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The Three Tenors Antitrust Case: What Did We Learn?

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Abstract

"PolyGram Holding," commonly known as "The Three Tenors Case" has been one of the most cited antitrust (anti-competitive) cases of the past ten years, yet the discussion has been largely confined to legal journals and the U.S. antitrust community. What can managers in large commercial music and entertainment organizations learn from the case? What are the practical implications? The paper argues that the case influences the conceptualization and structuring of certain types of joint venture deals, that the core problem initially arose from attempting to address an internal conflict of interest issue within PolyGram, and the case demonstrates the confusing nature of antitrust law for a practicing music manager.

Keywords: antitrust, anti-competitive behavior, joint venture, major record company

Abbreviations

FTC - the U.S. Federal Trade Commission
JV - Joint Venture
3T1 - *The Three Tenors* 1990 album released by PolyGram
3T2 - *The Three Tenors* 1994 album released by Warner
3T3 - *The Three Tenors* 1998 album released by PolyGram and Warner

Introduction

One of the unforeseen aspects of the Three Tenors legacy is that the franchise has been elevated to star status in the U.S. antitrust community (Verschelden 2007). This group of legal boffins is a niche audience admittedly, but the enthusiasm of their analysis has been noteworthy. The Three Tenors case has been extolled as an important development, clarifying the way certain legal principles will be applied in examining anticompetitive behavior in a joint venture context, with implications for future cases (McChesney 2004; Meyer 2010; Verschelden 2007). But of what relevance is this to managers working in music organizations?

This article will provide the background to the Three Tenors case,

summarize the court case, the ruling of the Federal Trade Commission (hereafter referred to as the FTC), the backlash that ensued from lawyers and law professors, the 2005 appeal, and the backlash to the appeal decision. It will then provide some organizational analysis to look more deeply at how the problems arose, before turning finally to what can be learned from the case and its practical implications for music and entertainment managers.

Unless stated otherwise, the facts of the case as outlined below are drawn from the Initial Decision (Public Record Version), published by James P. Timony, Administrative Law Judge on June 20, 2002, which is in the public domain and available online (FTC 2002). While Warner and PolyGram were both involved in the antitrust saga, they were treated as separate cases by the FTC, and this analysis focuses on the PolyGram case. The record label Decca also appears in the case. Decca was owned by PolyGram, and was the repertoire center, or "location-specific-creative-unit" (Bakker 2006, 92) responsible for the Three Tenors recordings within PolyGram at the time of the case. Decca, based in London, distributed its recordings through PolyGram "operating companies," each responsible for sales in a given country. In the 1990s Decca's recordings were marketed in the U.S.A. under the label London Records, and its catalog assets are now owned by the Universal Music Group.

Background

The first Three Tenors concert took place on July 7, 1990 at the Baths of Caracalla in Rome. The concert united José Carreras, Plácido Domingo, and Luciano Pavarotti for the first time. The event coincided with the 1990 FIFA World Cup, launching a tradition that was repeated for future World Cups. PolyGram recorded the concert and it became the most successful classical recording of its era, selling more than twelve million audio units and over three million video units (FTC 2002). This first Three Tenors album was referred to in the legal case as "3T1" (and will be henceforth referred to as 3T1).

The Three Tenors (Carreras, Domingo, and Pavarotti) united four years later for a concert on July 16, 1994 at Dodger Stadium in Los Angeles. This concert was recorded by Warner, and is referred to in the legal case as "3T2".

The third Three Tenors recording in the case was of an open-air concert in Paris that took place in front of the Eiffel Tower on July 10, 1998.

In the spring of 1997 Ahmet Ertegün, the Chairman of Atlantic (a Warner subsidiary based in the U.S.A.), had met with Alain Levy, his counterpart at PolyGram requesting that Pavarotti (who was under exclusive contract to PolyGram) be released to record the project for Warner. Rather than release him (in return for certain considerations), PolyGram proposed that the two organizations create a joint venture agreement. The ensuing joint venture (hereafter referred to as JV) involved Warner distributing the recordings within the U.S.A. and PolyGram distributing them outside of the U.S.A. The parties agreed to a 50/50 split of profits and losses. An US$18 million advance was paid, ultimately shared between the parties, which also included the rights to market a greatest hits compilation and a box set. This third Three Tenors recording was released on August 18, 1998 (and in addition to audio products included video and home television broadcast). It is referred to in the legal case as "3T3".

