Singing Along: A Comment on Goldberg & Muris On the Three Tenors

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Professor Goldberg vigorously attacks the merits of the Commission's "Three Tenors" decision, emphasizing its misplaced reliance on the issue of whether the challenged restraint resides within the boundaries of the firm. Professor Muris defends the Commission's analysis, which was adopted in large part by the D.C. Circuit on appeal, and argues that Professor Goldberg's call for a market power screen for all horizontal restraints ignores the legal costs of rulemaking. I take a third view of the debate. While conceding that the per se rule is properly applied to truly "naked restraints," I argue that the restraint at issue does not fall into this category and that the Commission's analysis relies on an inappropriately narrow view of the ancillary restraints doctrine. In particular, the Commission's analysis explicitly relies on the fact that the restraint occurred after the formation of the joint venture and displays unwarranted hostility towards PolyGram's free-rider defense. Neither antitrust law nor the economic realities of the joint venture support these two features of the Commission's decision, the latter of which was also adopted by the D.C. Circuit. In any event, the facts of the Three Tenors do not support the Commission's conclusion that the moratorium agreement was not ancillary to the joint venture.

1. INTRODUCTION

The Federal Trade Commission's ("Commission") recent PolyGram decision ("Three Tenors") holds that an agreement between two joint venture ("JV") parents, PolyGram and Warner Communications, to restrict discounting and price advertising for a ten-week period during the release of the JV's new product (the "moratorium agreement") is per se illegal (FTC, 2003).[1] The

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[1] The D.C. Circuit, in an opinion by Chief Judge Ginsburg, upheld the Commission's conclusions that the moratorium agreement was inherently suspect and that the parties' free-rider

Commission described the JV parents' attempt to restrain prices and advertising as "'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, 2003:47).

The decision has not been without controversy and commentary. An attack on the logic of the Commission's decision by Professor Goldberg (2005) and a defense by now Professor Muris (2005) appear within the pages of this journal.[2] I comment on both the merits and limits of the Goldberg critique, Muris' response, and the D.C. Circuit's analysis which in large part adopts the Commission's position.

While any antitrust litigants can count themselves fortunate to have their arguments analyzed by sophisticated antitrust thinkers like Muris and Judge Ginsburg, I argue that their conclusions rely on a misapplication of the doctrine of ancillary restraints. The error results in the conclusion that any efficiencies achieved by the moratorium agreement are not cognizable as a matter of antitrust law. Specifically, the Commission argues that any claimed efficiencies related to the JV are to be excluded from analysis of the moratorium agreement because the parents signed the moratorium subsequent to the formation of the JV, and because the parents mindfully excluded the Three Tenors' previous albums, 3T1 and 3T2, from the JV. However, it is my thesis that the Commission is wrong on the law and facts. Indeed, the purpose of this article is to expose what I perceive to be three fundamental mistakes in the Commission's opinion that have the potential to chill consumer welfare-increasing integration:

1) there is no legal authority to support the Commission's conclusion that the timing of a challenged restraint is dispositive of its ancillarity;

2) the Commission appears to ignore facts indicating that the JV parents considered the moratorium agreement contemporaneously with the formation of the JV;

3) the Commission's holding that the JV parents' free-riding defense was not cognizable as a matter of law is plainly incorrect.

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justification was not cognizable because it eliminated competition between products that were not part of the joint undertaking. PolyGram Holding v. F.T.C., No. 03-1293 (D.C. Cir. 2005), available at 2005 WL 1704732.

[2] Other notable responses to the decision are Kolasky and Elliot (2004); Davis (2004); and McChesney (2004). I thank Professor Muris for bringing McChesney's article to my attention.

Section 2 briefly summarizes the Three Tenors decision. Section 3 examines the three flaws in the Commission's analysis just described and their adoption by the D.C. Circuit. Section 4 takes stock of the Goldberg/ Muris debate in light of the analysis provided. Section 5 concludes.

2. THE THREE TENORS CASE

PolyGram and Warner both produce and distribute music. PolyGram produced and sold a recording of the first Three Tenors album ("3T1") in 1990. Subsequently, Warner sold a recording of the 1994 Three Tenors album ("3T2"). In 1996, both parties began negotiations to be the producer of the upcoming third recording that would be released in conjunction with the 1998 World Cup. PolyGram and Warner eventually entered a JV contract for the purpose of producing the third album ("3T3").

