LEGAL UPDATE

MICROSOFT: EXCLUSIVE DEALING UNDER SECTION 1 OF THE SHERMAN ACT: A NEW STANDARD?

Shannon A. Keyes *

I. INTRODUCTION

The United States Supreme Court has denied the Justice Department's petition for a direct appeal of *United States v. Microsoft Corp*.[1] The Justice Department petitioned the Supreme Court for a direct appeal, which would have bypassed the court of appeals under the Antitrust Expediting Act.[2] The case has been remanded to the court of appeals.[3] This Update focuses on the district court's only finding in favor of Microsoft, holding no liability for exclusive dealing under section 1 of the Sherman Act.[4] While the district court's findings on exclusive dealing under section 1 do not affect the overall result of this case, the impact of this finding can be considered dangerous precedent and could result in harsh effects on competition in high-technology industries, should it survive the pending appeal.[5]

The *Microsoft* decision raises important issues in the analysis of exclusive dealing under section 1 of the Sherman Act. An exclusive dealing contract is one in which a buyer promises to buy one or more of its products from a single

* B.A., 1997, University of Massachusetts at Amherst; J.D. (anticipated), 2001 Boston University School of Law.

[1] 87 F. Supp. 2d 30 (D.D.C. 2000), *cert. denied*, 69 U.S.L.W. 3222 (U.S. Sept. 27, 2000); *see also* Paul Davidson & Joan Biskupic, *Supreme Court Passes on Microsoft Case*, Sept. 27, 2000, *available at* <http://www.usatoday.com/life/cyber/tech/cti576.htm>.

[2] 15 U.S.C. § 29(b) (1994); *see also* Mary Jo Foley, *Supreme Court declines Microsoft case* (last modified Sept. 26, 2000) <http://www.zdnet.com/eweek/stories/general/0,111011,2632951,00.html>.

[3] *See Microsoft*, 69 U.S.L.W. at 3222.

[4] *See Microsoft*, 87 F. Supp. 2d at 35; 15 U.S.C. § 1 (1994).

[5] *See Microsoft*, 87 F. Supp. 2d at 53 ("The fact that Microsoft's arrangements with various firms did not foreclose enough of the relevant market to constitute a § 1 violation in no way detracts from the Court's assignment of liability for the same arrangements under § 2.").

seller.[6] The district court found in *Microsoft* that "Microsoft maintained its monopoly power by anticompetitive means and attempted to monopolize the Web browser market . . . ."[7] Microsoft was also found to have unlawfully tied its web browser to its operating system, Windows, a clear violation of section 1.[8] However, despite Microsoft's liability in these areas, the court did not find that Microsoft violated section 1 through its exclusive dealing arrangements.[9] The court based this finding on a seemingly precarious interpretation of previous exclusive dealing cases.[10] The court seemed to develop a new heightened standard for exclusive dealing. The court's ruling ignored the anticompetitive effects of the arrangements in favor of this new standard, which seems only to find liability when there are no alternative distribution sources.[11] Under this decision, exclusive dealings will be significantly harder to prove, as the court will now consider all alternatives, such as direct mailing, retail and downloading.[12] If this standard remains good law, *Microsoft*'s exclusive dealing analysis will hold grave results for high-tech industries, a segment of the economy where competition is particularly vital to promote innovation.

The purpose of the Sherman Act is to promote competition. Section 2 of the Act makes it unlawful for any person to "monopolize, or attempt to monopolize . . . any part of the trade or commerce among the several States, or with foreign nations . . . ."[13] Section 2 prohibits the combination of monopoly power along with the anticompetitive means used to maintain such power.[14] Section 1 prohibits contracts in restraint of trade or commerce.[15] Uniquely, section 1 applies to every contract between firms of any size and thus potentially has great impact.[16]

Contracts that constitute unreasonable restraints on competition, such as exclusive dealing contracts, have been held unlawful.[17] The concern is that

[6] *See* HERBERT HOVENKAMP, FEDERAL ANTITRUST POLICY: THE LAW OF COMPETITION AND ITS PRACTICE § 10.9, at 430 (2d ed. 1999).

[7] *Microsoft*, 87 F. Supp. 2d at 35.

[8] *See id.*

[9] *See id.* at 53.

[10] *Compare id.* at 51-54, *with* Aspen Skiing Co. v. Aspen Highlands Skiing Corp., 472 U.S. 585, 600-05 (1985), Jefferson Parish Hosp. Dist. No. 2 v. Hyde, 466 U.S. 2, 44-46 (1984), Tampa Elec. Co. v. Nashville Coal Co., 365 U.S. 320, 325-29 (1961), *and* Standard Oil Co. v. United States, 337 U.S. 293, 304-15 (1949).

