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

RESPONDENTS' *CORRECTED* REPLY BRIEF ON APPEAL FROM INITIAL DECISION AND ORDER

marketing plans for 3T3. RPF 43. PolyGram and Warner were, as Mr. O'Brien testified, "full partners" in their Three Tenors joint venture and consequently had a legitimate and common interest in maximizing the long-term success of the Three Tenors brand and the long-term output of Three Tenors products. RPF 50.[1]

2. The Joint Venture Agreement Did Not Establish The Scope Of Any "Covenant Not To Compete" And Did Not Identify And Define All Of The Important Aspects Of The Joint Venture.

Complaint Counsel's contention that the joint venture agreement was intended to establish "the scope of any covenant not to compete," CCAB at 6-7; IDF 61, also is unsupported by the record. No witness confirmed Complaint Counsel's hypothesis that the agreement was intended to set forth the full extent of any agreement not to compete, and no contemporaneous document supports Complaint Counsel's view that the "holdback" provision in the contract constitutes a "covenant not to compete" or that the exception to that provision under which the parties remained free to "exploit" 3T1 and 3T2 reflected a view that no restrictions whatsoever on the marketing of the prior albums would be required during the launch period. RPF 46-47. The exception to the holdback provision was not the subject of any separate negotiation, as Complaint Counsel suggest. *Id.* Rather, it was drafted and revised as the parties exchanged their proposed revisions to the entire agreement. CX 357-59, 361-62. Neither the "holdback" provision nor the exception had anything to do with the way in which the pre-existing albums would be marketed during the period surrounding the release of the new album; those provisions merely clarified that, while the parties could not "re-package" or "re-release" those albums or

[1] The fact that the "market functioned well," CCAB at 5, without a moratorium in 1994 and thereafter is irrelevant. Prior to 1998, the parties were not partners in any joint venture and had no legitimate interest in coordinating their marketing activities. Conversely, in 1998, PolyGram and Warner were contractually obligated to coordinate their marketing activities relating to 3T3, and were participants in an efficiency-enhancing collaboration. RPF 41. It is the existence of the joint venture that provided PolyGram and Warner with a legitimate and procompetitive reason – and, indeed, a contractual and fiduciary obligation – to cooperate with respect to the marketing of Three Tenors products. This was precisely the point w Rt4pand taa

venture and to ensure that 3T3 was marketed in a manner that served the long-term best interests of the Three Tenors brand. RPF 51-104. Absent the moratorium, aggressive discounting and promotion of the prior albums in certain territories could have had the anticompetitive effect of reducing the long-term output of Three Tenors product. *Id.* The contemporaneous documents and witness testimony make it perfectly clear that the moratorium was adopted for precisely these reasons. For instance, an April 29, 1998 PolyGram memorandum explained that the moratorium reflected the parties' decision "that the 'original' album should not interfere with the launch of the new album . . . . This will help ensure that when purchasers walk into retail on the day of release they face a simple, uncluttered selling proposition . . . . [T]his new policy strikes a balance between maximizing an opportunity on the 'original album' and yet protecting our considerable investment in the new album." RPF 76. Mr. Cloeckaert, PolyGram's Vice President for Continental Europe, testified that the marketing strategy reflected in the moratorium paralleled PolyGram's general practices in situations where it owns both the catalog products and the new release. RPF 81.

Despite the uncontradicted evidence regarding the parties' reasons for adopting the moratorium, Complaint Counsel assert that the moratorium was adopted "as a result" of concerns that the repertoire for the new album "would be neither as original nor as commercially appealing" as the prior albums. CCAB at 7. However, it is undisputed that the moratorium was adopted in March 1998 at the first joint marketing meeting after the joint venture agreement was executed, F. 92, and that the repertoire for 3T3 was determined months later. F. 1. There is no evidence that the repertoire for 3T3 was a motivating factor in the decision to adopt the moratorium. Rather, the evidence is that the moratorium was viewed by all parties as an important part of the joint venture from the outset because of the importance of ensuring a successful launch of the new album and the legitimate interest in preventing their respective operating companies from free riding on the Paris concert and the release of the new album. RPF 51-56.

