Amicus Curiae Brief in Support of Microsoft Corporation

Today Wilmer Cutler & Pickering, on behalf of its client, The Association for Competitive Technology filed a friend of the court brief in United States v. Microsoft Corporation, urging reversal of earlier District Court rulings by Judge Thomas Penfield Jackson. This is the only amicus brief designated by Microsoft to be filed in support of the company in the Court of Appeals.

The brief argues two main points. First, by breaking up Microsoft, the District Court risks fragmenting the Windows operating system standard in a way that will hinder future product development throughout the industry, destroy important network efficiencies, raise prices to consumers, and make personal computers both less useful and harder to use. Second, the District Court's decision, by misapplying the antitrust laws, would impose on the IT industry a set of rules that would chill both competition and innovation in ways that, over time, will dramatically reduce consumer welfare. The District Court's judgment should, therefore, be reversed.

A copy of the brief appears below. If you have any questions, please call Bill Kolasky at (202) 663-6357.

ORAL ARGUMENT SCHEDULED FOR FEBRUARY 26 & 27, 2001

No. 00-5212 (Consolidated with No. 00-5213)

IN THE UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

UNITED STATES OF AMERICA,

Plaintiff-Appellee,

v.

MICROSOFT CORPORATION,

Defendant-Appellant.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA
(No. 98-1232 (TPJ), Hon. Thomas Penfield Jackson, United States District Judge)

BRIEF OF ASSOCIATION FOR COMPETITIVE TECHNOLOGY AND COMPUTING TECHNOLOGY INDUSTRY ASSOCIATION AS AMICI CURIAE URGING REVERSAL IN SUPPORT OF DEFENDANT-APPELLANT MICROSOFT CORPORATION

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November 27, 2000

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PARTIES AND *AMICI*

All parties, intervenors, and *amici* appearing before the District Court and this Court are listed in the Brief for Microsoft Corporation.

CORPORATE DISCLOSURE STATEMENT

Computing Technology Industry Association ("CompTIA") is a not-for-profit computer industry trade association that was formed in 1982. Members span the entire spectrum of the computing and communications industry and consist of computer retailers and other industry resellers, computer and peripheral equipment manufacturers, software publishers, distributors, systems integrators and training, service, telecommunications and Internet companies.

Association for Competitive Technology ("ACT") is a nonprofit association representing companies in the information technology ("IT") industry. Its members include software developers, consulting firms, IT businesses, and IT professionals.

Neither CompTIA nor ACT has a parent company. No publically held company has a 10% or greater ownership interest in either CompTIA or ACT.

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GLOSSARY

Abbreviation	**Full Phrase**
ACT	Association for Competitive Technology
CompTIA	Computing Technology Industry Association
Conclusions of Law	*United States v. Microsoft Corp,* 87 F. Supp. 2d 30 (D.D.C. 2000)
Findings of Fact	*United States v. Microsoft Corp.*, 84 F. Supp. 2d 9 (D.D.C. 1999)
IP	Intellectual Property
IAPs	Internet Access Providers
IE	Internet Explorer
IT	Information Technology
Microsoft II	*United States v. Microsoft Corp.,* 147 F.3d 935 (D.C. Cir. 1998)
OEMs	Original Equipment Manufacturers

INTERESTS OF *AMICI*

Computing Technology Industry Association ("CompTIA") and Association for Competitive Technology ("ACT") are nonprofit trade associations. Collectively, CompTIA and ACT represent over 14,000 companies and individuals in the rapidly converging computing and communications industries. Their members include hardware manufacturers, software developers, distributors, service companies, consulting firms, and information technology ("IT") professionals. This court granted CompTIA and ACT leave to participate as *amici curiae* in an order dated November 3, 2000.

Amici's members (including Microsoft) do business in a rapidly growing technology market that is intensely competitive, producing new, better, and progressively less expensive products so rapidly that many consumers hesitate making a purchase today for fear that a faster, better, and cheaper product will be available tomorrow. Market forces determine the winners and losers in this fast-paced industry, and consumer choice has frequently transformed today's winner into tomorrow's loser.

In finding Microsoft liable, the District Court misapplied antitrust law in a manner that interferes with this process, ignoring the axiom that antitrust laws protect "competition, not competitors"[1] and threatening real harm to consumer welfare. In so doing, the lower court overlooked compelling evidence that Microsoft's challenged business practices, many nearly universal in the IT industry, were procompetitive, not anticompetitive. The District Court compounded its error by granting structural relief that will fragment the Windows operating system, retarding its further evolution and reducing the usefulness of a "standard" that has been a key driver in making this industry so dynamic and competitive. *Amici* see this as a potential

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[1] *Brown Shoe Co. v. United States*, 370 U.S. 294, 344 (1962).

disaster, subjecting *amici's* members to increased costs and technological chaos, and consumers to poorer products and higher prices.

STATEMENT OF THE CASE

The extraordinarily dynamic IT industry of the last fifteen years has generated enormous benefits for businesses and consumers. The decision below threatens to choke this dynamism by fragmenting the Windows operating system standard, which now supports a steadily increasing range of software applications, and by reducing the incentive and ability of leading software firms to compete vigorously by adding new functions to existing products.

1. Windows as the *De Facto* Operating System Standard

The emergence of Windows as a "*de facto* operating system standard" for personal computers was both natural and efficient. Operating systems are characterized on the demand side by strong positive "network effects": the more widely an operating system is used, the more valuable it is, both to consumers and to developers of applications software and other complementary products. *See United States v. Microsoft Corp.*, 84 F. Supp. 2d 9, 20 (D.D.C. 1999) (¶ 39) [hereinafter "*Findings of Fact*"]. There are also significant economies of scale on the supply side: an operating system developer must make a large initial investment, but the marginal costs of duplication and distribution are minimal. The combination of network effects and economies of scale make the emergence of a single operating system standard both inevitable and desirable.

Both consumers and software developers have benefited greatly from widespread use of Windows as a *de facto* operating system standard. Software developers benefit from reduced cost and risk because new programs and functions will run on most personal computers. This benefits consumers by "ensuring a large body of applications from which consumers can

choose." *Id*. Consumers also benefit because the operating system standard reduces their learning costs and gives them greater interoperability.

