

# KING & SPALDING CLIENT ALERT

## ***United States v. Microsoft: Court of Appeals Affirms Continuing Relevance of Antitrust Law in Governing the Behavior of Dominant Firms***

On June 28, 2001, an en banc panel of the United States Court of Appeals for the D.C. Circuit delivered a unanimous decision in *United States v. Microsoft Corp.* In a 125-page opinion, the D.C. Circuit narrowed the scope of Microsoft's antitrust liability, vacated the order divesting Microsoft into two companies, and removed district judge Thomas Penfield Jackson from further proceedings in the case. But it affirmed the district court's finding that Microsoft violated Section 2 of the Sherman Act by maintaining, through a variety of anticompetitive business practices, its Windows monopoly. The Court remanded the case for further proceedings, including a hearing on remedy.

This client alert offers a brief summary of the decision, and a few comments on its implications for antitrust enforcement in the years ahead.

### ***Background***

On May 18, 1998, the United States and several states filed a complaint alleging that Microsoft had violated Sections 1 and 2 of the Sherman Act. The complaint alleged that Microsoft possessed monopoly power in the market for PC operating systems; that high barriers to entry discouraged entry by new competitors; that new technologies, such as "middleware," posed a significant potential threat to Microsoft's monopoly; and that Microsoft had embarked upon an anticompetitive campaign aimed at protecting its monopoly and extending it into the market for web browsers.

Following a 78-day trial, the district court found that Microsoft possessed monopoly power in the market for Intel-compatible PC operating systems, and that Microsoft had used this power to injure competition in the operating systems market and in the market for web browsers. After a court-ordered mediation failed, the district court entered Conclusions of Law holding that Microsoft's anticompetitive campaign to protect its Windows monopoly violated Section 2 of the Sherman Act, and that Microsoft had also violated Section 2 by attempting to monopolize the market for web browsers and Section 1 by tying IE to Windows. The court subsequently entered an order requiring Microsoft to reorganize itself into two separate firms: an "OpsCo", which would receive the operating system business, and an "AppsCo", which would receive the rest of Microsoft's businesses.

### ***The D.C. Circuit's Opinion***

***Monopolization.*** At trial, the government asserted, and the district court agreed, that Microsoft had unlawfully monopolized the market for "Intel-compatible operating systems." The Court of Appeals affirmed this decision.

***Microsoft's monopoly power.*** On appeal, Microsoft offered two principal reasons why it did not possess monopoly power. First, Microsoft argued that the district court erred in excluding middleware products, such as Netscape's Navigator browser and Sun's Java technologies, from the relevant market.

Because Navigator and Java expose applications programming interfaces (“APIs”), these forms of middleware could, with further development of a more extensive API set, serve as a platform for which full-featured applications, such as word processors and spreadsheet programs, could be written. And because Navigator and Java ran on several operating systems, if either were developed as platform software it could, as Microsoft Chairman Bill Gates stated to his colleagues in a 1995 e-mail, threaten to “commoditize” the Windows operating system. Microsoft argued that the threat from cross-platform middleware denied Microsoft monopoly power in a relevant market properly defined to include these emerging technologies.

The Court rejected this argument, noting that although middleware could someday emerge that competes with Windows as a software platform, that day was not imminent: accordingly, middleware does not yet constrain the price that Microsoft charges for Windows.

Second, Microsoft argued that because of the high level of innovation in its industry, the district court’s finding that it currently enjoyed a 95% share of the market for Intel-compatible operating systems was “misleading” and did not indicate that it possessed monopoly power. The Court of Appeals rejected this argument, finding that Microsoft’s high share was protected by an “applications barrier to entry” arising from two facts: (1) that most consumers prefer to use an operating system for which a large number of applications is available, and (2) that most developers prefer to write applications for the most widely-used operating system. This “chicken-and-egg situation” “ensures that applications will continue to be written for the already dominant Windows, which in turn ensures that consumers will continue to prefer it over other operating systems.”

