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# Featuring the Three Tenors in La Triviata

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*In the “Three Tenors” case the FTC found an agreement to be an antitrust violation despite the fact that there was no way it could be anticompetitive. The Commission failed to heed the lessons of Coase’s classic paper on the nature of the firm, making a sharp distinction between activities within a firm (legal) and across firm boundaries (not legal). Analytically, there should be no distinction. The decision to integrate activities by contract rather than ownership is a matter of relative transactions costs. Since the boundaries of the firm are, ultimately, an economic decision reflecting the costs and benefits of the alternative arrangements, there is no economic justification for making the legality of any act contingent upon whether it was on the proper side of that boundary. Nor is there any particular virtue in using antitrust rules to alter the relative costs so as to shift that boundary to favor bringing activities within the firm. The paper proposes a “quick look” approach. The first thing to look for is some indication of market power. If antitrust harm is not credible, as in this case, because there was no market power, stop looking.*

Picture this. Luciano Pavarotti, Placido Domingo, and Jose Carreras are in a recording studio preparing to record yet another “Three Tenors” album. The orchestra is tuning up, the singers are going over the music, when suddenly in burst the Antitrust Police. The three are carted away in handcuffs for conspiring to combine their unique talents in restraint of trade. “Had they not combined in this manner,” intoned the commissioner, “there could have been three recordings, not one. The purpose of the antitrust laws is to increase output and better serve the consumer thereby. The public is clearly served by what we do here today.”

Far-fetched? In a recent decision, the Federal Trade Commission (FTC) unanimously ruled that two record companies, each owning the rights to one

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“Three Tenors” concert, violated the antitrust laws by agreeing to certain restrictions on marketing those recordings (FTC, 2003). The Commission’s decision has about the same economic content as in the imagined case of the prior paragraph. The lack of economic content is particularly surprising and disappointing because the author of the opinion, Timothy Muris, is a sophisticated practitioner of law and economics.<sup>1</sup>

The Commission’s driving assumption is that a contract constraining future behavior between two competitors with competing products, no matter how trivial the constraint, is highly suspect, while a contract of conveyance (that is, putting the two products into a single firm), which would enable the common owner to impose the same constraints, would be just fine. Ownership is the brightest of bright lines. An owner’s home is his antitrust castle and in it he can do no wrong; if he wants to promote one product and not another or change the relative prices, there’s no problem, unless he has some market power in a relevant market. But if he tries to do the same things by an agreement with an outsider, however innocuous they might be, then the behavior becomes anticompetitive.

Analytically, there should be no distinction. As Ronald Coase (1937) reminded us, many years ago, the decision to integrate activities by contract rather than ownership is a matter of relative transactions costs. The boundaries of the firm are, ultimately, an economic decision reflecting the costs and benefits of the alternative arrangements. There is no economic justification for making the legality of any act contingent upon whether it was on the proper side of that boundary. Nor is there any particular virtue in using antitrust rules to alter the relative costs so as to shift that boundary to favor bringing activities within the firm.

In the 1970’s, the Supreme Court reversed its field and finally recognized that vertical restraints, absent market power, did not present a competitive threat (although they didn’t go all the way on resale price maintenance). It is time for the courts to recognize that there are plausible economic rationales for horizontal restraints. At a minimum, when it is clear that the suspect activities could be undertaken within a firm and that there is no plausible market power, we ought to at least take seriously that the parties know better than the courts. For policy purposes we might want to set a low market power threshold, just as there is a lower standard for judging mergers than there is for monopolization. But the Three Tenors case falls so far short of any plausible threshold that there can be no doubt.

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<sup>1</sup> For another negative response to the decision, see Kolasky and Elliott (2004).

