UNITED STATES OF AMERICA
BEFORE FEDERAL TRADE COMMISSION

In the Matter of POLYGRAM HOLDING, INC., a corporation, DECCA MUSIC GROUP LIMITED, a corporation, UMG RECORDINGS, INC., a corporation, and UNIVERSAL MUSIC & VIDEO DISTRIBUTION CORP., a corporation.	Docket No. 9298

To: The Honorable James P. Timony
Administrative Law Judge

COMPLAINT COUNSEL'S STATUS REPORT AND STATEMENT OF THE CASE

In accordance with the scheduling order entered on September 10, 2001, complaint

promotion. The products covered by the two challenged restraints are compact discs, audio cassettes, video discs, and video cassettes featuring the Three Tenors -- Luciano Pavarotti, Placido Domingo, and Jose Carreras.

Although price restraints and advertising bans are not invariably unlawful (s*ee Broadcast Music, Inc. v. CBS*[1]), the scope of legitimate justifications is quite narrow. The defenses advanced by the PolyGram respondents will be shown to be factually unsupported and legally insufficient.[2]

PolyGram and Warner are vertically integrated producers and distributors of recorded music. Competition takes place at many levels, but for present purposes the most important arena of competition is this: PolyGram distributes audio and video versions of the first Three Tenors concert, recorded in 1990 at the World Cup soccer finals in Rome. Warner distributes audio and video versions of the second Three Tenors concert, recorded in 1994 at the World Cup soccer finals in Los Angeles.

In 1998, in addition to being competitors, PolyGram and Warner were also parties to a joint venture agreement. In 1996, concert promoter Tibor Rudas began laying the groundwork for a third Three Tenors extravaganza: a huge open-air concert in front of the Eiffel Tower scheduled to coincide with the World Cup final match in Paris, in July 1998. PolyGram and Warner were both interested in procuring distribution rights for products to be derived from the 1998 concert.

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

[2] Warner has entered into a consent agreement, and is not a party to this proceeding. *Warner Communications Inc.*, Dkt. No. C-4025 (Sept. 17, 2001).

Ultimately, it was agreed that PolyGram and Warner would collaborate in the distribution of the next Three Tenors recordings: Warner would distribute the 1998 Three Tenors audio and video recordings in the United States. PolyGram would distribute the products outside of the United States. The two music companies would share all costs, profits, and losses on a 50/50 basis.

In short, PolyGram and Warner were partners with regard to the 1998 Three Tenors recordings. However, the very same written agreement that established the collaboration (dated December 19, 1997) provides that PolyGram and Warner shall be free to market their pre-existing Three Tenors albums and videos in competition with the products of the venture.

During 1998, in the months leading up to the Paris concert, representatives of PolyGram and Warner re-visited the issue of whether the older (or "catalog") Three Tenors recordings would be permitted to compete with the new releases. The parties were concerned that the audio and video products that would be derived from the 1998 Three Tenors concert in Paris would be neither as original nor as commercially appealing as the 1990 and 1994 releases.

First, the music companies had doubts regarding the continuing vitality of the Three Tenors "formula." Pavarotti, Domingo, and Carreras had performed together at two previous World Cup concerts (1990 and 1994), and in the context of a world tour (1996-1997). PolyGram and Warner were concerned that, among the buying public, the novelty of these performances may be wearing thin. Second, there was dissatisfaction with the repertoire for the 1998 performance. The music companies wanted the 1998 recordings to contain all new repertoire –

the repertoire for the 1998 releases would repeat selections from the 1990 and 1994 recordings.

In or about March 1998, PolyGram and Warner agreed that -- in order to shield the 1998 Three Tenors recordings from competition -- the companies would not discount or advertise their catalog Three Tenors products in the weeks surrounding the release of the new products. In April, PolyGram issued a directive to its distribution operations ("operating companies" or "opcos") around the world explaining that, pursuant to the company's agreement with Warner, all price discounting and advertising for the "original" 1990 Three Tenors album and video must cease in late July.

