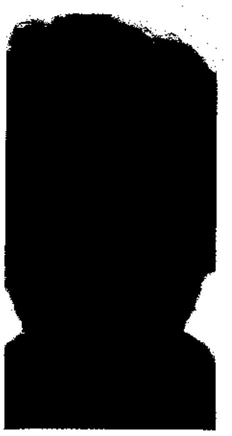

Falling through the cracks at Microsoft

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• • • • • • Cases like Microsoft's federal antitrust fight come along once a decade. However, the national press has reported the results, interviewed a few experts, and already moved on. It's as if nothing happened on a grander scale.

Why the silence about the bigger issues? For one reason, the trial was genuinely complicated, so bumper sticker debates on "Night Line"—not to mention MSNBC—shed little light on the core issues. Also, the whole thing has lost its immediacy. It's stuck in limbo, waiting for appeals courts to rule. In addition, as with political events, the trial reporters focused on public relations blunders and daily changes in competitive tactics; that emphasis devalued the bigger questions.

Finally, and even more disturbing, reporting devolved into brain candy. For example, in the middle of the trial *The New Yorker* published a sympathetic article on why Bill Gates felt misunderstood. Despite the depth of the psychological analysis, the article left the impression that this trial was just another personality conflict between Gates and the universe. It's partly that, of course, but that impression also trivializes the bigger issues.

In truth, this trial intermixed two separate stories: one about policy and the other about managerial decision making. The trial highlighted a fissure in public policy about high-tech markets in which two contrasting frameworks for examining issues exist. Also, this case arose because Microsoft's managers seem to misunderstand how the marketplace and the courtroom view this fissure.

Most reporters still don't understand this fissure. Since Microsoft fell through this crack, it's worth explaining.

Vertical contracting

We might call the first conceptual framework the vertical contracting framework. It's one of the oldest stories in antitrust. In fact, some of the oldest examples come from the era of railroad growth, which predates the US Sherman Antitrust Act.

This framework focuses on the use of discriminatory tactics. Why? Because a dominant firm can play one business partner off another, using discriminatory methods as a way to achieve de facto exclusive terms with downstream partners. That's a policy issue because society has an interest in eliminating exclusive arrangements. These may interfere with new entry by other firms or with the emergence of a wider variety of designs by existing firms.

This framework worked with Judge Jackson because, to be frank, Microsoft left an incriminating trail of evidence about its discriminatory tactics. Microsoft executives weren't particularly subtle with Dell, Compaq, and Gateway about any OEM carrying another firm's browser. Nor was there much nuance to Microsoft's contract restrictions with OEMs about their ability to tailor their designs, a contract provision known as first screen restrictions. The prosecution also had all sorts of high-powered e-mail evidence in which the boys of Redmond conducted their business dealings sans social graces. More on this later.

Anyway, and more to the point, the vertical contracting framework was a near-certain winner if the arguments were presented coherently. The Department of Justice lawyers—like lawyers everywhere—wanted a victory, and this framework offered an expedient way to get it. It was used because it could win in court. That's how trials work in America.

Another framework

The second conceptual framework might be called the platform framework. It begins with the premise that Microsoft has assumed/acquired/grabbed a central role as a platform provider. That is, Microsoft makes it its business to act as a firm that coordinates the direction of change. It acts as a focal point, coaxing others into using specific technical implementations and moving things forward as best it can.

This isn't easy, of course. Successful coordination of technical change requires control over many things. While it isn't usually in society's interest to let one firm control the rate and direction of innovation too much, it can be in society's interest to let somebody coordinate many firms, at least to some degree, if that coordination/control moves society's

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technology forward. That excuses some of Microsoft's behavior, to be sure, but not all of it.

Accordingly, proponents of this framework worry about whether a dominant firm is exerting control as a selfish end in itself or with the purpose of moving the platform forward. The latter goal benefits consumers, while the former arguably doesn't.

Yes, it also provides Microsoft with a partial defense. Since there can only be a few platform providers at a time, do any other potential platform providers seem particularly better? After all, would anyone trust Larry Ellison any more than Bill Gates? And was the IBM era any better for people outside IBM? No, no, and not really. In other words, didn't Microsoft get to this position by being comparatively good at its work?

