Legal Backgrounder

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A CHILL WIND FOR INNOVATION:
EUROPEAN COURT'S RULING IMPERILS HIGH-TECH ECONOMY

by

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The news accounts of the opinion of the European Union Court of First Instance upholding the European Commission's judgment against Microsoft provide no clue about its most important dimension – its deficiencies as an intellectual product. The 245 pages and 1,373 mind-numbing paragraphs explain nothing about the structure of the industry, or the objectives of the underlying law, or the complexities of modern industrial structure.

Reporters, no fools, don't read such opinions. They read press releases, and the European Union's public relations people are no fools either, so the controlling narrative was that a thoughtful court weighed the practices at issue and explained why it found them wanting. Not that the practices at issue were described in detail, as reporters stuck to such generalities as "Microsoft had refused to supply interoperability information about Windows to rival companies" and "had illegally bundled its own Media Player program into Windows." So the message driven home was that a monopolist had gotten its comeuppance, *again*, and that all is right with the world, at least on the far side of the Atlantic.

This message is not accurate. On the other hand, the opinion is so strange that it is not at all clear what message about it *would* be accurate, except to note that it is, in essence, what sociologist Max Weber called, "khadi justice," based on "expediential postulates" rather than "rational law."

The opinion dealt with two issues: (1) interoperability among servers, and (2) Microsoft's practice of incorporating Windows Media Player into the Windows XP distribution. In each case, the starting point for analysis was the charge that Microsoft had a dominant position in operating systems for desktop computers, and that it abused that position within the meaning of Article 82 of the EU treaty.[1]

Server Interoperability. The assumption in the news stories was that Microsoft was leveraging its dominance over PC operating systems to capture the server market by refusing to provide information necessary

[1]Article 82 says: [An abuse of a dominant position] may, in particular, consist in: (a) directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions; (b) limiting production, markets or technical development to the prejudice of consumers; (c) applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage; (d) making 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.

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for servers based on other operating systems to run with PCs (*e.g.*, paras 1288, 1347-50). In fact, this is not what either the original EC decision or the appeal said. There is nothing indicating that servers running Linux or Sun operating systems do not work with Windows-based PCs.

Instead, while the chain of logic is not clear, the opinion managed to get from the proposition that non-Windows servers should operate with Windows-based PCs to the proposition that servers running different operating systems must be interchangeable with each other. That is, when multiple Windows servers are linked, a situation Microsoft depicted as a "blue cloud" of computing power (*see*, *e.g.*, para 148), then it should be possible to drop a machine running a different operating system into the middle of the blue cloud and have it operate seamlessly with all the Windows servers and their PC clients (*see, e.g.*, para 390).

Microsoft protested that this would force it to give away to competitors its internal information so that they could clone Windows, because otherwise there is no way to guarantee interoperability. Not so, said the court, because Microsoft could give the competitor the specifications on what Microsoft's software accomplishes and leave it to that company to figure out an alternative route to achieve the same result.

This is a puzzling position by the court. Making computers work together smoothly and without bugs is a major part of the programmer's art. The court seemed to regard the enterprise as the equivalent of providing the dimensions of a mechanical part in a gear box.

Greg Papadopoulos is Chief Technology Officer of Sun Microsystems, which started this EC ball rolling in the first place, and which is itself betting billions of dollars on the concept of the integrated data center, carefully engineered so the parts work together. Perhaps Microsoft should have called him as a witness, because he said, in a blog entry called "The Industrial Revolution, Finally," (Oct. 17, 2006):

> I've commented frequently upon a central paradox of IT: software and hardware components are the products of fierce, high-volume competition, yet their final assembly by IT organizations is one-of-a-kind artisanship. . . .
>
> We ought to ask why this is so, because it is supremely inefficient. . . . computers and storage are simple to understand and quantify compared to the enormous complexity of their assembly into systems that deliver some (with hope, predictable) level of business service. This complexity not only is expensive, it's viscous. Business innovation, the central goal of IT, suffers.
>
> There is certainly a school of thought that this complexity is inherent and the proper (read: profitable) thing for a vendor to do is insulate the IT customer from it with 'services and solutions.' From our vantage point, this is a punt. It's far better to attack the composition of systems to provide useful service as an engineering problem, not as an Exercise Left to the Reader.

