

LEGAL UPDATE

UNITED STATES V. MICROSOFT: APPELLATE RULINGS

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On May 18, 1998, the United States Department of Justice and dozens of state attorneys-general filed an antitrust suit against Microsoft Corporation.¹ The plaintiffs charged that Microsoft had violated sections 1 and 2 of the Sherman Act² through its actions and business practices.³ Specifically, it was alleged that Microsoft had violated section one in seeking to maintain its monopoly in the operating system market and section two in attempting to establish a monopoly in the browser market.⁴ On April 3, 2000, the District Court for the District of Columbia, Judge Penfield Jackson presiding, issued its findings of law.⁵ Microsoft promptly appealed and, on June 28, 2001, the Court of Appeals for the District of Columbia Circuit sitting *en banc* issued its ruling.⁶

The D.C. Circuit upheld one of the district court's crucial findings, namely the definition of the relevant market for the section two claims.⁷ The district court had concluded that the relevant market was the market for Intel-compatible PC operating systems.⁸ In this market, Microsoft had a market share in excess of 95%.⁹ Microsoft argued, however, the district court had improperly excluded other products from the market definition.¹⁰ In particular,

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¹ United States v. Microsoft Corp., No. 98-1232 (D.D.C. 1999).

² 15 U.S.C. §§ 1, 2 (2000).

³ See United States v. Microsoft Corp., No. 98-1232 (D.D.C. 1999).

⁴ See *id.*

⁵ United States v. Microsoft, 87 F. Supp. 2d 30 (D.D.C. 2000) [hereinafter *Microsoft-Trial*].

⁶ United States v. Microsoft 253 F.3d 34 (D.C. Cir. 2001) [hereinafter *Microsoft-Appeal*].

⁷ See *id.* at 51-52.

⁸ See *id.* at 52.

⁹ See *id.* at 54.

¹⁰ See *id.* at 52.

Microsoft said the district court had excluded the Macintosh Operating System, various hand-held devices, portal Web sites, and so-called “middleware” programs.¹¹ The court of appeals held that Microsoft had not adequately challenged the district court’s findings of fact and accordingly upheld the district court’s findings.¹²

Perhaps Microsoft’s most important challenge was to the exclusion of “middleware” products from the relevant market, in particular, Netscape Navigator and JAVA.¹³ Navigator and JAVA represented threats to Microsoft’s operating system monopoly because they exposed application programming interfaces (“APIs”) that had the potential to allow cross-platform software development.¹⁴ APIs are “routines or protocols that [enable the computer to] perform certain widely-used functions.”¹⁵ An operating system such as Windows has APIs that third-party software developers may use in order to decrease the amount of code needed to write software (*i.e.*, by using APIs to do routine tasks and functions, software developers would not have to write their own code to perform those functions).¹⁶

Due to the use of operating system-specific APIs, a computer program must be altered or “ported” to run on another operating system.¹⁷ Navigator and JAVA were, however, developing APIs that were specific to their programming code but not dependent upon the underlying operating system.¹⁸ That is, Navigator and JAVA were written or ported for different operating systems but exposed common APIs that third-party developers could use to write programs. These programs’ functionality would be independent of the underlying operating system or cross-platform software. The development of such cross-platform “middleware” would threaten Microsoft’s monopoly over the operating system software.¹⁹ Microsoft’s Windows operating system would no longer be indispensable to computer programmers or users since a program written for middleware would work on any computer that had the middleware program on it.

Microsoft argued that these middleware products should have been included in the relevant market because they could, if developed effectively, compete with Windows.²⁰ The D.C. Circuit, however, upheld the district court’s finding

¹¹ See *id.* at 52. “‘Middleware’ refers to software products that expose their own APIs.” *Id.* at 53.

