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CLIENT ADVISORY

MICROSOFT: A UNIQUE CASE OR A PRECEDENT FOR THE FUTURE ENFORCEMENT OF ART. 82 EC?

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On 17 September 2007, the Court of First Instance ("CFI") upheld the European Commission's decision from 24 March 2004 ("Decision") to impose a €496-million fine upon Microsoft for having abused its dominant position in the client PC operating systems market by seeking to extend that position to two adjacent markets, *i.e.,* the market for work group server operating systems and the market for media players.[1] In the CFI's opinion, the Commission "did not apply any new rule of law in the present case" (recital 1335).

This client advisory summarizes the CFI's appraisal of the Commission's Decision (*infra* I). In light of the wealth of information that is already available, including the CFI's own four-page press release, this summary will be brief.[2] We will instead focus on the question of whether the CFI might have stretched the existing case law regarding the two practices that were found to be abusive (*infra* II). Although the Commission takes the view that this is "an exceptional case with extremely harmful abuses by a company in a quasi-monopolistic position on the market,"[3] we will also examine whether the *Microsoft* judgment might have wider implications for future antitrust enforcement in the EC (*infra* III).

I. THE *MICROSOFT* CASE IN A NUTSHELL

Microsoft's first abuse consisted in a refusal to provide manufacturers of work group server operating systems certain information to improve—not establish—the interoperability between their software and that of Microsoft. Microsoft had claimed that a significant part of that information was protected by patent and copyrights or contained trade secrets and that its refusal to license these intellectual property rights ("IPRs") was not unlawful. However, referring to the European Court of Justice's ("ECJ") judgment in *IMS*, the CFI concluded that the "exceptional circumstances" under which such a refusal can be abusive were met and that the refusal infringed Art. 82-b of the EC Treaty because it was "limiting…technical development to the prejudice of consumers."[4] The Decision ordered Microsoft to share the specifications for its client/server

1 Judgment in case T-201/04 of 17 September 2007, *Microsoft Corp. v. Commission*.

2 Press release n° 63/07 of 17 September 2007.

3 Press release n° 07/359 of 17 September 2007.

4 Building on its judgment in joined cases C-241 and 242/91 P, *RTE and ITP v. Commission,* [1995] ECR I-743), known as the *"Magill"* case, the European Court of Justice listed these « exceptional circumstances » in case C-418/01, *IMS Health*, [2004] ECR I-5039 (recital 38).

and server/server communications protocols with its competitors.

Microsoft's second abuse consisted in the bundled sale of Windows and its Windows Media Player.[5] In view of the dominant position of Windows on the client PC operating systems market and the fact that customers could not buy Windows without also buying Windows Media Player (as this functionality was integrated into Windows), Microsoft was found to have infringed Art. 82 of the EC Treaty, irrespective of whether the bundled sale specifically infringed Art. 82-d, which prohibits dominant companies from "making the conclusion of a contract subject to acceptance by the other party of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject matter of the contracts." In the CFI's view, the Commission's approach was in line with the existing case law on tying.[6] The Decision ordered Microsoft to offer customers in Europe a version of Windows from which the media functionality would be removed.

It is worth noting that in the US, the DC Court of Appeal dismissed the allegations of tying that were central to the case brought by the Department of Justice and while the agency sought and obtained commitments designed to promote interoperability, these did not relate to improved client/server or server/server interoperability.

The Commission's Decision had delegated wide powers of investigation and enforcement to a private trustee for the purpose of monitoring Microsoft's compliance with its Decision. For instance, the trustee could issue opinions on compliance, not just at the request of the Commission but also upon application by a third party or even on his own initiative. He also had wide access to Microsoft's assistance, information, documents, premises, and employees in order to carry out his monitoring task. The CFI held that there was no legal basis for such a sweeping delegation of powers, and it annulled the Commission decision on this point.

At this stage, it is unclear whether this annulment will affect the validity of the Commission's decision from 12 July 2006 imposing a €280.5-million fine for non-compliance with its Decision in the past and threatening to impose supplementary daily penalties of up to €3 million in case of continued non-compliance in the future.

