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ANTITRUST LAW: FTC OVERDUBS MERGER BY RECORDING GIANTS

Recently, the Federal Trade Commission ("FTC") tried to break into the recording industry. Though none of its songs reached the charts, it hit the industry with a bang. Federal Trade Commission v. Warner Communications, Inc.\(^1\) is the result of a potential record company merger that would have drastically affected the entertainment industry.

The Ninth Circuit in Warner exercised judicial reasoning and analyzed all the elements necessary for an appellate court to reverse a lower court decision. Many of the issues presented to the district court in this case were discretionary. Appellate courts do not often overrule discretionary lower court rulings. But, where a clear-cut abuse of process occurs, courts of appeal are stringent in their analysis of the case. The opinion in this case is emitted from a *per curiam* order containing all the ingredients for a textbook lesson in judicial reasoning on antitrust law in the entertainment industry.

Warner Communications, Inc., ("WCI") is a diversified communications company operating three record labels and distributing prerecorded music\(^2\) in the United States and abroad. In 1983, WCI was the second largest distributor of prerecorded music in the United States. Polygram Records, Inc. ("Polygram") operates classical and popular record labels and distributes prerecorded music in the United States and abroad. In 1983, Polygram was the sixth largest distributor of prerecorded music in the United States. These two recording companies proposed to merge their distribution operations in 1983 through a joint venture.\(^3\)

Upon discovering that WCI and Polygram intended to merge and

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1. 742 F.2d 1156 (9th Cir. 1984).
2. "Prerecorded music" as defined by the court is a "ready-to-play product, sold in an attractive package which often includes artwork and linear notes." Prerecorded music includes "all recorded sound performances sold to consumers in the form of singles, long playing albums, cassettes, tapes, eight-track cartridges and compact disks." *Id.* at 1163.
3. *Id.* at 1159. A joint venture is "an undertaking by two or more persons jointly to carry on a single business enterprise for profit, an enterprise in which they have a community of interest. Usually, both a sharing of profits and of losses is involved." Franco Western Oil Co. v. Fariss, 259 Cal. App. 2d 325, 344, 66 Cal. Rptr. 458, 472 (1968). See also 6 B. Witkin, SUMMARY OF CAL. LAW, Partnership § 16, p. 4267.
create a joint venture in their distribution operations, the FTC filed an action in federal district court in California. The complaint sought a preliminary injunction of the proposed merger under section 13(b) of the Federal Trade Commission Act. The FTC alleged that the proposed joint venture would violate section 7 of the Clayton Act and section 5 of the Federal Trade Commission Act.

During discovery, the district court ordered the FTC to produce two memoranda prepared by members of the FTC's Bureau of Economics. The district court then denied the FTC's motion for preliminary injunction. Two days later, the FTC filed an Emergency Motion for Injunction Pending Appeal, which the court of appeals granted.

The appellate court was faced with two issues. The first was whether the lower court abused its discretion in denying the FTC's motion for preliminary injunction preventing WCI and Polygram from merging. If the court found an abuse of discretion, it would then need to resolve the second issue of whether the court should grant a preliminary injunction. In its final determination, the court reversed the lower court holding and granted a preliminary injunction prohibiting the merger.

A denial of a preliminary injunction will be reversed if the district court abused its discretion or used an erroneous legal premise. The FTC claimed that WCI and Polygram would violate the Clayton Act if they were allowed to merge. The purpose of the Clayton Act is to arrest

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4. Unpublished opinion. For a brief discussion of the lower court opinion, see 1984-1 Trade Cas. (CCH) ¶ 66,025.

5. 15 U.S.C.A. § 53(b) (West Supp. 1985). "Whenever the Commission has reason to believe . . . that any . . . corporation is violating or is about to violate, any provision of law enforced by the Federal Trade Commission . . . the Commission . . . may bring suit in a district court of the United States to enjoin any such act or practice. Upon a proper showing that, weighing the equities and considering the Commission's likelihood of success, such an action would be in the public interest, [the injunction may be granted]."

6. 15 U.S.C.A. § 18 (West Supp. 1985). "No person [corporation] . . . shall acquire, directly or indirectly, the whole or any part of the stock or other share capital . . . or any part of the assets of another person [corporation] engaged also in commerce [where the effect of such acquisition] may be substantially to lessen competition, or to tend to create a monopoly."

