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The European Commission's Decision in the Microsoft Case
<u>and its Implications for Other Companies and Industries</u>

The European Commission has published a lengthy and carefully written Decision concluding its review of the Microsoft case after more than five years. This 300-page analysis obscures, however, a critically important fact – the Commission is seeking to make new law that will have an adverse impact on intellectual property rights and the ability of dominant firms to innovate. This adverse impact will not be confined to the software industry or to Europe. As the case now heads for the Court of First Instance, the novel legal standards announced in the Decision will affect all industries, altering market dynamics and reducing incentives for research and development that are essential to global economic growth.

The Commission's Decision puts in bold relief two important questions:

- First, when does a firm with a dominant position have a legal duty to license its proprietary technology and intellectual property rights to its competitors so that they can incorporate that very same technology into their own directly competing products? The Decision goes well beyond established legal precedents by asserting a broad and ill-defined duty on dominant firms to share the fruits of their research and development with other companies in the same product market.

- Second, when is it unlawful for a dominant firm to incorporate new components or features that demonstrably improve its finished product? The Decision effectively finds such product integration to be unlawful if an alternative component supplier may suffer a loss of market share, unless the dominant firm can prove that the integration is "indispensable" to achieving pro-competitive benefits. In this case, the Decision requires the dominant firm to prove the "indispensability" of its product design even though: (a) competitors offering a similar finished product have integrated the same component (and tout the benefits of that design); (b) this integration demonstrably creates new benefits for other businesses and consumers; (c) alternative component suppliers have many ways to distribute their products to consumers; and, (d) alternative component suppliers are simultaneously acquiring new users by the millions. While claiming to uphold a "rule of reason" test, the Decision departs markedly from rule of reason analysis and opens the door for even a single complaining component supplier to argue that innovation should be thwarted if its market position may be harmed.

Given the Commission's tendency to define product markets narrowly and to hold that a firm is dominant if it has a market share as low as 30-40 percent, these rulings put at risk the economic incentives for a broad range of companies and industries.

Compulsory Licensing and the Duty to Share Technology and Intellectual Property Rights with Competitors

Compulsory licensing has received broad attention in Europe at least since the Commission's decision in 1989 in the Magill case, which was upheld by the European Court of Justice in 1995. Most companies, however, took solace from the result because a number of facts made that case somewhat unique. First, the Court said that compulsory licensing was appropriate only in "*exceptional circumstances,*" which in Magill included the fact that three television broadcasters refused to license their copyrighted television listings, thereby preventing completely the appearance of a new product in a secondary market, namely, a comprehensive weekly television guide in Ireland and Northern Ireland. Instead, the broadcasters reserved for themselves exclusively this secondary market, and the Court found no objective justification for the refusal to license the creation of a new product for which there was likely to be substantial consumer demand. Many also took comfort from the fact that the validity of the intellectual property in question – a copyright claimed in television listings that were widely distributed free of charge – was a legal anomaly in Ireland and the United Kingdom and probably was too "thin" to qualify for intellectual property protection in continental Europe. Subsequent decisions by the Court of First Instance and Court of Justice have reinforced the limited nature of the Magill decision.

The Magill approach to compulsory licensing is effectively rejected, however, by the Commission's Decision in the Microsoft case. The Commission instead announces a broad and amorphous standard under which it "must analyse the *entirety of the circumstances* surrounding a specific instance of a refusal to supply and must take its decision based on the results of such a comprehensive examination." (Para. 558.) The Decision then sets forth a new balancing test under which the Commission can order compulsory licensing if "on balance, the possible negative impact of an order to supply on Microsoft's incentives to innovate is outweighed by its positive impact on the level of innovation of the whole industry (including Microsoft)." (Para. 783.) Underscoring the sweeping nature of this test, the Decision provides little explanation and no economic analysis for its conclusion that industry-wide innovation will be boosted in the long-term if one firm is divested of its exclusive intellectual property rights.

