

The Evolution of the "Microsoft Case"

by Alberto Mingardi e Paolo Zanetto

KEY FINDINGS

- The "new" brand name for the unbundled version of the Windows OS is still to be decided.
- The application by Microsoft for a suspension of the punitive measures against it has been rejected, since the company could not prove the "irreparable harm" considered by European law essential.
- The issue of abuse of dominant position is still a very sensitive one, in particular because of its impact on transatlantic relations.
- Commissioner Kroes must face the daunting challenge of antitrust reform. Mending the mistakes of the former Commission might enhance confidence in the law all over Europe.

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He could not believe his eyes. Reading e-mails in his Seattle office, Bob Kimball was tempted to believe it was some kind of practical joke. Director-General of Competition Philip Lowe, the chief executive of the European antitrust authority, was asking him an opinion on the new customized version of the Windows operating system for the European market, from which Media Player was stripped.

Basically, the European antitrust agency was asking RealNetworks, the main competitor of Microsoft in the digital media player market, for an opinion on how exactly Windows should be advertised in Europe.¹ Waiting to fly to Brussels to a meeting with European Commission officials, Kimball was stunned. Nothing of this kind could ever happen in the U.S.

Microsoft competitors can pass judgment on the actual compliance of Bill Gates' company with antitrust regulations. This is what is happening since February 2005 in the offices of the European Commission's Directorate-General for Competition. Not satisfied with the 650 million dollars fine inflicted on Microsoft the previous year, antitrust officials are not letting go of the Redmond-based software company. Indeed, a renewed spurt of activism seems to have taken hold of them. Since December 2004, when the European Court of First Instance rejected Microsoft's application to have the measures imposed against it suspended pending

the decision on the appellate case, the Commission felt more confident.²

Today the interest is focused less on the fine, promptly paid last June, than on the actual compliance by Microsoft with the measures.³ There are two other, more complex, facets of the whole issue. The first is the obligation to disclose to competitors significant parts of the source code of Windows, with the stated aim to achieve a greater interoperability between different software architectures. The second issue is more straightforward. The European Commissioner to Competition Mario Monti ordered Microsoft to offer on the European market an "unbundled" version of the Windows OS, that is, a version stripped of Windows Media Player, an application used to play music and movies on a PC. Despite its misgivings, Microsoft complied with the order, but now it seems that Brussels entertains qualms about the very name of the product.

Microsoft wishes to inform customers that they are purchasing an incomplete product, since it lacks a basic component. The name chosen by the marketing division of Microsoft for the compliant version of the operating system was Windows XP Reduced Media Edition, but this did not satisfy the European antitrust agency. Therefore the Directorate-General for Competition summoned the major competitors of Microsoft to have them submit alternative brand names for the system. At the end of the consultations, which entailed long meetings for executives with an otherwise very busy agenda, the name was arrived at of Windows XP – WMP Not Included – Home Edition. Still, this is not yet the definitive name, and the meetings to determine it will continue in the next few weeks.⁴

Pending a decision on the most agreeable name for its officials and Bill Gates' competitors alike, the European Commission threatens new actions. First, it has reserved the right to impose a new fine in case the disclosure of the source code of Windows XP is not deemed satisfying. Moreover, Director General Philip Lowe is still refusing to negotiate with Microsoft an agreement to the consumers' benefit.⁵ The policy of the Competition Directorate is still the one established by Commissioner Monti: no to negotiations, and go for broke, even when facing the prospect of a protracted and uncertain litigation in the European Court.⁶ Until the newly appointed Competition Commissioner Neelie Kroes will make her views known, Brussels keeps its adversarial stance.

Evidence of such a stance came in early February. The Commission started a new investigation on the joint acquisition by Microsoft and Time Warner of the American company ContentGuard, specialized in the digital rights management business, that is, providing embedded security features in audio and video files so as to prevent their unauthorized copy. The antitrust agency had originally started to look into the matter in August 2004, and was thus formalizing the investigation.⁷ The Commission will inform the parties by April 7th whether the acquisition, already approved by the American authorities, can proceed, on the ra-

tionale than the know-how from ContentGuard might provide Microsoft with "the power to put its rivals at a competitive disadvantage."⁸

Every business decision by Microsoft is closely monitored, waiting for the company to make a false step that the Commission can translate into new rulings or legal threats. In the meanwhile the appellate case from Microsoft is continuing, even though no decision is likely for some time. In other words, the two parties are locked in a Mexican standoff. Which begs the question, how was it possible to arrive to such a situation?

