Legal Backgrounder

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HIGH COURT HEARS KEY CASE ON ANTITRUST AND JOINT VENTURES

By

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On January 10, 2006, the Supreme Court will hear *Dagher v. Texaco, Inc.*, an antitrust case that presents the Court an opportunity to clarify issues of substantial importance to the formation and operation of joint ventures. The question presented is whether two joint venture partners, both of which have exited the market as independent actors and have formed a joint venture fully integrating their separate assets, commit per se unlawful price fixing when they agree on the price at which the joint venture will sell its own output. A divided U.S. Court of Appeals for the Ninth Circuit panel held that it was per se unlawful for the petitioners, Texaco and Shell, to establish a single, uniform price for their respective brands of gasoline sold by two joint ventures combining all of their gasoline refining and distribution operations in the United States. *Dagher v. Saudi Refining, Inc.*, 369 F.3d 1108 (9th Cir. 2004). The Washington Legal Foundation has filed an *amicus* brief supporting the petitioners' position that the Ninth Circuit's decision applying the per se doctrine to an economically integrated joint venture's pricing of its own output is manifestly incorrect, and should be reversed by the Supreme Court. The Solicitor General of the United States, representing the views of federal antitrust agencies, has also filed an *amicus* brief supporting the petition, as have several major business groups.

Background. Joint ventures are an increasingly common form of business organization. They create additional productive capacity; facilitate research and development; generate efficiencies through economies of scale and scope; achieve synergies through the pooling of complementary assets and skills; minimize waste through the elimination of duplicative operations; and diversify risk. Joint ventures play an increasingly important role in facilitating global integration and economic growth.

The joint ventures formed by Shell and Texaco (Equilon, covering the Western United States, and Motiva, covering the Eastern) exemplify the type of welfare-enhancing joint venture that one would think antitrust policy should embrace, not punish. Equilon and Motiva represented a complete integration of Shell's and Texaco's downstream gasoline refining and marketing operations. Upon the formation of these ventures, Shell and Texaco ceased separate refining and marketing of gasoline within the United States and hence ceased competing against each other in those operations. The Ninth Circuit and the district court agreed that the ventures "produced sufficient efficiencies and were sufficiently integrated to constitute indisputably legitimate joint ventures." *Dagher*, 369 F.3d at 1114. These

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efficiencies, which included up to $800 million in cost savings annually, would benefit consumers by enabling the ventures to compete more effectively against other larger competitors, such as Exxon, Mobil, and Chevron.

The Federal Trade Commission and the Attorneys General of four States recognized the potential pro-competitive benefits of the two ventures and cleared both ventures, subject to very limited divestitures, after a thorough review. *In re Shell Oil Co.*, 125 F.T.C. 769, 777-793 (1998). Notwithstanding the determination by both federal and state antitrust enforcement authorities that the ventures would not substantially lessen competition, respondents brought a putative class action on behalf of 23,000 gas station owners, alleging that the joint ventures' uniform pricing of Shell and Texaco brand gasoline was horizontal price fixing and per se illegal under § 1 of the Sherman Act. Both petitioners and respondents moved for summary judgment, and the district court granted judgment to petitioners, holding that the joint ventures' uniform pricing policies were not per se unlawful under § 1.

A divided panel of the Ninth Circuit reversed the district court's judgment. Judge Reinhardt, writing for the majority, held that it would be per se unlawful for the owners of a joint venture to agree to charge a single price for the venture's products if they are sold under "two distinct brands," *Dagher*, 369 F.3d at 1112, unless the owners could prove that uniform pricing was "reasonably necessary" to achieve the legitimate pro-competitive goals of the joint venture. *Id.* at 1125. Judge Fernandez dissented from that holding, arguing that an agreement between the owners of a "true, bona fide economically integrated joint venture" regarding the price the joint venture charged for its own output could not give rise to per se liability under § 1. *Id.* at 1125. The Supreme Court granted a writ of certiorari to decide whether it can ever be per se illegal under § 1 for an economically integrated joint venture to set the price of its own output.

Issues Before the Court. The first issue before the Supreme Court is whether § 1 of the Sherman Act applies to the decisions of a bona fide, fully integrated joint venture about the pricing of its own products. Petitioners and several of the *amici* (including WLF) argue that such decisions are economically indistinguishable from the pricing decisions of a merged entity, which undeniably constitute unilateral conduct outside the scope of § 1. The second issue before the Court is whether, even if § 1 applies, the decisions of a joint venture as to the pricing of its own output can ever be treated as per se illegal. The petitioners and *amici* supporting them all argue that they cannot be.