Windows has itself evolved, naturally and inevitably, to accommodate and sometimes incorporate new applications. These improvements benefit both applications developers and consumers. Indeed, the District Court acknowledged that the Windows improvement that is central to this case — the incorporation of web browsing functionality — directly benefited consumers by "increas[ing] general familiarity with the Internet" and "improving the quality of Web browsing software, lowering its cost, and increasing its availability . . . ." *Id.* at 110-11 (¶ 408)

2. The Nature of Competition in Computer Software

Strong network effects, strong economies of scale, and the nature of software as intellectual property ("IP") combine to make competition in computer software markedly different from competition in many other sectors. Creating software is risky, requiring large up-front investment with no assurance of success. If a product is successful, the developer must depend on legal protection of its IP rights to earn a return in the marketplace. The temporary "monopoly" afforded by IP law is what generates the returns that create the incentive to invest in new products. Software competition thus necessarily focuses principally on innovation—the creation of new IP— and is characterized by fierce drives to achieve these temporary "monopoly"-like market positions.

These "monopolies" are inherently transitory. The rate of innovation is so great that market leaders are regularly leap-frogged by new competitors. Established firms making one kind of software often incorporate the functionality of neighboring products into their programs, thereby improving their own products but also moving into other firms' previously distinct product space. This is what happened, for example, when WordPerfect (then the market leader)

integrated outlining and spell-checking functionalities into its word processing program, largely eliminating demand for stand-alone outliners and spell-checkers. This phenomenon is not unique to the software industry. On the farm, integrating the reaper, tractor, and threshing machine created the combine. This spelled the demise of the threshing machine as a stand-alone product, but the technological advance was certainly good, not bad. Integration of new functions into existing products is critical to commercial success in the software industry because software is an almost perfectly durable good: unlike other products whose makers enjoy repeat sales as goods sold in previous periods wear out or are consumed, existing software is replaced only when newly available software has such superior functionality and performance as to justify the cost of switching. An established software firm's strongest competition, therefore, is often its own installed base.

None of this means that basic antitrust principles should not be applied to the software industry. But in applying antitrust principles to this industry, as to any industry, the courts must be sensitive to its competitive dynamics. It is particularly inappropriate for a court, seeking to apply these principles to a rapidly changing industry, to rely simply on labels—such as "tying" or "market allocation"—to evaluate the competitive merits of single-firm conduct. As the Supreme Court noted in *Broadcast Music Inc. v. CBS*, 441 U.S. 1, 8 (1979), "easy labels do not always supply ready answers."

3. Proceedings in the District Court

Although Windows lawfully acquired its position as the *de facto* operating system standard, the court found that Microsoft had violated Section 2 of the Sherman Act by (1) maintaining its operating system "monopoly" through exclusionary conduct designed to prevent Netscape's Navigator (with Sun's Java) from becoming an effective alternative platform for software development, and (2) by attempting to monopolize the market for Internet browsing

software. The court also held that Microsoft violated Section 1 by "tying" its own web browser, Internet Explorer, to Windows.

In reaching these conclusions, the court relied heavily on labels, rather than analysis. It concluded, for example, that Microsoft's integration of web browsing functionality into Windows was a per se illegal tie without discussing whether such integration offered sufficient consumer benefits to require a fuller, rule-of-reason analysis. The court compounded this error by relying on internal e-mails to find that Microsoft's conduct was motivated by a desire to preserve its operating system monopoly and then using this evidence of subjective intent to trump any objective analysis of the competitive effects of Microsoft's conduct. Finally, the court accepted the Plaintiffs' proposal to break Microsoft in two without evaluating either the need for or the effects of that remedy and without according Microsoft (or the public) an opportunity to be heard.

SUMMARY OF ARGUMENT

This brief argues two points. First, by breaking up Microsoft, the District Court risks fragmenting the Windows operating system standard in a way that will hinder future product development throughout the industry, destroy important network efficiencies, raise prices to consumers, and make personal computers both less useful and harder to use. Second, the District Court's decision, by misapplying the antitrust laws, would impose on the IT industry a set of rules that would chill both competition and innovation in ways that, over time, will dramatically reduce consumer welfare. The District Court's judgment should, therefore, be reversed.

ARGUMENT

I. Breaking Up Microsoft Will Harm the IT Industry and Consumers and Is Not Justified by Any Threat to Competition.

In a market characterized by steadily and substantially declining consumer prices, the District Court nevertheless ordered the breakup of Microsoft thereby running the risk of

destroying a cornerstone of the industry's success, the Windows operating system standard. The District Court took this extreme step without a hearing on how the breakup would affect the public interest and with very limited consideration of whether the remedy is warranted by the violations the Court found or is necessary to cure them. Further consideration would have demonstrated that (A) the breakup will harm the IT industry and consumers and (B) the breakup is not a necessary or appropriate remedy for the violations found.

A. The Breakup Remedy Will Harm the IT Industry and Consumers.

In fashioning an equitable remedy for an antitrust violation, a court must select the remedy that will do "as little injury as possible to the interest of the general public." *United States v. E. I. du Pont De Nemours & Co.*, 366 U.S. 316, 327-28 (1961)(citation omitted). The reason is evident in this case: the remedy imposed will directly affect thousands of other companies, shape the design of current and future products used by millions of consumers, and influence a crucial segment of the national economy. The importance of the principle, "First, do no harm" cannot be overstated, but the District Court essentially abdicated to the Plaintiffs its job of assessing the public interest and they in turn may have been influenced by competitors of Microsoft that have vested interests in a particular outcome.[2]

Dissolution of a single company is an extreme remedy under the Sherman Act and should be ordered only as a last resort.[3] This is true for two reasons. Where only a single company, and not a combination or conspiracy, is involved (A) its current structure is likely to have evolved as a result of efficiencies that will be lost in a breakup,[4] and (B) the breakup will create problems of

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[2] *See United States v. Microsoft Corp.*, 97 F. Supp. 2d 59, 62 (D.D.C. 2000) ("Plaintiffs won the case, and for that reason alone have some entitlement to a remedy of their choice.").
[3] *See United States v. United Shoe Machinery Co.*, 247 U.S. 32, 46 (1918); *United States v. E. I. du Pont de Nemours,* 366 U.S. 316, 327-28 (1961).
[4] Kenneth G. Elzinga, David S. Evans, & Albert L. Nichols, *U.S. v. Microsoft: Remedy or Malady?* 9 GEO. MASON L. REV. (publication pending 2000) (manuscript at 68-77).

defining boundaries and duplicating or sharing resources that will require ongoing supervision and create new inefficiencies.[5] Both problems are readily apparent in this case where the breakup remedy will harm hardware manufacturers, software developers, and consumers in six critical ways.

