airport.

2. Time-sensitive Travelers and Nonstop Service

The relevant market may be narrower than all scheduled airline service in a city pair. USDOJ has frequently maintained that nonstop service is a separate market from connecting service for a group of “time-sensitive” travelers—those passengers who would not switch to connecting service if the cost of nonstop service went up five or ten percent. In the early days of deregulation, some carriers with overlapping hubs merged. This involved numerous nonstop overlaps, which USDOJ opposed on that basis. More recently, USDOJ has focused on nonstop service overlaps for travel between the merging parties’ hubs, referred to as “hub-to-hub” markets.¹⁶

3. Connecting Service Overlaps

USDOJ will also look at one-stop overlaps if the merging parties are the dominant one-stop carriers on a significant number of city pairs. To identify potentially problematic one-stop city pair overlaps, DOJ will apply a traffic data screen. For example, a “50/5” screen would identify city pairs in which the merging carriers combined had at least fifty percent of the passengers, and the smaller carrier had at least five percent. In Appendix A to its 2013 amended complaint against the US Airways-American Airlines merger, USDOJ listed over one-thousand overlap city pairs where the merger was “presumed” illegal, the vast majority of which were one-stop overlaps.¹⁷ In addition, USDOJ also assesses whether one-stop service provided by one party is the next best substitute to nonstop service offered by the other party. Appendix A included a number of these overlaps as well.¹⁸

4. Airport Access

A single airport also may be considered a relevant market when the transaction involves gates, or slots, at “constrained” airports.¹⁹ USDOJ has a

¹⁶ In announcing its challenge of United Airlines’ proposed acquisition of US Airways in 2001, the USDOJ cited to, among other concerns, the loss of competition on the hub-to-hub nonstop routes of the parties. See Press Release, U.S. Dep’t of Justice, Dep’t of Justice & Several States Will Sue to Stop United Airlines from Acquiring US Airways (July 27, 2001), available at http://www.justice.gov/atr/public/press_releases/2001/8701.htm.

¹⁷ Amended Complaint at 44, *United States v. US Airways Group, Inc.*, No. 1:13-CV-01236 (D.D.C. Sept. 5, 2013) ECF No. 73, available at <http://www.justice.gov/atr/cases/f300400/300479.pdf>.

¹⁸ *Id.*

¹⁹ “Constrained” airports are those where the demand from carriers who want to serve the airport

long history of scrutinizing gate and slot acquisitions by dominant carriers at constrained airports.²⁰ An airport may be constrained on airside capacity (a slot system has been established), groundside capacity (gates are fully leased with no ability to expand the number of gates rapidly), or both, so that new entry or expansion by incumbents at that airport is not feasible within a reasonable period of time.

In 2013, one of the bases for USDOJ's lawsuit challenging the US Airways/American Airlines merger was the increase in slot concentration at Washington National Airport that would occur as a result of the merger. According to USDOJ's complaint, US Airways' share of slots at Washington National would go from fifty-five percent to sixty-nine percent, and would eliminate existing and future head-to-head competition between the parties, effectively blocking other airlines' competitive entry or expansion at Washington National.²¹

In 2010, USDOJ investigated the proposed slot swap between US Airways and Delta at Washington National and New York LaGuardia that would have increased each party's already large share of slots at the respective airports. USDOJ did not challenge the US Airways/Delta slot swap under the antitrust laws; rather, it decided to file comments at the Federal Aviation Administration (FAA),²² which administers slots nationwide and has separate legal authority to approve, disapprove, or conditionally approve the transaction. According to USDOJ, the transaction would have increased US Airways' slot share at Washington National from forty-four percent to fifty-four percent and Delta's share at LaGuardia from twenty-four percent to forty-nine percent.²³ The FAA had proposed to approve the transaction subject to divestiture by the parties of forty slots at LaGuardia and twenty at Washington National. USDOJ filed comments in

exceeds the capacity of the airport, such as London Heathrow, Chicago O'Hare, or Washington National.

²⁰ In 1989, USDOJ challenged Eastern Airlines' proposals to sell eight gates at gate-constrained Philadelphia International Airport to USAir, which already operated a hub at that airport in competition with Eastern's hub. In 1991, USDOJ challenged Eastern's proposed sale of slots and gates at Washington National Airport to United, which operated what USDOJ considered a competing hub out of nearby Dulles International Airport. See *Competition in the Airline Industry*, at 2 (1999), available at <http://www.justice.gov/atr/public/testimony/2294.pdf> (testimony of Joel I. Klein, Assistant Att'y Gen., Antitrust Div., U.S. Dep't of Justice).

²¹ Complaint at ¶90, *United States v. US Airways Group, Inc.*, No. 1:13-CV-01236 (D.D.C., Aug. 13, 2013) ECF No. 1, available at <http://www.justice.gov/atr/cases/f299900/299968.pdf>.

²² Any member of the public may file comments on proposed FAA actions, and the USDOJ frequently files comments at other federal agencies when government action affecting competition is proposed. USDOJ's "competition advocacy" comments filed with FAA, USDOT, and other federal agencies are available at <http://www.justice.gov/atr/public/comments/comments.html>.