The facts are simple. In the 1990's the Three Tenors released three albums derived from live performances at the World Cup. PolyGram had the rights to the first, Warner the second, and the third was a joint effort between the two with Warner having distribution rights in the United States and PolyGram the rest of the world. The first two albums had been huge commercial successes, the first becoming the best selling classical record ever. The third album, or more precisely, a side agreement relating to that album, triggered the FTC investigation that culminated in this decision. In that side letter, entered into after the joint venture had been agreed to, Warner and PolyGram placed some restrictions on their marketing of the first two concert albums. The joint venture itself presented no problems for the Commission.

Because Pavarotti had an exclusive contract with Decca, a PolyGram subsidiary, Warner could not get the rights to the concert without PolyGram's approval. The deal struck with the concert promoter called for an \$18 million advance, half from each. They divided the world market, as noted above, and agreed to a 50-50 split of profits and losses. The contract gave them the rights to market a boxed set of performances from all three concerts and a greatest hits album. It also contained a limited covenant not to compete in which they each agreed not to release another Three Tenors recording for four years. None of this was problematic. The contract provided that each would be free to exploit their older Three Tenors products. In the Commission's words, "the relationship of 3T1 and 3T2 to the joint venture was clear: ownership and marketing rights for both were outside the joint venture" (FTC, 2003:8).

For a variety of reasons, the two companies developed doubts about the commercial potential of 3T3. Executives of the two companies agreed to a moratorium on advertising and discounting the first two recordings in the months after the release of 3T3. When lawyers for the two firms found out about this, they were concerned about the legality of the moratorium and had each management send a letter disavowing the moratorium. Counsel were apparently clever enough to anticipate the foolishness of the enforcement agencies. The letters were a pretense, the moratorium remained intact, and for 2 ½ months the parties substantially complied with its terms.

As it turned out, the third concert was a commercial failure. The two companies lost millions. Adding insult to injury, the FTC brought an action against them claiming that the moratorium agreement was an illegal restraint of trade. The joint venture itself was above reproach—only the separate agreement was at issue.

Over twenty pages of the opinion were devoted to establishing the legal standard that should be applied "when the plaintiff seeks to avoid pleading and

proving market power” (FTC, 2003:fn 37)<sup>2</sup> No pages were devoted to establishing why this would be a sensible question to ask. Using a “truncated rule of reason” test, the Commission established the ground rules. The Commission must satisfy the initial burden of showing that the practice is inherently suspect. The defendant then would bear the burden of showing that there were offsetting pro-competitive benefits. Its justification must be both cognizable and plausible. In this instance the Commission concluded that the justifications were neither cognizable nor plausible.

The first step in the analysis was to assert that the restraints were inherently suspect. The Commission did so by citing the arguments of the government’s expert witness and buttressing these with out-of-context sound bites from the defendant’s expert. The first issue was the agreement not to discount the two earlier recordings. “As Complaint Counsel’s economic expert, Dr. Stockum, testified, an agreement between competitors not to discount is likely to result in higher prices to consumers, restriction of output, and reduced allocative efficiency. . . . Dr. Stockum therefore concluded that, absent an efficiency justification, the agreement between PolyGram and Warner not to discount their catalog Three Tenors products was very likely to have had anticompetitive effects” (FTC, 2003:36). Defendant’s expert was induced to agree that “a naked agreement between competitors to restrict competition has ‘clearly pernicious effects on competition and consumers’” (FTC, 2003:37).

Would a naked agreement between two wheat farmers have pernicious effects? Most economists would agree that a naked agreement to fix prices would have pernicious effects only if it were plausible that the fixers had some market power. Yes, OPEC can fix prices and most economists would agree that the effects on consumers would be pernicious. Suppose, instead, that we ask the following question: if a publisher has four antitrust books in its catalog and it decides not to discount one of them for one semester; does that have a clearly pernicious effect on consumers? Most economists, I would hope, would say No. Is the Three Tenors CD more like OPEC or an antitrust casebook? For the Commission all arrangements that go beyond the firm’s boundaries are like OPEC.