PolyGram searched for a similar gesture from Warner, but such action was not immediately forthcoming. PolyGram was left to worry that Warner would not comply with the agreed-upon moratorium. (Indeed, there were individuals within Warner who were not content with the agreement.) However, with a series of written and oral communications in June/July 1998, the parties re-affirmed their plan to forgo discounting and advertising for the older Three Tenors recordings. Warner issued a memorandum to its operating companies in mid-July directing that the company's discount and promotional campaign for the 1994 Three Tenors album and video would be suspended between August 1 and October 15, 1998.

The events that follow this second consummation of a price fixing agreement are of collateral importance, and (as discussed below) not directly relevant to the issue of respondents' liability.

In late July 1998, after the Paris concert but before the August 10 release of the 1998 Three Tenors album, a new group of attorneys at the music companies reviewed the moratorium agreement. The attorneys arranged that Warner would send a letter to PolyGram purporting to

reject the moratorium agreement, and asserting Warner's intention to make unilateral decisions on pricing and promotion. However, this letter was itself countermanded by a Warner executive, and the parties proceeded to implement their agreement not to compete. That is, both PolyGram and Warner refrained from discounting or advertising their catalog Three Tenors recordings in the United States between August 1 and October 15, 1998.

II Discovery Issues

Discovery in this matter has proceeded at a slower pace than originally anticipated by complaint counsel. However, there are no issues that need to be resolved by the Court at this time.

On September 10, 2001, complaint counsel noticed depositions for ten current and former employees of respondents, principally persons identified by respondents as potential trial witnesses. Complaint counsel noticed these depositions to commence in late September. However, respondents did not produce a witness for deposition until October 29, 2001. Certain deponents noticed in early September are scheduled for late November. We expect that respondents' "turn around" time for follow-up depositions will improve, so that depositions may be completed on schedule.

Through interrogatories, complaint counsel requested that respondents describe in detail the efficiency defenses asserted in the Answer. Respondents' written response avers that the moratorium agreement was necessary to avoid "free riding" and "opportunistic behavior." However, there is no indication of who would be free riding on what investments, or what type of opportunistic behavior was anticipated. Instead, respondents have suggested that their expert reports will address these issues. Accordingly, we make no motion at the present time.

Complaint counsel's document request to respondents included specifications addressed to possible free-rider issues. Respondents have refused to produce responsive documents on the basis that such documents are irrelevant. Complaint counsel intends to revisit this issue after we see the factual contentions raised by the reports of respondents' experts.

In sum, there is a possibility that in the next several days complaint counsel may need to ask the Court to compel the production of documents relevant to respondents' efficiency claims.

III Legal and Factual Matters to Be Decided

The Commission's complaint does not challenge the existence of the PolyGram/Warner joint venture or its basic structure. That is, agreements governing "intraventure" output (*e.g.,* the price of the 1998 album and video, the territorial division of responsibility between PolyGram and Warner) are not at issue. The antitrust concern is the moratorium agreement, a restraint on the pre-existing and separate products -- the "extraventure" output -- of the joint venture participants.

The distinction between intraventure and extraventure restraints is critical to the legal analysis. Whereas price and output restraints applicable to the products of a joint venture are sometimes efficient (lawful),[3] no court has permitted competitors to adopt such restraints for products outside of the venture.[4]

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[3] *E.g., Broadcast Music, Inc. v. CBS*, 441 U.S. 1 (1979) (joint price setting for blanket license analyzed under the rule of reason where participating copyright owners remained free to grant licenses for individual works); *Polk Brothers, Inc. v. Forest City Enterprises, Inc.,* 776 F.2d 185, 189 (7th Cir. 1985) (restraint applicable sales from jointly constructed facility analyzed under the rule of reason where venturers remained free to increase output from separately operated facilities).