4. The Moratorium Was Limited To "Special" Discounting And Advertising Campaigns.

Complaint Counsel consistently fail to acknowledge the limited nature of the moratorium, characterizing it as a naked "price fixing" agreement, "broad advertising restriction,"

anticompetitive," and that the required effect on interstate commerce existed because "respondents' general business activities affect interstate commerce, and also [because]

position their three products in the crowded marketplace for thousands of recorded music products could conceivably support any inference of market power. Moreover, any inference of any anticompetitive effect in the United States from the fact that PolyGram and Warner operating companies *outside* the United States considered discounting the prior albums, CCAB at 26 n. 26, is squarely foreclosed by Dr. Stockum's admission that the relevant market conditions may be different outside the United States. RPF 120, 122; RRCPF 275-76, 288-91.[3] Likewise, although Complaint Counsel now assert that PolyGram's provision of co-op advertising funds to U.S. retailers for 3T1 in 1994 suggests that the moratorium likely prevented PolyGram from advertising 3T1 in the United States, CCAB at 26 n. 26, Complaint Counsel cannot point to any document or witness testimony that would support any such inference. Nor does the mere existence of the moratorium, CCAB at 26 n. 26, support any inference of some actual anticompetitive effect in the United States. The moratorium was a single worldwide agreement that was adopted in the context of a worldwide joint venture, not a stand-alone agreement applicable only to the United States. There is no evidence that the parties gave any consideration to the issue whether the rationale for the moratorium applied equally in every relevant territory; rather, the moratorium plainly was motivated by specific concerns regarding the European operating companies' plans to discount the prior albums in Europe. RPF 51-56.

It is telling that Complaint Counsel chose to assert the existence of actual effects in a footnote in their appeal brief rather than to present any such evidence at trial. Instead of asking their expert to render any opinion on the actual effect of the moratorium, Complaint Counsel were very careful to ask Dr. Stockum to opine only about the "*possirat31lj 39 0 TD -0. 12 Tf 0 0223 (*

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agreement between competitors not to advertise," *Id.* at 591:11-13 (emphasis added), without any reference to the existence of the joint venture. Complaint Counsel never asked Dr. Stockum to offer any opinion about the actual "likely" or even "potential" effects of this moratorium in the context of this Three Tenors joint venture. Rather, Complaint Counsel asked Dr. Stockum to opine whether the moratorium was "*necessary* to the formation of the joint venture," *Id.* at 617:21-621:17, or "*necessary* to the efficient operation of the joint venture," *Id.* at 621:18-638:24 (emphasis added). On cross-examination, Dr. Stockum admitted that the very academic literature on which he relied indicated that there are circumstances in which an agreement like the moratorium "would have no effect whatsoever." *Id.* at 652:19-655:6, 834:9-835:1. Dr. Stockum further conceded that it was "plausible" that the moratorium was procompetitive, Tr. at 643:7-644:9.

B. The Moratorium Is Not Illegal *Per Se*.

Complaint Counsel have practically abandoned any argument that the Initial Decision erred in concluding that the moratorium was illegal *per se*. And rightly so. As Judge Posner has explained, if the restraint at issue involves "a joint venture, then the Rule of Reason supplies the framework for antitrust analysis . . . . *NCAA* leaves no room for debate." *Chicago Prof'l Sports Ltd. P'ship v. National Basketball Ass'n*, 961 F.2d 667, 673 (7th Cir. 1992). Consistent with the lack of any "room for debate" on this subject, Complaint Counsel's discussion of the potential application of the *per se* rule is confined to a two and one-half page section of their brief that begins on page 52. If Complaint Counsel seriously believed the moratorium was illegal *per se*, they surely would have featured that argument more prominently; after all, a conclusion that the moratorium was illegal *per se* would logically precede any discussion of the rule of reason.

Complaint Counsel's apparent lack of confidence in the application of the *per se* rule is matched by their argument's lack of merit. In half-heartedly urging the application of the *per se* rule, Complaint Counsel rely principally on *Palmer v. BRG of Georgia, Inc.*, 498 U.S. 46

(1990), a *per curiam* opinion that spans seven full paragraphs. The notion that *BRG* "controls this case," CCAB at 53, is ridiculous. There was no joint venture or other procompetitive collaboration to create any new product or service involved in *BRG*; instead, there was simply a division of markets between two competitors accomplished through a license agreement. Although Complaint Counsel refer to the parties having "combined their assets in Georgia" and to "the formation of the venture," those are merely fictions created by counsel: neither the Eleventh Circuit's nor the Supreme Court's decision in *BRG* supports the notion that there was any "combination of assets" or "formation of a venture" involved in the case. Moreover, Complaint Counsel wrongly suggest that the agreement not to compete *outside* Georgia was judged *per se* illegal "because it restricted competition outside the scope of the venture [which, according to Complaint Counsel, was limited to Georgia]." CCPTB at 47. In fact, the Supreme Court held the *entire* agreement, including the restraint on competition *in Georgia* (i.e., "inside" Complaint Counsel's supposed joint venture), *per se* illegal because it was a naked allocation of markets (there in fact being no joint venture or other combination of assets). 498 U.S. at 49-50. In short, *BRG* is irrelevant to this case.[4] Similarly, in *New York ex rel. Spitzer v. Saint Francis Hosp.*, 94 F. Supp. 2d 399, 415 (S.D.N.Y. 2000), the court held that a series of agreements whereby hospitals jointly negotiated rates, divided markets, and allocated patients were illegal *per se*, not because they affected products or services that were beyond the scope of any legitimate collaboration but because *there was no lawful collaboration* between the defendant hospitals. *Id.*

