PUBLIC VERSION

UNITED STATES OF AMERICA
BEFORE FEDERAL TRADE COMMISSION

COMMISSIONERS: Timothy J. Muris, Chairman
Sheila F. Anthony
Mozelle W. Thompson
Orson Swindle
Thomas B. Leary

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

ANSWERING BRIEF OF COUNSEL SUPPORTING THE COMPLAINT <u>IN SUPPORT OF THE INITIAL DECISION</u>

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Dated: September 11, 2002

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GLOSSARY OF ABBREVIATIONS AND RECORD REFERENCES

References in this memorandum are made using the following abbreviations:

Answer	Answer of Respondents, filed August 23, 2001
App.	Respondents' Opening Brief on Appeal From Initial Decision and Order
Complaint	Complaint of the Federal Trade Commission, Dkt No. 9298, issued July 31, 2001
CPF¶	Complaint Counsel's Proposed Findings of Fact
CPRF¶	Complaint Counsel's Proposed Reply Findings of Fact
CX	

Dr. Stephen Stockum Volume 4 (March 8, 2002) 563:9 - 840:1

References to trial transcript are made using witness name, page and lines:

Moore 139:11-19

Trial transcript references that carry over to a later page are referenced in the following fashion:

Moore 101:14-103:4

Multiple references to the same witness and volume are made as follows:

Moore 73:1-8, 75:27-6:12

References to exhibits include prefix, number and page if applicable:

CX383 at UMG003284

References to investigational hearing or deposition transcripts that have been included in the trial record as exhibits include witness name and the designation “I.H.” or “Dep.”, exhibit number, and transcript page and lines:

Caparro Dep. (CX609) 71:8-21

INTRODUCTION

This case addresses an agreement between two of the largest record companies in the world – Polygram and Warner. During the 1990's, these firms were direct competitors in the sale of audio and video recordings featuring the world-renowned "Three Tenors" (Luciano Pavarotti, Placido Domingo and Jose Carreras). Polygram distributed the original Three Tenors album recorded in 1990 ("3T1"), and Warner distributed a follow-up Three Tenors album recorded in 1994 ("3T2").

Anticipating a third Three Tenors concert in 1998, Polygram and Warner formed a joint venture to distribute recordings of this performance ("3T3"). The focus of this case is not, however, the joint venture itself. Instead, this litigation challenges the legality of a side agreement between Polygram and Warner, made after the joint venture was formed, in which the record companies agreed to forgo price discounting and advertising on their separately owned, pre-existing Three Tenors products (the "moratorium"). The parties agreed to maintain higher prices for 3T1 and 3T2 in order to induce consumers to purchase the new, higher margin 3T3 products.

A horizontal restraint on price competition or the other core competitive activities of collaborators violates the antitrust laws unless such restraint is reasonably related to a pro-competitive joint venture, and reasonably necessary to the formation or efficient operation of that collaboration. The Three Tenors moratorium agreement satisfies none of these conditions. The agreement constrains the marketing of products that were

collaboration.

In short, Respondents cannot escape liability under well-established antitrust rules. Consequently, in their appeal of the Initial Decision, Respondents strive to re-invent the law applicable to horizontal restraints. Respondents ask the Commission to jettison the core principle of abbreviated rule of reason analysis: that horizontal agreements that fix minimum prices (and certain other categories of restraints) are presumed to be anticompetitive and require "competitive justification even in the absence of a detailed market analysis." *NCAA v. Board of Regents*, 468 U.S. 85, 110 (1984). *Accord California Dental Assoc. v. FTC*, 526 U.S. 756, 770 (1999) ("*CDA*"); *FTC v. Indiana Federation of Dentists*, 476 U.S. 447, 459 (1986) (*"IFD*"); *National Society of Professional Engineers v. United States*, 435 U.S. 679, 692 (1978) ("*NSPE*").

Respondents argue first that Complaint Counsel cannot rely upon abbreviated rule of reason review, but are instead required to offer direct evidence of competitive injury (that is, Complaint Counsel supposedly must compare prices during the moratorium period to pre-moratorium prices, and show a market-wide price increase attributable to the agreement). This argument is based upon a flawed reading of *CDA*. In *CDA*, the Supreme Court did not reject abbreviated rule of reason analysis. Instead, the Court limited the applicability of abbreviated review to those types of agreements that have an obvious anticompetitive effect. There is a strong theoretical and empirical basis for expecting a horizontal price restraint and an advertising ban on ordinary commercial products to result in competitive injury. Because the likely anticompetitive effects are obvious, the Three Tenors moratorium must be judged presumptively anticompetitive.

Alternatively, Respondents assert that abbreviated review of price fixing and advertising bans is

not appropriate when the agreement is adopted in the context of a "novel" joint venture. This argument also finds no support in the case law. The Supreme Court applied abbreviated analysis to joint venture restraints in *NCAA* and *BMI v. CBS*, 441 U.S. 1 (1979)

trio's first album became the best selling classical record of all time. IDF¶29. In 1994, the Three

In the spring of 1997, the Chairman of Atlantic Recording Corp. (a Warner subsidiary) met with his counterpart at PolyGram to ask that PolyGram release Luciano Pavarotti from his exclusive contract and permit him to record the 1998 Three Tenors album for Warner. IDF¶55. PolyGram

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[1] Given these negotiations, Judge Timony was justified in viewing as "questionable" Anthony O'Brien's speculation that, had he known that PolyGram was going to discount 3T1, he would not

3. The Three Tenors Moratorium Agreement

PolyGram and Warner were concerned that their new Three Tenors album, scheduled for release in August 1998, would be neither as original nor as commercially appealing as the 1990 and 1994 releases. IDF¶73. As a result, the parties agreed to observe a moratorium on competition.

At a meeting in March 1998, PolyGram and Warner agreed not to discount or advertise 3T1 or 3T2 audio and video products in the weeks surrounding the release of 3T3 scheduled for August 18, 1998. IDF¶¶90-96.[2] The agreement was motivated by a mutual recognition that competition from the older Three Tenors products could reduce the sales and profitability of the new Three Tenors release. IDF¶¶268-273. As explained by Warner executive Anthony O'Brien: Absent the restraints, consumers "may start comparing the repertoire along with the price and make a determination that, you know, the '94 concert is just fine for a few dollars less." IDF¶269.

4. PolyGram and Warner Learn That the Repertoire for the 1998 Concert May Not Be Original

In mid-June 1998, Rudas informed PolyGram and Warner of the intended repertoire for the upcoming Three Tenors concert. IDF¶133. Both record companies were alarmed to learn that, contrary to earlier promises, the repertoire would include several compositions that were also included on 3T1 and/or 3T2. IDF¶133. This development threatened the success of the 1998 album.

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have entered into the joint venture. ID 53 n.10. *See also* Roberts (JX 93) 143:20-144:1 (President of PolyGram Classics testifying that he would have entered into the 3T3 project even if there were reason to expect discounting of 3T2 by Warner upon the release of 3T3).

[2] Respondents represent that the moratorium barred only "extraordinary" promotions for 3T1 and 3T2. App. 11. As Judge Timony concluded, the moratorium prohibited the parties from offering any discounts that may be passed on to consumers. IDF¶¶44-45.

According to Warner executive Anthony O'Brien:

> [T]he problem that we had was that The Three Tenors [are] perhaps three of the laziest performers we have ever seen performing this type of music, and what we were hoping for, when we were making the '98 concert, was to have new and exciting repertoire. And they're not particularly given to sort of learning new arias, and so Nessun Dorma would come back again, or maybe Carreras would sing one of the Pavarotti songs or vice versa. And so although the album was different . . . it wasn't, perhaps, quite as new and exciting as we had hoped it to be. IDF¶136.

5. PolyGram and Warner Reaffirm and Then Implement the Moratorium Agreement

In July 1998, after some additional negotiations (*see* IDF¶¶141-147), PolyGram and Warner issued written directives to their respective operating companies worldwide instructing that all discounting, advertising, and promotion of 3T1/3T2 was prohibited from August 1, 1998 through October 15, 1998. IDF¶¶148-149, 152-153.