First, and most fundamentally, the lower court's stated objective of achieving two or more competing operating system standards for desktop computing is ill-conceived. Although Windows will, in time, be leapfrogged by a fundamentally different computing standard, the existence of a *de facto* standard at any given time is both natural and desirable from a consumer perspective. If there were multiple standards, software developers would be unable to reach the broadest possible range of customers at the lowest possible cost: they would have to make products for multiple standards or select a single standard at the risk that another will prove to be more popular. Either choice would produce greater costs to developers, reduce their incentives to innovate, and reduce software choices for consumers.[6]

Second, the remedy will encourage the fragmentation of the Windows operating system. If original equipment manufacturers ("OEMs") are free to offer customized versions of Windows, software developers would have to offer tailored versions of their software, or to add basic functionalities, to assure broad "Windows compatibility," increasing their costs and frustrating consumers expecting standard capabilities and compatibility with other products.[7]

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[5] *See, e.g., United States v. AT&T*, 552 F. Supp. 131 (D.D.C. 1982) (breakup resulting in nearly 15 years of judicial supervision over the business operations of AT&T and its progeny).

[6] *See* testimony of Mike Devlin, Trail Transcript 2/4/99am, at 30:25 - 31:17 ("There are several different Unix platforms. … [Sun's version of Unix and IBM's version] are two platforms in the sense that we have to do special engineering and testing for each of those platforms. [A] high percentage of our development costs are associated with the things that turn out to be different -- in particular, testing and so forth. . . .")

[7] *See, e.g.,* Stan J. Liebowitz, *An Expensive Pig in a Poke: Estimating the Cost of the District Court's Proposed Breakup of Microsoft,* 31 (Sept. 21, 2000) (estimating that "middleware

Third, the remedy will require ongoing judicial supervision of the product design and operational decisions of the two companies created by the breakup, and this will delay and frustrate hardware manufacturers, software developers, and the consumers whom the antitrust laws are designed to protect. Contrary to the District Court's apparent assumption that delineation between functionalities is self-evident, it is not at all obvious, even to those who work in the industry, which present or future functionalities would be allowed to be part of Windows, and the IT industry would have to wait for judicial interpretations.

Fourth, the courts, substituting their judgment for consumer-driven market choices, are likely to get these definitions wrong, barring the incorporation into Windows of features that have greater value to consumers in integrated form. The integration of web browsing software into Windows at no additional cost benefited most consumers, *Findings of Fact,* 84 F. Supp. 2d at 55 (¶ 186), yet the Court's order would require Microsoft to offer a non-integrated version as well, *United States v. Microsoft Corp.,* 97 F. Supp. 2d 59, 68 (D.D.C. 2000). Such relationships are complex and better resolved by a market that rewards efficiencies and penalizes extra costs than by a court.

Fifth, the breakup will likely lead to reduced efficiency and higher prices. Because Microsoft's applications and operating system products are complementary, Microsoft currently has an incentive to charge lower prices for both products than would a firm that made only one of them.[8] What the court risks is creating two companies, both with incentives to charge the highest prices possible and significantly reduce innovation, in place of one broad-based,

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balkanization" would increase costs for a typical independent software developer by 16.72% of revenues, amounting to an industry cost of $27.4 billion over 3 years), *available at* http://www.competitivetechnology.org/pubs/remedies3.pdf.

[8] This phenomenon is referred to by economists as "double-marginalization." *See, e.g.,* JEAN E. TIROLE, THEORY OF INDUS. ORG., 174-76 (1988).

innovation-driven company that charges far less for its products.[9] That outcome will harm consumers and the IT industry. In fact, an economic study by a leading expert on network effects estimated that the breakup would cost U.S. consumers between $50 billion and $125 billion in higher software prices over three years.[10]

Sixth, innovation in related areas of the IT industry will also be reduced. For example, the District Court's remedy would assign important components of Microsoft's server software (*e.g.,* the database server) to the applications company. Those in the industry know that Microsoft has brought significant innovation and price competition to the market for operating systems and applications for servers, including database and transaction management software. Microsoft's approach in this market was to price well below the industry leaders and to tightly integrate its server applications with the operating system   an approach that many business customers have embraced. The breakup remedy denies this integration and disables the low-cost, innovative competitor, enabling the higher-priced incumbent market leaders in the server space, such as Sun, IBM, and Oracle, to charge more for less.[11] The remedy, therefore, will result in consumer harm in an industry segment not considered by the court below, and will likely benefit only those companies that helped Plaintiffs craft the remedy. This is one of the many examples of unintended (at least by the District Court) consequences that would have been demonstrated in hearings on remedies or other consideration of real world impact.

In sum, for reasons similar to the (far simpler) case of "Beta" vs. "VHS" video systems, trying to compel competition is both counterproductive and unnecessary. Makers of

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[9] *See, e.g.,* Paul Krugman, *The Last Refuge*, DENVER POST, June 13, 2000, at B11 ("In the case of Microsoft, textbook economics says that a breakup of the kind now ordered, aside from disrupting the firm itself, will actually exacerbate the problem of market power, raising prices and increasing market distortions.").

[10] *See* Stan J. Liebowitz, *supra* note 7, at iii.

[11] *See id.* at 19-21.

complementary products (in the video systems, video machines and videotapes), as well as consumers, benefit from a single standard in the marketplace. And, as the success of DVD technology illustrates, once a superior technology emerges, it can rapidly displace the earlier de facto standard.