In 1998 PolyGram possessed a highly decentralized, federated structure (Bakker 2006). Given the significant joint investment in 3T3 (US$18 million), PolyGram wanted its operating companies (which were responsible for marketing the new recording in all territories except the U.S.A.) to get fully behind the new release, and channel the maximum promotional effort and resources into the launch of the new album. There was concern that operating companies might aggressively promote 3T1 around the time that 3T3 was released, effectively cannibalizing sales of the new album. This led to PolyGram and Warner discussing a "moratorium" seeking to discourage aggressive price discounting or advertising of 3T1 and 3T2 around the time of 3T3's release. The window of protection that was discussed was from August 1 to October 15, 1998. There is disagreement between the parties as to what eventually transpired, and sharp disagreement in the testimony, but there is no doubt that such a plan was discussed, and an attempt was made to execute it, based upon a belief by managers in both companies that they were legitimately protecting their mutual investment in 3T3.

The Court Case

On July 31, 2001 the Federal Trade Commission (FTC) in Washington issued a complaint against PolyGram, arguing that the moratorium represented an illegal agreement with a competitor to restrict price competition and promotional activity in violation of Section 5 of the Federal Trade Commission Act. It went to trial in March 2002, and the Initial De-

cision dated June 20, 2002, found the moratorium to be "presumptively anticompetitive" (FTC 2002, 75). The burden of proof lay with PolyGram to "show that the moratorium was necessary in order to promote competition and benefit consumers" (p. 75). It rejected PolyGram's "free riding defense," that aggressive promotion of 3T1 and 3T2 by operating companies may complicate or confuse a consumer's purchase decision, who would then see three Three Tenors albums aggressively promoted in retail. Nor was the argument that the moratorium was simply a mechanism to ensure internal focus considered persuasive.

On July 28, 2003 the Federal Trade Commission released its Final Order confirming the Initial Decision. The accompanying legal opinion concluded, "We find that the moratorium agreement between PolyGram and Warner unreasonably restrained trade and constitutes an unfair method of competition" (FTC 2003, 61).

A key issue for the FTC was that the moratorium was agreed to after the JV had been created, which seemed to indicate that it was not essential to its success. Much mention is made of the timing, such as: "[f]urthermore, PolyGram and Warner were contractually committed to the formation of the joint venture and the creation of 3T3 months before discussions of the moratorium began" (FTC 2003, 55).

There are also many references in the decision to the fact that 3T1 and 3T2 were not placed into the JV; they were not explicitly included in the JV agreement. The Initial Decision quotes a previous ruling: "It is to be expected that the joint venturers will put their venture-related businesses into the venture and 'not compete with their progeny'" (*re Brunswick,* 94 F.T.C. at 1275) (FTC 2002, 58). The Opinion accompanying the Final Order states that a company (i.e., PolyGram) that is 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," is engaged in "a frontal assault on the basic policy" of the antitrust laws (FTC 2003, 41). The ruling continues: "Here, despite Respondents' [PolyGram's] invocation of a Three Tenors 'brand', there is obviously no such thing, because one entity did not legally control all Three Tenors products. The marketing rights to 3T1 and 3T2 were held not by the joint venture but, rather, independently by the parties to the venture" (FTC 2003, 41-42). In addition to this, PolyGram had introduced another case in support of their appeal, but the Commission rejected the comparison saying, "Respondents [PolyGram] and Warner did not bring all of their Three Tenors

products into a single, integrated joint venture" (FTC 2003, 43).

The Ensuing Controversy

The ruling quickly attracted criticism from law professors and lawyers specializing in antitrust law. Two antitrust lawyers, William Kolasky and Richard Elliott, published in *Antitrust* magazine that, "It is said that hard cases make bad law, but sometimes easy cases can make even worse law, especially when theory gets in the way of common sense. A case in point is the Federal Trade Commission's *Three Tenors* decision last summer" (Kolasky and Elliott 2004, 50). In their article they argued "that the Commission's decision was wrong both as a matter of elementary economics and as a matter of the centuries-old law dealing with covenants not to compete among partners in a common enterprise" (p. 50). They argued that the decision was contradictory, as the Commission had no issue with a much broader restriction on competition contained in the JV agreement, where each party was not to release a Three Tenors recording for at least four years. These future recordings would also be outside the JV agreement. They argued that while the JV was criticized for not addressing the issue at the inception of the partnership, in reality it is difficult to anticipate and address all issues from the outset, and very common for such agreements to evolve over time. They argued that the Commission completely ignored the economic issue of opportunity cost in the record companies wanting attention to be placed on 3T3 and not 3T1 or 3T2. They concluded that the Commission's reasoning was "convoluted and ultimately incorrect" (p. 54).