[4] Complaint Counsel attempt to analogize HBJ's Georgia license to BRG and the accompanying agreement by BRG not to compete with HBJ outside Georgia to Warner's license to PolyGram to distribute 3T3 outside the United States and PolyGram's agreement not to discount or advertise 3T1 in the United States for a 10-week period. CCAB at 53-54. What Complaint Counsel ignore, of course, are the distinguishing facts, among others, that the moratorium arose in connection with marketing of a new, jointly-owned product that could not have been produced without the joint venture, that PolyGram was paying 50% of the costs of marketing 3T3 in the United States and Warner paying 50% of the cost outside the U.S., that PolyGram and Warner were sharing the risks and rewards of the joint venture, that the moratorium applied throughout the world, that 3T1 and 3T2 were not "outside" the joint venture because PolyGram and Warner planned to include recordings from those products in the greatest hits and/or box set albums, and that the moratorium was limited to a 10-week period surrounding the launch of the joint venture product. None of these crucial circumstances existed in *BRG*.

Complaint Counsel also point to *In re General Motors Corp. and Toyota Motors Corp.*, 103 F.T.C. 374 (1984, *vacated* 5 Trade Reg. Rep. (CCH) ¶ 23,491 1993 WL 767061 (F.T.C.) (Oct. 29, 1993), another case that provides no support for the position that a joint venture restraint will be subject to *per se* condemnation whenever it affects products that are

Circuit decision in *Brunswick* contains no suggestion that the restraints at issue there were illegal *per se*.

Finally, Complaint Counsel's contention that there is no support for the "reasonably related to" standard for ancillary restraints set forth in PolyGram's opening brief is ludicrous. In *NCAA*, the Court held that "it would be inappropriate to apply a *per se* rule in this case," because the case "*involve[d] an industry* in which horizontal restraints on competition are essential if the product is to be available at all." *NCAA v. Board of Regents*, 468 U.S. 85, 100-01 (1984) (emphasis added). Similarly, in *Broadcast Music, Inc. v. CBS*, 441 U.S. 1 (1979), the Court held that the blanket license was subject to the rule of reason because it "*accompanied* the integration" and was "*potentially beneficial* to both sellers and buyers." *Id.* at 20-21 (emphasis added). And, in *General Leaseways, Inc. v. National Truck Leasing Ass'n*, 744 F.2d 588, 595 (7th Cir. 1984), Judge Posner explained that a "plausible connection" between the challenged practice and "the essential character of the [joint venture] product" will result in rule of reason analysis under the ancillary restraints doctrine.

Moreover, the courts in *Rothery Storage & Van Co. v. Atlas Van Lines, Inc.*, 792 F.2d 210 (D.C. Cir. 1986) and *Polk Bros., Inc. v. Forest City Enters., Inc.* 776 F.2d 185(7th Cir. 1985) squarely endorsed the proposition that a restraint is ancillary to a joint venture, and thus subject to the rule of reason, if it is "*related to* the efficiency sought to be achieved." *Rothery Storage,* 792 F.2d at 224 (emphasis added); *Polk Bros*, 776 F.2d at 188-9 (holding that "ancillary restraints" are "those that are part of a larger endeavor whose success they promote"). Complaint Counsel do not cite or discuss *Rothery Storage* or *Polk Bros.* anywhere in their appeal brief, despite the fact that those cases were discussed extensively in PolyGram's opening brief. Complaint Counsel's failure to address these cases is inexplicable in light of the fact that they plainly are among the leading authorities on the standards for analyzing joint ventures under the antitrust laws and were authored by Judge Bork and Judge Easterbrook, two of the leading judicial authorities on antitrust issues.

