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TECHNOLOGICAL TYING: THE MICROSOFT SAGA IN THE UNITED STATES AND EUROPEAN UNION

This Article deals with a concept of technological tying under competition law of the European Union and antitrust rules of the United States. It analyzes the approaches taken by the competition authorities and courts on either side of the Atlantic through the example of Microsoft cases. As will be shown, the approaches differ significantly, focusing on diverse elements of the practice in question and conversely assessing some of them. The author concludes that neither of the approaches is free of shortcomings, insisting on the necessity of a more balanced and progressive approach toward the practice that perfectly reflects the evolution of competitive behavior of the dominant undertakings in step with technological progress.

Keywords: technological tying, Microsoft, product integration, dominant position.

Дараган В. Технологічне нав'язування продуктів: сага Майкрософт в Сполучених Штатах Америки та Європейському Союзі. – Стаття.

Стаття присвячена концепції технологічного нав'язування продуктів відповідно до конкурентного законодавства Європейського Союзу та антимонопольних правил Сполучених Штатів Америки. В статті аналізуються підходи антимонопольних органів та судів по обидві сторони Атлантики на прикладі справ Майкрософт. Як буде показано, підходи суттєво різняться, приділено увагу різним елементам розглянутої практики та протилежно оцінено деякі з них. Автор зазначає, що жоден з підходів не позбавлений недоліків, та наполягає на необхідності більш збалансованого та прогресивного підходу до практики, яка яскраво відображає еволюцію конкурентних практик відповідно до технологічного прогресу.

Ключові слова: технологічне нав'язування продуктів, Майкрософт, інтеграція продуктів, домінуюче положення.

Дараган В. Технологическое навязывание продуктов: saga Майкрософт в Соединённых Штатах Америки и Европейском Союзе – Статья.

Статья посвящена концепции технологического навязывания продуктов в соответствии с конкурентным законодательством Европейского Союза и антимонопольными правилами Соединенных Штатов Америки. В статье анализируются подходы антимонопольных органов и судов по обе стороны Атлантики на примере дел Майкрософт. Как будет показано, подходы существенно различаются, уделяется внимание различным элементам рассматриваемой практики и противоположно оцениваются некоторые из них. Автор отмечает, что ни один из подходов не лишен недостатков, и настаивает на необходимости более сбалансированного и прогрессивного подхода к практике, которая ярко отражает эволюцию поведения доминирующих компаний в соответствии с технологическим прогрессом.

Ключевые слова: технологическое навязывание продуктов, Майкрософт, интеграция продуктов, доминирующее положение.

Many small undertakings would not object to reaching a position of dominance. However, such a position may result in additional responsibility and certain risks, that are not likely to arise for companies with a lower market power. Naturally, sometimes dominant undertakings attempt to benefit from their own position in such a way, that either inevitably or with a high degree of certainty harms competition. Such conduct of dominant firms can often be considered an abuse of a dominant position.

Abusive behavior can take various forms, such as predatory pricing, loyalty rebates, refusal to deal, bundling and tying practices. However, the concept of tying appears to be the one that evolved through the years, keeping step with technological progress and the most recent developments in the IT sphere. The introduction of personal computers has created an outsized market, accessible for new players. Needless to say, the tightness of competition, as well as the level of control in the market, has changed dramatically over recent years. Thanks to advent of personal computers and, in the course of time, of the Internet, the new forms of abusive behavior came into being. As we will see further, technological tying turned out to be way more complex than the classical, contractual tying. However, popular quotation of one of forefathers of Chicago School of antitrust analysis, Robert Bork [1, p. 378], concerning the imposition of tying arrangements by every seller is still valid and applicable to technological tying, as well.

Definition of “tying” can be generalized as the “legal concept which occurs when the purchase of product A (tying product) is conditional upon the purchase of product B (tied product)” [2, p. 7]. It should be noted,

that only one of those products is available separately. To a great extent, this condition draws a line between the concepts of tying and bundling. The latter always refers either to the situation where two distinct products cannot be purchased separately, or where both products are available individually, but a bundle provides for a lower price.

The particular concept in issue, technological tying, involves an integration of one product into another product. As a result, two products constitute a single one, potentially containing an additional functionality. Therefore, elimination of integrated product frequently affects an effectiveness and, therefore, value of the entire product [3, p. 27].

In the European Union (hereinafter – the EU), the technological tying is included in the category of tying in general, and falls within the scope of article 102 of the Treaty on the Functioning of the European Union (hereinafter – the TFEU) [4].