In 2005, Victor Goldberg, a Law Professor at Columbia University, vigorously attacked the decision in the *Review of Law and Economics* (Goldberg 2005). Highlighting the trivial nature of the issue he entitled his piece "Featuring the Three Tenors in La Triviata." He argued that there is no way the agreement could be anticompetitive. If it would be permissible for one company to restrain promotion of its products to promote another, then it should be permissible for a joint venture integrated by contract rather than ownership. Commenting on the convoluted logic of the ruling he wrote, "most opera plots make more sense" (p. 59). He failed to see how any market power was operating when three CDs were involved out of thousands, for a ten-week period, and yet market power should be a key issue.

PolyGram petitioned to have the decision reviewed in the District

of Columbia Circuit Court of Appeals, and in 2005 the FTC decision was upheld (Meyer and Ludwin 2005). It categorically ruled out "the possibility that restraints on competition 'outside the venture' can ever be justified based on a need to limit 'free riding' or other opportunistic behavior" that may threaten the success of a JV collaboration (p. 65). This decision has in turn drawn criticism for being unnecessarily "unpalatable" (p. 67), creating uncertainty, and potentially harming innovation (p. 70).

After the D.C. Circuit appeal Professor Joshua Wright at the George Mason University School of Law criticized both the FTC and D.C. Circuit rulings. He criticized the FTC for displaying "unwarranted hostility" to PolyGram's "free rider" defense (Wright 2005, 399), a ruling which was "plainly incorrect" (p. 400). He also argued that "the moratorium agreement was improperly condemned" (p. 412) involving a "misapplication" of legal principles (p. 400).

Control and Marketing Prioritization in a Decentralized Company

To fully understand and relate to the case from a manager's viewpoint, it is important to delve more deeply into the organizational context. To an external observer, a large multinational music company may look like an integrated, single organization. In the context of a legal trial, it is in the interests of the Commission to consider PolyGram as one integrated entity. However, a large international music organization has its own internal market, its own internal trading between repertoire owners (labels) and operating companies or international affiliates who market and distribute product worldwide. PolyGram in 1998 had a federated, rights-based, decentralized structure (Bakker 2006). The organization believed that decentralization was the key to managing creativity (Arnold 1997). Let us look first at the way Decca functioned as a label, and then how the operating subsidiaries functioned.

The Decca label had control of the artists it signed and the way the recordings were priced and presented to the marketplace (Arnold 1997). Unlike pop recordings within PolyGram, classical recordings were not decentralized to the point where operating subsidiaries could use the Decca label to originate their own recordings, except in highly specific circumstances (Arnold 1997). Decca produced recordings which it owned, and marketed them through the network of subsidiary companies. If a label such as Decca makes a major investment in a new product, it is the one

bearing the risk. It relies on the support of the international marketing and distribution infrastructure to recoup its investment.

The subsidiary companies were profit centers responsible for sales within a given country (Arnold 1997). Around the time of the case, PolyGram directly controlled marketing subsidiaries in 45 countries (Arnold 1997). In a federated, decentralized structure, the Managing Director of a PolyGram Australia, or PolyGram Austria, is paid to be highly opportunistic, aggressively seeking revenue from every avenue. The operating company, not the label, was largely responsible for putting up the marketing investment required to support a recording (Arnold 1997). PolyGram labels such as Decca competed in this internal market for attention and marketing support from operating companies, and operating companies had the freedom to choose which products they would support (Arnold 1997). If catalog initiatives will generate income (e.g., 3T1), the fact that they may cannibalize sales of a new product (3T3) may not unduly concern them if they are not bearing the multi-million dollar risk on that new product. Thus while the interests of the label and the operating company overlap, they are not completely aligned.

