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, in which the Commission held that an agreement between two joint venture partners not to advertise or discount two directly competitive products for a ten-week period around the launch of a new joint venture product violated the antitrust laws without any showing that the restraint harmed anyone other than the two partners themselves. The Commission reached this remarkable result apparently because it viewed the case as a good vehicle for resuscitating the *Massachusetts Board of Optometry* framework for applying a truncated rule of reason to restraints the Commission deems “inherently suspect.”

In this article, we argue 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. We show that the Commission’s error has its roots in the *Massachusetts Board* formulation itself, which invites subjective judgments about which restraints are “inherently suspect.” The Commission would do better to apply the straightforward three-step structured rule of reason analysis the lower courts have evolved over the last twenty-five years, which the Supreme Court implicitly endorsed in *California Dental Association v. FTC*, and which the Second Circuit applied recently in *United States v. Visa*.

**The FTC Decision**

In the 1990s, the Three Tenors—José Carreras, Placido Domingo, and Luciano Pavarotti—released audio and video recordings from concerts at three World Cup soccer events. PolyGram distributed the recordings from the first Three Tenors concert (3T1), held at the 1990 World Cup in Rome. Warner distributed the recordings from the second concert (3T2), held at the 1994 World Cup in Los Angeles. Both were highly successful, although the second less so than the first.

In late 1997, PolyGram and Warner formed a joint venture to distribute the recordings from the third concert (3T3), to be held at the 1998 World Cup in Paris. Warner had initially considered distributing the recordings for 3T3 by itself, but ultimately decided that another Three Tenors recording was too risky an investment for Warner to undertake on its own. PolyGram thereafter proposed that the two companies distribute 3T3 as a joint venture, with Warner as the exclusive distributor in the United States and PolyGram the exclusive distributor outside the United States. The resulting agreement provided that the two companies would share profits and losses 50/50 from 3T3 (as well as from the production of a Greatest hits album and/or a Box Set incorporating the 1990, 1994, and 1998 Three Tenors albums), and that neither party would produce another Three Tenors CD for at least four years.

In March 1998, in order to encourage each company to put all of its Three Tenors promotional resources and efforts into 3T3 around the time of its launch, Warner and PolyGram agreed not to advertise or discount the two earlier Three Tenor CDs during a ten-week period surrounding the launch (“moratorium agreement”).

The FTC held that this moratorium agreement violated Section 5 of the FTC Act. Using the case as a vehicle for resuscitating the *Massachusetts Board of Optometry* analytical framework for a truncated rule of reason, which it had developed when the current chairman, Timothy Muris, was Director of the Bureau of Competition, the FTC concluded: (1) the moratorium restraints were “inherently suspect”; and (2) the proffered justification—to avoid free-riding by 3T1 and 3T2 that could undermine promotion of 3T3—was “not cognizable under the antitrust laws.” The Commission based the first conclusion on the admitted fact that the restraint eliminated price competition between 3T3 and its two closest substitutes for the period of the moratorium. It
reached the second conclusion on the ground that the restraint was not “ancillary” to the joint venture because it restrained products outside the joint venture and was entered into after the venture was formed, so it could not have been necessary to the venture. Applying this framework, the Commission effectively condemned the restraints as virtually per se illegal. The Commission went on, however, in the last section of its decision to perform a “more detailed factual analysis” in an effort to further justify its conclusion.

An Overly Narrow View of Covenants Not to Compete
The Commission’s most fundamental error in *Three Tenors* was its treatment of a narrowly tailored covenant not to compete between two partners to an admittedly lawful joint venture as “inherently suspect” under the antitrust laws and therefore unlawful in an absence of proof that the restraint was reasonably necessary to the very existence of the joint venture. This holding, reached without any inquiry into whether the parties had market power and without any inquiry into whether the restraint harmed consumer welfare in any meaningful way, runs counter to the general antitrust treatment of covenants not to compete. Courts generally regard agreements by partners in a legitimate common enterprise not to compete with the partnership as lawful, so long as their scope and duration are reasonable and the parties do not have market power. None of the arguments proffered by the Commission for treating this restraint differently can withstand scrutiny.

