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
IN SUPPORT OF THE INITIAL DECISION

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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	Complaint Counsel's Exhibit (CX201 - CX623)
ID	Page of Initial Decision
IDF¶	Initial Decision Findings of Fact
RPF¶	Respondents' Proposed Findings of Fact
JX	Joint Exhibit (JX1 - JX109)
PHC Tr.	Pre-hearing Conference Transcript, dated March 4, 2002
PolyGram or Respondents	PolyGram Holding, Inc., Decca Music Group Limited, UMG Recordings, Inc., and Universal Music & Video Distribution Corp.
RX	Respondents' Exhibit (RX701 - RX731)
Trial Tr.	Trial Transcript pages on which no witness testimony appears
Warner	Warner Music Group
3T1	The first Three Tenors album, *The Three Tenors*, released in 1990 by PolyGram.
3T2	The second Three Tenors album, *Three Tenors in Concert 1994*, released in 1994 by Warner.
3T3	The third Three Tenors album, *The Three Tenors – Paris 1998,* released in 1998 as a collaboration between PolyGram and Warner.

The testimony of the witnesses may be found as follows:

Professor Catherine Moore	Volume 1 (March 5, 2002)	7:25 - 272:14
Rand Hoffman (Public)	Volume 2 (March 6, 2002)	278:16 - 373:5
Rand Hoffman (In Camera)	*Volume 2 (March 6, 2002)*	*373:6 - 381:19*
Anthony O'Brien	Volume 3 (March 7, 2002)	389:9 - 558:3

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 not created by the PolyGram/Warner joint venture; thus, the challenged restraints are not reasonably related to (are outside of) the venture. The moratorium was not necessary for the formation of the venture, as PolyGram has itself stipulated. IDF¶262. And, as discussed fully below, the record evidence does not remotely support Respondents' free-riding argument, or their other hypotheses purporting to link the moratorium to the efficient operation of the

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). The Courts of Appeals have, on the basis of abbreviated analysis, condemned joint venture restraints in *Law v. NCAA*, 134 F.3d 1010 (10th Cir. 1998), *Blue Cross & Blue Shield United v. Marshfield Clinic*, 65 F.3d 1406, 1415-1416 (7th Cir. 1995), *Chicago Prof'l Sports Ltd. Partnership v. NBA*, 961 F.2d 667 (7th Cir. 1992), and *General Leaseways, Inc. v. National Truck Leasing Ass'n*, 744 F.2d 588, 592 (7th Cir. 1984). The courts had no significant prior experience with any of these collaborations. The unique features of each venture were considered only as part of the court's assessment of the competitive justification for the restraint. Full rule of reason analysis was not required.

Respondents' final argument is that a defendant may overcome the presumption of anticompetitive effects by advancing a "plausible" theory that the restraint promotes efficiency, even if the hypothesis is unsupported by record evidence. This contention is contrary to the case law as well as common sense. A clever lawyer will always be able to conjure up a plausible efficiency story. *See Marshfield Clinic*, 65 F.3d at 1415-16 (Judge Posner inventing a free-riding story for a market division agreement between HMOs). If plausibility alone were a sufficient defense, then abbreviated analysis would cease to be meaningful; every case would require a full rule of reason inquiry. This is not the law. Here, as in *BMI* and as in *United States v. Brown University*, 5 F.3d 658 (3d Cir. 1993), to warrant a full rule of reason analysis of a price restraint, defendants must first demonstrate – and not merely assert – that the challenged agreement was necessary to achieve a significant efficiency.

Respondents repeatedly assert that promotion of 3T1 and 3T2 would have undermined the

PolyGram/Warner venture (*i.e.,* that price fixing and an advertising ban served to increase sales of Three Tenors products). This rhetoric far outruns the evidence. Judge Timony correctly concluded that the testimony and documents do not support Respondents' efficiency claims. And argument alone – even if plausible – is insufficient to rebut the presumption of anticompetitive effects. Free-riding defenses, on their face no less plausible than that advanced by Respondents here, were summarily rejected in *Marshfield Clinic, Chicago Prof'l Sports,* and *General Leaseways.* A "marketing strategy" argument, on its face no less plausible than that advanced by Respondents, was summarily rejected in *NCAA* and *Chicago Prof'l Sports.* Plausibility alone then is not sufficient to make out a viable efficiency defense; evidence is required.

Because the moratorium restraints are presumptively anticompetitive, and Respondents have failed to demonstrate a plausible and valid efficiency justification, Judge Timony properly found that Respondents have violated Section 5. The order issued by Judge Timony is substantially identical to the consent order approved by the Commission for co-conspirator Warner (*Warner Communications, Inc.*, C-4205 (Sept. 24, 2001)), and should be affirmed.

STATEMENT OF THE CASE

A. Statement of Facts

1. PolyGram and Warner Acquire Distribution Rights to Competing Three Tenors Products

During the 1990s, the Three Tenors released three paired audio and video recordings, each derived from a live concert at the site of the World Cup final game. IDF¶¶4-5. PolyGram acquired the right to distribute recordings of the first Three Tenors concert, held in Rome in 1990. IDF¶28. The

trio's first album became the best selling classical record of all time. IDF¶29. In 1994, the Three Tenors performed a second World Cup concert at Dodger Stadium in Los Angeles. IDF¶30. Concert promoter Tibor Rudas licensed Warner to distribute recordings derived from this concert. IDF¶¶31-32.

PolyGram did not permit Warner's 1994 album to eclipse its own top-selling 1990 Three Tenors recording. Instead, PolyGram discounted 3T1, and promoted the message that this was the "original" Three Tenors recording – "unique and unrepeatable." IDF¶¶211, 214-221. Warner anticipated competition from PolyGram (3T1), and supported the release of 3T2 with a "high-power pop marketing effort." IDF¶¶202-204; CX247 at 3TEN00011271.

Warner and PolyGram did not arrange for a moratorium on competitive activity, and still the market functioned well. IDF¶200. During 1994 and thereafter, consumers benefitted from various price discounts, promotions, and product enhancements attributable to competition between 3T1 and 3T2. IDF¶¶226-232. PolyGram and Warner had little reason to complain about this competition. The 3T2 project was a commercial success for Warner. IDF¶222. And each of the Three Tenors albums was among the best-selling classical recordings in the United States in 1994, 1995, 1996, and 1997. IDF¶234.

