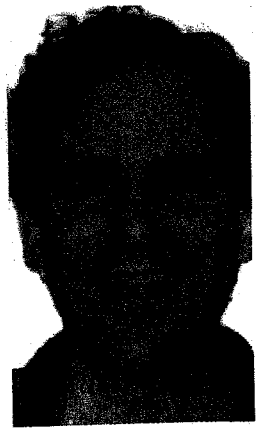


Hung up on AT&T



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..... The courts will eventually decide whether to accept the US Department of Justice's recommendation to break up Microsoft. That gives all of us plenty of time to decide whether this is a good or bad idea. Here are a few points to think about.

Many pundits believe AT&T's divestiture offers lessons for how to break up Microsoft. This must stop. Whatever else you might think of the trial, its veracity, or its aftermath, don't look to the phone company for lessons. Don't even consider using the phrase "baby Bills." It all points in the wrong direction.

The confusion is partly understandable. If we don't think too hard, AT&T's experience looks relevant. After all, it was a large firm before its breakup (and it still is). It had one of the highest market capitalizations in the world (and it still does). It too lost a major antitrust trial (we will get to that in a minute) and found itself ordered to divest into separate corporate entities. It sounds like the present setting, doesn't it? From such simple beginnings are bad ideas born.

A number of so-called lessons have now found their way into general discussion. The top three seem to be these:

- AT&T's breakup wasn't a big deal, so Microsoft's shouldn't be.
- AT&T's stock recovered after the breakup, so the stock value of two Microsofts will also recover.
- Since the telecom market became

more competitive after the breakup, so too will the computer market after the breakup of Microsoft.

None of these conclusions is particularly solid. All need significant qualification.

There is precedent

Breaking up a company for violating antitrust law is a very big deal. But not for the reasons most people think.

Some commentators think the proposed Microsoft breakup is a big deal because it will be complicated. These commentators are just naive. Breaking up is common and almost routine for American business.

More to the point, high-technology companies do this frequently. For example, Hewlett-Packard just finished a relatively large divestiture of its Medical Equipment and Systems Division. This action created two firms out of thousands of patents, several laboratories, and many sales forces. Nothing being discussed about Microsoft is any more complicated than what Hewlett-Packard has done. In some dimensions it's much easier.

There is, however, one key difference. Hewlett-Packard split itself voluntarily. That is, some upper-level executives decided how to organize the breakup. They weren't compelled to do this by force of law, as with Microsoft's breakup.

By the way, that's also a big difference with AT&T's case. To see why this matters, we need to get some facts straight about

the AT&T case. To wit, AT&T agreed to divest itself "voluntarily" only after receiving a big nudge from Judge Harold Greene.

More specifically, AT&T filed a motion for dismissal just after the prosecution finished its case. Judge Greene answered the dismissal request with a lengthy set of questions, providing AT&T with a road map of what legal issues it had to address during its defense. AT&T's lawyers looked at the road map and knew they were going to lose.

AT&T's lawyers and management then made a very deliberate calculation. They decided to settle with the government and stop the trial. Why? Because they were trying to avoid a federal ruling that AT&T was a monopolist that violated antitrust law. Such a ruling would've made AT&T vulnerable to years of private antitrust lawsuits, where the federal ruling would become automatic evidence in the private suit. This would've been very ugly. So AT&T accepted the government's proposal for a breakup as a way to forestall the federal ruling. The deal was ugly, too, but it was better than the more open-ended and much uglier alternative.

Microsoft faced a similar calculation in Judge Richard Posner's chambers, where negotiations took place prior to Judge Jackson's ruling. In sharp contrast, no breakup was under discussion with Posner. Microsoft could have settled for a few "conduct remedies" (which, incidentally, were lighter than those which Judge Jackson just imposed on them in addition to

the breakup). To top it off, the newspapers published veiled threats that a breakup would be proposed if negotiations failed. In other words, Microsoft could have settled with the government, avoiding a federal finding against it, avoiding the appeals process, forestalling some private suits, and avoiding a discussion about a breakup.

To be frank, I thought Microsoft would settle. So did the market. Indeed, I'm not going out on a limb by saying that 97 out of 100 CEOs would've settled simply to avoid the hassle—not to mention the expense—of what's about to happen to Microsoft over the next year or two. Reportedly, negotiations got close to settling but failed. Go figure.