Traditional Treatment of Covenants Not to Compete
The seminal and still controlling antitrust case dealing with covenants not to compete between partners in a common enterprise under the antitrust laws is *Addyston Pipe* from 1898. In that case, Judge (later Chief Justice) Taft undertook a detailed review of the common law of covenants not to compete to determine how they should be treated under the antitrust laws. From this review, he identified five common types of covenants not to compete that the courts had held should be enforced because they promoted trade:
- Covenants by sellers not to compete with the buyer;
- Covenants by partners not to engage in the same business outside the partnership;
- Covenants by partners upon dissolution of their partnership not to compete with each other;
- Covenants by buyers of property not to use it to compete with the seller; and
- Covenants by employees not to compete with their employer following termination.

Significantly, every one of these types of covenant, in some sense, constrains conduct “outside” the partnership or transaction at issue and at least one (third bullet above) is typically entered not when the venture is formed but rather when it is dissolved.

From these cases, Judge Taft derived the general principle that an agreement not to compete may be lawful so long as the restraint is “merely ancillary to the main purpose of a lawful contract, and necessary to protect the covenantee in the full enjoyment of the legitimate fruits of the contract, or to protect him from the dangers of an unjust use of those fruits by the other party.” In other words, such covenants serve as ties that bind the partners, to borrow Donizetti’s phrase, *qual due fiori a un solo stello* (like two flowers on a single stem).

Applying this basic principle, both federal and state courts generally have upheld covenants not to compete between partners to a common enterprise, so long as two conditions are met: (1) the partnership itself is lawful; and (2) the covenant is reasonable in duration and scope, given the subject matter of the common enterprise. The first condition generally requires a two-pronged inquiry. Courts first examine whether the partnership involves a bona fide integration of productive assets and is not simply a sham to hide naked price fixing or market allocation. If the partnership meets this test, the courts then examine, under Clayton Act Section 7 standards, whether the formation of the partnership will give the parties the power, either unilaterally or in coordination with the remaining firms in the market, to raise price or restrict output—that is, whether the partnership will have market power.

In taking this approach, the courts seem generally to accept that an agreement by each partner not to compete with the venture—for example, by producing a directly competitive product outside the venture—is a natural consequence of the venture. As the Supreme Court explained in *Penn Olin*, in assessing under Section 7 the formation of a joint venture that eliminated potential competition between the two partners: “the parents would not be expected to compete with their progeny.” Far from being “inherently suspect,” covenants by partners to a common enterprise not
to compete with the venture are therefore viewed as a natural consequence of the venture that serve to promote socially productive cooperation by helping to reduce the risk of opportunistic behavior, thereby protecting each partner’s investment in the venture. Where the parties to a joint venture lack market power, such covenants are lawful, so long as they are no broader than necessary to protect the parties’ investment in their common enterprise.

**Application to Three Tenors**

Had the Commission applied this well-established line of cases, it is hard to see how it could have found the *Three Tenors* covenant unlawful. First, the main purpose of the arrangement between Warner and PolyGram appears entirely lawful—to share the cost and risk associated with marketing a new Three Tenors recording—and involved a legitimate integration of productive assets. The Commission never suggested otherwise.

Second, there was no showing that PolyGram’s and Warner’s Three Tenor recordings had any significant market power. In differentiated product markets, every product may enjoy a small measure of localized market power; however, no one could seriously suggest that in a world with hundreds, if not thousands, of opera titles, the three Three Tenors CDs had sufficient market power to raise any serious antitrust concern.

Third, the ten-week moratorium appears on its face to have been designed for the legitimate purpose of preventing opportunistic behavior by the partners themselves and thereby protecting their investment in this new recording. The Administrative Law Judge found that each party feared that the other would misuse the joint promotion of 3T3 to divert sales to their preexisting products. The ALJ also found that because the repertory of the third concert overlapped that of the earlier concerts more than they had expected, Warner and PolyGram feared that such opportunistic behavior would divert so many sales from 3T3 that “they would not recoup their $18 million investment” in it. As *Addyston Pipe* shows, the Commission was simply wrong that a desire by the partners to a common enterprise to protect themselves from opportunistic behavior in order to protect their investment is not a cognizable justification for a covenant not to compete, even when entered into after the partnership is formed.

