THE MICROSOFT ANTITRUST CASES

COMPETITION POLICY FOR THE TWENTY-FIRST CENTURY

ANDREW I. GAVIL AND HARRY FIRST

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Commission's Office of Policy Planning. The views expressed in this book are solely his own and do not necessarily reflect the views of the FTC or those of any commissioner. No FTC resources were used in the completion of the book. Harry was the chief of the Antitrust Bureau of the New York State Attorney General's Office from May 1999 to May 2001, during which time he was responsible for supervising New York's efforts in the *Microsoft* litigation. The views he expresses in this book are solely his own and do not in any way reflect the views of the Office of the Attorney General.

Contents

1 The *Microsoft* Antitrust Cases

Microsoft Corporation's origins are legendary in the world of technology firms. Microsoft was founded in 1975 by Bill Gates and Paul Allen. Its most significant early product breakthrough came in the early 1980s, when it spearheaded the development of the first operating system for the IBM PC: the Microsoft disk operating system (MS-DOS). Late in 1985, building on the success of MS-DOS, Microsoft launched the first version of Windows. In 1989 it launched its first "suite" of office-productivity software, which it marketed under the name Office. The collective success of MS-DOS, Windows, and Office, fueled by advances in microchip technology and memory technology, was extraordinary. The personal-computer revolution propelled Microsoft to a position of preeminence in the computer world in little more than a decade, making it one of the most successful firms of the early information age.[1]

With that preeminence, however, came scrutiny by government antitrust enforcers in the United States and Europe. In 1990, Microsoft became a subject of extensive investigations that focused on its alliance with IBM and its use of restrictive licensing practices for Windows, which had already become its flagship product. Although these early investigations concluded with the entry of a consent decree in 1994, they fostered some of the principal story lines that would persist through years of legal challenges to Microsoft's practices. Whereas Microsoft's rivals and government prosecutors painted Microsoft as a ruthless predator abusing the power it had acquired in the market for PC operating systems to suppress competition, Microsoft countered that it was a victim of overzealous government prosecutors, who were too easily swayed by the lobbying efforts of its disgruntled rivals. Less clear at that time was that the firm's entanglement with the antitrust laws would persist and expand to include a multitude of public and private legal challenges in the United States and elsewhere in the world.

This book provides a comprehensive account of Microsoft's encounter with the global competition policy system (which now has spanned more than twenty years) and explores its lessons and its durable meaning. The enforcement effort directed at Microsoft—the collective "*Microsoft* cases"—provides a unique opportunity to study the strengths, the weaknesses, and some of the features of that system, which today includes federal, state, and private enforcers in the United States and more than a hundred public enforcement authorities around the world. That system, as revealed through the *Microsoft* cases, is institutionally and substantively intricate. Remarkably for a single group of related cases, the *Microsoft* cases illustrate virtually all of the richness of the antitrust tradition and the tensions inherent in it, from its origins through the emergence of today's global system.

Although we chronicle the most significant cases directed at Microsoft since 1990, specific emphasis is placed on the complementary public prosecutions of Microsoft initiated by the U.S. Department of Justice, twenty states, and the District of Columbia in May of 1998 and on the objections to its conduct initiated in Brussels by the European Commission. The U.S. actions were prompted by the imminent release of Windows 98, the next generation of Microsoft's operating system for desktop personal computers, which included Microsoft's latest version of a browser called Internet Explorer (IE). When those cases were filed in May of 1998, the Attorney General of the United States, Janet Reno, and representatives of the state government plaintiffs accused Microsoft of pursuing a wide-ranging campaign to destroy its principal browser rival, Netscape Communications, in order to obstruct competition in the emerging market for browsers and to perpetuate its monopoly of operating systems.[2] In a prepared statement, Joel Klein, the Assistant Attorney General in charge of the Antitrust Division, called on the federal district court "to put an end to Microsoft's unlawful campaign to eliminate competition, deter innovation, and restrict consumer choice."[3]

In investigating and eventually prosecuting their claims against Microsoft, federal and state prosecutors weren't assuming any novel role as government enforcers. Since July 2, 1890, when the first federal antitrust law—the Sherman Act—was signed into law, the federal government has frequently served as the policeman of national markets, dispensed to rein in overbearing private corporate power. Federal power, wielded in the public interest, was conceived by Congress as the antidote to such private power when it threatened to hinder competition.[4]