A foretold verdict

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On March 16th, 2004, against the advice of some of his closest advisers,⁹ the European Commissioner to Competition Mario Monti decided to shut the door in the face of Steve Ballmer, arrived in Brussels to finalize a settlement that by then the negotiators of both sides believed imminent. "I believe consumers will be better served with a decision that creates a strong precedent" declared Commissioner Monti in a foreboding statement.¹⁰

The following week Microsoft was found guilty of abuse of its dominant position. In addition to being fined more than 650 million dollars, Microsoft was ordered by the Commission to undertake two significant steps. First, Microsoft must disclose to its competitors part of the source code of its Windows OS, with the aim to provide full interoperability of its operating system with software running on different architectures. Moreover, the company was ordered to offer on the European market a version of its Windows operating system stripped of the Media Player feature.

The dogged determination of Commissioner Monti brought about a ruling which significantly departs from the established case law. The decision against Microsoft brings beyond any previous limit the circumstances in which a company can be required to disclose to competitors proprietary information.¹¹ Eu-

European law provides that the release of such information can only be ordered in “exceptional circumstances.” The few precedents dealt with content of little strategic significance, such as schedules and content of TV guides.¹²

Further, in the case of Microsoft the Commission contrived a wholly new standard of compliance with antitrust regulations, requiring innovative companies to prove that the introduction of new features in their products is “indispensable” to compete in a particular market segment.¹³ If the Court of First Instance will uphold this principle, the precedent will have a significant impact on the European economy. Businesses in many markets, from car-making to aerospace, will be discouraged to introduce innovative features.¹⁴ This would lead to a severe competitiveness gap with goods produced abroad.

This considerations notwithstanding, Commissioner Monti continues to defend his decision. In his speech on European Competition Day 2004, Monti commented the Microsoft case remarking that “the market concerned is complex for most users, possibly not so much for youngsters who use the Internet daily and are familiar with terms such as media players. However, we have to safeguard the interests of all customers, be they expert or not.”¹⁵ In other words, the Commission must protect the less savvy consumers from themselves.

Monti went on saying that “we concluded that by tying [...] Microsoft sharply reduces the incentive to innovate,” without considering the possibility that the alleged lack of innovation might simply be due to the fact that consumers are happy with the technological and commercial offers of Microsoft. Monti also stated that “our un-tying remedy does not mean that the customers will obtain PCs and operating systems without media players [...]. Consumers have the benefit of PC manufacturers acting as their ‘purchasing agents’ who choose the software to preload onto the PC.”¹⁶ Before the decision by Monti, never had OEM been forbidden to add software to their products; likewise – in Europe as much as in the rest of the world – ven-

dors can run their machines on the preferred operating system, be it Windows, Linux or whatever else.

The real enemies

Since the beginnings of the European Commission investigation, Microsoft realized that it had to counter first the accusations of its competitors, and only then face the charges of the European antitrust agency. In fact, it was Microsoft’s competitors that set the case in motion, persuading the Commission to proceed with the investigation against Microsoft under the auspices of Commissioner Monti. Likewise, Microsoft’s competitors provided the Commission with the necessary legal and economic advice to fight off Bill Gates.

These companies played their game, and the Commission was only too glad to go along.¹⁷

After being fined for more than 600 million dollars and being subjected to far-fetched requirements in the whole European market, Microsoft realized that in its legal battle against the Commission it could no longer ignore the fact that the case was largely supported by its competi-

tors. Bill Gates’ company was forced to a very burdensome change of strategy, which entailed the need to convince—and sometimes buy off—some of its historical competitors, companies whose interests never lied in the welfare of European consumers, but rather in weakening the legal standing of Microsoft and the erosion of its market share.

