DCI CASE STUDY

CS#1 November 16, 2021

The Microsoft Antitrust Saga

NATALIA MORENO BELLOSO

EUI Berkeley UNIVERSITY OF CALIFORNIA VU VRIJE UNIVERSITEIT AMSTERDAM

THE MICROSOFT ANTITRUST SAGA

Dynamic Competition Initiative
Note prepared by Natalia Moreno Belloso

For over two decades, Microsoft was the subject of antitrust scrutiny on both sides of the Atlantic. Innovation featured heavily in the resulting antitrust saga. At the heart of the events in the United States is the succession of decisions issued by the district court and appeals court in the 1998 monopolization case.

On May 18, 1998, the Department of Justice (DOJ), nineteen states and the District of Columbia filed an antitrust suit against Microsoft under Sections 1 and 2 of the Sherman Act. The complaint alleged that a range of Microsoft's practices were anticompetitive, in particular its tying of the Internet Explorer browser to the Windows operating system as well as various restrictive provisions in its agreements with original equipment manufacturers (OEMs) and others. The overarching narrative of the complaint was that Microsoft's practices were its response to a twofold competitive threat to its monopoly in the market for PC operating systems. First, there was the rise of internet browsers, such as Netscape's Navigator, which can be run on any operating system and offer the potential to be a platform to which operating system-independent applications can be written. Second, such browsers enable any application written in Java, Sun Microsystem's programming language, to be run regardless of the underlying operating system. The threat lay in the potential of these developments to reduce the "applications barrier to entry" from which Microsoft benefited: they could incentivize developers to create new applications that are not dependent on Windows, which would in turn diminish the reliance of OEMs on Windows and weaken Microsoft's operating system monopoly.

The narratives of both the DOJ and Microsoft featured innovation, but in markedly different ways. The DOJ complaint essentially contended that Microsoft's practices discouraged (potential) competitors from innovating, thereby delaying the introduction of technologies that threatened Microsoft's monopoly. Conversely, Microsoft's narrative focused on its own innovation, cautioning that antitrust enforcement would impair its incentives to innovate. Whereas the plaintiffs' conception of innovation centered on the creation of an alternative platform which would erode Microsoft's operating system monopoly, Microsoft focuses on innovation through the integration of novel functions into its products. Here, the innovation was making Internet Explorer an integral part of Windows.

In late 1998, District Judge Thomas Penfield Jackson issued his findings of fact, finding that Microsoft holds monopoly power in the PC operating systems market and that it engaged in various practices to protect this monopoly. Many of these practices harmed consumers directly, as well as indirectly by distorting competition and discouraging innovation. Echoing the DOJ's narrative, Judge Jackson concludes that "[m]ost harmful of all is the message that Microsoft's actions have conveyed to every enterprise with the potential to innovate in the computer industry. Through its conduct (...) Microsoft has demonstrated that it will use its prodigious market power and immense profits to harm any firm that insists on pursuing initiatives that could intensify competition against one of Microsoft's core products."

In April 2000, Judge Jackson issued his conclusions of law, ruling that Microsoft illegally maintained its monopoly in the PC operating system market, illegally attempted to monopolize the browser market and unlawfully tied its browser to its operating system. Two months later, Judge Jackson ordered the breakup of Microsoft into two companies – an operating systems business and an applications business – as a remedy. Unsurprisingly, Microsoft appealed the decision. In 2001, a federal appeals court ruled that Microsoft had indeed monopolized the PC operating system market in violation of the Sherman Act, but it reversed a number of other aspects of the initial ruling. While the appeals court underlined that "judicial deference to product innovation (...) does not mean that a monopolist's product design decisions are per se lawful", it did accord more merit to Microsoft's innovation-through-integration argument than Judge Jackson had done. Accordingly, it overturned the finding that Microsoft's tying was a per se violation, remanding the issue for reconsideration under a rule of reason analysis. It also overturned the breakup order.

A TIMELINE

Early FTC Investigation (1989–93)

November 1989 Microsoft and IBM issue a joint press release on their future plans for OS/2 (an operating system jointly developed by Microsoft and IBM) and Windows (developed solely by Microsoft).