B. The Remedy Is Not Justified by Any Harm to Competition.

The District Court found that Microsoft had, between 1995 and 1997, acted unlawfully to prevent rivals Netscape and Java from becoming an alternative platform for software development that would erode the so-called "applications barrier to entry" in the operating system space. It is undisputed, however, that Microsoft did not drive either Netscape or Java from the marketplace,[12] and there is no finding that Netscape and Java, either alone or in combination, would have emerged as a viable software development platform, even absent Microsoft's allegedly illegal actions.[13] A less intrusive remedy for exclusionary conduct would therefore be simply to enjoin that conduct, leaving Netscape and Java to emerge, if they can, as viable software development platforms. Nothing about the history of Netscape or Java suggests that it is necessary or in the public interest to break up Microsoft.[14]

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[12] *See Findings of Fact,* 84 F. Supp. 2d at 103 (¶ 378) (citing AOL estimates showing the number of users of Netscape Navigator, which incorporates Java, more than doubling over the relevant time period).

[13] *United States v. Microsoft Corp.,* 87 F. Supp. 2d 30, 44 (D.D.C. 2000) [hereinafter "*Conclusions of Law*"] ("the evidence does not prove that they would have succeeded absent Microsoft's actions"). *See also Findings of Fact*, 84 F. Supp. 2d at 112 (¶ 411) ("There is insufficient evidence to find that, absent Microsoft's actions, Navigator and Java already would have ignited genuine competition in the market for Intel-compatible PC operating systems."); *id.* at 110 (¶ 407) ("It is not clear whether, absent Microsoft's interference, Sun's Java efforts would by now have facilitated porting between Windows and other platforms enough to weaken the applications barrier to entry.").

[14] *See also* Elzinga, *et al.*, *supra* note 4, (manuscript at 42-51) (noting the inconsistency between the Plaintiffs' narrow market definition in the trial, where the competitive significance of alternative platforms is dismissed, and, in the remedies phase, where the porting of an office suite is supposed to transform these platforms into strong competitors).

The District Court had a responsibility, before imposing any remedy, to: (1) consider the interests of affected third parties and of the public in general; (2) consider whether "other measures will not be effective to redress a violation"; and (3) adopt a remedy that is no broader than necessary. *du Pont de Nemours,* 366 U.S. at 327-28 (citation omitted); *see also Aviation Consumer Action Project v. Washburn,* 535 F.2d 101, 108 (D.C. Cir. 1976). By uncritically entering Plaintiffs' proposed decree, without holding any hearing, and (by its own admission) without doing any significant independent evaluation of that remedy, the District Court abdicated those responsibilities, and imposed a remedy that will cause more harm than good.

II. The Legal Standards Used by the District Court To Find Microsoft Liable Would Chill Competition and Innovation in the IT Industry.

While breaking up Microsoft would cause immediate injury to the IT industry and consumers, the longer lasting and broader negative effect of the District Court's decision lies in the new legal rules it would impose. The District Court's judgment would chill both competition and innovation throughout the industry by (A) making it potentially illegal for leading firms to invest in improving products or otherwise sacrifice short-term profits to maintain their market-leading positions; (B) making it potentially illegal for market-leading firms to explore possible collaborations with emerging competitors or to compete vigorously for market share in neighboring markets; and (C) making it unlawful to add new functions to leading software programs where those functions are currently available in stand-alone products. In all three respects, the District Court's decision is at odds with established antitrust doctrine and is bad policy, as well as bad law.

A. Treating a Market Leader's Decision To Forgo Short-Term Profits To Maintain Its Market Position As Illegal Monopolization Would Outlaw Welfare-Enhancing Competitive Behavior.

Central to the District Court's decision is its holding that Microsoft, through various "predatory" acts, unlawfully maintained its lawfully-obtained Windows monopoly. But the court

defined "predation" as any conduct by a monopolist that would not be profit maximizing but for its effect in extending the monopoly by "erect[ing] or preserv[ing] barriers against competition . . . ." *United States v. Microsoft*, 87 F. Supp. 2d 30, 38 (D.D.C. 2000) [hereinafter "*Conclusions of Law*"]. By adopting this definition, the court condemned procompetitive conduct that is common in the IT industry, such as integrating new features into existing programs and cross-promotional agreements made to overcome a first-mover's advantages.

Two things are wrong with what the District Court did.[15] First, it condemns conduct that is not only lawful but desirable. It is entirely lawful and desirable for the holder of a lawfully-acquired monopoly to compete vigorously to sustain and even extend its monopoly, so long as it does so by procompetitive rather than anticompetitive means.[16] What antitrust law fears from a monopolist is not that it will compete vigorously but that it will be able to refrain from competing. Similarly, it is desirable, not objectionable, for a firm that enjoys a lawful monopoly in one field to compete vigorously in a related field, even if its monopoly in the one field gives it a competitive advantage in the other.[17] Second, a rule requiring lawful monopolists to pull their

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[15] For purposes of this brief, as below, *amici* accept the District Court's finding that Microsoft has a monopoly in a hypothetical market for Intel-based PC operating systems. *Amici* do not believe, however, that the record establishes, or that Microsoft in fact has, "the power to control prices or exclude competition," *United States v. E. I. du Pont De Nemours & Co.*, 351 U.S. 377, 391 (1956) (citations omitted), which is the proper test for monopoly power.

[16] *See, e.g., Spectrum Sports, Inc. v. McQuillan*, 506 U.S. 447, 458 (1993) (Antitrust "law directs itself not against conduct which is competitive, even severely so, but against conduct which unfairly tends to destroy competition itself."); *Ball Mem'l Hosp. Inc. v. Mutual Hosp. Insurance, Inc.*, 784 F.2d 1325, 1339 (7th Cir. 1986) ("Even the largest firms may engage in hard competition, knowing that this will enlarge their market shares.").

[17] *See Alaska Airlines, Inc. v. United Airlines, Inc.*, 948 F.2d 536, 548 (9th Cir. 1991) ("The anticompetitive dangers that implicate the Sherman Act are not present when a monopolist has a lawful monopoly in one market and uses its power to gain a competitive advantage in the second market."); *Berkey Photo, Inc. v. Eastman Kodak Co.*, 603 F.2d 263, 276 (2d Cir. 1979) ("So long as we allow a firm to compete in several fields, we must expect it to seek the competitive advantages of its broad-based activity—more efficient production, greater ability to develop complementary products, reduced transaction costs, and so forth. These are gains that accrue to

competitive punches would require antitrust courts to become the regulators of the software industry, examining the details of investment, product design, pricing and promotion decisions by any firm that establishes a market-leading position for a particular application. Such regulation, if applied to the many temporary monopolies that rise and fall in the dynamic IT sector, would strain judicial competence and seriously damage consumer welfare.