Both Warner and PolyGram substantially complied with the moratorium agreement in the

At trial, Complaint Counsel called two fact witnesses: Warner executive Anthony O'Brien and PolyGram in-house counsel Rand Hoffman. These witnesses confirmed the existence and implementation of the moratorium, and testified that the purpose of the restraints was to shield a weak product (3T3) from competition. Complaint Counsel also called two expert witnesses. Professor Catherine Moore, director of the music business program at New York University, provided background information regarding the music industry, and explained why the moratorium was not necessary for the effective marketing of Three Tenors products.
Dr. Stephen Stockum, an economist, explained that the moratorium was likely to be anticompetitive, and that the efficiency justifications proffered by Respondents are not valid.

In their pretrial submissions, Respondents stated an intention to call at trial eleven fact witnesses and two expert witnesses. Respondents' Proposed Witness List (January 18, 2002). However, following the conclusion of Complaint Counsel's case-in-chief, Respondents announced that they were resting without calling any of their thirteen intended witnesses. Trial Tr. 846:4-11.

Judge Timony found a violation of Section 5, and issued a cease and desist order.[3]

ARGUMENT

I. The Moratorium Agreement Is Presumptively Anticompetitive

Judge Timony determined that the Three Tenors moratorium agreement is presumptively anticompetitive (that is, likely to harm competition absent an efficiency justification). ID 56-58. The

[3] Contrary to Respondents' unsupported representation (App. 1), Complaint Counsel has not "stipulated" that there is no evidence that the moratorium agreement had an anticompetitive effect. The evidence demonstrates, and the Initial Decision concluded, that the likely effect of the Three Tenors moratorium was to raise prices and reduce output. ID 55-58.

ALJ's conclusions are supported by the record, and do not require a specific finding that market prices increased or that output declined during 1998.

Certain categories of restraints almost always tend to raise price or reduce output; the adverse competitive effects of such agreements are "intuitively obvious." *CDA*, 526 U.S. at 781; *IFD,* 476 U.S. at 459; *NCAA*, 468 U.S. at 109-10. Where such an agreement is proven, likely anticompetitive effects are presumed and the burden shifts to the defendant to demonstrate a countervailing efficiency sufficient to overcome the presumption. *CDA*, 526 U.S. at 771; *IFD*, 476 U.S. at 459; *NCAA*, 468 U.S. at 113. These are the principles that define what the Supreme Court has referred to as "abbreviated or 'quick-look' analysis under the rule of reason." *CDA,* 526 U.S. at 770.[4]

The proposition that certain categories of restraints are properly presumed to be anticompetitive – without direct evidence of adverse effects and even if employed in the context of a joint venture – was clearly established by the Supreme Court in *NCAA*. The case addressed price and

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[4] *See* ABA Antitrust Section, Monograph No. 23, *The Rule of Reason* (1999) ("[T]he quick look test applies to restraints that are 'facially anticompetitive' or 'inherently suspect.' In such case, of course, competitive harm is either readily apparent or will be presumed . . . . If no procompetitive justification is proved, the presumption of an adverse effect on competition prevails and the practice is declared unlawful."); W. Cohen, Per Se Illegality and Truncated Rule of Reason: The Search for a Foreshortened Antitrust Analysis § III.A.1 (FTC Staff Discussion Document Nov. 1997) (available at www.ftc.gov/opp/jointvent/persepap.htm) (Truncated analysis "presume[s] competitive harm from the very nature of the challenged conduct, so that plaintiffs need not demonstrate market power or specific anticompetitive effects to establish their *prima facie* case."); *Antitrust Guidelines for Collaborations Among Competitors Issued by the Federal Trade Commission and the U.S. Department of Justice* § 3.2 (April 2000).

The advantages of by-passing a full rule of reason analysis in appropriate cases are described in *BMI*, 441 U.S. at 8 n.11 and *Arizona v. Maricopa County Med. Soc'y*, 457 U.S. 332, 343 (1982).

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had resulted in higher costs to the insurers and patients . . . " 476 U.S. at 452-53. As in *NCAA*, likely anticompetitive effects were inferred from the nature of the agreement:

> A concerted and effective effort to withhold (or make more costly) information desired by consumers for the purpose of determining whether a particular purchase is cost justified is likely enough to disrupt the proper functioning of the price-setting mechanism of the market that it may be condemned even absent proof that it resulted in higher prices or, as here, the purchase of higher priced services, than would occur in its absence.

476 U.S. at 461-62. With the conclusion that the dentists' agreement was, on its face, likely to be

Commission's reading of that case. *California Dental Assoc.*, 2001 FTC LEXIS 22, *3 (Feb. 15, 2001) (Statement of Pitofsky, Anthony, and Thompson Respecting Commission's Decision Not to Petition for Certiorari) ("The Court ruled that a quick look was insufficient in this context, but found that neither a full rule of reason nor proof of actual market effects was required.").

Respondents' claim that abbreviated antitrust analysis requires a finding of actual injury to competition is based upon its misreading of the following snippet from the *CDA* decision:

> The point is that before a theoretical claim of anticompetitive effects can justify shifting to a defendant the burden to show empirical evidence of procompetitive effects, as quick-look analysis in effect requires, there must be some indication that the court making the decision has properly identified the theoretical basis for the anticompetitive effects and considered whether the effects actually are anticompetitive. Where, as here, the circumstances of the restriction are somewhat complex, assumption alone will not do.

526 U.S. at 775 n.12. Read in context, the import of this passage is as follows: First, there are circumstances where simply a "theoretical claim of anticompetitive effects" is sufficient to impose upon the defendant the burden of coming forward with empirical evidence of procompetitive effects. *Id.* at 770. Second, due to certain "complexities," limited advertising restraints in markets for professional services require more extensive scrutiny. *Id.* at 771-72. Third, the trial court's duty to consider whether, in more complex cases, the charged effects "actually are anticompetitive," is not (as Respondents suggest) an instruction that the court necessarily undertake "the fullest market analysis." *Id.* at 779. Instead, this is a reference back to the main text, where Justice Souter explains that with regard to the advertising restraints being reviewed, the theorized harm ("the CDA disclosure rules essentially bar advertisement of across-the-board discounts") does not necessarily describe any

[6] The issue raised by the moratorium is precisely that identified and distinguished by the majority in *CDA*. 526 U.S. at 771 (CDA advertising restraints are not "like restrictions on advertisement of price and quality generally"). Since the present case (unlike *CDA*) does not involve a professional service market with possible information asymmetries, it is proper to "place the burden of procompetitive justification on those who agree to adopt" broad advertising restrictions. *Id*.

[7] Respondents' attempt to distinguish *Chicago Prof'l Sports* is without merit. Respondents state that in *Chicago Prof'l Sports,* the restraint had the "actual effect of specifically limiting the number of Chicago Bulls telecasts." App. 34. Here, the moratorium had the "actual effect" of specifically barring discounting and advertising for 3T1 and 3T2.

[8] Respondents' reliance upon *United States v. Visa U.S.A., Inc.*, 163 F. Supp. 2d 322 (S.D.N.Y. 2001 cBit C D A

its face, and hence where the full rule of reason is invoked. To require a similar showing where a restraint is anticompetitive on its face would be equivalent to abandoning abbreviated rule of reason analysis. *Brown University*, 5 F.3d at 673 ("[I]f an abbreviated rule of reason analysis always required a clear evidentiary showing of a detrimental effect on price, output, or quality, it would no longer be abbreviated . . . . This is because proof of actual adverse effects generally will require the elaborate, threshold industry analysis that an abbreviated inquiry is designed to obviate.").[9]

The first task then is to determine whether the agreements between PolyGram and Warner to forgo discounting and advertising fall within a category of restraints that is likely, absent an efficiency justification, to lead to higher prices or reduced output.[10] This assessment is guided by common sense, legal precedent, and economic theory and research. *IFD*, 476 U.S. at 456; *NCAA*, 468 U.S. at 106-08; *DADA*, 111 F.T.C. at 494-96. The Commission should also consider whether the practices being restrained would otherwise constitute an important basis of competition in the marketing of the relevant products. *DADA*, 111 F.T.C. at 497.