²³ United States Department of Justice, Comments of the United States Department of Justice Before the Federal Aviation Administration Department of Transportation, Docket No. FAA-2010-0109 at 5-6 (Mar. 24, 2010), available at <http://www.justice.gov/sites/default/files/atr/legacy/2010/04/14/257463.pdf>.

support of the FAA's proposal, concluding that the divestitures would resolve its competitive concerns.²⁴ The parties decided not to proceed with their transaction subject to those conditions but later reformulated the transaction and agreed to divest thirty-two slots at LaGuardia and sixteen at Washington National. The FAA approved the reformulated transaction in 2011.²⁵

B. Concentration

The Merger Guidelines and the EU Guidelines advise that market shares and the Herfindahl-Hirschman Index (HHI) of market concentration are calculated pre and post-transaction. The HHI is the sum of the squares of the market shares of the competitors in the relevant market and, thus, gives more weight to firms with larger market shares. Market shares may be measured in revenue (ticket sales), units sold (passengers), or capacity (seats or flights operated). The Merger Guidelines classify markets with an HHI under 1500 as "unconcentrated" and over 2500 as "highly concentrated," and presume that a merger that increases the HHI by more than 200 points in a "highly concentrated" market is likely to enhance market power.²⁶ The EU is unlikely to challenge a merger with a post-merger HHI below 2000 with an increase less than 250 or above 2000 if the increase is less than 150, unless special circumstances are present.²⁷ A duopoly route of two equal-size carriers would have an HHI of 5000 and a four-to-three-merger resulting in equal-size carriers would have a post-merger HHI of 3333.

For nonstop overlaps, USDOJ practice in the airline industry often has been to count the number of carriers that are currently providing the relevant service or are well-positioned to provide it. Once a carrier is deemed able to provide the service, such as by having a hub at one of the end points, it is normally considered an easy matter for that carrier to add and subtract capacity on a route. As a result, snapshots of passenger or revenue shares on the route are not necessarily meaningful. Accordingly, city pairs that are impacted by a proposed consolidation have been categorized as "two-to-one" or "three-to-two," etc.²⁸

For one-stop or other connecting overlaps, USDOJ has examined whether the parties' connecting hubs are particularly well-positioned to provide connecting service on a city pair. In announcing its challenge of

²⁴ *Id.* at 2–3.

²⁵ Delta Airlines Inc., Docket No. FAA-2010-0109 at 5-6 (FAA Oct. 13, 2011) (notice of grant of petition with conditions).

²⁶ Merger Guidelines, *supra* note 10, at § 5.3.

²⁷ EU Guidelines, *supra* note 7, at Part III, ¶20.

²⁸ See *e.g.*, Amended Complaint at ¶¶ 31–32, *United States v. Nw. Airlines Corp.*, No. 98-74611 (E.D. Mich. Dec. 18, 1998) (listing two-to-one overlap routes and routes served only by Northwest, but for which Continental had a hub at the opposite end point).

United's proposed acquisition of US Airways, USDOJ noted that the parties' East Coast hubs made them "the only two airlines, or two of only three airlines, offering connecting service between [various East Coast city pairs]." ²⁹ And again in its 2013 complaint against the US Airways/American Airlines merger, USDOJ included an appendix that listed post-merger HHIs, measured in ticket revenue, and the changes in them, for over one-thousand city-pair markets affected, most of which were connecting markets. ³⁰ Each of the listed city pairs had a post-merger HHI greater than 2500, an increase in its HHI of over 200, and was a city pair where the merger was "presumptively illegal" according to the complaint.

C. Competitive Effects

Identifying city pairs where a consolidation will result in a potentially problematic level of concentration is an important but not dispositive step. The next step is to determine what the likely effect of the increased concentration will be on prices and output. Enforcement authorities have identified two possible means by which consumers can be harmed with price increases or output reductions resulting from a merger: "unilateral" effects and "coordinated" effects. ³¹

Unilateral effects arise when competition between the products of the merging firms is eliminated, allowing the merged entity to unilaterally exercise market power, for instance, by profitably raising the price of one or both merging parties' products, thus, harming consumers. In markets for relatively undifferentiated products (e.g., commodities or other fungible products or services), unilateral effects are more likely when two significant competitors merge to create a dominant seller. In markets for undifferentiated products or services, enforcement authorities will look primarily at market shares and the capacity currently available in the market. In differentiated product mergers, that is, where the merging parties' products compete but are imperfect substitutes (e.g., automobiles), unilateral effect concerns arise when the two merging companies' products are particularly close substitutes in the eyes of consumers—the closer the substitutability, the greater the concern about unilateral effects. Scheduled airline service does not necessarily fit neatly into either category, and the enforcement agencies will likely consider both possibilities.

Coordinated effects arise if the merger could increase the probability that, post-merger, merging parties and their competitors will successfully be

²⁹ See *supra* note 16.

³⁰ Complaint at App. A, *United States v. US Airways Group, Inc.*, No. 1:13-CV-01236 (D.D.C. Aug. 13, 2013) ECF No. 1, available at <http://www.justice.gov/atr/cases/f299900/299968.pdf>.