Many firms engage in conduct that is not profit maximizing in the short term (for example, introductory sales and promotional giveaways) in the interest of enhancing their long-term profitability. Such conduct, even when undertaken by a monopolist, is lawful so long as the firm is competing on the merits. Under well established law, there is nothing wrong with a monopolist cutting prices or investing in product improvement out of fear that, if it does not, it would lose its monopoly position.[18] That the monopolist forgoes short-term profits, seeking instead long-term profitability by extending its monopoly position, does not make such conduct unlawful.

A good illustration of the type of lawful conduct that would be prohibited under the District Court's formulation is what economists call "limit pricing"—pricing above cost but below the short-term profit-maximizing monopoly price to limit or discourage entry or expansion by rivals. The Supreme Court has held that because "[l]ow prices benefit consumers regardless of how those prices are set," limit pricing "cannot be viewed as . . . anticompetitive" so long as the resulting prices are above predatory levels. *See Atlantic Richfield Co. v. USA Petroleum Co.*,

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any integrated firm, regardless of its market share, and they cannot by themselves be considered uses of monopoly power.").

[18] *See, e.g.*, *United States v. Syufy Enterprises*, 903 F.2d 659, 668-69 (9th Cir. 1990) ("If a dominant supplier acts consistent with a competitive market—out of fear perhaps that potential competitors are ready and able to step in—the purpose of the antitrust laws is amply served."); *California Computer Prods., Inc*. v. *IBM*, 613 F.2d 727, 744 (9th Cir. 1979) (a monopolist has "the right to redesign its products to make them more attractive to buyers—whether by reason of lower manufacturing cost and price or improved performance.").

495 U.S. 328, 340 (1990). The Court has further held that prices are not predatory simply because they are set below a profit-maximizing level in order to exclude rivals; to be predatory they must be below an appropriate measure of the alleged predator's costs. *Brooke Group v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209, 222 (1993). As the Court explained, "the exclusionary effect of prices above a relevant measure of cost either reflects the lower cost structure of the alleged predator, and so represents competition on the merits, or is beyond the practical ability of a judicial tribunal to control without courting intolerable risks of chilling legitimate price-cutting." *Id.* at 223.[19]

In erroneously making short-term profit maximization the test for Section 2 liability without even citing these controlling Supreme Court precedents, the District Court relied on dicta from this Court's earlier decision in *Neumann v. Reinforced Earth Co.*, 786 F.2d 424, 427 (D.C. Cir. 1986), to the effect that "predation involves aggression against business rivals through the use of business practices that would not be considered profit maximizing except for the expectation that . . . entry of potential rivals [will be] blocked or delayed . . . ." But *Neumann* involved "sham litigation" designed to keep the rival from the market, *id*. at 428, with no possible benefit to consumers.[20] This Court obviously did not mean to bar a lawful monopolist from all price cutting or product improvement that may impede rivals, without regard to the benefit to consumers. Indeed, *Neumann* cautioned that a monopolist may use "superior efficiency" and "means … employed in the normal course of competition," *id*. at 427, to compete aggressively, even if the result is to drive a rival from the market or to deter entry.

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[19] *See also Arthur S. Langenderfer, Inc. v. S. E. Johnson Co.*, 729 F.2d 1050, 1057 (6th Cir. 1984)(rejecting a "profit maximizing rule" for assessing predatory pricing as "incompatible with the basic principles of antitrust").

[20] *See Professional Real Estate Inv., Inc. v. Columbia Pictures Indus.*, 508 U.S. 49, 60-61, 65-66 (1993) (adopting an objective standard for sham litigation and rejecting an alternative formulation that would have broadened the exception to include any litigation whose cost exceeded the profits that would be realized were it successful).

Aspen Ski Co. v. Aspen Highlands Skiing Corp., 472 U.S. 585 (1985), further illustrates that forgoing short-term profits is insufficient to prove illegal monopoly maintenance. In *Aspen*, the defendant, by discontinuing a four-mountain ski-lift pass, *lowered the quality* of its own product and thereby *reduced* demand for that product in order to exclude its only competitor. This was not competition on the merits, but rather direct "aggression against business rivals." *Neumann*, 786 F.2d at 427. In contrast, Microsoft *improved* Windows and Internet Explorer, making them *more attractive* to consumers in the marketplace, thereby *increasing* demand for Windows, PCs, and for software generally (including Microsoft's own). That conduct, therefore, represented competition on the merits and whether that conduct was profit maximizing is both irrelevant and beyond the competence of the courts to determine.[21]

In applying the law to the case before it, the District Court retreated somewhat from the erroneous legal standard it articulated, holding that most of Microsoft's conduct—in developing and improving Internet Explorer ("IE"), selling it at a zero price, and forgoing alternative revenue opportunities to promote usage of IE—was not predatory, even though it may have been unprofitable in the short-term, because Microsoft might still have undertaken these efforts "absent the strategic imperative to maximize its browser usage share." *Findings of Fact*, 84 F. Supp. 2d at 45 (¶ 140). What the lower court overlooked is that, as its own findings show, these procompetitive actions, not any restrictive practices, were what enabled Microsoft to win the contracts (particularly with AOL) that frustrated Netscape's ambition to have Navigator become

[21] *See generally* William H. Page & John E. Lopatka, *The Dubious Search for "Integration" in the Microsoft Trial*, 31 CONN. L. REV. 1251 (1999) (showing that Microsoft's conduct may have been profit maximizing absent any effect on the so-called applications barrier to entry).

the *de facto* browser standard.[22] Microsoft won the early rounds of the ongoing "browser wars" through competition on the merits, not through predation.