The situation was degenerating. The offices of the European competition agency, which by order of Commissioner Monti were to co-operate with Microsoft’s competitors, were besieged by a host of lawyers and economists hired by those companies.¹⁸ All the major law firms were mobilized to fatten the file against Microsoft. Sun hired Allen & Overy, disbursing a hefty fee for the services of Michael Reynolds, head of its International Antitrust Group.¹⁹ The Computer Communications Industry Association (CCIA), a trade group of Microsoft’s competitors, hired the largest law firm in the world, Clifford Chance, and in particular its

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specialist in European Union competition and intellectual property law, Thomas Vinje.²⁰

Between September and November 2004, Microsoft decided to bring this game to a close: it bought off its opponents, leaving the Commission to fight alone the case, without the unceasing prompting from Microsoft's competitors. The sum paid to Novell alone was 536 million dollars, but Sun and Time Warner have also received their fair share.²¹ The CCIA, a grouping of the major companies united against Microsoft in the European antitrust case, was paid off with 19 million dollars. Remarkably, an astounding 10 million dollars of this latter sum was granted to the president of the CCIA, Ed Black, as a reward for his effectiveness in the case against Microsoft in the last few years.²²

A few calculations will show the real damage wrought on Microsoft by the tactics used by its opponents along with the European Commission. The various settlements concluded by Microsoft with its competitors with the aim of having them cease their legal support to the Commission were worth about 3.5 billion dollars. In the next few years, the company expects its legal costs due to the European case to total about 750 million dollars.²³ Neither the image loss caused by the compulsory offering of an unbundled version of the Windows OS, nor the – potentially huge – damage due to the forced disclosure to competitors of a significant part of the Windows source code can be quantified. In comparison with these sums, the hefty fine imposed by the Commission (650 million dollars) might well be considered pocket change.

Ninety pages from the Court

On June 29th, 2004 John Connors, Chief Financial Officer of Microsoft, authorized a deposit of 656 million dollars on an escrow account on behalf of the European Commission.²⁴ By then, Steve Ballmer, CEO of Microsoft, had decided to fight the case in court, in the hope that the departure of Monti from the Com-

mission might cause it to adopt a less confrontational and ideological approach.

The company's lawyers have declared the intention to appeal to the European Court of First Instance, which in the past has often overturned the rulings by Mario Monti and his department. Still waiting for the decision on the GE-Honeywell merger, rejected by Monti after it had been approved by the American regulators, the Commission is acutely aware of its weakness in a court.²⁵

The first step was an application by Microsoft for the temporary suspension of the measures imposed by the Commission. In September 2004 Microsoft submitted to the Court of First Instance an appeal for such a suspension, pending the decision on its appellate case. The Court, presided by the Danish judge Bo Vesterdorf, then heard the arguments of the Commission and the defendant.²⁶

Microsoft reminded the judge that the decision of the Commission needed to be supported by a strong economic case, remarking that the ruling of March 2004 was not always consistent under this respect. Further, the company was able to show that in the preceding months the rival media file formats had achieved a number of significant successes, belying the notion of a monopoly by Microsoft in this market segment. Microsoft referred to the acquisition of MusicMatch by Yahoo and, in particular, to Apple and the enormous success of its iPod,²⁷ a success decreed by the consumers themselves.

Unfortunately, the unintended effect has been to cause the Commission to open an investigation on iPod and iTunes. The antitrust agency aims to overthrow the dominance by Apple in the market of pocket media file players. Taking into account that iPod is an innovative product that basically created an entirely new market, the urge of the Commission to regulate its fledgling development is nothing short of worrying.²⁸

The decision on the application for a suspension filed by Microsoft was pronounced shortly before Christmas.

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Judge Vesterdorf rejected the request on very specific grounds: European law provides for the suspension of punitive measures pending a decision on an appeal only if it can be shown that they cause a company “irreparable harm.”²⁹ This is quite a demanding standard: in fact, just only 15 per cent of such petitions succeed.³⁰ For a company such as Microsoft, which in its latest balance sheet reported liquid assets for more than 34 billion dollars, it is almost impossible to prove such an “irreparable harm.”³¹

However, the Court’s report on the grounds for its decision, which covers some 90 pages, shows a number of substantial openings to the case presented by the company. In it, the Court of First Instance conceded that Microsoft has a solid case on both of the main facets of the issue.