2. <u>PolyGram and Warner Agree to Collaborate on the 3T3 Project</u>

During 1996, Tibor Rudas approached PolyGram and Warner separately to discuss the next Three Tenors project, a huge open-air concert in front of the Eiffel Tower scheduled to coincide with the World Cup finals in Paris in July 1998. IDF¶51. Both record companies were interested in acquiring the right to distribute the 3T3 products. IDF¶¶52-54.

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 responded with an offer of its own: Warner and PolyGram should divide financial and operational responsibility, and share profits and losses on the 3T3 project. IDF¶56; JX22 at UMG001342.

This proposal was accepted, and the collaboration took the following form: In return for an $18 million advance and other consideration, Rudas licensed to Warner worldwide audio, video, and home television rights to the 1998 concert ("the 3T3 Rights"). IDF¶58. Warner then sub-licensed to PolyGram the right to exploit the 3T3 Rights in all territories outside the United States. IDF¶¶59-60. Thus, Warner was responsible for distributing the new album and video in the United States, and PolyGram was responsible for distribution elsewhere in the world.

In negotiating the terms of the 1998 Three Tenors project, PolyGram and Warner evaluated and discussed the appropriate scope of any covenant not to compete. IDF¶61. Several iterations of this contract provision were drafted and exchanged. IDF¶61. Early on, the parties agreed in concept that, for four years, neither would release a new Three Tenors album (except as part of the parties' collaboration). Warner insisted upon an express clarification: the non-compete should not apply to the pre-existing Three Tenors albums. IDF¶62. The final collaboration agreement, dated December 19, 1997, provides that PolyGram and Warner shall each be free separately to exploit its older Three Tenors recording. IDF¶63.[1]

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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. <u>The Three Tenors Moratorium Agreement</u>

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 United States and worldwide. IDF¶¶170-181. Between August 1, 1998 and October 15, 1998, neither Warner nor PolyGram discounted or advertised its respective catalogue Three Tenors products in the United States. IDF¶¶171-174.

B. Proceedings Below

The Commission issued its Complaint on July 31, 2001. Initially, Respondents represented that they would prove that PolyGram and Warner did not agree to a moratorium on competition, and/or that such agreement was never implemented. Respondents also claimed that they would demonstrate that the moratorium was necessary for the formation of the joint venture. Answer, Third and Fifth Additional Defenses. Respondents have now abandoned these arguments.

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).

output restrictions governing the telecast of college football games. Although the district court found both market power and actual anticompetitive effects, these factual conclusions were challenged on appeal by the NCAA. The Supreme Court answered that, given the nature of the challenged restraints, both these findings were unnecessary in order to affirm liability under the rule of reason:

> As a matter of law, the absence of proof of market power does not justify a naked restriction on price or output. To the contrary, when there is an agreement not to compete in terms of price or output, "no elaborate industry analysis is required to demonstrate the anticompetitive character of such an agreement." Petitioner does not quarrel with the District Court's finding that price and output are not responsive to demand. Thus the plan is inconsistent with the Sherman Act's command that price and supply be responsive to consumer preference. We have never required proof of market power in such a case.[5] This naked restraint on price and output requires some competitive justification even in the absence of a detailed market analysis.

NCAA, 468 U.S. at 109-110 (citations omitted) (emphasis added). The Court went on to evaluate and reject the NCAA's proffered efficiency justifications, finding that they were plausible but unsupported by the evidence (*i.e.,* invalid). *Id.* at 114-120.

Respondents misread *IFD,* asserting that it stands for the proposition that "proof of actual anticompetitive effect (or of market power as its surrogate) is required in any rule of reason case." App. 32. In *IFD*, competing dentists conspired to withhold x-rays requested by dental insurers for use in evaluating claims for benefits. The agreement was judged illegal without proof of the contours of the relevant market, without proof of market power, and "even absent proof that the Federation's policy

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[5] At this point in the opinion, Justice Stevens cites to three *per se* cases. Contrary to Respondents' interpretation (App. 37-38), the fact that the price and output of college football were not responsive to demand was "apparent" from the terms of the television plan; this was not a finding of actual competitive injury. *NCAA*, 468 U.S. at 106 n.30, 106-08. This explains why the Court cited as prior authority several *per se* cases, cases where there also was no direct evidence of competitive harm.

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 anticompetitive, the burden of proof shifted to respondents to establish a legitimate efficiency justification. *Id.* at 459. *See* ABA Antitrust Section, *Antitrust Law Developments* at 65 (5th ed. 2002) ("proof of actual anticompetitive effect was not essential in *Indiana Federation* because the agreement could . . . be condemned as a naked restraint").

Respondents manage to twist the *CDA* opinion into a sweeping rejection of abbreviated antitrust review. App. 31. In truth, the Supreme Court expressly approved abbreviated analysis for "restraints that give rise to an intuitively obvious inference of anticompetitive effect." 526 U.S. at 770, 781. The *CDA* Court endorsed truncated review for, *inter alia*, agreements between competitors to fix a minimum price (*NCAA*), to limit output (*NCAA*), to restrict competitive bidding (*NSPE*), or to withhold a particular service desired by customers (*IFD*). 526 U.S. at 770. *CDA* further indicates that a full ban on product advertising is properly presumed to be anticompetitive (*CDA*, 526 U.S. at 773-774), although the limited restrictions on the advertising of professional services adopted by the dental association required a more detailed analysis (*see* Section II.C. *supra*). Respondents' contention that *CDA* requires a finding of actual anticompetitive effects in all rule of reason cases is flatly contrary to the

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

anticompetitive effects (*i.e.,* increased prices/reduced output). 526 U.S. at 774-75.[6]

In sum, in abbreviated rule of reason cases, the courts infer competitive injury from the existence of the inherently suspect agreement. The plaintiff is not required also to offer direct evidence of competitive harm. In addition to the cases discussed above, *see BMI*, 441 U.S. at 7-8; *NSPE*, 435 U.S. at 692-93; *Marshfield Clinic*, 65 F.3d at 1415-16; *Brown University*, 5 F.3d at 674; *Chicago Prof'l Sports*, 961 F.2d at 674;[7] *General Leaseways*, 744 F.2d at 591; *Verson Wilkins, Ltd. v. Allied Products Corp.,* 723 F. Supp. 1 (N.D. Ill. 1989); *Mardirosian v. American Institute of Architects*, 474 F. Supp. 628 (D.D.C. 1979); *United States v. National Football League*, 116 F. Supp. 319 (E.D. Pa. 1953); *Detroit Automobile Dealers Ass'n*, 111 F.T.C. 417, 493 (1987) ("DADA"); and *Massachusetts Board of Registration in Optometry*, 110 F.T.C. 549, 603-604 (1988).[8]

Of course, there are antitrust cases in which courts have required proof of market power or evidence of actual anticompetitive effects: these are cases where the restraint is not anticompetitive on

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[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), is misplaced. In *Visa,* the parties submitted the case for review under the full rule of reason, and hence the court did "not consider whether this case could have been decided based on" a more abbreviated analysis. *Id.* at 344.