PolyGram submits that there is no basis for distinguishing this case from *Polk Bros.* and *Rothery Storage* other than disagreement with Judge Bork and Judge Easterbrook regarding the proper analytical framework for analyzing restraints adopted by joint venture partners. Complaint Counsel offer no other basis for distinguishing the cases, and it is beyond dispute that the Initial Decision's only grounds for distinguishing those cases from this case was based on a misreading of those decisions. Thus, while the Initial Decision reads *Polk Bros.* to require that a restraint be an "integral part" of a joint venture before it may be considered ancillary and subject to the rule of reason, ID at 52, the fact is that the words "integral part" appear in that decision only in explaining

ascrib[ing] to it a meaning – 'absolutely necessary,' *i.e.*, there being no less restrictive alternative – not fairly attributable to those courts"). In the same brief, the Commission proceeded to emphasize "that plaintiffs and courts can [not] merely second-guess those participating in an otherwise legitimate enterprise, and invalidate any restraint that is not the 'least restrictive' imaginable or practicable." *Id.* at 6.[6]

Here, it is undisputed that the moratorium was adopted in the context of the joint venture and the evidence makes clear that it is at least plausibly connected to the procompetitive purposes of the joint venture. Accordingly, the moratorium is subject to the rule of reason, not any *per se* rule.

C. The Moratorium Cannot Be Found Unlawful Under The Rule Of Reason Because Complaint Counsel Failed To Provide Any Evidence Of Anticompetitive Effect.

As noted above, Complaint Counsel chose not to develop any evidence of anticompetitive effect – and, indeed, expressly "disclaimed" any obligation to do so under the highly abbreviated version of the rule of reason they advocate here. Trial Tr. at 626:20-23. Because there is no evidence of any anticompetitive effect, Complaint Counsel can prevail under the rule of reason only if the moratorium is subject to some "presumption" of anticompetitive effect. However, the governing case law makes clear that no such presumption is available under the rule of reason and, in any event, any such presumption could not be triggered by the purely theoretical projections of "likely" competitive effects offered by Complaint Counsel's expert, Dr. Stockum. Moreover, PolyGram's procompetitive justifications for the moratorium are sufficient to trigger a need for a more detailed analysis of actual effects under the rule of reason regardless of whether any presumption applies. Under any version of the rule of reason –

[6] Complaint Counsel make no effort to defend the extremely narrow version of the ancillary restraints doctrine adopted by the Initial Decision, under which restraints would be condemned as illegal *per se* unless they "inevitably arose" from a joint venture or were absolutely "necessary" to make a joint venture work. ID at 51-52. That standard plainly is inconsistent with the cases discussed above and the Commission's position in *NCAA*.

The Court explained that the blanket license was subject to the rule of reason, rather than the *per se* rule, and remanded the case to the Court of Appeals. *Id.* at 19-25. On remand, the Court of Appeals affirmed the trial court's finding that "CBS has failed to prove that the existence of the blanket license has restrained competition." *Columbia Broadcasting System, Inc v. American Soc. of Composers Authors & Publishers, et al.*, 620 F.2d 930, 939 (2d Cir. 1980). Thus, *BMI* confirms PolyGram's position that, under *any*

Here, by contrast, Complaint Counsel's expert economist admitted both that he was unaware of any actual deleterious effect the moratorium may have had on price or output in the United States and that the moratorium had a significant potential for procompetitive effects. RPF 51-104.

that the specific settlements at issue “directly limited price and output competition,” “delayed expected generic entry,” and “enabl[ed] Schering to maintain high prices without losing sales.” Appeal Brief of Counsel Supporting the Complaint at 40, *Schering-Plough*, FTC Docket No. 9297 (filed Aug. 9, 2002). Based on the supposed *record evidence of actual anticompetitive effects* in that case – and not the abstract observations of an economist who did not even study the circumstances in which those settlements were agreed to – complaint counsel thus contend that the settlements are “presumptively anticompetitive.” *Id.*

The evidence presented by Complaint Counsel here in support of their proposed

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issue of whether a presumption of anticompetitive effects should apply on the facts of this rule of reason case. *See, e.g., United States v. Socony-Vacuum Oil Co.*, 310 U.S. 150 (1940) (naked price fixing); *FTC v. Ticor Title Ins. Co.*, 504 U.S. 621, 639 (1992) (same); *FTC v. Superior Court Trial Lawyers Ass'n*, 493 U.S. 411, 416-18 (1990) (same); *United States v. Reicher*, 983 F.2d 168 (10th Cir. 1992) (naked bid rigging); *Denny's Marina, Inc. v. Renfro Productions, Inc.*, 8 F.3d 1217 (7th Cir. 1993) (naked agreement not to compete).[9] Dr. Stockum likewise rendered no opinion regarding the actual (or even likely) effects of the moratorium on pricing in the United States but instead offered only the observation that naked agreements to fix prices are, in the abstract, anticompetitive. Trial Tr. at 583:16-17; JX 104-B (Stockum Expert Report). The relevant question, however, is whether the alleged restraint at issue here would have had any effect on competition in the United States music industry, and Complaint Counsel can point to no empirical evidence that could support an inference that PolyGram or Warner likely would have discounted the prior albums in the United States absent the moratorium. RPF 80, 97-100, 120, 122; RRCPF 271-72, 288-91.[10]