II. STRETCHING THE EC CASE LAW?

I. A. The Interoperability Issue

The *IMS* case law stands for the proposition that refusals to license by dominant holders of IPRs can only be abusive in the following "exceptional circumstances": i) access to the IPRs must be "indispensable for carrying on" business in a neighboring market; ii) the refusal to grant access will "exclude all competition" in that market; iii) the refusal "prevents the appearance of a new product for which there is potential consumer demand"; and iv) the refusal is not "justified."

When the ECJ identified these circumstances in *IMS*, it built on its *Magill* judgment, which concerned a highly facts-specific case. The three main TV channels in the UK had refused to grant a copyright license for the information featuring in their "mono-channel" TV guides to a publisher who wanted to produce and sell a guide that would enable the subscriber to have an overview of the programs on all three channels in one glance. The ECJ must have been inspired by a down-to-earth sense of justice when it upheld the Commission's view that the refusal to license was abusive. The refusal indeed deprived consumers of a product that was manifestly superior to the existing products and for which the information that was protected by copyright was absolutely essential. The ECJ may also have been driven in part by a view that television listings (as opposed to the programs themselves) were not really worthy of copyright protection.

Be it as it may, in *Microsoft*, the CFI seems to have somewhat stretched the meaning of each of the four "exceptional circumstances." In its Decision, the Commission had argued that the *IMS* list was not exhaustive and that other exceptional circumstances,

5 This media player has "streaming" capability, *i.e.*, the ability to begin playing content before it is fully downloaded.

6 This case law is set out by the European Court of Justice in case C-53/92P, *Hilti v. Commission*, [1994] ECR I-667 and in case C-333/94 P, *Tetra Pak v. Commission*, [1996] ECR I-5951.

including Microsoft's quasi-monopoly on the client PC operating systems market, could not be ignored. The CFI reviewed the legality of that Decision in light of the four *IMS* conditions, took the view that all four conditions were met and concluded that there was no need to take its review any further. Let us have a look at each of these four conditions.

Indispensability. No one contests that there are degrees of interoperability and that, prior to the Commission's Decision, Microsoft's competitors could already offer work group server software that was interoperable with Microsoft's product. However, the Commission took the view that Microsoft's competitors had to be given the opportunity to make their server software fully interoperable with Microsoft's software, more specifically with its Windows "domain architecture" which consists of an architecture of client/server as well as of server/server interconnections. Such full interoperability required disclosure of the specifications of the communication protocols that govern these interconnections.

While access to these specifications enables a server running on a non-Microsoft work group server software to act as "domain controller" and not merely as a "member server" within the Windows environment (recital 233), the key question under *IMS* should be whether full interoperability is indispensable for the viability of Microsoft's competitors. The evidence adduced by the Commission (and reviewed by the CFI) only showed that the more limited degree of interoperability available without disclosure of the communications protocols created a number of security, efficiency, or productivity problems for these competitors and that Microsoft's share of the server software market had grown rapidly at the expense of most of its competitors. Hence, the *IMS* indispensability requirement (which should only prohibit Microsoft from using its IPRs to block market entry) seems to have been watered-down to a sort of sustainability requirement (which prohibits Microsoft from using its IPRs to contain the growth of competitors and possibly cause—in a worst case scenario—their market exit in the long run). Yet, the CFI maintained that "the fact that competition is eliminated gradually and not immediately does not contradict the Commission's argument that the information at issue is indispensable" (recital 428).

Elimination of competition. Microsoft's refusal to license clearly did not eliminate all competition. However, the Commission took the view that it created at least a risk of such elimination. It referred to the fact that Microsoft had conquered a market share of around 60%, that Novell had lost market share, that UNIX vendors had a small market share, and that Linux products had not made the expected headway on the market. For the CFI, this was enough: "if the Commission were required to wait until competitors were eliminated from the market or until their elimination was sufficiently imminent, before being able to take action under Art. 82, that would clearly run counter to the objective of that provision (…)" (recital 561).

New product. In the Commission's view, access to Windows client/server and server/server communication protocols would give competitors a chance to make "advanced features of their own products available in the framework of the web of interoperability relationships that underpin the Windows domain architecture" (recital 654), and there was "ample scope for differentiation and innovation beyond the design of interface specifications" (recital 655).