*Anticompetitive conduct.* The Court largely affirmed the district court’s condemnation of a series of Microsoft business practices, which, in the Court’s view, served no business purpose other than to exclude competitors. With respect to the most important anticompetitive practices, the Court held that:

- Microsoft’s Windows licensing deals with OEMs, which restricted severely OEM’s distribution of Navigator on the machines they sold to consumers, violate Section 2. Microsoft’s OEM licenses reduced Navigator’s usage share not by improving Microsoft’s own product but, rather, by “preventing OEMs from taking actions that could increase [Navigator’s] share of usage.” Lacking wide distribution, Navigator failed to attract the attention from software developers required to fulfill its potential as a competitor to Windows.
- Microsoft’s contention that its OEM license restrictions were simply valid exercises of its rights under its Windows copyrights “borders upon the frivolous.” Only one of the restrictions at issue, a provision prohibiting OEMs from automatically launching a non-Microsoft “desktop”, involves an alteration of Microsoft’s copyrighted work substantial enough to justify its prohibition in the OEM licenses.
- Microsoft’s contractual and technological binding of IE and Windows violates Section 2. By commingling the IE software code as an irremovable part of Windows, the Court found, Microsoft sought to prevent OEMs, who would face increased support costs if they offered more than one browser, from offering Navigator or any other rival to IE. The Court further found that Microsoft’s

commingling of IE and Windows code had no procompetitive benefit, and served only as an strategy to exclude competition.

- Microsoft's agreements with various Internet Access Providers ("IAPs"), such as America Online, violate Section 2. The Court found that Microsoft's IAP agreements ensured that the majority of internet subscribers "are offered IE either as the default browser or as the only browser." As a consequence, Microsoft's deals with the IAPs "clearly have a significant effect in preserving its monopoly; they help keep usage of Navigator below the critical level necessary for Navigator or any other rival to pose a real threat to Microsoft's monopoly."
- Microsoft's contracts with independent software vendors ("ISVs"), wherein Microsoft promised to give preferential support and early access to new Windows APIs to ISVs who agreed to use IE as the default browsing software on any software they developed, had a "substantial effect in further foreclosing rival browsers from the market," and violated Section 2.
- Microsoft's threat to cancel its Office software for Apple's Macintosh computer if Apple continued to distribute Navigator with its machines had "a substantial effect upon the distribution of rival browsers" and "serve[d] to protect Microsoft's monopoly" in violation of Section 2.
- Microsoft's response to the threat to Windows from cross-platform Java applications -- specifically, its contracts requiring ISVs to use Microsoft's JVM as the default in any software they developed, and its failure to disclose to ISVs that use of Microsoft's JVM would in some instances produce Java applications that ran well only on Windows machines (a strategy that an internal Microsoft document referred to as "[k]ill[ing] cross-platform Java by grow[ing] the polluted Java market") -- served only to exclude rivals, and, therefore, violates Section 2.

**Attempted Monopolization.** The Court of Appeals reversed the district court's conclusion that Microsoft had attempted to monopolize the market for browsers, primarily because the district court had failed to define a relevant market within which Microsoft's prospects of gaining monopoly power in web browsers could be assessed. In its Findings of Fact, the district court stated that "a Web browser provides the ability for the end user to select, retrieve, and perceive resources of the Web." Aside from this "imprecise" definition, the district court discussed neither "the technological components of or functionalities provided by a browser," nor did it discuss whether other products, such as browser shells or various software "viewers", could function as substitutes for the browser.

**Tying.** The Court of Appeals next reviewed the district court's finding that Microsoft's contractual and technological bundling of IE with Windows constituted per se unlawful tying in violation of Section 1. The Court, concluding that the per se rule for tying was inappropriate in analyzing tying arrangements involving platform software products, reversed the district court's finding and remanded for further consideration of the government's claim under the rule of reason.

At trial, Microsoft argued that IE (the tied good) and Windows (the tying good) are not separate products. The district court rejected that argument, finding that many consumers, if given the option, would prefer to choose their browser separately from their operating system. In its arguments before the Court of Appeals, Microsoft asserted that basing the separate products inquiry on whether consumers

demanded products separately would “chill innovation to the detriment of consumers by preventing firms from integrating into their products new functionality previously provided by standalone products – and hence, by definition, subject to separate consumer demand.” The Court of Appeals found merit in this argument, stating that retrospective analysis of consumer demand is a “systematically poor prox[y] for overall efficiency in the presence of new and innovative integration.”