June 1990 Microsoft reveals the Federal Trade Commission (**FTC**) **is investigating a possible collusion** between Microsoft and IBM in the market for PC operating systems. The FTC soon broadens its investigation to one of monopolization or attempted monopolization by Microsoft.

August 1993 After the FTC deadlocks twice on whether to take action against Microsoft, the FTC closes its investigation and the Department of Justice (**DOJ**) **takes over the case**.

DoJ Licensing Case (1994–98)

July 1994 The **DOJ files a complaint against Microsoft**. The complaint focuses on Microsoft's licensing practices, in particular its use of long-term "per processor" contracts requiring original equipment manufacturers (OEMs) of computers to pay a royalty for each computer sold with a specific type of Intel processor regardless of whether a Microsoft operating system was installed. The complaint also takes issue with Microsoft's disclosure practices, preventing independent software vendors (ISVs) that develop applications for the forthcoming Windows 95 from developing for any other operating system.
> Microsoft signs a consent decree i.a. prohibiting "per processor" licenses, limiting the duration of licenses to one year and limiting the scope of non-disclosure agreements to confidentiality. The proposed consent decree also prohibits Microsoft from making the license of one product conditional upon the license of another product, but expressly excludes from this prohibition the development of integrated products by Microsoft.

February 1995 District Court **Judge Stanley Sporkin does not approve the consent decree** on the ground that it is not in the public interest under the Tunney Act. He finds the remedy too narrow as it does not cover all future Microsoft operating systems. He also finds it is not an effective antitrust remedy because it fails to address various other alleged anticompetitive practices. Both Microsoft and the DOJ appeal.

June 1995 Adopting a deferential stance to government-negotiated consent decrees, a **federal appeals court reverses** and removes Judge Sporkin from the case for creating an impression of bias.

August 1995 On remand, **Judge Thomas Penfield Jackson approves the consent decree**.

DoJ Monopolization Case (1996–2011)

July 1996 Netscape, Microsoft's leading competitor in the Internet browser market, submits a lengthy white paper to the DOJ detailing a legal and economic theory for a monopolization case against Microsoft.

September 1996 The **DOJ opens a new investigation** into Microsoft's conduct regarding Internet browsers.

October 1997 The **DOJ asks a federal court for Microsoft to be held in contempt of court** and be fined 1 million USD a day **for violating the consent decree** by conditioning the licensing of Windows 95 on OEMs also licensing Microsoft's browser Internet Explorer (IE). Microsoft argues it is offering an integrated product and that the consent decree specifically states that Microsoft is not prohibited from developing integrated products.

December 1997 Judge Jackson rejects the DOJ's contempt-of-court charges and fine **requests, but issues a preliminary injunction** barring Microsoft from licensing any Microsoft PC operating system on the condition that any Microsoft internet browser software is also licensed. Microsoft appeals, arguing that Windows 95 would "break" if the code distributed as part of IE were removed.

January 1998 Microsoft and the DOJ reach a partial settlement on the contempt charge in which Microsoft agrees to allow OEMs to remove the IE icon from the desktops of PCs before shipping.

June 1998 A federal appeals court reverses, holding that the Windows 95 and IE combination is a protected integration under the consent decree.

1997 1998

May 1998 The DOJ, 19 states and the District of Columbia file an antitrust suit against Microsoft. The complaint focuses on the twofold competitive threat posed to Microsoft: (i) Internet browsers, such as Netscape's Navigator, can be run on any operating system and offer the potential to be a platform for which operating system-independent applications can be written, and (ii) such browsers enable any application written in Java (i.e. Sun Microsystem's programming language) to be run regardless of the underlying operating system. These developments could incentivize developers to create new applications that are not dependent on Windows, which would in turn diminish the reliance of OEMs on Windows and weaken Microsoft's operating system monopoly.

↳ **Microsoft allegedly violated Sherman Act Section 1** through:
> agreements with Internet Service Providers (ISPs) and Internet Content Providers (ICPs) requiring them not to license, distribute or promote non-Microsoft products;
> agreements with OEMs prohibiting modification of the PC boot-up sequence and screens, thereby restricting the ability of OEMs to offer non-Windows browsers;
> agreements with OEMs requiring the tying of IE to Windows.