The Decision will likely be of interest to a variety of firms that depend upon intellectual property because the IP rights at issue in this case concern not mere television listings, but rather technology that is the fruit of substantial research and development and provides the basis on which firms compete directly with one another. In this instance, the focus is on operating system software, particularly operating systems deployed on what the Commission has termed "workgroup servers" (as opposed to personal computers or more powerful servers). Workgroup servers are defined as computers that are typically networked with one another and with personal computers and handle functions such as storing and providing files, sending files to a printer, and "directory services" that provide customers with control over which computer users have access to various network resources. Server operating system products from Microsoft, IBM, HP, Sun Microsystems, Novell, Red Hat, the open source community (Linux) and others compete with one another largely on the basis of how well they perform these and other functions. For example, some operating systems are better than others at maintaining perfectly synchronized sets of directory services data on multiple copies of a server operating system.

In performing these functions, two or more copies of a server operating system often interact with one another over the network, sometimes effectively acting as one computer. Software interactions of this type are handled by communications protocols – technology that handles the efficient exchange of data across a wire (or a wireless) connection between two computers. Some protocols are more efficient than others; some provide greater capabilities than others, and so forth. Microsoft has developed protocols, for example, that enable highly

reliable synchronization of directory services data. The Commission's Decision obligates Microsoft to create and then provide its competitors with detailed technical specifications (effectively a complete roadmap) enabling them to implement Microsoft's protocol technology in their own, directly competing server products. Microsoft is also required to provide its competitors with licenses to Microsoft's intellectual property rights in the protocols, including patents, copyrights, and trade secrets covering software and the specifications.

The sweeping nature of the new balancing test established by the Decision is underscored by the fact that the Commission has ordered compulsory licensing of these communications protocols despite the following:

First, in contrast to Magill, the Commission Decision does not confine the use of the compulsorily licensed intellectual property to a secondary market. The broadest practical impact of the Microsoft decision concerns the mandatory licensing of the technologies in the Windows server operating system so they can be incorporated into directly competing server operating systems *in the same primary market*.

Second, in contrast to Magill, the intellectual property rights at stake here are not "thin," but rather pertain to the essence of Microsoft's business, the development of operating system software. The Decision requires Microsoft to make available to its competitors well over 100 communications protocols that provide a wide range of capabilities in Microsoft's operating system products, including its synchronization capabilities. Microsoft has been granted dozens of patents on these protocols, and many more patent applications are pending for these technologies. Furthermore, the company has gone to great lengths to protect the technology in these protocols as confidential trade secrets. It is also notable that the specifications Microsoft must now license do not yet exist. Microsoft will have to create them. These specifications, which will comprise thousands of pages of valuable information, will qualify as copyrighted works in their own right and as copyrightable preparatory design material for a computer program under the EC's 1991 Software Copyright Directive.

Third, there is no basis for concluding that the use of Microsoft's proprietary communications protocols is indispensable to the creation of competing server operating systems. After all, there exist many competing versions of UNIX server operating systems, supplied by large companies such as IBM and HP, and the five-year Commission investigation has coincided with growth in the popularity of the Linux server operating system. Those competing products are already very often deployed in networks with personal computers and servers running Microsoft's own operating system products, and customers are continuing to purchase these products from multiple suppliers and connect them together. There is no reason to conclude that alternative server operating systems are in any danger of disappearing.

Fourth, the Decision rests on a very narrow product market definition that bears little resemblance to the real world. While companies have become accustomed to the Commission seeking to increase their market shares by defining product markets narrowly, this case takes that approach to a new level. The Commission issued three statements of objections over four years, each time defining the market more narrowly than before. The Decision limits the market for "workgroup server operating systems" to the performance of four discrete server tasks, even though Windows server operating systems support more than a dozen tasks and the four tasks identified by the Commission are not charged for separately. Under this approach, a single copy of a Microsoft (or competing) server operating system can be within the defined product market in one instant (when performing one of the four specified tasks), and outside the market the next (when performing other tasks). The Decision further narrows the market by limiting it to server operating systems installed only on server computers that cost less than $25,000, even though (i) Windows server operating systems are installed on server computers in a much broader price range and (ii) the price of a server

operating system is not dictated by the price of the server computer on which it is installed. This is akin to defining separate markets for an automobile tire based on the differing value of the cars on which the very same tire is installed, an approach that could be used to render virtually any product dominant if the Commission so chooses.

