



FENWICK & WEST LLP

Antitrust Update

Texaco v. Dagher: U.S. Supreme Court Provides Guidance on Antitrust Analysis of Joint Ventures

MARCH 1, 2006

The Supreme Court's decision on February 28, 2006, in *Texaco, Inc. v. Dagher* provides important and much-needed guidance for the antitrust analysis of joint ventures. As the Court recognized in explaining its decision to grant review, the decision is particularly important because joint ventures of various types are an increasingly common form of business collaboration. The decision of the Ninth Circuit had applied the draconian *per se* rule (no consideration of actual effect or justification permitted) to pricing by a joint venture, compounding the difficulty of advising clients concerning these transactions. The Supreme Court's decision returns the law to where most antitrust lawyers believed it was, but now with considerably more certainty. As long as the joint venture is not a sham, decisions by the joint venture about how to price its products will be reviewed under the so-called rule of reason. Under that standard, a court must review the challenged conduct in the total market context and weigh any competitive harm against the legitimate business justifications.

Background and the Trial Court Decision

The case was brought on behalf of a large class of service station owners who alleged price fixing by Texaco and Shell through their Equilon joint venture which combined their "downstream" operations in the Western United States. The oil business is divided into upstream operations, which include the exploration and production of crude oil, and the downstream operations, which include everything from the refining process through transportation, marketing, and sales to the ultimate consumers. Under the joint venture agreement, Shell and Texaco agreed to pool their resources and share the risks of loss and profit from Equilon's activities.

Before Equilon, Texaco and Shell made independent decisions about all their respective downstream operations, including the pricing of gasoline sold to company-owned and independent service stations. After Equilon was formed, pricing decisions were consolidated such that a single individual at Equilon was responsible for setting a price for the two brands. Before the joint venture, the brands were often

priced at different levels in the same market. After the joint venture, Equilon priced the brands at the same level in any given market.

Although Equilon was less than a complete merger of Texaco and Shell, it was a very significant transaction that raised serious antitrust issues by eliminating an important part of the direct competition between two well-known oil companies which together controlled about 25% of the gasoline sales in the western United States. The rationale for the transaction was increased efficiency, with estimated savings of more than \$800 million in costs as a result of the planned integration. The transaction was carefully reviewed both by the Federal Trade Commission and a number of the states. As a result of that review, the enforcement agencies identified several antitrust concerns and required certain concessions designed to eliminate those concerns. When Texaco and Shell agreed to the concessions, including some divestitures, the enforcement agencies allowed the transaction to go forward. As the Supreme Court later noted, the concessions did not address the pricing of Equilon gasoline.

Significantly, the plaintiffs did not challenge the formation of the Equilon joint venture as such. Rather, they argued that the agreement by Texaco and Shell for Equilon to determine the prices for the Texaco and Shell brands—which were to be maintained as distinct brands—was horizontal price fixing that was *per se* (automatically) illegal under the antitrust laws. Under a *per se* standard, a plaintiff only needs to prove that the forbidden conduct occurred. It need not prove that competition was actually harmed, and, in fact, the defendant cannot defend itself by showing the absence of such harm or the beneficial effects of the challenged conduct. *Per se* analysis applies only to a small list of offenses identified in the case law. Otherwise, the default standard of analysis is the rule of reason under which all relevant facts, including the nature of the market, evidence of actual harm, and justifications such as enhanced efficiency are considered.

The trial court ruled that a *per se* rule was inappropriate under these circumstances. The plaintiffs had affirmatively

disclaimed any desire to attempt to meet the more demanding standards of the rule of reason. In light of that disclaimer and the court's decision not to apply the *per se* rule, there were no factual issues for trial, so the trial court granted summary judgment for the defendants.