A. <u>Respondents' Agreement Not to Discount Is Presumptively Anticompetitive</u>

Judge Timony identified the theoretical basis for expecting that an agreement not to discount will yield higher prices (IDF¶¶236, 245-249), and evaluated whether such effects actually are

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[9] *See also BMI*, 441 U.S. at 20 n.33 ("The scrutiny occasionally required must not merely subsume the burdensome analysis required under the rule of reason, or else we should apply the rule of reason from the start.").

[10] *Cf.* T. Muris, *The Federal Trade Commission and the Rule of Reason: In Defense of* Massachusetts Board, 66 ANTITRUST L.J. 773, 800 (1998) ("An agreement by competitors is inherently suspect if it eliminates or limits significant aspects of their competitive rivalry or it otherwise acts to deny consumers the ability to choose among alternatives.").

anticompetitive. IDF¶¶235-261. Further, Judge Timony correctly concluded that the agreement between PolyGram and Warner not to discount 3T1 and 3T2 is a form of price fixing,[11] and is subject to abbreviated review. ID 56-57.

Numerous cases have held that an agreement to restrict price competition is presumptively anticompetitive. *E.g., BMI*, 441 U.S. 1; *NCAA*, 468 U.S. at 100; *NSPE*, 435 U.S. at 692; *United States v. Socony Vacuum Oil Co.*,310 U.S. 150, 218 (1940); *Brown University*, 5 F.3d at 674. Indeed, no principle of antitrust law is more firmly established than the proposition that an agreement between competitors to fix minimum prices threatens serious harm to the efficient functioning of a market economy. *E.g.*, *FTC v. Ticor Title Insurance Co.*, 504 U.S. 621, 639 (1992) ("No antitrust offense is more pernicious than price fixing."); *NCAA*, 468 U.S. at 100 (1984) (Horizontal price fixing is "perhaps the paradigm of an unreasonable restraint of trade.").[12]

Antitrust law's hostility to price-fixing agreements is rooted in fundamental and uncontroversial economic theory. IDF¶236; JX 104-B (Stockum Expert Report). Dr. Stockum therefore concluded that, absent an efficiency justification, the PolyGram/Warner agreement not to discount catalogue Three Tenors products is very likely to be anticompetitive. IDF¶237. Respondents' economic expert, Dr. Janusz Ordover, agreed that a naked agreement between horizontal competitors to restrict price competition has "clearly pernicious effects on competition and consumers." RX715 (Ordover Expert Report) ¶ 61.

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[11] *Catalano, Inc. v. Target Sales, Inc.*, 446 U.S. 643, 648 (1980) (per curiam) ("an agreement to eliminate discounts . . . falls squarely within the traditional *per se* rule against price fixing").

[12] *CDA* did not involve a price restraint, and so Respondents' arguments regarding *CDA* do not apply.

Respondents claim that the moratorium was employed by PolyGram and Warner in the context of a "novel" joint venture. This contention does not, however, save the moratorium from abbreviated review. Any evidence regarding efficiency benefits should simply be considered in the next stage of the competitive analysis. For example, in *BMI*, the Supreme Court declined to apply the *per se* rule not because the blanket license was novel, but because there was evidence that the horizontal price restraint was necessary to achieve a "substantial lowering of costs." 441 U.S. at 21. Respondents concede that BMI made such a showing. App. 50. Similarly, in *NCAA, NSPE*, *Marshfield Clinic, Law*, *Chicago Prof'l Sports, General Leaseways,* and *Brown University*: the diverse and novel settings did not derail the courts' threshold finding that a horizontal price (or output) restraint is presumptively anticompetitive. Efficiency analysis followed.[13]

Respondents next assert that courts have had little experience with price restraints in the music industry. But the evidence shows that in the sale of recorded music, as in other industries, price competition is output enhancing and important to consumers. Executives from PolyGram and Warner testified that their companies offer discounts to retailers in order to increase sales levels. IDF¶239. During 1994, PolyGram responded to the release of 3T2 by aggressively reducing the price of 3T1 in many markets – to the benefit of consumers. IDF¶240. And again in 1998, many PolyGram and

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[13] The present case is fundamentally different from *Continental Airlines v. United Airlines*, 277 F.3d 499 (4th Cir. 2002). The Court of Appeals determined that an agreement among airlines defining the size of the template placed at the entry point of x-ray machines at airport luggage checkpoints did not have obviously anticompetitive effects. Courts have no prior antitrust experience with such agreements; there is no economic literature that addresses such agreements; the relationship between the templates and the price of air transportation is not obvious; and it was essential that the airlines collectively reach some agreement defining the size of the x-ray machine opening.

[14] IDF¶¶84, 107-08, 121, 148, 179.

[15] *Accord CDA*, 526 U.S. at 769-770; *NCAA*, 468 U.S. at 109; *Chicago Prof'l Sports*

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anticompetitive. The same phenomenon is seen in *Law*, *General Leaseways*, and *Chicago Prof'l Sports.*

[20] *Blackburn v. Sweeney*, 53 F.3d 825, 827 (7th Cir. 1995); *United States v. Gasoline Retailers Ass'n*, 285 F.2d 688, 691 (7th Cir. 1961); *Federal Prescription Serv., Inc. v. American Pharm. Ass'n*, 484 F. Supp. 1195, 1207 (D.D.C. 1980), *aff'd in part and rev'd in part*, 663 F.2d 253 (D.C. Cir. 1981); *United States v. House of Seagram, Inc.*, 1965 Trade Cas. (CCH) ¶ 71,517 at 81,275 (S.D. Fla. 1965); *Mass. Board*, 110 F.T.C. at 606-608; *American Med. Ass'n*, 94 F.T.C. 701 (1979), *enforced as modified*, 638 F.2d 443 (2d Cir. 1980), *aff'd per curiam by an equally divided Court*, 455 U.S. 676 (1982). *Accord Illinois Corporate Travel, Inc. v. American Airlines, Inc.*, 806 F.2d 722, 724 (7th Cir. 1986) (prohibition on advertising discounts "is functionally a price restriction"); H. HOVENKAMP, XII ANTITRUST LAW 2023b at 144 (1999).

[21] *See also* [illegible]

[22] *Accord Morales v. Trans World Airlines, Inc.*, 504 U.S. 374, 388 (1992); *Bates*, 433 U.S. at 377-78; *Virginia Bd. of Pharmacy v. Virginia Citizens Consumer Council, Inc.*, 425 U.S. 748, 765 (1976); *Mass. Board,* 110 F.T.C. at 605; *American Medical Association*, 94 F.T.C. 701,

consistently concluded that advertising restrictions result in consumers paying higher prices. IDF¶246; *Bates*, 433 U.S. at 377.[23] Even a short-lived restraint on advertising can have a significant effect on consumers, as is evidenced by a study of the New York newspaper strike described at trial by Dr. Stockum. In New York, as elsewhere, newspapers are an important vehicle for grocery store advertising. After only a single week without newspapers, the authors identified a significant increase in supermarket prices attributable to the restriction on advertising.[24]

On the basis of economic theory and empirical findings, Dr. Stockum concluded that, absent an efficiency justification, Respondents' agreement not to advertise or promote catalogue Three Tenors albums is very likely to be anticompetitive. IDF¶248. Respondents' economic expert, Dr. Ordover, offered a similar conclusion: naked agreements between competitors not to advertise their respective products "are likely to be adverse to consumers." IDF¶249.