7. 15 U.S.C.A. § 45(1) (West Supp. 1985). "Unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce, are declared unlawful."

8. Warner, 742 F.2d at 1159. The memoranda, containing analyses of the proposed joint venture, recommended that the FTC terminate its investigation of the joint venture because it was unlikely the FTC would ultimately succeed on the merits. The lower court improperly relied on the two memoranda in denying the preliminary injunction. 1984-1 Trade Cas. (CCH) ¶ 66,025. See infra note 28.

9. Id.

10. American Motorcyclist Ass'n v. Watt, 714 F.2d 962, 965 (9th Cir. 1983).
anticipated anticompetitive effects in their incipiency. Some courts have characterized the purpose as nipping monopoly in the bud.

The lower court in *Warner* denied the preliminary injunction. In its conclusions of law, the lower court mentioned the term "collusion" in seven out of the eighteen stated conclusions. "Collusion is [a] secret combination, conspiracy, or concert of action between two or more persons for fraudulent or deceitful purpose[s]." The court interpreted the lower court's use of the term collusion to define a standard of law applicable to violations of section 1 of the Sherman Act. The FTC, on the other hand, alleged that section 7 of the Clayton Act had been violated. The difference between section 7 and section 1 is crucial to the analysis and to the outcome of the case. The standard for Clayton Act violations prohibits mergers whose effect "may be substantially to lessen competition, or to tend to create a monopoly." The term "may be" defines a much lighter burden than a showing of collusion required for a section 1 violation of the Sherman Act, which was applied by the lower court.

Many courts have reviewed the Clayton Act standard. It is well established in case law that a section 7 violation is proven upon a showing of reasonable probability of anticompetitive effects. This well-established standard should have been easy for the lower court to apply. However, the lower court required the FTC to show collusion before it would grant a preliminary injunction. Since collusion is the standard applied for section 1 violations of the Sherman Act, the FTC was held to a higher burden of proof than that which should have been applied to it based on its allegations in the complaint. The Ninth Circuit could only conclude that the lower court applied an incorrect legal standard.

The court then focused on a procedural error by the lower court. The lower court ordered the FTC to produce the two memoranda containing statistical analysis of market structures and effects on competition which were prepared by members of the Bureau of Economics. Although the memoranda were directly on point with the issues

presented to the court, the FTC contended that the memoranda were protected from disclosure under the government's deliberative process privilege.\textsuperscript{17}

A brief discussion of the FTC and its functions with respect to corporations and preventing monopolistic control will aid the analysis of the deliberative process privilege claimed by the FTC. The Federal Trade Commission, through section 6 of the Federal Trade Commission Act, has federal power to gather and compile information concerning, and to investigate any person or firm whose business affects, commerce.\textsuperscript{18} The FTC often gives advisory opinions to corporations or other businesses on proposed mergers and acquisitions.\textsuperscript{19}

In 1966, Congress enacted the Freedom of Information Act.\textsuperscript{20} The purpose of the Act was to ensure that government agencies would make available to the public a broad spectrum of information.\textsuperscript{21} Recognizing the need for qualifications, Congress specified several exemptions to the dissemination of government agencies' information. One such exemption is section 552(b)(5),\textsuperscript{22} known today as the governmental deliberative process privilege. The FTC asserted this privilege.

Courts have repeatedly interpreted this statute to provide the government with a privilege permitting it to withhold documents that reflect advisory opinions, recommendations and deliberations comprising part of a process by which government decisions and policies are formulated.\textsuperscript{23} Basically, the courts have interpreted the intent of the privilege as two-fold: to promote frank and independent discussion among those responsible for making government decisions\textsuperscript{24} and to protect against premature disclosure of proposed policies or decisions.\textsuperscript{25}