The Court next addressed the larger question of whether the per se test was appropriate for evaluating Microsoft’s tying arrangements. The Court characterized platform software markets as “pervasively innovative,” and asserted that “tying in such markets may produce efficiencies that courts have not previously considered.” The Court also noted that integration is common in the platform software market, even among firms without market power -- and firms without market power have no incentive to bundle unless there are efficiency gains to be realized. In light of these facts, the Court stated that it “[could] not comfortably say that bundling in platform software markets has so little redeeming virtue, and that there would be so very little loss to society from its ban, that an inquiry into its costs in the individual case [can be] considered [ ] unnecessary.” The Court remanded the case for evaluation of Microsoft’s tying arrangements under the rule of reason.

**Remedy.** The Court vacated the district court’s remedial decree for three independent reasons: (1) the district court’s failure to hold a remedies-specific evidentiary hearing; (2) the district court’s failure to provide adequate reasons for its decreed remedies; and (3) the narrowing on appeal of the scope of Microsoft’s liability.

The Court first noted that in light of the “acute factual disagreements” between Microsoft and the government on issues relating to the district court’s choice of the proper remedy, the district court clearly was required to hold a hearing. The district court’s claim that the parties’ disagreements on the proper remedy could be resolved only through “actual experience” rather than further hearings provoked an acid reaction from the Court of Appeals: “Trial courts are not excused from their obligation to resolve such matters through evidentiary hearings simply because they consider the bedrock procedures of our justice system to be of little use.”

The Court also castigated the district court for its failure to provide adequate explanation for the relief it ordered. The Court stated that the district court had defaulted almost entirely on its obligation to explain why either element of its remedial decree -- divestiture and interim conduct restrictions -- would terminate Microsoft’s illegal monopoly, deny Microsoft the fruits of its illegal conduct, or ensure that Microsoft could not continue its exclusionary practices in the future.

Finally, the Court held that its narrowing on appeal of the scope of Microsoft’s liability required that the district court’s remedial decree be vacated. The Court noted that the district court could have made findings to determine whether the Section 2 monopoly maintenance violations, taken alone, necessitated the equitable relief ordered. But because the district court had declined to make those specific findings, remand was necessary.

**Judicial Misconduct.** In the final 20 pages of its opinion, the Court of Appeals considered whether district judge Thomas Penfield Jackson had violated the Code of Conduct for United States Judges by speaking to reporters while *U.S. v. Microsoft* was pending, and whether his comments required

his disqualification and the vacation of his Findings of Fact and Conclusions of Law. The Court found that the district judge's press interviews and public statements breached Canon 3A(6), which prohibits public comment on the merits of a pending action; Canon 3A(4), which prohibits *ex parte* communications concerning the merits of a pending action; and Canon 2, which provides that "a judge should avoid impropriety or the appearance of impropriety in all activities." The Court also found that the district judge's comments created an appearance of partiality that required disqualification under 28 U.S.C. 455. However, because Microsoft had not established actual bias, the Court refused to vacate the district court's Findings of Fact and Conclusions of Law.

**Analysis.** Although the D.C. Circuit's opinion does not formally bind other Circuits, the opinion's scope and coherence ensure that it will stand as a landmark that other courts will look to in dealing with antitrust cases involving technology-driven markets. The D.C. Circuit has provided enough intellectual sinew and doctrinal innovation to occupy lawyers, courts, and antitrust scholars for years. We offer several brief comments on some of the most interesting parts of the opinion.

*Antitrust and the "new" economy.* The Court of Appeals began its opinion by noting the "significant debate" over whether antitrust doctrine rooted in nineteenth-century industries should apply to firms "competing in dynamic technological markets characterized by network effects." The Court declined to take sides explicitly, but noted that recent economic research suggested, in the Court's view, "that the economic consequences of network effects and technological dynamism act to offset one another, thereby making it difficult to formulate categorical antitrust rules absent a particularized analysis of a given market." This last point suggests that the Court views as overblown the argument that antitrust doctrine is unsuited to the "new" economy, and that antitrust claims involving innovation-rich markets will continue to be assessed according to well-established antitrust principles. In particular, the Court's rejection of Microsoft's argument that the pace of innovation in software markets prevents it from exercising monopoly power suggests that although the threat of nascent competition from leapfrog technology should always be a factor in assessing market power, it is not a magic wand to be waved by defendants.