Respondents have not offered the Commission any basis to conclude that advertising is less beneficial or less important in the sale of recorded music than in those industries that have been more systematically studied by economists. In fact, it is quite clear that advertising is an important basis of

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[23] Economic literature regarding advertising restraints and a summary thereof was submitted to the ALJ as Appendix A to Complaint Counsel's Findings of Fact, Conclusions of Law, Memorandum of Law in Support Thereof and Order (April 26, 2002). Among the articles submitted are Love & Stephen, *Advertising, Price and Quality, in Self-Regulating Professions: A Survey*, 3 INT'L J. ECON. BUS. 227, 236 (1996) (analyzing 17 empirical studies of professional advertising, and concluding that "the overwhelming impression from the results [of these studies] is of advertising having a downward effect on professional fees."); and J. Langenfeld & L. Silvia, *The Federal Trade Commission Horizontal Restraint Cases: An Economic Perspective*, 61 ANTITRUST L.J. 653, 673 (1993) ("Restrictions on advertising clearly increase the cost of consumers' obtaining information on the lowest price.").

[24] IDF¶247; Stockum 599:6-600:10; Amihai Glazer, *Advertising, Information and Prices – A Case Study*, 19 ECON. INQUIRY 661 (1981).

rivalry in the recorded music industry, and that (absent a concerted restraint) competitive forces lead record companies to advertise extensively. IDF¶¶250-251.

Advertising has proven to be an important competitive tool in the marketing of Three Tenors products. In 1994 and thereafter, PolyGram used advertising in an effort to teach consumers that 3T1, the "original" Three Tenors recording, was still the best performance, still widely available, and indeed often available at a discounted price. IDF¶¶252-253. Warner used advertising in its effort to create a distinct identity for 3T2, and to suggest to consumers that the newer release was the superior product. IDF¶¶201-209, 254. Thus, in 1996, when a PolyGram executive writes that PolyGram (3T1) and Warner (3T2) are fighting "head on for every conceivable advantage," it is apparent that advertising is an important strategic weapon in that battle. IDF¶¶229-232.

During 1998, both PolyGram and Warner operating companies wished to offer their older Three Tenors recordings at significant discounts. In each case, discounting was coupled with an aggressive advertising campaign. IDF¶¶102-105, 115-118, 255-258. Warner forecast that by cutting the wholesale price of 3T2 and advertising the album on television and in other media, the company could increase sales by 170 percent and increase overall profits as well. IDF¶¶255-256. This initiative was directed at consumers in Europe, but illustrates a proposition fully applicable to the U.S. market: Advertising of recorded music can create additional demand, and hence an environment in which discounting by record companies is more likely to occur. IDF¶259. *See also* Ordover Dep. (JX90) 49:20-24 ("there are clearly economic models in which a restriction on advertising may affect the

[25] *Cf.* P. AREEDA & H. HOVENKAMP, ANTITRUST LAW ¶ 2023.1c4 at 515 (2001 Supp.) ("[T]he less information a consumer has about *relative* price and quality, the easier it is for market

incentive and intention – absent the moratorium – to promote 3T1 and 3T2 aggressively. IDF¶¶84, 102-107, 115-118, 131-132. Market conditions in the U.S. were apt to be similar. (iii) Upon the release of 3T2 in 1994, PolyGram provided co-op advertising funds to U.S. retailers in compensation for discounting and advertising 3T1. IDF ¶¶213, 217-218.

Son Constr. Co., 783 F.2d 1157, 1160 (4th Cir. 1986) (claim that agreement with competitor did not influence contractor's bid is not a defense to bid rigging; "accepting the appellants' position would lead to self-serving testimony in virtually every bid rigging trial"); *Lee-Moore Oil Co. v. Union Oil Co.*, 599 F.2d 1299, 1301-1302 (4th Cir. 1979); *In re Cardizem CD Antitrust Litig.*, 105 F. Supp.2d 682, 701 & n.13 (E.D. Mich. 2000); P. AREEDA & H. HOVENKAMP, ANTITRUST LAW ¶ 1509 at 368 (2001 Supp.).[28]

II. Respondents' Efficiency Defenses Must Be Rejected

A. An Efficiency Justification Must Be Both Plausible and Valid

Respondents have the burden of demonstrating a countervailing efficiency justification. *CDA,* 526 U.S. at 771; *IFD*, 476 U.S. at 459; *NCAA*, 468 U.S. at 113. More specifically, Respondents must show that the moratorium was necessary in order to promote competition and bena66on ani T5te comp.T25 0 iTw

[28] Although it is no defense to liability, Respondents' contention that they would not have discounted absent the moratorium does undermine any claim that the restraint was reasonably necessary for the success of the venture.

(1986). At trial the association produced no evidence of erroneous treatment decisions attributable to the misuse of x-rays, and no evidence that any consumer had in fact been harmed. 101 F.T.C. at 177. For this reason, the Commission rejected the asserted efficiency defense, and judged the inherently suspect agreement to be unlawful. *Id*. The Supreme Court affirmed, specifically noting that the Federation had failed to introduce sufficient evidence to validate its quality of care argument. *IFD*, 476 U.S. at 464. *See also NCAA,* 468 U.S. at 113 ("Under the Rule of Reason, these hallmarks of anticompetitive behavior place upon the NCAA a heavy burden of establishing an affirmative defense that competitively justifies this apparent deviation from the operations of a free market."); *Brown University*, 5 F.3d at 674 (defendant university "bears the burden of establishing an affirmative justification" for suspect restraint).

In each of the following cases, a plausible efficiency defense was rejected for lack of sufficient supporting evidence: *NCAA*, 468 U.S. at 114 ("There is therefore no predicate in the findings for petitioner's efficiency justification."); *Maricopa*, 457 U.S. at 353 ("nothing in the record even arguably supports the conclusion that this type of insurance program could not function if the fee schedules were set in a different way"); *Law*, 134 F.3d at 1022, 1024 (evidence did not support contention that NCAA salary restrictions would create more balanced competition among teams); *Chicago Prof'l Sports*, 961 F.2d at 675 (evidence did not support free-riding defense); *General Leaseways*, 744 F.2d at 592 (evidence did not support free-riding defense); *Mardirosian*, 474 F. Supp. at 649 ("not a single fact is alleged" in support of defendant's efficiency argument).[29]

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[29] *See also* Muris, Mass. Board, *supra* note 10 at 778-79 ("Compared to the plausibility stage inquiry, the court must delve more deeply into the factual assertions of the parties to determine whether

Contrary to Respondents' representation, *CDA* does not teach that where the conspirators simply advance a plausible efficiency rationale for an inherently suspect restraint, the Commission must undertake a full rule of reason review. Rather, the Court affirmed that where a restraint is anticompetitive on its face, in order to defeat liability the defendant must offer "empirical evidence of procompetitive effects." 526 U.S. at 775 n.12. In *CDA*, the challenged agreement was not obviously anticompetitive, and Respondents proffered a plausible efficiency justification. Even so, the Court concluded that upon remand "a plenary market examination" may not be necessary. 526 U.S. at 779.[30]

CDA is then entirely consistent with the analytical framework outlined above. Since both the price restraint and the advertising ban agreed to by PolyGram and Warner are *prima facie* anticompetitive, the burden shifts to the Respondents to advance evidence supporting a plausible and

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(1) the claimed efficiency benefits are real, and (2) the restraint is reasonably necessary to achieve them. If a proffered explanation fails on either count, then the court should declare the challenged restraint unlawful under the abbreviated rule of reason."); H. Hovenkamp, *Competitor Collaboration After* California Dental Association, 2000 U. Chi. Legal Forum 149, 181 (2000) ("Once the plaintiff has shown a restraint with significant anticompetitive potential, the defendant may defend the restraint by showing that it is procompetitive in fact."); W. Cohen, *supra* note 4 at § III.A.1 ("[T]he Court in *NCAA* and *Indiana Federation of Dentists* preserved the presumption of competitive harm long enough to inquire whether justifications had been demonstrated in fact. Finding that they had not, the Court condemned the challenged conduct."); H. HOVENKAMP, XIII ANTITRUST LAW ¶ 2131c at 136-37 (1999) (courts should "require specific proof" justifying any efficiency defense for joint venture rules that limit members' output outside the venture).

