LEGAL UPDATE

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

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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

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³ See Microsoft, 69 U.S.L.W. at 3222.
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.”).
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seller. 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

7 Microsoft, 87 F. Supp. 2d at 35.
8 See id.
9 See id. at 53.
11 See Microsoft, 87 F. Supp. 2d at 53.
12 See id.
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. Second, they raise the barriers to entry in the market. 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.* 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. 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.” This decision seemed to create a standard different from the “qualitative substantiality” test of *International Salt Co. v. United States.* 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%.”

*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. 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.


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

25 See id. § 10.9e, at 436.
arrangement may substantially lessen competition.  

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. The Court upheld the contract after intense scrutiny of its economic impact. Among other things, the Tampa Court looked at the affected market and the probable foreclosure. 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. The Court established a clear test to determine whether or not the foreclosure is substantial. 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). If foreclosure is sufficiently high, “Tampa’s rule of reason requires courts to examine numerous other factors . . . .” 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.”

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. This case involved a hospital that contracted to use only a particular firm of anesthesiologists. 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. The Court did not condemn the exclusive dealing contracts

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26 See Standard Oil, 377 U.S. at 298, 314.
28 See id. at 333-35.
29 See id.
30 Id. at 328.
31 See id. at 329.
32 See HOVENKAMP, supra note 6, § 10.9e, at 437.
33 Id. § 10.9e, at 435-36.
34 Id. § 10.9e, at 437-38.
36 See id. at 5.
37 See id. at 26-31.
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at issue, despite 30% foreclosure, because there was no showing of anti-
competitive effect. 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.

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. However, no Supreme Court decision
on exclusive dealing has ever announced such a standard. Most courts
continue to follow Tampa’s rule of reason approach for evaluating exclusive
dealing contracts.

III. MICROSOFT’S EXCLUSIVE DEALING ANALYSIS

The court began its analysis of the exclusive dealing claim by incorporating
elements of previous exclusive dealing cases. The court stated that “where
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.” Although the court uses the “substantial
foreclosure” language of Tampa, it already foreshadowed the importance it
will place on “outlets available to a competitor.” 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. 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

See id. at 26, 31.

See id. at 45-46 (O’Connor, J., concurring).

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

See generally Aspen Skiing Co. v. Aspen Highlands Skiing Corp., 472 U.S. 585
293 (1949).

See Hovenkamp, supra note 6, § 10.9e, at 436.


Id. at 46.

Id. at 46, 52.

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 be 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.


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).
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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.
62 See Microsoft, 84 F. Supp. 2d at 86-87.
63 See Microsoft, 87 F. Supp. 2d at 39-43.
64 Id. at 40 (emphasis added).
65 See id. at 52.
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 focused 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 preempts 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.
79 See Microsoft, 87 F. Supp. 2d at 53.
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products to potential customers or have it available for downloading from the Internet.\textsuperscript{80} Relevant cases established that if foreclosure falls below the requisite amount the court should look to all relevant factors, not just distribution alternatives.\textsuperscript{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.\textsuperscript{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.\textsuperscript{83} Nor does the court provide guidance as to how much of the market these three distribution outlets account for.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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

\textsuperscript{80} See id.
\textsuperscript{82} See Microsoft, 87 F. Supp. 2d at 53-54.
\textsuperscript{83} See id.
\textsuperscript{84} See id.
\textsuperscript{85} See id.
\textsuperscript{86} See id.
\textsuperscript{87} See id.
\textsuperscript{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.