Fourth, it is hard to see how the covenant not to compete could have been any more narrowly tailored to achieve its stated objective. The moratorium was limited to the two prior Three Tenors recordings and did not extend to any of the thousands of other titles in the two companies’ libraries. And it was limited in duration to just ten weeks around the release of 3T3. Ironically, the Commission did not object to another, significantly broader covenant not to compete in the joint venture agreement, one that prevented either party from producing another Three Tenor CD for at least four years.

In finding the moratorium unlawful, the Commission relied on two key arguments: First, that any agreement between rivals as to price and advertising is inherently suspect; Second, that the efficiency justification advanced by the parties—the need to prevent free riding, which is just another name for opportunistic behavior—was not “cognizable” as a matter of law under the antitrust law. The Commission offered four reasons for this latter conclusion:

- The moratorium was entered after the joint venture was formed and so was not necessary to the venture;
- The restraint applied to products “outside” the joint venture;
- The restraint eliminated interbrand, rather than just intra-brand, competition, because “one entity did not legally control all Three Tenors products;”
- There was no showing that Warner and PolyGram spent more on promoting 3T3 with the moratorium than they would have without it.

We have already shown in discussing the traditional treatment of covenants not to compete that the first basis for the Commission’s decision—that covenants not to compete between joint venture partners are “inherently suspect”—is contrary to well-established law. The second conclusion warrants more scrutiny. As we will see, the fundamental problem with the Commission’s analysis of the efficiency justifications proffered by the parties for the moratorium is that the Commission focused on efficiencies from an *ex post*, rather than an *ex ante*, perspective. As Judge Taft intuited, the willingness of parties to enter into risky joint undertakings depends importantly on their ability to protect themselves from opportunistic behavior by their other partners that might prevent them from recouping their investment. And that is why courts generally permit covenants by partners not to compete with the partnership within the field in which it operates even when they are entered into after the partnership is formed—because the freedom to impose restraints *ex post* can affect importantly the ex ante willingness of parties to enter into risky joint ventures. This explains why it is not unlawful for a partner leaving a partnership to agree not to compete with the partnership for some period of time. Keeping this general principle in mind, we can better examine each of the Commission’s four rationales for rejecting the parties’ efficiency claims.

**Entered After the Venture Was Formed.** As Coase and Williamson taught, it is very difficult to draft complete contracts at the time a joint venture is formed. It is essential, therefore, that parties to joint ventures have freedom to alter terms of contact as they learn more about their joint product, market conditions, and each other. Not surprisingly, it is very common for partnerships to adopt additional restraints after the partnership is first formed. Many law firms, for example, have amended their partnership agreements to prohibit retired partners from continuing to receive retirement payments if they join a competing firm within a certain radius of any of their offices.
Given the difficulty of drafting complete contracts, parties would be far less likely to form joint ventures if they did not have the freedom to later adjust the terms of their agreement to assure that each partner did not behave opportunistically. In this case, the parties concluded a few months after the initial joint venture agreement that 3T3 would be a sufficiently weak product that they needed to take additional steps to prevent sales around the crucial launch period being diverted to the parties' pre-existing Three Tenors products. Denying parties the flexibility to take steps like this after the venture is first formed would force parties to similar joint ventures in the future either to try to negotiate a more costly and comprehensive (and likely more restrictive) agreement from the outset or to forgo such ventures entirely. Given the difficulties of writing complete contracts at the outset of a joint venture, such a rule will serve only to increase transaction costs and deter efficient joint ventures.

**“Outside” the Venture.** The Commission's characterization of the moratorium as affecting products “outside” the venture is equally unhelpful. Partnership agreements often restrain the conduct of partners “outside” the venture—for example, preventing them from competing with the partnership for some period of time after they leave it. (Indeed, in the initial joint venture agreement here, PolyGram and Warner convenanted not to release another Three Tenors recording for at least four years.) For this reason, courts have traditionally focused instead on whether the restraint reaches too broadly. Here, had Warner and PolyGram agreed not to discount or advertise their entire opera repertory or to have continued the moratorium for several months, it would have been understandable for the Commission to have found the restraint broader than necessary to achieve its stated purpose. What this illustrates is that the “outside/inside” distinction is too blunt an instrument and that these cases require judgments of degree.