[30] *See* Calkins, *supra* note 15 at 549 ("In *CDA,* the Supreme Court was invited to hold that whenever a defendant can point to 'facially plausible' efficiencies, scrutiny of its actions must proceed under the full-blown rule of reason – the Full Monty. The Court refrained from doing so."); P. AREEDA & H. HOVENKAMP, ANTITRUST LAW ¶ 2023.1c8 at 519 (2001 Supp.) ("The Supreme Court [in *CDA*] did not mean that any time competitors could offer a plausible explanation that their price- or output-affecting agreement was procompetitive they were entitled to full rule of reason treatment.").

valid efficiency justification. Unsupported hypothetical efficiency arguments do not convert the analysis to a full blown rule of reason review.[31]

B. The Challenged Restraint Must Be Reasonably Necessary to Achieve the Claimed Efficiency Benefit

An efficiency justification is valid only if the challenged conduct is reasonably necessary in order to achieve the legitimate objective identified by the respondent. *BMI*, 441 U.S. at 19-21 (blanket license was "an obvious necessity" for achieving integrative efficiencies, and joint setting of price was "necessary" for the blanket license); *Marshfield Clinic*, 65 F.3d at 1416 (territorial division unlawful unless "essential to the provision of a lawful service"); *Brown University*, 5 F.3d at 678-79 (restraint must be "reasonably necessary to achieve the legitimate objectives proffered by the defendant"); *Law*, 134 F.3d at 1019 (same); *Collaboration Guidelines* ¶ 3.36(b) (April 2000) ("The Agencies consider only those efficiencies for which the relevant agreement is reasonably necessary."); P. Areeda, VII ANTITRUST LAW ¶1505 at 383-84 (1986) ("To be reasonably necessary, the restraint must not only promote the legitimate objective but must do so significantly better than the available less restrictive

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[31] *Collaboration Guidelines*, Example 10, is consistent with Complaint Counsel's contention that full rule of reason review of a suspect restraint is appropriate only where an efficiency theory is supported by the evidence. In Example 10, as evidence of a free-riding problem, the venturers point to: (i) documents in both firms' files dating from the time of joint venture negotiations showing that the free-riding concern is not pretextual, and (ii) the experience of a similar software joint venture, launched without the suspect restraint, that was unsuccessful. By contrast, here Respondents have stipulated that the moratorium was not necessary to the formation of the venture, and no business documents from Respondents' files discuss the purported justifications for the moratorium. The most analogous business experience, the successful release of 3T2, was accomplished without a restraint on competition. Indeed, while negotiating the terms of the 3T3 venture, the parties were aware of PolyGram's efforts to promote 3T1 following the release of 3T2. The parties' willingness to enter into the 3T3 joint venture without a moratorium supports the conclusion that the moratorium was not necessary for the formation or efficient operation of the venture.

[32] Contrary to Respondents' charge (App. 20), Judge Timony did not require that the

Alternatively, Respondents argue that necessary means "plausibly procompetitive." As discussed above, the "plausibility is sufficient" defense would effectively abolish abbreviated rule of reason analysis. Absent a showing that the Three Tenors moratorium was in fact reasonably necessary, there is no pro-competitive benefit to weigh against the obvious anticompetitive potential of the restraints.

C. <u>Pretextual Justifications Should Be Disregarded</u>

Judge Timony correctly concluded that the parties' actual motivgardeTcrorthe poratorium Tj -36 -30 TD -0.437

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[33] *SCTLA*, 493 U.S. at 421-2; *Law*, 134 F.3d at 1023; *Chicago Prof'l Sports v. NBA*, 754 F. Supp. 1336, 1359 (N.D. Ill. 1991), *aff'd*, 961 F.2d 667 (7th Cir. 1992).

[34] *See also Microbix Biosystems, Inc. v. Biowhittaker, Inc.*, 172 F. Supp.2d 680, 695 (D. Md. 2000), *aff'd* 2001 U.S. App. LEXIS 11576 (2001); *Red Lion Medical Safety, Inc. v. Ohmeda, Inc.*, 63 F. Supp. 2d 1218, 1234-1235 (E.D. Ca. 1999); *Telecomm Technical Services Inc. v. Siemens Rolm Communications, Inc.,* 66 F. Supp. 2d 1306, 1319 (N.D. Ga. 1998).

D. Respondents' Free-Riding Defense Should Be Rejected.

"A free rider is a firm [that] takes free advantage of a service or product that is valued by customers but provided by a different firm."[35] According to Respondents, without the moratorium agreement, promotional investments by PolyGram and Warner intended to benefit sales of 3T3 may instead have led some consumers to purchase at a lower price 3T1 (distributed by PolyGram) or 3T2 (distributed by Warner). Even if this contention were accurate, it would not be sufficient to justify the parties' agreement to fix prices and forgo all advertising.

The Commission's opinion in *Toys "R" Us* surveys the relevant case law and identifies three requirements for the successful invocation of the free-riding defense. Respondents must show that: (i) absent the challenged restraints, free riding is likely to have the effect of eliminating some valued service from the marketplace; (ii) there was no reasonable means by which the competitor that benefits from the valued service (the alleged free rider) could have compensated the firm that was providing such service; and (iii) there were no less restrictive alternatives. *Toys "R" Us, Inc.,* 126 F.T.C. 415, 600-07 (1998), *aff'd*, 221 F.3d 928 (7th Cir. 2000) ("TRU"). As none of these requirements is satisfied, Respondents' free-riding defense must be rejected.[36]

1. No Valued Service Was Threatened by Free Riding.

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[35] H. Hovenkamp, *Federal Antitrust Policy: The Law of Competition and its Practice* § 5.2b1 at 202 (2d ed. 1999).

[36] Respondents suggest that Complaint Counsel's economic expert has conceded the plausibility of the proffered efficiency justification. Dr. Stockum merely acknowledged that it is "plausible" in the abstract that advertising for 3T3 may lead some consumers to purchase 3T1 or 3T2. Stockum Dep. (JX85) 153:14-156:21. As detailed in his expert report and explained herein, this alone does not establish a meritorious free-riding defense.

distribution rights to 3T3 – initially without the participation of PolyGram. IDF¶¶52, 222, 285.

Given that advertising for one product often benefits rival products, more than just lost sales is required in order to justify a resort to price fixing – or else price-fixing agreements would be the rule rather than the exception. *See* H. HOVENKAMP, XII ANTITRUST LAW

to notify its operating companies that if Warner were found selling 3T2 at discounted prices in any territory, then the local PolyGram operating company could respond by discounting 3T1. IDF¶¶129-30, 290.[40]

Third, Respondents have no basis for their assertion that potential free riding and the moratorium are in any way related to the parties' future decision whether to release the greatest hits or box set albums. No analysis is presented in Respondents' brief (App. 44), and the accompanying citation (RPF¶¶55, 72) does not relate to these inchoate products.[41] The moratorium agreement also has not been shown to benefit post-moratorium sales of 3T1, 3T2, and/or 3T3. Respondents' discussion of a "negative spillover" that causes other "asymmetrical long-term harm" (App. 46) is inscrutable, unrelated to free riding as that term is used in antitrust economics, and in any event is not supported (or even elucidated) by Dr. Ordover's report or by the cited references (RPF¶¶86-101). It is not apparent what if any valued service is affected, and there is no evidence that the threat is substantial, or even related to the U.S. market.[42]

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[40] Respondents stipulated that the moratorium was not necessary for the formation of the joint venture (IDF¶262), but then mischaracterize Mr. O'Brien's testimony to attack their own stipulation App. 45-46. In late 1997, O'Brien expressed concern that, if as part of the negotiations for the 3T3 project, WMI demanded that Tibor Rudas reduce his royalty on 3T2, then this (the royalty demand, not discounting) could "blow the deal" with Rudas. CPRF¶¶94-96; IDF¶264. The evidence cited by Respondents (RPF¶95) is inapposite.