Failing to recognize that these findings were fatal to the Plaintiffs' case, the court below proceeded to find Microsoft guilty of unlawful monopolization on the basis of three allegedly restrictive practices that it concluded crossed the line into predation—integrating IE into Windows, restricting OEMs from removing IE from the Windows desktop, and entering into restrictive cross-promotion arrangements with Internet Access Providers ("IAPs"). *Conclusions of Law*, 87 F. Supp. 2d at 50-53. In each case, however, the conduct the District Court condemned is both common in the IT industry and procompetitive.

Integration. As discussed in Part II.C below, integrating new functions into existing software is a common form of competition in the IT industry. As this Court has already found, adding web browsing functionality to Windows offers facially plausible benefits to consumers.[23] It could not, therefore, be found to violate Section 1 without a showing of injury to competition, and there was no such showing. *See* pp. 23-24 *infra*. It follows *a fortiori* that the conduct cannot have violated Section 2, because "[c]oncerted activity subject to § 1 is judged more sternly than unilateral conduct under § 2." *Copperweld Corp. v. Independence Tube Corp.*, 467 U.S. 752, 768 (1984).

OEM Restrictions. The provisions in Microsoft's license agreements with OEMs that state that OEMs cannot alter Windows without Microsoft's permission are likewise common in

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[22] *See, e.g., Findings of Fact,* 84 F. Supp. 2d at 77 & 85 (¶¶ 272 & 304) (finding that Microsoft's "coup" in winning the AOL contract gave Internet Explorer a significant share of the market and "contributed to extinguishing the threat that Navigator posed to the applications barrier to entry"); *id.* 79-83 (¶¶ 281-98) (describing how Microsoft won the AOL contract because of the attractiveness of its componentized design, which Netscape could not match, and the significant engineering assistance, technical support, precise delivery dates and promotional assistance Microsoft offered).

[23] *See, e.g.*, *United States v. Microsoft Corp.,* 147 F.3d 935, 550 (D.C. Cir. 1998) [hereinafter *"Microsoft II"*].

the IT industry and served the legitimate business purpose of protecting Microsoft's copyrighted Windows desktop design. Software developers need to be able to protect their designs in order to realize the value of their copyrighted inventions. This being the case, for those provisions to be unlawful, there would need to be a finding, at a minimum, that they injured competition.[24] The district court made no such finding. To the contrary, it found that including Internet Explorer did not "prevent OEMs from meeting demand for Navigator, which remained higher than demand for Internet Explorer well into 1998." *Findings of Fact*, 84 F. Supp. 2d at 102 (¶ 376).

Cross-Marketing Arrangements. The types of discounts, promotional consideration, rebates, and cross-marketing arrangements the court found potentially exclusionary in the IAP channel are also common in the IT industry. They represent vigorous competition on the merits, serving the legitimate purposes of facilitating entry into new markets and preventing IAPs from misappropriating the free advertising provided by placement on the Windows desktop. The provisions in Microsoft's cross-marketing agreements were actually shorter-term and less restrictive than many in the industry. Most significantly, the District Court found, in rejecting the Plaintiffs' exclusive dealing claim, that these restrictions did not foreclose Netscape from the market. *Conclusions of Law*, 87 F. Supp. 2d at 53. As with the tying claim, this should have ended the matter with respect to Section 2.

In finding these commonplace and procompetitive IT industry practices unlawful, even in the absence of any finding of foreclosure or consumer injury, the court below relied heavily on internal e-mails and statements as evidence of predatory intent. *See, e.g., Findings of Fact*, 84 F.

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[24] *See California Dental Ass'n v. FTC*, 526 U.S. 756 (1999)(holding that so long as the defendant offers a "plausible" procompetitive explanation for an alleged restraint, the plaintiff must prove that the restraint harms competition before the burden shifts to the defendant to show that it is reasonably necessary to achieve the claimed benefits).

Supp. 2d at 49, 50, 51-52 (¶¶ 155, 160, 166-68). But, as Judge Posner has noted, courts widely accept the "antitrust commonplace . . . that if conduct is not objectively anticompetitive the fact that it was motivated by hostility to competitors . . . is irrelevant." *Olympia Equip. Leasing Co. v. Western Union Tel. Co.,* 797 F.2d 370, 379 (7th Cir. 1986).[25] Such intent evidence is more likely to mislead than to illuminate, thereby creating unacceptable risks for businessmen. As Areeda and Hovenkamp explain, "[A]n antitrust rule permitting jurors to sift through records pertaining to the firm's intent cannot help but chill perfectly appropriate behavior that the antitrust laws are intended to encourage."[26]

B. The Court's Findings on Attempted Monopolization Would Chill Potentially Procompetitive Collaborations and Aggressive Competition for Market Share.

The District Court's conclusion that Microsoft's conduct amounted to attempted monopolization of the so-called Internet browser market also threatens to chill innovation and competition in the IT industry. The court's decision would substantially broaden the offense of attempted monopolization in two significant respects. First, it would make it virtually per se unlawful for successful firms to explore collaborative relationships with emerging competitors. Second, it would permit a "dangerous probability of success" to be proven simply by showing that a firm has secured a 50-60 percent market share without requiring any showing that the firm will ever be in a position to exercise market power—that is, the power to raise price and exclude competitors. Both propositions are wrong as a matter of law and would have serious adverse repercussions for the IT industry.

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[25] *See generally* III PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 651a, at 74 (1996) ("the nature and consequences of a particular practice are the vital consideration, not the purpose or intent[, … a]nd are almost always established by objective facts.").

[26] IIIA PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 755c, at 233. *See, e.g.*, *Fishman v. Estate of Wirtz,* 807 F.2d 520, 543 (7th Cir. 1986) ("Hostility to a rival is not a sure sign of anticompetitiveness because '[v]igorous competitors intend to harm rivals, to do all the business if they can. To penalize this intent is to penalize competition.'") (quoting *Ball Mem'l Hosp. Inc. v. Mutual Hosp. Ins., Inc.*, 784 F.2d 1325, 1339 (7th Cir. 1986)).

1. The District Court's Treatment of Competitor Collaborations

The lower court's first basis for finding attempted monopolization was that Microsoft allegedly proposed a market allocation arrangement to Netscape in June 1995. In so ruling, the court relied solely on *United States v. American Airlines, Inc.*, 743 F.2d 1114, 1116 (5th Cir. 1984), in which the court found American Airlines liable for attempted monopolization by virtue of its CEO Robert Crandall's infamous taped conversation with his counterpart at Braniff: "Raise your goddamn fares 20 percent. I'll raise mine the next morning." *See Conclusions of Law*, 87 F. Supp. 2d at 45-46.