The Ninth Circuit Decision

On appeal, a divided panel of the Ninth Circuit reversed, holding that the plaintiffs had made a sufficient showing that a *per se* rule should apply to the pricing by Equilon. In making this determination, the court stated that Equilon's pricing policy was not set by a single entity, but rather was a decision made by two competitors. The court reasoned that there is a "triable issue of fact" as to whether Shell and Texaco had agreed upon the pricing strategy in advance when negotiating Equilon's formation, as opposed to after Equilon formally came into existence.

Although the Ninth Circuit panel was able to cite case authority nominally supporting each step of its analysis, the result was surprising to many antitrust experts. The court relied primarily on a 1969 decision of the Supreme Court in *Citizen Publishing Co. v. United States* which held that a joint venture between the only two newspaper companies in Tucson, Arizona, was illegal. In that arrangement, the papers retained their separate news and editorial departments but created a new entity to manage the production and distribution, including pricing. Justice Douglas's opinion for the Court found liability in a short paragraph that referred to the fact that horizontal price-fixing is *per se* illegal. The Ninth Circuit recognized that decisions after *Citizen Publishing* "do seem to suggest that the Court, if confronted with a similar joint venture today, might not find the enterprise as a whole unlawful." It correctly noted that the existence of a joint venture does not immunize any conduct associated with it. While few would disagree with that proposition, the Ninth Circuit drew the line between appropriate and inappropriate conduct in a way that seemed to threaten core conduct by a joint venture.

Although the Equilon joint venture had expressly contemplated the combination of all downstream operations, the court held that agreement as to the joint venture's pricing of the formerly competing products that it would control was not reasonably ancillary to the joint venture, but rather was a "naked" restriction subject to *per se* treatment. The terms "ancillary" and "naked" are words that express the conclusion, rather than providing a methodology for arriving at the conclusion. Nevertheless, one can extract several factors that seemed to influence the court's decision.

The court was obviously bothered by the fact that the challenged pricing decisions involved separate brands that had existed before the joint venture. It was also bothered by the fact that Equilon decided to charge the same price for the two brands in any given market. The timing of the challenged agreement also seemed to matter. The court noted that there was testimony that the decision to "unify" the pricing of the brands was made contemporaneously with the formation of the alliance between Texaco and Shell but before the joint venture officially existed. In addition, the court focused on testimony that this "unified" pricing was not necessary to achieve the cost savings that were the rationale for the transaction. The court concluded that Equilon could and should price each brand "independently on the basis of normal market factors" such as "cost of production and marketing, supply, demand, and the like." It is not at all clear, however, what a single pricing manager responsible for the overall profitability of Equilon should do to conform to this requirement, especially if she decided that the best interest of the joint venture was for the products to have the same price in the same market.

The Ninth Circuit majority was obviously sensitive to the criticism from the dissenting judge that the decision made it impossible for any joint venture to price its product. In response, the court attempted to distinguish other situations where the *per se* rule would not apply. The court stated that it would have decided differently if the joint venture had created and sold a new product, or if the joint venture had merged the product lines into one collective brand. Similarly, the court said that the result would not necessarily be the same if the parties had independently decided to charge the same price after conducting separate product analyses for each brand, or if the parties had come forward with persuasive evidence that the single price was important to achieving the legitimate aims of the joint venture. While these are differences, there is no apparent economic basis for them, as the dissent pointed out.

When the Supreme Court granted certiorari, most antitrust commentators assumed that it did so with the intent of reversing the Ninth Circuit. They were right.

The Supreme Court Decision

In an 8 to 0 opinion by Justice Thomas, the Supreme Court reversed the Ninth Circuit, ruling that the District Court had been correct to apply the rule of reason and to grant summary judgment for the defendants. The Court's phrasing of the question foreshadowed the result: whether "it is *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 took only six pages to reverse.

The Court began with the assumption that Equilon was a legal joint venture. It also made clear that, if the plaintiffs had challenged the formation of Equilon, they would have had to “show that its creation was anticompetitive under the rule of reason,” and noted that the FTC and state antitrust enforcers had allowed the joint venture to go forward subject to certain modifications, but without restrictions on the pricing of Equilon gasoline.