Microsoft also allegedly violated Section 2 of the Sherman Act by unlawfully maintaining its monopoly in the PC operating system market and unlawfully monopolizing the Internet browser market.

October 1998 A **consolidated antitrust case goes to trial** before Judge Jackson. The trial ends up going beyond the initial complaint, also encompassing Microsoft's alleged efforts to thwart competitive threats other than Internet browsers (e.g. Apple's QuickTime software for multimedia playback or IBM's office productivity applications), which together come to be referred to as the "middleware threats".

November 5, 1999 Judge Jackson issues his initial findings of fact, which are heavily weighed against Microsoft. He finds that Microsoft holds monopoly power in the market for Intel-compatible PC operating systems. He also finds that Microsoft has engaged in various actions to protect its monopoly power from middleware threats (in particular Netscape's Navigator and Sun's Java) and that many of these actions have harmed consumers directly, as well as indirectly by distorting competition and discouraging innovation.

April 3, 2000 Judge Jackson issues his conclusions of law, ruling that Microsoft has violated both Sections 1 and 2 of the Sherman Act. He finds liability for illegal monopoly maintenance in the market for Intel-compatible PC operating systems, attempted monopolization of the browser market and unlawful tying of its browser to its operating system.

June 2001 The **appeals court affirms the liability finding for monopoly maintenance** in the operating system market, but **reverses the liability finding for monopolization** of the Internet browser market. It **remands the tying ruling** for reconsideration under a different legal standard. It also **overturns the breakup order** and orders Judge Jackson's removal from the case for giving the appearance of bias.

1999 2000 2001

November 19, 1999 Judge Jackson appoints Richard Posner, Chief Judge of the Seventh Circuit, **as a mediator** to facilitate a settlement.

April 1, 2000 After failed efforts to reach a settlement, **Judge Posner ends the mediation**.

June 2000 Judge Jackson issues his final judgment, ordering as a remedy the breakup of Microsoft into two companies: an operating systems business and an applications business. Microsoft appeals.

September 2001 Stressing the need to secure an effective remedy as quickly as possible, the **DOJ announces it will no longer pursue** the tying count nor **a breakup** of Microsoft in order to avoid prolonging the proceedings.

November 2001 Microsoft and the DOJ submit a proposed consent decree for approval.

November 2002 Judge Kollar-Kotelly approves the consent decree proposed by Microsoft, the DOJ and nine plaintiff states with only minor modifications. She issues largely the same final judgment to the non-settling states, dismissing the additional remedies requested. Microsoft is ordered to comply for five years. Only Massachusetts appeals the remedial decree.

Microsoft agrees i.a. to:
> refrain from retaliating against OEMs for promoting non-Microsoft middlware or shipping PCs with a non-Microsoft operating system;
> allow OEMs flexibility in promoting non-Microsoft middleware (e.g. by allowing them to install icons and shortcuts for non-Microsoft middleware)
> refrain from granting consideration to an ISV conditional on the ISV not developing or distributing software in competition with Microsoft;
> provide OEMs and end users a mechanism to enable or remove access to Microsoft middleware;
> disclose the APIs used by Microsoft middleware to interoperate with a Windows operating system;
> provide access to the communications protocols used to communicate or interoperate with a Microsoft server operating system.

2002 2003 2004

March 2002 District Court Judge Colleen Kollar-Kotelly starts remedies proceedings for the non-settling states, which propose far harsher remedies.

June 2004 A **federal appeals court approves the remedial decree** in its entirety, rejecting Massachusetts' objections.

May 2006 Microsoft and the DOJ agree to extend parts of the consent decree for two years (until November 2009). Judge Kollar-Kotelly approves the extension.

October 2007 With the bulk of the consent decree about to expire, several states request an extension until 2012. The court temporarily extends the consent decree until January 2008 to allow more time to consider the motion for extension.

June 2007 The DOJ files a brief arguing the consent decree should not be extended.

2005 2006 2007

January 2008 Judge Kollar-Kotelly grants an extension, but only until November 2009. Given the previous partial extension, all provisions of the consent decree are now coterminous.

April 2009 The parties agree to an additional 18-month extension.

May 2011 The consent decree and final judgment expire.

