

## INNOVATION AND INTEGRATION: THE *MICROSOFT* CASE & WINDOWS XP

by

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With the U.S. Court of Appeals for the District of Columbia Circuit's decision arriving on the eve of Microsoft's introduction of Windows XP, the company's next-generation operating system, the potential for smokestack industry antitrust theory constraining modern innovation is again squarely presented. To what extent, if any, should classic "tie-in" antitrust concepts inhibit the development of consumer-friendly software programs which package instantly available applications which users previously had to combine for themselves?

The situation is complicated by the European Commission's extension of its antitrust investigation of Microsoft to examine the incorporation of a media player with Windows, a feature which has been an integral part of the Windows product for over 10 years. Like its derailment of the GE/Honeywell combination, the Commission under Dr. Mario Monti seems more concerned with protecting competitors than with furthering the interests of consumers.

Microsoft's request for Supreme Court review of the appellate court's partial removal of the trial judge could well succeed, but the D.C. Circuit has moved forward regardless, rejecting a Microsoft motion for a stay and remanding the case to newly-chosen District Court Judge Colleen Kollar-Kotelly. Observers in the meantime must somehow find the logic in an appellate court decision stating that Judge Thomas Penfield Jackson had flagrantly violated federal law and the judicial canons of ethics, while at the same time according his findings of fact and conclusions of law a respect usually reserved for judges with no appearance of impartiality. And since the press privilege protects many hours of taped but otherwise unpublished comments by the District Judge, the record can never be complete regarding the extent of his apparent partiality and animus.

According to the Court of Appeals, the District Judge's violations of the Code of Conduct for United States Judges and Section 455(a) of the Judicial Code were "deliberate, repeated, egregious, and flagrant," including his apparently ingrained distaste for the defense of technological integration — the central issue on incorporation of Internet Explorer ("IE") and the expected focus of debate regarding Windows XP. Months before his Findings of Fact and Conclusions of Law, the District Judge, in secret, told questioned Microsoft's integration of a web browser into Windows, saying that he would also find offensive a camera with a built-in light meter. These are not the comments of an impartial, unbiased jurist, ready to consider integration objectively.

The District Judge's insistence on secrecy implied full knowledge of the impropriety, and of course made it impossible for Microsoft to have objected sooner, an objection that the appellate court said would have succeeded; had Microsoft timely known the truth, the trial judge would have been disqualified, voluntarily or if necessary by court order. Nonetheless, the court of appeals gave the District Judge's findings of fact the same

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deference under the Federal Rules (reversible only if “clearly erroneous”) usually accorded only to judges with no suggestion of bias or partiality. The partially retroactive disqualification actually maximizes the injustice to the defendant and the damage to public confidence in the judicial process, especially since the Findings of Fact were virtually devoid of record citations.

The District Judge's conduct destroyed, at the least, the *appearance* of impartiality, and there the debate should end, since that is all the law requires. The case has to go back for a partial rehearing on integration and remedies — that should be extended to a plenary hearing, to vacuum these proceedings from the specter of this judicial misconduct.

The same skepticism towards Microsoft expressed by Judge Jackson before his decision may extend to today's Justice Department, which is reported to be looking closely at Windows XP to decide whether to challenge its combination of features, avidly sought by consumers but previously available only in pieces. Windows XP will present users with far-reaching improvements in reliability, performance, and system security, and will also facilitate multi-use and user customization, workplace enhancements, and marked file improvements. It will continue to integrate Internet Explorer, and add instant messaging, digital photography and movie making, and other media features to the new design. If Microsoft's petition for certiorari is not granted, the issue of the legality of integrating the IE browser with the Windows operating system (“OS”) will be presented on remand according to new legal criteria announced by the Court of Appeals, and these statements of the law will also have decided implications on the expected tie-in debates regarding XP.

What then did the Court of Appeals say about integration? First, the court acknowledged that, as a general rule, courts are properly *very skeptical* about claims that competition has been harmed by a dominant firm's product design changes. Innovation, especially in markets where products are changing, is usually intended to instigate consumer appeal, and sometimes it makes one product incompatible with others. If monopolists can't innovate, then some innovation obviously will be deterred.

The Court of Appeals concluded that Microsoft offered insufficient justification for integrating IE into Windows by excluding IE from the Add/Remove utility and commingling browser and operating system code. (In fact, Microsoft defended these integrations as “highly efficient and provid[ing] substantial benefits to customers and developers,” but the court found these justifications unspecific and not adequately substantiated, and thus the design, found to advance a Windows monopoly, was violative of the Sherman Act). The Court of Appeals upheld Microsoft's causing Windows to sometimes override the user's choice of a default browser. Microsoft argued that it had “valid technical reasons” for the overrides and the plaintiffs offered no rebuttal whatsoever.