The District Court's reliance on *American Airlines* is misplaced. Unlike Crandall, who proposed a naked price fixing agreement that would have been per se illegal, Microsoft was doing something IT firms do every day: exploring a possible collaboration that on its face had the potential to promote competition by bringing together the complementary strengths of two firms to develop software more efficiently.[27] As this Court ruled in *Rothery Storage & Van Company v. Atlas Van Lines,* 792 F.2d 210, 228-30 (D.C. Cir 1986)(Bork, J.), competitor collaborations of the type Microsoft claims it sought to explore with Netscape are often procompetitive and, if consummated, must generally be evaluated under the rule of reason to determine whether their procompetitive benefits outweigh any potential loss of competition from the elimination of rivalry between the two firms.[28] Whether or not the collaboration Microsoft

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[27] *See generally* THOMAS M. JORDE & DAVID J. TEECE, ANTITRUST, INNOVATION, AND COMPETITIVENESS 16 (1992) (The requirements of the innovation process increasingly "are such that no single firm has the capacity to conduct all of the activity alone, for reasons of cost, competence and timeliness."); ADAM M. BRANDENBURGER & BARRY J. NALEBUFF, CO-OPETITION 4 (1996) (In network markets, "[y]ou have to compete and cooperate at the same time."); CARL SHAPIRO & HAL R. VARIAN, INFORMATION RULES: A STRATEGIC GUIDE TO THE INFORMATION ECONOMY 258 (1999) ("To compete effectively in network markets you need allies.").

[28] *See also, Addamax Corp. v. Open Software Found., Inc.*, 152 F.3d 48, 52 (1st Cir. 1998) ("Joint venture enterprises . . ., unless they amount to complete shams, . . . are rarely susceptible to per se treatment.") (citation omitted); *Northrop Corp. v. McDonnell Douglas Corp.*, 705 F.2d

proposed exploring would have been lawful under the antitrust laws had it proceeded is beside the point. If the mere act of exploring such collaboration—without even reaching an agreement—exposes a firm to a finding that it is attempting to allocate markets and thereby monopolize them, the entire IT industry will feel the chill.

2. The District Court's Reliance on Microsoft's Growing Market Share

The lower court's second basis for finding attempted monopolization was Microsoft's 50 percent and growing share of web browsing usage, which the court held showed a dangerous probability that Microsoft would succeed in gaining a monopoly in the alleged Internet browser market. *See Conclusions of Law*, 87 F. Supp. 2d at 46. Under this theory, almost every successful software firm would at some point in its life have a dangerous probability of achieving monopoly power. It is common for a software firm that designs a better product to capture 50 percent or more of the users of a particular software application for some period of time. Netscape itself did just that when it first introduced Navigator. *Findings of Fact,* 84 F. Supp. 2d at 101-02 (¶ 372). But as Microsoft's success in displacing Netscape shows, these markets can shift back and forth with remarkable speed.

One of the most forceful descriptions of this phenomenon comes from Dr. Franklin Fisher, the Plaintiffs' principal economic expert in this case. He explains that in rapidly changing markets characterized by technical innovation, market shares do not accurately predict a company's possession or lack of monopoly power:

> An obvious but important lesson from [the] analysis of the process of competition in a market with rapid technological change is that in assessing whether a firm in such a market has monopoly power, one must be sure to observe the process of innovative competition at work. A snapshot taken at a single moment in time can be

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1030, 1050-54 (9th Cir. 1983) ("teaming arrangement" by which one joint venturer would be prime contractor for land-based aircraft and the other would be prime contractor for carrier-based aircraft should be judged under the rule of reason).

> entirely misleading. It might, for example, show one firm (the innovator) well ahead of its rivals and with a substantial share of even a reasonably well-defined market. But since the snapshot could not reveal either the competitive process whereby the firm attained its position or the competitive response of rival firms, it could not form a reliable basis for making inferences about the presence or absence of monopoly power.

Franklin M. Fisher, *et al, Folded, Spindled, and Mutilated: Economic Analysis of U.S. v. I.B.M.*, 38 (1983).[29]

To find a dangerous probability of monopoly, a court must find that the defendant is poised to capture a dominant position durable enough to give it market power—that is, the ability to raise prices above a competitive level or to restrict output over an extended period of time. *NCAA v. Board of Regents,* 468 U.S. 85, 109 n.38 (1984) (citations omitted). That is plainly not the case here and is historically not the case in the IT industry. Today over one third of Internet Explorer's usage derives from a single contract with Netscape's own parent, AOL. *See Findings of Fact*, 84 F. Supp. 2d at 85 (¶ 303). That contract expires in just a few months. *Id.* at 84 (¶ 301). Microsoft cannot possibly hope to keep that contract, and its current market share, unless it can persuade Netscape's parent that Microsoft continues to offer the best product at the best price. In addition, Netscape Navigator continues to be widely distributed by many of the leading OEMs and ISPs. Indeed, while Microsoft was allegedly seeking to exclude Netscape from the market, Netscape's installed base more than doubled—growing from 15 million to 33 million users in the United States alone. *Id.* at 103 (¶ 378). Faced with this kind of growth by its principal rival, Microsoft hardly seems poised to gain a durable monopoly over the browser market.

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[29] *See also* IIIA PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 807e2, at 359-60 (1996) ("[I]f the defendant can experience rapid growth in market share, others can as well. Market shares that go from 0 to 60 percent in two years . . . suggest an unstable market in which it is unlikely that any firm could maintain a monopoly output reduction for very long.").

C. Treating the Addition of New Functions to Existing Software as Per Se Illegal Tying Would Outlaw Welfare-Enhancing Innovations.