¹² See *id.*

¹³ See *id.*

¹⁴ See *id.*

¹⁵ *Id.*

¹⁶ See *id.*

¹⁷ See *id.*

¹⁸ See *id.*

¹⁹ See *id.*

²⁰ See *id.*

that the middleware threat was and still is only at a nascent stage.²¹ The middleware must develop a sufficient pool of programs to overcome the “applications barrier to entry,” namely a sufficient number of programs to entice people and programmers to use middleware applications.²² The middleware must be developed to expose a certain amount of APIs in order to attract the attention of software developers.²³ Further, it must have a significant amount of market share or use in order to provide incentives for developers to write programs for it.²⁴

The court of appeals also upheld the district court’s finding of substantial entry costs to the relevant market from the application barrier to entry.²⁵ The court noted that this barrier derives from two points related to software consumers, stating that “(1) most consumers prefer operating systems for which a large number of applications have already been written; and (2) most developers prefer to write for operating systems that already have a substantial consumer base.”²⁶ In other words, consumers prefer an operating system that has the most amount of compatible software, and developers prefer to write software that is marketable to the largest number of possible consumers. Thus, the entry costs for the operating system market include not only the intrinsic costs of developing an operating system but also the costs of creating a pool of software sufficiently large enough to entice customers and other software developers to use the alternative operating system.

After upholding the district court’s findings with respect to the definition of the relevant market and the existence of substantial barriers to entry in that market, the D.C. Circuit reviewed the specific allegations of exclusionary or anticompetitive conduct. The plaintiffs argued that Microsoft violated section 2 in:

- (1) the way it integrated IE [Internet Explorer] into Windows; (2) its various dealings with various Original Equipment Manufacturers (“OEMs”), Internet Access Providers (“IAPs”), Internet Content Providers (“ICPs”), Independent Software Vendors (“ISVs”), and Apple Computer; (3) its efforts to contain and to subvert Java technologies; and (4) its course of conduct as a whole.²⁷

In analyzing Microsoft’s conduct in the integration of Internet Explorer (“IE”) into Windows, the court of appeals focused on three specific actions:

- excluding IE from the ‘Add/Remove Programs’ utility; designing Windows so as in certain circumstances to override the user’s choice of a

²¹ *See id.* at 53-54.

²² *See id.* at 55.

²³ *See id.*

²⁴ *See id.*

²⁵ *See id.* at 54-58.

²⁶ *Id.* at 55.

²⁷ *Id.* at 58.

default browser other than IE; and commingling code related to browsing and other code in the same files, so that any attempt to delete the files containing IE would, at the same time, cripple the operating system.²⁸

Microsoft's decision to preclude manufacturers from removing IE and commingling the IE and operating system code utility were held to be anticompetitive because such action discouraged OEMs from installing alternative browsers.²⁹ That is, OEMs were discouraged from installing alternative browsers because the installation of a second browser would add to the testing and support costs for OEMs, and they would spend more money answering customer calls prompted by redundant products installed on the computers.³⁰

The D.C. Circuit, however, held that Microsoft was not liable for its actions in designing Windows to override a user's choice of a default browser other than IE in certain circumstances.³¹ This was because Microsoft proffered procompetitive (or at least not anticompetitive) reasons for these changes.³² The plaintiffs made no attempt to rebut these proffered reasons, so the court of appeals overturned Microsoft's liability on this count.³³

Microsoft's dealings with OEMs to prevent distribution of rival browsers are more complicated. Microsoft made license agreements with OEMs that limited the ability of OEMs to support or distribute a browser other than IE.³⁴ For instance, Microsoft contractually limited the ability of OEMs to change the desktop appearance of Windows 95 or 98, i.e., to remove the IE icon or software.³⁵ The license restrictions also prevented the OEMs from altering the boot sequence, i.e., the sequence of program registrations that appear the first time a computer is started.³⁶ With the exception of license restrictions that prevented the OEMs from automatically installing an alternative desktop interface, the court of appeals found Microsoft's proffered justifications without merit.³⁷

Importantly, the D.C. Circuit held that Microsoft's copyright defense "border[ed] upon the frivolous."³⁸ Microsoft defended its actions by stating that it was merely "exercising its rights as the holder of valid copyrights."³⁹ The court of appeals replied that intellectual property rights do not give the

²⁸ *Id.* at 64-65.

²⁹ *See id.* at 66.

³⁰ *See id.* at 61, 64-65.

³¹ *See id.* at 67.

³² *See id.*

³³ *See id.* at 67.

³⁴ *See id.* at 60-61.

³⁵ *See id.* at 61.

³⁶ *See id.*

³⁷ *See id.* at 64.

³⁸ *Id.* at 63.

