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IN THE UNITED STATES DISTRICT COURT
DISTRICT OF UTAH, CENTRAL DIVISION

CALDERA, INC.,

Plaintiff,

vs.

MICROSOFT CORPORATION,

Defendant.

CALDERA INC.'S MEMORANDUM IN OPPOSITION TO DEFENDANT'S MOTION FOR PARTIAL SUMMARY JUDGMENT ON PLAINTIFF'S "LICENSING PRACTICES" CLAIMS

Judge Dee V. Benson
Magistrate Judge Ronald N. Boyce

Case No. 2:96CV645B

FILED UNDER SEAL

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COMES NOW Caldera, Inc. complaining of Microsoft Corporation, and files this Memorandum in Opposition to Defendant's Motion for Partial Summary Judgment on Plaintiff's "Licensing Practices" Claims.

INTRODUCTION

Beginning in 1990, Microsoft deployed what would become one of its most effective weapon against DR DOS: exclusive licenses with OEMs. Although these licenses did not contain express exclusivity clauses, they utilized a collection of devices to create the same exclusive effect as an express contractual clause. Under these licenses, an OEM would have to pay Microsoft a royalty on *every* machine the OEM shipped *regardles*s of whether the machine contained MS-DOS. This "per processor" term meant that an OEM could only ship a competing operating system if it was willing to pay twice: The OEM had to pay the maker of the competing system, such as DRI, and it had to pay Microsoft. Microsoft's licenses also required the OEM to make large minimum commitments with up-front payments for these commitments. Because Microsoft's pricing structure rewarded OEMs that made overly-optimistic minimum commitments, OEMs regularly had large pre-paid balances when their licenses expired. OEMs would forfeit these balances unless they renewed their license with Microsoft. Further tightening its stranglehold on OEMs , Microsoft dramatically increased the duration of these licenses to two, three, or even four years — far in excess of the product life of MS-DOS versions.

Microsoft's own documents show that these restrictive terms were introduced to ensure that no OEM could switch to DR DOS. In fact, almost no OEM that adopted one of Microsoft's restrictive licenses ever patronized DR DOS. OEMs simply could not afford to license DR DOS even though it was a superior product. Microsoft's OEM licenses thus cut off DR DOS from the single most important customer base for operating systems.

RESPONSE TO MICROSOFT'S "STATEMENT OF UNDISPUTED FACTS"

Caldera disputes in every material respect Microsoft's purported "Statement of Undisputed Facts." Caldera incorporates by reference its Consolidated Statement of Facts in its entirety.

Caldera responds to Microsoft's numbered paragraphs as follows:

1. Caldera generally agrees with Microsoft's descriptions of its per copy, per system, and per processor license agreements. Though Microsoft obscures the fact, the Court should understand that under a per processor license, Microsoft required an OEM to identify the particular microprocessors used in its computers and to pay a royalty to Microsoft for all computers shipped containing one of the designated microprocessors, *regardless of whether the computers contained MS-DOS*. **Leitzinger Report** at 10-13.

2. Disagreed. Overwhelming record evidence demonstrates that OEMs were, in fact required to take per processor licenses, and were not given the option to choose either per copy or per system licenses. **Consolidated Statement of Facts** ¶¶ 299-304, 387-388. Microsoft also ignores the economic coercion involved in the purported "choice" it offered OEMs. ***Id.*** ¶¶ 139-143. Even its own evidence — **McLauchlan Depo.** at 31-32, **Hosogi Depo.** at 30; **Lin DOJ Decl.**; and **Waitt DOJ Decl.** — recognizes this fact. Microsoft's proffer also explicitly recognizes an OEM had to pay Microsoft a royalty

under a per processor license *whether or not* MS-DOS was included. *See, e.g.,* **Lum Depo.** at 90; **Fade Depo.** at 110; **Hosogi Depo.** at 30.

3. Disagreed. Microsoft offers no contemporaneous evidence of when, where, and why per processor licenses were originally offered, and the credibility and honesty of its employees is at issue. When investigated by the Korean Fair Trade Commission, Microsoft's general counsel specifically represented that the practice began in early 1990. **Exhibit 276**; *see* **Consolidated Statement of Facts** ¶ 58. Although Microsoft purports that per processor licenses made "contract amendments" easier, it fails to recognize that the only thing complicating its licensing practices was the fact that it had *itself* needlessly complicated its licensing practices. Microsoft's own economist testified that other ways aside from a per processor license were available to simplify contract administration. **Schmalensee Depo.** at 346.

4. Disagreed. Again, Microsoft offers absolutely no contemporaneous documentation that reduction of piracy was in any way a motivating factor for Microsoft's implementation of the per processor license, and the credibility and honesty of its witnesses is at issue. *See* **Consolidated Statement of Facts** ¶ 305. Microsoft's economist testified that any OEM bent on perpetrating fraud against Microsoft could do so under a per processor license, as well as under a per system or per copy license. **Schmalensee Depo.** at 335-336, 371. Insofar as "naked" machines (*i.e.*, machines sold without pre-loaded operating systems) are concerned, Microsoft did not need to receive a royalty itself for every machine it shipped, but at most needed to ensure that some royalty was paid as to every machine, whether to itself or to a supplier of competing operating systems. *See* **Leitzinger Report** at 36-37. Moreover, Microsoft's economist agrees that per processor licenses were implemented even with major worldwide OEMs that posed absolutely no threat of piracy. **Schmalensee Depo**. at 343; *see also* **Leitzinger Report** at 37-38.

5. Disagreed. Microsoft purports to identify a scant 27 instances in which it "negotiated exemptions" with the many *thousands* of OEMs worldwide. Of its witnesses cited, Kempin was equivocal and could recall at best one instance; Lum stated it "might" have happened but could not recall any particular instance; and Apple referred only to a small exemption for orders from the federal government at a time when Microsoft was then under investigation. Beyond this, Microsoft cites nothing other than an interrogatory response to the DOJ to support its contention; that response neither attaches the licenses nor identifies pertinent contract language and expressly includes exceptions granted to both per processor and per system licenses without any indication of which exceptions covered which type of license. As to Microsoft's suggestion that "other OEMs . . . nonetheless offered non-Microsoft operating systems with their computers during the term of their per processor licenses," Microsoft cites the following: (1) Richard Fade's testimony that unidentified OEMs bought an extra operating system for a special group of customers who *desired* computers with two systems (DOS and UNIX); (2) the declaration of Kent Roberts from Dell Computers, in which he claims Dell would pay for a second operating system if a customer wanted it instead of MS DOS; and (3) Theo Lieven's testimony in which he merely says Vobis bought DR DOS and MS DOS at different times. *See* **Licensing Memo**. ¶ 5. Only Roberts's explanation actually supports Microsoft's assertion that an OEM was willing to pay for MS-DOS even though it was not actually loaded on a machine. But his explanation of Dell's position, which was provided in an effort to help Microsoft with the FTC, is at odds with what Dell actually told Novell in 1991: "Due to the contract with Microsoft *DR DOS needs to be offered on a no cost basis* except for the upgrade program cost." **Exhibit 242** at A0116293 (emphasis added). As the DOJ's current case against Microsoft reveals, Microsoft and Dell have a special relationship. *See* Testimony of Joachim Kempin, *United States v. Microsoft*, 98cv01232,

1999 WL 97524, at 69-72 (Feb. 25, 1999) (Dell is charged less for Windows than other OEMs). And even as to Dell, Microsoft makes no suggestion that it or any other OEM already under a Microsoft per processor license negotiated a further license for DR DOS. In fact, the evidence is to the contrary. *See* **Consolidated Statement of Facts** ¶¶ 136-138, 293, 299-300, 302-303, 387-388.

6. Disagreed. Microsoft was well aware of the price points and tight margins involved in the OEM business. Microsoft presented extremely harsh price differentials to OEMs that made per system licenses, in fact, not a viable option. *See* **Consolidated Statement of Facts** ¶¶ 139-143. As to the purported ability of OEMs to license "new processor lines as the OEM introduced them," Microsoft ignores that only five types of Intel x86 (or compatible) processors existed in 1992 — 8086, 8088, x286, x386, and x486 — and that licenses typically covered multiple processors and enhanced processors that had not yet come to market. *See, e.g.*, **Exhibit 214** (specifying 386 and "486 or above"); **Leitzinger Report** at 12. Microsoft asks this Court to ignore reality when suggesting that new processors were an ordinary and frequent occurrence.

7. Disagreed. The record evidence is that Microsoft emphasized onerous price differentials, not "relatively minor suggested price differentials" as Microsoft argues. *See* **Consolidated Statement of Facts** ¶¶ 139-143. As to Microsoft's internal price guidelines, record evidence shows dramatic departure from such guidelines. *See* **Consolidated Statement of Facts** ¶¶ 139-143.

8. Microsoft makes assertions about the extent of its use of per processor licenses, but in no way provides actual evidence for Caldera or the Court to scrutinize. Microsoft has elsewhere provided evidence that, in 1991 for example, per processor licenses accounted for 77.5% of all MS-DOS contracts signed. *See* **Leitzinger Report**, Exhibit 4. Microsoft also ignores that it selectively deployed per

processor licenses at OEMs where DRI/Novell had successfully made sales or was considered a threat. *See* **Consolidated Statement of Facts** ¶¶ 137, 302-304 and Appendix C.