2008 2009 2010 2011

KEY READINGS ON MICROSOFT AND INNOVATION

Given that much of the Microsoft case centered on innovation, a question that comes to mind is what the effects of the case were on innovation. That is, what were the consequences of antitrust intervention against Microsoft? Did it promote or dull innovation? Below are three works which express different views on this matter.

Richard J Gilbert, *Innovation Matters: Competition Policy for the High-Technology Economy* (MIT Press 2020) Chapter 8.

In his recent book *Innovation Matters*, Richard Gilbert discusses the antitrust case brought by the DOJ in the US as well as the cases brought by the European Commission challenging Microsoft's conduct related to media players and workgroup servers in the EU. Gilbert concludes that antitrust intervention ultimately had a positive effect on software innovation by imposing limits on conduct by Microsoft that would exclude competition and by encouraging Microsoft to enhance the interoperability of its software products.

Benedict Evans, 'How To Lose a Monopoly' (*Benedict Evans*, 1 January 2020).

In this 2020 blogpost, Benedict Evans looks back at how Microsoft (and IBM before it) lost dominance in tech. He argues that Microsoft's fall from dominance had less to do with antitrust intervention and more with the appearance of unforeseen competition. Microsoft stopped being the relevant environement for which to develop with the rise of the Internet. Then, even though it still provided the client for users to access the Internet (i.e. the Windows PC), Microsoft lost dominance over the client to smartphones, when Apple proposed a better client model (i.e. the mobile iPhone).

Sruthi Thatchenkery and Riita Katila, 'Innovation and Profitability Following Antitrust Intervention Against a Dominant Platform: The Wild, Wild West?' (2021).

Empirical work on the effects of antitrust and regulatory interventions against high-technology firms is scarce. The same holds true for empirical studies related to the *Microsoft* case. In this recent study, Sruthi Thatchenkery and Riita Katila investigate the effect of the *Microsoft* case on innovation and profitability in the enterprise infrastructure applications ecosystem. Specifically, they examine how intervention against Microsoft (i.e. the dominant enterprise server platform) changed the subsequent innovation by and profitability of complementors (i.e. the developers of infrastructure applications). They find that innovation by complementors increased following the intervention, suggesting that innovation becomes more attractive when there is less room for the dominant platform to thwart competition from complementors. They also find that profitability decreases, suggesting that more inefficient and wasteful development may take place under a weakened dominant platform (e.g. redundant applications).

FURTHER READING

- Richard Schmalensee, 'Antitrust Issues in Schumpeterian Industries' (2000) 90 The American Economic Review 192.
- Nicholas Economides, 'The Microsoft Antitrust Case' (2001) 1 Journal of Industry, Competition and Trade 7.
- Richard J Gilbert and Michael L Katz, 'An Economist's Guide to U.S. v. Microsoft' (2001) 15 Journal of Economic Perspectives 25.
- Timothy F Bresnahan, 'Pro-Innovation Competition Policy: Microsoft and Beyond' (Competition Policy Research Center, Fair Trade Commission of Japan Inaugural Symposium, Tokyo, 2003).
- Geoffrey A Manne and Joshua D Wright, 'Innovation and the Limits of Antitrust' (2010) 6 Journal of Competition Law & Economics 153.
- William H Page and Seldon J Childers, 'Antitrust, Innovation, and Product Design in Platform Markets: Microsoft and Intel' (2012) 78 Antitrust Law Journal 363
- Tim Wu, 'Taking Innovation Seriously: Antitrust Enforcement If Innovation Mattered Most' (2012) 78 Antitrust Law Journal 313.

TYING ANALYSIS

- J Gregory Sidak, 'An Antitrust Rule for Software Integration' (2001) Yale Journal on Regulation 1.
- Charles M Gastle and Susan Boughs, 'Microsoft III and the Metes and Bounds of Software Design and Technological Tying Doctrine' (2001) 6 Virginia Journal of Law and Technology 7.
- Herbert Hovenkamp, 'IP Ties and Microsoft's Rule of Reason' (2002) 47 The Antitrust Bulletin 369.
- Jay Pil Choi, 'Tying and Innovation: A Dynamic Analysis of Tying Arrangements' (2004) 114 The Economic Journal 83.

BREAKUP ORDER

- Howard A Shelanski and J Gregory Sidak, 'Antitrust Divestiture in Network Industries' (2001) 68 University of Chicago Law Review 1.