The JV between Warner and PolyGram included a provision prohibiting Warner and PolyGram from producing another 3T album for four years. It also contemplated joint production of a Paris concert, and joint marketing and production of the third 3T album, "3T3." The JV agreement explicitly held separate Warner and PolyGram's respective 1990 and 1994 3T recordings, "3T1" and "3T2." After the JV's creation, a second agreement (the "moratorium agreement") limited the parties' rights to engage in special price discounting or advertising on 3T1 and 3T2 for a ten-week period during the new 3T Paris concert and introduction of the 3T3 album.

Because the moratorium agreement was "outside" the JV, the Commission held that it was not ancillary and therefore unrelated to any integrative efficiencies thereby created. The moratorium, stripped of its relation to the JV, was thus simply the type of naked restraint that antitrust law routinely condemns. The Commission did not challenge the JV's formation or the provision in the original JV agreement forbidding the parent companies from producing a new 3T recording for four years. Accordingly, the Commission challenged only the moratorium agreement between the JV parents.

3. THE COMMISSION'S ERRORS

The Commission's opinion raises fundamental questions concerning the necessary conditions for application of the rule of reason in joint venture cases. Given the prevalence of joint venture activity in today's economy, and the benefits that this type of activity create for consumers, the importance of delineating clear and economically sensible standards for integrative firm conduct cannot be overstated. The Commission has recognized the importance of joint ventures in its Competitor Collaboration Guidelines, which tout the potential benefits these agreements create for consumers such as lower prices, improving quality, or bringing new products to the market more quickly (DOJ/FTC, 2000:§2.1). The Commission's analysis stands at odds with this recognition by committing three fundamental errors to which I now turn.

3.1. THERE IS NO LEGAL AUTHORITY FOR THE PROPOSITION THAT AGREEMENTS FORMED AFTER THE JOINT VENTURE ARE NOT ANCILLARY RESTRAINTS

The Commission argues that the timing of the moratorium agreement is an important, though not dispositive, factor in determining ancillarity (FTC, 2003:55). Because PolyGram and Warner committed to formation of the JV and the creation of the T3 "months before discussions of the moratorium began," the Commission finds any claim that the moratorium was ancillary to the JV pretextual, and found "no evidence that any of these promotional activities 'devalued' the Three Tenors 'brand,' unduly confused consumers, or otherwise threatened Three Tenors output" (FTC, 2003:56-58).[3]

Professor Muris also asserts that the timing of the agreement was not crucial to the Commission's analysis, and to bolster his analysis, formulates a hypothetical scenario where the moratorium takes effect at the same time as the joint venture.[4] Muris asserts that even under this hypothetical scenario the moratorium agreement would violate the antitrust law because such an agreement is akin to horizontal price-fixing. I address this argument in Section 3.3. However, suffice it to say that there is substantial reason to believe that time timing of the agreement played an important role in the Commission's analysis. For example, the Commission writes that the timing of the agreement suggests that it is merely a pretextual justification: "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 they entered into the moratorium agreement" (FTC, 2003: 33). Perhaps the most direct evidence of the role of timing in the Commission's analysis is the statement rejecting the free-rider defense claiming: "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" (FTC 2003: 37). The "therefore" suggests that the

[3] The accuracy of the factual assertions is discussed in Section 3.2.

[4] Muris (2005).

Commission found the timing of the agreement essential, if not dispositive, of the question of ancillarity.[5]

The fact that PolyGram and Warner signed the moratorium agreement after the formulation of the JV is inappropriate to consider as a factor in favor of per se analysis, much less a sufficient condition. The issue is whether the moratorium agreement is properly characterized as "naked" or "ancillary." Not a single legal definition of ancillarity requires that the parties sign the moratorium agreement contemporaneously with the JV.6