³¹ Merger Guidelines, *supra* note 10, at §§ 6-7; EU Guidelines, *supra* note 7, at Part IV, ¶ 22.

able to coordinate their behavior, or better coordinate their behavior, in an anti-competitive way, for example, by raising prices. The primary task of enforcers is to determine whether market characteristics exist that make coordination easier, such as market transparency, product homogeneity, and numerous small transactions with buyers. Anticompetitive coordination is more likely to emerge in markets where it is relatively simple for sellers to agree on how they will coordinate. In addition, for coordination to be sustainable, the coordinating firms must be able to monitor each other to assure themselves that others are not cheating on the agreement, and there must be some form of credible punishment mechanism if deviation is detected. Further, the reactions of outsiders, such as current and future competitors not participating in the coordination, as well as customers, should not be able to defeat the coordination.³²

In the past, USDOJ has concluded that anticompetitive coordination among firms in the airline industry is possible and has in fact occurred. Empirical research conducted by USDOJ economists and others has supported these conclusions about coordinated effects in the airline industry. The airline industry is data-rich, and USDOJ collects traffic data from USDOT, the parties, and other sources in order to measure the correlation between concentration (the number of carriers, market shares, or HHIs) and fare levels across city pairs. USDOJ has consistently found that fares for nonstop service are higher when there are fewer nonstop carriers on a route, which indicates that nonstop fares are constrained by other nonstop service, but not by connecting service, at least not until the fare differential or distance traveled, and, hence, the time of travel becomes large.³³

In the past, USDOJ has also examined whether two merging airlines are often the first and second best-positioned bidders for a significant number of corporate or government travel contracts.³⁴ This inquiry includes an overlap city-pair analysis, but also looks at whether the two carriers' entire networks, including service amenities, schedule frequencies, and international service or alliances, make them particularly attractive alternatives to one another

³² See generally Merger Guidelines, *supra* note 10, at §7.2; EU Guidelines, *supra* note 7, at Part IV, ¶¶ 39-57.

³³ The existence of a "hub premium" in fares has not escaped the attention of savvy travel agents and others. In 1996, a class of air travelers sued under the antitrust laws a group of major carriers who refused to sell so-called "hidden city" tickets. The "hidden city" practice involved the passenger purchasing a lower-priced one-stop ticket that connected at the carrier's hub, deplaning at the hub and simply discarding the unused portion of the ticket. *See, e.g.*, In re Nw. Airlines Corp. Antitrust Litig., 208 F.R.D. 174 (E.D. Mich. 2002). While travelers may have considered the practice a clever form of arbitrage, carriers viewed it as fraudulent, and have battled the practice for years. Nevertheless, the practice remains and continues to be contentious. *See, e.g.*, Patrick Gillespie, *Why Is United Airlines Suing a 22-year-old?*, CNN MONEY (Dec. 31, 2014, 12:04 PM), <http://money.cnn.com/2014/12/29/news/united-orbitz-sue-skiplagged-22/>.

³⁴ *See, e.g.*, *supra* note 16.

given the demands of large corporate (or government) customers.

D. Entry

The prospect of new entry (that is, entry induced by the merger) may be sufficient to alleviate competitive concerns if the entry would be timely, likely, and sufficient to counteract an anticompetitive fare increase in the relevant market.³⁵ At one time, hub economics were so powerful that it was rare for one carrier to enter a city pair with another carrier's hub at one end point, except from its own hub. More recently, the proliferation of low cost carriers (LCCs) offering point-to-point service has increased the number of city pairs where point-to-point entry is economically feasible. At the same time, legacy carriers have lowered their cost structures, through bankruptcy and otherwise, to reduce their cost disadvantage relative to LCCs. The effect of lower costs is that legacies are now better able to enter some non-hub markets on a point-to-point basis. USDOJ asks whether the new entrant would be profitable at premerger prices, placing significant weight on the prior history of entry in city pairs in response to an increase in fares or margins in that market. USDOJ still considers it likely that a carrier will enter a spoke emanating from its hub, but it also realizes that a legacy carrier may well enter routes to and from any city where it has significant service and brand identity. Nevertheless, there remain many thin connecting routes between smaller cities that are likely only servable by a hub-and-spoke network carrier.

One entry barrier that frequently comes up in airline consolidations is airport access at slot-constrained airports. Slot constraints, by definition, mean that there are carriers who would like to enter or expand their service at an airport, but cannot because they lack slots (and/or gates or other ground facilities). A number of airline consolidations in the United States and Europe have been allowed to proceed when the merging parties agreed to divest slots at constrained airports to competitors.³⁶

E. Efficiencies

Under the Merger Guidelines, DOJ also considers the efficiencies that

³⁵ Merger Guidelines, *supra* note 10, at § 9.

³⁶ See, e.g., Press Release, U.S. Dep't of Justice, Justice Department Requires US Airways and American Airlines to Divest Facilities at Seven Key Airports to Enhance System-Wide Competition and Settle Merger Challenge (Nov. 12, 2013), available at http://www.justice.gov/atr/public/press_releases/2013/301616.pdf; Press Release, U.S. Dep't of Justice, United Airlines and Continental Airlines Transfer Assets to Southwest Airlines in Response to Department of Justice's Antitrust Concerns (Aug. 27, 2010), available at http://www.justice.gov/atr/public/press_releases/2010/262002.pdf; and Press Release, Eur. Comm'n, Mergers: Commission Clears Proposed Takeover of Austrian Airlines by Lufthansa, Subject to Conditions (Aug. 28, 2009), available at http://europa.eu/rapid/press-release_IP-09-1255_en.htm?locale=fr.