Turning to the price-fixing claim, the Court acknowledged that price-fixing agreements between competitors (known as “horizontal” price-fixing agreements) are subject to a *per se* analysis rather than the more generally applicable rule of reason. In one sentence, however, the Court held that Equilon “did not present such an agreement” because Texaco and Shell “do not compete with one another in the relevant market” but rather participate in that market jointly through Equilon. Thus, the Court concluded, “the pricing policy challenged here amounts to little more than price setting by a single entity....” While this analysis provides clear guidance, it is somewhat inconsistent with more recent antitrust decisions for the decision to turn on a formalistic distinction. Probably a more accurate way to describe the analysis would have been to say that the joint venture satisfies the requirement of an agreement but that the pro-competitive efficiency potential inherent in joint ventures justifies a fuller inquiry than is available under a *per se* rule.

In response to a question from Chief Justice Roberts during oral argument, the attorney for the plaintiffs conceded that *per se* analysis would not have applied if Equilon had “simply chosen to sell its gasoline under a single brand.” The Court noted that “[w]e see no reason to treat Equilon differently just because it chose to sell gasoline under two distinct brands at a single price.” The Court thus rejected the Ninth Circuit’s obvious concern about Equilon’s decision to “unify” the pricing of the Texaco and Shell brands while at the same time keeping them as separate brands. In effect, it also rejected the Ninth Circuit’s attempt to distinguish the facts at issue from other joint venture pricing decisions.

The Court also rejected the Ninth Circuit’s reliance on the “ancillary restraints” doctrine. The Court held that the doctrine concerns “the validity of restrictions imposed by a legitimate business collaboration, such as a business association or joint venture, on *nonventure activities*.” (Emphasis added.) For such nonventure restrictions, one must determine whether the restriction is a “naked restraint on trade” and therefore *per se* illegal or “one that is ancillary

to the legitimate and competitive purposes of the business association, and thus valid.” Presumably, the Court meant to say that ancillary restrictions are subject to the rule of reason, because even where the ancillary restraint doctrine applies questions remain about the balance between the competitive gain and loss resulting from the restriction. In any event, however, the Court held that the doctrine had no application here because the claim involved “the core activity of the joint venture itself—namely, the pricing of the very goods produced and sold by Equilon.” Without saying so, the Court refused to follow the Ninth Circuit’s more detailed parsing of the connection between the cost savings that were the rationale for the joint venture and the pricing by the joint venture. A key issue for future cases will be to distinguish between “core” activities and “nonventure” restrictions, but, as with Equilon, the stated nature, purpose, and scope of the joint venture should provide considerable guidance.

Surprisingly, the Court cited *Citizen Publishing Co. v United States* in support of its treatment of the ancillary restraints doctrine. Plaintiffs had cited the case as the principle support for their *per se* theory, and the Ninth Circuit had relied on it in its opinion. In *Citizen Publishing* the Supreme Court devoted most of its attention to the question whether the “failing firm” exception applied, concluding that it did not. Nevertheless, Justice Douglas’s opinion for the Court provided some apparent support for the challenge to Equilon. The pricing for the newspapers was vested in the joint venture; profits were divided by a fixed ratio; and the parties agreed not to engage in any other publishing business in Pima County, where Tucson is located. Equilon involved similar agreements. In one relatively short paragraph in *Citizen Publishing*, in typically forceful language, Justice Douglas affirmed the trial court’s holding that the joint venture was anticompetitive, stating that “[t]he §1 violations are plain beyond peradventure” and that “[p]rice-fixing is illegal *per se*.” There are distinctions that could be drawn to distinguish Equilon, as the dissenting judge in the Ninth Circuit noted. *Citizen Publishing* was a challenge to the joint venture as such, and did not involve a prior finding by an antitrust enforcement agency that the joint venture—as opposed to the consolidated pricing authority—did not violate the antitrust laws. Moreover, assuming that newspapers were the relevant market, the joint venture created a monopoly, while Equilon faced a number of competitors. Surprisingly, however, the Supreme Court did not attempt to distinguish *Citizen Publishing* on these grounds. Rather, it cited it for something that the decision did not expressly address—the ancillary restrictions doctrine.

