Supreme Court Preview: Antitrust Scrutiny of Joint Ventures

By Louis K. Fisher*

Editor's Note: On February 28, 2006, the Supreme Court issued an opinion authored by Justice Thomas and joined by all Justices who participated in the decision. (Justice Alito had joined the Court after oral argument and did not participate.) The Court held that it is not "per se illegal under §1 of the Sherman Act, 15 U. S. C. §1, for a lawful, economically integrated joint venture to set the prices at which the joint venture sells its products." The Court reasoned that although the joint venture's "pricing policy may be price fixing in a literal sense, it is not price fixing in the antitrust sense," because the policy was "little more than price setting by a single entity—albeit within the context of a joint venture—and not a pricing agreement between competing entities with respect to their competing products." The Court also stated that "for the same reasons that per se liability is unwarranted here, we conclude that petitioners cannot be held liable under the quick look doctrine." The Court did not expressly rule out the possibility that the plaintiffs could have raised a "Rule of Reason" challenge (which they had elected to forego), but it emphasized that "[a]s a single entity, a joint venture, like any other firm, must have the discretion to determine the prices of the products that it sells."

One of the most significant business cases that the Supreme Court will hear this term is *Texaco Inc. v. Dagher*,[1] which presents the question whether it can be concerted action which is *per-se* illegal under Section 1 of the Sherman Act[2] for an economically-integrated joint venture to set the selling price of its own products.[3] Section 1 of the Sherman Act provides in pertinent part that "[e]very contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce. . . is declared to be illegal."[4] The Supreme Court, interpreting this language, has held that an agreement between competitors not to compete on price—that is, "price fixing"—violates Section 1 *per se*.[5] But the Court has also held that "this is not a question simply of determining whether two or more potential competitors have literally 'fixed' a price. . . . When two partners set the price of their goods or services they are literally 'price fixing,' but they are not *per se* in violation of the Sherman Act."[6] Even more fundamentally, two nominally-separate entities, such as a parent corporation and its wholly-owned subsidiary, may in certain circumstances be viewed as acting unilaterally, rather than pursuant to a "contract, combination. . .or conspiracy" subject to Section 1 scrutiny.[7] In the *Dagher* case, the Supreme Court will address how these principles apply to the operations of an economically-integrated joint venture through which two erstwhile competitors have merged certain lines of business, but not their entire corporations.

The joint venture at issue, which was formed by Texaco Inc. and Shell Oil Company, is embodied in an entity, called Equilon, that engages in the refining and marketing of gasoline in the western United States. Upon its formation, Texaco and Shell gave the joint venture trademark licenses and assets that included twelve refineries, twenty-three lubricant plants, two research laboratories, 22,000 branded service stations, over 24,000 miles of pipeline, 107 terminals, and approximately 24,000 employees.[8] Texaco and Shell owned Equilon, and shared its profits and losses, according to a fixed percentage based on the relative value of the assets that each had contributed. Texaco and Shell also agreed not to compete with Equilon in refining and marketing gasoline in the United States. Texaco and Shell continued to operate independently in, for example, their production of crude oil, their refining and marketing of gasoline outside the United States, and their chemical, aviation, and marine fuels businesses. After reviewing the transaction, the Federal Trade Commission and the attorneys general of four western states entered consent agreements with Texaco and Shell providing that, in exchange for certain divestitures designed to alleviate competitive concerns, the regulators would not challenge Equilon's formation under the antitrust laws.

A group of service-station dealers who bought gasoline from Equilon filed suit under Section 1 of the Sherman Act, claiming that it was illegal for Equilon to sell Texaco-branded and Shell-branded gasoline at the *same* price in each geographic marketing area. The dealers alleged that before the venture's formation, Texaco generally sold Texaco-branded gasoline to dealers at a slightly lower price than Shell sold Shell-branded gasoline to dealers, although Texaco's and Shell's geographic pricing areas were not the same. In the months after its formation, Equilon integrated the former Texaco and Shell pricing functions, and established the same geographic marketing areas for Texaco-branded and Shell-branded gasoline. Equilon then began charging the same price for Texaco-branded gasoline and Shell-branded gasoline to dealers in the same geographic area. According to undisputed evidence produced by Equilon, this "unification" of the price for Texaco-branded and Shell-branded gasoline was motivated by a desire to avoid the possibility of being sued under the Robinson-Patman Act, which generally makes it unlawful to sell products "of like grade and quality" to different purchasers and "to discriminate in [the] price" charged to each purchaser.[9]