Complaint Counsel likewise lack any empirical support for their contention that the restriction on advertising included in the moratorium had any likely anticompetitive effect in the United States. Academic analyses of, *inter alia*, the competitive effects of market-wide

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[9] Most of the cases Complaint Counsel cite on this point do not involve joint ventures, let alone joint ventures in the music industry. Two cases that do involve joint ventures – *United States v. Columbia Pictures Indus., Inc.*, 507 F. Supp. 412 (S.D.N.Y. 1980) and *United States v. National Football League*, 116 F. Supp. 319 (E.D. Pa. 1953) – actually show that there *is* a need for evidence regarding the effects of the particular restraint at issue in the particular market. In *Columbia Pictures*, the court enjoined the creation of the Premiere joint venture, whereby three major movie studios sought to create a pay-television network that would have exclusive access to *each* of their films for a nine month period. This provision of the joint venture was considered illegal *per se* because the court concluded that it did not serve any lawful objective, 116 F. Supp. at 425-35; the case says nothing about whether it is presumptively anticompetitive for joint ventures to agree not to compete against their joint venture product in limited ways and for a specified period. Moreo3cA-0.1544c case says nothing325 0 TD -0.18hCoun6ogeer se

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3. The Procompetitive Justifications For The Moratorium Are Sufficient

("The moratorium must be necessary."), *id.* at 60-61 (concluding moratorium was not

justifications for the moratorium is not the correct legal standard. Unfortunately, however, after stating that the relevant standard is "reasonable necessity," CCAB at 32-33, Complaint Counsel proceed to argue that PolyGram's procompetitive justifications are insufficient to require some analysis of actual effects based on what is clearly a strict necessity standard. Thus, Complaint Counsel contend that PolyGram "must show that the moratorium was *necessary* in order to promote competition and benefit consumers," *id.* at 28, that the moratorium was not "necessary to assure the production of the Paris concert, the creation of 3T3, or the distribution of 3T3," *id.* at 38, that the moratorium was not "necessary to preserve incentives to advertise and promote 3T3 in the United States," *id.* at 40, that the moratorium was not a "necessary" part of the marketing plans for 3T3, *id.* at 46, and that "the moratorium was not necessary to protect confidential information," *id.* at 51. However, these observations are all irrelevant under the "reasonable necessity" standard discussed by Complaint Counsel at pages 32-33 of their brief, under which PolyGram would be required to show only that the moratorium was "reasonably necessary" to a legitimate objective of the joint venture. *See Brown University*, 5 F.3d at 678-79 (restraint must be "reasonably necessary to achieve the objectives proferred 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.")

Moreover, even Complaint Counsel's "reasonable necessity" standard imposes too strong a burden because there is no basis for considering the necessity of a challenged practice at this stage in the rule of reason analysis. It is the plausibility of a procompetitive justification, not its necessity, that is the touchstone for requiring a more detailed analysis of actual effects under the rule of reason. In *CDA*, the Supreme Court recognized that it is enough at this stage of the rule of reason analysis for the defendant to identify a "plausible" procompetitive justification and that, once such a justification is identified, the net effect of the restraint must be anticompetitive for there to be any violation. 526 U.S. at 771 (holding that actual, net competitive effects must be considered where restraint "might plausibly be thought to have a net competitive effect, or possibly no effect at all").

Guidelines at 24 ("free riding or other opportunistic conduct that could reduce significantly the ability of the collaboration to achieve cognizable efficiencies"); *Polk Bros.*, 776 F.2d at 189-90 ("[C]ontrol of free riding is a legitimate objective" because it "makes it easier for people to cooperate productively in the first place"); *Rothery Storage*, 792 F.2d at 212-13 ("The free ride can become a serious problem for a partnership or joint venture because the party that provides capital or services without receiving compensation has a strong incentive to provide less, thus rendering common enterprise less effective."); *Chicago Prof'l Sports*, 961 F.2d at 673 (free riding is "an accepted justification for cooperation"); RPF 84 (Stockum Dep. 56:13-15) ("free riding can at least potentially create inefficiency in the market").