Fifth, the Decision rejects Microsoft's desire to maintain its intellectual property for its own use, adopting an impressionistic analysis that would enable the Commission to order compulsory licensing in virtually any market and in any case. The Decision pays little regard to the incentives that intellectual property rights create for a company to invest in product improvements and for a company's competitors to invest in their own innovations rather than simply copying from others. Instead, the Decision opts for compulsory licensing on the basis of an assertion that "on balance" innovation in the industry overall would be greater if the technology and IP rights were shared with competitors. (Para. 783.) Such an approach clearly creates new law and economic policy for Europe. By casting aside the exceptional circumstances test of Magill, the Decision obligates dominant firms to license their technology to competitors whenever the Commission determines that reducing a dominant firm's incentive to innovate would nonetheless be good for an industry overall. This unbounded test would have a profoundly negative effect on innovation and investment by market leaders around the world who sell their products in Europe.

Finally, the Decision ignores international treaty obligations designed expressly to prevent this type of broad-based compulsory licensing of intellectual property rights. Article 13 of the WTO's Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) expressly permits compulsory licensing of copyrighted material only in "special cases which do not conflict with a normal exploitation of the work and do not unreasonably prejudice the legitimate interests of the right holder." Despite repeated references to this obligation in Microsoft's submissions, the Decision dismisses the treaty with a simple conclusory sentence (Para. 1052) and an assertion that the European courts should not apply the TRIPs rules to the case in any manner (Para. 1053). Nonetheless, it is impossible to reconcile the Decision's broad approach to compulsory licensing with the substance of the treaty obligations imposed by TRIPs. It has long been understood that it is part of the "normal exploitation" of copyrighted material to exercise the exclusive right to make use of that copyrighted material in a primary product market. And it has long been understood that it takes more than a showing of competitor benefit from the sharing of IP to overcome the prejudice to a right holder's legitimate interests that would result from such compulsory licensing. In this sense, the Decision creates a troubling departure from international legal rules designed to encourage innovation through well-established intellectual property rights.

Windows Media Player and the Ability of Dominant Firms to Integrate New Features into Their Finished Products

The Decision next presents issues relating to Windows Media Player as a standard contractual "tying" case under EC law, but they are not. Unlike previous EC cases, this Decision concerns the ability of a dominant firm to improve its finished product by integrating new components or features into it – in this case the integration into Windows of multimedia playback capabilities. It is not a case of a company seeking to use contractual restrictions to force customers to purchase an ancillary product in an aftermarket for goods or services. Moreover, there is no evidence that the alleged tie has restricted consumer choice or eliminated incentives for consumers to use third-party media players. No competitor has been forced from the market. The entire case rests on the purported adverse impact on a single competitor, RealNetworks, a Seattle based company. Based on this, for the first time in the history of competition law, the Decision compels the creation of a degraded version of a finished product and orders that product to be offered with the same trademarked brand name

as an existing product that consumers clearly associate with a particular set of features and level of quality.

The Decision rests on Article 82(d), but it pays little heed to the text of that provision, which states that it is an abuse for a dominant firm to make "the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts." Despite this, there is nothing in the Decision that turns on Microsoft's contracts. Rather, the Decision finds unlawful the design of Microsoft's operating system products. Like other suppliers of operating system software, Windows includes functionality that enables computers to play sounds and video. Microsoft first introduced these capabilities in Windows in 1992, and it has steadily improved them since that time. These advances are important to third party software companies, which develop products that utilize the audio and video capabilities in Windows to enable their programs to make full use of multimedia computer hardware. This approach both ensures greater consistency and quality for computer users and is cheaper than requiring each software developer to reinvent the wheel by creating its own multimedia software code. Microsoft makes the media capabilities in Windows available to third party software developers via application programming interfaces, an approach also used for hundreds of other Windows features.