**Interbrand vs. Intrabrand Competition.** The third reason the Commission gave for refusing to accept the parties’ free-rider argument was that the Three Tenors could not be viewed as a single brand because no one entity owned it and therefore the moratorium restrained interbrand, not intrabrand, competition. This, again, is wholly a formalistic distinction with little, if any, economic substance. “Three Tenors” is, without question, a brand, and it is a brand that could exist only through Warner and PolyGram cross licensing to one another the exclusive rights they had to works by the three artists. Warner and PolyGram, therefore, shared the brand, even though each one had rights to distribute some Three Tenor products independently. Using the moratorium to limit this intrabrand competition may well have served to promote interbrand competition with other opera recordings, even from an ex post perspective. This would occur because a successful launch for 3T3 would help it gain the attention it needed in order to compete effectively with other similar recordings. And from an ex ante perspective, allowing parties to a joint venture freedom to adjust the terms of their agreement in the manner Warner and PolyGram did here, so as not to cannibalize the sales of their joint venture product and thereby protect their investment, promotes interbrand competition. It makes such collaborations—without which the jointly created product might not be brought to market at all—less risky.

**Did Not Increase Promotional Spending on 3T3.** The Commission's final reason for rejecting the parties' free-rider argument was that the parties failed to show that they spent more promoting 3T3 with the moratorium than they would have without it. This reasoning overlooks the basic economic concept of opportunity cost. By agreeing not to advertise and discount the earlier 3T1 and 3T2 releases during the launch of 3T3, Warner and PolyGram effectively agreed to forgo the incremental revenue each could have earned through such opportunistic behavior. This forgone revenue was, itself, a promotional expense and, might, at the time, even have been viewed as one of the most effective promotional expenditures for 3T3 the parties could have made. Diverting sales from 3T3 to the earlier releases during the critical launch period would have reduced its ratings on the all important music charts (a high rating on which can be critical in generating additional sales). Even with the moratorium, 3T3 bombed, but that does not entitle the Commission to second-guess the wisdom of that expenditure. The market punished Warner and PolyGram; there was no need for the Commission to pile on.

**Problems with the Massachusetts Board of Optometry Framework**

As noted at the outset, the FTC apparently selected the *Three Tenors* case as a vehicle to resurrect the *Massachusetts Board of Optometry* framework for truncating the rule of reason in appropriate cases. As synthesized in Chairman Muris's *Three Tenors* opinion, that framework involves three basic steps. It asks, first, whether the restraint is “inherently suspect.” If it is, the burden shifts to the parties to proffer a justification that is both “cognizable under the antitrust laws” and “facially plausible.” Finally, if such a justification is proffered, a full rule of reason analysis may still be avoided if the plaintiff can make “a more detailed showing that the restraints at issue are indeed likely, in the particular context, to harm competition.” (Just how this last determination can be made without a rule of reason analysis is left unexplained.)

The Commission's reliance on *Mass. Board of Optometry* revives the debate over the proper analytical framework for applying
the rule of reason that was featured in this magazine in a Point/Counterpoint exchange between one of the authors and the then-head of the Antitrust Division of the Department of Justice, Joel Klein. There, we debated whether the agencies could require the parties to an alleged restraint to justify a restraint before the agencies proved that the restraint harmed or was likely to harm competition in a way that would harm consumer welfare by raising price or restricting output. We had thought this debate was decisively resolved by the Supreme Court in California Dental, but current and former FTC officials continue to wage a rearguard action, seeking to limit that decision’s analytical framework to the professional advertising context in which it arose. California Dental will bear no such limitation. In it, the Supreme Court held that so long as the defendant proffers a “plausible” efficiency justification for a restraint, the plaintiff must show with empirical evidence that the restraint is anticompetitive before the burden shifts to the defendant to prove the justification for it. The Supreme Court’s approach in California Dental is consistent with the standard three-step rule of reason framework the lower courts now use in virtually all rule of reason cases, including, most recently, the Second Circuit’s decision in United States v. Visa. Under this standard framework, the first step is to inquire whether the parties to the alleged restraint have market power and, if so, whether the restraint is likely to injure competition in a way that will lead to a sustainable increase in prices or restriction of output. If, and only if, the plaintiff meets this initial burden do the defendants have to prove that the restraint was designed to achieve efficiencies that would enable them to compete more effectively, thereby lowering price and expanding output. And, finally, if the defendants make such a showing, the plaintiff has an opportunity to show that the restraint was not reasonably necessary to achieve the alleged legitimate objectives.