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.

Warner operating companies capitalized upon the public's revived interest in the Three Tenors by dramatically reducing the price of these products (coupled with substantial advertising campaigns). IDF¶242. The fact that in 1998 neither PolyGram nor Warner was willing, unilaterally, to forgo discounting of its catalogue Three Tenors product[14] confirms the obvious: discounting of Three Tenors products is an important basis of competition.

Respondents also plead that the anticompetitive effect of their price fixing arrangement may have been ameliorated, because the moratorium applied to only two of the many music products available (market power) and was in effect for only ten weeks (duration). These contentions are irrelevant to the issue of whether the agreement not to discount 3T1 and 3T2 should be judged presumptively anticompetitive.

The parties' confidence that increasing the price of 3T1 and 3T2 would channel consumers toward purchasing 3T3 is a strong indication that PolyGram and Warner in fact exercised market power. *See NCAA*, 468 U.S. at 116-17 n.60. More importantly, as a matter of law, proof of market power is not a requirement for establishing liability where the challenged restraint is anticompetitive on its face. *Law,* 134 F.3d at 1020 ("[W]here a practice has obvious anticompetitive effects – as does price-fixing – there is no need to prove that the defendant possesses market power. Rather, the court is justified in proceeding directly to the question of whether the procompetitive justifications advanced for the restraint outweigh the anticompetitive effects under a 'quick look' rule of reason.").[15]

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[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*, 961 F.2d at 674. *See also* S. Calkins, California Dental Association*: Not a Quick Look But Not the Full Monty*, 67 ANTITRUST L.J. 495, 496 (2000) ("The most important lesson of *CDA* is that the

Further, an agreement to restrict price competition is so inherently likely to "disrupt the proper functioning" of the market (*IFD*, 476 U.S. at 461-62), that the restraint can be deemed inherently suspect without regard to its duration. For example, the price fixing agreement judged *per se* unlawful in *FTC v. Superior Court Trial Lawyers Ass'n*, 493 U.S. 411, 416-18 (1990)("SCTLA") lasted only two weeks. Price restraints applicable to specific bid transactions, and effective for only a single day, have also been judged *per se* illegal.[16] Even a price-fixing agreement that has never been implemented is presumed to be anticompetitive.[17] Finally, given that an unaccepted invitation to fix prices is presumed to be anticompetitive,[18] it would be odd indeed if an accepted invitation were

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defendant's principal argument throughout the proceeding – that the Commission could prohibit its restraints only through elaborate, formal proof of market power – was rejected."); T. Muris, California Dental Association v. Federal Trade Commission*: The Revenge of Footnote 17*, 8 S. Ct. Econ. Rev. 265, 306-07(2000).

[16] *E.g., United States v. Reicher*, 983 F.2d 168 (10th Cir. 1992); *United States v. W.F. Brinkley & Son Construction Co.*, 783 F.2d 1157 (4th Cir. 1986). *See also Denny's Marina, Inc. v. Renfro Productions, Inc.,* 8 F.3d 1217 (7th Cir. 1993) (agreement to exclude competitor from temporary trade show judged *per se* illegal); *United States v. Columbia Pictures Industries, Inc.*, 507 F. Supp. 412 (S.D.N.Y. 1980), *aff'd*, 1981 U.S. App. LEXIS 21309 (2d Cir. 1981) (agreement among joint venture partners restricting competition with venture for nine months judged *per se* illegal); *NFL*, 116 F. Supp. 319 (agreement among joint venture partners restricting competition on particular days judged presumptively anticompetitive).

[17] *E.g., Socony-Vacuum Oil Co.*, 310 U.S. at 224 n.59; *United States v. SKW Metals & Alloys, Inc.*, 195 F.3d 83, 90-91 (2d Cir. 1999); *United States v. Hayter Oil Co.*, 51 F.3d 1265, 1270-71 (6th Cir. 1995); *Konik v. Champlain Valley Physicians Hospital Medical Center,* 733 F.2d 1007, 1019 (2d Cir. 1984); H. HOVENKAMP, XII ANTITRUST LAW ¶ 2004a at 61 (1999) ("The action the Sherman Act condemns is not only the sale of a good at fixed price, but the mere agreement to fix the price. As a result, a violation can be found even when the defendant made no sales whatsoever, or made no sales at the fixed price.").

[18] In a series of consent decrees, the Commission has endorsed the proposition that an invitation to fix prices may violate Section 5 of the FTC Act. *E.g., Precision Moulding Co.*, 122 F.T.C. 104 (1996); *Quality Trailer Products Corp.*, 115 F.T.C. 944 (1992).

treated less seriously.

For these reasons, Respondents' suggestion that the Commission evaluate, on a case by case basis, whether a suspect restraint has been in place sufficiently long to cause some threshold level of harm is incompatible with abbreviated analysis. A similar argument was rejected in *Chicago Prof'l Sports*. The Court of Appeals evaluated restrictions on output adopted by the members of a professional basketball league. The NBA's claim that the challenged rule constrained one team (and only a small fraction of that team's games) did not dissuade the court from finding liability on the basis of abbreviated rule of reason review:

> That the NBA's cutback [in the number of games telecast] is only five games per year is irrelevant; long ago the Court rejected the invitation to inquire "into the reasonableness" of price and output decisions. Competition in markets, not judges, sets price and output. A court applying the Rule of Reason asks whether a practice produces net benefits to consumers; it is no answer to say that a loss is "reasonably small." (What is more, if five superstation games is tiny in relation to the volume of telecasting, the benefits from the limitation are correspondingly small.").