result from a proposed merger or acquisition, but it only gives weight to those efficiencies that are “merger-specific” (i.e., unlikely to happen in the absence of the merger), well-defined, and reasonably substantiated.³⁷ Even those cognizable efficiencies are likely to make a difference only when the expected adverse competitive effects (absent the efficiencies) are not great.³⁸ Among the efficiencies that USDOJ has favorably considered in connection with proposed airline mergers and acquisitions, are the merged carrier’s ability to provide improved online service to more destinations, cost savings in airport operations, information technology, fleet optimization, and supply chain economics, all to the benefit of consumers.³⁹ Under the EU Guidelines, efficiencies must benefit consumers, be merger-specific, and be verifiable.⁴⁰

F. Failing Firms and Assets

A transaction that might initially appear to be anticompetitive may be allowed to proceed if the parties demonstrate that one of the parties is a “failing firm.” The failing firm defense is well established in U.S. antitrust law and applies to the airline industry in the same manner as other industries.⁴¹ The basic policy underlying the defense is that an otherwise anticompetitive acquisition will not harm competition or consumers if the firm and its assets would exit the relevant market(s) without the transaction. The key elements of the failing firm defense are:

- Imminent failure of the firm (or a subsidiary, division, or group of assets);
- The firm cannot successfully reorganize in bankruptcy or otherwise; and
- There is no reasonable less anticompetitive purchaser for the firm or assets.

Both USDOJ and the EU have applied the failing firm doctrine in the airline

³⁷ Merger Guidelines, *supra* note 10, at § 10.

³⁸ *Id.*

³⁹ *See, e.g.*, Press Release, U.S. Dep’t of Justice, Statement by Assistant Att’y Gen. R. Hewitt Pate Regarding the Closing of the America West/US Airways Investigation (June 23, 2005), available at http://www.justice.gov/atr/public/press_releases/2005/209709.pdf; and Press Release, U.S. Dep’t of Justice, Statement of the Department of Justice’s Antitrust Division on Its Decision to Close Its Investigation of the Merger of Delta Air Lines, Inc. and Northwest Airlines Corporation (Oct. 29, 2008), available at http://www.justice.gov/atr/public/press_releases/2008/238849.pdf.

⁴⁰ EU Guidelines, *supra* note 7, at Part VII, ¶78.

⁴¹ “[W]here the evidence suggests a failing firm will not be able successfully to reorganize, we agree it may be better to be acquired by a competitor than to suffer liquidation. A good example of this is American Airlines’ acquisition of its competitor TWA, which was bankrupt, out of money, and without another buyer.” *See Antitrust for Airlines*, at 9, *Before the Reg’l Airline Ass’n President’s Council Meeting* (2005) (remarks by J. Bruce McDonald Deputy Assistant Att’y Gen. Antitrust Div. U.S. Dep’t of Justice), available at <http://www.justice.gov/atr/public/speeches/217987.pdf>.

industry.⁴²

III. PARTIAL ACQUISITIONS

Although most transactions that are the subject of government antitrust scrutiny involve the acquisition of complete ownership and control, partial acquisitions—including partial acquisitions in the airline industry—also have been challenged. The analytic framework that USDOJ uses to analyze partial acquisitions is described in Section 13 of the Merger Guidelines. If a partial acquisition gives the acquiring party effective control over the target firm or involves substantially all of the relevant assets of the target firm, the transaction is analyzed like a complete acquisition.⁴³ If a partial acquisition does not result in effective control of the target firm or substantially all of its relevant assets, then the issue is whether the transaction is likely to lessen competition (1) by giving the acquiring firm the ability to influence the competitive conduct of the target firm; (2) by reducing the incentive of either firm to compete aggressively with the other; or (3) by giving the acquiring firm access to nonpublic, competitively sensitive information of the target firm that could facilitate collusive conduct.⁴⁴

In 1998, USDOJ challenged Northwest Airlines' partial acquisition of Continental Airlines. Northwest was then the fourth largest airline in the United States, and Continental was the fifth largest.⁴⁵ According to the amended complaint, Northwest and Continental competed on price and service in "thousands of routes throughout the United States" and were "each other's most significant competitor . . . on seven densely traveled routes between cities where they operate[d] their hubs—Detroit, Memphis, and Minneapolis for Northwest; and Cleveland, Houston, and Newark for Continental."⁴⁶ On five of those seven routes their combined share of nonstop flights was one hundred percent; on the other two it was ninety-three percent and eighty-three percent, respectively.⁴⁷

Over a period of several months in 1998, Northwest acquired sufficient Continental stock to give it fifty-one percent of the voting power over Continental and the consequent ability to influence virtually all of

⁴² *Id.*; Press Release, Eur. Comm'n, Mergers: Commission Approves Acquisition of Greek Airline Olympic Air by Aegean Airlines (Oct. 9, 2013), available at http://europa.eu/rapid/press-release_IP-13-927_en.htm; see also Press Release, U.S. Dep't of Justice, Justice Department Announces It Won't Challenge American Airlines/TWA Acquisition (Mar. 16, 2001), available at http://www.justice.gov/atr/public/press_releases/2001/7682.htm.

⁴³ Merger Guidelines, *supra* note 10, at §13.

⁴⁴ *Id.*

⁴⁵ Amended Complaint at ¶ 1, *United States v. Nw. Airlines Corp.*, No. 98-74611 (E.D. Mich. Dec. 18, 1998).

⁴⁶ *Id.* ¶¶ 2, 3 at 2.

⁴⁷ *Id.* ¶ 31 at 10.