9. Disagreed. DRI did not do anything "similarly" to Microsoft. Microsoft is a monopolist. Its actions alone are subject to scrutiny in this antitrust litigation. In any event, Microsoft ignores the fact that any such terms in DRI contracts were "highly exceptional" and were never employed for the purpose of excluding competitors from OEMs. **DiCorti Depo.** at 357; **Gunn Depo.** at 270, 271. Moreover, in stark contrast to Microsoft, DRI only deployed such contract terms in circumstances where specific acts of piracy had been previously identified; thus, such contracts addressed particular OEMs selling illegal copies of DR DOS. **DiCorti Depo.** at 168-173. Moreover, any pricing policy encouraging the *actual* bundling of DR DOS was not anti-competitive: DRI was only paid when DR DOS was installed. Microsoft's per processor licenses, on the other hand, were designed to extract a royalty *whether or not* the OEM shipped MS-DOS on any particular computer.

10. Caldera generally agrees with Microsoft's description of the mechanics of its minimum commitment practices. However, Microsoft totally ignores its coercive use of minimum commitments, and that it had in fact established a practice to ensure that large prepaid balances existed at the end of a license term to coerce affected OEMs to negotiate follow-up licenses with Microsoft. *See* **Consolidated Statement of Facts** ¶¶ 144-146, 294-296. Microsoft recognized that its minimum commitment practices tied OEMs to MS-DOS, and blocked out DR DOS. ***Id.*** ¶¶ 146-148, 292, 294-296.

11. Disagreed. Microsoft did not allow OEMs to recoup prepaid balances "to preserve good will," as suggested by Microsoft. Indeed, the cited testimony of Hosogi and McLauchlan does not express such motivation at all, and Kempin's testimony is oblique, at best. Instead, Microsoft ensured that prepaid

balances would exist so that they could use them to block out DR DOS in subsequent negotiations. *See* **Consolidated Statement of Facts** ¶¶ 146, 294, 296.

12. Disagreed. DRI and Novell's licensing practices did not operate anything "like" Microsoft's minimum commitment provisions. Microsoft is a monopolist. Its actions alone are subject to scrutiny in this antitrust lawsuit. In any event, minimum commitment provisions in DRI and Novell licenses did not result in prepaid balances that were subject to *forfeiture* at the end of the term, as were Microsoft's. *See* **Consolidated Statement of Facts** ¶¶ 144-146. DRI's licenses for DR DOS were open-ended and never placed OEMs in the position of losing prepaid royalties due to contract expiration. **Speakman Depo.** at 97-99; **Owens Depo.** at 72. Even if an OEM chose not to renew a license with DRI or Novell, they were entitled to work off any prepaid balance after expiration of the license term. **Speakman Depo**. at 97-99.

13. The term "standard" is ambiguous as to the duration of Microsoft's OEM licenses. Microsoft ignores that even a two-year term exceeds the MS-DOS life cycle, and that it was pushing for its "standard" term to increase to three years after DR DOS arrived on the scene. *See* **Consolidated Statement of Facts** ¶¶ 150-154, 297-298. If by "standard" Microsoft means that OEMs were subject to a *penalty* if they opted for a one year term, and that they received a *discount* if they opted for three or more years, then Caldera agrees. *See* **Consolidated Statement of Facts** ¶ 152. As to the "discount" received for entering into a three-year agreement, OEM executives have testified that even a one dollar price differential was significant, given the tight margins in the industry. ***Id.*** ¶ 139.

REITERATION OF CONSOLIDATED STATEMENT OF FACTS, IN PART, FROM MICROSOFT'S OEM STATUS REPORTS

14. Contrary to the arguments of Microsoft's attorneys now, Microsoft employees knew exactly the exclusionary effect of their licensing tactics. Their OEM status reports are awash with evidence crippling to Microsoft's lame after-the-fact rationalizations to avoid liability. Although laid out clearly in its Consolidated Statement of Facts, Caldera reiterates some of the evidence here for emphasis.

- **As To Per Processor Licenses:**

15. Repeated entries in Microsoft OEM status reports starkly reveal awareness that per processor licenses excluded DRI from the market:

> Opus agreement has finally been signed by Redmond. *Another DRI prospect bites the dust with a per processor DOS agreement.*
>
> **Exhibit 81** (emphasis added)
>
> Hyundai Electronics INC. (HEI)
>
> DRI is still alive. We are pushing them to sign the amendment on processor based license. *This will block out DR once signed.*
>
> **Exhibit 96** at MS0049007 (emphasis added)
>
> Congratulations are in order for John "DRI Killer" McLaughlan (No, he isn't having another baby) who signed a $2.5M agreement with Acbel (Sun Moon Star). The agreement licenses DOS 5 per processor on a worldwide basis for 3 years (they will be replacing DRI DOS which they currently ship outside the US).
>
> **Exhibit 101**
>
> Trigem
> Their new agreement is per 86/286/386 processor system license for DOS3/4/5. *No more DR-DOS from Trigem.*
>
> **Exhibit 102** (emphasis added)

Hyundai Electronics (HEI)
— DRI visited Hyundai executives and the pricing issue was raised again. *The new license is a per processor deal, which allowed us to completely kick out DRI.*

Exhibit 108 at X556822 (emphasis added)

Liuski, which has been an MS-DOS PP [packaged product] customers for several years now at a run rate of approximately 25k-27k per year, has signed a license for MS-DOS 4.01 & 5.0. The PER PROCESSOR license is a one year license at a one year minimum of 18k units per year at a royalty rate of $[ ]. *On the surface this would seem like a decrease in revenues.* They currently pay $[ ] for MS-DOS PP (remember there are cogs in the $[ ]). The reason for the conversation to royalty is to retain their loyalty to MS-DOS. *They were seriously considering DRI product, thus we needed to be more aggressive.*

Exhibit 119 at X0590013 (emphasis added)

Budgetron is the one account in Canada where DRI's presence was very strong. Budgetron's market is strictly the low end VAR (or dealer) who would endure DRI DOS for a lower priced machine. *This new contract guarantees MS-DOS on every processor manufactured and shipped by Budgetron, therefore excluding DRI.*

Exhibit 125 at X190989 (emphasis added)

We have told EMI that we will discuss direct licensing with them if we can get MS-DOS "per processor" *and lock out DRI.* I dont want to do this but if they are really shipping 20K PC's a month loaded up with DRI — I have no choice. *IF this continues and EMI grows in the mass merchant channel then other oems in this channel will start looking at DRI as a cheap alternative.*

Exhibit 212 (emphasis added)

looks like it is not as bad as we may think. However, *I still think we should get a version ready for per processor deals and lock Novell OUT!* I will work with Johnlu to make this happen.

Exhibit 329 (emphasis added)

- **As To Minimum Commitments:**

16. As with per processor licenses, Microsoft's OEM status reports reveal that Microsoft

used minimum commitments to block out DR DOS:

> HYUNDAI ELECTRONICS INC. (HEI)
>
> — The DR threat still lives, especially in the export section which needs a low priced DOS for XTs to be shipped to Eastern Block. *We will maintain and utilize HEI's UPB [unspecified product billing] situation to keep out DRI.*
>
> **Exhibit 74** at X561629 (emphasis added)
>
> *Through adjustments to the minimum commitments for OS/2 and DOS Shell in order to get a Per Processor DOS/Shell agreement,* we have effectively reduced our expected revenue for FY91 to less than $3 Million. . . . The major goal was to go Per Processor, and we are within weeks of signing this three year commitment. Albeit still at a very good royalty, but Per Processor is a major commitment from HP.
>
> **Exhibit 122** at X0597322 (emphasis added)
>
> Will sign WIN and DOS per proc. LICENSE this Friday. . . . This will include all of Compuadd's notebooks (386sx up) which they had never licensed for Win. *The only concession we had to make was to let them recoup 500k prepaids this Q.*
>
> **Exhibit 302** (emphasis added)

17. OEM status reports also reveal that Microsoft was using a "UPB [unspecified product billing] Reduction Plan" to continue to wage war against DR DOS. *See, e.g.*, **Exhibit 209**; **Exhibit 170** ("I believe $2.3M PPB [prepaid balance] is favorable balance for us to push Samsung at our site. (not too big and not too small)"); **Exhibit 226** ("Be ready to merge their agreements with UPB issue"; "close new 3 year agreement with UPB plan"); **Exhibit 253** ("The risk with this is that there is no loyalty with our package product customers. Their cost to switch to DR-DOS is minimal since they have no long term financial commitment with Microsoft").

18. Microsoft plainly manipulated minimum commitments to its advantage. An internal memo entitled "Discussion of Prepaid Balances, Worldwide OEM, Q90-4" contains the following admission:

> Prepaid balances have become a by-product of the way we conduct our OEM business. They are well understood by our OEMs. *They also have definite benefits, tying customers to us.*
>
> We can use prepaid balances to encourage OEMs to license more of our systems products, increase our market penetration and create opportunities for increased sales of our application products.