As a result of the influence of the Chicago School, the European Commission admits that product tying has always been a common practice for both dominant and non-dominant undertakings and that often it does not lead to the negative consequences for competition. Moreover, there is also no objection raised in regard of possible advantages not only for the undertakings (e.g. savings in production, distribution and transaction costs) but more importantly for the clients (e.g. better quality and/or lower price of products) [5]. However, as opposed to the possible efficiencies of tying arrangements, one shall not completely exclude the potential negative effects of the practice concerned, such as foreclosure of competition, price discrimination and higher prices [5]. For this reason, thorough and complex analysis is absolute necessary in each individual case in order to adequately assess an impact of the tying on the clients and market situation, especially when it concerns the technological market.

The EC has developed a four-part test for establishing the violation of Article 102 by means of tying arrangements, which was later confirmed by the General Court's decision in *Microsoft I* case [6].

First, the four-part test requires tying and tied goods to be separate products. At this stage, the Commission applies two simple tests in order to check whether the products are actually distinct or not: the demand test and the supply test [7, p. 3].

Secondly, the undertaking concerned shall hold a position of dominance in the market of the tying product. It should be noted that regardless of the firm's position in the market, if it is not able to provide consumers with the

core and expected functionality, the firm can find itself in rather unequal position comparing to its competitors. Consequently, such situation may be highly beneficial for rivals, but not necessarily beneficial for consumers and competition at large (to certain extent, the issue of functionality and consumers' expectations is addressed in the next, third, step of the test). Hence, an attitude of competition authorities toward technological tying should not be based on the position of the undertaking concerned whether it is dominant or not.

Third, there shall be no opportunity provided by the undertaking to customers to purchase the tying product without the tied product. For instance, in *Microsoft I*, the General Court refused to consider the fact, that Microsoft did not charge extra price for additional functionality, neither did it impose on consumers an obligation to use the functionality. Moreover, and this element is also utterly important for the last step of the test, Microsoft did not impose on end users any limitations concerning the additional or exclusive use of the software manufactured by Microsoft's rivals [6, r. 806]. Also, OEMs were not prevented from installing third-party media streaming software in addition to WMP.

Finally, the tying arrangement shall foreclose the competition [6, r. 794]. It is noteworthy, that for the last condition to be met, there is no need to show the existing effect, if the tie is capable of foreclosing competition.

In *Microsoft I*, the Commission came up with three arguments proving the existence of foreclosure effect. First, WMP had unrivaled omnipresence on client PC globally. Such a position was easily achieved due to the fact that the number of Windows client PC users corresponded to the number of WMP users [8, r. 843-879]. Second, complementary content providers relied mostly on the WMP format. This argument was based on the "indirect network effects" theory, that is the more users choose given software, the more investments would be made in new products consistent with that software, in such a manner increasing its popularity [8, r. 879-899]. The third reason is that market analyses indicated the tendency of usage of WMP to the prejudice of the other media players [8, r. 900-944].

Although the *Microsoft II* case, initiated three years after, never made it to the Court, the EC applied the same four-part test with regard to the integration of Internet Explorer into Windows operating system. Moreover, the Commission adopted a very similar, if not identical, theory of harm to consumers and competitors in both cases. More particularly, the Commission relied on the concept of coercion as a result of tying, producing

anticompetitive effects by way of not providing computer manufacturers and eventually end users with the possibility of purchasing Windows without Windows Media Player or Internet Explorer. Moreover, it was assumed that since technological markets are characterized by network effects, Microsoft was able to use its dominant position in the market of operating systems to bring the products, namely WMP and IE, on the same level of ubiquity by means of tying the products to Windows and using it as a distribution channel. Finally, for the same reason the Commission states that Microsoft was enabled to leverage its dominance abusively created in the other markets (media players market and web browsers market accordingly) to neighboring markets, as both WMP and IE are undoubtedly considered as software platforms for web content and applications correspondingly. In such a manner, in the Commission's view, the content and application developers were motivated to create content and applications for WMP and IE above all others. Hence, the structure of competition was distorted and innovation in the web and media was stifled [9, p. 120].

The approach of the European Commission and the General Court appeared to be inconsistent with the development of IT industry due to several reasons. Both the EC and the General Court to some extent failed to carry out a complex analysis of the Microsoft's conduct and its impact on the consumers and competition. Instead, an increased focus was put on the position of the Microsoft's rivals. Even though the Commission's concerns were mostly addressed to the potential foreclosure of competition, the assumptions were not economically justified. Furthermore, the Microsoft's justifications were not correctly assessed and therefore were not accepted by either the EC and the General Court.

Microsoft I and *Microsoft II* have been highly discussed due to many reasons but mostly because of the divisiveness and unusualness by which both cases can be characterized. To a large extent, they could not have been correctly assessed in comparison with any other case, therefore creating some kind of a unique precedent in competition jurisprudence. However, the Commission sent a statement of objections to Google in April 2016, ascribing to the American technology giant, *inter alia*, the practice similar to the one used by Microsoft. In substance, it means that now Microsoft cases may serve, for better or worse, as a certain standard to rely on in Google investigation.