In important ways, however, the government's prosecution of Microsoft was unprecedented. It pitted the century-old Sherman Act against the volatile business practices of the information age. As the most significant monopolization case brought by the government since the litigation against International Business Machines (IBM) and American Telephone & Telegraph (AT&T) thirty years earlier, the prosecution also was unique in the degree to which it attracted immediate and continued attention outside the antitrust community. The notoriety of Microsoft and the ubiquity of its products guaranteed that the case would captivate the legal, business, and technology communities, as well as the public at large. With more than 90 percent of users of personal computers dependent on Microsoft's Windows operating system (on which the controversy centered), consumers, businesspeople, academic and corporate customers, and industry observers and investors all sought daily reports of the case's progress. For perhaps the first time in modern antitrust history, an antitrust case became a true cause célèbre. The press followed the case's daily progress with rapt attention.

Moreover, as the *Microsoft* cases expanded to engross the full range of public, private, domestic, and international institutional actors that today are responsible for enforcing the antitrust laws, they tested the capacity of the antitrust system to efficiently reach consistent, reasoned, and economically sound judgments about markets and competition. By 2001, the 1998 prosecutions had triggered a far wider engagement with the U.S. antitrust system as the proceedings against Microsoft multiplied throughout the country. Producers of complementary software, Microsoft's rivals, consumers, and customers (including government customers such as school districts), initiated scores of antitrust claims directed at Microsoft. In all, Microsoft was sued more than two hundred times in the United States, in both state and federal courts, as a consequence of the conduct highlighted by the government cases. Potential recoveries in the billions of dollars were sought by rivals and millions of consumers. Microsoft not only had to defend itself; it also had to manage numerous cases, many of them brought as class actions, with overlapping claims in multiple jurisdictions. And the courts had to do the same, coordinating the cases both formally and informally given the procedural tools available.

Microsoft's encounter with the antitrust system, however, wasn't confined to the United States. A global competition policy system was emerging. Reflecting that changing regulatory landscape, Microsoft's antitrust troubles expanded beyond the borders of the United States. Simultaneously with the U.S. cases, the investigation and prosecution of Microsoft on related grounds proceeded outside the United States, most importantly in Europe. Early in 2004, after a five-year investigation and lengthy negotiations with Microsoft, the European Commission, which is charged with enforcing the European Union's competition laws, concluded that Microsoft had indeed violated those laws by tying its Windows Media Player to the Windows PC operating system and by refusing to give its rivals in the market for operating systems for workgroup servers the interface information that would enable their products to interoperate with Windows. This proceeding was followed by a second case, filed and settled in 2009, charging that Microsoft was unlawfully tying its Internet browser, IE, to its dominant Windows PC operating system.

Taken together, the public and private *Microsoft* cases in the United States and elsewhere in the world thus illuminate many of the most pressing challenges to policing competition in the global marketplace of the twenty-first century, especially in technology industries.

Goals of the Book

This book has three primary goals. The first is to provide a comprehensive account of the decades-long effort to police Microsoft, emphasizing the government-led efforts in the United States and the European Union but also examining the extensive private litigation in the United States. What were these cases about? What were their goals? What did the evidence show? Were the cases ultimately successful in securing their goals? Did they serve the broader public policies of competition law? With respect to the private cases, we will ask whether consumers were indeed harmed by Microsoft's conduct and, if so, whether they were adequately compensated. In answering these questions, we detail the theories behind the cases and the facts as revealed by the evidence; we will also examine the legal principles and economic analysis that were used to resolve them. As we will see, these elements became plot lines in complex and competing narratives woven together and advocated by Microsoft and its adversaries. Which narratives proved to be most consistent with the evidence, and thus most persuasive?

In chapter 2 we examine Microsoft's early encounters with U.S. and European competition authorities—the "pre-history" of the major battles that commenced in 1998. In chapters 3 and 4 we take an in-depth look at the cases commenced by the federal government and the states in 1998. In chapter 5 we turn to the private litigation that followed in the United States during the subsequent decade. In chapter 6 we discuss the proceedings in Europe that began in late 1998.