Issue 1: Does Section 1 apply to the pricing decisions of a fully integrated joint venture? Section 1 of the Sherman Act provides: "Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal." By its terms, § 1 applies only to concerted activity and "does not reach conduct that is 'wholly unilateral.'" *Copperweld Corp. v. Independence Tube Corp.*, 467 U.S. 752, 768 (1984). The metric for determining whether conduct is concerted or unilateral centers on whether the conduct "deprives the marketplace of the independent centers of decisionmaking that competition assumes." *Id.* at 769. A restraint that "do[es] not suddenly bring together economic power that was previously pursuing divergent goals," is "not an activity that warrants § 1 scrutiny." *Id.* at 771.

Applying these standards, petitioners and several of the *amici* supporting them argue that the decisions of a bona fide, fully integrated joint venture as to the prices it will charge for its own output clearly constitutes independent, unilateral economic activity, which lies outside the scope of § 1.[1] They argue that a fully integrated joint venture, which combines the substantial assets of the venturers, is in economic function identical to an entity formed by a merger, citing *Arizona* v. *Maricopa County Medical Society*, 457 U.S. 332, 356 (1982), in which the Court wrote that in "such joint ventures, the partnership is regarded as a single firm competing with other sellers in the market."

[1]The Solicitor General, in its *amicus* brief, does not support this argument of the petitioners and the other *amici*.

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Here, by contributing all of their downstream assets to the two ventures, the petitioners simultaneously ended their independent participation in the downstream market — just as if the transaction were structured as a merger. Once the joint ventures were formed, the ventures' post-formation pricing of their own output could not result in any further loss of "independent centers of decisionmaking." *Copperweld*, 467 U.S. at 769. As the leading treatise in the field persuasively argues, "it would be inconsistent to prevent [a joint venture] from functioning by characterizing its normal operations as per se or otherwise unlawful conspiracies." VII Areeda & Hovenkamp, ANTITRUST LAW ¶1475b, at 304 (2d ed. 2003).

Where the owners of a joint venture have exited the market in which the venture competes, an agreement between the owners regarding the pricing of the venture's output is no more concerted action within the meaning of § 1 than is a decision by the partners in a new law firm as to the rates the firm will charge for their legal services. Because those pricing decisions do not affect the behavior of the participants in their non-venture business, they should generally be "regarded as those of a single entity rather than the parents' daily conspiracy." *Id.* ¶1478c, at 325. In contrast to an agreement among the parties to a joint venture as to the prices the parties will charge for their respective output prior to the consummation of a transaction, decisions regarding the price of the venture's own post-formation output, even if reached at the time the venture is formed, do not "deprive[] the marketplace" of any additional increment of independent decisionmaking beyond that lost through the formation of the joint venture. *Copperweld*, 467 U.S. at 769.

Issue 2: Can a joint venture's pricing of its own output ever be per se illegal? The petitioners and the *amici* supporting them argue, alternatively, that even if § 1 were applicable to a joint venture's pricing of its own output, the Supreme Court should still reverse the Ninth Circuit's judgment. In making this argument, petitioners and their *amici* rely on the Supreme Court's decision in *Broadcast Music, Inc. v. Columbia Broadcasting System, Inc.*, 441 U.S. 1 (1979), which makes it clear that decisions by joint ventures as to how to price their output cannot be treated as per se unlawful price fixing. As the Court stated, "[w]hen two partners [in a joint venture] 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." *Id.* at 9.

Despite a passing nod to the principles enunciated in *BMI*, the Ninth Circuit panel ignored *BMI*'s clear application to this case and, in a deviation from traditional joint venture analysis, held that a joint venture's uniform pricing policy could constitute per se unlawful "naked" price fixing unless the policy was "reasonably necessary" to achieve the efficiencies promised by the joint venture. Petitioners and the *amici* supporting them argue that this holding rests on two fundamental misunderstandings of the proper scope of the per se doctrine under § 1.