In contrary, the position of the U.S. courts and antitrust authorities is fairly favorable for dominant undertakings involved in technological tying.

Historically, the American antitrust jurisprudence has been influenced by two widely different legal doctrines, namely Harvard and Chicago Schools. In the course of time, a predominance of the former gave way to more flexible ideas originated in the University of Chicago. One of the underlying concepts of the Chicago School is that the focus of antitrust should be on the protection of consumers by means of stimulation of higher production, better quality, faster innovation and lower prices [1, p. 378]. Thus, the Chicago School opposed to the protection of competitors as a reasonable objective of the antitrust policy [1, p. 50]. It serves as a rationale behind the idea that if the competitors are less efficient and thus lose opportunities, it is actually not a bad thing, but quite the opposite [10, p. 4]. The area of tying seems to be the last outpost of the Harvard School, although it should be noted that the U.S. courts nevertheless accept certain efficiencies deriving from the tying practices. However, as it will be shown below, in technological tying cases the U.S. courts tend to rely on the considerations of technological progress, thus allowing technological integration of the products.

In the US legislation, the issue of tying is addressed in section 1 of the Sherman Act [11].

Considering the complexity of the technological tying, it comes with a little surprise, that one of the most notable U.S. antitrust cases involved the largest player in the technologically dynamic market of operating systems and its practice of product integration. The *Microsoft* cases may serve as an illustrative example of how the courts have dealt with the issue product integration. As described below, the courts may surprisingly put an emphasis on different aspects and assess the same practice from the opposite points of view.

The reasoning, formed by the judges and economists, played a key role in *Microsoft II* case in 1997. At the time, the Department of Justice (the “DOJ”) accused Microsoft of both contractual and technological tying of IE (version 3.0 and 4.0) to Windows 95 operating system, which, in the DOJ’s opinion, was contrary to the consent decree concluded with Microsoft in 1995. Essentially the Windows 95 OS and Internet Explorer could be obtained only on the same disk, and the installation of web browser was required in order for the operating system to function [12, p. 940-941]. Moreover, the browser uninstallation would lead to deactivation of the operating system. Eventually the tie changed into contractual in substance, since Microsoft made a purchase of IE 4.0 compulsory for the licensing of Windows 95 to OEMs. As a result, OEMs were obliged to license,

pre-install, and distribute the IE together with the Windows OS. Microsoft in its defense argued that it introduced an ‘integrated product’, meaning that every time Microsoft added a function to the OS it was developing a new product [12].

Contrary to the DOJ’s position, the Court of Appeals did not find a violation of the decree. Instead, the court interpreted it in a way that provided for an explicit exemption for integrated products [3, p. 950-951]. The court also defined an “integrated product” as the one that “combines functionalities (which may also be marketed separately and operated together) in a way that offers advantages unavailable if the functionalities are bought separately and combined by the purchaser. The court found that combination, for instance, of Windows 95 and Netscape’s browser would not produce benefits equal to the ones produced by combination of Windows OS and IE. The court had no other choice but to admit a beneficial nature of the tie, considering that it was indeed an integration of products advantageous for consumers, not merely a tying arrangement designed to harm the competition [13, p. 953].

The last finding was based on rather simple test. In fact, the test provided that combination “must be different from what the purchaser could create from the separate products on his own” and the combined form must “be better in some respect” [13, p. 949]. Such a narrow approach may be explained by the limited competence of courts to assess high-tech product designs and the high cost of error [13, p. 950]. Microsoft quite easily met both requirements of the test. For the first part, although consumers had a possibility to obtain products separately, Microsoft combined the two in a way that created a design bringing together the functionalities of the distinctive products. With regard to the second part of the test, the integration improved browsing and non-browsing functionalities of the operating system [13, p. 952].

The court’s reasoning confirms its rather deliberate position. Indeed, such a position was necessary in order to avoid the risk of dangerous mistake that could be possibly disadvantage the consumers by preventing them from obtaining the operating system with a web browser pre-installed. At the time, it was rightfully presumed that the given decision will create a valuable precedent for future technological tying cases. However, the *Microsoft III* case casted doubt on that assumption.

Just one year later, in 1998, a new antitrust suit against Microsoft was filed by the DOJ and a group of nineteen state plaintiffs [14]. This time,

Microsoft was accused of use of four different anticompetitive practices falling within the scope of two categories, namely 1) unlawful tying and unlawful exclusive dealing arrangements (violating Art. 1 of the Sherman Act); 2) unlawful monopoly maintenance and attempted monopolization (violating Art. 2 of the Sherman Act).

Concerning the violations under section 1, the court found Microsoft liable for tying, however rejected the claim of exclusive dealing. In its conclusions, the court found that Microsoft had a monopoly in PC operating systems market, had illegally imposed tying arrangements and entered into exclusionary contracts in order to remove its rival, Netscape, from the browser market, and had engaged in number of other actions in an effort to maintain its monopoly in the aforesaid market and aimed at monopolization of the browser market [14]. In the court's opinion, the tie induced OEMs not to pre-install competing browsers and therefore discouraged consumers from using them.