[4] *See Palmer v. BRG of Georgia, Inc.*, 498 U.S. 46 (1990) (nationwide agreement not to compete judged *per se* illegal where licensing relationship between the parties was applicable to

Georgia only); *General Motors Corp.*, 103 F.T.C. 374 (1984) (consent agreement) (manufacturing joint venture between General Motors and Toyota approved by the Commission, subject to the conditions aimed at reducing the likelihood of collusion between the manufacturers with regard to extraventure products); *Brunswick Corp.*, 94 F.T.C. 1174, 1275 (1979) (agreement restricting venturer's sale of pre-existing, extraventure product judged *per se* illegal),

United States or elsewhere in the world.

2. Whether a horizontal agreement to fix minimum prices is presumptively anticompetitive.

Complaint counsel will ask the Court to conclude that a horizontal agreement to fix prices has a significant potential for anticompetitive effects, and is therefore presumptively anticompetitive. *See, e.g., NCAA v. Board of Regents*, 468 U.S. 85, 100 (1984) ("Horizontal price fixing is perhaps the paradigm of an unreasonable restraint of trade."); *United States v. Trenton Potteries Co.*, 273 U.S. 392 (1927). There will be expert testimony addressing this issue.

3. Whether a horizontal agreement to forgo all advertising is presumptively anticompetitive.

Complaint counsel will ask the Court to conclude that an advertising ban has a significant potential for anticompetitive effects, and is therefore presumptively anticompetitive. *See, e.g., Blackburn v. Sweeney*, 53 F.3d 825, 827 (7th Cir. 1995); *Mass. Board of Registration on Optometry*, 110 F.T.C. 549 (1988). There will be expert testimony addressing this issue.

4. Whether price and advertising restraints directed to audio and video products that are produced unilaterally and separately marketed by PolyGram and Warner -- outside of the joint venture -- are *per se* unlawful.

Complaint counsel will ask the Court to conclude that the challenged restraints on the marketing of the 1990 and 1994 Three Tenors recordings are not ancillary (reasonably related) to the collaboration between PolyGram and Warner, and are therefore *per se* unlawful. *See* cases cited at fn. 4, *supra.*

5. Whether the challenged restraints are reasonably necessary to avoid free riding.

If the Court concludes that the challenged restraints are ancillary to the PolyGram/Warner

(4th ed. 1997).

7. Whether each of the corporate respondents is liable for engaging in unfair methods of competition.

The evidence will show that each of the respondents is liable for violating Section 5 under one or more of the following standards: (i) direct participation in the unlawful conduct; (ii) participation in the unlawful conduct through an agent (*see, e.g., American Society of Mechanical Engineers v. Hydrolevel Corp.*, 456 U.S. 556 (1982)); (iii) actual or tacit approval of the unlawful conduct of a subsidiary (*see, e.g., P.F. Collier & Son Corp. v. FTC*, 427 F.2d 261 (6th Cir.), *cert. denied*, 400 U.S. 926 (1970)); and (iv) enterprise liability (*see, e.g., Six West Retail Acquisition, Inc. v. Sony Theatre Management Corp.*, 2000-1 Trade Cas. (CCH) ¶ 72,823

Son Constr. Co., 783 F.2d 1157, 1160 (4th Cir. 1986)); (iii) that the restraints may have assisted respondents to recover their investment (*see, e.g., Chicago Professional Sports Ltd. Partnership v. NBA*, 754 F. Supp. 1336, 1359 (N.D. Ill. 1991) ("'We do it because it's more profitable' is not a defense under the Sherman Act."), *aff'd*, 961 F.2d 667 (7th Cir. 1992), *cert. denied*, 506 U.S. 954 (1992)).

IV Settlement Discussions

Complaint counsel and counsel for respondents have discussed settlement, but have been unable to identify terms of settlement acceptable to both parties.

Respectfully submitted,

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Dated: November 27, 2001