The Commission’s treatment of the advertising restriction follows the same pattern. It first cites the testimony of the government’s witness: “an agreement

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<sup>2</sup> The commission justified this approach by arguing that in some contexts market power is irrelevant: “In most cases, conduct cannot be adjudged illegal without an analysis of its market context to determine whether those engaged in the conduct or restraint are likely to have sufficient power to harm consumers. In a smaller but significant category of cases, scrutiny of the restraint itself is sufficient to find liability without consideration of market power” (FTC, 2003:29).

among competitors not to advertise is likely to harm consumers and competition by raising consumers' search costs and reducing sellers' incentives to lower prices (FTC, 2003:38). The witness cited numerous empirical studies "that have found that advertising restrictions result in consumers paying higher prices. . . . On the basis of economic theory and empirical studies, [he] concluded that, absent an efficiency justification, Respondent's agreement not to advertise or promote the catalog Three Tenors albums is very likely to be anticompetitive" (FTC, 2003:38-40). Again, defendant's expert agreed with the proposition that "a naked agreement among competitors not to advertise is likely to cause consumer harm" (FTC, 2003:40). Of the sixteen studies cited for this proposition, ten relate to the removal of governmental restrictions on competition by optometrists (FTC, 2003:38-40). Hardly a representative sample. The effects of advertising on prices are more controversial than the Commission suggests. I suspect that some future defendants would be delighted to find such an endorsement of the pro-competitive nature of advertising in an FTC opinion. But, regardless of whether the statement is accurate, it is irrelevant. Consider the publisher of the aforementioned antitrust texts; would it be behaving in an anticompetitive manner if it chose to limit advertising on three of its texts while promoting a fourth? Does the answer change if separate publishers own the texts and the four texts together have one percent of the relevant market? The answer to the first question is clearly No, and there is no good reason for the answer to the second to be any different.

Having satisfied itself that the restraints were inherently suspect, the Commission turned to the matter of justifications. The only justification proffered by the defense was the "free rider" argument. If there were aggressive promotion of 3T1 and 3T2, this would induce the joint venture to withhold promotion from 3T3. Moreover, a weak performance by 3T3 might jeopardize the future productions covered by the contract—the boxed set and greatest hits albums. The Commission did not have to consider the merits of this argument. The opinion rejected it as a matter of law, holding that this justification is not cognizable under the antitrust law. Why? It again comes down to ownership. Even if there were efficiencies, the fact that the first two albums were not owned by the joint venture means that these efficiencies cannot be recognized as an antitrust defense. If I understand this, I think it means that horizontal restraints can be justified by invoking efficiencies, except when those efficiencies arise from horizontal restraints. Most opera plots make more sense.

The Commission further held that even if the free rider justification were cognizable it would fail as a factual matter. First, it noted that the timing of

events showed that the moratorium was not necessary to bring 3T3 to market. When the parties entered into the joint venture, they did not constrain competition from the earlier albums, so, clearly, the album would have been produced without the restraints. The Commission did not quite find this dispositive, but it appears to have given it considerable weight. It cited evidence from the recording industry that it was common to market the existing catalog to take advantage of a new release by another company. It cited the government's expert on the music business and executives from the two firms to the effect that "the prospect of a new album's losing sales to competing catalog products typically does not lead record companies to curtail their marketing of a new album" (FTC, 2003:56). This is just bad economics. The decision on how much to invest in marketing an album is a difficult one. If it were clear to the record company that a sizable chunk of its revenue stream would be diverted to someone else, other things equal, the promotion budget would be reduced. I am not saying that this was an important consideration in this particular case. But we ought not dismiss the defendant's argument on the basis of totally bogus reasoning and a few citations to misleading testimony.