[11] *See Microsoft*, 87 F. Supp. 2d at 53.

[12] *See id.*

[13] 15 U.S.C. § 2 (1994).

[14] *See* United States v. Grinnell Corp., 384 U.S. 563, 570-71 (1966).

[15] *See* 15 U.S.C. § 1.

[16] *See id.*

[17] *See* HOVENKAMP, *supra* note 6, § 10.9, at 430 ("Exclusive dealing arrangements have

exclusive dealing arrangements allow for two types of economic inefficiencies. First, they threaten to eliminate opportunities for competitors' existing products to find other outlets in the market.[18] Second, they raise the barriers to entry in the market.[19] Clearly such inefficiencies, if left unchecked, would have deleterious consequences on competition.

II. EXCLUSIVE DEALING IN THE COURTS

The origin of modern exclusive dealing analysis is *Standard Oil Co. of California v. United States*.[20] In 1947, Standard Oil Co., the largest seller of gasoline in seven western states, made exclusive dealing contracts with independent stations constituting 16% of all retail gasoline outlets and covering 6.7% of all retail sales in the area.[21] The Court held that Standard Oil was liable because its use of contracts, resulting in 6.7% of all retail sales, created "such a potential clog on competition . . . were it to become actual, it would impede a substantial amount of competitive activity."[22] This decision seemed to create a standard different from the "qualitative substantiality" test of *International Salt Co. v. United States.*[23] The *Standard Oil* decision adopted "a virtual per se rule against requirement contracts if the percentage of the market foreclosed by the agreement exceeded about 7%."[24]

Standard Oil is important for several reasons. First, it said exclusive dealing is not generally presumed to suppress competition and ruled that the adverse effects of exclusive dealing arrangements are not to be assumed merely from the dollar volume impact on competitor opportunities to make sales to the foreclosed retailers.[25] The *Standard Oil* Court held that foreclosing a substantial share of the retail market (here almost 7%) where the market is otherwise concentrated and entry is restricted, enables a court to infer that the

been condemned under § 1 of the Sherman Act and § 3 of the Clayton Act, as well as § 5 of the FTC Act.").

[18] *See* Tampa Elec. v. Nashville Coal Co., 365 U.S. 320, 327 (1961) ("[S]uch contracts are proscribed . . . if their practical effect is to prevent lessees or purchasers from using or dealing in the goods, etc., of a competitor or competitors of the lessor or seller and thereby competition has been foreclosed in a substantial share of the line of commerce affected.") (citation omitted).

[19] *See id.* at 328 ("[T]he opportunities for other traders to enter into or remain in that market must be significantly limited as was pointed out in *Standard Oil Co. v. United States* . . . .").

[20] 337 U.S. 293 (1949).

[21] *See id.* at 295.

[22] *Id.* at 314.

[23] 332 U.S. 392, 396 (1942).

[24] HOVENKAMP, *supra* note 6, § 10.9e, at 435.

[25] *See id.* § 10.9e, at 436.

arrangement may substantially lessen competition.[26]

In *Tampa Electric Co. v. Nashville Coal Co.*, a coal supplier argued that its agreement to fill an electric utility's total requirements for coal for twenty years should not be enforced because it violated section 3.[27] The Court upheld the contract after intense scrutiny of its economic impact.[28] Among other things, the *Tampa* Court looked at the affected market and the probable foreclosure.[29] Based on *Tampa*, as a threshold matter, when deciding whether an exclusive dealing contract violates section 1, the courts should determine whether a "substantial share of the relevant market" has been foreclosed by the contract.[30] The Court established a clear test to determine whether or not the foreclosure is substantial.[31] Once foreclosure of a sufficient percentage is found, courts should then consider the agreements' actual impact on competition (as opposed to merely the size of the foreclosed market share).[32]

If foreclosure is sufficiently high, "*Tampa*'s rule of reason requires courts to examine numerous other factors . . . ."[33] The rule of reason factors include: "(1) the duration of the contracts; (2) the likelihood of collusion in the industry . . . (3) the height of entry barriers; (4) the nature of the distribution system and the distribution alternatives remaining available after exclusive dealing is taken into account; and (5) other obvious anti-or pro-competitive effects."[34]

In *Jefferson Parish Hospital District No. 2 v. Hyde*, unlike *Standard Oil*, the Court does not state that there is a minimum acceptable level of foreclosure.[35] This case involved a hospital that contracted to use only a particular firm of anesthesiologists.[36] Upon determining whether the hospital's contract was valid, the court analyzed the dealing under section 1 and under *Tampa's* rule of reason standard.[37] The Court did not condemn the exclusive dealing contracts

[26] *See Standard Oil*, 377 U.S. at 298, 314.