Continental's management decisions, including decisions regarding its competitive conduct.⁴⁸ USDOJ believed that Northwest's ownership of a controlling interest in Continental also would reduce the incentive of each carrier to compete against the other.⁴⁹ It concluded that Northwest's partial acquisition would diminish actual competition in the seven hub-to-hub markets and in "numerous other markets," as well as potential competition in additional key markets, thereby creating the likelihood of increased fares and decreased service.⁵⁰

The case ultimately settled during trial. Under the terms of the settlement, Northwest agreed to divest all but seven percent of the voting interest in Continental, and to accept significant restrictions on its ability to vote any stock it retained.⁵¹

In December 2012, Delta Air Lines reached an agreement to purchase the forty-nine percent stake in Virgin Atlantic that was then held by Singapore Airlines. At that time, Delta and Virgin Atlantic had nonstop overlaps in two transatlantic markets—New York-London and Boston-London—and Delta's one-stop services overlapped with Virgin Atlantic's nonstop flights on another ten routes between North America and London and Birmingham. However, there were other significant competitors on all of those routes. British Airways and American Airlines, which operate under a joint venture agreement on North Atlantic routes, were very robust competitors on the overlapping nonstop routes in particular. Presumably because Delta did not plan to acquire a majority stake in Virgin Atlantic, and because other viable airlines would continue to provide competitive constraints, both EU and US competition authorities determined not to challenge the proposed transaction.⁵²

IV. AIRLINE ALLIANCES AND CODE SHARING

Section 1 of the Sherman Act, 15 U.S.C. § 1, prohibits conspiracies and agreements that restrain or eliminate competition.⁵³ Agreements between

⁴⁸ *Id.* ¶¶ 14, 16 at 5.

⁴⁹ *Id.* ¶ 37 at 12.

⁵⁰ *Id.* ¶ 38 at 12.

⁵¹ Press Release, U.S. Dep't of Justice, Department Announces Tentative Settlement in Northwest-Continental Lawsuit (Nov. 6, 2000), available at http://www.justice.gov/atr/public/press_releases/2000/6905.htm.

⁵² Press Release, U.S. Dep't of Justice, Statement of the Department of Justice Antitrust Division on Its Decision To Close Its Investigation of Delta Air Lines' Acquisition of an Equity Interest in Virgin Atlantic Airways (June 20, 2013), available at http://www.justice.gov/atr/public/press_releases/2013/298788.htm; Press Release, Eur. Comm'n, Mergers: Commission Clears Proposed Joint Acquisition of Virgin Atlantic by Delta and Virgin Group (June 20, 2013), available at http://europa.eu/rapid/press-release_IP-13-587_en.htm.

⁵³ "Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade

direct competitors, such as two airlines serving the same markets, are referred to as “horizontal” agreements and are normally challenged as restraining competition between the two parties. Agreements between parties at different levels of production or distribution, such as between an airline and a travel agent or corporate client, are referred to as “vertical agreements” and are normally challenged as exclusionary, that is, as inhibiting competition from actual or potential competitors of one of the parties.⁵⁴ In addition, like participants in other transportation or network industries, airlines can be both horizontally and vertically related to one another, depending on the situation. For example, airlines that interline passengers with one another are in a vertical relationship with respect to that traffic, even though they are direct competitors for other traffic. Alliances and code sharing agreements may, therefore, constitute horizontal agreements in some city-pair markets but vertical agreements in others.

A. Horizontal Agreements

Horizontal agreements have been classified by the U.S. courts as either “per se illegal” or subject to a “rule of reason” analysis to determine their legality.⁵⁵ Rule of reason cases are further subdivided into “quick look” cases and “full rule of reason” cases.

Any agreement that is not illegal *per se* is analyzed in the United States under the rule of reason. The basic test under the rule of reason is whether, on balance, the restraint “is one that promotes competition or one that suppresses competition.”⁵⁶ The rule of reason does not permit a restraint on competition to be justified by social or other non-competition related policies.⁵⁷ The net adverse effect on competition must be significant, rather than trivial or attenuated.⁵⁸

Most agreements between or among airlines are subject to a rule of reason analysis because they are potentially pro-competitive, or at least

or commerce among the several States, or with foreign nations, is declared to be illegal.” 15 U.S.C. § 1 (2004).

⁵⁴ See *Business Elec. Corp. v. Sharp Elecs. Corp.*, 485 U.S. 717, 730 (1988) (discussing horizontal and vertical agreements); *In re Nw. Airlines Corp. Antitrust Litig.*, 208 F.R.D. 174, n.34 (E.D. Mich. 2002) (discussing horizontal and vertical agreements in the airline industry).

⁵⁵ The *per se* rule provides that once a plaintiff establishes that an agreement is of a certain nature (horizontal price-fixing, bid-rigging, market allocation, and certain group boycotts), the adverse effect on competition is presumed without detailed examination of market conditions and impact. The *per se* rule is reserved for an agreement that “facially appears to be one that would always or almost always tend to restrict competition and decrease output.” *Broad. Music, Inc. v. Columbia Broad. Sys., Inc.*, 441 U.S. 1, 19-20 (1979). Suspected *per se* conduct will often be investigated by USDOJ as a criminal matter (e.g., the air cargo prosecutions).

⁵⁶ *Nat’l Soc’y of Prof’l Eng’rs v. United States*, 435 U.S. 679, 691 (1978).