In \textit{Warner}, the court utilized a two-pronged test to determine whether the Bureau of Economics' memoranda, regarding various aspects of market structures and the effects on competition from the proposed merger between WCI and Polygram, were privileged. First, the

\begin{itemize}
  \item \textsuperscript{17} \textit{Warner}, 742 F.2d at 1161.
  \item \textsuperscript{18} 15 U.S.C.A. § 46 (West Supp. 1985). See also 12 \textsc{Von Kalinowski, Antitrust Laws and Trade Regulation} § 126.01 (1985).
  \item \textsuperscript{19} 16 C.F.R § 1.1 (1985).
  \item \textsuperscript{20} 5 U.S.C.A. § 552 (West Supp. 1985).
  \item \textsuperscript{21} \textit{Id}.
  \item \textsuperscript{22} This exemption prevents dissemination of inter-agency or intra-agency memoranda or letters which would not be available by law to a party other than a party in litigation with the agency. \textit{Id} at § 552(b)(5).
  \item \textsuperscript{23} \textit{Warner}, 742 F.2d at 1161. See also NLRB v. Sears, Roebuck & Co., 421 U.S. 132, 150 (1975) (predecisional NLRB advice memorandum considered privileged information).
  \item \textsuperscript{24} Environmental Protection Agency v. Mink, 410 U.S. 73, 87 (1973).
  \item \textsuperscript{25} Coastal States Gas Corp. v. Dept. of Energy, 617 F.2d 854, 866 (D.C. Cir. 1980).
\end{itemize}
documents had to be predecisional—generated before the adoption of an agency's policy or decision.\(^{26}\) The court concluded that the authors of the memoranda investigated and drafted the opinion before the FTC made the decision to challenge the proposed joint venture. Therefore, the documents satisfied the predecisional requirement for the privilege. Second, the documents must have been deliberative in nature—containing opinions, recommendations, or advice about agency policies.\(^{27}\) The court determined that the memoranda contained analysis and recommendations sufficient to be deliberative in nature. The court concluded that the Bureau of Economics' memoranda sufficiently satisfied all the requirements to meet the deliberative process privilege. This ruling was subject to several qualifications.\(^{28}\) But the court held that the qualifications applicable in the case did not outweigh the intent of the privilege as noted earlier. Thus, the lower court abused its discretion in ordering the production of the memoranda.\(^{29}\)

It is apparent why the Ninth Circuit ruled as it did. The court was obviously protecting a governmental interest as well as itself. Without the memoranda, the court could start fresh with its own analysis of whether to grant preliminary relief in the case. Also, the court would not

\(^{26}\) Id. at 866. In Coastal States, the court added that even if the document is predecisional at the time it is prepared, it can lose that status if it is adopted as the agency position on the issue. Id. Though this has no bearing on the Warner case per se, had the Bureau of Economics prepared the opinion after the suit was filed, the memoranda would have lost the predecisional status. As recognized in Sears, 421 U.S. at 152, after a final decision, memoranda are in the public interest and therefore lose the (b)(5) exemption from the statute.

\(^{27}\) Coastal States, 617 F.2d at 866.

\(^{28}\) The deliberative process privilege is qualified to the extent that if a litigant's need for accurate fact-finding overrides the government's interest in non-disclosure, the litigant may obtain deliberative materials. United States v. Leggett & Platt, Inc., 542 F.2d 655, 658 (6th Cir. 1976) (court held that to override the government interest in secrecy, the court must find that the litigant's objective, rather than its subjective, need for the documents overrides the governmental interest in secrecy).

The Warner court used four factors to balance the competing interests: 1) the relevance of the evidence; 2) the availability of other evidence; 3) the government's role in the litigation; and 4) the extent to which disclosure would hinder frank and independent discussion regarding contemplated policies and decisions. Warner, 742 F.2d at 1161. See, e.g., Carl Zeiss Stiftung v. V.E.B. Carl Zeiss, Jena, 40 F.R.D. 318, 327-29 (D.D.C. 1966), aff'd, 384 F.2d 979 (D.C. Cir. 1967), cert. denied, 389 U.S. 952, (1967); In re Franklin Nat'l Bank Sec. Litig., 478 F. Supp. 577, 583 (E.D.N.Y. 1979) (court used five factors in its determination, adding the "seriousness" of the litigation and the issues involved).

Though not binding precedent, the factors are relevant to the discussion in the case and were properly exercised by the court. In Warner, the court determined that the memoranda were relevant. But the other three factors outweighed the deleterious effects the court predicted if they allowed the lower court to effectively compel disclosure of this type of memorandum, thereby ultimately injuring the quality of agency decisions.

\(^{29}\) Warner, 742 F.2d at 1162.
have to defer to the lower court’s findings, since they were based on improperly admitted documents.