Significantly, the plaintiffs in *Dagher* expressly disavowed any attempt to engage in a full "rule-of-reason" analysis. Rather, they alleged that the challenged conduct was unlawful either *per se* or under the "quick-look" theory. The *per-se* rule applies to certain categories of restraints that the courts have concluded are "plainly anticompetitive" and likely to have no "redeeming virtue."[10] "Quick-look" analysis also allows the plaintiff to avoid a full market analysis, but only where "an observer with even a rudimentary understanding of economics could conclude

that the arrangements in question have an anticompetitive effect on customers and markets."[11]

By disavowing a full "rule-of-reason" analysis, the plaintiffs effectively waived any challenge to the *existence* of a joint venture between Texaco and Shell to produce and sell branded gasoline. A joint venture, like a merger, is "judged under the rule of reason" because it "hold[s] the promise of increasing a firm's efficiency and enabling it to compete more effectively."[12] In *Dagher*, the plaintiffs conceded that Equilon is a potentially procompetitive joint venture, since Texaco and Shell integrated their entire domestic downstream gasoline businesses, with an expectation of efficiency gains amounting to several hundred million dollars per year.

These same efficiencies, combined with Equilon's lack of obvious market power, also make "quick-look" condemnation of Equilon's existence clearly inappropriate. "Quick-look" condemnation might apply, for example, to "a domestic selling arrangement by which, say, Ford and General Motors distributed their automobiles nationally through a single selling agent" (at least under market conditions in 1981, when this example was offered by antitrust's leading commentator).[13] A quick look might suffice in such circumstances because "the judge will know that these two large firms are major factors in the automobile market, that such joint selling would eliminate important price competition between them, that they are quite substantial enough to distribute their products independently, and that one can hardly imagine a pro-competitive justification actually probable in fact or strong enough in principle to make this particular joint selling arrangement 'reasonable' under Sherman Act § 1."[14] But in the case of Equilon, Texaco and Shell, by fully integrating their downstream domestic gasoline businesses, achieved much more substantial, potentially pro-competitive efficiencies than do Ford and General Motors in Professor Areeda's hypothetical.[15]

The competitive effect of Equilon's formation was akin to a merger, and was analyzed as such by the Federal Trade Commission and state attorneys general when they decided to permit the formation after certain divestitures. Mergers are analyzed under the "rule-of-reason" approach, in which the primary consideration is the market power, if any, that the combined entity will possess. And Equilon as formed did not have such market power. Indeed, while the prior governmental review did not preclude the plaintiffs from challenging the venture's existence,[16] it effectively precluded them from challenging Equilon's existence under "quick-look" analysis. Since federal and state regulators engaged in a full economic analysis of Equilon's formation and determined that (with divestitures) no challenge was appropriate, it plainly cannot be said that "an observer with even a rudimentary understanding of economics could conclude that the arrangements in question have an anticompetitive effect on customers and markets."[17] Thus, the plaintiffs eschewed the only level of analysis (full "rule of reason") under which they could possibly have hoped to challenge Equilon's existence itself.

In the decision under review, the Ninth Circuit accepted the validity of Equilon's existence. But a majority of the panel (in an opinion by Judge Stephen Reinhardt) reversed the district court's grant of summary judgment for the defendants. The panel majority concluded that the plaintiffs might be able to prove that the decision to charge the same price for all Equilon gasoline (both Texaco-branded gasoline and Shell-branded gasoline) was *per-se*-illegal price fixing. The majority reasoned that "the issue with respect to legitimate joint ventures is whether the price fixing is 'naked' (in which case the restraint is illegal) or 'ancillary' (in which case it is not)."[18] Whether a restraint is "naked" or "ancillary," the majority continued, "depends first and foremost on a determination of whether the specific restraint is sufficiently important to attaining the lawful objectives of the joint venture that the anti-competitive effects should be disregarded."[19]