Absent the moratorium there was a substantial risk that the PolyGram and Warner op-cos' free riding activities would have "driv[en] [valued] services from the market." *In re Toys 'R Us, Inc.*, 126 F.T.C. 415, 600-17 (1998), *aff'd*, 221 F.3d 928 (7th Cir. 2000). The relevant witnesses testified that a successful launch of 3T3 was critical to the long-term success of *all* Three Tenors products, and that the aggressive simultaneous promotion of the prior albums would have jeopardized the prospects for a successful launch of the new album. RPF 53-57. In the long run, promotion of the prior albums during the critical release period for the new album likely would have resulted in less promotional spending and reduced the parties' incentives to create and distribute the greatest hits and/or box set albums. *Id.* Conversely, as PolyGram executive Rand Hoffman testified, a successful launch would increase the value of the catalogue products and lead to increased long-term sales of all Three Tenors products. RPF 53 (Trial Tr. (Hoffman) at 359:12-360:17 ("[T]he catalog is more valuable if the new record is a success, and to make a new record a success, the key is the launch period.) Mr. O'Brien likewise testified that, in the event of an unsuccessful launch, Warner would have spent less money promoting Three Tenors products in the future. RPF 101.

Complaint Counsel provide no support for their assertion that the parties could have compensated one another for any free riding activities in some way that would have adequately addressed their free riding concern. This case is fundamentally distinguishable from

the cases relied upon by Complaint Counsel because the moratorium was *not* designed to internalize whatever benefit the PolyGram and Warner op-co's may have obtained from a short-term spike in the sales of the two older albums associated with any promotion of those albums during the launch period. Rather, the moratorium was motivated by a concern that any such promotional activities during the critical launch period would have harmed the Three Tenors brand and reduced the long-term output of Three Tenors products. Both parties believed that this risk of harm to 3T3 and the Three Tenors brand was asymmetrical to, and greater than, any benefits that could have been obtained from promoting the prior albums. RPF 86-101. Thus, the only "compensation scheme" that would have effectively dealt with that problem would have been one that priced the op-co's ability to use the promotional opportunity created by the Paris concert and the new album to specially promote the two prior albums at a level that was high enough to eliminate *any* incentive to do so – which is effectively what the moratorium itself did. Any other compensation scheme would, as Dr. Stockum admitted (RFP 86, 141), simply have given either PolyGram or Warner more incentive to "free ride" (and the other less), without addressing the harm to the joint venture at all. In other words, a complicated compensation scheme designed to place a value on the op-co's option to use the Paris concert and the release of the new albums instead of the new album would not have made any sense in the context of this joint venture.

Because of the common interest that PolyGram and Warner had in preventing their op-cos from free riding on the promotional opportunity they jointly created through the Paris concert and the release of the new album, this case is fundamentally distinguishable from *Toys 'R Us.* In that case, the toy manufacturers who were paying for the services that were the subject of TRU's free riding justification did not believe that "extra services" were needed for the distribution of their products. 221 F.3d at 937. Instead, it was only TRU –

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extraordinary promotional opportunity surrounding its release, and sought to prevent their affiliated distributors (*i.e.,* the op-cos) from free riding on that opportunity. As the Seventh Circuit noted in *TRU*, PolyGram's and Warner's interests were perfectly aligned with those of consumers when the spent more than $18 million to create the promotional opportunity that was the subject of their free riding concern. *Id.* ("[W]ith respect to the cost of distribution services, the interests of the manufacturer and the *consumer* are aligned.").[12]

While Complaint Counsel purport not to understand the concern that free riding by the op-cos would cause a net "negative spillover" to the Three Tenors brand, CCAB at 39, and claim that it is "unrelated to free riding as that term is used in antitrust economics," *id.*, the fact remains that tegative spillover" 9wn ex wi, thatfreeposi4 to the T-(While Co1ins that is lover" to the T) Tj 2

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such routine free-riding concerns could justify a restraint like the moratorium. Rather, the free riding concern here was limited to the factual circumstances surrounding this joint venture and would not justify the adoption of a similar restraint outside the context of a similar joint venture. As Dr. Stockum admitted, and as Professors Ordover and Wind confirmed, the moratorium was at least plausibly procompetitive in addressing that concern.

(2) The Moratorium Was A Reasonable And Procompetitive Effort To Increase The Aggregate Long-Term Output Of Three Tenors Products In The Context Of The Joint Venture.

Complaint Counsel have never offered any coherent theory for their position that, in the context of their joint venture, PolyGram and Warner should have been precluded from adopting a marketing strategy for 3T3 under which they agreed that they would not simultaneously promote the prior albums. No witness testified that it would have made any sense to simultaneously promote the old albums during the launch of the new album. To the contrary, the witnesses consistently testified that simultaneous promotions would have presented a substantial risk to the launch of the new album and the long-term success of all Three Tenors products. *See* RPF 55 (Cloeckaert Dep. at 68-70; *see also* O'Brien Tr. at 99; Saintilan Dep. at 78-84; Stainer Dep. at 57-58). And PolyGram's marketing expert, Professor Wind, opined that this was a sound strategy for maximizing the long-term success of the Three Tenors brand. RPF 112 (Wind Report at 16-17). Indeed, it is difficult to imagine why PolyGram and Warner would bother entering into an agreement to restrict the promotion and discounting of two older classical cd's if they did not view the agreement as an important part of the marketing plans for their joint venture product. Rather, the record evidence makes clear that the moratorium was part of an effort by PolyGram and Warner to ensure that their Three Tenors products could compete

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price was too low, the parties to the joint venture could simply adjust the price. *Id.* at 591-93. Here, there was no comparably similar way to calculate the appropriate "cost" of free riding during the brief ten-week period surrounding the release of 3T3.

effectively in the highly competitive music industry, in which thousands of recordings are constantly vying for consumers' attention.