³⁹ *Id.* at 62.

holder license to violate antitrust laws.⁴⁰ Instead, the court stated that Microsoft could only implement such restrictions if they were necessary to prevent substantial alterations of their copyrighted work.⁴¹ Only the restrictions upon OEMs that prevented them from automatically installing an alternative interface after the initial boot-up sequence met this burden of preventing substantial alteration.⁴²

Microsoft also embarked on an aggressive campaign to induce IAPs to distribute IE instead of Navigator. This was accomplished through several specific programs. Microsoft gave free licenses for IE to IAPs and gave a bounty for each IE-using customer that the IAP enrolled.⁴³ Microsoft then developed an IE Access Kit (“IEAK”) that allowed IAPs to easily modify and customize the IE interface and gave these IEAKs to IAPs free of charge.⁴⁴ Finally, Microsoft entered into a series of exclusivity agreements with IAPs, whereby Microsoft provided access to the IAPs from Windows if the IAPs promoted IE exclusively or agreed to keep Navigator usage or distribution below a specified level.⁴⁵

The D.C. Circuit held that no antitrust liability could attach for Microsoft’s free products or rebate programs as long as Microsoft did not engage in price predation, which the plaintiffs did not address.⁴⁶ Specifically, the court of appeals stated that “[t]he rare case of price predation aside, the antitrust laws do not condemn even a monopolist for offering its product at an attractive price, and we therefore have no warrant to condemn Microsoft for offering IE or IEAK free of charge or even at a negative price.”⁴⁷ Accordingly, the court of appeals overruled the district court’s findings of liability on these grounds.

The issue of liability for Microsoft’s exclusivity agreements is also a more complex issue. A monopolist may be found liable under sections 1 or 2 of the Sherman Act for an exclusive deal or arrangement that is anticompetitive.⁴⁸ Sections 1 and 2 prohibit an exclusive contract “whose probable effect is to ‘foreclose competition in a substantial share of the line of commerce affected.’”⁴⁹ The case law has, however, developed a higher standard for liability under section 1 than under section 2. The district court applied a foreclosure standard⁵⁰ while the court of appeals applied a 40% or 50% standard in evaluating the exclusivity agreements.⁵¹

⁴⁰ *See id.* at 63.

⁴¹ *See id.*

⁴² *See id.* at 63-64.

⁴³ *See id.* at 67.

⁴⁴ *See id.* at 68.

⁴⁵ *See id.* at 67-68.

⁴⁶ *See id.* at 68.

⁴⁷ *Id.* at 68.

⁴⁸ *See generally id.* at 45-48.

⁴⁹ *Id.* at 69 (citing *Tampa Electric Co. v. Nashville Coal Co.*, 365 U.S. 320, 327 (1961)).

⁵⁰ *See United States v. Microsoft*, 87 F. Supp. 2d 30, 52 (D.D.C. 2000) (finding liability

Both courts agreed that the plaintiffs had not met their burden with respect to section 1 but also stated that the analysis under section 2 was independent of the section 1 analysis.⁵² The two courts agreed that section 2 prohibited exclusive deals that closed a substantial percentage of the market to competitors (but apparently less than 40%).⁵³ Under this lower standard for section 2, the court of appeals agreed with the district court that Microsoft's exclusive deals were anticompetitive and that Microsoft offered no procompetitive justifications for this action.⁵⁴

Microsoft was also charged with anticompetitive conduct in its dealings with ISVs, ICPs, and with Apple Computer as distribution channels for Internet browsers.⁵⁵ Even though these entities represented less efficient channels for distributing browser software, Microsoft sought to use them to promote IE at the expense of Navigator. As with the OEMs, Microsoft gave ICPs and ISVs licenses to bundle IE with their software or Internet content and provided inducements in the form of preferential technical support in exchange for their cooperation.⁵⁶ In order to secure Apple Computer's acquiescence in promoting IE over Navigator, Microsoft threatened to delay or cancel the release of Microsoft's Mac Office.⁵⁷

The district court and the court of appeals found that the deals with the ICPs did not support liability because the plaintiffs did not demonstrate that Microsoft's actions had a substantial effect upon Navigator's distribution or usage.⁵⁸ Microsoft's deals with ISVs, however, did have the effect of further inhibiting Netscape's ability to distribute Navigator, and Microsoft proffered no procompetitive reason for this action.⁵⁹ Finally, the D.C. Circuit found that Microsoft's arrangement with Apple to have Apple exclusively distribute IE in exchange for Microsoft's continued support of Mac Office was similarly anticompetitive.⁶⁰ This exclusive contract had a substantial effect on the ability of Navigator or other browsers to be distributed.