[41] To the extent that the moratorium leads to higher market prices and greater profits (without a legitimate efficiency), this may make it more attractive for PolyGram and Warner to introduce new products. But this is simply a by-product of cartelization, and is not a valid efficiency defense. *See SCTLA*, 493 U.S. at 423 (contention that price fixing increases incentives for new entry is not a valid defense); *Catalano,* 446 U.S. at 649 (same).

[42] Respondents inaccurately attribute to Professor Moore the view that a record company "typically would spend more money promoting a product if it was successful during the initial release."

Finally, Respondents' economic expert, Dr. Ordover, opined that if there were a serious free-riding problem in connection with the marketing of 3T3, the problem existed in Europe but not the United States. IDF¶306; Ordover Dep. (JX90) 36:25-37:4 ("for whatever reason, the United States market seemed to have somewhat different dynamics than the feared dynamics in other countries").[43] Dr. Ordover calculated that the magnitude of sales diverted from 3T3 to 3T1 in the United States due to free riding during the moratorium period (August - October 1998) would have been quite small (sales of less than $86,000 per month). IDF¶294. Dr. Ordover was thus unable to conclude that free riding in the United States would have had a significant impact on the venturers' incentives to advertise 3T3. IDF¶294.[44] Respondents' professed concern about long-term harm thus has little basis in reality.

In sum, the Three Tenors moratorium agreement was not necessary to preserve incentives to advertise and promote 3T3 in the United States; no valued service was threatened.

PF108. *Compare* App. 46 n.15 *with* Moore 197:15-199:23. A rational decision-maker would base post-moratorium advertising levels on the expected benefit of such investment. Respondents have not shown that the moratorium agreement would have any effect on this calculation, or that the effect is significant and beneficial to consumers. In this regard, Dr. Ordover acknowledged that in theory discounting and promotion of 3T1 by PolyGram may actually increase (rather than decrease) Warner's incentive to promote 3T3. Conversely, the moratorium may decrease Warner's incentive to advertise 3T3. Ordover Dep. (JX90) 115:16-116:13, 118:8-119:1. But in reality, Dr. Ordover found the spillover in the U.S. to be insignificant. *See infra*.

[43] *See also* RX716 (Ordover Expert Report) ¶ 49 ("the challenged restraints were crafted to address the parties' concerns over pricing and advertising campaigns that might be implemented in Europe and other regions outside of the United States"); Ordover Dep. (JX90) 22:8-10 ("this alleged moratorium, which I don't think actually pertained to the United States in any meaningful way"); 25:24-25 (moratorium "would have been a non-event from the standpoint of U.S. distribution"); 27:15-16 (moratorium was "a non-issue in the U.S. Although, it might have been viewed as a major issue in Europe.").

[44] *See also* Ordover Dep. (JX90) 55:2-8; 158:25-159:21.

2. PolyGram and Warner Shared the Cost of Advertising 3T3.

Even assuming that there were a legitimate concern with free riding here, there is also a well-established solution: joint advertising arrangements. Professor Hovenkamp explains:

> In a competitive market Farmer Brown cannot afford to pay for advertising that benefits all local producers of potatoes. She will not advertise at all, even though the effect of the advertising would be to give consumers better information. However, the farmers collectively could increase their joint welfare, as well as that of consumers, if they organized a potato growing association, and each paid a proportionate share of the costs of the advertising. In that case both the benefit and the cost would be shared by all growers.[45]

Where firms that share the benefits from advertising also share of the costs of such advertising, any free-riding problem is remedied. *TRU*, 126 F.T.C. at 602 ("compensation to the high service retailer eliminates free-rider problems").[46]

This is exactly what PolyGram and Warner decided to do here: share the cost of promoting 3T3 in the United States. IDF¶301. The parties elected to share advertising costs on a 50:50 basis, but could have adopted a different cost sharing formula if they concluded that one firm was benefitting disproportionately.[47] The ability of PolyGram and Warner to compensate one another for the value of the 3T3 advertising defeats the asserted free-riding defense. *E.g., Chicago Prof'l Sports*, 961 F.2d at 675; *General Leaseways,* 744 F.2d at 592.

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[45] H. Hovenkamp, *supra* note 35 § 5.2b3 at 203.

[46] *See also* H. Hovenkamp, *supra* note 35 § 5.2b3 at 203; D. Carlton & J. Perloff, *Modern Industrial Organization* at 531 (1994) ("advertising subsidy from the manufacturer to the dealer prevents the free-riding problem from eroding the dealer's incentive to advertise").

[47] In *TRU*, the Commission explained that it is not important that compensation from one competitor to another be "exactly the right amount." It is sufficient that the cost-sharing mechanism "ensure[s] the continuation of the beneficial activity." *TRU*, 126 F.T.C. at 602.

Chicago Prof'l Sports was a challenge to a National Basketball Association rule restricting the number of basketball games that could be telecast by individual teams. The Court of Appeals concluded that this inherently suspect output restraint could not be justified by the asserted need to prevent one team (the Chicago Bulls) from free riding on advertising funded by other teams in the league. Judge Easterbrook explained that the Chicago team could instead be required to compensate other teams (and the league as a whole) for the benefits provided. "Free-riding is the diversion of value from a business rival's efforts without payment . . . . When payment is possible, free-riding is not a problem because the 'ride' is not free." 961 F.2d at 675.

General Leaseways is also directly on point. This case involved an association of local companies that leased and maintained trucks. Each member of the association was obligated to perform emergency repairs on trucks owned by other members that broke down within the repairer's territory. The antitrust challenge addressed an agreement among the trucking companies that no member could expand its business into the territory of another member. To the charge that this was an illegal market division agreement, defendants asserted a free-riding defense: that absent the restraint, one member of the association may grow so large relative to others "that it was consistently demanding more repairs . . . than it was performing." 744 F.2d at 592. This efficiency justification was summarily rejected. Judge Posner concluded that, as the members of the association charge one another for the emergency repair service, free riding was not a threat. *Id.* at 592.[48]

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[48] *See also Marshfield Clinic*, 65 F.3d at 1416; *High Technology Careers v. San Jose Mercury News*, 996 F.2d 987, 992 (9th Cir. 1993) (free-riding defense fails because the alleged free-rider "paid what it was asked to pay"); *United States v. Microsoft Corp.,* 1998-2 Trade Cas. (CCH) ¶ 72, 261 at 82,682 (D.D.C. 1998) (summary judgment decision); *Toys R Us, Inc.,* 126 F.T.C. at 601

Respondents' efforts to distinguish these precedents are unpersuasive. Respondents point out that PolyGram and Warner both had the ability and incentive to free ride. But in *Chicago Prof'l Sports*, every team in the NBA was in a position to benefit from the league's promotional expenditures. Similarly, in *General Leaseways*, all members of the venture benefitted from the repair services guaranteed by the association. There is nothing unique then about the structure of the PolyGram/Warner venture.

Respondents argue that PolyGram and Warner would continue to have an incentive to discount and promote their catalogue Three Tenors products regardless of how financial responsibility for 3T3 advertising is allocated. App. 46-47.[49] But from the standpoint of consumers, this is a good thing; this is confirmation that sharing advertising expenses is less restrictive of competition than the moratorium agreement. Stated differently, the cost-sharing mechanism assures that the venture has appropriate incentives to advertise 3T3, while preserving the individual venturers' incentives to market 3T1 and 3T2.