Papadopoulous' vision cannot be reconciled with that of the EU court. So, is Papadopoulos' vision now illegal in the EU? Or is it illegal only if it succeeds – if Sun's new box-car size datacenters are so compelling that they sweep the market, then must Sun tear them apart and open them to its competitors on a blade-by-blade basis, ensuring that they work perfectly by sending all the engineering data necessary to make this happen – information that constitutes Sun's competitive crown jewels?

Furthermore, the EC action against Microsoft was based on a complaint Sun filed in 1998, when Microsoft's server market share was 40% or less. So perhaps Sun better get busy opening up its datacenters right now – we could call it the theory of anticipatory dominance. If you are going to win in the market, you must act to forestall the possibility that this actually happens.

The court never discusses why it is insufficient for firms to compete to sell integrated arrays of servers rather than individual machines. Or, if interoperability is important, and software companies should be devoting huge efforts to it, as indeed they are, then why should the EU or any government get in the middle of a complicated contractual relationship?

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The final irony of the case lies in a remark made in a Grokster Law interview with four Free Software Foundation Europe (FSFE) staffers who participated in the case as interveners. After a long round of self-congratulation, Jeremy Allison, a Google employee generously loaned to FSFE to help out against Microsoft, observed:

> Yes, we won in court, but essentially we're losing in the marketplace. Between the beginning of the case and now . . . the workgroup server market has gone from, I think it was either 40% or 45% . . . to 70% Microsoft. So if you look at things like Active Directory, Exchange servers, they are steamrolling in that market. It's at the tipping point . . . .[2]

So the Unix family, of which Linux is a member, started with a superior position that it has managed to lose at a phenomenal rate all the while whining that the issue is Microsoft's refusal to interoperate.

Given that the case did *not* contend that Microsoft PCs cannot be made to work with Linux-based servers, this looks a lot like an admission that Free and Open Source Software can make it in the marketplace only if it is allowed to free ride on Microsoft engineering.

In any event, the next battleground will be over interaction with Linux. The EU law reflects that Microsoft must interoperate, but it does not require the company to *give away* its intellectual property. But the EC is already arguing that the property, although absolutely vital to competitors, is also not worth much of a license fee. The underlying issue is that Linux, although supported by the wealthiest tech companies in the world, has a licensing model that makes payments difficult.[3] So the Linux coders not only need access to Microsoft engineering, they need it for free.

Media Player. The second part of the opinion dealt with the undisputed fact that Microsoft had sold Windows XP with Windows Media Player bundled into it. The 2004 EC decision required the company to market XP N, a version without the player. As of March 1, 2006, XP had shipped 35 million copies of XP in Europe, of which a mere 1,787 were ordered without the player.

The legal term for the practice at issue is "tying," which means that a company refuses to sell product A to a customer unless the customer agrees to buy its requirements of product B as well. Some classic examples: a copier manufacturer requires the customer to buy paper, or a nail gun maker requires the purchase of its brand of nails.

Tying has been a problem area of antitrust law. The practice was stigmatized as "anti-competitive" early on, and only after the Chicago-school reforms of antitrust doctrine that occurred starting in the 1970s did awareness develop of tying's complexity or of its utility as a business practice. In the appeal of the U.S. case against Microsoft, the DC Circuit tossed in a long discussion of tying philosophy and practice, reviewing the many insoluble conundrums presented by the doctrine in the context of the tech industry, in the course of explaining why any judge unfortunate to get the case on remand should apply the Rule of Reason rather than a rule of *per se* illegality. *U.S. v. Microsoft Corp.*, 253 F.3d 34, 84-97 (D.C. Cir. 2001) (*en banc*).