Finally, Microsoft was charged with anticompetitive behavior relating to its actions towards JAVA programming language. Specifically, Microsoft developed a version of JAVA that worked better on Windows than Sun-

only when "the agreements have the effect of foreclosing a competing manufacturer's brands from the relevant market").

⁵¹ See *Microsoft-Appeal*, 253 F.3d at 70.

⁵² See *id.*

⁵³ See *id.* at 70-71.

⁵⁴ See *id.* at 71.

⁵⁵ See *id.*

⁵⁶ See *id.*

⁵⁷ See *id.* at 73.

⁵⁸ See *id.*

⁵⁹ See *id.* at 71-72.

⁶⁰ See *id.* at 73.

compliant JAVA but was less portable than the Sun-compliant version.⁶¹ Microsoft then took various steps to encourage use of its version of JAVA among software developers and ICPs.⁶² Microsoft also used its influence with Intel to induce Intel to refuse to give technical assistance to Sun and thereby impede the Sun's ability to develop the portability of its JAVA.⁶³

The court of appeals held that Microsoft's development of JAVA that ran better on Windows than on other operating systems was not anticompetitive or was at least outweighed by the procompetitive benefits.⁶⁴ Microsoft's other actions with respect to JAVA were, however, found to be anticompetitive.⁶⁵ This included agreements with ISVs that conditioned the receipt of technical information about Windows on the ISVs' promotion of Microsoft's version of JAVA.⁶⁶ Microsoft's actions in discouraging Intel from working with Sun Microsystems on developing JAVA were similarly found to be anticompetitive.⁶⁷ The D.C. Circuit consequently threw out the district court's holding of liability under the "course of conduct as a whole" theory, stating that the district court did not cite specific acts by Microsoft in support of this finding.⁶⁸

One of the more important reversals was the D.C. Circuit's decision to overturn Microsoft's liability under section 1 for attempted monopolization of the browser market. This reversal was prompted primarily by the plaintiffs' failure to adequately define the relevant market or show that the relevant market could be monopolized.⁶⁹ The court of appeals stated that it was not sufficient for the plaintiffs to rely upon Microsoft's liability under section 2 for its actions related to the operating system market in establishing Microsoft's liability in the browser market.⁷⁰

The other antitrust issue raised in the Microsoft case was the question of liability for "tying" under section 1 of the Sherman Act.⁷¹ The basics of tying liability are simple in themselves, but the analysis suffers from a conceptual holdover from the industrial age. The district court summarized the elements of tying, stating that "(1) two separate 'products' are involved; (2) the defendant affords its customers no choice but to take the tied product in order to obtain the tying product; (3) the arrangement affects a substantial volume of

⁶¹ *See id.* at 74. Portability relates to how easily a program written in one operating system code language may be translated to another operating system code language. *See id.*

⁶² *See id.* at 74.

⁶³ *See id.* at 77.

⁶⁴ *See id.* at 75.

⁶⁵ *See id.* at 75-76.

⁶⁶ *See id.*

⁶⁷ *See id.* at 77-78.

⁶⁸ *Id.* at 78.

⁶⁹ *See id.* at 81.

⁷⁰ *See id.* at 80-81.

