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## Technology Ties: Getting Real after Microsoft

The D.C. Circuit's 2001 decision in *United States v. Microsoft* opened the door for high-tech monopolists to tie products together if they can demonstrate that the procompetitive justification for their practice outweighs the competitive harm. Although not yet endorsed by the Supreme Court, the Microsoft decision poses a significant threat to stand-alone application providers selling products in dominant operating environments where the operating systems ("OS") provider also sells competitive stand-alone applications. In the recently-filed private lawsuit—*Real Networks v. Microsoft*<sup>1</sup>—Real Networks included in its complaint tying allegations against Microsoft, a dominant OS provider, claiming that the defendant tied the sale of its OS to the purchase of (allegedly less desirable) applications for its operating system. The fate of lawsuits such as Real is almost assuredly contingent upon whether courts follow the Microsoft holding and resulting legal standard or adhere to a more traditional tying analysis, which requires per se condemnation of such practices.

These cases and the development of the law of technology ties are likely to have a profound effect on the development of future operating systems and the long-term viability of many independent application providers who offer products that function in such OS's. With dominant OS providers like Microsoft reaching further into the application world—through the development and/or acquisition of applications that function on their dominant OS environments—OS providers increasingly are becoming competitors to independent application providers, while at the same time providing the industry-standard OS on which these applications run. The ability to technologically tie a dominant

OS to an application raises some significant antitrust issues. On one hand, the ability to bundle a dominant OS with an application may provide some technological benefit to consumers with more seamless integration, reduced transaction costs, and the ability to provide application interfaces to content developers. On the other hand, such bundling may foreclose independent application providers from space on the OS, significantly diminishing their ability to compete, and as a result, limiting consumer choice. Moreover, with the ability to tie applications to their OS's, companies like Microsoft may have a reduced incentive to develop premier applications for their OS's, since they know that most OEMs and customers will simply accept an inferior bundled product, rather than spend the additional money to purchase an independent application, even if superior to the bundled one. Especially in the computer industry, where margins for OEMs are already razor thin, the temptation for OEMs will be to accept free, forced bundles to the exclusion of separate applications that must be installed, and potentially maintained and serviced by the OEMs. The end result is a potential threat to competition and to consumers as well.

This article discusses the law of tying, examines the Real lawsuit, and looks to how the European Commission resolved the issue in its most recent Microsoft decision.

### **The Traditional Law of Tying**

Bundling multiple products is a common business practice and can be procompetitive. However, bundling is regulated by the antitrust laws and may violate Section 1 of the Sherman Act where the practice serves to diminish competition in the sale of one of the bundled products by tying the sale of one product to the sale of the other. Such tying is illegal where the bundler has market power in one product (the "tying product") and conditions its purchase on the purchase of a separate, unwanted product (the "tied product").

Under the traditional law of tying as set forth by the Supreme Court in *Jefferson Parish*, a tying plaintiff can establish a violation of Section 1 if it can demonstrate: (1) the existence of two separate products; (2) that the defendant conditions the sale of the desired (tying) product on the sale of a second (tied) product; (3) that the arrangement affects a substantial volume of interstate commerce; and (4) that the defendant

has market power in the market for the tying product.<sup>2</sup> Of course, traditionally, tying is a per se offense; if the plaintiff can demonstrate the above elements, there is no need for a court to further analyze whether the defendant's practice negatively affected the market or whether the defendant proffered legitimate procompetitive justifications for its bundle.

### **Technology Tying: The Move to Rule-of-Reason**

The D.C. Circuit Court's decision in *Microsoft* changed the law of tying. Specifically, the D.C. Circuit held that Microsoft's bundling of its Internet Explorer and Windows OS resulted from an integration of software applications rather than contractual tying. In the case of such "technology ties," the D.C. Circuit held that per se condemnation was not appropriate. Instead, the Court remanded the case to the district court for analysis under the rule-of-reason.<sup>3</sup> Because the case settled, the lower court did not have the opportunity to decide whether the procompetitive benefits of Microsoft's product integration outweighed its anticompetitive effects.<sup>4</sup>