961 F.2d at 674 (citations omitted).[19]

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[19] *See also SCTLA* at 434-435 (Every horizontal price fixing agreement "poses some threat to the free market . . . . For reasons including market inertia and information failures, however, a small conspirator may be able to impede competition over some period of time.");
In re High Fructose Corn Syrup Antitrust Litig., 295 F. 3d 651, 656 (7th Cir. 2002) ("[S]ellers would not bother to fix list prices if they thought there would be no effect on transaction prices.").

Respondents argue that the moratorium is not inherently suspect because the competitive activity being restrained could not have occurred without the PolyGram/Warner joint venture. App. 11. The argument is wrong on both the facts and the law. As to the facts, Respondents cite no evidence that 3T3 would not have been created and distributed without the joint venture (*e.g.*, distributed separately by PolyGram, Warner, or some other record company). Under the case law, the issue has no legal import. In *NCAA*, the competition restricted by the challenged restraints (price and output of football telecasts) would not have occurred absent the underlying joint venture. Even so, the Court characterized the agreement as a "naked" restraint, and the television plan was judged presumptively

B. Respondents' Agreement Not to Advertise Is Presumptively Anticompetitive

Judge Timony correctly identified the theoretical and empirical basis for concluding that the agreement between PolyGram and Warner to forgo all advertising – including truthful and non-deceptive, and price-related advertising – also is presumptively anticompetitive. ID 57-58.

Agreements not to advertise have repeatedly been treated as *per se* violations by the courts.[20] In *CDA*, the Supreme Court adopted a more permissive view toward limited advertising restraints in a professional services market; but the Court carefully distinguished the case under review from a total ban on advertising in an ordinary commercial market. *CDA*, 526 U.S. at 773; P. AREEDA & H. HOVENKAMP, ANTITRUST LAW ¶ 2023.1 at 512-513 (2001 Supp.) ("[*CDA*] distinguished a class of differentiated markets having unusually large information costs from the more general run of markets . . . . [I]t would be a serious error to apply the rule of this decision in simpler or more ordinary markets where such [market failure] claims are not so readily justified.").[21] In an ordinary commercial market,

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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* Muris, *Revenge*, *supra* note 15 at 269 ("[C]oncerns over the differences between professional advertising and that by 'merely' commercial enterprises are crucial to understanding the Court's *CDA* decision.").

the Court indicated, a finding that competitors had agreed to ban all price advertising would require the actors to come forward with a procompetitive justification. *CDA*, 526 U.S. at 773.

Antitrust law's hostility to advertising bans is supported by economic theory and empirical research. Standard economic models explaining how competition serves to promote consumer welfare and economic efficiency are premised upon the assumption that consumers are well-informed. Information disseminated through advertising serves to educate consumers about the availability of alternatives, quality differences among competing products, sales locations, means of purchase, and pricing. IDF¶245. This information assists consumers in finding their preferred products at low prices, and thus serves to promote competition. IDF¶245. *See CDA*, 526 U.S. at 773 (endorsing the lower court's observation that "'price advertising is fundamental to price competition' and that '[r]estrictions on the ability to advertise prices normally make it more difficult for consumers to find a lower price and for dentists to compete on the basis of price'"); *Bates v. State Board of Arizona*, 433 U.S. 350, 364 (1977) ("[Advertising] performs an indispensable role in the allocation of resources in a free enterprise system."). It follows that an agreement to restrict advertising, and particularly a complete ban on advertising, has the clear potential to harm consumers and competition.[22]

Economists have studied the effect of advertising restrictions in numerous industries, and have

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[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, 1005, 1030 (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); Muris, *Revenge*, *supra* note 15 at 307 ("[B]oth economic theory and economic evidence reveal the anti-consumer, price-increasing effect of restraints on advertising."); F. McChesney, *De-bates and Re-bates: The Supreme Court's Latest Commercial Speech Cases*, 5 Sup. Ct. Econ. Rev. 81, 87 (1997).

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 incentive to lower prices to the extent that you may not be able to attract a large number of people to your store with a lower price").

The parties' joint marketing strategy following the release of 3T3 in 1998 is further evidence of the competitive importance of advertising. The product that PolyGram and Warner wanted consumers to purchase (3T3) was aggressively advertised in every available media: newspapers, television, radio, magazines, brochures, store windows, mailers, the internet. IDF¶168. Conversely, for those products that the parties wished consumers to avoid (3T1 and 3T2), PolyGram and Warner agreed to withhold all advertising and promotion. The record companies intended that their advertising ban would conceal the availability of Three Tenors recordings that were better values for some consumers, so that under-informed consumers would instead purchase the higher margin 3T3 release. IDF¶¶269-270; O'Brien 485:21-487:13. The potential anticompetitive effect of this strategy, Judge Timony properly concluded, is obvious.[25]

C. Complaint Counsel Is Not Required to Prove What Respondents' Prices Would Have Been Absent the Restraints

Respondents claim that PolyGram and Warner were impervious to market forces, and would not have discounted or promoted catalogue Three Tenors products in the United States even without the moratorium agreement. This argument is unsupported by the evidence.[26] More importantly, even if

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[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 participants to charge supracompetitive prices or provide inferior quality."); Muris, *Revenge*, *supra*, note 15 at 291-92 ("[P]roducers can raise price with less fear of losing customers to competitors if the customers are less aware of alternatives.").

[26] The following evidence supports a finding that, absent the moratorium, PolyGram and Warner likely would have discounted and/or advertised 3T1 and 3T2 in the United States following the release of 3T3: (i) The parties believed it necessary to agree upon a moratorium for the United States. IDF¶¶37-38, 98, 268-273; *see High Fructose*, 295 F. 3d at 651, 656 ("[S]ellers would not bother to fix list prices if they thought there would be no effect on transaction prices."). (ii) Documents from PolyGram and Warner operating companies located outside of the United States show a unilateral

true, this contention does not negate the conclusion that the moratorium is inherently suspect.