Exhibit 98 at X200770 (emphasis added)

19. The exclusionary nature of Microsoft's minimum commitment practices were so well-established that they found their way into Microsoft's Board of Directors Report for the fourth quarter of 1991:

> Because prepaid balances can be recouped with royalties from products shipped in succeeding quarters, prepaid reduce the amount of revenue we will recognize related to future customer shipments. On the other hand, prepaid balances not only smooth the revenue stream somewhat, *but, in the face of increasing competition (Novell/DRI, IBM), make it costly for a customer to move to a competitor.*

Exhibit 104 at MS0164489 (emphasis added)

20. Indeed, the "OEM Sales Business Manual, Policies and Procedures" from September 1992 notes: "When properly managed at moderate levels, PPB [pre-paid balances] can benefit Microsoft." **Exhibit 324** at MS0013277.

- **As To License Duration:**

21. Microsoft's increasing push for three-year license duration is evident in Microsoft's status reports and pricing proposals. *See, e.g.,* **Exhibit 79**; **Exhibit 101**. The blocking effect was well understood:

> Printaform
>
> The new deal is effective 10/1 for DOS 4.01/5.0 in Windows 3.0 on all 286, 386, and future 486 systems. They will license DOS 3.3 on the 8088's. The new contract is for a three year term so that we don't have to worry about low end competition. This will be the first OEM in Mexico bundling Windows 3.0 on its systems, *and we eliminated DRI's chances with Printaform for at least 3 years*.
>
> **Exhibit 68** at X0590649 (emphasis added)

22. Microsoft's OEM reports from this era make repeated reference to the "competitive defense against DR DOS provided by 2-3 year license agreements." **Exhibit 167**; *see also* **Exhibit 255** at X0597052 ("Joon Park closed Samsung license much to my relief. It is a 3 year per processor license agreement."); **Exhibit 211** at MS7090708 ("aggressively go after existing DR DOS accounts and keep them out of our current ones . . . secure long term MS-DOS 5.0 contracts (three or more years) whenever possible"); **Exhibit 225** at MS7031119 ("MS will verify if DR is a real threat or a device to obtain lower royalties . . . if the threat is real I suggest MS lower their high volume royalties for the 386 SX to $[ ] and increase the term of the agreement to three years"); **Exhibit 226** (repeated reference to closing new three-year agreements).

23. At a presentation in June 1991 to the Microsoft OEM sales force, the "Strategy Against DRI" — indeed, one of the "Key Objectives for FY92" — was to "Push Longer Term Per Processor Contract." **Exhibit 132**. *See also* **Exhibit 145** at X518126 (Kempin memo, July 1991: "Secure long term contract with OEMs, whereby the standard contract length should be three years instead of two to deny entry . . .").

ARGUMENT

Microsoft's arguments defending its licensing practices are lifeless and stale. That is hardly surprising: Microsoft presented the self-same arguments to the United States Department of Justice, the European Commission on Competition, and the Korean Fair Trade Commission, and *each* condemned Microsoft. *See* **Consolidated Statement of Facts** ¶¶ 408-413. What is particularly objectionable, however, is that Microsoft lacks any sense of candor with this Court on these issues. On the one hand, Microsoft ignores or distorts the evidence against it; and, on the other hand, cites misleading propositions of law without *any* attempt to make a connection with the facts of this case, and without *any* effort to understand (or even to undertake analysis of) the complex issues it glibly raises.

The facts and the law are overwhelmingly against Microsoft. Summary judgment should be denied.

I. SUMMARY JUDGMENT IS PARTICULARLY INAPPROPRIATE WHERE THE MONOPOLIST DEFENDS ITS CONDUCT BY REFERENCE TO PRO-COMPETITIVE BENEFITS

Summary judgment is generally disfavored in antitrust cases. *See* **Consolidated Statement of Facts** at 9-11. Summary adjudication concerning Microsoft's licensing practices is particularly inappropriate, where the sole issue raised by Microsoft is whether its licensing practices, when engaged in by a clear monopolist, had an unreasonable anti-competitive effect. *See Ratino v. Medical Service*, 718 F.2d 1260, 1268 n. 23 (4th Cir. 1983) ("The question of whether a restraint promotes or suppresses competition is not one that can typically be resolved through summary proceedings. Rather, resolution must await a full-developed trial record. This is also particularly applicable in cases of novel antitrust claims."). Such a determination requires that "the factfinder weigh[] all of the circumstances of a case in deciding whether a restrictive practice should be prohibited."[1] *Continental T.V.* v. *GTE Sylvania Incorp.*, 433 U.S. 36, 49 (1977).

The Supreme Court also disapproves granting summary judgment merely because the monopolist offers some theoretical economic justification for its practices in order to convince the court that the practices should be declared legal as a matter of law. As the Supreme Court has emphasized, economic theory is no substitute for development of a factual record, unless special circumstances exist, such as when the plaintiff's theory is incredible or counter-intuitive. *See Eastman Kodak Co. v. Image Technical Svcs*, 504 U.S. 451, 471-478, 112 S.Ct. 2072, 2084-88 (1992); *see also* **Consolidated Statement of Facts** at 10 n. 3 (distinguishing *Matsushita Electric Industrial Co. v. Zenith Radio Corp.*, 475 U.S. 574, 106 S.Ct. 1348 (1986)).

II. MICROSOFT'S LICENSES CONSTRUCTED ILLEGAL EXCLUSIVE DEALINGS

It is a simple matter for this Court to conclude triable issues of fact exist to send Microsoft's licensing practices to the jury. The Department of Justice specifically condemned Microsoft's practices, and the most influential of antitrust treatises agrees. Beyond this, Caldera has amassed a mountain of evidence demonstrating the anti-competitive effect of Microsoft's per processor licenses, minimum

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[1] This is no small task. The factfinder "must ordinarily consider facts peculiar to the business to which the restraint is applied; its condition before and after the restraint was imposed; the nature of the restraint and its effects, actual or probable. The history of the restraint, the evil believed to exist, the reason for adopting the particular remedy, the purpose or end sought to be attained . . . ." *Chicago Bd. of Trade v. United States*, 246 U.S. 231, 238 (1918). Moreover, evaluation of the specific type of restraint at issue here — mechanisms to effectuate exclusive dealing — requires analysis of the practice's *actual* effect on competition in the relevant market, which itself requires a detailed understanding of the operating system market. *See infra,* at 15-18. Microsoft has not even bothered to define the relevant market, much less proffer evidence concerning the impact on either competition or the market.

commitment practices, and extended license duration. As well, the evidence refutes Microsoft's purported pro-competitive justifications.

Summary judgment should be denied.

A. Per Processor Licenses: An Infamous Pedigree

Microsoft argues that no reasonable juror could conclude that Microsoft's per processor licensing scheme was unreasonably anti-competitive. Yet Professor Areeda's frequently cited antitrust treatise *and* the United States Department of Justice (after a lengthy investigation) *expressly condemned Microsoft's licensing practices*. Moreover, Microsoft *agreed* to stop these practices as part of the Consent Decree. *United States v. Microsoft*, 1995-2 Trade Cases ¶ 71.096, 1995 WL 505998, at * 6 (D.D.C. 1995) (Consent Decree was in the "public interest"). This infamous pedigree alone suggests that a triable issue of fact exists as to whether per processor licenses are anti-competitive.

1. Areeda & Hovenkamp specifically condemn Microsoft's per processor licenses

In their authoritative text on antitrust law, Areeda & Hovenkamp condemn Microsoft's per processor license as anti-competitive conduct, lacking any pro-competitive justification. 3A P. Areeda & H. Hovenkamp, ANTITRUST LAW ¶ 768b4, at 151-53; 11 *id.*, ¶1807b, at 117-118. In a shocking lack of candor with this Court, Microsoft ignores this treatise entirely in its summary judgment papers on this issue.

Areeda & Hovenkamp begin by warning of the dangerous possibilities for foreclosure by a dominant firm in the computer software business:

> Intellectual property has a peculiar attribute: Once developed, it can be used an infinite number of times at no incremental cost to the owner. As a result, there is no "capacity

> constraint" on the number of times that a particular piece of, say, computer software can be licensed. *This makes market-dominating software particularly useful for foreclosure, because the number of licenses can always be infinitely expanded to take up the entire market.*

Id. at 151 (emphasis added).