The ancillary restraints doctrine enunciated in *Mitchel v. Reynolds*[7], *United States v. Addyston Pipe & Steel Co.*,[8] and the Restatement (2nd) of Contracts, §§ 187, 188 (2)(a), examines the relationship between the restraint and its ability to "enhance the value of the contract," or permit "the enjoyment of [its] fruits." While it is clear that these authorities contemplate the legality of those restraints which increase the value of the contract, modern application of the doctrine divides in several ways those restraints related to efficiencies of the JV and those that should be considered separately for legal purposes. The Restatement (2nd) of Contracts draws the line at those restraints that are ancillary to a "transaction or relationship." The courts in two leading cases, *Rothery Storage & Van Co. v. Atlas Van Lines, Inc.* and *Polk Bros., Inc. v. Forest City. Enters., Inc.*, endorse the approach that a restraint is ancillary where it is "related to the efficiency sought to be achieved," or it is "part of a larger endeavor whose success they promote."[9] Significantly, Judge Easterbrook's conception of the doctrine in *Polk Bros.* only requires that a challenged agreement "*arguably*" "promoted enterprise and productivity at the time it was adopted,"

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5 It should be noted that the D.C. Circuit's analysis does not rely on this timing distinction in finding that the free-rider defense is not cognizable.

6 In *Polk Bros.*, 776 F.2d at 187-91, the restraint at issue was not adopted until after the formation of the joint venture but was ancillary to the joint venture because it eliminated "free-riding." See also *SCFC ILC, Inc. v. Visa USA, Inc.*, 36 F.3d 958, 970-72 (10th Cir. 1994) (finding by-law adopted approximately forty years after formation to be a reasonable means to preventing free-riding).

7 1 P. Wms. 181, 24 Eng. Rep. 347 (1711)

8 85 F. 271, 280 (6th Cir. 1898), *aff'd as modified*, 175 U.S. 211 (1899).

9 *Rothery Storage & Van Co. v. Atlas Van Lines, Inc.*, 792 F. 2d 210 (D.C. Cir. 1986); *Polk Bros., Inc. v. Forest City. Enters., Inc.*, 776 F.2d 185, 188-89 (7th Cir. 1985). Other cases support this view of the ancillarity requirement. See, e.g., *Chicago Prof'l Sports Ltd. P'Ship v. National Basketball Ass'n*, 961 F.2d 667, 674-76 (7th Cir. 1992) (restraints involving joint venture "leaves no room for debate" as to application of the rule of reason*); General Leaseways, Inc. v. National Truck Leasing Ass'n,* 744 F.2d 588, 595 (7th Cir. 1984) ("plausible connection" between the challenged restraint and "the essential character of the [joint venture] product" results in rule of reason analysis).

to mandate application of the rule of reason.[10] Collectively, each formulation contemplates an analysis emphasizing both the overall purpose of the endeavor and the economic realities surrounding the ability of the parties to achieve that goal.

In that light, a useful way of thinking about ancillarity is to consider the possible purposes for the agreement. Two competing interpretations seem plausible. The moratorium agreement was either meant to (1) increase the profitability of 3T1 and 3T2 by fixing a supracompetitive price; or (2) maximize sales of 3T3 and related products by eliminating competition between 3T1 and 3T2 during its launch.

There is no evidence that the first option of increasing the profitability of 3T1 and 3T2 by fixing prices is the right answer. Indeed, the Commission's premise is that both Warner and PolyGram would have maximized profits on those records by *discounting*, not raising, prices. In other words, because each party would earn 100% of the sale proceeds from 3T1 or 3T2, and only 50% from the sales of 3T3, it does not make economic sense that the parties would be concerned about promotion inducing substitution away from 3T3 to the 3T1 and 3T2 unless the agreement would promote sales across all Tenor products. Moreover, the collusion theory begs the question of why the parties would only raise the price for ten weeks if this was the goal?

The second option is much more plausible. Under this interpretation, it seems clear that the rule of reason applies because the restraint is related to the efficiencies of the JV. While the Commission was, of course, free to argue that the agreement was illegal, it should not have been free to do so under the per se rule without changing the law. What is left is the argument that the moratorium agreement was not ancillary because it was executed after the JV's formation.

The Commission's conception of ancillarity not-so-impliedly requires such restraints to be made upfront, or at least simultaneously with the JV.[11] This temporal distinction is not supported by precedent or policy. In fact, the

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[10] *Polk Bros.*, 776 F.2d at 189. Judge Ginsburg mentions but does not distinguish *Polk Bros.*, which involved a venture between two retail competitors to build a new store offering products that one, but not both, offered in their respective stores. The D.C. Circuit's analysis concedes that PolyGram's free-rider argument "has some force" because "the moratorium appears likely to have mitigated the 'spillover' effects that could be expected to follow an aggressive launch of the 1998 album," but ultimately rejects the argument because the moratorium would eliminate "competition of products that were not part of the joint undertaking." *Supra* note 1.