Respondents in substance are arguing that the minimum selling price fixed by PolyGram and Warner was reasonable, or at the competitive level. This defense was rejected by the Supreme Court decades ago in *United States v. Trenton Potteries Co.*, 273 U.S. 392, 397-8 (1927) (Price fixing agreements are unlawful "without the necessity of minute inquiry [into] whether a particular price is reasonable or unreasonable as fixed and without placing on the government in enforcing the Sherman Law the burden of ascertaining from day to day whether it has become unreasonable through the mere variation of economic conditions."). *See also Catalano*, 446 U.S. at 647 ("It is no excuse that the prices fixed are themselves reasonable."); Krattenmaker, *Per Se Violations in Antitrust Law: Confusing Offenses with Defenses*, 77 Geo. L. J. 165, 173 (1988) ("Principles embedded in the antitrust laws further teach that the reasonable price is the one generated by the invisible hand of the marketplace, not a price chosen by firms on one side of the market.").

Thus, the assertion that "we would not have competed anyway," does not defeat liability or earn Respondents a full rule of reason review. For example, in *Palmer v. BRG, Inc.*, 498 U.S. 46 (1990), one bar review company, BRG, had never done business outside of Georgia, and did not intend to do so.[27] Nevertheless, a market allocation scheme in which BRG agreed with a competitor to operate only in Georgia was judged a *per se* violation. *See also United States v. W.F. Brinkley &*

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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.

[27] *Palmer v. BRG of Georgia, Inc.*, 874 F.2d 1417, 1424 (11th Cir. 1989), *amended*, 893 F.2d 293 (11th Cir. 1990), *rev'd*, 498 U.S. 46 (1990).

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 benefit consumers. *NCAA*, 468 U.S. at 114; *NSPE*, 435 U.S. at 692-96. Judge Timony properly found that the proffered justifications are either implausible on their face or invalid in view of the relevant evidence. As a result, the presumptively anticompetitive restraints were summarily condemned, without needing to assess market power or examine actual anticompetitive effects. *Accord IFD*, 476 U.S. at 459; *NCAA*, 468 U.S. at 110; *Brown University*, 5 F.3d at 673.

Respondents assert that a plausible efficiency theory alone – without evidence showing that the theory applies in the instant case – triggers the need for a full rule of reason review. App. 50. This

[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.

precept would return antitrust analysis to the days of the strict *per se*/rule of reason dichotomy, with abbreviated analysis surviving in name only. Under Respondents' mistaken view of the law, abbreviated analysis would govern only where a defendant's attorneys and experts are too hapless to utter the words "free riding," or otherwise fail to assert any efficiency rationale (albeit knowing that no supporting evidence is required). This is not what the Supreme Court intended when it relaxed the rule of *per se* liability in *BMI, IFD,* and *NCAA*.

In *BMI*, the Supreme Court evaluated at length evidence establishing that the licensing of copyrighted music pursuant to the blanket license resulted in substantially lower transaction costs (441 U.S. at 20-23), and that the blanket license could not be marketed without an agreement among competitors on the price of this jointly-produced product (*id.* at 21, 23). Only then did the Court conclude that the challenged price restraint must be reviewed under the full rule of reason.

In contrast, in *IFD*, the respondent dental association did not produce evidence to validate the proffered efficiency defense, and hence the Supreme Court summarily condemned the challenged restraint. The association asserted that its members were justified in withholding x-rays from insurance companies in order to prevent the insurers from making unwise and perhaps dangerous choices regarding the course of treatment for patients. In its decision below, the Commission expressly held that the association was obliged to offer evidence to support this claim:

> We note at the outset that the burden of proving sufficient justification for restraints which have been shown substantially to harm competition rests with respondents. Such justifications cannot be speculation only but must be established by record evidence in order to be considered an adequate justification for otherwise anticompetitive behavior.

IFD, 101 F.T.C. 57, 175 (1983), *vacated*, 745 F.2d 1124 (7th Cir. 1984), *rev'd*, 476 U.S. 447

(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

[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.

alternatives.").[32]

According to Respondents, the term "necessary" in these cases does not mean necessary in the common vernacular, but instead means "related to." This would read the phrase "reasonably necessary" out of the relevant cases and the *Collaboration Guidelines*. This interpretation is inconsistent with the numerous antitrust cases rejecting a defendant's efficiency justification, and finding liability, because the claimed objectives could be achieved in a less restrictive manner. *NCAA*, 468 U.S. at 114 ("NCAA football could be marketed just as effectively without the television plan."); *id.* at 119 (NCAA television plan not necessary for maintaining a competitive balance among teams); *Maricopa*, 457 U.S. at 352-53 (maximum fee schedule established by physicians not necessary where schedule set by insurers was a workable alternative); *Chicago Prof'l Sports*, 961 F.2d at 674-76 (free-riding problem could be remedied by sharing expenses of promotion); *General Leaseways*, 744 F.2d at 594-95 (free-riding problem could be remedied by charging co-venturers for services provided); *Mardirosian*, 474 F. Supp. at 650; *Mass. Board*, 110 F.T.C. at 607-08 (broad restrictions on truthful advertising not necessary to prevent deceptive advertising). *Accord Collaboration Guidelines* ¶ 3.36(b) ("[I]f the participants could have achieved . . . similar efficiencies by practical, significantly less restrictive means, then the Agencies conclude that the relevant agreement is not reasonably necessary to their achievement.").

[32] Contrary to Respondents' charge (App. 20), Judge Timony did not require that the moratorium be "absolutely necessary" in order to be judged as an ancillary restraint. ID 52 ("Thus, to be ancillary, the restraint must be an integral part of the venture or reasonably necessary to its promotion."). Also, we are unable to find in the Initial Decision the complained of holding (App. 49) that a restraint "adopted after the formation of a joint venture" is necessarily unlawful.

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. Pretextual Justifications Should Be Disregarded

Judge Timony correctly concluded that the parties' actual motivation for the moratorium agreement was to enhance their own profits by shielding 3T3 from competition. ID 60; IDF¶¶268-273. Certainly, this is not a procompetitive (*i.e.*, pro-consumer) justification, and is not a valid antitrust defense.[33]

For purposes of litigation, Respondents have contrived alternative explanations for the moratorium, asking the Commission to evaluate marketing issues that were not actually considered by PolyGram and Warner at the time that they entered into the moratorium agreement. The contemporaneous documents speak of concern that 3T3 may lose sales to 3T1 and 3T2 (IDF¶¶107, 147-148), not of free riding or "long term asymmetrical effects." All such post hoc explanations should be summarily rejected. As a matter of law, a pretextual business justification is not a legitimate antitrust defense. *Eastman Kodak Co. v. Image Technical Services, Inc.*,504 U.S. 451, 461 (1992).[34]

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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.