The District Court's decision to treat Microsoft's integration of web browsing functionality into Windows without also offering a non-integrated version as a per se illegal tie is similarly wrong as a matter of law and would damage technological innovation if adopted as a new antitrust policy. Adding new functions to existing software is a nearly universal form of innovation in the software industry and is essential in persuading customers to upgrade from their existing software to a new, improved version. For example, word processing programs have incorporated formerly separate spell-checkers and outliners, personal finance programs have incorporated tax functions, the AOL proprietary client software has incorporated instant messaging, Oracle is integrating its database with its applications server, and email programs have incorporated contact managers. If companies that gain a "dominant" position in a given field were barred from innovating in this manner, consumers would be denied new benefits that result from integration, and the software industry would stagnate.

This Court has already considered this issue at length in reversing the District Court's preliminary injunction against Microsoft under the 1995 consent decree. *Microsoft II*, 147 F.3d at 948-951. That opinion explained that courts should not be "in the unwelcome position of designing computers," *id*. at 950 (quoting IX Phillip E. Areeda, *Antitrust Law* ¶ 1700j, at 15), and should not "embark on product design assessment." *Microsoft II*, 147 F.3d at 949. Noting that the issue is *not* whether "an integrated product is superior to its stand-alone rivals," the Court ruled that Microsoft "ha[d] clearly met the burden of ascribing facially plausible benefits

to its integrated design as compared to an operating system combined with a stand-alone browser such as Netscape's Navigator." *Id.* at 950.[30]

The District Court refused to follow this Court's ruling in *Microsoft II*, not because it found that there were no "facially plausible" benefits from adding web browsing functionality to Windows, but because it concluded that this Court's approach—which it dismissed as *dictum*—was inconsistent with the Supreme Court's decision in *Jefferson Parrish v. Hyde*, 466 U.S. 2 (1984). *See Conclusions of Law*, 87 F. Supp. 2d at 47-48.

In so ruling, the District Court overlooks one of the most important advances in modern antitrust doctrine. Ever since its decision in *Broadcast Music, Inc. v. CBS*, 441 U.S. 1 (1979), the Supreme Court has cautioned that the courts should not apply simplistic labels, such as price fixing or tying, to declare conduct per se illegal in new contexts where the label may not fit. Warning that "[l]iteralness is overly simplistic and often overbroad," the Court held in *BMI* that before characterizing conduct as per se unlawful, a court should examine "whether the practice facially appears to be one that would always or almost always tend to restrict competition and decrease output . . . , or instead one designed to 'increase economic efficiency and render markets more, rather than less, competitive." *Id.* at 9, 19, 20 (citations omitted). Only if the conduct is a "naked restrain[t] of trade with no purpose except stifling of competition" can it be characterized as per se unlawful. *Id.* at 2 (quoting *White Motor Co v. United States,* 372 U.S. 253, 263 (1963)).[31]

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[30] *See also Microsoft II,* 147 F.3d at 950 ("Professor Areeda argues that new products integrating functionalities in a useful way should be considered single products regardless of market structure.") (citing X PHILLIP E. AREEDA *et al.*, ANTITRUST LAW ¶ 1746b at 225-26 (1996)).

[31] *See also California Dental Ass'n v. FTC*, 526 U.S. 756 (1999)(holding that so long as the defendant offers a "plausible" procompetitive explanation for an alleged restraint, the plaintiff must prove that the restraint harms competition before the burden shifts to the defendant to show that it is reasonably necessary to achieve the claimed benefits).

This Court's decision in *Microsoft II* comports with this Supreme Court jurisprudence. It also comports with previous lower court decisions refusing to label the introduction of integrated products as per se illegal ties.[32]

Nothing in *Jefferson Parrish* or *Eastman Kodak v. Image Technology Services,* 504 U.S. 451 (1992), requires a contrary result. Both cases rely on the assumption that the alleged tying—anesthesia services to surgery in *Jefferson Parish* and copier repair services to copier parts in *Image Technical Services*—was anticompetitive because consumers were forced to purchase products from the defendants that they would prefer to get from others. Adding functionality to an existing software program could not be more different from these types of contractual ties. Adding functionality, on its face, enhances a software's capabilities. And, unlike the surgical patient in *Jefferson Parish* who could be anesthetized only by a specific anesthesiologist or the copy machine owner in *Image Technical Services* who could use only specific repair companies, a purchaser of integrated software remains free to continue using stand-alone products, such as Navigator.[33]

Since, as this Court has already found, integrating web browsing functionality into Windows provided "facially plausible" benefits to consumers,[34] the District Court could not, under the controlling Supreme Court case law, find an illegal tie without engaging in a full rule of reason analysis. This it failed to do. Had it done so, the court would have found—as it did with respect to exclusive dealing—that Microsoft's conduct could not have violated Section 1

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[32] *See, e.g., ILC Peripherals Leasing Corp. v. IBM*, 448 F. Supp. 228, 233 (N.D. Cal. 1978); *Innovation Data Processing, Inc. v. IBM*, 585 F. Supp. 1470, 1476 (D.N.J. 1984); *Foremost Pro Color v. Eastman Kodak Co.*, 703 F.2d 534, 542-43 (9th Cir. 1983). *See generally* William H. Page & John E. Lopatka, *The Dubious Search for "Integration" in the Microsoft Trial*, 31 CONN. L. REV. 1251, 1273 (1999) .

[33] *See* Page & Lopatka, *supra* note 33, at 1273.

[34] *See Microsoft II,* 147 F.3d at 950.

because it did not foreclose Netscape from any channel of distribution, much less from the market as a whole.[35]

CONCLUSION

"Consequences cannot alter statutes, but may help to fix their meaning." *In re Rouss*, 116 N.E. 782, 785 (N.Y. 1917) (Cardozo, J.). The antitrust laws were not intended to bring a booming, highly-competitive industry to a standstill. But the District Court's ruling is likely to do just that. There is no objective evidence that the business practices at issue in this case caused injury to competition or consumers. The District Court's ruling will stifle growth, innovation, and competition in the technology industry; the remedy imposed will harm consumers and throw the industry into confusion about the new rules restricting competition. The District Court's judgment should be reversed.

Respectfully submitted,

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[35] *See Findings of Fact,* 84 F. Supp. 2d at 102 (¶ 376) (Including Internet Explorer with Windows for free did not "prevent OEMs from meeting demand for Navigator, which remained higher than demand for Internet Explorer well into 1998.")