⁵⁷ *Id.*

⁵⁸ *United States v. Topco Assocs.*, 405 U.S. 596, 606 (1972).

competitively neutral. Common examples include interline agreements,⁵⁹ alliance agreements, code-sharing, information exchanges, joint ventures of all sorts, including industry joint ventures,⁶⁰ and trade associations.⁶¹

Domestic code-share alliances are joint ventures between or among airlines and are subject to the normal operation of the Sherman Act. Like international alliances, domestic alliances involve agreements on fares among the parties, sometimes on overlapping routes. USDOJ applies a standard rule of reason analysis to domestic alliances and may challenge them in court. By statute, however, a domestic alliance must also be submitted to USDOT for its review and approval under 49 U.S.C. § 41720 to determine whether it constitutes an unfair or deceptive practice or unfair method of competition under 49 U.S.C. § 41712, formerly Section 411 of the Federal Aviation Act.⁶² Although USDOJ did not challenge the Delta/Northwest/Continental domestic alliance under the Sherman Act, USDOT imposed, at the behest of USDOJ, conditions on its approval under its statute that limited certain joint pricing activity by the parties.⁶³ Under USDOT's approval order:

- No code-sharing is permitted for local traffic on routes where more than one of the carriers offers nonstop service, including their hub-to-hub routes.
- Each carrier must act independently in establishing the terms

⁵⁹ An interline agreement allows one carrier to sell an itinerary, or part of an itinerary, on a second carrier, which commonly occurs when a connecting flight requires two or more different carriers. See Arpad Szakal, *Interline and Code-share Agreements*, <http://www.aviationlaw.eu/wp/wp-content/uploads/2013/09/Interline-and-code-share-agreements.pdf> (explaining interline and code sharing agreements).

⁶⁰ Industry-wide joint ventures include the Airlines Tariff Publishing Company (ATP) and the Airlines Reporting Corporation (ARC). A consumer class action survived summary judgment where the class alleged that Northwest, Delta and US Airways conspired with ARC to prohibit the sale of "hidden city" tickets. See generally *In re Nw. Airlines Corp. Antitrust Litig.*, 208 F.R.D. 174 (E.D. Mich. 2002). The court rejected a "fraud prevention" defense, holding that disclosure of a passenger's true itinerary was unilaterally imposed by the carriers and not a bargained-for element of sale for the passenger, and, thus, the elements of "fraud" were not present. Moreover, the information exchanged added nothing to the information each carrier possessed about its own passengers, so the exchange "enabled" no fraud prevention as in *Cement Manufacturers Protective Ass'n v. United States*, 268 U.S. 588 (1925).

⁶¹ Industry trade associations include Airlines for America (formerly known as the Air Transport Association) or the International Air Transport Association (IATA).

⁶² In theory, international joint ventures and alliances are subject to the normal operation of the antitrust laws, but in practice, such alliances apply to USDOT for statutory immunity, where the competitive issues are examined with USDOJ input. See Proposed Final Judgment No. 147-2 at Part IV.C (Nov. 12, 2013), available at <http://s3.documentcloud.org/documents/818343/amr111213.txt>.

⁶³ See Termination of Review Under 49 U.S.C. 41720 of Delta/Northwest/Continental Agreements, 68 Fed. Reg. 16854 (Apr. 7, 2003), available at <https://www.federalregister.gov/articles/2003/04/07/03-8288/termination-of-review-under-49-usc-41720-of-deltanorthwestcontinental-agreements>; see also Press Release, U.S. Dep't of Justice, Department of Justice Approves Northwest/Continental/Delta Marketing Alliance With Conditions (Jan. 17, 2003), available at http://www.justice.gov/atr/public/press_releases/2003/200645.pdf.

and conditions of its frequent flyer programs and in bidding on corporate contracts, although the carriers may offer a customer the option of a joint bid when consistent with the antitrust laws.

- Each carrier must observe restrictions on the extent to which it can set prices on flights operated by another carrier.⁶⁴

B. Vertical Agreements

Alliances and code-sharing can also raise vertical issues. Most airlines are both competitors and customers of other airlines. When two airlines are both offering to sell a seat to the same passenger to travel between the same cities, they are direct horizontal competitors. When those same two airlines interline connecting passengers with one another, they are in essence buying and selling through passengers to one another and are, thus, in a vertical relationship. When two vertically related airlines enter an alliance or code share agreement, other airlines that had previously obtained interline passengers from one of the alliance parties might find that the alliance partners favor each other to such an extent that they can no longer obtain connecting interline passengers on the same terms. Competition laws treat this as an “exclusive dealing” situation. Exclusive dealing is usually, but not always, permissible under the antitrust laws.

