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A deal takes off

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It took unspoken signals from officials and days of backroom negotiations to end a blockbuster antitrust lawsuit and allow the US Airways/American Airlines deal to go forward. **Ron Knox** explores how it happened.

For the vast majority of onlookers and pundits, the US government's lawsuit to block US Airways' mega-merger with American Airlines looked to be charging headlong towards the courtroom, destined to become the most significant antitrust merger challenge in years, if not decades.

But within a handful of weeks, the tone and timbre of the government's seemingly steadfast voice against the merger changed drastically, observers close to the deal tell *GCR*. By the time the United States' attorney general, Eric Holder, took the nearly unprecedented step of commenting publicly on the status of settlement talks between the two sides, leaders within the US Department of Justice's antitrust division had already agreed in principle to a deal that would see the airlines sell take-off and landing slots at a handful of airports around the country. In exchange, the government's lengthy and seemingly unassailable lawsuit against the deal would disappear, allowing the deal to close and American Airlines to move forward with its long-planned emergence from bankruptcy.

For some of those same observers, the settlement, which became official with a

flurry of court filings on 12 November, gloss over or outright avoided addressing much of the damage the government had claimed the merger would cause to consumers and the industry. Prosecutors said in the lawsuit that the deal would end price competition on more than 1,000 routes around the country and open the door to widespread collusion on fares and fees within the industry. The settlement set all of that aside in exchange for the airlines giving up a hundred or more slots, observers said.

“The DoJ complaint had alleged problems in hundreds of relevant market city pairs, including one-stop markets. At this moment I don’t see how the settlement solves this problem,” Baker Botts partner John Taladay told *GCR* the day after the settlement became public.

What happened in the time between complaint and settlement includes waves of political and courtroom pressure from groups as diverse as Republican attorneys general and union representatives, all directly asking the Department of Justice and, at times, the Obama administration to drop its opposition to the deal and help ensure jobs and local city-to-city flights – things the airlines said would vanish if their merger fell apart.

Why the settlement came about remains murky, except for what William Baer, head of the DoJ’s antitrust division, has said publicly: that the deal will help spur competition in the industry that would have been impossible to create without it. But interviews with sources close to the settlement process reveal more about how the deal came about than has been made public previously.

The merger between US Airways and American Airlines – a tie-up that had been bruited about for years before a deal was finally struck in August – always appeared destined to raise antitrust issues, essentially for one reason: Ronald Reagan National Airport. Nestled along the Potomac River just outside of Washington, DC, the airport is a major entranceway to the nation’s capital, and the two airlines combined would control a significant majority of the take-off and landing slots for flights in and out of the city. Reagan and the three New York City-area airports are the only US airports that are slot-controlled, meaning that government regulators control the number of flights in and out of an airport to maximise traffic without causing delays.

In the days before the DoJ sued to block the deal, the airlines put together a package of potential slot divestitures, including some at Reagan, and sent it to antitrust division officials to try to open lines of communication and avoid a trial.

The overtures – which happened at the last minute and were modest in the number of slots the airlines were willing to sell – were largely ignored, sources say. The proposed divestitures were far from the kind of relief the government was seeking, so Baer and the division filed the lawsuit almost immediately afterwards.

The fact that the government sued to block the deal was no real surprise to observers with whom *GCR* spoke in the days after the suit was filed; what was surprising was the lawsuit's content. The division looked far beyond the obvious slot issues at Reagan and instead targeted the competition US Airways provided on one-stop routes through its hub-and-spoke network in smaller cities around the country. Using those routes as the yardstick for measuring competition, DoJ officials found overlaps everywhere they looked. Plus, the DoJ said that reducing the number of US legacy airlines from four to three would essentially create an environment where tacit collusion was rampant. Fares and fees would rise in tandem across the industry, even more so than they already do. In statements made while announcing the lawsuit, Baer made it clear the division's concerns went well beyond Reagan. He said the division had not mapped out any package of commitments that would solve its concerns. He said the only solution he could see was a "full-stop injunction."

Once in court, however, the case began to tilt away from the government. When prosecutors asked for a March 2014 trial date, for example, they ended up with a schedule that would see them give their opening remarks before Thanksgiving. When given the opportunity, the airlines' lead trial counsel, Richard Parker, at O'Melveny & Myers, and others stood up in court and pressed Judge Colleen Kollar-Kotelly to quash the government's request for extensive testimony from executives and those in the airline industry. They wouldn't need much to prove the merger was good for competition, Parker said; he called the case "simple". Kollar-Kotelly agreed to a much shorter list of witnesses, in line with what the airlines had asked for.