Next, with explicit citation to Microsoft's conduct and the Consent Decree, the treatise gives an apt summary of the exclusionary nature of per processor licenses:

> Suppose, for example, that one firm manufactures a market-dominating software operating system for new computers, which computer manufacturers ordinarily install at the factory before shipping the computer. Other nondominant operating systems are also available, however, *and in open competition and markets subject to quick technological change it is quite possible that the dominant software will lose its position to a rival*. However, the dominant firm takes advantage of its current position by using a license agreement requiring computer manufacturers to pay a fee for each computer they produce, whether or not that computer actually employs the dominant firm's operating system.
>
> For example, a computer manufacturer able to install any operating system it pleases on 1000 computers annually might respond to customer demand by installing 700 of the dominant firm's operating system and 300 of the various alternative operating systems of nondominant firms. But suppose that the license fee for using the dominant firm's system is $50 per computer manufactured, rather than per computer that actually incorporates the system. In that case, the manufacturer must pay the $50 for each of the 1000 computers, whether or not it installs the dominant firm's system, and will have to add an additional licensing fee for installing the alternative system of a nondominant firm. *Alternatively the only way the nondominant system maker can compete in price with the dominant firm is to charge a licensing fee of zero*.
>
> Such licensing arrangements have been upheld when it is difficult to determine whether a particular unit of the product incorporates the licensed technology; so the mutual convenience of licensor and licensee requires royalties based on the number of units produced rather than the number actually thought to employ the license. *But software on computers is readily detected, and there seem to be few or no offsetting efficiency benefits from arrangements that simply raise the costs of nondominant firms*.

Id. at 152 (emphasis added) (citing *Automatic Radio Mfg. Co. v. Hazeltine Research*, 339 U.S. 827 (1950); *Microsoft Consent Decree,* 59 Fed. Reg. 42,845 (1994)). The last paragraph of the above quotation is especially significant: Areeda & Hovenkamp anticipate *and reject* Microsoft's attempt to defend the per processor license as some sort of total sales royalty. *See* **Licensing Memo**. at 9-17.

Areeda & Hovenkamp also expressly condemn the coercive "discount" Microsoft offered to OEMs that signed per processor licenses. After observing that a *de facto* exclusive dealing arrangement is created by a policy of offering discounts only to those buyers who agree to use exclusively the seller's product, the treatise again takes Microsoft to task:

> Also troublesome is the "all or none" quality of discounting policies of this nature. For example . . . [t]he impact of [Microsoft's] policy was to give computer makers the incentive, first, to agree to the fee structure in order to get the lower price; and second, to install Microsoft operating systems on all their computers once the agreement was in place.
>
> Such a scheme is problematic, however, *only when the defendant is a dominant firm in a position to force manufacturers to make an all-or-nothing choice*. For example, suppose that Microsoft has a 90 percent share of IBM-compatible operating systems, and compatibility concerns led some 90 percent of customers to prefer a Microsoft operating system. At the same time, however, the remaining 10 percent of customers have unique needs or tastes and would prefer a non-Microsoft system such as IBM's OS2 system. In such circumstances the computer manufacturer would be best off serving the mix of customers that come to its door, perhaps selling 90 percent of its computers with a Microsoft system installed and the remaining 10 percent with the systems of rivals. *In that case the discount policy effectively forces the manufacturer to make the choice of either installing the Microsoft system on 100 percent of its computers or on none at all*. Since the hardware makers cannot afford the second alternative, given Microsoft's dominance, it selects the first.

11 P. Areeda & H. Hovenkamp, ¶ 1807b, at 117-118 (emphasis added).

Once again, Areeda & Hovenkamp anticipate and reject Microsoft's efforts to defend its actions. Microsoft claims that OEMs were "free" to reject the per processor license, and seeks to defend its actions by reference to DRI's. As the treatise explains, only Microsoft — the monopolist — was "in a position to force manufacturers to make an all-or-nothing choice" presented by per processor licenses. *Id*. As a result, such discounts effectively coerce the buyer and make it impossible for competing firms to match the discount.

2. The United States Department of Justice condemned Microsoft's per processors as anti-competitive

The Department of Justice also soundly condemned Microsoft's per processor license. The DOJ published the following "Competitive Impact Statement" explaining the anti-competitive effect of this practice:

> Microsoft's licensing practices *deter OEMs from entering into licensing agreements with operating system rivals* and discourage OEMs who agree to sell non-Microsoft operating systems from promoting those systems. By *depriving rivals of a significant number of sales that they might otherwise secure*, Microsoft makes it more difficult for its rivals to convince ISVs to write applications for their systems, for OEMs to offer and promote their systems, and for users to believe that their systems will remain viable alternatives to MS-DOS and Windows.
>
> *Microsoft's exclusionary contracts harm consumers.* OEMs that sign Microsoft's exclusionary licenses but offer consumers a choice of operating systems may charge a higher price, in order to cover the double royalty, for PCs using a non-Microsoft operating system. Even consumers who do not receive a Microsoft operating system still pay Microsoft indirectly. Thus, Microsoft's licensing practices have raised the cost of personal computers to consumers. Microsoft's conduct also substantially lengthens the period of time required for competitors to recover their development costs and earn a profit, and thereby increases the risk that an entry attempt will fail. In combination, all these factors deter entry by competitors and thus harm competition. By deterring the development of competitive operating systems, Microsoft has deprived consumers of a choice of potentially superior products. Similarly, the slower growth of competing operating systems has retarded the development of applications for such systems.

United States v. *Microsoft Corp*., 59 Fed. Reg. 42,845, at 42,851 (Aug. 19, 1994) (Proposed Final Judgment and Competitive Impact Statement) (emphasis added).

In another shocking lack of candor, Microsoft utterly ignores this finding by the DOJ — and offers no explanation why it *abandoned* its practices rather than face *prosecution*. As well, Microsoft ignores similar findings by the Korean Fair Trade Commission and the European Commission on Competition. *See* **Consolidated Statement of Facts** ¶¶ 408-413.

3. *SmithKline Corp. v. Eli Lilly & Co.*

In *SmithKline Corp. v. Eli Lilly & Co.,* the Third Circuit invalidated an arrangement that is closely analogous to Microsoft's per processor licensing scheme. Eli Lilly produced five different brands of a particular drug, but offered a three percent discount on *all* purchases if the buyer bought certain minimum levels of *three* of the five brands. *SmithKline Corp. v. Eli Lilly & Co.*, 427 F. Supp. 1089, 1105 (E.D. Pa. 1976). Two of the brands — Keflin and Keflex — were dominant market leaders, accounting for 75% of all purchases. Both were under patent to Lilly. Two of the other brands had no market appeal. The fifth brand — Kefzol — was a generic brand that was growing in popularity. As a practical result, hospitals could only qualify for the discount if they bought the requisite minimums of the Keflin, Keflex, and Kefzol brands.[2] *See id*., at 1106 ("This meant that the great bulk of hospitals, in accordance with the prescribing habits of their physicians and in order to qualify for the bonus rebate on Keflin and Keflex, would purchase Kefzol in the specified amount").

This alleged volume discount had an exclusionary effect akin to that of the per processor license. Another manufacturer, SmithKline, had a license to make the generic brand. In other words, the SmithKline generic — like DR DOS — was in unique position to offer a competing version of the same product without violating intellectual property laws. And like OEMs under per processor licenses, hospitals

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[2] This arrangement was not analyzed as a tie because the discount only involved the purchase of different brands of the same product type, not the linking of two separate products. *See id*., at 1101, 1107.

were theoretically "free" to buy the generic brand from SmithKline and the non-generic brands (Keflin and Keflex) from Lilly. Doing so, however, would cause hospitals — like any OEM that wanted to put DR DOS on some portion of its machines — to lose the discount not only as to the generic portion of their purchases, but also as to their purchases of Keflin and Keflex, the dominant market brands. *See id*. Likewise, nothing in theory stopped the hospital from buying the generic drug twice: once from Lilly to get the discount and once from SmithKline to sell to customers. OEMs, of course, also had this same highly theoretical "choice."

The Third Circuit declared the arrangement illegal: "the practical effect of that decision [to buy some portion of requirements from SmithKline] would be to deny the . . . purchaser the 3% bonus rebate on all its . . . purchases." *SmithKline Corp. v. Eli Lilly & Co.*, 575 F.2d 1056, 1061-62 (3rd Cir. 1978). Given the much greater consumer demand for the non-generic brand over the generic brand, the only way SmithKline could match Lilly's 3% across-the-board discount was to offer between a 16% and 35% discount on its brand. *Id*., at 1062. The Third Circuit considered the arrangement especially problematic because Lilly had over 90% market share; there was evidence Lilly was using the discount to combat erosion of an industry standard brand in the face of an upstart substitute; and there were high barriers to entry in the market. *SmithKline*, 575 F.2d at 1059, 1061, 1065. The analogy to Microsoft's use of per processor licenses is compelling. *See* **Consolidated Statement of Facts** ¶¶ 141-142 (pricing effect); ***id***. at 2 n. 2, ¶¶ 81-82 (market share); ***id.*** ¶¶ 30-34, 104, 169-171, 292 (Microsoft fears of intra-standard competition); **Kearl Report** at 14-19 (barriers to entry).

B. A Triable Issue of Fact Exists as to Whether Per Processor Licenses Were Exclusionary

Caldera challenges Microsoft's licensing practices under both sections 1 and 2 of the Sherman Act. *See* **Exhibit 1** ¶¶ 72-77, 86-92 (First Amended Complaint). Section 1 prohibits contracts that unreasonably restrain trade. *Standard Oil Co.* v. *United States*, 221 U.S. 1, 59-60 (1911). Likewise, section 2 prohibits "the use of monopoly power 'to foreclose competition, to gain a competitive advantage, or to destroy a competitor.'" *Eastman Kodak Co. v. Image Technical Svcs.*, 504 U.S. 451, 482-83, 112 S. Ct. 2072, 2090 (1992) (quoting *United States v. Griffith*, 334 U.S. 100, 107, 68 S. Ct. 941, 945 (1948)). As the Tenth Circuit has explained, contracts and dealings to purchase exclusively from a single seller run afoul of sections 1 and 2 because of their tendency to destroy competition among sellers:

> The antitrust vice of these arrangements is the foreclosure of part of the market in which the seller competes by taking away the freedom of the buyer to choose from the products of competing traders in the seller's market.