By seeking to use a subjective label (“inherently suspect”) as a substitute for empirical evidence of market power and harm to competition, the Massachusetts Board framework runs a great risk of leading agencies and courts to commit the kind of Type I (false positive) error the Commission committed in Three Tenors. Nothing in the Supreme Court’s decisions in BMI, NCAA, or California Dental sanctions such an approach. The ease with which lower courts now apply the traditional three-step rule of reason framework shows that whatever gain in administrability the authors of Massachusetts Board hoped to achieve can no longer justify the increased risk of error.

For this reason, we continue to believe that the framework used by the lower courts and endorsed by the Supreme Court in California Dental is the better way to analyze horizontal restraints. The ease with which that test can be applied in practice is illustrated by the Second Circuit’s decision in United States v. Visa. In that case, the district court found, and the Second Circuit affirmed, that the relevant market in which Visa and MasterCard competed was the market for “network services,” in which the card issuers were the customers. The court further found that Visa and MasterCard, with a combined market share of 73 percent, had market power, a finding confirmed by testimony from merchants that they could not refuse to accept MasterCard and Visa even if faced with significant price increases. The court next found that both price competition and innovation were harmed by Visa and MasterCard by-laws that excluded American Express and Discover from the market by prohibiting MasterCard and Visa issuers from issuing any other card. Finally, the court found the defendants’ proffered justification for the restraint—that it serve to promote “cohesion” with the MasterCard and Visa networks—pretextual because there was no evidence that the defendants’ networks were any less cohesive overseas where, in the absence of exclusionary rules, Visa and MasterCard member banks also issue American Express cards. The simplicity of that analysis, leading to the right result, stands in marked contrast to the convoluted, and ultimately incorrect, reasoning of the Commission’s Three Tenors decision.

Where Do We Go from Here?
The flippant answer is, of course, to the court of appeals. But unless and until the court of appeals reverses the Commission, antitrust lawyers will have to counsel their clients in light of the Commission’s decision. Fortunately, the decision leaves ample room for careful antitrust counselors and their clients to avoid the trap into which PolyGram and Warner stumbled. The most obvious is to counsel clients to identify as many possible forms of opportunistic behavior as possible at the time the joint venture is formed, and include any restraints needed to deter such conduct in the initial agreement. If additional restraints are needed later, care should be taken to document the reasons the restraints are necessary to the continued success of the venture.

Unfortunately, this advice is easier to give than to follow. The Commission’s decision is potentially very far reaching and could call into question many common, garden variety covenants not to compete of the kind that are an everyday occurrence in our economy. For example, as case 10 in the DOJ/FTC Competitor Collaboration Guidelines illustrates, it is not uncommon for companies forming a joint venture to create a new product to agree not to create a directly competing product on their own, or even that they will stop selling a preexisting product in the same product space. So long as they do not have market power, the commentary indicates that such covenants are not necessarily unlawful if they serve to help justify investment in the new product, and if introduction of the new product has the potential to increase competition by replacing weak products with one strong product. The same treatment should apply whether the restraint is entered when the venture is first formed or later when the parties recognize the need for it. The antitrust laws ought not require omniscience.
1 Donizetti, Lucrezia Borgia, Act II. In the opera, Orsini and Gennaro sing of the ties that bind two brothers "qual due fiori un solo stello"—like two flowers on a single stem.


3 Massachusetts Bd. of Registration in Optometry, 110 F.T.C. 549 (1988).


5 344 F.3d 229 (2d Cir. 2003).