Next, the court determined whether the lower court should have granted preliminary relief to the FTC. The court analyzed and applied standards from long-standing precedent to reach its decision. The decision of whether to grant preliminary relief turned on a determination of the likelihood of the FTC’s success on the merits and on a balance of the equities.

In order to meet its burden of proof with respect to success on the merits, the FTC had to raise questions going to the merits so serious, substantial, difficult and doubtful as to make them grounds for thorough investigation and study.\(^{30}\) Once the FTC did this, the issue was put before a court which makes a preliminary assessment of the merger’s impact on competition. The courts have stated that because section 7 of the Clayton Act prohibits any merger which may substantially lessen competition in any line of commerce, it is necessary to examine the effects of a merger in each such economically significant submarket.\(^{31}\) This will determine whether there is a reasonable probability that the merger will substantially lessen competition. The court in \textit{Warner} found several factors from case law applicable to this recording industry merger, which were useful in determining the impact on competition. Some of these included the market shares of the merging firms, the degree of concentration within the industry, and the relevant product market.\(^{32}\)

Defining the relevant market is a burdensome yet critical process in antitrust litigation. Both WCI and the FTC offered evidence as to the relevant market. This decision has an important bearing on the outcome of any proposed merger. The choice of one relevant market over another will determine whether certain conduct may have an impact on competi-

\(^{32}\) The Court in \textit{Brown Shoe} generally discussed the nature of Clayton Act violations as those actions which would substantially lessen competition. \textit{Id.} at 334. The Court then stated that in order to thoroughly examine antitrust violations with respect to either horizontal mergers (mergers between business competitors, such as the proposed merger in \textit{Warner}) or vertical mergers (joining with a corporate customer or supplier), a court must look at the “effect on competition generally in an economically significant market.” \textit{Id.} at 335. The significant market is commonly referred to as the relevant market. The relevant market is determined by examining the reasonable interchangeability of use between the product and substitutes for it. \textit{Id.} at 325. The Court held that in order to fully determine any effect on competition, the relevant market must be analyzed. Various components of the relevant market are the product market and the geographic market. \textit{Id.} at 324. Once a court has established these markets, it can then proceed to determine the issue of whether the merger would have an effect on competition. The Ninth Circuit has vigorously adopted \textit{Brown Shoe} as the law for section 7 violations. \textit{See, e.g.,} Equifax, Inc. v. Federal Trade Commission, 618 F.2d 63 (9th Cir. 1980).
tion. If the effect is anticompetitive, the proposed merger will not be permitted by the courts. Conversely, if the conduct would not affect competition in an anticompetitive manner, then the proposed merger would be permitted. The FTC argued that the relevant market was prerecorded music. WCI contended that the relevant market was recorded music. The court determined that the relevant market was prerecorded music based on a more tenable showing by the FTC.

The next question was whether the proposed merger would affect the concentration within the chosen relevant market. After an assessment of statistics, the court determined that the prerecorded music industry was moderately concentrated at the distributor level while the top four record distributors commanded approximately sixty-seven percent of the domestic market. If WCI and Polygram were permitted to form a joint venture, their market share alone would be approximately twenty-six percent while the market share of the top four firms would be approximately seventy-five percent. This was sufficient for the court to reason that the result of the proposed merger would definitely have anticompetitive effects on the prerecorded music industry.

As a final analysis, the court found that entry into the record distribution industry was very expensive. Since there were few independently produced prerecorded music distributors, a new entrant would have difficulty obtaining and sustaining enough volume to be competitive. Thus, there existed a natural barrier to entry into the industry. Based on these factors, the court held that the FTC was likely to succeed on the merits.