Defendants usually invoke the free rider rationale because it is one of the few defenses that have been blessed by the Supreme Court. I don't find the free rider characterization particularly helpful in this case. It is more useful to begin by assuming an integrated firm. Consider a record company, for example Warner, with an existing catalog. When it is contemplating whether it should produce a specific new recording and, if so, how to market it, it will consider the interrelation between this recording and its catalog. In many instances the appearance of the new recording would be expected to have no effect on the existing catalog. In some instances, the new recording might promote sales of some items in the catalog and, perhaps, hurt others. The company must decide how much to allocate for promotion and where it should allocate the funds. Should it spend 100% on the new album? Or should it give some promotional support to some of the pre-existing albums? Should it maintain the flexibility to change the allocation as new information comes in? The record companies make these allocation decisions, at least implicitly, every day, and their decisions never show up on the antitrust radar screens. A priori, we can't say which strategy would be the most effective for any particular album.

The same is true when the interrelation is with recordings owned by another firm. Could the firm prove that the promotional strategy it had adopted for a particular album was efficient or that the results could not have been achieved in a less anti-competitive way? I doubt it. Nor should it have to, just because the decision involved coordination across organizational boundaries. Are there differences between the case in which the firm allocates its promotion budget

internally and the case in which it contracts with the owner of another recording to engage in a specific level of promotion (in this case zero)? Sure there are differences, but none matter insofar as the competitive effect is concerned. One obvious difference is the number of recordings that could potentially be affected. In the Three Tenors case the number is two; in the example in the previous paragraph, the number is in the thousands. If this were at all relevant, it cuts against the Commission's decision.

The Commission, in language reminiscent of pre-*GTE Sylvania* vertical restraint decisions, argued that contracting across organizational lines interfered with the workings of a free market:

Defendants are arguing "that competitors may agree to restrict competition by products wholly *outside* a joint venture, to increase profits for the products of the joint venture itself. Such a claim is 'nothing less than a frontal assault on the basic policy of the Sherman Act,' . . . for it displaces market based outcomes regarding the mix of products to be offered with collusive determinations that certain new products will be offered under a shield from direct competition" (FTC, 2003:41).

If this be a frontal assault, then let the assault begin. The notion that there is some deviation from "market based outcomes" is based on an economic misunderstanding. In the stylized world of formal economic models, resources are allocated in impersonal markets, and non-market institutions, like firms, just get in the way. But in a world in which transactions costs exist—our world—institutions matter. A firm is an alternative to the impersonal market which will displace "market based outcomes" when the relative transactions costs tilt in the firm's favor. Activities within the firm will be shielded from direct competition. And if the relevant transactions costs favor integration short of full ownership, then market based outcomes will be displaced by contract. In short, the notion that the moratorium entailed a departure from some market based ideal was a red herring.

The defendants argued that the moratorium was intended to enhance the value of the Three Tenors brand. The Commission rejected this argument, again invoking the ownership card. "There is obviously no such [brand], because one entity did not legally control all Three Tenor products" (FTC, 2003:41). Of course one entity did own the brand—namely, the three tenors (assuming that their joint efforts survive the challenge of my opening paragraph). They receive royalties from all three albums and it is in their interest to maximize those royalties. Since it appears that 3T3 did not cover its advance, they might well have had different preferences than the record companies, preferring greater marketing of the older albums for which they



would receive royalties. Regardless, two points should be clear. First, the existence of a valuable brand does not depend on exclusive ownership. Second, the Three Tenors themselves could have put together the moratorium by contract, either in their original contracts with the record companies, upon agreeing to produce 3T3, or by buying back the rights from the first two recordings.

By trying to play the Commission's game, the defense undermined their case:

During the oral argument, Respondents in effect conceded this flaw in their response to a hypothetical positing that Sony had received the rights for 3T3 and then Sony had entered into the same moratorium agreement with Warner and PolyGram restricting price discounting and advertising of 3T1 and 3T2 during the 3T3 release period. This hypothetical assumes that the same benefits to the Three Tenor "brand" exist that the Respondents assert exist for the joint venture. Respondents conceded that for Sony to enter into such an agreement with Warner and PolyGram would be *per se* illegal, even if it might maximize the value of the Three Tenors "brand" in the long term (FTC, 2003:44).