See Perington Wholesale, Inc. v. *Burger King Corp.*, 631 F.2d 1369, 1374 (10th Cir. 1979).

A two-part inquiry determines whether an exclusive dealing arrangement violates the antitrust laws:

(1) the agreement at issue must be exclusive; and (2) the agreement must have an adverse effect on competition. *Tampa Electric Co. v. Nashville Coal Co.*, 365 U.S. 320 (1961); *see* **Licensing Memo**. at 3-4. The first inquiry focuses on *the contract or buyer level* and asks whether the arrangement truly excludes a particular buyer from purchasing from other sellers. The second inquiry focuses on *the market level* and asks whether the use of the arrangement has an actual anti-competitive effect on the marketplace.

1. Step One: The Per Processor License Precluded Individual OEMs From Considering DR DOS

This Court's first enquiry is to determine whether an OEM under a per processor license could actually buy DOS from any manufacturer other than Microsoft. As a factual matter, Caldera has brought forth abundant evidence that individual OEMs and Microsoft viewed the per processor license as exclusionary. *See* **Consolidated Statement of Facts** ¶¶ 130-154, 292-300. This alone is enough to withstand summary judgment.

A contract need not be denominated *exclusiv*e nor must exclusivity be an express condition of the arrangement, in order for it to be "exclusive" under sections 1 and 2. Any agreement with the "practical effect" of exclusivity is covered. *Tampa Electric*, 365 U.S. at 327 (quoting *United Shoe Machinery Corp. v. United States*, 258 U.S. 451, 457 (1922)). As the Tenth Circuit has explained: "An exclusive supply agreement entails a commitment by a buyer to deal only with a particular seller. . . . The agreement need not specifically require the buyer to forego other supply sources *if the practical effect is the same*." *Perington Wholesale, Inc.*, 631 F.2d, at 1374 (emphasis added). *De facto* exclusive contracts and dealing arrangements are commonly scrutinized under the Sherman Act and include requirements contracts and other arrangements where the seller "gives the buyer a discount, a rebate, or more favorable terms in exchange for the buyer's commitment not to purchase a rival's goods." 11 P. Areeda & H. Hovenkamp, ANTITRUST LAW ¶ 1821, at 155.

De facto exclusive dealings may be inferred from the operation of incentive schemes that make exclusivity the buyer's only feasible economic choice. Courts have readily found the existence of exclusive dealing where a monopolist offers a discount on terms that, due to market demand and price pressure, force a buyer to purchase all its requirements from the monopolist even though such a restrictive condition is not explicitly stated. *E.g.*, *SmithKline Corp.* v. *Eli Lilly & Co.*, 575 F.2d 1056 (3rd Cir. 1978) (discussed, *supra*, at 7-8). Moreover, in the specific context of intellectual property licenses, a licensing scheme may make it economically infeasible for a licensee to try competing technology: "A license that does not explicitly require exclusive dealing may have the effect of exclusive dealing if it is structured to increase significantly a licensee's cost when it uses competing technologies." U.S. Department of Justice, Antitrust Guidelines for the Licensing of Intellectual Property § 4.1.2 (1995). Contrary to Microsoft's argument in its summary judgment brief, a defendant (particularly a dominant monopolist) cannot escape liability merely by pointing out that buyers could have "avoided" the exclusive effect by purchasing on uneconomical terms. As pointed out above, both Areeda's treatise and the DOJ specifically rejected Microsoft's argument.

Microsoft's motion makes no sustained argument that Caldera's claim fails at step one.[3] Empty rhetoric is all Microsoft can muster: "Caldera cannot meet this first hurdle: showing that two- or three-year per processor licenses with minimum commitments excluded competitors." **Licensing Memo**. at 4. The current position taken by Microsoft's lawyers is starkly at odds with the statements of Microsoft's OEM account managers at the time the licenses were executed. *See supra* ¶ 15. Microsoft cannot credibly contend before this Court that the per processor licensee did not exclude DR DOS from reaching OEMs.

Indeed, Microsoft offers no evidence supporting its contention that OEMs had a meaningful choice to reject the per processor license in favor of other licensing schemes. In fact, no such choice existed, due to the convergence of two market phenomena: First, OEMs had razor thin margins, making it hard for

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[3] According to Microsoft, "[c]ourts have not hesitated to reject antitrust claims where the agreements were not truly exclusive." **Licensing Memo.** at 4. It cites four cases, without development or analogy — indeed, without even a parenthetical explanation. Microsoft's cases are not helpful to its cause. First, Caldera is entitled to a jury trial. *See Spitt Spark Plug Co.*, 840 F.2d 1253, 1257-58 (5th Cir. 1988): "*jury question*" as to exclusivity created even by contract expressly denominated "non-exclusive," where defendant allegedly offered promotional gifts to buyers who refused to carry competing products; upholding directed verdict only because defendant lacked sufficient market power. Second, Microsoft is confused about the step-one and step-two inquiries. *See Perryton Wholesale, Inc. v. Pioneer Distributing Co.*, 353 F.2d 618, 624 (10th Cir. 1965): no antitrust violation where truly exclusive contract foreclosed only 5% of the market. Third, Microsoft is confused about the evidence in this case, or rather, chooses to ignore it. *See United Air Lines, Inc. v. Austin Travel Corp.*, 867 F.2d 737, 742 (2nd Cir. 1989): refusing to label a contract requiring customers to use defendant's service for 50% of business a *de facto* exclusive contract because the plaintiff *failed to produce any evidence* customers *actually* refrained from using competing products; *Western Parcel Express v. United Parcel Service*, No. C-96-1526-CAL, 1998 WL 328621, *14 (N.D. Cal. June 15, 1998): contract was not truly exclusive *because it was terminable at will by either party*; did not require exclusivity; and *did not base any discount upon exclusive use*; and the plaintiff failed to provide any testimony of customers that *they believed the contract had an exclusionary effect.*

OEMs to turn down any discount. *See, e.g.,* **Exhibit 367** ("We consider DR DOS to be a good and viable product but have since been precluded from considering it seriously even for a small number of our systems because of the CPU licensing arrangement. Margins and competition are such in our business that we could not afford to use DR DOS."). Second, MS-DOS was the entrenched monopoly product, and the per processor discount was all-or-nothing: an OEM could not merely forego the discount as to those purchases it decided to make from DRI. *See* Areeda & Hovenkamp, *supra*. As a result, an OEM — like a hospital in *SmithKline* — could not afford to forfeit the discount available on MS-DOS sales by rejecting the per processor license, merely to open up some machines to DR DOS. *See* **Consolidated Statement of Facts** ¶¶ 139-142.

Under these circumstances, the only way DRI and Novell could convince an OEM to license DR DOS was to offer it for a zero royalty. *See* **Exhibit 242** ("Due to contract with Microsoft DR DOS needs to be offered on a no cost basis"). Microsoft's own expert summed up the effect of this discount as follows:

> [T]o the extent there was a discount associated with the per-processor discount, you could think of it as a discount for a closer relationship *or for something approaching exclusivity*.

Schmalensee Depo. at 342 (emphasis added).

Even beyond the above evidence, Caldera has produced evidence that Microsoft simply *refused* to offer any choice to OEMs except the per processor license.[4] As the correspondence and testimony of OEMs illustrates, OEMs were given a single take-it-or-leave choice:

- "The second issue is the fact that the only OEM agreement you have been prepared to offer us on MS-DOS and Windows is a per processor license." **Exhibit 306**.

- "3. In order to obtain licensing rights to MS-DOS from Microsoft, we were required to enter into an OEM Agreement with Microsoft which stipulates that we must pay them a license fee for every system shipped, regardless of whether or not we use MS-DOS on that particular system.

  4. *We were not given the option of licensing MS-DOS on any other basis*. Foregoing a license for MS-DOS altogether was not an option. MS-DOS is used by a substantial segment of the industry and our business would not survive if we were not able to offer it to our customers." **Exhibit 367.**

Microsoft also argues that the per processor license was not exclusive because Microsoft granted exceptions. **Licensing Memo.** at 5. Yet, Microsoft only claims to have granted twenty-seven exceptions out of the many hundreds of OEMs covered by per processor licenses. Caldera believes even this tiny number of exceptions is deceptive, *see supra* ¶ 5, and thus is not evidence of a "habit" of granting exceptions so widespread that in practice the per processor license was not exclusive. *See* **Consolidated**

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[4] This is precisely why the principle case relied upon by Microsoft — *Barr Labs., Inc. v. Abbott Lab.*, 1989-1 Trade Cas. (CCH) ¶ 68,647 (D. N.J. 1989) — in fact aids Caldera. There, the defendant merely offered a traditional volume discount to customers. However, plaintiff presented some testimony that defendant's practice was to coerce exclusivity. The court held it "cannot find at this time that there is no evidence to show that there might not have been some implied or verbal agreement whereby the purchaser also would not buy the product from Barr." *aff'd*, 978 F.2d 98 (3rd Cir. 1992). Similarly, this Court must assume for summary judgment purposes that Microsoft did not offer OEMs any choice, but per processor licenses.