If one firm's products are indistinguishable from those of its rivals and if free riding is sufficiently widespread, then no single firm may have an incentive to advertise the relevant products. Professor Herbert Hovenkamp offers the example of a single potato farmer:

> [I]f products are fungible, advertising will benefit all local producers of the product, whether or not they paid for the advertising. For example, if Farmer Brown advertises the merits of Farmer Brown's Potatoes, she might be horrified to discover that many customers think that potatoes are potatoes. Farmer Brown's advertisement may increase potato sales, but they will be distributed over all potato producers in the advertising market.
>
> 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 . . .

H. Hovenkamp, *Federal Antitrust Policy, supra* note 35 §5.2b3 at 203.

It is important to distinguish the very dramatic free-riding problem faced by the hypothetical Farmer Brown from the marketing challenge routinely faced by producers of differentiated products. As Dr. Stockum explained: "It is common for advertising and other promotional activity to benefit a competitor different from (and in addition to) the firm that funded the advertising." CX612 (Stockum Rebuttal Report) at ¶ 17; IDF¶277. This observation was echoed by Respondents' marketing expert, Dr. Wind:

> I know as a fact that whenever one company advertises, it affects other companies. For example, if Heinz advertises ketchup, other sales of other ketchup also tend to go up. So many times what you have is, in a sense, by stimulating the demand for a given brand, you are stimulating the demand for other products, other substitute products or similar products . . . . So that's a fact of life.

Wind Dep. (JX91) 126:6-127:1. Dr. Wind testified that there are "tons of examples" of one firm capitalizing upon the marketing activities of a competitor. The prospect of free-riding does not necessarily lead sellers of consumer products to curtail advertising. Instead, Dr. Wind explained, sellers

generally respond to this challenge by sharpening their marketing campaigns ("emphasiz[ing] the uniqueness of their offering"), and by using advertising and other marketing tools to create a distinct identity for the target product. IDF¶¶278-279.[37]

Even within the recorded music industry, the free-riding issue identified by Respondents is commonplace: Advertising intended to benefit one album often leads to sales of competing albums (perhaps an older album by the same artist on a different label, perhaps an album by an entirely different artist). IDF¶280.[38] In this regard, Warner's experience marketing 3T2 during 1994 is instructive but not unique. Warner anticipated competition from PolyGram (3T1). IDF¶202. But Warner did not forgo all advertising (and Warner did not seek a moratorium with its rival). IDF¶¶204, 283. Instead, Warner devised an aggressive marketing campaign aimed at distinguishing 3T2 and convincing consumers that 3T2 was preferable to 3T1. IDF¶¶201-205, 208, 284. One PolyGram executive described Warner's effort in support of 3T2 as "the most impressive campaign I have seen in my days."[39] Despite some "spillover" benefit to PolyGram's 3T1, Warner's marketing campaign for 3T2 was a success; the project was profitable; and four years later Warner was anxious to acquire

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[37] Dr. Ordover also acknowledged that the spillover effect from advertising often has an inconsequential effect on the firm's incentives to advertise. Ordover Dep. (JX90) 199:11-15 ("[T]here are plenty of activities that firm[s] undertake fully aware of these kind of spillover effects and saying to themselves, well, the effect is there but it's either insignificant or I can live with it and do what I intend to do."). *See also* CX612 (Stockum Rebuttal Expert Report) ¶ 17.

[38] PolyGram executive Bert Cloeckaert testified at deposition that PolyGram is often the beneficiary of the spillover effect of advertising. Cloeckaert Dep. (JX97) 46:3-17 (PolyGram benefits when a competitor offers an attractive product because more "people are tempted to go to a record store . . . and when you go there, there is a chance that you pick up something else. Since we are a major player, the chance they pick anything from us is significant."). *See also* IDF¶281.

[39] Hidalgo Dep. (JX88) 46:15-47:10.

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 ¶ 2032b at 184 (1999) ("free riding is ubiquitous in our society"). The case law therefore requires Respondents to show a danger that, because of free riding and absent a restraint, some valued service (*e.g.,* advertising for 3T3) would have disappeared or have been substantially curtailed.

The evidence on this issue does not support Respondents' free-riding defense. First, Respondents stipulated that the Three Tenors moratorium was not necessary to the formation of the PolyGram/Warner collaboration. IDF¶262. In fact, the moratorium was entered into after the parties were contractually committed to the 3T3 project. The moratorium therefore was not necessary to assure the production of the Paris concert, the creation of 3T3, or the distribution of 3T3. IDF¶¶262-64.

Second, witnesses representing both Warner and PolyGram testified that 3T3 would have been aggressively and appropriately promoted without the moratorium, and indeed that the moratorium had no significant effect on the resources devoted to advertising and promoting 3T3. IDF¶¶288-89; O'Brien 448:12-21; 490:19-22 ("I think that 3T3 would have been appropriately marketed and promoted in the United States without regard to the moratorium with PolyGram."). This proposition was, in effect, tested and confirmed in June 1998, when it appeared to PolyGram that the Three Tenors moratorium might fall apart. At that time, PolyGram did not alter its marketing strategy, did not cut back on its advertising budget, and did not withdraw from the venture. PolyGram's only response was

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.

XIII ANTITRUST LAW ¶ 2223b3 at 334 (1999) ("[F]ree rider defenses should be rejected when the firm that controls the input is able to sell, rather than give away, the good or service that is subject to the free ride.").

3. Other Less Restrictive Alternatives

Other substantially less restrictive alternatives for addressing the hypothesized free-riding issue were available to PolyGram and Warner. First, as the putative free-riding problem was located in Europe and not the United States (IDF¶306), the scope of the moratorium could also have been limited to Europe.[50]

In addition, Judge Timony correctly explains that the parties could have addressed the claimed free-riding problem by creating a unique identity for 3T3, employing the ordinary tools of marketing and product design. ID 63. There is no intrinsic reason why Three Tenors albums must be as fungible as potatoes.