To assess the durable meaning of the *Microsoft* cases, however, it also will be necessary to locate them in their broader institutional and political context. As was noted above, the government cases filed in the United States in 1998 triggered a far broader effort to constrain Microsoft from abusing its market power and to remedy the consequences of its conduct. This institutional complexity led to political complexity. Through three successive administrations in Washington, federal and state antitrust agencies sought to coordinate their efforts while Microsoft and its rivals sought to persuade the various and changing government officials of their respective views of Microsoft's conduct.

A second major goal of the book, therefore, is to use the *Microsoft* cases—public, private, domestic, and international—to illuminate and evaluate the institutional and remedial dimensions of contemporary antitrust enforcement. Two federal agencies, a multiplicity of states, numerous private parties, and a number of foreign antitrust enforcement agencies all pursued Microsoft. Courts and (at least in theory) juries in the United States were charged with sifting through often complex economic and technical evidence to resolve the various claims and defenses of the parties. Expert witnesses, especially economists, also emerged as critical players in this system, influencing the framing and presentation of the key issues in the cases.

What reasons could there be for constructing such a multi-layered, arguably overlapping, global "antitrust system" in which a single U.S.-based firm can be subject to investigation by multiple government enforcement institutions and exposed to years of private suits by the victims of its conduct? Is it sensible public policy to subject successful firms to the scrutiny—and uncertainty—of investigation and possible legal action by so large and so diverse a group of potential challengers? How can multiple public enforcers with overlapping enforcement authority—and potentially with different judgments about the nature of any given case—readily cooperate or sort out differences of opinion when they arise?

Third, and related to the first two goals, the *Microsoft* cases sparked a continuing and intense debate among ardent critics and supporters of antitrust enforcement about the standards to be applied in judging the conduct of large firms, referred to as "monopolists" in the United States and as "dominant firms" in most other parts of the world. The international scope of that debate confirmed the coming of age of the "global" competition policy system. Whereas enforcers and commentators in the United States had for decades presumed to take a leading role in discussions of competition policy, their counterparts abroad emerged with greater confidence as equals in this debate, initiating cases of their own and issuing public guidelines and guidance statements detailing their enforcement priorities. Notwithstanding sometimes vocal and public criticism of their efforts from

U.S. antitrust enforcement officials, they often concluded that the increasingly non-interventionist views of U.S. officials and courts were inconsistent with their own assessments of sound policy.

This debate about substantive and remedial standards has revealed not only differences of opinion among economists and lawyers, but also significant and continuing ideological divisions. Those divisions often flow more from political judgments than from economic judgments about the ability of markets to self-correct in response to abusive conduct by dominant firms, the competence of government agents to police their conduct, and the probable effect of specific legal judgments on the innovation incentives of dominant firms and those who would challenge them. Often expressed as presumptions about the likely incidence and consequences of error by decision makers and the comparative virtues and efficacy of markets and the rule of law, they can profoundly influence policy makers' preferences for alternative institutions, legal standards, burdens of proof, perceptions of evidence, and remedies.

In chapters 7–9, assessing these institutional, substantive, and remedial issues, we seek to answer some of the most important questions raised by advocates and critics of the *Microsoft* cases: Were the institutions charged with enforcement of their respective national competition laws up to the challenge of evaluating the effects of Microsoft's conduct? Were the laws themselves up to the task of accurately judging Microsoft's conduct? Were the tools of antitrust analysis suited to the economics of the computer software industry? Were the remedies imposed on Microsoft through negotiated settlements and court orders adequate? Did they halt Microsoft's anticompetitive conduct? Did they appropriately deter Microsoft (and other large firms) from engaging in similar conduct in the future? Did they effectively restore the competition that Microsoft suppressed? In chapter 7 we assess the range of remedies that were proposed and imposed on Microsoft globally and offer a set of "lessons learned" from the *Microsoft* remedy experience. In chapter 8 we focus on the challenges and virtues of institutional diversity, showing how the *Microsoft* case benefited from today's diverse and decentralized antitrust enforcement system. In chapter 9 we return to the central questions of our study of the *Microsoft* litigation and the implications their answers have for competition policy in the twenty-first century.

A study of the *Microsoft* cases remains timely and important for a number of reasons. After more than two decades of public, private, domestic, and foreign investigations and lawsuits, the *Microsoft* cases collectively provide a unique opportunity to study the integrity and operation of the still-evolving global competition policy system. It is now more possible than ever before to seek answers to the many questions we have posed—to identify and assess the lessons learned from the cases from institutional, remedial, and substantive law perspectives.