[27] 365 U.S. 320, 322 (1961).

[28] *See id.* at 333-35.

[29] *See id.*

[30] *Id.* at 328.

[31] *See id.* at 329.

> To determine substantiality in a given case, it is necessary to weigh the probable effect of the contract on the relevant area of effective competition, taking into account the relative strength of the parties . . . and the probable immediate and future effects which pre-emption of that share of the market might have on effective competition therein.

Id.

[32] *See* HOVENKAMP, *supra* note 6, § 10.9e, at 437.

[33] *Id.* § 10.9e, at 435-36.

[34] *Id.* § 10.9e, at 437-38.

[35] 466 U.S. 2, 26-31 (1984).

[36] *See id.* at 5.

[37] *See id.* at 26-31.

at issue, despite 30% foreclosure, because there was no showing of anti-competitive effect.[38] The concurring Justices found that the exclusive dealing of 30% was not prohibited because it was not a large enough amount and there was no threat of adverse economic consequences.[39]

A number of observers note that the Supreme Court's use of a 30% market share threshold suggests that foreclosure up to this level is likely to be deemed acceptable in exclusive dealing cases.[40] However, no Supreme Court decision on exclusive dealing has ever announced such a standard.[41] Most courts continue to follow *Tampa's* rule of reason approach for evaluating exclusive dealing contracts.[42]

III. *MICROSOFT'S* EXCLUSIVE DEALING ANALYSIS

The court began its analysis of the exclusive dealing claim by incorporating elements of previous exclusive dealing cases.[43] The court stated that "[w]here agreements have been challenged as unlawful exclusive dealing, the courts have condemned only those contractual arrangements that substantially foreclose competition in a relevant market by significantly reducing the number of outlets available to a competitor to reach prospective consumers of the competitor's product."[44] Although the court uses the "substantial foreclosure" language of *Tampa*, it already foreshadowed the importance it will place on "outlets available to a competitor."[45] After confirming that the rule of reason test is appropriate, the court acknowledged that the analysis of exclusive dealing is focussed on prohibiting agreements that have the *effect* of foreclosing competition.[46] The court then began to narrow its argument. The court claimed that this effects based inquiry was contingent on "so much of the market's available distribution outlets [placed] in the hands of a single firm as to make it difficult for other firms to compete effectively, or even to exist, in

[38] *See id.* at 26, 31.

[39] *See id.* at 45-46 (O'Connor, J., concurring).

[40] *See, e.g.*, David A. Balto, *Networks and Exclusivity: Antitrust Analysis to Promote Network Competition*, 7 GEO. MASON L. REV. 523, 552 (1999); Douglas J. Hammer, *Refusals to Deal in "Locked-in" Health Care Markets: General Counsel's Response*, 1995 UTAH L. REV. 549, 558 (1995).

[41] *See generally* Aspen Skiing Co. v. Aspen Highlands Skiing Corp., 472 U.S. 585 (1985); Jefferson Parish Hosp. Dist. No. 2 v. Hyde, 466 U.S. 2, 4-32 (1984); Tampa Elec. Co. v. Nashville Coal Co., 365 U.S. 320 (1961); Standard Oil Co. v. United States, 337 U.S. 293 (1949).

[42] *See* HOVENKAMP, *supra* note 6, § 10.9e, at 436.

[43] *See* United States v. Microsoft Corp., 87 F. Supp. 2d 30, 51-52 (2000).

[44] *Id.* at 46.

[45] *Id.* at 46, 52.

[46] *See id.* at 52.

the relevant market."[47] While the effect of exclusive dealing arrangements on competition is essential to any exclusive dealing claim, such an analysis misstates the relevant inquiry.[48]

The court elaborated an assortment of conditions that previous courts have looked at to evaluate anticompetitive effects.[49] The court listed six factors traditionally included in the exclusive dealing analysis.[50] The court did not follow with a discussion of how all these factors applied to the present case.[51] However, the application of the six factors can generally be inferred from the opinion.[52]

The first factor that the court listed was the degree of exclusivity.[53] The court discussed how the agreements showed a high degree of exclusivity.[54] The court found that Microsoft, for all practical purposes, had completely cut off two major Microsoft customers, Compaq and AOL, from any competitor.[55] Microsoft also sought an exclusive dealing contract with IBM.[56] The company rejected the offer in order to promote its own software.[57] Microsoft was intent on obtaining a highly exclusive arrangement here as well.[58] The record shows a strong basis for finding anticompetitive effects.[59] The exclusive dealing contracts' actual anticompetitive effects were severe. Netscape's Navigator

[47] *Id.*

[48] *See supra* Part II. *See, e.g.,* Aspen Skiing Co. v. Aspen Highlands Skiing Corp., 472 U.S. 585, 605 (1985) ("The question whether Ski Co.'s conduct may properly be characterized as exclusionary cannot by answered by simply considering its effect on [the competitor].").