In the international context, for example, it is possible that in some gateway-to-gateway markets, carriers must be able to obtain a minimum number of interline passengers from behind the gateway cities in order for their gateway-to-gateway leg to be economically viable. If, as a result of an alliance or code-share agreement, a competitor of one of the partners was forced to exit the gateway-to-gateway route, fares on that route could increase, in turn harming consumers and raising “vertical foreclosure” concerns under competition laws. Whether a particular alliance agreement would constitute illegal foreclosure depends on many factors, including other sources of connecting passengers and the efficiencies generated by the alliance. Although competition authorities have not challenged airline

⁶⁴ The marketing carrier’s fares must be the same as the operating carrier’s fares on routes that are not served by the marketing airline (the marketing airline is the airline that does not operate the flight but nonetheless sells seats under its code). On routes served by two or more of the partners with connecting service, when one airline is the marketing airline it must sell seats on flights operated by the partner airline for the same fares it charges for its own flights or for the fares established by the operating airline. On routes where one airline offers nonstop service and the other airline offers connecting service, the latter airline’s fares for the nonstop service must be the same as the operating carrier’s fares. *See* Termination of Review Under 49 U.S.C. 41720 of Delta/Northwest/Continental Agreements, 68 Fed. Reg. 16854 n.1 (Apr. 7, 2003), *available at* <https://www.federalregister.gov/articles/2003/04/07/03-8288/termination-of-review-under-49-usc-41720-of-deltanorthwestcontinental-agreements>. The stated purpose of the restrictions is to prevent such pricing practices from becoming a vehicle for signaling and collusion.

alliances on vertical grounds in the past, the possibility remains.

Not only have authorities shown a lack of interest in airline foreclosure cases, a private antitrust case that raised foreclosure issues failed. Virgin Atlantic tried to challenge British Airways' use of contracts with travel agencies and corporate clients that awarded increased loyalty discounts when certain sales thresholds were reached.⁶⁵ Virgin had argued that these contracts prevented or delayed (i.e., foreclosed) its entry on certain city pair routes. The court rejected Virgin's claims on multiple grounds, including that Virgin had failed to show harm to competition on the routes in question, such as higher fares, lower output, or reduced service quality.⁶⁶

C. Antitrust Immunity for International Alliances

Agreements between and among domestic and foreign airlines are eligible for statutory antitrust immunity (ATI) under 49 U.S.C. §§ 41308-09. USDOT is responsible for deciding whether such an agreement meets the statutory requirements for immunity. The Secretary *may* grant ATI upon a finding that the agreement is "required by the public interest."⁶⁷ Moreover, the Secretary *shall* grant ATI to any agreement that "substantially reduces or eliminates competition"⁶⁸ if the Secretary also determines that the agreement "is necessary to meet a serious transportation need or to achieve important public benefits (including international comity and foreign policy considerations)," and the "transportation need cannot be met or those benefits cannot be achieved by reasonably available alternatives that are materially less anticompetitive."⁶⁹ USDOT has described the process as a two-step analysis starting with the competitive analysis, followed by the benefits analysis, with the burden on opponents to show competitive harm, and on the parties to demonstrate countervailing benefits.⁷⁰

V. REMEDIES

USDOJ has no authority to disapprove a merger or enjoin alleged anticompetitive conduct on its own; rather, it must file a lawsuit seeking relief from a federal district court.⁷¹ Section 4 of the Sherman Act and Section 15

⁶⁵ Virgin Atlantic Airways v. British Airways PLC, 257 F.3d 256 (2d Cir. 2001).

⁶⁶ *Id.* at 264.

⁶⁷ 49 U.S.C. § 41308(b) (1994) (emphasis added).

⁶⁸ 49 U.S.C. § 41308(c) (1994) (emphasis added); 49 U.S.C. § 41309(c)(2) (1996).

⁶⁹ 49 U.S.C. § 41309(b)(1) (1996).

⁷⁰ Final Order at 7-8, Joint Application of American Airlines, Inc., (July 20, 2010) (No. DOT-OST-208-0252), available at <http://www.airlineinfo.com/ostpdf78/834.pdf>.

⁷¹ Post-complaint, USDOJ may seek additional discovery through interrogatories, requests for admissions, document requests, and depositions pursuant to the usual discovery tools provided to plaintiffs by the Federal Rules of Civil Procedure. These tools are in addition to USDOJ's pre-complaint

of the Clayton Act confer jurisdiction on federal district courts “to prevent and restrain violations” of the antitrust laws by injunction and authorize the government “to institute proceedings in equity to prevent and restrain such violations.” In fashioning relief, courts may enjoin repetition of past violations and seek to restore competitive conditions. The equitable merger remedies potentially available to USDOJ include preliminary or permanent injunctive relief preventing the consolidation, divestiture of assets, and behavioral relief.

In merger cases, USDOJ prefers “structural” remedies such as asset divestiture, which once accomplished, require no further oversight. According to its *Policy Guide To Merger Remedies*, USDOJ “will pursue a divestiture remedy in the vast majority of cases involving horizontal mergers.”⁷² Although it is common for merger consent decrees to allow parties to consummate their merger and accomplish the divestiture afterward, the time allowed to do so is limited. “Generally, the [USDOJ] will allow the parties an opportunity to find a purchaser on their own within sixty to ninety days,”⁷³ but USDOJ always reserves the right to approve any proposed purchaser.⁷⁴ Such post-consummation divestiture decrees are accompanied by a stipulated “Hold Separate” order requiring the merged firm to preserve the divestiture assets.

The most common forms of non-structural (“conduct”) relief in merger cases are information firewalls, nondiscrimination requirements, mandatory licensing, transparency provisions, anti-retaliation provisions, as well as prohibitions on certain contracting practices.⁷⁵

Boilerplate provisions generally contained in USDOJ decrees include provisions terminating the challenged conduct, requiring specific compliance efforts, arranging for periodic compliance reports, and permitting inspection of company records. USDOJ decrees are almost always limited in duration, most often ten years.