Anyway, note the key difference. AT&T negotiated its breakup as a way to avoid further litigation. Microsoft is having a breakup foisted on it because negotiations failed. In one case the firm made its peace with the government by breaking up. In the other case the firm could've avoided the breakup but didn't and is now kicking and screaming about it.

Stock value in the long run

If Microsoft executes the breakup well, stockholders should do just fine. After all, Microsoft is loaded with many products and assets that won't lose their value overnight. Nothing's going to displace Windows on the desktop. Nothing's going to displace Office. They both generate an enormous amount of revenue. It doesn't matter whether those assets are divided between two companies or owned by one.

More importantly, Microsoft's mid-level positions are stacked with an abundance of talented and ambitious employees. And let's just say what everyone knows, but no employee will say in a newspaper: Many of these talented people would be willing/happy/eager/able to run their own software company without Steve Balmer and Bill Gates.

That said, everyone is expecting Microsoft's upper management to resist a breakup with all the petulance for which it is infamous. That's where the possibility for disaster lies. If a breakup is execut-

ed reluctantly, all comparisons with AT&T are irrelevant.

More to the point, a divestiture isn't fun. It can't be. It requires coordinating consultants, accountants, and lawyers over many months. That requires patience, financial acumen, and a keen eye for legal detail. Aside from needing a manager with these talents, a good divestiture requires a manager with a certain kind of temperament, someone who knows how to calm nervous employees. That is, defections are reduced during restructuring if the managers have less volatile temperaments.

It's no insult to say that these requirements don't play to the comparative advantages of Bill and Steve. Said another way, both of them are demonstrably good at building commercial empires, but there's little evidence of their ability to divide an empire. I bet both could manage it if they cared, but I also bet that neither of them cares passionately about a breakup, no matter what shape it takes.

So here's the point. AT&T's stockholders eventually did well after its breakup, but so what? That doesn't tell us anything about this case, where much rides on whether management executes the breakup well.

Competition in the long run

The telecommunications industry did become more competitive after AT&T's breakup. Prices declined in most locations. Equipment markets and long-distance markets exploded with new entrants. In addition, AT&T was a big, bloated firm prior to divestiture, and divestiture helped bring the spur of competitive discipline to the firm's equipment and long-distance business. Most observers also believe the Internet revolution was enhanced by the decentralization of power in the industry—a decidedly good thing.

Yet, for all these benefits, none of these circumstances resonates with any comparable detail in the Microsoft case.

Well, then, what will a breakup do to the computer market? That is, if the conduct remedies are accepted, what additional

effect will the breakup produce? At best, a breakup seems to enhance two potential pathways for more competitiveness.

First, it's in society's interest to have two firms in Seattle fighting each other over the next revolutionary technology. To be sure, the browser wars are over, but there's bound to be something else soon that influences both applications and operating systems. With this new competitive structure, we'll see two versions of that technology instead of one version.

Is that a good thing? Yes, it is, especially if the new technology is a sufficiently disruptive technology like the browser. Maybe it'll be voice recognition; maybe it'll be some sort of XML application. Who knows? It just has to be big enough to get new competition going, to induce multiple designs and lots of activity. Two choices are better than one in that kind of situation.

Second, a breakup will be good if it partly reduces the power of Redmond decision-makers to control the fates of others. Of course, this comes at a cost. A breakup reduces the power of those same decision-makers to coordinate actions between the applications and operating systems divisions.

Said another way: The biggest supporters for this proposal are my Silicon Valley friends who believe that there are many small software firms that have difficulty commercializing their software. Because Redmond is partly restrained by a breakup, so this view goes, it gives those small firms a chance at Microsoft's expense.

The biggest detractors of a breakup, on the other hand, are my friends at Microsoft who believe that most of the Valley's small firms have an inflated sense of self-importance and unrealistic optimism about their commercial prospects. In this view, the breakup reduces Microsoft's power and only hurts its ability to coordinate change.

Unfortunately—and this is my larger point—none of this has anything to do with AT&T's experience. Plenty of good things did happen after AT&T's breakup, to be sure, but little of it's comparable to what Microsoft may someday encounter.