One must conclude that, at least as it relates to joint venture analysis, *Citizen Publishing* has now been limited to its

facts. *Citizen Publishing* illustrates a fairly common problem in antitrust. With few exceptions, the Supreme Court has chosen not to overrule, or even explicitly criticize, its earlier decisions. Yet, every experienced antitrust lawyer recognizes that the Court's decisions in the last 25 or 30 years reflect a significantly different view of antitrust law and economics from the earlier years. There is no doubt that many of the earlier decisions, particularly many of the decisions of the Warren Court in the 1960's, would not be decided the same way if the Court were to consider them today. Yet, they remain on the books as apparently controlling precedent. The doctrine of *stare decisis* is not at its most forceful in antitrust law.

Practice Pointers and Take-Aways

Most experienced antitrust lawyers expected the Supreme Court to reverse the Ninth Circuit decision. Over the last 30 years, there has been a steady tendency for the Supreme Court to narrow the scope of *per se* rules. The Ninth Circuit's decision was not only inconsistent with the general direction of antitrust law; it also interjected great uncertainty about when *per se* analysis might apply to decisions about pricing and other competitive variables by joint ventures between erstwhile competitors. So, the actual holding in *Texaco Inc. v. Dagher* is not a surprise. Yet, Supreme Court decisions in any area of the law are obviously important and often have effects beyond the strict limits of the holding. In this case, however, the Court's opinion appears to be tightly focused and unlikely to have much influence outside the specific question presented. The main additional guidance from the case is the confirmation that challenges to legitimate joint ventures fall under the rule of reason.

The Court's decision in this case is broadly consistent with the advice that most experienced antitrust lawyers have been giving, but it is definitely useful to have that advice confirmed by the Supreme Court. First, parties cannot use joint ventures as a sham to engage in anticompetitive conduct. Sham activity would still be subject to *per se* analysis. The question of whether a joint venture is a sham will turn on whether there is a plausible efficiency-enhancing justification for the transaction, as there clearly was for Equilon. Assuming that hurdle is cleared, actions taken by the joint venture that are within its "core activity" will be subject to the rule of reason, even though they would be subject to a *per se* rule if the competitors had made the same agreement outside the joint venture. The question of what is "core activity" will obviously vary from case to case, but, as with Equilon, a joint venture that contemplates production, marketing, distribution, and sale will normally include pricing. The timing of the decision about pricing—whether before the joint

venture is operational or afterwards—apparently does not matter.

While a legitimate joint venture will preclude *per se* analysis of its core activities, parties must be very careful about agreements that touch competitive variables outside the scope of the joint venture. For example, if the joint venture partners continue to compete outside the joint venture, agreements as to pricing that apply to that competition between the joint venture partners and/or the joint venture would fall within the *per se* rule. On the other hand, agreements that, while not "core," are plausibly necessary to make the joint venture work effectively should receive rule of reason treatment. Obviously, however, the line between "reasonably ancillary" and "so remote as to be naked" is not entirely clear at the margins.

Finally, it is important to be clear about what *Texaco v. Dagher* did and did not involve. The case concerned only the appropriate application of *per se* analysis to actions taken by a joint venture. As noted above, the Court made clear that the rule of reason applies to a challenge to the joint venture itself. That is not to say, however, that every joint venture will survive rule of reason analysis or that extremely detailed economic analysis is always necessary to conclude that there is a competitive problem. Even legitimate joint ventures can create antitrust problems depending on the nature and concentration of the market and the business justification for the restrictions involved.

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