The Circuit Court observed that "not all ties are bad" and noted that ties may benefit the market by providing transaction cost savings and economies of scale and scope.<sup>5</sup> The D.C. Circuit concluded that especially in high-tech markets, such benefits were possible and indeed common. As a result, the D.C. Circuit concluded that the *Jefferson Parish* per se rule was inappropriate. The Court posited that because the Supreme Court has admonished that presumptions of illegality are appropriate only after courts have "considerable experience with certain business relationships," and "technological integration of added functionality into software that serves as a platform for third-party applications" is an area where the courts do not have such experience, summary condemnation was indeed incorrect.<sup>6</sup>

Thus, the D.C. Circuit adopted a rather relaxed rule-of-reason approach. Instead of deciding whether the platform OS and application were two separate products, and if they were, summarily condemning the forced tying of the two, the D.C. Circuit proposed that courts should weigh whether the bundle's benefits outweigh the "cost to consumers" by looking at whether the justifications for the product integration were on balance more significant than the anticompetitive effects

of the arrangement. The onus was shifted in Microsoft to the plaintiff to demonstrate that on balance the tie was anticompetitive.

The D.C. Circuit was particularly concerned that a per se prohibition of technology ties would not provide courts the opportunity to fully analyze whether a bundle was efficient in high-tech markets.<sup>7</sup> The Court placed heavy emphasis on the need to respect and not interfere with new product development. A specific fear was that per se condemnation would chill platform innovation and improvement.<sup>8</sup> For example, the D.C. Circuit worried that per se condemnation would discourage platform providers from adding new functionality to their OS's. Feature improvements could be seen as an illegal bundle if other independent application providers later created separate stand-alone applications that incorporated the features added to the OS, hence creating consumer demand for that separate product. Under *Jefferson Parish*, the D.C. Circuit reasoned, such a scenario could lead to a finding of two separate products (i.e., the OS and the features added to the OS) requiring summary condemnation of the bundle. A rule-of-reason approach, on the other hand, would allow for a more careful analysis of the bundle to determine its actual effects on the market.

### **Real Networks v. Microsoft**

In December 2003, Real Networks filed a complaint against Microsoft in the Northern District of California under Sections 1 and 2 of the Sherman Act. One of Real's principal claims was that Microsoft illegally tied the sale of its Windows OS to the sale of its Windows Media Player ("WMP"). According to the Real complaint, "[d]igital media players are separate products from PC operating systems, and firms have found it efficient to supply the products separately. Some operating systems are offered without a digital media player, and digital media players are offered as standalone products separate from operating systems."<sup>9</sup>

Some history is instructive. Microsoft's involvement in the media player market began with its release of its Windows 3.0 OS in 1991. Windows 3.0 enabled users to view still photographs, but did not have streaming media capability. In September 1996, Microsoft introduced NetShow, and, at around the same time, entered into an agreement with Real

Networks to collaborate on a streaming media product. Microsoft licensed Real's products, and incorporated the Real Media Player into Microsoft's Internet Explorer. Concurrently, Microsoft also invested in Real.<sup>10</sup>

In June 1998, Microsoft introduced Windows 98. The streaming NetShow product was distributed on the Windows 98 installation CD, but was not pre-installed on the OS. Microsoft soon thereafter released its WMP product and withdrew its investment in Real; the WMP product, however, still supported the Real format. With the Second Edition of Windows 98 in 1999, Microsoft incorporated WMP as a pre-installed and non-removable component of Windows. By 1999, WMP no longer supported Real Networks formats, effectively foreclosing Real from pre-installation distribution with the Windows OS.<sup>11</sup>

Real's Complaint cited some damning documents it obtained from Microsoft. In one, Microsoft executives compared the battle against Real to the battle against Netscape—the Microsoft executives noted that Real “is like Netscape, the only difference is we have a chance to start this battle earlier in the game.” Microsoft executives further considered “reposition[ing] streaming media battle from NetShow versus Real to Windows versus Real” and “follow the [Internet Explorer] strategy whenever appropriate.” According to Real, these documents show intent by Microsoft to tie the OS and WMP, effectively foreclosing Real from competing in many accounts.<sup>12</sup>

These allegations are significant if the Real court ultimately follows the Jefferson Parish per se rule; Real has a strong claim if it can substantiate these allegations. Again, under the Jefferson Parish test, Real need only demonstrate the following:

- (1) that the OS and WMP are two separate products;
- (2) that Microsoft conditions the sale of the OS on the sale of the WMP;
- (3) that the arrangement affects a substantial volume of interstate commerce; and
- (4) that Microsoft has market power in the tying (OS) product market.<sup>13</sup>

The third and fourth elements easily are met. The media player market is sufficiently “substantial” and Microsoft clearly has “market power” in the OS market. As to the first two elements, Real needs to demonstrate that there is separate consumer demand for a media player from the demand for the OS (Windows). Given that Real, Apple and several other companies offer independent media players, it appears that Real can argue that the products indeed are “separate.” Microsoft may argue that the OS and WMP are inextricably intertwined, in that they share crucial software code in their platforms and work together more efficiently, but under Jefferson Parish, the existence of separate consumer demand for the two products should be sufficient for Real to meet its burden.

If the Real court undertakes a more rigorous rule-of-reason approach, looks to the significance of the effect of Microsoft’s bundle, and dissects Microsoft’s procompetitive justifications more carefully, the fate of Real’s claim is more uncertain. One need not look any further than the recent EC decision involving Real and Microsoft to see that more rigorous analysis in action.<sup>14</sup>

### **The European Commission’s Decision in Microsoft**

On March 24, 2004, the EC announced that it concluded its five-year investigation into Microsoft’s business practices. Among other things, the EC concluded that Microsoft abused its position of dominance in the OS market, in violation of Article 82, by tying WMP to the OS.<sup>15</sup> The Commission fined Microsoft €497 million, and ordered Microsoft to sell a version of its Windows OS without WMP within 90 days of the issuance of the decision.<sup>16</sup>

In the EC’s decision, the Commission decided that under a rule-of-reason analysis, the forced bundling of WMP with the Windows OS was illegal, balancing the procompetitive justifications proffered by Microsoft for its practice against its negative effects on the media player market, in a manner similar to that set forth by the D.C. Circuit in its Microsoft case.<sup>17</sup> The EC analyzed Microsoft’s conduct and reached its decision to condemn Microsoft’s bundling practice in the following manner.

First, Microsoft argued that the products were not separate. Microsoft contended that WMP functionality was added on to its OS and thus was a part of the OS product. WMP, in other words, was an improvement to the OS. This argument mirrors the D.C. Circuit Court's rationale for abandoning the Jefferson Parish separate products test in favor of a rule-of-reason approach.<sup>18</sup> Although the Commission recognized that there were some instances in which feature enhancement to an OS would be perceived as integrated with the OS and not a separate product, such was not the case here. The Commission found that the software code was not sufficiently integrated between the OS and WMP. In addition, Microsoft bundled WMP with other OS's, and third parties offered stand-alone media players; all of which demonstrated that media players and OS's were distinct products with distinct demands.<sup>19</sup>

Microsoft also argued that the tie did not adversely affect competition in the media player market. The Commission rejected that contention. The Commission noted that Microsoft refused to allow OEMs the right to remove the media player from the OS; the decision concluded that this practice created a disincentive for OEMs to install additional media players on their systems—to do so, according to the Commission, would require the OEMs to expend time and money and undertake additional service and installation responsibilities. In the highly price-competitive PC business, OEMs were extremely reluctant to shoulder any burdens that might result in higher costs (and lower profits). As proof that the bundle had adversely affected competition in the media player market, the decision noted that Real's products were preinstalled on only between 1% and 15% of computers sold worldwide in a one-year period.<sup>20</sup>

The Commission acknowledged that Real had alternative distribution channels other than OEMs, but concluded that the inability to gain access to OEMs precluded Real's player from gaining a sufficient level of customer exposure. At the same time, EC also concluded that because of the tie, WMP became more pervasive. The bundle provided a level of distribution so great that software developers and content providers were given the incentive to write code compatible only with WMP, thereby decreasing the attractiveness of rival products. The EC concluded: "Microsoft's tying behaviour ensures that the ubiquity of its client PC operating system is shared by its streaming media player. . . . [T]his creates

disincentives for OEMs to ship third party streaming media players pre-installed on their PCs, and harms competition in the market for streaming media players.”<sup>21</sup>