[11] Perhaps timing explains why the Commission did not challenge the four-year noncompete provision between Warner and PolyGram, which was part of the original JV agreement, but certainly, as did the challenged moratorium agreement, controlled assets outside the JV (for example, future 3T recordings).

Supreme Court has frequently found restraints imposed after the formation of the initial joint venture to be ancillary. In *Continental T.V. v. GTE Sylvania*, GTE altered its distribution system by imposing restraints after the initial contractual relationship with dealers had begun.[12] Similarly, in *Business Electronics Corp. v. Sharp Electronics Corp.*, the rule of reason was applied to analyze whether the agreement to terminate a dealer long after the relationship started was appropriate.[13] At the very minimum, as discussed above, the moratorium agreement satisfies the definitions of ancillarity in the case law. It is also clear that the moratorium agreement meets the requirements of the Restatement (2[nd]) of Contracts, which also rejects the Commission's temporal requirement. Simply stated, the Commission's analysis is not justified on this point.

As with the approaches outlined in *Polk Bros.* and *Rothery*, the Restatement's focus on the contractual "relationship" between the parties appears to favor an analysis of the economic realities existing over time rather than at any single moment. Contrary to these established approaches, the Commission's austere concept of ancillarity may deter potential co-venturers on the margin. Indeed, at a minimum, the Commission's ruling should cause some trepidation for parties considering a joint endeavor, because it takes away the flexibility afforded parties to reach agreements moving forward as necessary to benefit the venture.

3.2. THE EVIDENCE INDICATES THAT THE MORATORIUM AGREEMENT WAS NO MERE AFTERTHOUGHT

As a legal matter, the timing of the moratorium agreement and its exclusion from the JV do not support the conclusion that it is a naked restraint. However, one might argue that these factors support a conclusion that, on the facts of this case, any efficiency justification claimed from the moratorium agreement is pretextual. The Commission does not take this approach and insists that the efficiencies are not cognizable as a legal matter and even antithetical to antitrust law. Nonetheless, the factual argument is important because it shows that the Commission's conclusion regarding non-ancillarity is not supported by the record.

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12 433 U.S. 36 (1977). See also cases cited *supra* note 6.

13 485 U.S. 717 (1988). Justice Scalia also expressly rejects the reasoning that an agreement is not ancillary unless "it is designed to enforce a contractual obligation of one of the parties to the contract" (at 729 n.3). Justice Scalia instead adopts the requirement that the restraint "merely enhances the value of the contract." The moratorium agreement, as I will show, satisfies both tests.

Professor Muris is surely correct that it is entirely unremarkable that some agreements outside the scope of the JV are appropriately analyzed without the need for a finding of market power.[14] In other words, per se or "inherently suspect" analysis is properly reserved for those contractual arrangements that are known, through experience and empirical verification, to restrict market output or increase market price. Judge Ginsburg explains that the rebuttable presumption of illegality is only appropriate because of "the close family resemblance between the suspect practice and another practice that already stands convicted in the court of consumer welfare."[15] The use of this presumption must be tied directly to economic learning and evidence that the particular restraint will harm competition.[16] Make no mistake, both the economic impact of cartel price fixing and naked restrictions on advertising are known, as the Commission's lengthy cite to the economic literature indicates. But the citation is somewhat misleading. The fundamental question is whether the economic learning on price-fixing is sufficient to justify the presumption that the ten week moratorium during the promotion of 3T3 would harm market prices. The literature cited does not directly address the impact of advertising and discounting restrictions on products outside the JV on *market* prices and output. This is not to say that the studies are not relevant. They are. But they should be afforded little weight because they quantify the impact of restraints under conditions that deviate significantly from the moratorium agreement. Application of the per se rule is appropriate where the restraint, from experience, is known to "have a pernicious effect on competition and lack of any redeeming virtue."[17] It is quite uncertain that these agreements lack any redeeming virtue in their JV context, which includes the impact of the restraint on the combined sales of the 3T albums.