E. Respondents' Marketing Strategy Defense Should Be Rejected

Respondents argue that, because of similarities among the various Three Tenors albums and the potential for consumer confusion, it was necessary to suppress promotion of 3T1 and 3T2 in order to implement a sound marketing strategy for Three Tenors products. App. 47-48. Judge Timony

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[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 necessary for the efficient marketing of 3T3 in some other territory. *Law v. NCAA*, 902 F. Supp. 1394, 1406 (D. Kan. 1995), *aff'd*, 134 F.3d 1010 (10th Cir. 1998) ("Pro-competitive justifications for price-fixing must apply to the same market in which the restraint is found, not to some other market."). *See also Sullivan v. National Football League*, 34 F.3d 1091, 1112 (1st Cir. 1994); *RSR Corp. v. FTC*, 602 F.2d 1317, 1325 (9th Cir. 1979). The welfare of consumers in one territory may not be sacrificed for efficiency gains outside of that market.

rejected Respondents' marketing strategy defense (ID 64-65), and this conclusion should be affirmed.[51]

Some background information is helpful: It is common for a recording artist, over the course of a career, to release albums with more than one record label. IDF¶331. When this occurs, the company releasing the new album ordinarily is forced to compete with the company that distributes that artist's older, catalogue recordings. It is the experience of the recorded music industry that every time an artist has switched labels, the new recording was marketed without an agreement constraining competitive activity in support of the catalogue albums – except with regard to 3T3. RPF¶149. For

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[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 Savings,* 2001 U.S. LEXIS 22915, *10-11 (E.D.N.Y. 2001). Although the experts were deposed, deposition is a discovery device and is not a substitute for cross-examination.

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

[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 music: Professor Catherine Moore. IDF¶¶328-29. Professor Moore explained that Warner and its collaborators could have and perhaps did create a distinct identity for 3T3 in the eyes of consumers. Moore 119:19-137:14. Professor Moore further explained that, given this distinct identity, 3T3 could have been effectively marketed without withholding discounting and promotion for 3T1 and 3T2.

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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.,*

reduces costs, improves quality, enhances innovation); it does not merely facilitate the sale of an undesired product. The Three Tenors moratorium agreement fails this fundamental test.

Even assuming *arguendo* that Respondents' efficiency argument is consistent "with the basic policy of the Sherman Act," expert testimony and industry experience indicate that the Three Tenors moratorium was not necessary for the effective marketing of Three Tenors products. In support of their contrary contention, Respondents assert that a hypothetical Three Tenors monopolist that controlled all Three Tenors products "might well" forgo discounting and promotion of 3T1 and 3T2 upon the release of 3T3. App. 47.[55] But antitrust law recognizes a fundamental distinction between unilateral conduct and concerted conduct; it is axiomatic that a single firm may act in ways that are impermissible to the members of a joint venture. *See generally Copperweld Corp. v. Independence Tube Corp.*, 467 U.S. 752, 768 (1984).

Chicago Prof'l Sports is again instructive. The Court of Appeals considered an agreement among professional basketball teams limiting the number of games that an individual team may license for broadcast in competition with the league's national television contracts. The league argued, and the court acknowledged, that single-firm licensors of entertainment products often enter into exclusive license arrangements with a single network. The league sought to do no more. But this analogy to single firm conduct did not persuade the Court of Appeals that the NBA's output restraint should be

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[55] The relevant witness, PolyGram Vice President Bert Cloeckaert, testified that in considering how best to co-market a new release and catalogue albums by the same artist, there are as many different theories as there are marketing executives. Some marketers prefer to promote catalogue albums at the same time as the new release. Cloeckaert Dep. (JX 97) 98:9-101:8. As there is no single correct or efficient co-marketing strategy for the various Three Tenors albums, the moratorium cannot be judged to be reasonably necessary. *Cf. NCAA*, 468 U.S. at 114.

analyzed under the full rule of reason. A firm is generally free to choose its customers, and is even permitted to reduce output so as to exploit whatever market power it lawfully possesses. However, competitors that act in concert (including joint venture partners) are held to a stricter standard. The NBA's marketing strategy argument, essentially identical to the claim advanced here by Respondents, was therefore rejected. 961 F.2d at 672-73.[56]

In sum, Respondents' consumer confusion argument is unsupported by the evidence. The marketing challenge that lies at the heart of this case is more mundane: that an artist's new release may lose sales to an older album featuring the same artist but marketed by a competing record company. This situation arises frequently in the recorded music industry, and is routinely and effectively addressed through the ordinary tools of marketing: *e.g.,* advertising, public relations, packaging, product design. IDF¶¶280, 331; ID 63. Further, instead of elevating the price of 3T1 and 3T2, the parties were free to discount 3T3. Instead of suppressing advertising for 3T1 and 3T2, the parties were free to enhance the promotion of 3T3. Judge Timony correctly concluded that it was neither necessary nor pro-competitive for PolyGram and Warner to agree that marketing activities for competing products would be withheld.[57]

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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. *See* W. Cohen & G. Zinfagna, *Inside the Competitor Collaboration Guidelines: The Forest*

F. The Moratorium Was Not Necessary to Protect Confidential Information

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

Judge Timony concluded that the Three Tenors moratorium is *per se* unlawful because the restraints are outside, and not ancillary (reasonably related) to, the collaboration between PolyGram and Warner. ID 54. This holding should be affirmed.

The doctrine of ancillary restraints affords parties to a joint venture an opportunity to demonstrate that an inherently suspect restraint is efficient by virtue of being necessary to facilitate procompetitive integration. Conversely, "[t]he mere coordination of decisions on price, output, customers, territories, and the like is not integration, and cost savings without integration are not a basis for avoiding *per se* condemnation." *Collaboration Guidelines* § 3.2. *Accord Maricopa*, 457 U.S. at 351-54; *Blue Cross & Blue Shield v. Marshfield Clinic*, 152 F.3d 582, 591 (7th Cir. 1998).

An obvious corollary to the foregoing is that in evaluating a joint venture, the scope of the integration of assets defines the scope of potentially permissible restraints; restraints that are outside of or only tenuously related to the integration are prohibited.[59] Consider, then, the scope of the PolyGram/Warner collaboration. The parties agreed to divide responsibility for exploiting the rights to

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[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).

3T3: Warner was responsible for marketing 3T3 in the United States, and PolyGram was responsible for marketing 3T3 outside of the United States. The parties further decided that they would not bring 3T1 and 3T2 into the venture. IDF¶¶61-63. That choice precludes the parties from coordinating the price and advertising for these non-venture products.