Statement of Facts ¶¶ 301-304. But worse, the fact that Microsoft suggests it had to grant exceptions *in order to permit OEMs to license non-Microsoft operating systems* simply proves that the per processor license itself was exclusive: The only way an OEM could license another product was to get out from under the per processor term.[5]

Microsoft also contends the per processor license was not exclusive because some OEMs actually licensed DR DOS.[6] **Licensing Memo.** at 4-5 . Assuming Microsoft is not referring to OEMs that got one of its mysterious exceptions, what Microsoft is really saying is that some ill-defined (but clearly miniscule) number of OEMs were willing to pay the penalty for breaking the exclusive arrangement. *See supra* ¶ 5. The evidence is overwhelming that very few OEMs were willing to pay Microsoft's tax. *See* **Exhibit 367** ("Both before and after entering into the OEM agreement, we have had requests from some customers for DR DOS that we have not been able to fulfill. . . . [W]e could not afford to . . . pay a double license."); *see also* **Exhibit 284** ("We clearly do not feel we, or our customers, should be forced to pay Microsoft a royalty on your software when it is not supplied or desired."); **Exhibit 306** ("[A] small proportion of our business involves providing Non Microsoft operating systems such as networks and

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[5] One wonders why exceptions would be granted, too, if piracy were a true motivating factor. *See infra*.

[6] Microsoft also baldly asserts that imposing an exclusionary arrangement on a *distributor* is less harmful to competition than imposing it on *actual consumers*. *See* **Licensing Memo.** at 5. Microsoft knows that such argument is deceptive and misleading, because OEMs are not mere "distributors" of operating systems; they are the key *consumers*, accounting for almost 90% of the market. *See* **Kearl Report** at 8. Microsoft has put forth not a single shred of evidence that a competing manufacturer could circumvent Microsoft's exclusionary arrangements by creating its own exclusive distributorship.

others to our customers who require it. This means that we will be paying a royalty to Microsoft even though we would not be supplying Microsoft products.").

And so, although Microsoft suggests that a contract must be completely exclusionary — *i.e.*, 100% of a buyer's purchases must be covered — to be deemed exclusionary for antitrust purposes, antitrust law says otherwise. *See* 3A P. Areeda & H. Hovenkamp, ANTITRUST LAW ¶ 768b4, at 149 (examples of exclusionary conduct by a seller include where "the buyer agrees . . . to buy a *high proportion* of its requirements from the monopolist . . . [or] to buy a fixed amount that *substantially approximates* its requirements" (emphasis added)). Were Microsoft correct, a monopolist could escape antitrust scrutiny by offering small exceptions or carve-outs on a sporadic basis.[7] In practice, however, the per processor license was exclusionary, under any definition of that term.

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[7] Microsoft cites *Barr Lab., Inc.* v. *Abbot Lab.*, 978 F.2d 98, 110 n.24 (3rd Cir. 1992), for the proposition that "[a]n agreement affecting less than all purchases does not amount to true exclusive dealing." *See* **Licensing Memo.** at 5. In fact, that opinion merely poses the question whether a partial exclusionary contract comes within the coverage of the Clayton Act § 3, which has the express limitation that it applies to contracts containing a provision that a buyer "shall not use or deal in the goods . . . of a competitor." 15 U.S.C. §14. That statutory phrasing has caused some courts to conclude that partial exclusive contracts are not covered by the Clayton Act because the buyer can use or deal in goods of a competitor, albeit only partially. *See Tampa Electric Co. v. Nashville Coal Co.*, 365 U.S. 320 (1961) (declining to answer the question). Sections 1 and 2 have no similar statutory limitation.

Were this Court to accept Microsoft's argument that section 1 has some technical requirement that the contract be 100% exclusionary, Caldera would still have a claim under section 2. *Cf.* 3A P. Areeda & H. Hovenkamp, ANTITRUST LAW ¶768b2 ("[W]e see little need for an independent §2 offense, except in the rare case where the buyer might be thought constrained in the absence of a qualifying agreement [under section §1].").

2. Step Two: The Per Processor Injured Competition.

According to the Supreme Court, if use of the exclusive contract or dealing forecloses a "substantial share" of the relevant market or causes "a significant fraction of buyers or sellers [to be] frozen out of a market," competition is injured. *Tampa Electric Co. v. Nashville Coal Co.,* 365 U.S. 320 (1961). What constitutes foreclosure of a substantial share turns on "the structure of the market for the products or services in question — the number of sellers and buyers in the market, the volume of their business, and the ease with which the buyers and sellers can redirect their purchases or sales to others." *Jefferson Parish Hospital Dist. No. 2 v. Hyde*, 466 U.S. 2, 45 (1984) (O'Connor J., concurring). Additionally, consideration must be given the particular terms of the agreement to assess how tightly the exclusivity binds: Courts consider factors such as the financial incentives of buyers to enter into the arrangement, the existence of lengthy terms, and whether there are penalties for termination or non-renewal.[8] *See U.S. Health Care, Inc., v. Healthsource, Inc.*, 986 F.2d 589, 595-596 (1st Cir. 1993).

Microsoft's summary judgment papers make, at best, a superficial run at the substantial foreclosure issue, but muster no evidence to define the market, its structure, or in any way explain OEM business to aid this Court's consideration. *See* **Licensing Memo.** at 5-6. This is insufficient to put this point at issue on summary judgment.

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[8] In addition to the per processor term, Microsoft included a host of other terms to magnify the exclusive effect, including: (1) the use of minimum commitments, *see infra*; (2) unreasonably extending the duration of the licenses, *see infra*; (3) no early termination provision; and (4) requiring accelerated payment of all minimum commitments in the event of default. *See* **Exhibit 214**, at 8 and exhibit B.

Indeed, Microsoft cannot seriously contest that the exclusionary effect of the per process license injured competition by foreclosing a substantial share of the market. Microsoft's highest executives acknowledged that the per processor license permitted it — an entrenched monopolist — to prevent displacement by a technologically superior upstart competitor, depriving consumers of choice. Jim Allchin wrote to Bill Gates on March 26, 1992:

> I feel we are much too smug in dealing with Novell. Perhaps, they didn't hurt us in DOS yet — *but it's not because of product* or their trying. *It's because we already had the OEMs wrapped up*.

Exhibit 349 at MS7079459 (emphasis added)

Moreover, the per processor license precluded and retarded the ability of competing operating systems to build reputation, experience, and consumer acceptance that are essential to longer-term viability, especially in the face of high barriers to entry and large tipping effects. *See, e.g.*, **Exhibit 212** (explaining that a per processor license was needed to "lock out DRI" at an OEM named EMI that was shipping DR DOS because if "EMI grows in the mass merchant channel then other oems in this channel will start looking at DRI as a cheap alternative"); **Exhibit 118** (desire to get Vobis under per processor license motivated by "Amstrad and other German companies . . . noticing Vobis' success and its DRI bundling"); **Leitzinger Report** at 5-6; **Kearl Report** at 14-19. After extensive investigation, the Department of Justice found that the per processor license deprived consumers of choice, raised the cost for personal computers, and deterred innovation. *See supra*, at 5-6.

Even assuming Caldera must show per processor licenses foreclosed a substantial share of the market, Caldera can easily meet that burden for summary judgment purposes. Microsoft concedes that as much as 60% of the OEM market from 1992 to 1994 was covered by per processor licenses, and OEMs constitute over 90% of the entire DOS market. *See* **Licensing Memo**. ¶ 8. But worse, Microsoft was forcing OEMs to sign per processor licenses at an alarming rate: in 1991 alone, *77% of all OEM licenses Microsoft executed for MS-DOS were per processor licenses.* **Leitzinger Report**, Exhibit 4. These figures clearly demonstrate that prior to 1994 — when the Consent Decree forced Microsoft to stop the practice — per processor licenses were in place at most major OEMs around the world and were rapidly being forced upon the remainder of the OEM channel. And such numbers actually *underestimate* the true anti-competitive effect because Microsoft selectively prosecuted its per processor strategy: Microsoft specifically deployed per processor licenses at OEMs where DRI/Novell had successfully made sales or was considered a threat. *See* **Consolidated Statement of Facts ¶¶** 137, 302-304, and Appendix C.[9]

C. There Were No Pro-Competitive Justifications for Per Processor Licenses.

"Neither the aims of intellectual property law, nor the antitrust laws justify allowing a monopolist to rely upon a pretextual business justification to mask anticompetitive conduct." *Image Technical Services*, 125 F.3d at 1218. Suspicion has clearly been cast on Microsoft's after-the-fact justifications for its licensing schemes. The Court should bear in mind that Microsoft offers not one single piece of paper

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[9] Microsoft cites *Bowen v. New York News, Inc.*, 366 F. Supp. 651, 679-80 (S.D.N.Y. 1973), where the court found no substantial foreclosure because the plaintiff had failed to produce any evidence that intra-brand competition was lessened and, in fact, competitors had "successfully competed" with defendant. In contrast, DRI was run out of business, eliminating the only competing DOS product.

as contemporaneous evidence of its justifications — but only the say-so of its employees in deposition. The jury is entitled to assess credibility.