First, the Ninth Circuit's holding fails to recognize that per se illegality for horizontal price fixing is limited to agreements "among competitors on the way in which they will compete with one another." *NCAA v. Board of Regents*, 468 U.S. 85, 99 (1984). The decisions of both the Supreme Court and the federal circuit courts of appeal define horizontal price-fixing as an agreement among sellers of competing products on the price that they will charge for the competing products. *See BMI*, 441 U.S. at 8 (price-fixing consists of "agreements among *competitors* to fix prices on their individual goods or services") (emphasis added); *Augusta News Co. v. Hudson News Co.*, 269 F.3d 41, 47 (1st Cir. 2001). Here, because Shell and Texaco have exited the downstream markets in which Equilon and Motiva operate, they no longer compete in those markets and any agreement between them as to the prices charged by the ventures in those markets cannot constitute a per se illegal horizontal price fixing agreement. There is no dispute that the uniform pricing policies at issue govern only sales by the joint ventures and never fixed the prices of any products Shell or Texaco sold individually outside the ventures. Indeed, since the joint venture agreements prohibit the Petitioners from continuing to compete

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in the relevant market, any agreement between Shell and Texaco as to the prices the ventures will charge for their products cannot be an agreement regarding "competition with one another." *NCAA*, 468 U.S. at 99.

Second, even if this case involved a horizontal agreement, the Ninth Circuit's holding confuses the test for the ultimate legality of an alleged restraint with the threshold question of whether a restraint is "naked" for the purpose of determining whether it is per se unlawful or requires rule of reason review. Under the Supreme Court's prior decisions, a restraint is "naked" only if it "*facially* appears to be one that would always or almost always tend to restrict competition and decrease output," rather than "one designed to 'increase economic efficiency and render markets more, rather than less, competitive.'" *BMI*, 441 U.S. at 19-20 (emphasis added) (quoting *United States v. United States Gypsum Co.*, 438 U.S. 422, 441 n.16 (1978)). Applying this standard, the Supreme Court held in *Northwest Wholesale Stationers, Inc. v. Pacific Stationery & Printing Co.* that a restraint may not be condemned per se unless there are no "*plausible* arguments that [it was] intended to enhance overall efficiency and make markets more competitive." 472 U.S. 284, 294 (1985) (emphasis added). If there is a plausible pro-competitive explanation for an alleged restraint, then a court must instead evaluate the restraint under the rule of reason, with the plaintiff having the burden of proving both that the restraint will harm competition and that the restraint is not reasonably necessary to achieve the claimed pro-competitive purposes. *See California Dental Ass'n v. FTC*, 526 U.S. 756, 771-775 (1999).

Requiring joint venture owners to prove that their uniform pricing policy was "reasonably necessary to further the legitimate aims of the joint venture" to escape per se illegality, as the Ninth Circuit did in *Dagher*, puts the cart before the horse. That standard, as a test for per se illegality, would leave judges and juries free to second-guess the business decisions of joint venture partners, even where there is no conceivable harm to competition. These dangers are amply illustrated by the panel's decision here. In finding that Petitioners had not shown that "unified pricing . . . further[s] the ventures' legitimate efforts to produce better products or capitalize on efficiencies," *Dagher*, 369 F.3d at 1122, the panel majority observed that its "analysis would be different" if the parties had combined their two product lines into one or eliminated the old product lines and invented an entirely new one. *Id*. at 1124. The Supreme Court's prior decisions simply do not permit a court to substitute its business judgment, in this manner, for that of the parties as to how a joint venture should market its products and at what prices, lest they become price regulators. *See, e.g.*, *Verizon Commc'ns, Inc. v. Law Offices of Curtis V. Trinko*, 540 U.S. 398, 406 (2004); *United States v. Trenton Potteries Co.*, 273 U.S. 392, 396 (1927). Once a decision was made to continue to market both brands, how those brands were priced was purely a matter of business judgment, not a per se illegal naked restraint of trade.

Bottom Line. In short, as petitioner and *amici* argue, the Ninth Circuit's treatment of the pricing decisions of a fully integrated, pro-competitive joint venture as a per se unlawful naked restraint is contrary to both Supreme Court precedent and economic common sense. The likelihood of such false positives resulting from the application of the per se doctrine to the pricing policies of bona fide joint ventures — a likelihood that came to fruition in the Ninth Circuit's opinion — would undermine the incentive to create welfare-enhancing joint ventures that are increasingly important to the global economy and would thereby "chill the very conduct the antitrust laws are designed to protect." *Trinko*, 540 U.S. at 414 (internal quotation omitted). The Supreme Court, therefore, should — and hopefully will — reverse the judgment of the Ninth Circuit.

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