Virtually the same facts which prompted the District Judge to find that Microsoft's integration maintained a Windows monopoly (Sherman § 2) also identified an illegal tie under Sherman § 1: bundling at a single price, refusal to allow IE removal from the Original Equipment Manufacturer desktop or by use of the Add/Remove utility, and sometimes overriding the user's choice of default web browser. Curiously, the District Judge did not include commingling of code as a basis for tying liability. Even more curiously, the appellate court reversed the tying conclusion under Sherman § 1 only pages after finding that the same facts violated Sherman § 2.

The Court of Appeals remanded, holding that the *rule of reason* should govern the legality of *tying arrangements involving platform software products*. The court found that the IE/Windows combination offered the “first up-close look” at the technological integration of added functionality into software that serves as a platform for third-party applications. Therefore application of *per se* tying rules, perhaps appropriate in simpler cases, carried a serious risk of harm.

The Court of Appeals described the four classic elements of a *per se* tying violation: (1) two separate products; (2) market power in the tying product; (3) no choice but to purchase the tied product; and (4) foreclosure of a substantial volume of commerce. The Court of Appeals then highlighted the “poor fit” between the classic separate-products test of *Jefferson Parish Hosp. Dist. No. 2 v. Hyde*, 466 U.S. 2 (1984) and the IE/Windows integration. Obviously, unless products are “separate,” they cannot be “tied.” In the classic cases, this was easy — movie projectors and film, morning ads and evening ads in newspapers.

Then in *Jefferson Parish* the Supreme Court considered a hospital conditioning surgical care on the purchase of affiliated anesthesia services. Were these two, so inter-related “products” separate or not? Was this a *per se* case, to which the Supreme Court had consigned tie-in analyses in *International Salt Co. v. United States*, 332 U.S. 392 (1947) and *Northern Pacific RR Co. v. United States*, 356 U.S. 1 (1958), or did new economic research now cast doubt on the assumption that “tying agreements serve hardly any purpose beyond the suppression of competition?”

In *Jefferson Parish* the Supreme Court observed that no tying arrangement could exist unless there is a sufficient *demand* for the *tied* product (anesthesia) separate from the *tying* product (surgery facilities) to identify a distinct product market in which it is *efficient* to offer the one *separately* from the other. That was the central issue in *Jefferson Parish*, since some surgeons wanted other anesthesiologists than the hospital’s affiliates. Do sellers without market power bundle the two products? Most anesthesiologists did not have hospital affiliations. On balance, then, these were distinct products, and consumers who wanted the tied product and were separately purchasing it were *foreclosed* from that option by the tying arrangement. There (and unlike IE or Windows XP), direct competition on the merits was *foreclosed*.

The Court of Appeals then made a key finding: “not all ties are bad.” Bundling saves distribution and consumer costs. For example, spell checkers are bundled in word processors. Bundling capitalizes on economies: witness the “shared” library files that perform both OS and browser functions and thus save “clutter.” In short, unless ties were efficient, there would be separate consumer demand for each individual component of every good, and piecemeal sales, for example, of the computer “keyboard, monitor, mouse, central processing unit, disk drive, and memory.” Almost no one purchases this way in this market.

So *Jefferson Parish* formulated *separate consumer demand* as a litmus test for deciding when a tie could be welfare-enhancing, and therefore appropriate for rule of reason analysis. A further useful observation — if firms without market power bundle, they have concluded that the cost savings outweigh the benefits of separate choice, and if everyone bundles, there must be strong net efficiencies, and the “two” products should likely be treated as one. *Jefferson Parish* demonstrated the value of the “separate products demand” as a gauge for analyzing the possible welfare consequences of a combination where efficiencies can be assessed against any inevitable reduction in consumer choice.

The Court of Appeals found merit in Microsoft's argument that *Jefferson Parish's* consumer demand test would “chill innovation to the detriment of consumers by preventing firms from integrating into their products new functionality previously provided by standalone products, and hence, by definition, subject to separate consumer demand.” Looking at *prior* demand is backwards, and could frustrate new and innovative integration. One competitor may decide that bundling is good, and since someone has to go first, that bundling is almost certain to exist while there is still separate demand by consumers for the “tied” product, and reluctance by other competitors to spend the time and resources to accomplish the integration. *Jefferson Parish* could well miss these pro-consumer developments, depending on the timing of the case in the history of the market’s evolution. Consumers, and the innovator, would lose.