At the same time, this view raises several troubling questions. Why would a dominant platform provider help a complementary firm that has become large enough to act as another platform provider? Why would a dominant platform provider not use access to technical information as a bargaining tool? Why would a dominant platform provider let middleware firms have enough design freedom to grow into a major force? Let's face it: A platform provider wouldn't do any of these things, but it's in society's interest if they do.

To be clear, the courts didn't address either side of these questions. For tactical reasons Gates' legal team seemed to worry about conceding that Microsoft was a platform provider at all. To do so would concede that Microsoft had some control, which, in turn, makes it especially vulnerable to an antitrust violation under the vertical contracting approach. Also, there was another difficulty. No antitrust law really exists for platform providers. It would've been rather risky to base a defense on it. Conservative judges usually don't like new theories.

Two frameworks and a specific firm

To summarize: The Microsoft antitrust trial was largely fought on the basis of the vertical contracting framework. The defense never really offered a full view of platforms, the day-to-day strategic concerns at Microsoft. Neither did the prosecution. This expediency deferred the really big question: What legal limits, if any, should the government place on platform providers for innovative markets?

To put it more starkly, the government lawyers figured out how to use a very old framework to win a legal case in a very new industry. Winning overrode other considerations. In contrast, Microsoft executives were appalled that a vertical contracting framework was being used to examine their behavior. They lost because they didn't take care to guard against violating these old and established legal norms.

So this gets us to the last question: If this vertical contracting framework is so old and so well known, how could Microsoft's executives (and in-house lawyers) leave such an incriminating trail? Or to put it another way, if this legal stuff is really antiquated and doesn't matter much to Microsoft's core business, why did the company do so many things that invited scrutiny? Why didn't it play clean under the old rules if it could still get what it wanted by playing clean?

Consider a few examples. Didn't Microsoft's managers know that sending a threatening letter to Compaq to withdraw the operating system license would come back to haunt them? Sure, it was explained in the trial that this letter was a bureaucratic mistake. But a good lawyer knows that the letter should never have been sent in the first place since it's an action that's easily misinterpreted. It makes the company look out of control, brazenly willing to abuse its market power.

Similarly, didn't Microsoft's lawyers know that exclusive contracts with ISPs would be interpreted as a potential tying arrangement, a clear antitrust violation? Sure, these provisions had little real competitive benefit in practice, but that's all the more reason not to use them. They don't look innocent on the surface because such contract provisions are absolutely illegal at dominant firms. Their use here made Microsoft look unwilling to regulate its own behavior.

Finally, didn't Microsoft's managers understand that threatening to withhold technical information from Netscape could be interpreted as a discriminatory behavior? Sure, there are limits to what Netscape had rights to know, but so what? It was obvious that Microsoft would face a lawsuit unless it justified its decisions with anything other than very precise reasoning. Any quid pro quo for technical information is always suspicious when dominant firms are involved.

Where was Microsoft's Antitrust Compliance Program? Such a program could've stopped all these actions or at least muted them to some extent. At best, it infuses a company with respect for the legal responsibilities associated with having a dominant market position. At a bare minimum, it limits the amount of incriminating evidence.

Antitrust compliance is routine among Fortune 500 companies because, if nothing else, these programs are an ounce of prevention for keeping companies out of court. So the absence of such a program at a firm with the world's highest market capitalization represents something extraordinary. This only happens when somebody at the top is asleep or nobody at the top cares. Since this firm is usually awake, it's not hard to reach the obvious conclusion.

But that conclusion is puzzling. Why does a company's management that's otherwise strategically brilliant and admirable in many respects remain so opposed to meeting minimal legal requirements from the federal government? If these particular requirements ostensibly make little difference to its overall business, Microsoft should just do them and move on. But if there's resistance to surrendering power for the simple reason that surrendering anything reduces Redmond's control over others, maybe the government case was using archaic legal rules to regulate the right point after all.

What do you think?