Summary judgment was inappropriate, in the majority's view, because "[t]he defendants have thus far failed to offer any explanation of how their unified pricing of the distinct Texaco and Shell brands of gasoline served to further the ventures' legitimate efforts to produce better products or capitalize on efficiencies."[20] In reaching this conclusion, the majority claimed that it "of course recognize[d] that joint ventures may price their products."[21] By way of illustration, the majority stated that its "analysis would be different if" Equilon had "merge[d]" its Texaco and Shell "product lines into one collective brand."[22] Thus, the majority found "it significant that the defendants did not simply consolidate the pricing decisions within the joint venture[]—they *unified* the pricing of the two brands by designating one individual in [the] joint venture to set a single price for both brands."[23] Absent adequate explanation for *not* having made what the majority saw as "the rational decision to sell the different brands at different prices," the pricing of Equilon's own products was *per-se*-illegal price fixing.[24]

The first thing to be said about the Ninth Circuit's decision is that the distinction between *per-se*-illegal price fixing and a joint venture's legitimate pricing of its own products cannot possibly turn on the particular price charged for the products, or on whether the same or different prices are charged for a venture's different brands. From an antitrust perspective, once the pricing function for Equilon's gasoline was consolidated, it made no competitive difference whether Texaco-branded gasoline and Shell-branded gasoline were sold at the same wholesale price, at wholesale prices that differed by the same amount (*e.g.*, two cents or ten cents per gallon) in each pricing period and geographic market, or at wholesale prices that differed by a varying amount in each pricing period and geographic market. Indeed, it would have made no competitive difference if Equilon, instead of selling both Texaco-branded and Shell-branded gasoline, sold only a single brand—which the Ninth Circuit majority expressly recognized would be valid. The majority seemed to think that maintaining two separate brands yet charging the same

price for them was not "rational" and therefore was less likely to serve the efficiency-enhancing goals of the joint venture, as required by the majority's application of the "ancillary-restraint" test. But, as Texaco pointed out in its petition for certiorari, "[h]ow a court could believe itself competent to engage in such analysis [of the rationality of a particular pricing decision] is hard to fathom."[25]

In all events, regardless of whether a particular pricing decision could ever be examined under the "ancillary-restraint" test, Texaco and Shell are correct in arguing that the test does not apply to the *Dagher* case at all. The pricing decisions for a joint venture's own products, and other decisions about how to operate the business that the joint venture was formed to pursue, are *neither* "ancillary" *nor* "naked" restraints of trade.

A "naked" restraint is one where, for example, "in reliance on the existence of a valid joint venture between Coca Cola and Pepsi designed to research new types of soda flavors, the two companies imposed a price floor on all soda sold nationwide."[26] Such a restraint on the pricing of Coca Cola's and Pepsi's *non*-venture products would not be even arguably necessary to achieve the efficiencies of the research joint venture.

An illustration of an ancillary restraint, on the other hand, is where prospective venturers would not be willing to enter into the venture without a distinct agreement not to compete with each other. For example, two companies might not be willing to jointly construct a building for their two stores, thereby effectively committing to operate the stores out of adjoining space, without an agreement that the two stores will not sell competing products.[27] Another type of ancillary restraint occurs when the venture owners' competition with the venture is limited or forbidden, as may be necessary to prevent "free riding" and a corresponding lack of full incentive to contribute to the venture's success.[28] (In fact, Texaco and Shell entered into agreements not to compete with Equilon, and it has never been suggested that these were not legitimate ancillary restraints.) Ancillary restraints escape the *per-se* rule, but they are subject to "rule-of-reason" analysis and so may be struck down if their anticompetitive effects outweigh their enhancement of procompetitive venture efficiencies.