In the late 1990s, Microsoft released a version of Windows that included the ability for a computer to play audio available on the Internet without downloading the audio file to the computer (known as "streaming" media). The Decision asserts that Microsoft violated Article 82(d) by enabling this streaming media capability in Windows. The Decision purports to apply a traditional tying analysis (*see* Para. 794) to this product improvement to conclude that Microsoft's integration of improved media playback functionality in Windows has foreclosed competition from third-party media players. The Commission asserts that consumer benefits from Microsoft's product design decisions do not justify this purported foreclosure. Despite the Decision's effort to describe its tying analysis in a narrow manner, the actual application of the test articulated in the Decision is so broad that it will likely be of concern to any firm that is arguably dominant and adds new capabilities to its products over time.

First, despite Article 82(d)'s explicit focus on "commercial usage," the Decision essentially ignores prevailing commercial practices among suppliers of similar finished products. All other contemporary operating systems, such as Apple's OS X, similarly tout their integrated media capabilities. The Decision expressly rejects (Para. 822) the principle that tying analysis for finished products should focus not on whether there exists a separate demand for a component but on whether there is any demand for the finished product with that component missing. For example, the fact that there is a market for shoelaces does not mean there is a market for shoes that have their laces missing. Common sense dictates that it would be misguided for regulators to require shoes to be sold in such a manner, even if this would create greater opportunities for companies that sell shoelaces.[1] The Decision goes on to dismiss the fact that all other operating systems also come with media playback software, ostensibly because some (but not all) of these finished products incorporate media players developed by other suppliers. (Para. 822.) Yet the demand for finished products clearly does not turn on who developed individual components (indeed, most of the time consumers are unaware of who created which component anyway). The Decision's approach would undermine commercial practices in a wide variety of industries.

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[1]In effectively rejecting this approach, the Decision departs from the Commission's own Vertical Guidelines, which states that "since customers want to buy shoes with laces, it has become commercial usage for shoe manufacturers to supply shoes with laces. Therefore the sale of shoes with laces is not a tying practice."

Second, the Decision bases its tying analysis not even on a distinct component that any firm provides on a separate basis, but rather on a single capability of that component. The Decision acknowledges Microsoft's point that it started integrating media playback functionality into Windows in 1992, well before RealNetworks was founded. (Para. 814.) It nonetheless asserts that Microsoft violated the law in the late 1990s when it improved the media playback functionality in Windows by adding streaming capability, because in doing so "it matched other vendors' products in the essential functionality that many customers came to expect from a media player." (Para. 816.) Such analysis effectively means that a dominant firm can integrate a new component into a finished product, but not if the Commission concludes – five years after the fact – that the component has a feature that "many consumers" decided were attractive and important. No business can make product design investments based on a standard that is so vague and that penalizes efforts to provide consumers with features they find attractive.

Third, the Decision sidesteps one of the fundamental prerequisites for a traditional tying case, that consumers are forced to use the component that has been integrated into the finished product. The Decision ignores the fact, undisputed in the record, that consumers typically use multiple media players and this number continues to increase over time. It dismisses with a single sentence the U.S. Final Judgment that regulates Microsoft's conduct (Para. 828), even though this gives PC manufacturers and users the ability easily to remove all of the end user access to Windows Media Player and to select a third-party media player as the "default" handler of various media files. These provisions effectively give PC manufacturers the ability to promote an alternative media player on an exclusive basis if they wish to do so. Instead, the Decision dismisses as "second best" the wide variety of channels available to media player providers for distributing their products to consumers, such as downloading from the Internet or entering into contracts with PC manufacturers. Nonetheless, it is undisputed in the record that RealNetworks has used these vehicles to distribute more than 300 million copies of its media player to consumers around the world.