1. Per processor licenses were an overbroad, restrictive method by which to combat piracy

Microsoft vaguely contends that it changed its licensing practices in order to combat "piracy" and counterfeiting. **Licensing Memo**. at 6. Microsoft's own economist conceded that per processor licenses would not deter an OEM bent on defrauding Microsoft. **Schmalensee Depo.** at 336. Moreover, Microsoft contradicts this alleged business justification arguing out of the other side of its mouth that OEMs were *free to choose* whatever license type they wanted, and were allegedly able to get *exemptions* anyway. Microsoft should at least pick a story and stick to it: giving a "pirate" its choice of licenses is not much protection against piracy.

If there were a real problem with piracy, an obvious way existed to address the problem without forcing such restrictive terms on an OEM and reducing consumer choice: *Microsoft could simply obtain an agreement from its licensees not to ship naked machines*.[10] *See* **Leitzinger Report** at 37. Charging OEMs MS-DOS license fees for systems that ship with DR DOS because the customer prefers DR DOS does nothing to deter piracy, but plenty to deter competition.

Other major software companies (and indeed, much smaller companies with far fewer resources than Microsoft) have been able to address the piracy problem without such measures. P. Areeda & H. Hovenkamp, ANTITRUST LAW ¶ 1502, at 372 (justification defense "will be lost if the plaintiff shows

[10] A "naked machine" is one shipped without an operating system, which likely may be loaded illegitimately later.

that it can be achieved by a substantially less restrictive alternative"). Alternative actions include appropriate enforcement actions where warranted; use of sophisticated numbering and labeling (holographic) technology; and regular compliance audits. **Leitzinger Report** at 37. Per processor licenses did nothing to address the far more serious problem of unlawful copying and manufacturing of MS-DOS packages that were then sold by a licensee to other OEMs or directly to end users. It did nothing to prevent an OEM from trying to "cheat" as to the number of processors it used. In short, it did not address the heart of any purported piracy problem.

Finally, Microsoft did not employ per processor licenses *only* against suspected pirates. **Schmalensee Depo.** at 343. The actual targets of Microsoft's per processor strategy were not small-scale, fly-by-night operations run out of an alley in Hong Kong or Taiwan, but were major multinational corporations, including major U.S. companies, with substantial intellectual property portfolios of their own and with highly visible and traceable production and distribution channels. It stretches credulity to posit a piracy justification for companies such as these.

2. Per processor licenses were not mere volume discounts

Per processor licensing is clearly distinguishable from volume discounting. *See* **Licensing Memo**. at 7. With true volume discounting, marginal prices paid by an OEM for MS-DOS would decline with increasing volume, but at no point would the OEM be required to pay Microsoft a royalty for systems *that did not include Microsoft software*. Indeed, Microsoft's own economist agreed per processor licenses were not volume discounts. **Schmalensee Depo**. at 341-342. So did Microsoft's worldwide director of OEM sales. **Consolidated Statement of Facts** ¶ 390.

Moreover, in the normal volume-discount situation, DRI or Novell would have had an opportunity to meet Microsoft's *lowest price* for the *last increment of volume* required by an OEM. Instead, under the per processor licensing scheme, a new entrant with a better product not only had to *meet the lowest price*, but also had to *recompense the OEM for the penalty* it was required to pay on the units shipped which did not contain MS-DOS. This raised the costs for Microsoft's rivals, without corresponding benefit either to the OEM or to the users. Entry for the innovative product was deterred because Microsoft chose to make its lowest price available *only* in an exclusionary fashion.

From the point of view of the OEM, it may well have meaningful volume efficiencies to be realized. However, these efficiencies derive *solely* from volume — *and high volume does not require a per processor license*. The OEM does not need to cut itself off from a product it might want to buy in order to gain whatever efficiencies it seeks. The choice, in any event, should belong to the OEM.

3. Per processor licenses achieved no appreciable efficiencies

Exclusive dealing or total requirements contracts are often defended on grounds of efficiencies achieved. In passing, Microsoft trots out the argument here, and asserts it was "a method of simplifying the processes of contracting and accounting" for MS-DOS. **Licensing Memo**. at 6. Microsoft offers no explanation at all why this is true.[11] Any "problems" it had dealing with per system and per licenses arose *not* from some theoretical marketplace constraint, *but instead* from the complicated way in which Microsoft itself developed its contracting practices. *See* **Schmalensee Depo**. at 339-341. Moreover,

[11] As well, Microsoft offers nothing but unsupported and contradictory evidence to support its claim that OEMs requested per processor licenses to ease their administrative burdens. *See supra* ¶ 3.

Microsoft's per processor contracts imposed the same reporting requirements on OEMs as did its per system licenses; indeed, even under the per processor license, OEMs were still required to report to Microsoft the actual number of copies of MS-DOS shipped, just as under a per copy license. **Leitzinger Report** at 38-39. Microsoft leaves only deafening silence as to why it is easier for an OEM to account for the total number of computers shipped with a particular microprocessor — rather than account for the total number of computers shipped using a particular model number, or simply the total number of MS-DOS copies used.

D. Microsoft's Minimum Commitments and Increased Duration Contributed to This Exclusionary Effect

To defend its minimum commitments practice, Microsoft extolls the virtues of volume discounts. But Caldera does not object to the concept of volume discounts.[12] What Caldera objects to is Microsoft's imposition of a *non-refundable commitment to buy* through the minimum commitment arrangement. Unlike the volume discount cases cited by Microsoft, its minimum commitments required OEMs to make a prospective, binding commitment to meet certain levels and *then* make non-refundable quarterly payments in order to qualify for the volume discount. Once an OEM got over-committed (*i.e.*, where its prepayments exceeded the number of units actually shipped), it was locked into Microsoft if it wanted to recoup its prepaid balances. In such a circumstance, the minimum commitment had an even greater

[12] Ordinarily, volume discounting is associated with cost savings since increases in the volume purchased result in decreased production and transaction costs. However, the marginal cost to Microsoft of producing an additional unit of an operating system for an OEM is zero. Thus, no volume-related transaction costs exist where the OEM copies what it needs from the single copy of software provided by Microsoft.

exclusive effect than a pure requirements contract because the OEM had to "buy" even more than its actual requirements from Microsoft.

Microsoft has never offered a justification explaining why its volume discounts had to be structured in this way and, more importantly, why a traditional volume discount would not have achieved the same efficiencies allegedly provided by the minimum commitment. Microsoft's minimum commitments violate the Sherman Act for the simple reason that Microsoft is a monopolist, and must use devices that are "no broader than necessary to effectuate [its] business." *SCFC ILC, Inc. v. Visa USA, Inc.*, 36 F.3d 958, 970 (10th Cir. 1994); *see also Sullivan v. National Football League*, 34 F.3d 1091, 1103 (1st Cir. 1994) (a restraint is not reasonable "if a reasonable, less restrictive alternative to the policy exists that would provide the same benefits as the current restraint").

Microsoft suggests that minimum commitments were widespread in the industry. **Licensing Memo**. at 7. Even if that were true, widespread industry use of an exclusionary practice does not justify it; to the contrary, such widespread use may make the monopolist's use of exclusive dealing especially egregious because competition in the market is already dampened. *See Tampa Electric Co. v. Nashville Coal Co.*, 365 U.S. 320, 334 (1961) (pointing out that one of the serious problems with exclusive dealing invalidated in *Standard Oil Co.* v. *United States (Standard Stations)*, 337 U.S. 293 (1940), was that "there was an industry-wide practice of relying upon exclusive contracts"); *see also infra*, at 27-28 (noting that conduct which is legal when done by a non-dominant firm, may be illegal when engaged in by a monopolist).

Microsoft asserts, with scarcely any support,[13] that "[m]inimum commitments have no anticompetitive effects so long as the amounts to which OEMs committed themselves were reasonable estimates of their likely use of the licensed product (and there is no evidence to the contrary in this case)." **Licensing Memo**. at 7. Yet Microsoft's own documents — indeed, its OEM Sales Manual and a report to its Board of Directors — specifically note that Microsoft pushed OEMs to over-commit so as to give Microsoft leverage to block out would-be competitors. **Consolidated Statement of Facts** ¶ 294-96.