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[14] McChesney (2004) contends that the moratorium agreement would have been per se unlawful because the Commission could have directly shown anticompetitive effects in the form of increased prices or reduced output. This point begs the question "which prices?" The prices and output levels of T1 and T2? The prices and output levels of T1, T2 and T3 combined? The agreement complicates the proper unit of analysis. Traditional antitrust doctrine defends against the increases in *market* prices, not the pervasively common downward sloping demand curves that give every firm some control over price.

[15] *Supra* note 1.

[16] See, e.g., Broad. Music, Inc. v. CBS, 441 U.S. 1, 9 (1979) ("it is only after considerable experience with certain business relationships that courts classify them as per se violations"). McChesney (2004) concedes that the "the joint venturers advanced a novel argument, one that no court had yet adjudicated . . .. and the novelty of the factual setting meant it at least deserved consideration").

[17] *Northern Pacific Rail. Co. v. United States*, 365 U.S. 1, 5 (1958).

Do the facts surrounding the restraint actually support a finding of ancillarity between the moratorium agreement and long-term sales of the 3T albums? I argue that the answer is no. The facts show that the moratorium agreement was not quite as isolated from the JV as the Commission's opinion suggests. Warner and PolyGram offered evidence that the moratorium agreement was contemplated by the parties upfront and signed approximately one month after formation of the JV.[18] Further, there was at least some testimony that the parties "would not have continued with the deal" if PolyGram had suggested that it intended to discount 3T1 during the launch period. Evidence that the parties actually contemplated the agreement contemporaneously with the formation of the JV is surely relevant to understanding the economic context and purpose of the agreement, which are absolutely essential to ancillarity analysis.

The parties adopted the JV agreement in February 1998 and the moratorium agreement in March 1998. Thirty days of separation between formation of the JV and the challenged agreement is an extremely thin reed upon which to rest the Commission's rejection of the conventional application of the ancillary restraints doctrine. Further, there was no evidence that there had been any prior discounting by the parties of 3T1 and 3T2 at any time other than their respective launches in 1990 and 1994 and some cooperative advertising done by PolyGram in 1994.

That the moratorium agreement was solving a problem that only arose upon the creation of new products surely suggests that the desire to solve these problems was not simply an afterthought. It is difficult to reconcile these facts with the Commission's statement that the JV parents "were contractually committed to the formation of the JV and the creation of 3T3 months before discussions of the moratorium began" (FTC, 2003:55).

[18] The parties discussed the potential need for "an ad moratorium until November 15" in January before the JV was finalized February 5, 1998. The parties entered into this moratorium at the first joint marketing meeting after the formation of the JV on March 10, 1998. An April 29, 1998 internal PolyGram memorandum described the moratorium as reflecting the parties' decision "that the 'original' album should not interfere with the launch of the new album . . .. This will help ensure that when purchasers walk into retail on the day of release they face a simple, uncluttered selling proposition . . .. [T]his new policy strikes a balance between maximizing an opportunity on the 'original album' and yet protecting our considerable investment in the new album." This expression bolsters the JV parents' assertion that the moratorium was, in fact, created with free-riding concerns in mind. Evidence of the parties' intent and actions are surely relevant to ascertaining the economic purpose of the venture, a logical prerequisite to figuring out whether the ancillary restraint arguably promotes this purpose.

3.3. THE COMMISSION IS WRONG THAT PREVENTION OF PARENTAL FREE-RIDING WAS NON-COGNIZABLE AS A MATTER OF LAW

PolyGram argued that the purpose of the moratorium agreement was to prevent the JV parents from free riding on the promotional efforts surrounding the introduction of 3T3 by discounting 3T1 and 3T2. The Commission rejected the respondents' proposed business justification for the moratorium agreement out of hand largely due to the fact that they did not adopt a "Three Tenors" brand. Commissioner Muris writes that because PolyGram and Warner chose to keep independent control of 3T1 and 3T2, they:

> "[c]annot claim the integrative efficiencies that could conceivably have been brought about by combining the production and marketing of all Three Tenors products. Accordingly, the restrictions on marketing of [the prior recordings] cannot be considered 'ancillary' to the present joint venture, <u>as a matter of law</u>, because they are <u>not related to the efficiencies the joint venture was created to produce</u>" (FTC, 2003:48, emphasis added).