7 The FTC acknowledged that "[a]rguably, this conclusion could be characterized as a finding of 'per se' illegality." PolyGram Opinion, supra note 2, at 49. Such a result is at odds with the Supreme Court's well established principle that "the per se rule is only appropriate in the case of a naked [restraint] of trade with no purpose except stifling of competition." See Broadcast Music, Inc. v. CBS, 441 U.S. 1, 20 (1979) (citing White Motor Co. v. United States, 372 U.S. 253, 263 (1963)).

8 The "more detailed factual analysis" includes no discussion of market definition, market share, market power, entry barriers, or any of the other hallmarks of a normal rule of reason analysis. Further, proof of actual anti-competitive harm would require a proper analysis of the extent to which consumers, even if briefly faced with higher 3T1 and 3T2 prices under the moratorium, may switch to other products or postpone purchases.


10 Id. at 281.

11 Id. at 282.

12 Donizetti, Lucrezia Borgia, Act II.

13 See generally ABA SECTION OF ANTITRUST LAW, ANTITRUST LAW DEVELOPMENTS 128–29 (5th ed. 2002) [hereinafter ALD 5].

14 This has been true since Addyston Pipe, 85 F. at 282–83 ("[W]here the sole object of both parties in making the contract . . . is merely to restrain competition, and enhance or maintain prices, it would seem there is nothing to justify or excuse the restraint.").

15 Whether or not the market power inquiry is explicitly framed in these terms, it is clear that a proper rule of reason market analysis is mandated. See, e.g., National Soc’y of Prof’l Eng’rs v. United States, 435 U.S. 679, 689 (1978) ("[T]he Rule of Reason . . . has been regarded as a standard for testing the enforceability of covenants in restrain of trade which are ancillary to legitimate transactions").


17 See Addyston Pipe, 85 F. at 280 ("[W]hen two men became partners in a business, although their union might reduce competition, this effect was only an incident to the main purpose of a union of their capital, enterprise, and energy to carry on a successful business, and one useful to the community. Restrictions in the articles of partnership upon the business activity of the members, with a view of securing their entire effort in the common enterprise, were, of course, only ancillary to the main end of the union, and were to be encouraged.").


20 PolyGram Opinion, supra note 2, at 8.

21 Similarly, in Polk Bros., Inc. v. Forest City Enterprises, Inc., 776 F.2d 185, 190 (7th Cir. 1985), the court recognized that concern about free riding on promotional efforts was a plausible justification for an agreement by two otherwise competing stores not to sell competing products in a joint venture shopping center.

22 Judge Taft’s intuition is supported by the subsequent work of Ronald Coase and Oliver Williamson, among others, in explaining why it is difficult to control opportunistic behavior through other means because of the transaction costs associated with writing complete contracts that anticipate every possible way in which such behavior might occur. See generally Ronald Coase, The Nature of the Firm, in THE FIRM, THE MARKET, AND THE LAW (1988); OLIVER WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM (1985); Howard Chang, David Evans & Richard Schmalensee, Some Economic Principles for Guiding Antitrust Policy Towards Joint Ventures, 1998 COLUM. BUS. L. REV. 223 (1998).

23 See, e.g., Addyston Pipe, 85 F. at 281.

24 See Coase, supra note 22; Williamson, supra note 22; Chang et al., supra note 22, at 239–40.

25 PolyGram Opinion, supra note 2, at 8.


28 See California Dental Ass’n, 526 U.S. at 780 (citing Kolasky, supra note 27, favorably; with a but see citation to Klein, supra note 27).


30 526 U.S. 774–75 n.12.

31 344 F.3d 229 (2d Cir. 2003).

32 In some cases, ‘proof of actual detrimental effects, such as a reduction in output,’ can obviate the need for an inquiry into market power, which is a ‘surrogate for detrimental effects.’” See FTC v. Indiana Federation of Dentists, 476 U.S. 447, 460–61 (1986) (citing 7 PHILLIP AREEDA, ANTITRUST LAW ¶ 1511, at 429 (1986)).

33 Although ordered differently, the traditional antitrust analysis of covenants not to compete ancillary to a partnership (as set out earlier in this article) addresses these same fundamental issues—notably, whether there is market power, whether the partnership is a legitimate integrative venture, and whether the restraints are reasonably necessary to further the venture.


36 344 F.3d 229 (2d Cir. 2003).