*Burden-shifting rule of reason analysis.* Perhaps the most interesting feature of the Court's opinion is the method used to assess the various forms of conduct alleged to monopolize. Although monopolization is a Section 2 claim, the Court employed a three-step burden shifting approach of a type more commonly seen in Section 1 cases. (For an example in the Section 1 context, see *Massachusetts Board of Registration in Optometry*, 110 F.T.C. 549 (1988)). The Court inquired first whether the government had established a *prima facie* case by demonstrating a substantial harm to competition. If the government made this showing, the Court inquired whether Microsoft had offered a procompetitive justification for its conduct -- i.e., "a non-pretexual claim that its conduct is indeed a form of competition on the merits because it involves, for example, greater efficiency or enhanced consumer appeal." If Microsoft established a procompetitive justification for its conduct, the burden then shifted back to the government to show either that the conduct is not necessary to the realization of the procompetitive benefit, or that the anticompetitive harm arising from the conduct outweighs its procompetitive benefit.

While the Court's burden-shifting approach does not formally alter what a plaintiff must show in order to establish that conduct is anticompetitive, it does help to organize the parties' presentation of

evidence regarding whether conduct harms or promotes competition, as well as the court's assessment of that evidence.

But while the burden-shifting approach should help rationalize future Section 2 litigation, its use in the Court's opinion is somewhat awkward given that (1) neither the parties nor the district court operated within the burden-shifting framework (at least not explicitly), and (2) Microsoft appears to have relied heavily on its market definition and monopoly power arguments, rather than producing procompetitive justifications for the various forms of conduct alleged to be anticompetitive. As a consequence, because the Court was provided with relatively little material to plug in to its burden-shifting test, the Court's analysis of Microsoft's conduct can appear peremptory.

*Antitrust and product integration.* In assessing whether Microsoft's bundling of Windows and IE harmed competition, the Court noted that "[a]s a general rule, courts are properly very skeptical about claims that competition has been harmed by a dominant firm's product design changes." The reason for the skepticism, of course, is the fear that judicial interference in product design decisions will squelch innovation. But even though some degree of judicial deference may be appropriate, the Court was clear that such deference "does not mean that a monopolist's product design decisions are per se lawful." The D.C. Circuit's only direct experience with tying in a platform software market stems from its consideration, in a related matter (commonly referred to as "*Microsoft II*"), of whether Microsoft's bundling of IE with Windows 95 violated the terms of an agreement Microsoft reached with the government at the close of an earlier investigation of Microsoft's business practices. Microsoft read *Microsoft II* as establishing a special, highly deferential test for "technological tying" that "disclaimed judicial capacity to evaluate high-tech product design." But the Court insisted that its pronouncements in the related case were limited "to resolution of the decree-interpretation issue then before us," and admitted that if its opinion in that case was understood to relate to tying law, it "cannot be said to conform to prevailing antitrust doctrine."

If such decisions are not per se lawful, then what is the test? The Court does not provide a clear answer, but it does run through a list of relevant questions. Is bundling a common practice in the market? Even for firms without market power? And does innovation or some other feature of the market suggest that integration will lead to substantial efficiencies?

*Causation, liability, and remedy.* Finally, the Court's discussion of causation in the antitrust context deserves brief attention. Microsoft argued that the government was required to establish that Java or Navigator, if left alone, would actually have developed into viable platform substitutes for Windows. The Court rejected this argument, holding that the government need only show "(1) [that] as a general matter the exclusion of nascent threats is the type of conduct that is reasonably capable of contributing significantly to a defendant's continued monopoly power and (2) [that] Java and Navigator reasonably constituted nascent threats at the time Microsoft engaged in the anticompetitive conduct at issue." The Court held that the government had made a sufficient showing. But the Court went on to say that because "we have found a causal connection between Microsoft's exclusionary conduct and its continuing [monopoly] only through inference," issues of causation would rise again in the district court's consideration, on remand, of the proper remedy. The Court of Appeals did not explicitly foreclose consideration of divestiture, but the Court's opinion makes clear that any divestiture order that it reviews after remand will receive close scrutiny.

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