The Supreme Court's decision in *NCAA v. Board of Regents of the University of Oklahoma*[29] involved the type of restraint that, as in the foregoing examples, limited non-venture operations and thus was either naked or ancillary. The Court recognized that some degree of cooperation was necessary for the product—athletic "contests between competing institutions"—"to be available at all."[30] The type of cooperation that created this product, however, did not result in ownership of the product by the NCAA. Accordingly, by limiting the number and price of games that each school could sell for television broadcast, the NCAA was reducing competition among its members outside the joint venture. This restraint was not so obviously unrelated to the NCAA's legitimate collaboration as to be condemned *per se*, but it nevertheless was struck down without a full market analysis because its strong anticompetitive effects clearly outweighed any procompetitive benefits.

None of these examples exploring the naked/ancillary distinction involves decisions about the operation of the business that the venture was formed to pursue. And it is well-recognized that such operational decisions must be made by the joint venture. For example, in *Broadcast Music, Inc. v. Columbia Broadcasting System, Inc. (BMI)*,[31] the essential question was whether copyright owners could jointly sell licenses to their copyrights through an industry association marketing a blanket license. Once the Court held that it was permissible to sell a blanket license, it easily concluded that "a necessary consequence of an aggregate license is that its price must be established."[32] No specific showing of "necessity" or "ancillarity" was required to avoid Sherman-Act liability for this operational decision of an otherwise-valid business activity.

Both the plaintiffs and the Ninth Circuit majority have relied heavily on the Supreme Court's decision in *Citizen Publishing Co. v. United States*[33] as supposed authority for holding that the pricing of a joint venture's own products can be unlawful-*per-se* price fixing. In *Citizen Publishing*, two newspapers integrated their production equipment, distribution equipment, circulation departments, and advertising departments, but not their news or editorial departments.[34] Before discussing at length the "failing-firm" defense,[35] the Court stated cursorily that "[t]he § 1 violations are plain beyond peradventure. Price-fixing is illegal *per se*. Pooling of profits pursuant to an inflexible ratio at least reduces incentives to compete for circulation and advertising revenues and runs afoul of the Sherman Act. The agreement not to engage in any other publishing business in Pima County was a division of fields also banned by the Act."[36]

The Court's conclusion in *Citizen Publishing* that the joint venture's pricing of its products could be held unlawful *per se* is attributable to the fact that the Court found the joint venture itself—that is, the "[p]ooling of profits pursuant to an inflexible ratio"—to be unlawful. The newspapers in *Citizen Publishing* apparently were the *only* two competitors in the market,[37] and their efficiency-enhancing integration appears to have been insubstantial. In *Dagher*, by contrast, federal and state regulators concluded that Equilon would not have sufficient market power (post-divestitures) to warrant an objection to its formation, and Texaco and Shell combined their entire domestic downstream gasoline businesses, with estimated annual efficiencies of several hundred million dollars. For these reasons, *Citizen Publishing* easily can be distinguished.

Furthermore, as the Ninth Circuit recognized, subsequent Supreme Court decisions "suggest that the Court, if confronted with a similar joint venture today, might not find the enterprise as a whole unlawful."[38] In particular, the Court in *BMI*[39] and *NCAA*[40] adopted a much more

nuanced approach to joint ventures and associated restraints. *BMI*, for example, upheld a joint venture to sell a blanket copyright license, as well as the venture's setting of the price for that product. Thus, *Citizen Publishing* must be read in light not only of its specific facts but also of the Court's more recent decisions relating to joint ventures. In that light, *Citizen Publishing* has little or no application to the *Dagher* case.

The conclusion that Section 1 cannot interfere with a joint venture's pricing of its own products, or related operational decisions, can be reached in either or both of two related ways. First, such decisions represent unilateral conduct subject only to Section 2 of the Sherman Act, not concerted activity covered by Section 1. (Of course, an agreement between Equilon (or Texaco and Shell) *and Exxon Mobil* about the pricing of Equilon's gasoline would be subject to—and, indeed, *per se* unlawful under—Section 1.). Second, because the formation of Equilon ended all competition between Texaco and Shell in the domestic downstream gasoline market, the pricing of Equilon's products, even when viewed as concerted activity, cannot have had any anticompetitive effect.