As regards Media Player, the judge acknowledged the legal merit of the argument that the benefits accruing the consumers by the availability of a bundled product might outweigh any harm due to anti-competitive effects. The Court went as far as stating that the objection raised by Microsoft “is likely to raise one or more important questions of principle which may affect the legality of the Commission’s analysis.”³²

Concerning the disclosure of Windows’ source code to competitors, the Court acknowledged the commercial value and the confidential nature of such information. The judge remarked that Windows’ source code is an “hitherto secret” technology, and “fundamentally different” from the information at issue in the one similar case ever heard in Europe, namely the compulsory release of information on the schedules of TV programs. Judge Vesterdorf pointed out that the central issue lies in balancing consumers’ protection with the negative impact on the company’s incentive to innovate caused by the dissemination of confidential information.³³

Shortly after the decision of the suspension of the remedies imposed by the Commission, Microsoft announced that it would not appeal against it.³⁴ At the same time, the appellate case against the original decision by the Commission goes on, and a decision

is expected in two-three years’ time. Meanwhile, the executives of Microsoft never tire to declare the company ready to negotiate and find an agreement suitable to the Commission and the consumers.³⁵ Unfortunately the Eurocrats are turning a deaf ear to this request and seem to be unwilling to reach an accommodation.

Waiting for a reform

Facing such a stalemate, it is not yet clear what the approach will be of Neelie Kroes, the newly-appointed Commissioner to Competition. After having taken office in early November, Kroes still has not involved herself in the case of Microsoft. Perhaps she is still collecting herself after the ordeal of her confirmation hearings.

Neelie Kroes is not an academic, as in the case of Monti, neither is she a career bureaucrat, as the Director-General of Competition

Philip Lowe. Her background is in business and politics: she is a former minister in the Dutch Cabinet, and she was an executive of large companies and a member of the board of major multinational companies. This has led some to attack her for being liable to a possible conflict of interests. However, as both Commissioner Kroes and the Chairman of the Commission Barroso have remarked, a business background is to be seen as added value, and not as an offence.³⁶

The true challenge facing the newly-appointed Commissioner is a reform of the European antitrust system. After the many decisions of the European Court that have overturned his policies, even Mario Monti opted for a fundamental reform of the mergers and acquisitions department of the Directorate-General for Competition. In contrast, every reform proposal in the area of abuse of dominant market position – to which the case of Microsoft pertains – has quietly died down.³⁷

The current system for coping with abuses of dominant market position has been widely criticized, particularly for the excessive legalism to the detriment of a more rigorous economic analysis, as happens in

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other areas of competition law.³⁸ Further, in the current system every measure is unilaterally decided by the Commission, without due process of law, which would entail the presence of a plaintiff, a defendant and a judge above the parties. In contrast, the antitrust agency is both prosecutor and judge in the case. This obvious dissonance has caused many decisions of Brussels to be overturned on appeal by the EU Court.³⁹

To further complicate the scene is the fact that the notion of abuse of dominant position is particularly sensitive because it impinges on transatlantic relations. The new Commission led by Manuel Durão Barroso would like to have a more friendly relationship with America than was the case in the last few years, and the regulation of dominant market position is one of the areas stressed by the US Administration to achieve a closer alignment of the law on the two sides of the Atlantic.

Larry Lindsay, National Economic Council Director in the first Bush Administration, wrote "antitrust policy is one area in which European motives are becom-

ing increasingly hard to defend, even for committed Atlanticists. Problems began when the European Commission blocked the planned merger of General Electric and Honeywell in 2001," or, in other words, when Mario Monti decided to change course. Also, in his opinion, "the record-setting fine that Europe levied against Microsoft coupled with demands for highly interventionist remedies further fuelled suspicions about European motives."⁴⁰

Hewitt Pate, U.S. Assistant Attorney General for Antitrust, has been a consistent critic of the way his European counterparts run cases of dominant position, and warns that the lack of confidence and clearness on the European front makes very hard for multinational corporations to operate there.⁴¹

Commissioner Kroes is facing a daunting task: everyone agrees that the reform of antitrust is by now a priority. To correct some of the mistakes of the past administration could help to rebuild the confidence in the law in Europe. If the Commission will prove to be unable to mend itself, it is very likely that the hand will pass to the courts.

Endnotes

- 1 Meller (2005).
- 2 Buck (2004g).
- 3 European Commission (2004c).
- 4 Buck (2005c).
- 5 Microsoft Corp. (2004b).
- 6 Buck (2005a).
- 7 European Commission (2004b).
- 8 Buck (2005b).
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- 14 Burnside (2005).
- 15 Monti 820049.
- 16 Ibidem.
- 17 Mingardi, Zanetto (2004B).
- 18 Buck (2004e).
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