The relevant evidence shows that the moratorium was a legitimate effort to increase the aggregate long-term output of Three Tenors product an

concluded that the moratorium likely was procompetitive in increasing the aggregate long-term output of Three Tenors products. RPF 112, 114.[14] Together with the concessions of Complaint Counsel's experts, the testimony of the witnesses involved in the joint venture, and the absence of any evidence that the moratorium had (or was likely to have) any anticompetitive effect in any relevant market, the opinions of Professors Ordover and Wind plainly are sufficient to support a decision in PolyGram's favor.

c. Complaint Counsel Failed To Establish The Existence Of Any Less Restrictive Alternative To The Moratorium.

It was Complaint Counsel's burden to establish the existence of any "less restrictive alternative" to the moratorium. *County of Tuolumne v. Sonora Cmty. Hosp.*, 236 F.3d 1148, 1159-60 (9th Cir. 2001). To meet that burden, Complaint Counsel were required to show that any proposed alternative would have been "substantially less restrictive *and* [ ] virtually as effective in serving the legitimate objective *without significantly increased cost.*" *Id.* (quoting 10 Phillip E. Areeda, Tw (ig2)5 0 TD /F4 12 Tf -.08285 Tc -0.08685 Tc (eA74 9 -24 TD /F0 25 0 TD /F4 12 T

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have been less restrictive of competition under the well-established framework for analyzing a challenged practice under the rule of reason.

The alternatives discussed by Complaint Counsel, CCAB at 43-44, fail to satisfy the controlling legal standards in any event. First, there is no evidence that a Europe-only moratorium – a suggestion first raised in Complaint Counsel's post-trial briefing, that was not discussed by any witness, and that reflects an apparent concession that the moratorium may have been procompetitive in Europe – would have been less restrictive or as effective as the moratorium. PolyGram and Warner adopted the moratorium as part of their single, worldwide marketing plan for their worldwide joint venture for the creation and distribution of Three Tenors products. The costs of developing that plan obviously would have been significantly increased if PolyGram and Warner had been forced to evaluate the benefits of controlling free riding in every territory throughout the world, as Complaint Counsel apparently believe they should have done. The record evidence showed that there were significant efficiencies in developing a uniform marketing plan in the context of this worldwide joint venture, and that the adoption of different rules for different territories could have led to substantial inefficiencies. RPF 130. Moreover, as the moratorium itself was not shown to have had *any* anticom

concerns that gave rise to the moratorium. As the relevant witnesses (including Complaint Counsel's own marketing expert, Professor Moore) consistently testified, record companies generally consider the presence of catalog products in developing their marketing plans for any new release, and often decide not to promote the catalog products alongside the new release. RPF 51-53. Thus, a decision that the moratorium was unlawful would deprive PolyGram of one of the "ordinary tools of marketing and product design" solely because its product happened to be created in the context of a joint venture.

D. There Is No Evidentiary Support The Cease And Desist Order Issued By The ALJ.

Complaint Counsel do not dispute that a cease and desist order may be entered only if there is a "real threat" that similar conduct will recur. *United States v. Oregon State Med. Soc'y*, 343 U.S. 326, 333 (1952); *TRW, Inc. v. FTC*, 647 F.2d 942, 954-55 (9th Cir. 1981). If that standard is satisfied here, it is difficult to imagine any situation in which it would not be satisfied. It is undisputed that PolyGram has not adopted any similar agreement, viewed the reasons for adopting this agreement as being closely related to the unique features of the Three

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challenge or contest the validity of the order." Rule of Practice 2.32. PolyGram did not waive those rights, and Complaint Counsel thus were required to establish in this case that there was a "real threat" that conduct similar to the moratorium would recur absent the entry of the order included in the Initial Decision. Complaint Counsel failed to show that *any* cease and desist order – let alone the 20-year order included in the Initial Decision, which would require that all of Respondents' current and future officers, directors and employees sign and acknowledgment that they have read the order regardless of whether they had any involvement in the conduct at issue in this case, and which would reverse the substantive and procedural burdens of the antitrust laws -- is justified. The Initial Decision can be reversed on that basis alone.