The Commission also disagreed with Microsoft’s argument that high-tech industries somehow should escape traditional antitrust analysis because they develop rapidly. Microsoft argued, as the D.C. Circuit Court emphasized in its Microsoft decision, that “[a] product which might presently give the appearance of being in a strong or dominant position in the market would in fact be at constant risk of being displaced by a completely new product. . . . By extension, the implication was that there would be no position of entrenched market power in such industries.” The Commission flatly disagreed: “[t]he specifics of any particular industry (be it ‘hi-tech’ or ‘old economy’) must of course be taken into account when analyzing issues of market definition and market power. Differing characteristics will undoubtedly have an influence on the specific assessments that are reached. This, however, does not mean that no antitrust analysis could be applied to ‘new economy’ markets.”<sup>22</sup>

The Commission specifically pointed to network effects as evidence of increased likelihood of the development of a dominant position in platform industries. The decision noted, “[a] streaming media would not meet with significant consumer demand if there was no or no significant amount of corresponding digital content which this player could play back.”<sup>23</sup> Moreover, a streaming media that did not reach sufficient consumers would not attract content providers to develop content for such media players that had a more limited reach. As a result, according to the Commission, media players without substantial distribution opportunities likely would not be competitive in the market because developers had less incentive to write to them—a classic example of the competitive dangers in networked industries.

The Commission entertained in great detail Microsoft’s procompetitive justifications for the technological tie. First, Microsoft contended that the tie reduced transaction costs; such savings could be passed to consumers. Microsoft maintained that the tie saved resources otherwise spent to maintain a separate distribution system for the media player product. The Commission entirely rejected this argument. Such a “justification” supports any tying arrangement, for it is the nature of a tie to use one modus of distribution for two



products. The savings, according to the Commission (especially in a software market) are minimal: “distribution costs in software licensing are insignificant; a copy of a software programme can be duplicated and distributed at no substantial effort.”<sup>24</sup> This, however, is potentially a substantial efficiency proffered by Microsoft, and may carry the day in the U.S. litigation. If Microsoft, through its bundle, assumes service and installation responsibilities for OEMs who already operate only with minimal margins, the bundle will allow these OEMs to maintain some profits on their products. On the other hand, if the products were separate, OEMs would need to assume higher costs by undertaking the service and installation costs themselves.

Second, Microsoft contended that the technology tie increased the product performance of both the OS and WMP. Microsoft maintained that the tying of the media player to the OS enabled application developers to write functionality for the media player. But as the Commission noted: “Microsoft has failed to supply evidence that tying of WMP is indispensable for the alleged pro-competitive effects to come into effect.”<sup>25</sup> The Commission reasoned that the same efficiency could be achieved if the media player was bundled by the OEM, rather than made a required element of the OS. Microsoft further failed to demonstrate that application developers could not write functionality to other media players, like Real’s Media Player: “Microsoft has offered no proof that developers only want to place calls to WMP. . . . The fact that software vendors may place calls increasingly to WMP rather than to other media players reflects WMP’s ubiquity due to the tying of WMP.”<sup>26</sup> Thus, Microsoft could not demonstrate a benefit of the tie, because the same efficiency could be brought to market if any media player was installed with the OS. In fact, as the Commission noted, many developers had written code already for the Real Media Player; it was only the forced tie that had reduced the attractiveness of the Real Media product to independent software developers.

Balanced against the actual and potential anticompetitive effects of reduced consumer choice and diminished competitive alternatives, the Commission held the practice illegal and ordered Microsoft immediately to cease tying the products.

## **Whether and Why Software Platform Markets Deserve More Lenient Treatment**

In *Microsoft*, the D.C. Circuit relied heavily on the rapid rate of technological change in software platform markets and the benefits that may be realized through the integration of software platforms and applications, while largely ignoring the tendency of high-tech markets—especially software platform markets—to exhibit strong tendencies toward monopolization.

According to the *Microsoft* court, there are fundamental differences between high-tech software platform markets and “old economy” industries, necessitating different considerations in the laws of tying. The court noted that technological markets are characterized by rapid rates of change. We are all familiar with the rate in which operating systems and other software systems are updated—sometimes new versions are introduced every six months—and application cycles rarely last for more than one year, especially early in the life of the product. This rapid rate of change, according to the D.C. Circuit, leads to only transient power in a market, and makes the establishment of static monopoly power much less likely. Tying law, the Court reasoned, should not be so restrictive as to impede innovation in light of the often temporary and illusory nature of market power.