Microsoft's assertion — that minimum commitments can only have an anti-competitive effect if OEMs over-committed — overlooks the fact that Microsoft did not use minimum commitments in isolation. Rather, Microsoft used them in connection with per processor licenses and the unreasonable extension of the duration of the licenses.[14] Caldera's section 2 claim challenges the *entirety* of Microsoft's licensing

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[13] Without any development or explanation, Microsoft cites two cases dealing with liquidated damages provisions. The unremarkable conclusion is that such clauses are not exclusionary so long as they are reasonable. *See Barry Wright Corp. v. ITT Grinnell Corp.*, 724 F.2d 227, 238-239 (1st Cir. 1983); *In re 'Apollo' Air Passenger Computer Reservations Sys. (CRS)*, 720 F. Supp. 1068, 1075-76 (S.D.N.Y. 1989). Reasonable liquidated damages, however, serve a specialized function — *i.e.*, to calculate damages in the event of breach — and are the least restrictive alternative of achieving this purpose. Caldera's complaint is quite different: Microsoft's minimum commitment provisions are not the least restrictive means by which to implement a volume discount, and so "reasonableness" does not even enter the equation.

[14] The Department of Justice stated it this way: "Microsoft has further foreclosed the OEM channel through the use of long-term contracts with major OEMs, some expiring as long as five years from their original negotiation date. In some cases these contracts have left OEMs with unused balances on their minimum commitments, which Microsoft can allow to be used if the contract is extended, but which would be forfeited if the OEM does not extend the contract. These practices have allowed Microsoft to extend the effective duration of its OEM contracts, further impeding the access of PC operating system competitors to the OEM channel." 59 Fed. Reg. 42,845, at 42,850 (Proposed Final Judgment and Competitive Impact Statement).

practices, not merely each component individually. *See U.S. Healthcare, Inc. v. Healthsource Inc.*, 986 F.2d 589, 597 (1st Cir. 1993) ("Exclusive contracts might in some situations constitute the wrongful act that is an ingredient in the monopolization claims under section 2"); *see also* **Caldera's Motion to Strike Memo.** at 4-6 (totality of conduct must be considered under section 2).

Moreover, the extended duration of Microsoft's licenses meant that DRI or Novell only got the chance to "match" Microsoft's volume discount when licenses expired, which Microsoft was pushing from two to three years. *See* **Consolidated Statement of Facts** ¶¶ 150-154. Microsoft does not even dispute Caldera's allegation that Microsoft intentionally extended the license terms beyond the life-cycle of MS-DOS in an effort to foreclose DR DOS. Again, Microsoft's own documents show that this allegation is true. *See* **Consolidated Statement of Facts** ¶¶ 152-154. The exclusionary effect is almost tautological: If per processor licenses and minimum commitments were objectionable when executed two-years at a time, then they are 50% worse three-years at a time.[15] *See* **Consolidated Statement of Facts** ¶ 154 (Lieven testimony).

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[15] Microsoft's suggestion that longer-term exclusive dealings have been upheld in other cases, such as the 20-year requirement contract in *Tampa Electric*, is disingenuous. *See* **Licensing Memo.** at 8. This sort of raw, numerical comparison is obviously irrelevant: Microsoft would surely object if Caldera argued a one-year term was unreasonable because that was the length of the contracts invalidated in *Standard Oil Co.* v. *United States (Standard Stations)*, 337 U.S. 293 (1940). As *Tampa Electric* itself indicates, whether a durational term is reasonable turns entirely on the "particularized considerations" of the industry and product at issue. 365 U.S., at 334. And of course, Microsoft offers nothing other than bald assertion, without reference to industry structure or reality. *But see* **Consolidated Statement of Facts** ¶¶ 150-154 and Appendix A.

III. MICROSOFT'S "TOTAL SALES ROYALTY PROVISIONS" CASES ARE INAPPOSITE, AND OFFER NO PROTECTION IN ANY EVENT

Microsoft devotes the bulk of its argument to a line of cases dealing with the permissibility of calculating a patent royalty based on total sales, rather than actual use. These cases actually hurt Microsoft's defense, for their premise is that there is something improper about a seller charging something for nothing, even when the seller is, by virtue of his patent, a *lawful* monopolist. Here, Microsoft stands accused of using *unlawful* monopolization practices to achieve the same end.

Microsoft cannot avail itself by analogy to the total sales royalty defense, which is only a defense to patent misuse. This is a special creature of patent law designed to accommodate the unique features of patent licensing. Patent law sanctions such arrangements when it is difficult to determine whether a particular patent has been incorporated into a product, *e.g.*, when a patent is licensed as part of a package where many patents may be used in combination with each other and some not used at all. *See* E. Kintner & J. Lahr, AN INTELLECTUAL PROPERTY LAW PRIMER 69 (2nd ed. 1982). As a result, charging a royalty only for those products that incorporate the patent becomes an exceedingly complex task, and consequently total sales royalties are *permitted* for convenience sake. *See Automatic Radio Manufacturing Co. v. Hazeltine Research, Inc.*, 339 U.S. 827 (1950). Indeed, where it is difficult to determine if the patent is in use, the licensee is not really paying "something for nothing," even in the event the licensee does not use the patent: The licensee is, in effect, buying insurance against a claim of infringement by the licensor. *See Zenith Radio Corp. v. Hazeltine Research, Inc.*, 395 U.S. 100, 139-140 (1969). If the licensee only paid on a usage basis, the licensor could claim the patent made its way into a product on which the licensee did not pay a royalty, resulting in protracted litigation as the licensee attempted to prove the patent was not used.

No comparable justification exists in the record here. As the Areeda treatise explains, such policy considerations have no place in the context of operating system software whose use in a particular computer unit is easy to detect: It readily appears when you turn on the machine. *See supra*, at 4.

Finally, the total sales royalty cases cited by Microsoft, **Licensing Memo**. at 10-16, indicate that the law seeks to discourages a monopolist, whether lawful or not, from coercing lucrative royalties untethered from an actual sale. *See, e.g.*, *Hull* v. *Brunswick Corp.*, 704 F.2d 1195, 1199 (10th Cir. 1983) (meaningful alternatives must be made available). Caldera not only contends that Microsoft's pricing structure made any alternative to per processor licenses not meaningfully available, but also that Microsoft used naked coercion by offering only per processor licenses to OEMs who required Microsoft's monopoly product on some of its computers. *See* **Consolidated Statement of Facts** ¶¶ 302-04. This is precisely the sort of conduct condemned by the Supreme Court in *Zenith Radio Corp. v. Hazeltine Research, Inc.*, 395 U.S. 100, 140 (1969). Even given Microsoft's understanding of the law, a triable issue of fact exists as to whether Microsoft has satisfied a key requirement for utilizing the total sales royalty defense — *i.e.*, absence of coercion.

IV. MICROSOFT'S ATTEMPT TO ASSERT AN *IN PARI DELICTO* DEFENSE IS TO NO AVAIL

Microsoft argues, without development, that both DRI and Novell engaged in the same anti-competitive behavior as Microsoft. **Licensing Memo**. at 6. This allegation, even if true, would present no defense for Microsoft. Microsoft is a dominant monopolist with 90% market share. *See*

Consolidated Fact Statement at 2 n.2. As one court recently observed in a case involving a similarly dominant monopolist (Intel), the antitrust law imposes "affirmative duties" on monopolists to refrain from anti-competitive conduct. *Intergraph Corp. v. Intel Corp.*, 3 F. Supp. 1255, 1277 (N.D. Ala. 1998). Even conduct by a monopolist that is otherwise lawful may violate the antitrust laws where it has anti-competitive effects. *Image Technical Services, Inc. v. Eastman Kodak Co.*, 125 F.3d 1195, 1207 (9th Cir. 1997) ("Legal actions, when taken by a monopolist, may give rise to liability, if anticompetitive."); *Greyhound Computer v. IBM*, 559 F.2d 488, 498 (9th Cir. 1977), *cert. denied*, 434 U.S. 1040 (1978) (otherwise lawful conduct may be unlawfully exclusionary when practiced by a monopolist); *Oahu Gas Service, Inc. v. Pacific Resources, Inc.*, 838 F.2d 360, 368 (9th Cir. 1988), *cert. denied*, 488 U.S. 870 (1988) ("Because of a monopolist's special position the antitrust laws impose what may be characterized as affirmative duties").

Moreover, a monopolist cannot escape antitrust liability upon allegation that its victim may have engaged in similar conduct. *See* **Caldera's Product Pre-announcement Opposition** at 24-25. This is especially true given the conduct at issue. As Areeda & Hovenkamp explain, Microsoft's licensing practices had an anti-competitive effect precisely because of its dominant market position. *See* 11 P. Areeda & H. Hovenkamp, ANTITRUST LAW ¶1807b, at 117 ("Such a scheme is problematic, however, only when the defendant is a dominant firm in a position to force manufacturers to make an all-or-nothing choice.").

In any event, the licensing practices of DRI and Novell were fundamentally different from Microsoft's in that they were *not* exclusionary and were *in fact* justified by legitimate business reasons. *See supra* ¶¶ 6, 9.

CONCLUSION

For all of the foregoing reasons, Microsoft's Motion for Partial Summary Judgment Regarding Plaintiff's "Licensing Practices" Claims should be denied.

Respectfully submitted,

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I hereby certify that on April ____, 1999, true and correct copies of the above and foregoing instrument (Case No. 2:96CV0645B, U.S. District Court, District of Utah, Central Division) were sent via Federal Express to:

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