Warner and PolyGram agreed to share the cost of advertising and promoting 3T3 upon terms satisfactory to them. This limited form of cooperation eliminates the free-riding problem and obviates the need for the parties to engage in price fixing or to adopt an advertising ban. *See* H. HOVENKAMP,

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("[Free-riding] concerns evaporate because TRU is compensated for the services, and there is no threat that the services will be driven from the market."), *aff'd*, 221 F.3d 928, 938 (7th Cir. 2000) ("[The toy] manufacturers were paying for the services TRU furnished, such as advertising, full-line product stocking, and extensive inventories . . . . [T]hus these services were not susceptible to free riding.").

[49] Respondents refer to this as a continuing "incentive to free ride," but this is a misnomer. Since no firm is taking free advantage of the 3T3 advertising, there is no free riding as that term is used in the antitrust cases.

[50] As a matter of law, Respondents cannot justify the agreement to restrain competition in the marketing of Three Tenors products in the United States with the claim that the moratorium was

[51] Judge Timony's conclusion that "[t]he suppression of 3T1 and 3T2 was not necessary to the effective marketing of 3T3" (ID 64) is substantially identical to the finding in *NCAA* that "NCAA football could be marketed just as effectively without the television plan." 468 U.S. at 114.

The reports of Respondents' experts, though properly admitted in evidence, should be given little weight when assessing the validity of the asserted efficiency defenses. ID 58 n.25. Among the principal deficiencies with these reports is that the presentations are entirely theoretical: Professors Ordover and Wind did not show that their efficiency "hypotheses" were applicable to the marketing of Three Tenors products. Wind Dep. (JX91) 10:12-11:20 ("So I did not analyze what actually happened."). Judge Timony correctly pointed out that, in preparing his report, Dr. Wind reviewed no documents from the files of Warner; reviewed no deposition testimony of any individual responsible for marketing 3T3 in the United States (no such deposition was taken); and reviewed no deposition testimony of any Warner employee. ID 58, n.25. Dr. Ordover's view that only sham joint ventures should be subject to abbreviated antitrust analysis (Ordover Dep. (JX90) 44:2-22) is inconsistent with Supreme Court precedent (*NCAA*), and distorts his analysis. Dr. Ordover also assumed incorrectly that there is no need to consider the availability of less restrictive alternatives. Ordover Dep. (JX 90) 77:8-11.

Finally, the ALJ properly discounted the reports in recognition of the fact that Professors Ordover and Wind did not testify at trial, and were not subject to cross-examination. The limitations, qualifications and clarifications critical to understanding any expert report were not fully explored. *See Weil v. Long Island Stsrmrst.3464 Tw (c -0r9keting 25. Dr. Ordosuc 0 OrdosTw 20018 U.S.LEXIS 22915, *108-*

example, during 1994, 3T2 was effectively and successfully launched by Warner without restraining competition from 3T1 (PolyGram). IDF¶¶35, 222, 283. In 2000, Sony released a fourth Three Tenors album, without restraining competition from any of the earlier Three Tenors albums. IDF¶¶197-199. Even in the case of 3T3, PolyGram and Warner agreed to enter into their venture without any restraint on competition, agreeing to the moratorium only after they were committed to the project. This experience teaches that a moratorium was not necessary in 1998 following the release of 3T3.[52]

What distinguishes 3T3 from the universe of albums successfully released without a moratorium on competition? According to Respondents, PolyGram believed that potential consumers of 3T3 "were particularly susceptible to confusion among the various Three Tenors products, and that this confusion could lead to lower sales of all Three Tenors products." App. 13. PolyGram marketing executive Paul Saintilan was purportedly concerned that customers might be so overwhelmed if presented with both a discounted 3T1 and a full price 3T3 that they might not buy any Three Tenors product at all, because "it's too hard" to decide. RPF¶69. (This may be Respondents' "asymmetrical harm": the consumer finds it is difficult to decide which of the three available Three Tenors albums to purchase, and so buys none.)

This novel claim that choosing among Three Tenors products is "too hard" for consumers is

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[52] *Cf. NCAA*, 468 U.S. at 119 (rejecting NCAA's efficiency defense where "in the most closely analogous sport, college basketball, competitive balance has been maintained without resort to a restrictive television plan"); *Chicago Prof'l Sports*, 961 F.2d at 675 (rejecting NBA's efficiency defense where major league baseball does not restrict individual teams from selling telecast rights to games).

neither plausible,[53] nor supported by the evidence. Saintilan's professed concern about consumer confusion was not based upon research, data, or observation. IDF¶312. As Judge Timony recognized: "There is no evidence that consumers were confused in selecting among the Three Tenors albums. It was 'speculation.'" IDF¶313 (citations omitted). As there is no evidence of confusion, there is no basis for Respondents' oft-repeated claim that promotion of 3T1 and 3T2 would undermine the launch of 3T3 or lead to lower sales of all Three Tenors products.[54]

At trial, the ALJ heard testimony from one witness with expertise in the marketing of recorded

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[53] Why would it be more difficult for consumers to select a Three Tenors album than, say, a Frank Sinatra album, or a long distance carrier, or a detergent, or a computer, or an automobile? Respondents offer no explanation.

[54] The PolyGram manager's subjective or good faith belief that discounting 3T1 and 3T2 would reduce long-term output is not sufficient to validate the efficiency defense. *See, e.g., NCAA*, 546 F. Supp. at 1309 (suspect restraints not saved by the good faith of those responsible for the television plan), *aff'd*, 468 U.S. at 101 n.23.

Even if there were a consumer confusion problem, the appropriate strategy for addressing this issue is to provide potential consumers with additional and clearer information (*e.g.*, through distinctive packaging and effective advertising). IDF¶¶314-318. A seller is not permitted to make its product appear unique by inducing a rival to withdraw its competing products. As a matter of law, confusing competition is preferred to the clarity offered by monopolization and collusion. *See, e.g., United States v. Western Electric Co.*, 583 F. Supp. 1257, 1260 (D.D.C. 1984) ("There is no doubt that some find confusion in the mushrooming of [telephone] service and equipment options that have become available in the wake of [the AT&T] divestiture; others may regard such proliferation as healthy in that they give the consumer greater choice at potentially lower prices. In any event, that policy dispute, too, is resolved by the antitrust laws and the decree.").

Moore 20:2-9; 139:14-19. "Based upon her demeanor and experience [Judge Timony] found [Professor Moore's] testimony to be particularly credible." IDF¶329.

The record evidence shows that the real marketing challenge here is not that consumers are confused by multiple Three Tenors products. Respondents' problem was that consumers are discerning. The parties feared that, given a choice between 3T3 and one of the older Three Tenors albums, some consumers would view a discounted 3T1 or 3T2 as the better value. IDF¶¶268-269. The surest way for PolyGram and Warner to maximize their profits on 3T3 was therefore to agree to maintain high prices on the older Three Tenors recordings. IDF¶269.

The regrettable fact that 3T3 was (in the eyes of the record companies and perhaps consumers) a disappointing product cannot justify an effort by the venturers to insulate this product from competition. This defense was offered and rejected in *NCAA*. The NCAA joint venture argued that a restriction on the telecast of college football games was necessary in order to protect live attendance at games. Such a strategy, the Supreme Court explained, would diminish rather than enhance consumer welfare:

> The NCAA's argument that its television plan [restricting the number of college football games televised] is necessary to protect live attendance is . . . [based] on a fear that the product will not prove sufficiently attractive to draw live attendance when faced with competition from televised games. At bottom the NCAA's position is that ticket sales for most college games are unable to compete in a free market. The television plan protects ticket sales by limiting output – just as any monopolist increases revenues by reducing output. By seeking to insulate live ticket sales from the full spectrum of competition because of its assumption that the product itself is insufficiently attractive to consumers, petitioner forwards a justification that is inconsistent with the basic policy of the Sherman Act.

NCAA, 468 U.S. at 116-117. An efficient restraint is one that promotes consumer welfare (*e.g.,*

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[56] We may assume, as Respondents contend, that PolyGram and Warner believed themselves to be "full partners." App. 8. Still, the moratorium represents concerted action rather than unilateral action.