In the remainder of this chapter, we provide a general overview of the federal antitrust laws in the United States that were invoked to judge Microsoft's conduct, especially Section 2 of the Sherman Act. Since its enactment in 1890, Section 2 has prohibited three offenses: "monopolization," "attempt to monopolize," and "conspiracy to monopolize." It has been invoked against some of the most storied names in American business history, including Standard Oil, Alcoa, DuPont, AT&T, and IBM. Through these and other cases, standards for judging the legality of single-firm conduct have evolved and significantly influenced the legal and economic analysis of Microsoft's conduct.

Antitrust Laws and Monopoly in the United States: A Brief History

To begin our examination of the *Microsoft* cases, it is first necessary to appreciate the basic legal framework of U.S. antitrust laws. As the oldest set of contemporary competition laws in the world, they have influenced other jurisdictions, sometimes by their specific letter but more often through the economic concepts that have developed to guide their interpretation and application, especially since the 1970s. This is true in the analysis of cartels and mergers, as well as with respect to the acts of single, powerful firms.

At the federal level, the principal prohibitions are contained in three statutes: the Sherman Act of 1890, the Clayton Act of 1914, and the Federal Trade Commission Act of 1914. There are also individual state antitrust laws in nearly all of the fifty states and in the District of Columbia, and there are complementary federal and state consumer-protection laws that can be invoked in conjunction with or as alternatives to federal antitrust laws.

The federal antitrust laws are enforced by two federal agencies (the Federal Trade Commission and the Antitrust Division of the Department of Justice), by the attorneys general of the states, and by private parties. The "private right of action," an original feature of the Sherman Act, is now codified in Section 4 of the Clayton Act. It has often been referred to as empowering "private attorneys general" who by pursuing their own self-interests also serve the public interest.[5] As we discuss in chapter 5, the U.S. private right of action, uniquely in the world, permits the victims of antitrust violations to recover treble damages—that is, three times their actual damages—and, in addition, their attorneys' fees and litigation costs. When integrated into the federal system of litigation, which authorizes class actions and broad discovery of evidence, this right of action can provide a formidable deterrent to anticompetitive conduct and a means of securing compensation. Critics have argued, however, that it provides so great an incentive to bring suit that weak cases are inadvertently encouraged and unwarranted settlements may result simply to avoid the costs of typically complex and protracted antitrust litigation. These concerns have also been expressed by the U.S. Supreme Court, which has invoked them to constrain the scope of both the private right of action and the substantive antitrust law.[6]

As we have already noted, the antitrust system of the United States operates today in the far wider context of a global system of "competition laws." This expansion of antitrust into a global enterprise is a direct consequence of two developments: the maturing of the European Union since its inception in 1957 and, more recently, the dissolution of the Soviet Union in 1991 and the consequent redirection of many countries in Eastern Europe and elsewhere away from centrally planned economies and toward greater reliance on market principles. Although the laws of other jurisdictions often have features in common with U.S. laws, they are increasingly modeled on the somewhat different laws and institutions of the European Union.[7]

The principal allegations in the governments' cases against Microsoft in the United States arose under the first two sections of the Sherman Act, which contain its principal prohibitions. Section 1 of the Act prohibits "contracts, combinations in the form of trust, or otherwise, and conspiracies" that unreasonably "restrain trade." A violation of Section 1, therefore, has two elements. First, there must be "concerted action"—that is, coordinated action by more than one person or firm. Second, the conduct challenged must have an unreasonably adverse effect on competition. Since the Supreme Court's 1911 *Standard Oil* decision, the standard for judging concerted action's effect on competition has been the "rule of reason."[8] Under the rule of reason, adverse competitive effect sometimes can be presumed, as with the most obvious kinds of anticompetitive conduct—for example, the formation of a cartel to fix prices rather than compete. In such cases, the courts have traditionally applied a "*per se*" approach to applying the rule of reason that presumes that the conduct in question is unreasonably anticompetitive and precludes evidence of any defenses. The presumption is therefore irrebuttable. Often, however, the effects of concerted action are less obvious. In such cases, courts and enforcement agencies have relied on a range of relatively more comprehensive methods of applying the rule of reason that involve shifting but rebuttable presumptions. Using a sliding scale, the courts evaluate the relative strength of the evidence of both anticompetitive and procompetitive effects, especially efficiencies, to reach a judgment about a particular restraint's reasonableness.[9] Section 2 of the Sherman Act complements Section 1 and prohibits three distinct offenses: monopolization, attempt to monopolize, and conspiracy to monopolize. In contrast to Section 1, Section 2 can reach the actions of a single firm—what is sometimes referred to as "unilateral" or "single-firm" conduct.[10]