[49] *See Microsoft*, 87 F. Supp. 2d at 52.

[50] *See id.*

> (1) the degree of exclusivity in the relevant line of commerce implicated by the agreements' terms; (2) whether the percentage of market foreclosed by the contracts is substantial enough to import that rivals will be largely excluded from competition; (3) the agreements' actual anticompetitive effect in the relevant line of commerce; (4) the existence of any legitimate, procompetitive business justifications offered by the defendant; (5) the length and irrevocability of the agreements; and (6) the availability of any less restrictive means for achieving the same benefits.

Id.

[51] *See id.* at 52-54.

[52] *See id.*

[53] *See id.* at 52.

[54] *See id.* at 52-53.

[55] *See id.* at 53.

[56] *See* United States v. Microsoft Corp., 84 F. Supp. 2d 9, 39 (D.D.C. 1999).

[57] *See id*.

[58] *See id*. at 41.

[59] *See, e.g., id.* (discussing the negative effects Microsoft's pursuit of an exclusive arrangement for software had on IBM, including the loss of the 1995 back-to-school market).

was a significant rival to Microsoft's Internet Explorer.[60] Not only were several customers been completely excluded from distributing Navigator,[61] the exclusive dealing arrangements also resulted in drastic reductions in Navigator's usage share.[62]

The court found in the Justice Department's favor in another factor as well, a lack of business justification for Microsoft's actions.[63] The court firmly stated that there were no pro-competitive reasons for Microsoft's conduct, noting that "Microsoft fail[ed] to advance any legitimate business objectives that actually explain[ed] the full extent of this *significant exclusionary impact*."[64] The court would also weigh the length and revocability of the agreements as an additional factor.[65] In other words, if the agreements lasted for a year or less, or could be terminated in that time, this would weigh in Microsoft favor.[66] This is an accurate description of the exclusive dealing arrangements. However, this factor is tempered by Microsoft's monopoly power.[67] Microsoft's monopoly status, combined with the tying of Internet Explorer to its operating system, provides the appropriate background on which to judge the duration of the agreements.

The final prong the court lists is "the availability of any less restrictive means for achieving the same benefit."[68] It seems logical to state that the Court would agree there are less restrictive means available, considering that the court has already held that the conduct at issue violated section 2 of the Sherman Act and was unlawful tying.[69] Microsoft's reasons for the contracts were to increase Internet Explorer's market share.[70] There were many other ways to achieve this goal.

Although Microsoft has apparently not prevailed on a majority of the

[60] *See id.* at 29.

[61] *See* United States v. Microsoft Corp., 87 F. Supp. 2d 30, 53 (D.D.C. 2000).

[62] *See Microsoft*, 84 F. Supp. 2d at 86-87.

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[63] *See Microsoft*, 87 F. Supp. 2d at 39-43.

[64] *Id.* at 40 (emphasis added).

[65] *See id.* at 52.

[66] *See* Roland Mach. Co. v. Dresser Indus., Inc., 749 F.2d 380, 394-95 (7th Cir. 1984) ("Exclusive-dealing contracts terminable in less than a year are presumptively lawful . . . ."); Barry Wright Corp. v. ITT Grinnell Corp., 724 F.2d 227, 237 (1st Cir. 1983) (finding two-year contracts reasonable).

[67] *See Microsoft*, 87 F. Supp. 2d at 36 ("[T]here are currently no products—and . . . there are not likely to be any in the near future—that a significant percentage of computer users worldwide could substitute for Intel-compatible PC operating systems without incurring substantial costs.").

[68] *Id.* at 52.

[69] *See id.* at 35.