WCI presented cases where courts permitted mergers to occur when the acquired company was intending to leave the distribution market due to economic necessity and inadequate resources similar to Polygram’s

33. Warner, 742 F.2d at 1163.
34. Recorded music includes home tapes of prerecorded music. Id.
35. Id. at 1163-64. The FTC offered persuasive evidence regarding the relevant market. The Commission presented record company documents and affidavits distinguishing the recorded music market from the prerecorded music market. The court recognized that there were distinct characteristics belonging to each market. Ultimately, it determined that the two were not interchangeable. Based on that and other evidence presented by the FTC regarding the degree of concentration in the prerecorded music market, the court held that the relevant market to be analyzed for anticompetitive effects would be prerecorded music. Id. at 1163.
36. Id.
37. Id.
38. Some $125,000,000 in sales at the wholesale level is required to maintain a national distribution operation. Id. at 1164.
39. Id.
situation.\textsuperscript{40} The court in \textit{Warner} quickly rejected this argument, citing cases which criticized such judicial reasoning.\textsuperscript{41} WCI presented a cogent argument against any possible effects resulting from the proposed merger. But the court adopted a policy argument presented by other courts regarding the strength (or lack of strength) of a financial weakness argument.\textsuperscript{42} Though not a rigorous analysis, the court was able to discern between the reasons for allowing and not allowing WCI's argument. The court, in effect, conceded that WCI's argument was valid but was insufficient by itself to justify a merger.\textsuperscript{43}

Ultimately, the court had to reach the issue of equities; the last step of the analysis and probably the factor with the weakest support in case law. In addition to the FTC showing a reasonable probability of a likelihood of success, the court balanced equities to reach its result. The difficult choice presented to the court was what type of equities should be considered in an entertainment industry case such as this. The court in \textit{Warner} cited no authority that defined the equities applicable to record company mergers. Rather, general public and private equities were weighed against a borrowed equity affecting injunctions. The balancing of equities by the court went through some vigorous tipping back and forth before the case was resolved. The court was not sure of the exact weight to place on each equity. It is well established that, although private equities may be considered, public equities receive far greater weight.\textsuperscript{44} Various types of public equities include beneficial economic effects and pro-competitive advantages for consumers.\textsuperscript{45} The court in \textit{Warner} was unable to determine whether these equities would support or

\textsuperscript{40} Lektro-Vend Corp., 660 F.2d 255 (7th Cir. 1981); International Shoe Co. v. Federal Trade Commission, 280 U.S. 291 (1930). In \textit{International Shoe}, the Court held that in some situations where a company's resources are so depleted and the prospect of rehabilitation so remote that the company faced the probability of a business failure, its capital stock may be purchased by a competitor. If there is no other prospective purchaser and the stock is not purchased with the purpose of lessening competition, it is not prejudicial to the public. Therefore, the merger does not substantially lessen competition or restrain commerce within the intent of the Clayton Act.

\textsuperscript{41} United States v. Phillips Petroleum Co., 367 F. Supp. 1226 (C.D. Cal. 1973) (the issue in an antitrust case is not a determination of the reasons for selling, but only the anticompetitive effect of the sale), aff'd mem. 418 U.S. 906 (1974).

\textsuperscript{42} \textit{Warner}, 742 F.2d at 1164. See Kaiser Aluminum & Chem. Corp. v. Federal Trade Commission, 652 F.2d 1324, 1339 (7th Cir. 1981) (financial weakness, while perhaps relevant in some cases, is probably the weakest ground of all for justifying a merger).

\textsuperscript{43} \textit{Warner}, 742 F.2d at 1165.

\textsuperscript{44} Federal Trade Commission v. Weyerhaeuser Co., 665 F.2d 1072, 1083 (D.C. Cir. 1981) (equities used in the antitrust analysis). See also \textit{National Tea Co.}, 603 F.2d at 697 and n.4.

deny the grant of injunctive relief, since the record contained conflicting evidence regarding economic effects and advantages. 46

The court extracted an equity from a different circuit which, if applicable, would support the grant of injunctive relief. A denial of a preliminary injunction would preclude effective relief if the FTC ultimately prevailed at the trial level and divestiture were ordered. 47 The court reasoned that if it permitted the proposed joint venture, Polygram would dismantle its distribution operations. If a divestiture order were subsequently given, it would be exceedingly difficult for Polygram to revive its operations to comply with the order. 48 Fearing this potential result, the court decided to place great weight on the borrowed equity.

WCI presented the court with a few private equities, 49 but the court refused to accept them. Though the court did say that the private equities were entitled to serious consideration, private equities alone did not outweigh the FTC's showing of a likelihood of success. 50 After placing the weights on the scale, the court concluded that since the FTC had demonstrated a likelihood of success and public equities supported injunctive relief, the scale tipped in favor of granting the preliminary injunction. 51

This academic lesson in judicial reasoning has not resulted in voluminous subsequent citations. In fact, since the date of the opinion, only two cases have cited Warner. 52 This should not be surprising, since the court in Warner applied long-standing precedent that has been routinely cited in prior cases.