[57] Respondents cite the *Collaboration Guidelines* for the proposition that the competitive effects of the PolyGram/Warner venture and the moratorium agreement should be analyzed together. This fundamentally misconstrues the *Guidelines*. In general, the *Guidelines* instruct, antitrust analysis should address the competitive effects of the precise agreement that is alleged to harm competition. There are exceptional circumstances in which two agreements "are so intertwined" that they must be assessed together. *Collaboration Guidelines* § 2.3. Such exceptional circumstances are not present here.

F. <u>The Moratorium Was Not Necessary to Protect Confidential Information</u>

Respondents claim that the moratorium helped assure that neither PolyGram nor Warner would free ride on the "confidential marketing plans developed by the joint venture partners." App. 44. This argument is unsupported by the evidence and wholly pretextual. No witness and not a single document indicate that the moratorium was intended to protect against the misuse of confidential marketing plans. This is the attorneys' post hoc rationalization for the moratorium agreement, and is therefore not a valid defense. *See* Section II.C., *supra.*

There is no evidence that PolyGram and Warner even exchanged confidential marketing information relating to 3T3. CPRF¶¶41-50. Even if, hypothetically, confidential marketing information were exchanged, Respondents have not shown that such information would be susceptible to free riding. *See Collaboration Guidelines* Example 10 ("neither participant may be capable of misappropriating the other's marketing contributions").

Finally, the contrived problem could have been remedied by ensuring that the individuals responsible for marketing 3T1 (for PolyGram) and 3T2 (for Warner) did not have access to competitively-sensitive information regarding 3T3.[58]

Among the Trees, 2000 U. CHI. L. FORUM 191, 192 (2000) ("the cornerstone of [the *Collaboration Guidelines* is] a focus on the 'relevant agreement,' potentially as narrow as a single component of a complex collaboration, provided that the individual restraint's competitive effects can be meaningfully evaluated in isolation").

[58] Because of the structure of the PolyGram/Warner venture, this remedy would have been simple to implement. Representatives of PolyGram's U.S. marketing operation (responsible for 3T1) had no marketing responsibility for 3T3, and did not attend the marketing meetings for this product. Similarly, representatives of Warner's non-U.S. marketing operation (WMI, responsible for 3T2) had no marketing responsibility for 3T3, and did not attend the marketing meetings for this product. CPF ¶ 123; CPRF¶¶41-50.

III. The Moratorium Agreement Is Not Ancillary to the Collaboration Between PolyGram and Warner and Therefore Is *Per Se* Unlawful

p e r s e

[59] *See NCAA*, 707 F.2d at 1156 n.September 11, 200215; *New York v. Francis Hospital*, 94 F. Supp. 2d 399, 418 (S.D.N.Y. 2000) (collaboration between hospitals in providing several new services cannot justify agreement not to compete on independently provided services).

Stated differently, the existence of some integration of activities on the part of the competitors is not an automatic escape from *per se* liability. For example, in criminal bid-rigging conspiracies, the firm that agrees not to compete (*e.g.*, for a construction contract) often receives in exchange a sub-contract from the successful bidder. This limited "collaboration" in performing the construction project does not provide the contractor and sub-contractor a basis for defeating *per se* liability. *E.g., United States v. MMR Corp.*, 907 F.2d 489 (5th Cir. 1990); *New York v. Hendrickson Bros., Inc.*, 840 F.2d 1065 (2d Cir. 1988); *United States v. Metropolitan Enterprises, Inc.*, 728 F.2d 444 (10th Cir. 1984).

[60] Another case illustrating the distinction between restraints upon products inside versus outside the venture is

Warner inside the United States. PolyGram's rights to 3T1 pre-date the arrangement and were not

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[61] When evaluating whether to apply the *per* se rule in the joint venture context, courts consider whether the restraints apply to the marketing of products created outside the joint venture. As explained in *Continental Airlines*, in *BMI*, "the challenged restraint added an entirely new good . . . to the market, without eliminating the goods that had previously been available . . . The [*BMI*] Court accepted the restraint's potential legitimacy, because permitting the challenged restraint offered 'real choice.'" 277 F.3d at 516. See also *BMI,*441 U.S. at 21-24; *NCAA*, 468 U.S. at 114; *Maricopa*, 457 U.S. at 355. Here, that choice was eliminated.

with a competitor to fix prices or to restrict advertising in connection with the sale of audio and video products, and imposing upon Respondents the burden to prove certain affirmative defenses. Similar prohibitions may be found in numerous Commission orders.[62] The core substantive provisions of Judge Timony's order (Paragraphs II and III) are substantially identical to those included in the consent agreement approved by the Commission for co-conspirator Warner. *Warner Communications, Inc.*, C-4205 (Sept. 21, 2001). Other provisions that Respondents complain of are common to nearly all Commission orders, including the twenty-year term, the obligation to distribute the order to relevant employees, and the obligation to cooperate with any future compliance investigation.

Respondents assert that they are unlikely to again enter into a joint venture similar to the 3T3 transaction, and hence that no cease and desist order should issue. This argument misconstrues the function of a Commission order, misconceives the Commission's remedial authority, and ignores the record evidence.

The purpose of a remedial order is not simply to prevent a replay of the precise scenario that gave to liability. The oft-cited principle is that all roads to the prohibited goal should be closed so that the Commission's order may not be by-passed with impunity. *E.g., FTC v. Ruberoid Co.,* 343 U.S. 470, 473 (1952).

As detailed herein, the claim that the Three Tenors moratorium arose in the context of a joint

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[62] Commission orders enjoining horizontal price restraints: *Berkley*, 2000 FTC LEXIS 47 (April 11, 2000); *Pools By Ike, Inc.*, 1999 FTC LEXIS 176 (Nov. 1, 1999); *Korean Video Stores Assoc. of Maryland*, 119 F.T.C. 879, 885 (1995). Commission orders enjoining advertising restraints: *Sensormatic Electronics Corp.*, 125 F.T.C. 587, 592-93 (1998); *Community Associations Institute*, 117 F.T.C. 787, 791 (1994).

venture does not defeat liability. This failed defense cannot now be transmuted into a limitation upon the Commission's authority to issue a cease and desist order. To be more precise, the Commission may now enjoin Respondents from entering into anticompetitive price and advertising restraints whether in the context of a joint venture (as in this case), or in an entirely different setting. For example, in *Brunswick Corp.*, 96 F.T.C. 151 (1980), manufacturers of outboard motors, acting in the context of a manufacturing joint venture, unlawfully agreed to divide markets. The Commission's order prohibits all such agreements not to compete, whether arising in the context of a joint venture or otherwise. More recently, in *Urological Stone Surgeons, Inc.*, 125 F.T.C. 513, 522 (1998), the Commission charged that numerous urologists, co-venturers in the creation and operation of a "lithotripsy facility," unlawfully agreed to fix prices. The Commission's order prohibits all agreements to fix prices for lithotripsy services, whether arising in the context of a joint venture or otherwise.

The relevant issue then is not whether Respondents will repeat their unlawful behavior in the context of a future joint venture, but whether these restraints will be repeated in any setting. Judge Timony's conclusion that there is a substantial danger that the unlawful price and advertising restraints will recur is amply supported by the evidence.

The marketing challenge that gave rise to the Three Tenors moratorium is commonplace in the recorded music industry: the fear that a new release by one of Respondents' recording artists may lose sales to the artist's older albums. IDF¶¶331-332. Was there something unique about PolyGram's concern that 3T3 would lose sales to catalogue Three Tenors albums? PolyGram Vice President Bert Cloeckaert answered this question with a definitive no: "For every major release in any record company there is always an element of anxiety because of big investment, because of big expectations,

to make sure that everything is set up to deliver the quantities we need to make money on that project.

CERTIFICATE OF SERVICE

I, Melissa Westman-Cherry, hereby certify that on September 11, 2002, I caused a copy of the Answering Brief of Counsel Supporting the Complaint in Support of the Initial Decision to be served by hand upon the counsel listed below:

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