Palmer v. BRG of Georgia, Inc., 498 U.S. 46 (1990), best illustrates the distinction between ancillary restraints and restraints that are outside the venture. HBJ, a nationwide provider of bar review classes, licensed a competitor to use HBJ's trade name and teaching materials in the State of Georgia only, and agreed not to compete with the licensee in Georgia. In return, the licensor (HBJ) received a license fee and a commitment that the licensee would not compete with the licensor anywhere in the United States (outside of Georgia). In other words, the parties combined their assets in Georgia only, yet they agreed not to compete anywhere in the country. Even though the latter restraint was agreed to in connection with the formation of the venture, because it restricted competition outside the scope of the venture, it was judged *per se* illegal.[60]

The holding of *BRG* controls this case. Warner licensed its competitor PolyGram to distribute 3T3 outside the United States, and (later) exacted a promise that PolyGram would not compete with

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[60] Another case illustrating the distinction between restraints upon products inside versus outside the venture is *In re General Motors Corp. and Toyota Motors Corp.,* 103 F.T.C. 374 (1984), *vacated*, [FTC Complaints & Orders 1993-1997 Transfer Binder], Trade Reg. Rep. (CCH) ¶ 23,491 (F.T.C. 1993). The Commission approved a manufacturing joint venture between GM and Toyota, subject to certain restrictions on the exchange of competitively-sensitive information aimed at reducing the likelihood of collusion between the manufacturers with regard to non-venture products. *See also Maricopa*, 457 U.S. at 356 (agreement among participants in medical plan to fix prices of separately provided services judged *per se* illegal); *Brunswick Corp.*, 94 F.T.C. 1174, 1275-77 (1979) (agreement restricting venturer's sale of pre-existing, non-venture product judged *per se* illegal), *aff'd as modified sub nom. Yamaha Motor Co. v. FTC*, 657 F.2d 971, 984 (8th Cir. 1981).

Warner inside the United States. PolyGram's rights to 3T1 pre-date the arrangement and were not part of the integration; PolyGram's U.S. marketing operation was not used for the betterment of the collaboration; and PolyGram's U.S. distribution assets were completely uninvolved in the collaboration. IDF¶¶265-267. The challenged restraints on the marketing of 3T1 and 3T2 far exceed the scope of the parties' integration and should be condemned as a matter of law.

No case cited by Respondents holds that Respondents' proposed test of ancillarity (*i.e.,* whether the restraint is "related to the procompetitive purposes" of the joint venture) is sufficient. Respondents can identify no case in which joint venture partners were permitted to fix the selling price for their non-venture output: products separately produced, separately distributed, pre-dating the collaboration, and not part of the integration. As there is no tangible nexus between the PolyGram/Warner agreement to share distribution rights for 3T3, and the parties' later agreement to withhold promotion of 3T1 and 3T2, the moratorium agreement is *per se* illegal.[61]

IV. <u>Issuance of a Cease and Desist Order Against Respondents Is Appropriate</u>

Upon determining that Respondents violated Section 5 of the FTC Act, the ALJ is authorized to enter an appropriate order to prevent a recurrence of the violation. *SCTLA*, 107 F.T.C. at 599. Consistent with this authority, Judge Timony issued an order enjoining Respondents from again agreeing

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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. There was not any difference on this one." Cloeckaert Dep. (JX97) 42:17-43:6. The incentive and opportunity to restrain competition will arise frequently because Respondents have recording contracts with several artists that formerly released albums with one of Respondents' competitors. IDF¶¶331-332.

In addition, Respondents are currently engaged in at least one other collaboration where a similar incentive and opportunity to restrain competition is presented. Respondents and Sony have formed a joint venture known as "Pressplay" to distribute music over the Internet. Respondents, Sony, and other music companies will provide their music to the venture on a non-exclusive basis. This means that music products marketed by the venture may also be marketed (*e.g.,* by Sony) through traditional retail outlets. Absent an order, Respondents and Sony may find it profitable to fix prices on products sold to retail stores in order to enhance the venture's internet sales and profits. IDF¶334; *see also* IDF¶333.

CONCLUSION

The presumption that price fixing results in consumer harm is a core principle of modern antitrust analysis – but it is more than this. This tenet also serves as a useful warning to the business community: agreements among rivals to restrain price competition are disfavored; alternatives should be carefully considered; be prepared to demonstrate a serious justification. Attorneys for PolyGram and Warner apparently warned their clients of the risk of implementing the Three Tenors moratorium. IDF¶¶154, 160-63. Still, the business managers elected to proceed, pausing only to destroy documents. ID 66.

The existence of a joint venture may raise the possibility that even suspect restraints are efficient. What justification then have Respondents offered for agreeing to fix prices and to ban advertising for Three Tenors products? They say that there was a risk of free riding – but only in Europe. In any event, any free-riding problem in the U.S. was remedied because PolyGram and Warner were sharing the costs of such advertising. In the words of Judge Easterbrook: "When payment is possible, free-riding is not a problem because the 'ride' is not free." *Chicago Prof'l Sports,* 961 F.2d at 674-675.

Merely identifying a plausible free-riding issue – without supporting evidence – cannot be sufficient to defeat liability for inherently suspect restraints, or abbreviated analysis becomes meaningless. Suppose an agreement between Coke and Pepsi not to discount their soft drink products. If the rivals could plausibly claim that advertising for Pepsi induces some thirsty consumers to go to the store and purchase Coke, then, under Respondents' formulation, this price fixing agreement would require analysis under the full rule of reason. This is not an antitrust rule that makes sense, and as such must be rejected.

Respondents also assert a concern about consumer confusion. But there is no evidence of such confusion. It is more accurate to say that Respondents faced the commonplace challenge of distinguishing a new product in a competitive marketplace. Perhaps 3T3 was not "quite as new and exciting" as the parties had hoped it would be. IDF¶136. Nevertheless, all of the ordinary tools of marketing were available to the parties, including discounting and advertising, packaging and product design. It was not necessary or pro-competitive for PolyGram and Warner to agree that marketing activities for competing products would be withheld.

For all of these reasons, the Initial Decision and Order should be sustained.

Respectfully submitted,

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September 11, 2002

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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