The Sherman Act's "basic distinction between concerted and independent action" was emphasized by the Supreme Court in *Copperweld Corp. v. Independence Tube Corp.*,[41] which held that while a parent corporation and its wholly-owned subsidiary are nominally distinct entities, their decisions are not concerted activity covered by Section 1.[42] Once the parent has acquired the subsidiary, such actions do not represent a "merging of resources" that "increases the economic power moving in one particular direction."[43] The Court similarly recognized in *Arizona v. Maricopa County Medical Society*[44] that an economically-integrated joint venture "is regarded as a single firm competing with other sellers in the market," and that "a price-fixing agreement among the [partners] would be perfectly proper."[45] Applying these principles to *Dagher*, the *formation* of Equilon represented a "merging of resources" and is reviewable under Section 1, but the pricing of Equilon's products does not represent any further merging of resources and thus is not concerted action. In other words, "[o]nce a venture is judged to have been lawful at its inception and currently, decisions that do not affect the behavior of the participants in their nonventure business should generally be regarded as those of a single entity rather than the parents' daily conspiracy."[46]

Moreover, even if subject to Section 1, Equilon's pricing decisions cannot possibly violate the statute, because they have no anticompetitive effect. Texaco-branded gasoline sold by Equilon and Shell-branded gasoline sold by Equilon, just like Buick-branded automobiles sold by General Motors and Chevrolet-branded automobiles sold by General Motors, might "compete" in the sense that consumers choose between them. But any such "competition" is not relevant competition under the antitrust laws. Indeed, the profits and losses of Equilon were shared by Texaco and Shell in proportion to the assets contributed by each at the venture's formation, and not in proportion to the relative sales by Equilon of Texaco-branded gasoline and Shell-branded gasoline. The *formation* of that profit-sharing arrangement ended all competition between Texaco and Shell in domestic sales of downstream gasoline (but was justified by the venture's lack of market power and procompetitive efficiencies). The subsequent pricing decisions cannot have had a further anticompetitive effect.

The plaintiffs and their *amici* argue in response that,unlike the parent and subsidiary in *Copperweld*, Texaco and Shell did not have a *complete* unity of interest, and had not ended *all* actual and potential competition among themselves. They point to the fact that as owners of the brand names that were licensed to Equilon and used both inside and outside the venture, Texaco and Shell each had an interest in having Equilon act so as to increase the value of one brand over the other. At the venture's formation, however, Texaco and Shell had agreed to "Brand Management Protocols" that prohibited Equilon from devaluing either brand. The plaintiffs' *amici* seem to suggest the Brand Management Protocols themselves were anticompetitive restraints because they supposedly limited, however slightly, Equilon's ability to maximize its own profits. But that would be relevant, at most, only in analyzing the extent of procompetitive efficiencies generated by Equilon's *formation*; it would not make the pricing of Equilon's products subject to Section 1 scrutiny.

For similar reasons, it is irrelevant that Texaco and Shell continued to compete in non-venture businesses such as aviation fuels, and potentially could compete again in domestic downstream gasoline sales if the venture were unwound. To the extent, if any, that the pricing of Equilon gasoline had a potential effect on competition in the sale of non-gasoline products or in the future sale of branded gasoline, that effect is considered only in the analysis of whether it was valid for Texaco and Shell to *form* Equilon as a joint venture with authority to set prices for gasoline owned and sold by Equilon.

The plaintiffs' speculation about anticompetitive effects and diminished procompetitive efficiencies do not change the conclusion that Equilon's formation could not possibly be held unlawful under Section 1 based on anything other than a full "rule of reason" analysis, which the plaintiffs have disavowed. And, with Equilon's existence not subject to challenge in this case, the plaintiffs' arguments are insufficient to condemn decisions as to the pricing of Equilon's own products. Far from being subject to either a *per-se* rule or "quick-look" analysis, such decisions are not subject to Section 1 at all.