What the Court did not focus on—but what the EC did in its analysis of the WMP tie-in—was the countervailing tendencies in such high-tech platform markets toward monopolization, possibly heightening the need to consider closely the competitive practices of some participants in these industries. High-tech markets in particular are often susceptible to network effects, and cause lock-in.

Networked industries often tend toward monopolization. The value of a product is tied to its pervasiveness. For example, WMP is more attractive because it is more available; third parties are more prone to support and more likely to write applications that support the WMP format because of the ubiquity of the program. Of course, the WMP format is further supported by the pervasiveness of the Windows platform.

In addition, in networked industries, consumers are prone to “lock-in,” making it very difficult to establish a competing brand. Once consumers are familiar with a product, they are often reluctant to switch to something different. This is not necessarily a function of preference: software (especially enterprise software) oftentimes is expensive, requires knowledge and experience to operate, service and maintain, and can demand significant expenditures to update.

As a result, activities of dominant participants in such markets may demand increased, rather than decreased, scrutiny. Although it is important to foster the development of new and better software that does not necessarily mean that antitrust law must adopt a completely laissez-faire approach to technology. Disciplined antitrust enforcement—for example, careful attention to forced bundling arrangements—may indeed benefit innovation and therefore consumers in the long-term.

In the end, there are benefits to a rule-of-reason approach in tying cases. The approach preserves the possibility that technological integration that results in an innovation that benefits consumers will not be chilled, and at the same time allows courts to analyze whether a tie is necessary to maintain those benefits or is instead a mechanism by a monopolist to leverage its strength in one market to exclude rivals in another. The Real case presents significant antitrust issues for the district court to consider. Microsoft will no doubt rely on many of the same procompetitive justifications for its practice as it did in the EC case, and given the D.C. Circuit’s decision in the earlier Microsoft case, such procompetitive arguments may carry the day.



## Endnotes

1 RealNetworks, Inc. v. Microsoft Corp., No. C 03-5717 (JW) (EAI) (Complaint) (N.D. Cal. Dec. 18, 2003).

2 Jefferson Parish Hosp. Dist. No. 2 v. Hyde, 466 U.S. 2, 24-26 (1984).

3 United States v. Microsoft Corp., 253 F.3d 34, 84-97 (D.C. Cir. 2001) (en banc).

4 In several older cases, including the IBM cases, see, e.g., Transamerica Computer Co. v. IBM, 698 F.2d 1377 (9th Cir. 1983), ILC Peripherals Leasing Corp v. IBM, 458 F. Supp. 423 (N.D. Cal. 1978), and Response of Carolina v. Leasco Response, Inc., 537 F.2d 1307 (5th Cir. 1976), the courts held that technological integration did not comprise illegal tying. Those cases, however, involved the creation of new product innovations, rather than simply combining two software products that served different functions.

5 Microsoft, 253 F.3d at 89.

6 See id.

7 See id. at 94.

8 See id.

9 RealNetworks, supra note 1, at ¶ 140.

10 See id. at ¶¶ 125-30.

11 See id. at ¶ 144.

12 Id. at ¶ 145.

13 Jefferson Parish, 466 U.S. at 24-26.

14 Comp /C-3/37.792 Microsoft, available at <http://europa.eu.int/comm/competition/antitrust/cases/decisions/37792/en.pdf> (“Commission Microsoft Decision”).

15 See id.

16 See *id.*

17 See *id.* at ¶ 5.3.2.

18 It also puts the practice closer to that which courts have adopted in the IBM technological integration cases. See, *supra*, note 4.

19 See Commission Microsoft Decision, at ¶¶ 803-13.

20 See *id.* at ¶ 5.3.2.1.4.

21 *Id.* at ¶ 857.

22 *Id.* at ¶ 470.

23 *Id.* at ¶ 420.

24 *Id.* at ¶ 958.

25 *Id.* at ¶ 963.

26 *Id.* at ¶ 968.



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