Although the facts are completely different, both Warner and Re-

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46. Warner, 742 F.2d at 1165. Oddly, the court was able to determine such difficult statistics as levels of concentration and barriers to entry into the recording distribution market, yet they could not conclude, as a matter of law, that the benefits received by consumers from denying the merger outweighed the effects that would result if the merger were allowed.


48. Warner, 742 F.2d at 1165.

49. WCI argued that if the joint venture were denied, Polygram would not be able to operate effectively. Polygram asserted difficulty in signing artists as well as keeping them due to the uncertainty of the proposed merger. WCI also argued that there were private equities in allowing Polygram to escape its troubled financial condition and in allowing Polygram's shareholders to reap benefits of a merger. Id. at 1165, citing United States v. G. Heileman Brewing Co., 345 F. Supp. 117, 122-24 (E.D. Mich. 1972); Great Lakes Chemical, 528 F. Supp. at 98-99.

50. Warner, 742 F.2d at 1165.

51. Id.

52. Regents of Univ. of Cal. v. American Broadcasting Cos., 747 F.2d 511 (9th Cir. 1984); White Consol. Indus., Inc. v. Whirlpool Corp., 612 F. Supp. 1009 (N.D. Ohio 1985) (Warner was cited in the conclusions of law, listing factors relevant to determining the acquisition's impact on competition).
gents of University of California v. American Broadcasting Cos. involved a lower court ruling regarding a preliminary injunction. The issue before the court in Regents was whether the lower court abused its discretion in granting a preliminary injunction. The court followed an analysis similar to that used by the Warner court. In finding that the plaintiff had a fair chance of succeeding on the merits of the underlying antitrust litigation, the court in Regents ruled that the balance of hardships tipped sharply in favor of the plaintiff and therefore affirmed the lower court decision.

The dissent in Regents thought that, with respect to equities, the majority failed to consider some personal equities that the defendant would suffer if the preliminary injunction were affirmed. Warner was cited for support of this position. The dissent cited to language in Warner stating that private injuries are entitled to serious consideration. The dissent obviously failed to read the entire statement in Warner. The Warner court held that although private injuries are entitled to serious consideration, private equities alone do not outweigh a plaintiff’s showing of a likelihood of success. The majority in Regents determined that the plaintiff had a fair chance of succeeding on the merits.

Perhaps the dissent in Regents thought that the majority did not pay enough attention to the private equities. With a narrow reading of the language in Warner, the dissent believed that the defendant should not have been denied a stay of the preliminary injunction. The problem with that analysis is that Warner cannot and should not be taken so narrowly. It is clear from Warner that private equities are not sufficient to deny relief if the plaintiff shows a likelihood of success on the merits of the underlying litigation. The dissent attempted to narrowly extract language from Warner. Upon a proper reading, the use of Warner in the dissent is unpersuasive.

Warner will have a salutary effect on the law. Its consistent interpretation and sound reasoning of antitrust law in the entertainment industry lends itself to strong precedent. Joint ventures and mergers in the

53. Regents, 747 F.2d at 521-22.
54. Id. at 521. The court analyzed the plaintiff’s likelihood of success on the merits, balanced the hardships, and considered the public interest.
55. Id.
56. Id. at 522. The dissent was written by Judge Beezer.
57. Id. at 525.
58. Id., citing Warner, 742 F.2d at 1165.
59. Warner, 742 F.2d at 1165.
60. Regents, 747 F.2d at 521.
61. The dissent also questioned the other issues analyzed by the majority, including the likelihood of success on the merits and the balancing of hardships. Id.
entertainment industry are a growing concern. As motion picture and recording companies join their operations, the more difficult it becomes for new competition to break in. Cases such as *Warner* indicate that the law is providing a strong right arm for competitors. The antitrust laws were established to prevent anticompetitive conduct.

Ultimately, WCI and Polygram dismantled their merger plans. Today, both appear to be viable companies in the prerecorded music distribution market. Who knows? Someday Polygram may be the record label for the next FTC album. Then again, that too may have a drastic effect on the entertainment industry.

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