The Supreme Court should hold in *Dagher* at least that a defendant's particular pricing decisions (such as whether to charge the same or different prices for two brands under common control) are irrelevant, and that a valid joint venture's pricing of its own products is neither *per-se*

unlawful nor invalid on a "quick look." While that would be sufficient to reverse the Ninth Circuit's judgment, the Court also should hold that a valid joint venture's pricing of its own products is not concerted action subject to Section 1. Such a holding would provide important guidance to all businesses that have formed or may form efficiency-enhancing joint ventures, which are an increasingly important element of the national economy.

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Footnotes

[1] No. 04-805 (June 27, 2005), *cert. granted.* The case was consolidated for argument with *Shell Oil Company v. Dagher*, No. 04-814 (June 27, 2005), *cert. granted.*

[2] 15 U.S.C. § 1.

[3] An economically-integrated joint venture is a collaboration "in which persons who would otherwise be competitors pool their capital and share the risks of loss as well as the opportunities for profit." Arizona v. Maricopa Cty. Med. Soc'y, 457 U.S. 332 (1982).

[4] *Id.*

[5] *See, e.g.*, United States v. Trenton Potteries Co., 273 U.S. 392, 397 (1927).

[6] Broad. Music, Inc. v. Columbia Broad. Sys., Inc., 441 U.S. 1, 8-9 (1979) (hereinafter, "BMI").

[7] Copperweld Corp. v. Independence Tube Corp., 467 U.S. 752, 769-71 (1984).

[8] Dagher v. Saudi Refining Co., 369 F.3d 1108, 1111 n.3 (9th Cir. 2004). These include both contributions to Equilon, which operated in the western United States, and contributions to Motiva, a separate joint venture that operated in the eastern United States. Motiva is not at issue in the Supreme Court.

[9] 15 U.S.C. § 13(a).

[10] *BMI*, 441 U.S. at 9.

[11] Cal. Dental Ass'n v. FTC, 526 U.S. 756, 770 (1990).

[12] *Copperweld*, 467 U.S. at 768.

[13] Phillip Areeda, The "Rule of Reason" in Antitrust Analysis: General Issues 37-38 (Federal Judicial Center 1981), *quoted in* NCAA v. Bd. of Regents of Univ. of Okla., 468 U.S. 85, 109 n.39 (1984).

[14] *Id.*

[15] *Cf.* United States v. Penn-Olin Chem. Co., 378 U.S. 158 (1964) (recognizing need for full "rule of reason" analysis of joint venture to construct chemical plant).

[16] *See BMI*, 441 U.S. at 13.

[17] *Cal. Dental*, 526 U.S. at 770.

[18] 369 F.3d at 1118.

[19] *Id.* at 1121.

[20] *Id.* at 1122.

[21] *Id.* at 1124.

[22] *Id.*

[23] *Id.* at 1122 (emphasis in original).

[24] *Id.*

[25] Texaco Inc. v. Dagher, No. 04-805, 2004 WL 2912786, at *26 (Dec. 14, 2004), *petition for cert.*.

[26] 369 F.3d at 1118.

[27] *See, e.g.,* Polk Bros., Inc. v. Forest City Enters., Inc., 776 F.2d 185 (7th Cir. 1985).

[28] *See, e.g.*, Rothery Storage & Van Co. v. Atlas Van Lines, Inc., 792 F.2d 210 (D.C. Cir. 1986).

[29] 468 U.S. 85 (1984).

[30] *Id.* at 101.

[31] 441 U.S. 1 (1979).

[32] *Id.* at 21; *see also* Augusta News Co. v. Hudson News Co., 269 F.3d 41, 48 (1st Cir. 2001) ("a joint venture often entails setting a single price for the joint offering").

[33] 394 U.S. 131 (1969).

[34] *Id.* at 133-34.

[35] *Id.* at 136-39.

[36] *Id.* at 135 (citations omitted).

[37] *Id.* at 133.

[38] 369 F.3d at 1119.

[39] 468 U.S. 85.

[40] 441 U.S. 1.

[41] 467 U.S. 752 (1984).

[42] *Id.* at 767.

[43] *Id.* at 768-69, 771.

[44] 457 U.S. 332 (1982).

[45] *Id.* at 356, 357.

[46] VII Phillip Areeda & Herbert Hovenkamp, Antitrust Law ¶ 1478, at 325 (2003).