The most recent example of a USDOJ enforcement action in the airline industry occurred in 2013. After a six-month investigation, USDOJ, along with five states and the District of Columbia, filed a lawsuit in August 2013 alleging that the merger of American Airlines and US Airways, if implemented, would violate Section 7 and should be enjoined.⁷⁶ USDOJ

investigatory powers.

⁷² *Antitrust Division Policy Guide to Merger Remedies* (June 2011) at 5, available at <http://www.justice.gov/atr/public/guidelines/272350.pdf>.

⁷³ *Id.* at 25.

⁷⁴ *Id.*

⁷⁵ *Id.* at 13.

⁷⁶ See generally Complaint, *United States v. US Airways Group, Inc.* (No. 1:13-CV-012360) (D.D.C. Aug. 13, 2013) [hereinafter *U.S. v. USAA*].

pointed to fare and fee increases and capacity reductions that had followed recent industry consolidation.⁷⁷

American and US Airways had seventeen nonstop overlapping routes,⁷⁸ but USDOJ's analysis gave considerable weight to other factors as well. According to USDOJ, "[t]he merger would create the largest airline in the world and result in four airlines [American, United, Delta, and Southwest] controlling eighty percent of the United States commercial air travel market."⁷⁹ It alleged that adverse competitive impacts would be felt in "more than a thousand routes where one or both offer connecting service,"⁸⁰ and at Washington National Airport, where "the combined firm would control 69% of the slots," substantially raising barriers to entry.⁸¹ USDOJ claimed that fares and ancillary fees would rise, citing the likely termination of US Airways' discount Advantage Fares and the increased likelihood of coordinated behavior.⁸² It also contended that there were insufficient "acquisition-specific and cognizable efficiencies" to offset the alleged adverse competitive effects,⁸³ and that, far from being a "failing firm," American was "likely to exit bankruptcy as a vigorous competitor" in the absence of the merger.⁸⁴

On November 12, 2013, USDOJ announced that it had reached an agreement with the parties that would settle the lawsuit.⁸⁵ Under the terms of the settlement, which was set forth in a Proposed Final Judgment filed in the district court the same day, the parties would divest slots, gates and related facilities at both Washington National (104 slots, up to five gates and related ground facilities) and New York LaGuardia (34 slots and up to two gates and related ground facilities) Airports. In addition, the parties also agreed to divest two gates and related facilities at five key airports: Boston Logan,

⁷⁷ *Id.* ¶ 4, at 4; *id.* ¶ 35 at 14.

⁷⁸ *Id.* ¶ 82 at 30. The 17 nonstop overlaps were fewer than the number of nonstop overlaps between Southwest and AirTran, whose merger USDOJ did not challenge in 2011.

⁷⁹ Press Release, U.S. Dep't of Justice, Justice Department Files Antitrust Lawsuit Challenging Proposed Merger Between US Airways and American Airlines (Aug. 13, 2013), available at http://www.justice.gov/atr/public/press_releases/2013/299960.htm

⁸⁰ Complaint, U.S. v. US/AA, ¶ 82 at 30.

⁸¹ *Id.* ¶¶ 83, 84 at 30.

⁸² *See generally id.* ¶¶ 41-67 at 15-26; *see generally id.* ¶¶ 71-81 at 27-30. US Airways offers Advantage Fares on many connecting routes in competition with nonstop fares offered by legacy carriers. According to USDOJ, these fares "have proven highly disruptive to the industry's overall coordinated pricing dynamic," *id.* ¶ 54 at 21, *i.e.*, they have disciplined fares for nonstop service by the legacy carriers.

⁸³ *Id.* ¶ 94 at 33.

⁸⁴ Press Release, *supra* note 79.

⁸⁵ *See generally* Press Release, U.S. Dep't of Justice, Justice Department Requires US Airways and American Airlines to Divest Facilities at Seven Key Airports to Enhance System-Wide Competition and Settle Merger Challenge (Nov. 12, 2013), available at http://www.justice.gov/atr/public/press_releases/2013/301616.htm.

Chicago O'Hare, Dallas Love Field, Los Angeles International, and Miami International. The carriers purchasing the divestiture assets had to be approved by USDOJ, which stated that it intended to give preference to carriers not already operating a large number of flights at the airports in question.⁸⁶ The Proposed Final Judgment required the parties to first offer to Southwest and JetBlue the slots each was currently leasing from American at LaGuardia Airport (LGA) (10 slots to Southwest) and Washington National (16 slots to JetBlue.)⁸⁷ Thereafter, the remaining slots would be divested to at least two carriers at Washington National and one at LaGuardia.⁸⁸ The slots were to be divested within 90 days and the gates and facilities within 180 days.⁸⁹ Consistent with USDOJ practice, a Divestiture Trustee would be appointed to carry out the divestitures if the parties failed to do so.⁹⁰ The parties are prohibited from re-acquiring the divested assets during the term of the Proposed Final Judgment, which is ten years, also a standard provision.⁹¹ The Proposed Final Judgment was entered by the court on April 25, 2014, as the Final Judgment without modification.

⁸⁶ See Proposed Final Judgment at IV.A; *id.*

⁸⁷ See Part IV.F, G.

⁸⁸ *Id.*

⁸⁹ See *id.* Part IV.C-D.

⁹⁰ See *id.* Part V.A.

⁹¹ See *id.* Parts XII, XVI.