⁷¹ *See id.* at 84.

interstate commerce; and (4) the defendant has ‘market power’ in the tying product market.”⁷²

The central question is how to differentiate between two separate products and one product that has a substantially beneficial product or “functionality” integrated in it. The district court interpreted the precedents of the Supreme Court to require that the determination of whether the item was one integrated product or two separate products be made from the consumers’ perspective.⁷³ Accordingly, the important factual inquiry was whether “consumers today perceive operating systems and browsers as separate ‘products,’ for which there is separate demand” rather than “abstract or metaphysical assumptions as to the configuration of the ‘product’ and the ‘market.’”⁷⁴ In sum, the

‘essential characteristic’ of an illegal tying arrangement is a seller’s decision to exploit its market power over the tying product ‘to force the buyer into a purchase of a tied product that the buyer either did not want at all, or might have preferred to purchase elsewhere on different terms.’⁷⁵

Under this analysis, the district court found that Microsoft did engage in illegal tying arrangements with its operating system and its IE browser. Specifically, the district court found that Microsoft’s actions were not motivated by “technical necessity or business efficiencies; rather, it [the decision to integrate IE with Windows] was the result of a deliberate and purposeful choice to quell incipient competition before it reached truly minatory proportions.”⁷⁶

The D.C. Circuit, however, adopted a balancing test in the guise of an antitrust rule of reason analysis. The court of appeals stated that the separate products test or consumer demand test as used by the district court was designed to be a proxy to determine whether the tying arrangement was “welfare-enhancing, and unsuited to per se condemnation.”⁷⁷ The court noted that per se liability should be rejected if there is no separate demand for the tied product, as the products are then considered to be one product.⁷⁸ Further, the court of appeals opined:

If integration has efficiency benefits, these may be ignored by the *Jefferson Parish* [separate product consumer demand or indirect industry custom test] proxies. Because one cannot be sure beneficial integration will be protected by the other elements of the per se rule, simple

⁷² *United States v. Microsoft Corp.*, 87 F. Supp. 2d 30, 47 (D.D.C. 2000).

⁷³ *See id.* at 49.

⁷⁴ *Id.*

⁷⁵ *Id.* at 50 (quoting *Jefferson Parish Hospital District No. 2 v. Hyde*, 466 U.S. 2, 12 (1984)).

⁷⁶ *Id.* at 51.

⁷⁷ *Id.* at 87.

⁷⁸ *See id.* at 88.

application of that rule's separate-products test may make consumers worse off.⁷⁹

The D.C. Circuit also noted that the case of Windows and IE was different from previous tying cases because IE is "physically and technologically integrated with the tying good [Windows]" and the defendants in previous tying cases did not contend that "their tie improved the value of the tying product to users *and* to makers of complementary products."⁸⁰ By employing the rule of reason analysis, the defendant has the chance to prove that the gain from the tying outweighs any change in the consumer's choice.⁸¹ Accordingly, the court of appeals rejected the district court's per se analysis in favor of a balancing test, which would balance the efficiency gains of "bundling" against the costs in terms of loss of consumer choice.

The differences between the two tests are, in some senses, staggering. The per se analysis disallows any sort of product integration if consumers' perceived of or demanded the products separately. This would, as the argument goes, stifle innovation. On the other hand, the D.C. Circuit's balancing test substitutes for a test that, in spite of its theoretical clarity, yields very little in the way of pragmatic prognosis. First, part of what determines whether a product is 'tied' under the separate products test is that the defendant has monopoly power in the tying product and that consumers have no choice but to take the tied product to get the tying product. In other words, the defendant has the ability to systematically distort perception of efficiency gains.

More importantly, there is difficulty in determining what these efficiency gains are and how they can be measured. There is no scholarly or judicial consensus on whether there are any efficiency gains in this or similar situations, or, if so, what they are and how they can be measured. In light of these problems, the D.C. Circuit's decision may have merely muddied the waters of antitrust tying analysis without ensuring better product innovation. Unfortunately, it does not appear that there will be a review of this holding by the Supreme Court, which denied Microsoft's petition for certiorari.⁸² Further, as of publication, a settlement agreement has been reached among Microsoft, the Justice Department, and nine state attorneys general, though nine other states are pursuing an independent remedy through the courts.⁸³

⁷⁹ *Id.* at 89.

⁸⁰ *Id.* at 90.

⁸¹ *See id.* at 92.

⁸² See Declan McCullagh, *High Court Nixes MS Appeal*, WIRED.COM, at <http://www.wired.com/news/antitrust/0,1551,47418,00.html> (Oct. 9, 2001).

⁸³ *See* David Smith, *Gartner: School's Out for Microsoft*, ZDNET NEWS, at <http://www.zdnet.com/zdnn/stories/comment/0,5859,5101739,00.html> (Nov. 20, 2001).