In no sensible world should Sony's hypothesized behavior be illegal. If the "brand" benefits exist, as hypothesized, and the moratorium made sense if the three albums were under common ownership, it would also make sense under separate ownership. Assuming that no one in their right mind would assert that there is an economically relevant market for Three Tenors recordings, the hypothesized agreement would increase the expected combined value of the three recordings. Its effect on the overall market for record albums would be, it is fair to say, *de minimus*.

Suppose that in their initial contracts with the record companies the Three Tenors had maintained the exclusive right to market all their albums as they saw fit, even if different companies produced the albums. Or suppose that they merely had a clause in each of their contracts stating that marketing decisions, including promotions and discounting, should be coordinated between the record companies. Or, even worse, suppose that they made the joint marketing contract after the first two albums had been on the market. Which, if any, of these would clear the Commission's hurdle? All should, again for the simple reason that there is no market power.

My recurring theme has been if there is no market power, then the antitrust law should be indifferent as to whether an action takes place within a firm or across firm boundaries. One response to this is the slippery slope. Indeed, one

commentator on the case, Ronald Davis (2004:56), made precisely that argument:

If Warner and PolyGram may lawfully collude on the prices they charge for 3T1 and 3T2 CDs, on the ground that these are really, really close substitutes for 3T3, what rationale stops them from colluding on products that are just slightly less substitutable for 3T3 recordings? After all, other operatic recordings take sales away from Three Tenors performances, and vice versa. If the companies were permitted to price fix all the operatic recordings in their product line, surely that would strengthen the 3T3 joint venture and ensure that the parents' incentives are aligned with it.

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Would anyone be comfortable with a rule that allowed Warner and PolyGram to use the 3T3 joint venture as a lawful occasion to agree on the pricing and promotion of all items in their product line in the \$10 to \$20 retail price range? Of course not. ... The fear of this slippery slope justifies a rule strictly forbidding agreements that limit competition on price, output, promotion, and the like.

I would suggest that Mr. Davis look at the other end of the slope. The FTC has approved a merger of Bertelsmann and Sony, which, together account for roughly one quarter of the CDs sold in the world. (PolyGram had already been merged into a firm with an even greater market share.) That, apparently, does not give the combined entity sufficient market power to cause concern. The combined firm has thousands of titles in its catalog. If when it introduces a new opera CD in the market it were to cut back on the promotion of all the other opera CDs, or even all the classical CDs, in the catalog, the FTC could not care less. If it is okay for an entity to coordinate the pricing and advertising of tens of thousands of CDs in its catalog, where is the harm in the coordination of three? Which is more likely to be anti-competitive, the Bertelsmann-Sony merger or the Three Tenors moratorium? Any legal system that says the latter has lost its economic compass.

I am not, I repeat, advocating that horizontal restraints be subjected to the same market power standard as mergers or monopolization claims. There are good reasons for a less stringent standard. Defining relevant markets and measuring market share can be time-consuming and costly. Bright lines facilitate counseling of the private sector. If horizontal restraints are more likely to produce bad outcomes, a simple cost-benefit analysis would favor a lower standard. But that doesn't mean "no standard." I am suggesting that under a

“quick look” doctrine, the first thing we should look for is some indication of market power. If antitrust harm is not credible because there is no market power, stop looking.

If I learned that some other economist was planning to write about this case and we agreed that only one of us should write about it, would that be an antitrust violation? We have restrained competition in the most basic sense, and since there is no requirement to prove anything about a market including market power, I should think that this naked restraint would fail the Commission’s test. If we agreed to write a joint paper, then I guess we would be okay. And if my fellow co-conspirator were another Columbia law professor then our anti-competitive conduct would surely be shielded. I don’t know how the Commission might choose to deal with the more nuanced question of liability if my co-conspirator were a Columbian, but in the Business School or Economics Department, or some other corner of the University. We can only fear that they would someday try to fill this gap in their jurisprudence.

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