And again:

> "[r]espondents' only proffered justification is <u>impermissible as a matter of law</u>, because the supposed 'efficiency' of restraining competition in the offering of products outside of a joint venture to enhance market opportunities for a new joint venture product is not cognizable under the antitrust laws" (FTC, 2003:54)

As such, Commissioner Muris' rejection of the free-riding justification rests on two key assertions: (1) that the moratorium is not ancillary to the JV, which has already been addressed, and (2) that rejection is appropriate because the agreement controls assets "outside" the JV. Muris' article also makes this second claim.[19]

While there is no authority for the proposition that contractual restrictions between JV parents aimed at preventing free-riding are *always* analyzed under the rule of reason, silence on this issue cannot be interpreted as a rule

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[19] Muris (2005: 67) ("[T]he tenors chose to secure the independent promotion of their various products, rather than integrated promotion by either a single entity or consortium. As a result of that choice . . . there was none of the sort of integration of production, manufacturing, and distribution that one would expect in a 'brand.' Rather, the only coordination with respect to the first two albums was the moratorium on discounting and promotion. In the absence of any connection to integrative efficiencies, antitrust courts have no trouble condemning restraints on price and advertising.").

condemning such restraints as naked price-fixing agreements. To the contrary, and discussed above, the lack of direct authority suggests that there is insufficient experience in the courts to justify application of the per se rule.

The Commission's "free-riding" analysis gets it wrong. The agencies' own Competitor Collaboration Guidelines state that an ancillary prohibition on sales of a competing product by the JV's parents, and on research and development on the competing product, may survive antitrust scrutiny.[20] Importantly, the Collaboration Guidelines point out that the rule of reason might apply to such an arrangement.

The Commission's opinion attempts to distinguish the Collaboration Guidelines' Example 10 because it refers to "cognizable efficiency goals," such as restrictions that are necessary for the activities of the JV itself (FTC, 2003:46 n. 63). This distinction turns on the premise that elimination of this type of free-riding is the equivalent to a claim that "competition itself is not reasonable." The Commission follows this statement defending the conduct that JV parents call "free-riding" as an "essential part of the process of competition that occurs daily in our economy" and offers the example of rival SUV companies "free-riding" on the increase in SUV demand stimulated by General Motors' discounting, advertising, and promotional efforts. The Commission opines that prevention of this sort of free-riding is analogous to the moratorium agreement and, importantly, that such a restriction is antithetical to the antitrust laws and not cognizable as a matter of law according to the teachings of the *NCAA* and *Professional Engineers* cases. Professor Muris expands upon this General Motors hypothetical in his article, where he asserts that manufacturer attempts to internalize the spillovers from SUV advertising would violate the antitrust laws.[21] I do not believe antitrust so narrowly construes the concept of free-riding. Nor do I believe it should.

Consider exclusive dealing analysis. Manufacturers frequently attempt to internalize the benefits of promotional investments by eliminating free-riding. Further, the antitrust laws recognize the potential efficiency gains of contractually aligning the incentives of a dealer who may otherwise devote insufficient promotional resources to a product when the opportunity to promote rival products exists. For example, exclusive dealing might protect a manufacturer's property rights on investments it has made in training a distributor's sales staff or constructing a new and improved store. A dealer has the incentive to free ride on these investments by using them to sell rival products. Antitrust law recognizes that these investments are socially desirable

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[20] See, e.g., Competitor Collaboration Guidelines, § 3.36, (DOJ/FTC, 2000).

[21] Muris (2005: 67-68, n.2).

and widely accepts such justifications for exclusivity.[22] Similarly, where manufacturers pay for promotion such as premium shelf space, retailers have the incentive to free-ride on the manufacturer's promotion compensation arrangement by pocketing the manufacturer payments, or promoting higher margin low-brand name products. Manufacturers and retailers attempt to minimize these costs in a variety of ways, including exclusive dealing and the use of category management.[23] Solving this type of free-riding problem by increasing retailer loyalty is also a generally recognized efficiency under the antitrust law.[24] The fundamental economic point is that the antitrust law does not uniformly condemn attempts to minimize the dealer's ability to free-ride on the manufacturer's promotional investments to the benefit its competitors.