Then, days later, the airlines turned around and asked the government for potentially millions of documents stemming from the DoJ's previous airline merger investigations. Those filings and statements by Parker and others made it clear that the airlines planned on making legal hay of the division's past proclivity for clearing nearly identical airline mergers with little or no intervention over antitrust concerns. Certainly, the *US/AA* deal would create the world's largest airline. But that title is currently held by rival legacy carrier United, which only won the mantle after the DoJ cleared its merger with Continental. The title can also be claimed by Delta – if one measures passengers rather than passenger-kilometres – but that is only since 2009, when the division approved its merger with Northwest Airlines.

US Airways and American made clear it was their plan – in court and in the media – to make the DoJ defend both its decision to challenge the deal, and its decisions to clear other, similar deals going back a decade. For whatever success or failure the strategy may have ultimately had in court, the message resonated – as did the airline's larger public relations strategy as a whole.

The airlines employed a team of lobbyists, lawyers and consultants to shape and deliver their message more successfully than perhaps any two potential merger

partners before them. *GCR*'s review of federal lobbying records showed that in the months prior to the DoJ's lawsuit being filed, the airlines spent a part of more than US$8 million to convince legislators and others that the deal would be good for passengers and the communities the airlines currently serve. In the days before and after the government sued to block the deal, the airlines reached out to lawmakers and other interested parties to urge them to back the deal and pressure the feds to drop their opposition.

Outside opposition to the DoJ lawsuit began in earnest in early October, when Greg Abbott, the Republican attorney general of Texas, dropped out of the lawsuit and appeared, almost bizarrely, at a press conference alongside AMR Corp chief executive Thomas Horton to announce the settlement. With the American Airlines "Admirals Club" inside Dallas/Fort Worth International Airport as their backdrop, Abbott and Horton praised the airlines' promises of maintained jobs and local airline routes for Texas cities – things that appeared to have never been in doubt regardless of how the merger challenge ended.

The talk of protecting jobs and preserving service quickly drowned out whatever concerns about harm to competition there had once been among those on the sidelines of the merger. Over two weeks, from mid-October until Halloween, Obama administration officials heard from local chambers of commerce, airports, unions, American's creditors, mayors of the airlines' major hub cities and 68 Democratic lawmakers who backed the merger and asked that prosecutors drop their challenge and let the deal close.

Publicly, the antitrust division was steadfast in its opposition to the deal. "We're aware of these views," DoJ spokesperson Gina Talamona told *GCR* on 24 October. But, she said, the division brought its lawsuit because it believed the deal would hurt competition and consumers and that belief hadn't waivered.

At the same time, however, officials at the DoJ had responded to senators and others who had voiced their support for the deal, saying the administration had heard their calls to end the lawsuit and took their concerns seriously.

Back in court, sources close to the strategy say the airlines and their counsel were focused on building their case and meeting a series of rapid fire deadlines in Judge Colleen Kollar-Kotelly's truncated pretrial schedule. The airlines thought they had a shot at winning, certainly; examinations of the thousand-or-so routes the DoJ pegged as problematic showed some that only a handful of passengers used every day. They also had a much more favourable view of low-cost discount airlines, such as Southwest and JetBlue, and their ability to add price competition to the industry. In a complaint that ultimately went unanswered, the airlines were quietly confident it would fall apart once depositions began.

But a month or so into pretrial proceedings – and around the same time the political pressure began to mount outside the courtroom – the parties were made

to file a joint report with the court outlining the possibility of a settlement. As is typical, neither side would rule the possibility out altogether, and by 29 October, the airlines and the government told the court that they had agreed to a mediator if and when they decided to try to hash out a way to settle the lawsuit.

The mediator was never used. Instead, during the course of what was a relatively friendly and rushed litigation, lawyers for American picked up on a kind of unspoken suggestion from DoJ prosecutors that it might be worthwhile for the airlines to once again make a settlement offer. It was a hint, mainly, that maybe there was a solution out there that did not involve trial.

Soon after, according to sources and published reports, the airlines approached the DoJ with a package proposal delivered in a two-page letter that included some slot sales to help quell the division's concerns, and some guarantees that would lock the airlines into specific behaviour – preserving prices on routes and so on – for a certain amount of time as a way to appease the states that had joined the federal government's lawsuit. The DoJ came back with a simple but clear counter-offer: it wanted more.