There is an inherent tension in a federated, decentralized organization such as PolyGram between the advantages of centralization and the advantages of decentralization. Decentralization allows the organization to make quick, entrepreneurial decisions anchored in the reality of local marketplace conditions and local consumer tastes. Centralization allows all these disparate nation states to unite around key, international marketing priorities. Centralized control was never strong in PolyGram, with notorious historical lapses such as Casablanca in Los Angeles where control was almost completely lost, resulting in enormous damage (Bakker 2006). (Representatives from the head office in the Netherlands went "native," joining in the disco label's festivities which included a secretary in their offices on Sunset Boulevard walking around each day taking the cocaine orders (Dannen 1991). It should be noted in passing that the record industry's 'colorful' U.S. history has probably not endeared it to U.S. regulators).

In such a decentralized environment, prioritization can be a hotly contested issue, and there could be frustration in the label when operating companies pursued local priorities in preference to the label's (Arnold 1997). 3T3 was an international marketing priority. It was in Decca's interests to have maximum focus on the new recording for the specific

period surrounding its launch. As in the movie industry, initial chart positions can be enormously influential in determining the sales trajectory and profitability of a project. Decca sought to focus attention on 3T3, to make it a priority in the midst of all the *internal* clutter, so that the new release had the best chance of success.

The Initial Decision in the case refers to this testimony (at point 83), that PolyGram's management was "concerned about the activities of PolyGram's own operating companies, and wanted to be sure that they did not promote 3T1 in a way that would divert sales from 3T3" (FTC 2002, 14). The initial concern was *internal* competition. In this case, the moratorium was being used by Decca as an instrument of control, an instrument to force internal prioritization and focus on the operating companies. The fact that the company was involved in a JV with a competitor only served to complicate the situation. If an operating company is asked to curtail promotion of a product (3T1), and it understands that the JV partner has a product that could act as an equal substitute (3T2), it is natural that it will ask whether the JV partner will also be complying with the plan. This is what occurred, and is what led to the moratorium agreement.

The judge's dismissal of consumer confusion possibly arising through multiple versions is interesting, as discussion of multiple versions and consumers being "overwhelmed by choice" was highly topical at the time (Arnold 1997). At the time of the case "a well-stocked record store might carry as many as eighty recordings of a major work such as Beethoven's fifth symphony. Deutsche Grammophon carried thirteen recordings of this work in its 1996 catalog, the Decca catalog offered ten recordings of this work, and the Philips catalog carried eight" (Arnold 1997, 12). This was perceived as a problem, inhibiting purchase through confusion (Arnold 1997). Thus a marketing impulse to simplify a consumer proposition may look to an antitrust regulator as an attempt to curtail consumer choice.

What Can Managers in Music Organizations Learn?

What can music and entertainment managers learn from the case? In terms of practical implications for managers, three recommendations are proposed:

1. Greater care in anticipating issues at the outset of the venture;
2. Greater care in structuring; and
3. A recognition that antitrust law is too confusing and uncertain for general managers to attempt to navigate without highly spe-

cialized legal assistance.

Anticipate Issues at the Outset of the Venture

It would have helped PolyGram's defense considerably if it had been able to anticipate some of the issues that arose, and had introduced them into the JV agreement from the outset. What sorts of opportunistic behavior might arise (Kolasky and Elliott 2004, 54)? How will the JV partners interact once the venture is launched (Meyer and Ludwin 2005, 70)?

Exercise Greater Care in Joint Venture Legal Structuring

PolyGram's case would have been considerably strengthened had 3T1 and 3T2 been placed into the JV. The problematic nature of the fact that 3T1 and 3T2 were outside the JV was reiterated in the 2005 D.C. Circuit decision (Meyer and Ludwin 2005). This would presumably have complicated the deal, but had 3T1 and 3T2 been integrated into the JV, pricing and promotional conversations relating to those catalog albums would have been conversations about joint property, that the venture owned and legally controlled, not catalog assets owned by individual organizations. Creativity can be brought to bear in terms of examining every option, for example, "existing products might be wrapped into the venture but subject to a separate set of cost- and revenue-sharing formulae. Or they may be included for some purposes—sales and marketing, perhaps, so as to bring within the venture those functions that might bear most directly on the venture's success—but not others" (Meyer and Ludwin 2005, 70).

To make this point more emphatically, Figure 1 depicts the relationship that existed, with the catalog albums outside the JV. Figure 2 depicts the relationship that would have provided better protection.