Explaining his decision to deviate from the rule established by D.C. Circuit in *Microsoft II*, Judge Jackson pointed out two reasons. First, since *Microsoft II* was based on the alleged violation of a consent decree, he considered *Microsoft II* to be a non-antitrust case to some extent but rather the case about contractual intent [14]. Consequently, from Judge Jackson's perspective, *Microsoft II* decision was not intended to constitute a controlling rule of law for the present case. Second, Judge Jackson affirmed that an understanding of product integration in *Microsoft II* decision contradicted the Supreme Court precedents in three ways. In *Microsoft II*, the market was viewed from the perspective of defendant instead of consumer's point of view, as established in *Jefferson Parish*. Further, the approach taken by the court in *Microsoft II* did not require the defendant's claim of advantage from the integration of products to be proved. Finally, the genuine-technological-integration test did not make a comparison between any theoretical advantages of the integration and any anticompetitive effects [14].

The D.C. Circuit found itself in position when the rationale of the relevant precedent of the Supreme Court conflicted with the current economic theory [15]. Having taken into account the ideas suggested by current economic theory, the court affirmed prospective transaction-cost savings and economies of scale or scope resulted from the tying practices [13, p. 34, 87]. The court also stated that the test established in *Jefferson Parish* was not always capable of distinguishing procompetitive and anticompetitive

tie-ins. In view of this, the court deviated from the traditional *per se* approach in tying cases and therefore overruled the district court's decision that tying of IE to Windows by Microsoft was illegal. As a consequence, the D.C. Circuit introduced a new rule for tying cases "involving platform software products", holding that such cases should be assessed under a "rule of reason". In accordance with rule of reason, in order to find Microsoft liable for imposition of illegal tying arrangement, the plaintiffs would have to show that negative effects on competition outweighed the procompetitive explanations offered by Microsoft. Moreover, they were also expected to show evidence proving that Microsoft's conduct "unreasonably restrained competition". However, the government decided not to pursue the tying claim on remand. Such a decision may hardly be surprising considering the high level of standards for finding tying violations established by the appeals court.

As has been seen, the U.S. courts indeed have more experience in dealing with technological tying. In addition, the Chicago School weighed in a lot on the issue of technological tying and such influence could not be completely ignored by the courts. However, it should be noted that the Law and Economics school also influenced the policy of the European Commission and EU courts, even though it took way more time than in the case of their U.S. colleagues. More particularly, the Chicago School convinced judges and lawyers, as well as many other economists, on either side of the Atlantic that competition policy must be only concerned with the goal of maximizing efficiency [16, p. 64]. As a result, this special attention was adopted in a form of "rule of reason" test in the U.S. and latterly in a form of the "effect-based" approach in the EU. Moreover, the position of the U.S. courts has evolved over the years since 1970s, whereas the EU courts and competition authorities first faced the technological tying quite recently.

In the light of the foregoing, it is becoming clear that the approach taken by the European Commission and the General Court is inconsistent with the particular qualities of the technologically developing markets, such as computer industry in general, but more specifically the operating systems market and applications market. More particularly, both the EC and the General Court ignore the essential difference between tying of ordinary products and integrated software. Even though the Commission recognizes a need for economic considerations in assessment of the tying arrangements, it however fails to duly take into account the core economic differences between traditional and technological tying.

In substance, the tests developed by the EC and later supported by the General Court gave rise to many questions concerning each step of the test. It appears that the Commission interprets technological tying in a way that does not offer a chance for the opposing party to justify its conduct, whatever the arguments it may come up with.

Moreover, it is excessively focused on protection of competitors of the dominant undertaking involved in tying, thus ignoring the benefits that product integration may bring to the consumers. Consequently, not only is the current position of European authorities to certain extent unfavorable for consumers, but also capable of slowing down a technological progress in IT industry.

In this regard, the experience of the U.S. courts may be of vital importance. The rule of reason test, adopted instead of traditional per se rule, provides for comparison of efficiencies produced by tying against the reduction of consumers' possibility to choose products and potential negative impacts on competition in the market concerned. It demonstrates the fundamental difference in perception of tying in the U.S. and EU. However, this approach is neither free from shortcomings. The reason is that it does not provide comprehensive guidance for the courts to assess the practice in question and therefore the judges can find it rather difficult to correctly balance the benefits and adverse effects. For this reason, software manufacturers cannot possibly know the exact rules of the game and therefore can be entrapped between the possibility to be accused in unlawful practice and fear to introduce innovative and valuable bundles. As a result, although this approach is more progressive, it nonetheless fails to address all the issues arising out of technological tying.

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