The back-and-forth negotiations between airline lawyers and DoJ officials Renata Hesse and David Gelfand continued for days, sources say, until the airlines agreed to what Baer called "zero delta" – a deal in which US Airways did not gain a single take-off or landing slot at Reagan. By the time the outlines for a potential deal were in place, Attorney General Holder said at an unrelated press conference that the government wanted a deal that would focus on adding competition to airports and routes where it didn't currently exist.

In the eventual settlement, the airlines agreed to sell off what has since been dubbed the "magic number" of slots – all of American's 104 slots at Reagan, 34 slots at LaGuardia Airport in New York, and two gates each at airports in Boston, Chicago, Los Angeles, Dallas and Miami. It was the largest divestiture in the history of US airline mergers. Plus, the airlines agreed to preserve some routes and prices as a way of appeasing the states and the Department of Transportation – and as a way, as one observer puts it, for the DoJ to "have its cake and eat it too" by not having to ask for a behavioural remedy and getting one anyway.

The plan, Baer said when announcing the deal, is for those slots to be sold to a low-cost carrier, a company such as Southwest or JetBlue, who can use the different take-off and landing slots to construct a network of flights to some of the country's most popular airports.

"Making slots and gates available to low-cost carriers will lower barriers to entry, providing the incentive and ability for those carriers to invest in new capacity, and positioning those carriers to provide significant new competition system-wide," Baer said.

He stressed that without the settlement, new low-cost competition never would have existed. If the airlines had won at trial, they could have merged without selling anything. Had the government won, everything would remain essentially the same, with US Airways and American owning a majority of the slots at Reagan and with little low-cost competition on the horizon. “Why settle the case? Because [...] this settlement improves on a problematic status quo,” Baer said. “It provides more competition than exists today in this industry.”

While the remedy looks run-of-the-mill – after all, almost all merger challenges are solved through some asset sale – observers say the deal is more creative than that. Sure, Reagan was a problem from the beginning and selling off slots there was the clearest way to avoiding trial. But the slot sales at the other airports are intended to create a kind of low-cost network that will add price competition on routes around the country – after all, the more airports low-cost carriers can take off from and land at, the more cities they can then connect to, growing the network exponentially. It is a solution that may ultimately lead to lower prices and more choices, some say.

“There were a lot of people surprised at the eventual settlement, but I wasn’t,” says Jeff Blumenfeld, partner at Lowenstein Sandler, who represented the Transportation Workers Union in court. “I always thought it was a settleable case.”

He says that in some ways, he views the airline industry before the merger as a kind of duopoly – United and Delta – with a lot of fringe players with far smaller networks. Now, he says, the new American will add a much-needed third major airline to the US market and give low-cost carriers an added network. The antitrust question was always whether passengers were better off with “this two-two structure” where you had United and Delta as behemoths and US Airways and American as smaller carriers, or whether people would be better off with three big airlines, Blumenfeld says. The answer, at the end of the day, was that a “two-to-three” deal, as he calls it, was better for everyone.

Other observers point out that the argument made in the DoJ’s complaint appears far different from Blumenthal’s assessment. Were US Airways to disappear, its low-cost pricing strategy – which made its flights often hundreds of dollars cheaper that its legacy carrier rivals – would disappear along with it. And because they lack hub-and-spoke networks, low-cost carriers such as Southwest and JetBlue can never truly match the older, larger legacy airlines. As the division itself said in the complaint, “[C]ompetition from Southwest, JetBlue, or other airlines would not be sufficient to prevent the anti-competitive consequences of the merger”.

Joseph Alioto, an enigma of the plaintiffs bar and a rabble-rouser when it comes to big-business mergers that eventually win antitrust approval, said after the

settlement that while he believed Baer was a “breath of fresh air at the antitrust division”, he thought Holder eventually bowed to rising political pressure and told the division to work out a deal that avoided trial.

Privately, others in the antitrust bar, including some involved in the case, say that they believe political pressure did play a role in the settlement. From Holder’s decision to publicly address the settlement talks, to the government’s apparently sudden willingness to listen to deals when nothing short of an injunction would suffice two months earlier, the signs certainly suggest that someone felt pressure to work out a deal in the case, those observers say.

Baer, meanwhile, held firm that the division agreed to the settlement because it was best for consumers. He insisted that Holder supported the decision to sue to block the deal, and when asked if Holder had at any point urged the division to settle the case, Baer replied: “I don’t go into my conversations with the attorney general, but the answer’s no.”

A version of this story appears in the upcoming edition of GCR Magazine.