The CFI goes along with that view, stretching again the *IMS* wording: "the circumstance relating to the appearance of a new product (…) cannot be the only parameter which determines whether a refusal to license an IPR is capable of causing prejudice to consumers within the meaning of Art. 82-b [since], as that provision states, such prejudice may arise where there is a limitation not only of production or markets, but also of technical development" (recital 647). This seems like a giant leap. In *Magill* (where the TV channels were compelled to license their copyright) , the dominant company had prevented imminent market entry of a new product that was so superior that it was likely to out-compete its own product. In contrast, the *Microsoft* case deals with the mere eventuality that the dominant company might make it more difficult for its competitors to upgrade their existing products.

The CFI even goes a step further: "Art. 82 covers not only practices which may prejudice consumers directly but also those which indirectly prejudice them by impairing an effective competitive structure" and that Microsoft is doing exactly that "by acquiring a significant market share" on the work group server operating system market (recital 664). In other words, the link with consumer welfare is dropped, and the focus on the process of rivalry between competitors re-emerges.

No objective justification. According to Microsoft, full interoperability would have a negative impact on its incentives to innovate. The Commission had observed that any such impact would be "outweighed by its positive impact on the level of innovation of the whole industry (including Microsoft)" (para. 783 in the Decision). In the CFI's opinion, Microsoft did not explain how its incentives to innovate would suffer from full interoperability (recital 697). It was simply worried—for no good reason—that such disclosure would enable its competitors to clone its software (recital 700). The CFI also contrasts Microsoft's refusal with the widespread disclosure practice of others in the industry, with Microsoft's own commercial strategy in the early years, and even with IBM's commitment in 1984 with regard to mainframe parts and software (recitals 702 and 710).

It is hard to compare *Microsoft* with *IMS* on this point. Perhaps Microsoft's fear of cloning was unsubstantiated. However, its argument that full interoperability would chill its innovation efforts seemed to have just as much merit as the Commission's counter-argument that disclosure would create incentives for its competitors to innovate. Is there a bias against the dominant company's capacity and readiness to innovate and a bias in favor of that of its competitors? That may be too sweeping a critique. However, a dominant company will have to point at significant short-term efficiencies to dispel the Commission's concerns about its conduct's potential long-term negative impact on the competitive process.

II. B) The Tying Issue

Tying is explicitly mentioned as an abuse in Art. 82-d. However, that provision only describes the <u>object</u> of tying: a seller who has two products belonging to separate markets and is dominant for one of the products (the tying product), prohibits or discourages the customer from buying that product without also buying the other product (the tied product).

The case law has clarified that tying only infringes Art. 82-d if it has the <u>effect</u> of significantly distorting competition in the market of the tied product without justification. In this respect, the CFI stresses that the Commission had not relied on a "new and highly speculative theory," but "had examined more closely the actual effects which the bundling had already had on the streaming media player market and also the way in which that market was likely to evolve" (recital 868). The CFI's assessment of Microsoft's tying practice seems to raise more question marks at the first level (object of tying) than at the second level (effects of tying). But let us review the CFI's observations at both levels.

Separate products. The CFI opens its findings with an encouraging statement: "the IT and communications industry is an industry in constant and rapid evolution, so that what initially appear to be separate products may subsequently be regarded as forming a single product, both from the technological aspect and from the aspect of competition rules" (recital 913). However, turning to the case at hand, the CFI agrees with the Commission that Windows and Windows Media Player are separate products. Although Microsoft may have been bundling the sale of these two products since 1992, "it is difficult to speak of commercial usage [within the meaning of Art. 82-d] in an industry that is 95% controlled by Microsoft" (recital 940). In any event, it is irrelevant that consumers prefer to buy packages of system software (*e.g.,* an operating system like Windows) and application software products (word processing, media player, etc). What matters is that the intermediaries who create these packages—in particular the original equipment manufacturers ("OEMs") who account for the large majority of sales of Windows—should be free to source its components from different suppliers so that they can assemble the packages of their choice (recital 923). While these observations seem to make sense, Art. 82-d contains no exception from the "commercial usage" requirement simply because the usage is largely that of a quasi-monopolist.