Fourth, the Decision at its heart relies on one inescapable fact: it is not based on an assessment of harm to competition, but rather on the impact of Microsoft's product design on a single competitor. The Decision concludes that integration of improved media playback software in Windows "foreclosed" the market based on a loss of market share by RealNetworks, which participated in the Commission's case. The data cited in the Decision show that competitors saw their product usage grow, sometimes as fast as or faster than Microsoft's own. For example, between 2000 and 2002, both Windows Media Player and Apple QuickTime's usage in homes doubled and Musicmatch's usage in homes grew almost six-fold. (Para. 907.) Even RealNetworks has continued to grow its base of customers in absolute terms during this period. Ironically, on the very same day that the Commission issued its Decision, saying that the relevant market data "consistently" pointed to a detrimental trend for Microsoft's competitors (Para. 944), Musicmatch issued a press release saying that "with a 32 percent increase in market share over the past six months, Musicmatch has achieved its all time market share high." The fact that a single competitor may lose relative market share does not mean that competition is suffering. There are two victims in a classical tying case: the consumer who is forced to pay for what he or she does not want and the excluded competitor who cannot do business with the tied consumer. Both are absent in this case.

Fifth, the Decision sidesteps the many benefits that developers, consumers and others in the PC industry derive from Microsoft's integration of media playback functionality in Windows. In so doing, the Decision ignores the substantial unrebutted evidence that this integration has made PCs more attractive and easier for consumers to use and Windows a better platform for software developers and web-based content providers. The Decision does so by articulating a novel legal test – that these pro-competitive benefits should be excluded unless Microsoft can prove that the integration of these features was "indispensable" to the creation of them. (Para.

963.) This exclusion fundamentally departs from the traditional rule of reason analysis that the Commission said it followed on the day it released its Decision. A rule of reason test would compare anti-competitive harm with pro-competitive benefits. In contrast, after effectively finding that a decrease in one competitor's relative market share constitutes harm to competition, the Decision concludes that product integration is unlawful unless it is "indispensable" to the attainment of pro-competitive benefits, regardless of how modest the harm or how great the benefits may be. This test is so squarely stacked against innovation that one may fairly question whether any dominant firm can be confident when integrating a new component or features in the future.

Finally, the Decision takes the unprecedented step of requiring that innovative features be removed from a product, even though there is no reason to believe a consumer would want the resulting product. The Decision requires Microsoft to offer a version of Windows in Europe without the media playback functionality that was designed as part of the operating system, even though this will provide consumers with a less capable product and hinder the interaction between Windows and applications that are built to run on it. In so doing, the Decision undercuts Trans-Atlantic coordination by adopting a remedy specifically rejected by the U.S. Department of Justice after more than five years of careful review, and by a U.S. District Court after more than 60 days of courtroom testimony – including from RealNetworks. As the District Court put it, stripping functionality out of Windows would "disrupt the industry, harming independent software vendors and consumers." Moreover, requiring Microsoft to develop and market a degraded version of its flagship product tramples on Microsoft's copyrights and its right to control its own trademark, effectively creating a compulsory licensing regime that forces Microsoft to apply the Windows trademark to a product that plainly is not Windows.

In sum, the Decision creates new law in an effort to justify unprecedented regulatory intervention with respect to the integration of new functionality into finished products by a dominant firm. We live in a world in which most products result from combining a variety of individual components. Indeed, product innovation results in no small measure from such integration. Many of the companies that provide these goods would qualify as dominant under the Commission's narrow approach to defining product markets. The Decision opens the door to intrusive regulation of product design – not to mention a record fine – based on a complaint by a single component supplier, even when this integration is the market norm and other suppliers continue to grow. Such a result, if allowed to stand, would almost certainly spell bad news for the European and global economies.

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