III. CONCLUSION

For all of the foregoing reasons, the Initial Decision should be reversed in its entirety and the Commission should adopt the findings and order proposed by Respondents.

Respectfully submitted,

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TABLE OF CONTENTS

Page

I. INTRODUCTION 1

II. ARGUMENT.. 3

A. Complaint Counsel Mischaracterize Both The Three Tenors Joint Venture And The Limited Moratorium On The Discounting And Promotion Of The Older Three Tenors Products. 3

1. The Three Tenors Joint Venture Was Not Limited To The "Distribution" Of The New Album. 3

2. The Joint Venture Agreement Did Not Establish The Scope Of Any "Covenant Not To Compete" And Did Not Identify And Define All Of The Important Aspects Of The Joint Venture..................... 4

3. The Moratorium Was Designed To Prevent Free Riding And Maximize The Long-Term Output Of Three Tenors Products And Was Unrelated To Any Subsequent Concern Regarding The Repertoire For 3T3. 5

4. The Moratorium Was Limited To "Special" Discounting And Advertising Campaigns. 7

5. Complaint Counsel Disclaimed Any Effort To Prove – And, In Fact, Presented No Evidence – That The Moratorium Had Any Effect On Competition In The United States. 7

B. The Moratorium Is Not Illegal Per Se. 10

C. The Moratorium Cannot Be Found Unlawful Under The Rule Of Reason Because Complaint Counsel Failed To Provide Any Evidence Of Anticompetitive Effect. 16

1. The Absence Of Any Evidence Of Anticompetitive Effect Mandates A Decision In PolyGram's Favor Because There Are No Presumptions Of Anticompetitive Effects Under The Rule Of Reason. 17

2. Any Presumption Of Anticompetitive Effect Would Not Apply On This Record. 23

3. The Procompetitive Justifications For The Moratorium Are Sufficient To Require A Decision In PolyGram's Favor......................... 28

a. The Presence Of Any Plausible Procompetitive Justification Triggers A Need For More Detailed Analysis Under The Rule Of Reason. 28

TABLE OF CONTENTS
(continued)

Page

b. PolyGram's Procompetitive Justifications For The Moratorium Require Further Analysis Of Actual Effects Under The Rule Of Reason. 32

(1) The Moratorium Was A Reasonable And Plausibly Procompetitive Effort To Address A Specific Risk Of Free Riding. 32

(2) The Moratorium Was A Reasonable And Procompetitive Effort To Increase The Aggregate Long-Term Output Of Three Tenors Products In The Context Of The Joint Venture. 35

c. Complaint Counsel Failed To Establish The Existence Of Any Less Restrictive Alternative To The Moratorium. 38

D. There Is No Evidentiary Support The Cease And Desist Order Issued By The ALJ. 39

III. CONCLUSION 41

861152.1

FEDERAL CASES

Association of Independent Television Stations, Inc. v. College Football Assn.,
637 F. Supp. 1289 (W.D. Okla. 1986) 37

Blue Cross & Blue Shield of Wisc. v. Marshfield Clinic,
65 F.3d 1406 (7th Cir. 1995)... 13

Broadcast Music, Inc. v. CBS,
441 U.S. 1 (1979) 14, 19, 20, 36

Cal. Dental Ass'n v. FTC,
526 U.S. 756 (1999) 2, 17, 18, 23, 24, 31, 32

Cal. Dental Assn. v. FTC,
224 F.3d 942 (9th Cir. 2000 18

Chicago Prof'l Sports Ltd. P'ship v. National Basketball Ass'n,
961 F.2d 667 (7th Cir. 1992) 2, 10, 21, 22, 32

Columbia Broadcasting System, Inc v. American Soc. Of Composers Authors & Publishers,
620 F.2d 930 (2d Cir. 1980)... 20

Continental T.V., Inc. v. GTE Sylvania Inc.,
433 U.S. 36 (1977) 37

County of Tuolumne v. Sonora Community Hosp.,
236 F.3d 1148 (9th Cir. 2001) 38

Denny's Marina, Inc. v. Renfro Productions, Inc.,
8 F.3d 1217 (7th Cir. 1993).. 26

Detroit Auto. Dealers Ass'n,
111 F.T.C. 417 (1987)... 23

FTC v. Superior Court Trial Lawyers Assn.,
493 U.S. 411... 26

FTC v. Ticor Title Ins. Co.,
504 U.S. 621 (1992) 26

General Leaseways, Inc. v. National Truck Leasing Assn.,
744 F.2d 588 (7th Cir. 1984)... 14, 35

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