Coercion. The CFI supports the Commission's interpretation of the terms "supplementary obligations" in Art. 82-d on the ground that consumers cannot obtain the tying product without the tied product. The fact that they do not face any contractual penalty or financial disincentive if they install and use an additional third-party media player on their PCs, is irrelevant (recital 970). In other words, the fact that consumers are not forced or encouraged to enter into an exclusive dealing arrangement with Microsoft for its media player, is irrelevant. This seems to be a novel step.

Foreclosure. The CFI shares the Commission's view that the bundled sale of Windows and Windows Media Player unduly foreclosed competition in the media player market for essentially three reasons.

First, the tie had "significant consequences for the structure of competition" (recital 1054) because it gave Microsoft's media player tremendous market penetration (*i.e.,* virtual "ubiquity") and discouraged OEMs (for technical reasons) or end-users (for convenience reasons) to install an additional player onto the PC. At bottom, the CFI believed that the tie did not constitute competition on the merits: "the significant growth in the use of Windows Media Player has not come about because that player is of better quality than competing products or because those media players (…) have certain defects" (recital 1057).

Second, the tie produced a network effect: "the greater the number of users of a given software platform, the more there will be invested [by content providers and software designers] in developing products compatible with that platform, which in turn reinforces the popularity of that platform with users" (recital 1061).

Third, following the implementation of the tie, the market share data show "a tendency towards Windows Media Player and away from RealPlayer and QuickTime Player." (recital 1081). The fact that a number of third-party media players are still present on the market (recital 1089) and that the number of media players and the extent of the use of multiple players are actually increasing (recital 1055) is irrelevant because "the Commission did not state that the tying would lead to the elimination of all competition on the market," but only "that there was a reasonable likelihood that the maintenance of an effective competitive structure would not be ensured in the foreseeable future" (recital 1089).

Perhaps a controversial point in the CFI's assessment is that the first reason is considered to be sufficient to justify the conclusion that the tying produces undue foreclosure effects (recital 1059). It is controversial because it focuses on the degree of market penetration of Windows Media Player, not on the degree of foreclosure that this penetration might or might not have caused on the competing products. While considered not to be decisive, the second reason conceptually raises another interesting issue. Foreclosure is said to be caused by the likely behavior of <u>third</u> parties (*i.e.,* content providers and software designers) who—as a result of the ubiquity of Windows Media Player—would had an incentive to develop products that are compatible with it. Besides, it is not explained how this trend—assuming it will occur—will put Microsoft's competitors at a disadvantage. The third reason seems to be more to the point, and it can only be regretted that the CFI did not clearly state that tying can only be unlawful if it creates a significant foreclosure effect in the tied product market.

Justification. According to Microsoft, the tying fitted in its legitimate business model of integrating new functionality (including media functionality) to Windows on an ongoing basis, and it enabled software developers and content providers to create their products more efficiently by calling upon functionality in Windows. The CFI rejected that argument because the remedy sought by the Commission (namely the offering of Windows without Media Player as an alternative, not as a substitute) "does not interfere with Microsoft's business model" (recital 1150). It added that "although, generally, standardization may effectively present certain advantages, it cannot be imposed unilaterally by an undertaking in a dominant position by means of tying."

This last observation sounds a little circular. The question is whether the bundling practice <u>unduly</u> forecloses competition (assuming it indeed forecloses competition). If there is no (or no significant) demand for Windows stripped of Windows Media Player, one wonders why Microsoft should be compelled to weaken its business model of systematically adding functionalities to Windows by selling these software products also separately.

III. THE IMPACT OF *MICROSOFT* ON FUTURE ANTITRUST ENFORCEMENT POLICY

The Commission's competition department published a Discussion Paper on the application of Art. 82 to exclusionary abuses in December 2005. While the Commission did not make any firm promises, most observers expected that this Discussion Paper would—after a consultation round in the first half of 2006—be converted into genuine Guidelines. But there has been no visible progress on formal Art. 82 Guidelines since circulation of the Discussion Paper.

The question is whether the Commission will now reactivate work on this project. In its *Microsoft* press release, the Commission announced that it "will consider its implications for future antitrust enforcement in these sectors and in others," but that statement keeps all options open. It can work on a set of Guidelines or it can continue to shape its policy on a case-by-case basis. There are indeed several interesting abuse cases in the pipeline, *e.g., Intel, Rambus, Qualcomm*.