Consider one form of promotion that might be offered by General Motors: a dedicated sales staff on the dealer's lot committed to aggressively promoting the new General Motors SUV. The dealer has the incentive to free-ride on General Motor's payments and investments in the dedicated sales staff by pocketing the money, saving the costs of promotional effort, or by turning consumers towards non-GM models, or General Motors non-SUV models on the lot that may earn the dealer a higher margin. Aware of this incentive to free-ride on General Motor's compensation mechanism *ex ante*, General Motors may attempt to control this type of free-riding with an exclusive dealing contract. Such a contractual mechanism to control this type of free-riding would certainly hold up to antitrust scrutiny.

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[22] See *Ryko Mfg. Co. v. Eden Servs.*, 823 F.2d 1215, 1234 (8th Cir. 1987). This type of free-riding also likely explains the use of exclusive dealing contracts in *Standard Stations, Standard Oil Co. of Cal.*, 337 U.S. 293, where the exclusive dealing provision prevented gasoline dealers from switching to lower-cost stations that had not invested in the dealers. Prevention of free riding also likely explains the use of exclusive dealing in *Beltone Electronics*, where Beltone used advertising to generate sales leads that were supplied to retailers who were not permitted to sell other brands. *In re Beltone Elec. Corp.*, 100 F.T.C. 68. For a discussion of the efficiencies of exclusive dealing generally, see Marvel (1982) and Klein (2003).

[23] Klein and Wright (2005) show that category management can solve dealer free-riding problems by shifting control of the retailer's shelf space to the manufacturer without resorting to exclusivity within the product category and sacrificing consumer demand for variety.

[24] See, e.g., *Joyce Beverages v. Royal Crown Cola Co.*, 555 F. Supp. 271 (S.D.N.Y. 1983); *Hendricks Music Co. v. Steinway, Inc.*, 689 F. Supp. 1501, 1514, 1545-48 (N.D. Ill. 1988) ("[i]t is perfectly legitimate and, in fact, pro-competitive for manufacturers to insist that their dealers devote undivided loyalty to their products and not to those of their competitors"); Roland *Mach. Co.,* 749 F.2d at 395 (exclusive dealing indicates "commitment to pushing that brand"). While the cases lack an economic explanation as to why exclusivity is necessary in some cases to generate the desired level of promotional effort, the rationale is clearly accepted. The economic explanation for the use of exclusive dealing to solve a broad set of problems involving inadequate distributor promotion, and not simply "classic dealer free-riding" involving discounting, appears in Klein (2003: note 22).

Professor Muris concedes that antitrust law allows this type of internalization of spillovers but distinguishes this example because "exclusives between a manufacturer and retailer are not close to the FTC's example, which posited agreements between competing makers of different SUVs."[25] Obviously, exclusive dealing involves vertical agreements while the FTC example involves agreements between competitors. To make it clear, I agree that some horizontal agreements that prevent free-riding are rightly condemned as per se illegal. In particular, price-fixing agreements or agreements to restrict advertising *unrelated* to the fruits of a joint venture would fall into this category. The exclusive dealing example serves merely to highlight the point that antitrust law does not always find the elimination of this type of free-riding antithetical to its purpose.

This point holds for some horizontal relationships as well. For example, antitrust law allows parties to a joint venture to raise this type of justification. For example, *Polk Bros.* involved an agreement between competitors not to sell competing products at a jointly offered new store. Promotion of products at the jointly offered store would create an incentive to discount these products at the individually owned stores. The agreement in that case was upheld under the rule of reason. It is also worth pointing out that the moratorium agreement offered a less restrictive means of solving the free-riding problem, by prohibiting discounting and promotion for only ten weeks but allowing sales of the albums, than in *Polk Bros.* where the venturers strictly prohibited the sale of competing items at the joint store at any time.

Importantly, the D.C. Circuit found the free-riding defense not cognizable and distinguished the moratorium from that in *Polk Bros.* because it involved products "not part of the joint undertaking." The D.C. Circuit therefore appears to have based its analysis on this factual distinction rather than the conclusion that prevention of this type of free-riding is always antithetical to the antitrust laws.

4. CHIMING IN ON THE GOLDBERG / MURIS DEBATE

Professor Goldberg's double-barreled attack on the Commission's opinion is crippling, but ultimately short of fatal. Professor Goldberg argues that: (1) the Commission's opinion exhibits a preference for efficiencies exploited by integration rather than contract; and (2) all horizontal restraints should be subject to a market power screen because without that power the restraint is not able to produce consumer harm.