EMPIRICAL WORK

- Christos Genakos, Kai-Uwe Kühn and John Van Reenen, 'Leveraging Monopoly Power by Degrading Interoperability: Theory and Evidence from Computer Markets' (2018) 85 Economica 873.

Dynamic Competition Initiative

TAKEAWAYS FROM THE DCI ROUNDTABLE ON US v MICROSOFT

This note is based on the feedback gathered from 10 experts who participated in an interdisciplinary roundtable on the US Microsoft case on **16 November, 2021**. The note contains comments but also questions about the case. There is no attribution to individual participants. All participants have, however, vetted the note as representative of the content of the discussion.

Note prepared by Miguel Mota Delgado, Selçukhan Ünekbaş & Natalia Moreno Belloso

1. *US v Microsoft* is often placed on the pedestal of good antitrust in today's policy conversation. There is, however, uncertainty about the actual impact the case had on innovation. We do not have good empirical tools to measure this. How then should we proceed?

2. During the case itself, the US Department of Justice did not have a sophisticated theory of innovation in mind in *US v Microsoft*. It had in mind that there was bad conduct that was perpetuating a monopoly or increasing entry barriers to competition for operating systems (or that was likely to do so).
   - Microsoft's own innovation could not be the only innovation concern of the Department of Justice during the case. It also had to care about innovation from all the other competitors and potential competitors.
     - That said, innovation was never a big cylinder in the engine of *US v Microsoft*.

3. Is the lesson from *US v Microsoft* that **the proper function of antitrust is to prevent dominant firms from duplicating efforts by innovators in adjacent, neighbouring, or substitute product areas?**
   - − A downside of this approach is the risk of condemning good business foresight. Documentary evidence shows that Microsoft had correctly identified the disruptive threat of the Internet.
     - On 26 May, 1995, Gates wrote an internal memo to Microsoft's executive staff titled 'The Internet Tidal Wave'.
   - \+ An upside is that the superior resources of incumbent firms are leveraged towards more distant and uncertain innovation trajectories.

4. Suppose a firm is stuck trying to hold on to what it has, e.g., a dominant market position. **Antitrust policy can then be 'therapeutic', helping the firm in getting unstuck**. What is needed then is the development of indicators of degree of effort. Such indicators can tell us whether the firm is 'stuck' or 'unstuck'.

5. Can we say that cases like *US v Microsoft* were brought against firms that were declining in their core markets, even if such a decline might not have been apparent at the time?
   - Under this approach, firms in decline are the ones that cannot sustain themselves exclusively through 'competition on the merits'.

6. **Is good antitrust one that scares monopolies into self-regulation?**
   - Antitrust enforcement against Microsoft may have had effects not only through influencing companies' innovation incentives, but also through interfering with how business is conducted (i.e. through companies' organisational structures or decision-making practices).

7. The strategy and management scholarship is overlooked in antitrust policy discussions. It would be fruitful to mainstream some insights from this body of literature in future research initiatives.

8. It is important that antitrust enforcement take the time to develop theories articulating sound principles and illustrate how these can be applied in a sound way.
   - Can we say that what determines innovation today is different from what determined innovation at the time of *US v Microsoft*? If so, should we develop a different type of antitrust policy today?

9. The legitimacy of current antitrust enforcement initiatives against players such as Google, Amazon, or Facebook is questionable. These initiatives are not tackling the core of the business models and, in any case, it is still too early and there are not enough facts to support them.

Interesting questions for future research

- Do we see a correlation (strong or not) between business decline and anticompetitive conduct?
- Do we see business model changes following antitrust intervention?
- Does antitrust policy target conduct that firms implement when creating the business or rather practices that firms develop once they are more established?
- How does the top management in a firm think about its competitive environment? Can we document competitive paranoia? What antitrust implications can be drawn from a managerial fear of disruption?
- What does the top management in a firm believe in terms of prospects for growth or decline and how does that relate to anticompetitive conduct?
- Do iconic cases such as *IBM*, *Intel*, or *Microsoft*, which raise the level of antitrust awareness in the respective industry, move firms in that industry from the receiving end of antitrust scrutiny to the supply side of antitrust complaints?