Get Help — It's Too Hard

If there is one thing that should be clear from this short history and analysis, it's that the Three Tenors rulings resulted in "confusion" (Verschelden 2007, 465) and "uncertainty" (Meyer and Ludwin 2005, 63). The Three Tenors case was approached by the FTC as an opportunity to clarify certain aspects of the application of antitrust law to joint venture agreements (McChesney 2004). If this was an aspiration, from a managerial point of view it was a comprehensive failure, and the resulting confusion has made it more likely that managers will appear before the FTC. It is understood that healthy debate and dissenting opinions are important to

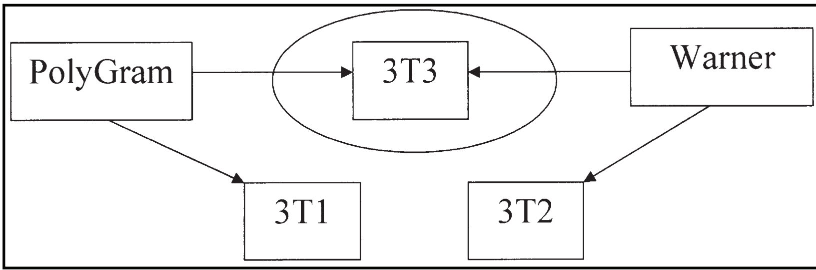

Figure 1. 3T1 and 3T2 excluded from the JV agreement.

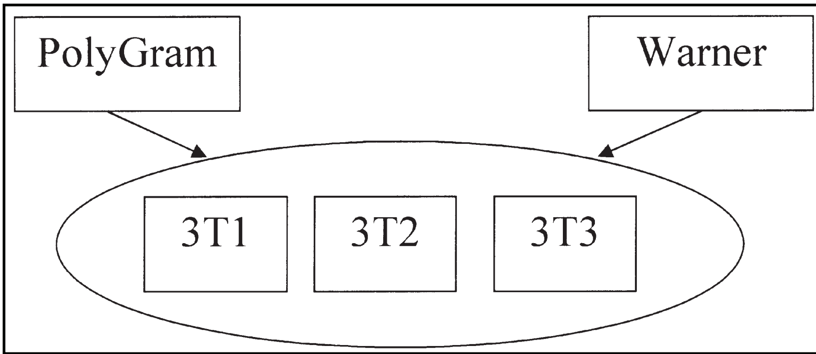

Figure 2. All albums explicitly included in the JV agreement.

evolving the law, but the degree of controversy surrounding this case has done nothing to inspire managerial confidence that clear guidelines exist on how one should proceed. If law professors whose specialization is antitrust law can profess incredulity at FTC decisions, what hope is there for the average general manager? It is interesting that PolyGram and Warner had lawyers involved in JV meetings and deliberations, yet this did not prevent the partnership falling foul of the FTC. The author has presented the facts of this case as a cautionary tale to business students in Australia and Switzerland (in the context of marketing ethics and music business courses) and has often received the comment from students that the ruling appeared counterintuitive. This accords with Kolasky and Elliott's comment that the FTC ruling shows what happens when "theory gets in the way of common sense" (2004, 50). Therefore it is important that general

managers do not simply employ common sense and their own intuition in crafting agreements!

Another point that should be made, given the extensive coverage of murder trials in television dramas, is that music managers may come to an antitrust matter with the expectation that managerial *intention* will represent a key part of the trial and the defense. They may imagine themselves saying, "At no time did I intend to harm the interests of the American consumer, Your Honor." One quickly discovers however that, "Modern antitrust law is steeped in microeconomics, and suits rely heavily on economic expert witnesses. Indeed, expert testimony is often the 'whole game' in an antitrust dispute because experts testify about dispositive issues such as the competitive effect of a business practice or the relevant boundaries of a market" (Haw 2012, 1261).

Conclusion

This paper has summarized the background to the trial, the legal rulings, the published criticism of the rulings, and attempted to summarize what can be learned from it all, not for a legal audience, but an audience of music managers. The key learnings are to:

1. Anticipate issues at the outset of the venture;
2. Exercise greater care in structuring; and
3. Recognize that antitrust law is too confusing and uncertain for general managers to attempt to navigate without highly specialized legal assistance.

The degree to which contemporary major record companies have become more centralized is the degree to which measures like a moratorium will become less necessary in enforcing marketing prioritization. That said, the case is still highly relevant given the consolidation of major record company ownership, and the fluid, dynamic nature of the contemporary music industry. The creation of deals and partnerships will continue, and history that isn't understood will be repeated.

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