The court acknowledged with due deference the *Jefferson Parish* rule that *certain* tying arrangements pose an unacceptable risk of stifling competition and are unreasonable *per se*. However, applying this analysis to the integration of additional software functionality into an OS creates undue risks of error and of deterring welfare-enhancing innovation. The sort of tying arrangement attacked in Microsoft was unlike any the Supreme Court had considered. Those cases involved *patented* product ties, or bundling *without* real integration, and no real claims of value for users and makers as well. It would seem that all of these factors, *absent* in *Jefferson Parish*, are *present* in the design combinations offered in Windows XP, which also does not *foreclose* purchase of the alleged “tied” product (no one needs two anesthesiologists), but rather enables it, *if that is the consumer’s choice*. Microsoft had argued that IE and Windows are integrated products, and bundling makes Windows a better applications platform for third-party software. These and other claimed efficiencies made the *per se* test the wrong path to analysis.

Most prior computer tying cases had involved bundling with hardware, such as IBM’s integration of memory into its CPUs, a classic design improvement. The closest case of course was the Court of Appeals decision in 1998 interpreting the 1994 Microsoft consent decree, which held that the Windows/IE bundle was an “integrated product” as defined in the decree. Basically the Court of Appeals now concluded that rule of

reason analysis gives the *first* innovator the chance to argue the balance between efficiencies versus any inhibition of consumer choice. In computer software, integration is common among firms with and without market power, and the latter of course must be driven almost exclusively by efficiencies and perceived customer demand, since they lack market power. Today, virtually all OS makers bundle browsers. Was it illegal for Microsoft to have been first?

The court also observed that “because of the pervasively innovative character of platform software markets,” tying may produce unencountered efficiencies not expected by the *per se* rule. If an OS maker bundles a browser, then the browser’s API’s render redundant those in the OS, and consumers don’t have to pay twice. There was insufficient empirical evidence regarding the effect of Microsoft’s practice on the amount of consumer surplus created or consumer choice foreclosed to permit a sensible judgment. “[E]asy labels do not always supply ready answers.” The D.C. Circuit concluded that the rule of reason more freely permits consideration of the benefits of bundling in software markets, particularly those for OSs, and a balancing of these benefits against the costs to consumers whose ability to make direct price/quality tradeoffs in the tied market may be affected.

The same justification that Microsoft presented for bundling IE APIs (that their inclusion with Windows increased the value of third-party software [and Windows] to consumers) would seem to apply with equal vigor to the combination of instant messaging, media functions, and photograph and movie storage and editing, some of the principal Windows XP “hitherto separate” functions (although a media player has been an integral part of Windows since 1990). These programs obviously need a platform as a function predicate, and so long as the platform continues to contemplate add-ons perhaps desired by the consumer, the playing field may be tilted a bit, but reasonably so, since the consumer benefits (instant access, technological compatibility, and presumably cost) are distinct (if not dramatic) and competitors, while perhaps disgruntled, are by no means foreclosed.

Nor is this a “Microsoft-only” conclusion, since the same legal analysis would protect platform software well beyond Windows from a *per se* condemnation whenever a new, previously independent, function was added to a PC, or a browser, or middleware or some entirely new net appliance. The market would be left to decide for itself what combination it favored, without literal application of rigorous standards perhaps fitting in situations a century less complex. The Court of Appeals also left useful instructions for the remand, all of which logically should apply to the Windows XP design: challenged conduct must unreasonably restrain competition, with an inquiry into the “actual effect” of the conduct on competition in the *tied* good market (the putative market for browsers, or perhaps in a future debate, the market for media or photographic functions). And of the harms, the conduct must be, *on balance*, anticompetitive; there will be pro-competitive justifications, and it is *plaintiffs’* burden to show that the anticompetitive effect of the conduct outweighs its benefit.

Finally, if there is price bundling, then remember that OS vendors without Microsoft’s alleged market power also sell their software bundled with a browser, so the natural inference is that sale of the items as a bundle serves consumer demand and that unbundled sales might not, for otherwise a competitor would profitably offer the two products separately and capture sales of the tying good from vendors that bundle.

Just as the first cars with radios, and the first cameras with light meters, Internet Explorer on remand and Windows XP as it debuts offer consumers instantly available, valuable functions, which many consumers want to incorporate into their PCs, and they do not unreasonably inhibit consumers choosing any other reasonably constructed alternative with the same, better, or even worse attributes than the programs grouped with the new Windows OS. Under the Microsoft Court of Appeals test, this might irritate competitors — as does every meaningful competition, but the efficiencies so outweigh that irritation that the combinations should be ratified under any fair application of the rule of reason.