The bulk of the legislative history of the Sherman Act explores its first section, which most directly addressed the principal concern of the day: the "trusts." It was these trusts—formed in, for example, the oil, sugar, railroad, whiskey, and tobacco industries—that most preoccupied the Congress in 1890.[11] Through collusion, sometimes overt and sometimes tacit, rivals in these and other industries coordinated their pricing and their production in lieu of competing. Consumers were the losers and literally paid the price.

The trusts were feared, however, not only for their power over price but also for their willingness to protect and effectuate that power by engaging in "exclusionary" or "predatory" conduct.[12] Such conduct might be directed at barring the entry into the market by would-be rivals of the trusts, or at punishing members of the trust who deviated from its agreed-upon prices and practices. Often the targets of exclusionary conduct by the trusts were smaller businesses, and it has long been evident that the Sherman Act and the later Clayton Act were viewed in part as vehicles for protecting such smaller businesses from the exclusionary tactics of their larger rivals. But that was understood as an intermediary purpose. The ultimate goal was to protect consumers from the consequences of the diminished rivalry that followed from exclusion.[13] Yet for the Sherman Act's drafters there was no distinction between protecting competitors and protecting competition—to protect competition, rivals had to be shielded from the exclusionary strategies of dominant firms. As we shall learn, however, the Supreme Court, in its recent interpretations and applications of the Sherman Act, has viewed these two complementary purposes as distinct and has prioritized the protection of "competition" over the protection of individual "competitors." It has reasoned that it is necessary to do so lest the law be used to shield unworthy rivals from healthy though aggressive competition. This argument was frequently advanced by Microsoft in response to charges that it had harmed its rivals.

Today, the economic relationship between collusion and exclusion that was implicitly acknowledged in Sections 1 and 2 of the Sherman Act is better understood than it was in 1890. In order to exercise what economists call "market power"—the ability to charge prices above the competitive level or to otherwise restrict other dimensions of competition, such as service, quality, or innovation—a single firm or a group of colluding firms may have to impair or totally preclude rivals from responding through entry or expansion. Without some control over entry, the effort to exercise market power may well fail, because it will attract new or expanded entry by firms willing to provide customers better products, services, and/or lower prices. This imperative to control entry as a means of facilitating the exercise of market power is as true for a single dominant firm as it is for a group of rivals who have formed a trust or a cartel. For the monopolist bent on raising or maintaining price, it must be true that entry by new firms or expansion by firms already in the market is very difficult or that cost-effective strategies are available for the monopolist to make it so. In fact, the monopolist might well be willing to invest significant resources in such strategies, provided the payoff in power over price is sufficiently promising. This conduct—undertaken primarily in the hope that it will facilitate the collection of supra-competitive profits[14]—is sometimes referred to as "rent-seeking." "Barriers to entry" are often viewed, therefore, as a prerequisite to the successful exercise of market power, whether it is exercised by a coordinated group of rivals or by a single firm. And under the antitrust laws conduct that creates, raises, or fortifies barriers to entry can be suspect when it facilitates the exercise of market power. Such barriers impair the ability of actual or potential rival firms to respond to the monopolist's high-priced goods and hence reduce consumers' ability to switch their allegiance.

In recognition of the relationship between power over price and entry into the market, Section 2 of the Sherman Act is directed at exclusion. It was added late in the legislative process, but it is essential to the operation of Section 1. It was viewed as a complement to Section 1, intended to catch any firms that somehow slipped past Section 1's prohibition of concerted action, successfully reaching the status of "monopoly," but only when they acted to prevent competition by some illicit means.[15] Sections 1 and 2 acknowledged collusion and exclusion, therefore, as the twin foundations of modern antitrust policy.[16]

Prohibiting the conduct of a single firm that excludes rivals, however, can be tricky. The Sherman Act's requirement of exclusionary or predatory conduct manifests an intuition about competition that was evident even in the legislative history of 1890: that competition will always have winners and losers. Monopoly may be the consequence of a successful battle for supremacy in a field. From the points of view of both the victor