[25] Muris (2005: n.2).

I have commented at length on the first point. It appears relatively clear that the Commission's opinion, as Professor Goldberg claims, favors ownership over contract in the important sense that efficiencies are less likely to be deemed cognizable if they are not within the JV.[26] I limit my comments here to the issue of whether a market power screen is always appropriate.

Professor Goldberg's analysis seems to imply that any agreement external to the JV should be granted immunity in the absence of market power because the firm could have chosen to integrate ("for the Commission, all arrangements that go beyond the firm's boundaries are like OPEC").

Professor Goldberg calls for a market power screen for all horizontal restraints, even if the filter applied is less stringent than the one used for mergers and monopolization. Professor Muris critiques this proposal by advocating the legal function of per se rules and correctly pointing out that the real social costs (administrative and litigation costs, judicial effort, etc.) ought to be a primary consideration when selecting legal standards. This disagreement appears to be a symptom of the disagreement regarding the proper scope of the ancillary restraints doctrine rather than a separate debate.

Professors Goldberg and Muris appear to agree on some level that there ought to be some form of truncated analysis applied to naked restraints.[27] Surely, some categories of horizontal restraints are, through economic theory and judicial experience, so well known to create consumer harm through reducing long-term output or increasing the market price that the costs associated with rule of reason analysis outweigh the benefit of its application. To the extent that Professor Goldberg views this as a null set, economists have gone to great lengths empirically documenting the adverse consequences of collusion, bid-rigging, and market allocation arrangements. These "naked restraints" are so named because they are not plausibly linked to any efficiency-enhancing integration and are properly analyzed under a regime cautious to economize on the societal resources identified by Professor Muris.

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[26] Professor Muris argues that the Commission's opinion does not favor ownership over contract, but rather, the entire arrangement exhibits a complete failure by the JV parents to produce "a scintilla of evidence that the parties chose to promote all three products jointly." Perhaps the Three Tenors case is best read as a case involving a wholly pretextual efficiency justification rather than for the proposition that prevention of parental competition in the JV context is not cognizable as a matter of law. Unfortunately, neither the Commission's analysis nor the facts of the case support such a reading.

[27] Compare Goldberg (2005), ("there are good reasons for a less stringent standard.... Defining relevant markets and measuring market share can be time-consuming and costly") with Muris (2005) ("Rules that avoid consideration of market power make the most sense when the cost of proving actual consumer injury is high in individual cases, and that harm is strongly correlated with easily observable behavior").

The real question in the Three Tenors case is whether the moratorium agreement was in fact a naked restraint justifying per se treatment. As I have argued, it was not.

5. CONCLUSION

When considered in the context of the JV, the Three Tenors attempt at preventing free-riding with the moratorium agreement is cognizable under the antitrust laws. The moratorium agreement was improperly condemned without requiring a showing that the JV had the power to increase market prices or reduce market output. It find it unlikely that the Commission would have prevailed under such an analysis because it would have been forced to present evidence that the JV was able to raise market prices, not simply the prices of their own individual albums.[28]

At the end of the day the Commission's analysis supports the following troublesome propositions: (1) an efficiency enhancing ancillary restraint may be analyzed under the per se rule when the restraint is executed after the formation of the JV; and (2) contractual devices aimed at solving free riding problems may not be raised as a matter of law when the restraint is external to the JV. It should be noted that the D.C. Circuit's analysis seems to adopt the second, but not the first, of these proposition.

Application of these propositions threatens to deter collaborations between competitors and their resulting consumer welfare benefits. While per se analysis is an important weapon of a sensible and efficient antitrust policy, its theoretical underpinnings show that its application in the Three Tenors case is inappropriate. The legal basis and empirical foundation justifying the application of truncated analysis to naked price-fixing simply does not justify summary condemnation of an agreement plausibly linked to increasing the long term output of the combination of Three Tenors products.

[28] It is, of course, possible that the Three Tenors albums constituted a relevant market for antitrust purposes. I am highly skeptical that this is the case. The point is that the Commission's mode of analysis did not require this question to be answered before assuming the moratorium agreement would injure consumers.

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