In both scenarios, the first question is whether the outcome in *Microsoft* requires the Commission to pursue a more economic enforcement policy based on a more thorough analysis of the conduct's actual and potential anticompetitive effects and on a greater willingness to weigh these against that conduct's efficiencies.

The answer seems to be clearly negative. One could even argue that the judgment invites the Commission to peddle back. For instance, given the CFI's focus on potential foreclosure in *Microsoft*, it could consider dropping passages from its Discussion Paper, such as: "the longer the conduct has already been going on, the more weight will in general be given to actual effects" (para. 55 of the Discussion Paper).

The second and more interesting question is whether the Commission—notwithstanding its success in *Microsoft*—can decide to advocate more rigorous standards for its enforcement policy in any future Guidelines, even when these standards go beyond the requirements of settled case law.

The answer to this question seems less clear-cut. We offer the following considerations.

First, the scope of judicial review in individual cases is limited. Neither the CFI, nor the ECJ are permitted to substitute their assessment for that of the Commission where its assessment is the result of complex economical appraisals—as is typically the case in competition cases. In *Microsoft*, the CFI adds that the same principle applies when that assessment is the result of complex technical appraisals (recital 88). This suggests that the Commission might also have a margin of discretion to adopt a more rigorous enforcement policy in Art. 82 cases. However, the Commission should be careful not to confuse national courts. These courts have a duty to interpret and apply Community law in line with the settled case law of the CFI and the ECJ.

Second, the Commission has always enjoyed a margin of discretion not to pursue individual cases that present insufficient Community interest, *inter alia* because the alleged infringement does not produce significant harm in the common market.[7] This suggests that the Commission can opt for a policy to investigate only those cases for which it has a robust theory of harm. However, rejections of complaints are also subject to judicial review and the CFI and the ECJ are likely to scrutinize these decisions in light of the standard of proof emerging from their own judgments.

Third, the *Microsoft* case could be seen as exceptional in view of the quasi-monopolistic position of Windows. This might explain why the CFI endorsed the Commission's leveraging theory on potential foreclosure grounds and rejected Microsoft's efficiency defenses. However, some

7 Cf. judgment of 18 September 1992 in case T-24/90, *Automec v. Commission*, [1992] ECR-I 2223 (recital 86): In setting its priorities, the Commission must "balance the significance of the alleged infringement as regards the functioning of the common market, the probability of establishing the existence of the infringement and the scope of the investigation required in order to fulfill."

of the CFI's language is sweeping enough that it could re-emerge later (e.g. the passage according to which the Commission can intervene without having to wait until the elimination of competitors was sufficiently imminent). Moreover, the CFI and the ECJ have already used sweeping language on potential foreclosure in other, allegedly less exceptional, cases, *e.g.* those concerning loyalty rebates offered by companies that did not enjoy a quasi-monopoly position and had sometimes even lost market share in the period during which they had offered these rebates.[8]

Fourth, the CFI and the ECJ are particularly vigilant when the Commission makes a prospective appraisal of the likely impact of a company's conduct on future competition, notwithstanding the economically complex nature of such appraisal. Admittedly, we have seen this trend mainly in merger cases.[9] However, to the extent that Art. 81 or Art. 82 also require a prospective analysis, the same trend may emerge.[10] The Commission should therefore not feel inhibited by the CFI's deferential approach in *Microsoft* to better articulate the elements of its prospective analysis in future Art. 82 cases along the lines set out in the Discussion Paper.

8 See the ECJ's judgment of 15 March 2007 in case C-95/04 P, *British Airways v. Commission*, not yet reported.

9 See *e.g.*, Judgment in case C-12/03P, *Commission v. Tetra Laval*, [2005] ECR I-987 (recital 42): "a prospective analysis of the kind necessary in merger control must be carried out with great care since it does not entail the examination of past events (…) or of current events, but rather a prediction of events which are more or less likely to occur in future (…)."

10 See the CFI's judgment of 27 September 2006 in case T-168/01, *GlaxoSmithKline v. Commission*, not yet reported (with a reference to the prospective analysis in recital 249).

We hope that you find this brief summary helpful. If you would like more information, or assistance in addressing or commenting on the issues raised in this client advisory, please feel free to contact:

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