[70] *See id.* at 44.

factors, Microsoft has managed to refute an exclusive dealing claim under the court's analysis.[71] It is seemingly odd, when a claim is evaluated under a six-prong test, that the defendant could prevail without establishing a majority of the factors in its favor.[72] Perhaps this is why the court placed little emphasis on all six factors after stating them.[73] Instead, the court focussed on the "substantial foreclosure" factor.[74] The court's focus on "substantial foreclosure" is a significant deviation from precedent.[75] The court discussed how Microsoft insured that Netscape was completely excluded from several major customers.[76] The court went on to discuss how Microsoft similarly excluded Netscape Navigator, its only significant rival, from other Internet content providers (ICPs), independent software vendors (ISVs) and Apple.[77] These customers represented the only viable channels for obtaining browser usage share.[78] Despite the obvious evidence of substantial exclusion due to the exclusive agreements the Court stated:

> Notwithstanding the extent to which these "exclusive" distribution agreements preempted the most efficient channels for Navigator to achieve browser usage share, however, the Court concludes that Microsoft's multiple agreements with distributors did not ultimately deprive Netscape of the ability to have access to every PC user worldwide to offer an opportunity to install Navigator. Navigator can be downloaded from the Internet. It is available through myriad retail channels. It can (and has been) mailed directly to an unlimited number of households.[79]

No matter how substantially Microsoft foreclosed competitors from effective distribution outlets, under this standard it would be difficult to condemn an exclusive dealing contract as long as competitors could mail their

[71] *See* discussion *supra* notes 52-73.

[72] *See id.*

[73] *See Microsoft*, 87 F. Supp. 2d at 52 (listing six factors for evaluating exclusive contracts).

[74] *See id.* ("This court has previously observed that the case law suggests that, unless the evidence demonstrates that Microsoft's agreements excluded Netscape altogether from access to roughly forty percent of the browser market, the Court should decline to find such agreements in violation of § 1.").

[75] *See supra* Part II.

[76] *See Microsoft*, 87 F. Supp. 2d. at 53 ("Compaq essentially ceased to distribute or pre-install Navigator at all in exchange for significant financial remuneration from Microsoft. AOL's March 12 and October 28, 1996 agreements with Microsoft also guaranteed that, for all practical purposes, Internet Explorer would be AOL's browser of choice . . . .") (citation omitted).

[77] *See id.*

[78] *See* United States v. Microsoft Corp., 84 F. Supp. 2d 9, 46-48 (D.D.C. 1999).

[79] *See Microsoft*, 87 F. Supp. 2d at 53.

products to potential customers or have it available for downloading from the Internet.[80] Relevant cases established that if foreclosure falls below the requisite amount the court should look to all relevant factors, not just distribution alternatives.[81]

The court sets up a requirement of forty percent foreclosure and then states that this requirement is not satisfied because Netscape still had access to retail, Internet, and direct mail as modes of distribution.[82] However, the court does not provide an analysis that effectively links the bare existence of additional distribution outlets and a finding of no substantial foreclosure.[83] Nor does the court provide guidance as to how much of the market these three distribution outlets account for.[84] The court does state that Netscape was not deprived access to every single PC user worldwide because of the existence of these additional outlets.[85] It seems to say that since every PC user worldwide is accessible by one or more of these additional distribution methods, there is no possibility that Microsoft's exclusive dealing arrangements could have cut off forty percent of the market.[86] Since every PC user is accessible, if this line of reasoning is followed, did Microsoft cut off any part of the market at all? Clearly Microsoft's anti-competitive conduct did foreclose some part of the market, and excluded Netscape from competition.[87] By not clearly establishing how much of the relevant market these alternative modes of distribution accounted for the court revealed a significant weakness in its reasoning.[88]

IV. CONCLUSION

The district court's analysis of exclusive dealing under section 1 of Sherman Act is a substantial departure from previous exclusive dealing standards. As precedent, the decision makes it significantly harder to prove exclusive dealing arrangements are unlawful. Since the analysis applies to section 1, which applies to all firms, it will potentially have a major impact.

The district court recognized the many antitrust violations for which Microsoft was responsible. Indeed, the only issue it ruled in Microsoft's favor was exclusive dealing. Given a proper understanding of the claim, it appears

[80] *See id*.

[81] *See, e.g.*, Jefferson Parish Hosp. Dist. No. 2 v. Hyde, 466 U.S. 2, 26-27 (1984); Tampa Elec. Co. v. Nashville Coal Co., 365 U.S. 320, 328-29 (1961).

[82] *See Microsoft*, 87 F. Supp. 2d at 53-54.

[83] *See id.*

[84] *See id.*

[85] *See id.*

[86] *See id.*

[87] *See id.*

[88] *See id.*

almost impossible not to find that the exclusive dealing at issue was unlawful. The lower court acknowledged the *Tampa* factors without discussing their application to Microsoft's exclusive dealing practices. Instead, it seemed to establish a new standard for substantial foreclosure, which mistakenly relies primarily on distribution alternatives rather than a balanced analysis.