The EU, in contrast, applied a mechanistic test. The major questions were whether Windows and a media player were separate products, and whether Microsoft had a legitimate reason for tying them together that outbalanced any anti-competitive effect. The answers were that they were separate products, primarily because when the media player was introduced circa 1999 it was distributed separately from the operating system (para 915), and because, while other operating systems also bundle a media player, it is often supplied by a third party, not by the OS maker. The argument that the bundling is justified because consumers *want* a media player included was rejected on the ground that such a desire did not justify bundling by Microsoft. OEMs could do it, choosing among available offerings.

It is hard to engage with such a mechanistic approach. Among the issues *not* analyzed:

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[2]Groklaw, *Want to meet four men who dared to fight MS -- and won?* Thursday, Sept. 20, 2007 @ 02:09 AM EDT, http://www.groklaw.net/article.php?story=20070919214307459.

[3]Members of the Linux Foundation include HP; IBM; Intel; Cisco, Google, Motorola – over 90 companies in all. http://www.linux-foundation.org/en/Members.

1) A media player involves a complex relationship between the operating system provider, the creator(s) of media player(s), content producers, and consumers. The opinion was oblivious to the complexities of such a multi-sided market.

2) A common course of development as a product matures is that more features become standard parts of the package. In 1952, backup lights for automobiles were an add-on. Under the EU theory, the fact that they were once separate would make it a tie to add them as standard equipment, which would lead to an infinite chain whereby we would still be buying them in the aftermarket today.

3) If a media player is a "separate product" because it was distributed separately when it first appeared, then what about other features that were at some time or are now sold separately – browsers, security, search features, voice recognition? Is Microsoft forbidden to wrap any of these into a standard Windows package? If so, then how can it serve apps writers who want to make use of these functionalities? Or serve consumers who want turnkey service that is guaranteed to work

4) The issue is not just Windows without a media player, but Windows without a browser, or without voice recognition, or without search capability, or without . . . whatever. Then there would then be combinations – get up to five features and there are 32 possibilities.

5) Microsoft does not refuse to interoperate with other media players. Any provider that can build a better mousetrap and convince content creators and consumers that it *is* better can connect to Windows and ride on its ubiquity.

One cannot say that opinion is wrong on these issues; it is oblivious to them.

So where does all this leave the tech world? With a problem. Any company with a significant market share could be defined as "dominant," and forced to disaggregate an integrated product into as many separate pieces as the EC, or competitors, desire. The possibility is very real that the EU will force manufacturers to forego integration lest they run afoul of some objection filed in the future, complete with retroactive fines, and force consumers to pay for the integration services.

For an immediate example, makers of integrated circuits should worry. As Moore's Law works its magic, they are incorporating into a single chip features that were once put on complementary chips, as recently noted by tech investment guru Paul McWilliams. Paul McWilliams, "Moore's Law Takes a Bite Out of Analog," *Next Inning Technology Research*, 11/21/06, http://www.convergencelaw.com/files/McWilliams-Moore's_Law.pdf.

Conclusion. After the decision came down, EC Competition Commissioner Neelie Kroes took a victory lap, at which she spoke of "superdominant companies," and said Microsoft's market share "is not acceptable" and must be reduced. A spokesman later explained that what she really meant, since holding a dominant market position is not an offense in the EU, was that "once the illegal abuse has been removed . . . the logical consequence . . . would be to expect Microsoft's market share to fall." But this is obviously one of those cases where a public official made the gaffe of saying what she really thinks and plans, and any relationship to law is strictly coincidental.

So other companies may be calculating that much of Microsoft's problem is due to its unusual position, perhaps combined with its reluctance to truckle when regulators spout economic nonsense, and that the khadi's rule is that Microsoft loses but no one else need worry.

They could be right. But an old saw says that he who goes to law holds a wolf by the ear, and the Microsoft competitors went to law, for the sake of short term advantage. They, and others, will probably wind up with some bite marks. Already, the financial press is identifying new targets.