

COMMENT & ANALYSIS

How Brussels and Microsoft squared up

By Tobias Buck in Brussels

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It was March 17 2004 and Mario Monti was facing one of the toughest decisions of his career. The European Union's competition commissioner had returned to his flat overlooking the leafy Brussels quarter of Ixelles after yet another gruelling negotiating session aimed at resolving a long-running conflict with the world's most powerful technology group.

Microsoft had been the target of an antitrust probe by the Commission, the union's executive arm, for more than five years. What had started as a routine inquiry in December 1998 had escalated into a battle that was already being talked about as the biggest antitrust investigation in European history.

As Mr Monti reviewed the issues, he knew the affair was reaching a climax. His officials had patiently built what everyone in the Commission believed was a watertight case. Microsoft, they alleged, had abused its dominant position in the market for computer operating systems by strangling competition in the adjacent markets for media players and server software.

They believed they had sufficient evidence to find Microsoft guilty of breaking EU competition rules – and to impose what was certain to be a massive fine.

But that afternoon a team of senior executives led by Steve Ballmer, the group's forceful chief executive, had made him a tantalising offer. If he refrained from issuing a formal ruling against the group, Microsoft would address the Commission's key concern by agreeing to carry rival media-player software on its ubiquitous Windows operating system. It would also release a wealth of technical information about its flagship product to rival companies – allowing other developers to design products that worked smoothly with the Windows platform.

Both changes would be immediate and would apply across the globe.

Microsoft, the Italian commissioner knew, was dangling concessions that far exceeded anything achieved by antitrust agencies in the US or anywhere else. Cutting a deal with Microsoft would also avoid opening a new front against the US administration, which had been following the Commission's probe against an American business icon with growing concern. Most importantly, it would remove the threat of a legal challenge by Microsoft against the Commission decision – and the menacing prospect of years of litigation in the European courts.

"It was very tempting," Mr Monti recalls. "In terms of institutional pride we were home and dry." Yet there was one issue that still nagged at the bespectacled former economics professor. It was a point that Microsoft, despite Commission pleadings, had failed to resolve and that one senior Commission official encapsulated in the question: "How do we avoid seeing you again?"

Mr Monti and his advisers feared that if the Commission failed to rule against the company, there was nothing to stop Microsoft from using similarly aggressive tactics to limit competition in other markets. It had urged Microsoft to accept a settlement that would restrict the group's ability to add new features to Windows. But Mr Ballmer had refused

point-blank to accept any deal that would prevent it from enhancing the group's flagship product.

In Mr Monti's eyes, that intransigence outweighed all other considerations. The commissioner wanted a strong legal precedent, to draw a line in the sand that even the world's biggest and richest information technology group would hesitate to cross.

The following morning, he assembled his team of advisers and senior aides for one last discussion. One participant recalls: "Everybody was totally aware that we were about to take an extremely important decision and nobody wanted it to be wrong. We were stressed."

Mr Monti had before him the final report from the officials working on the case. It concluded that the group's latest settlement offer "does not address the concerns we expressed". A few hours later he announced his decision.

Consequences of Mr Monti's March 2004 ruling against Microsoft – which was accompanied by a record €497m (\$613m, £344m) fine imposed on the group – reverberate across the global technology industry to this day. The finding has cast a long shadow over both company and regulator and has raised as many questions as it answered.

How should regulators deal with a company as powerful as Microsoft? Should they intervene or leave market forces gradually to erode its monopoly? Are regulators agile enough to make sense of the fast-paced world of technology? And where should they draw the line between the need to promote competition and a company's right to defend its intellectual property?

Some of these questions will be addressed next week, when the European Court of First Instance opens a week-long hearing to examine Microsoft's appeal against the ruling. If the court throws out the appeal, it would open the floodgates to similar investigations against the group. Already, the Commission has set its sights on Microsoft's new operating system, called Vista, which is due out next year and into which the company plans to integrate ever more programs.

But if Mr Monti's decision does not stand, the Commission's ability to launch further antitrust probes against Microsoft would be severely constrained. Moreover, losing the biggest case it has ever conducted would dash the international standing of the Brussels regulator.

Such high stakes were unimaginable on the morning of December 14 1998, when a delivery van pulled up outside a granite-clad office block on Avenue Cortenbergh in Brussels' EU quarter and began unloading boxes.

Dispatched by Sun Microsystems, one of Microsoft's fiercest rivals, they contained a formal antitrust complaint as well as thousands of pages of economic data and legal analysis. The two had already clashed on antitrust matters in the US. Now Sun was taking the battle to Europe.

At the heart of the complaint was the assertion that Microsoft was withholding crucial information needed to make Sun's servers work smoothly with Windows-driven computers. It claimed that Sun, and companies like it, were as dependent on access to Windows as railway companies were on access to the only bridge spanning a river.

Sun's submissions had found their way to the home of the Commission's directorate-general for competition and state aid, known in Brussels as DG Comp. The unit in charge was C3, responsible for monitoring the software sector.

The unit had since 1999 been run by a hard-driving Spanish official called Cecilio Madero. As Microsoft would soon discover, the ex-banker's bull-like appearance was matched by an energy that inspired the team of young officials working under him.

Three officials – none of them much older than 30 when they started on the case – formed the core of the investigating team: Jean Huby, a young Frenchman whose quick mind and aggressive style in turn impressed and infuriated the Microsoft team; Oliver Sitar, an Austrian competition lawyer who left the team after Mr Monti's decision for a spell at a New

York film school; and Nick Banasevic, a soft-spoken British economist who joined from the Commission's foreign affairs directorate and is the only one still working on the case.

Lawyers would occasionally groan at Mr Huby's habit of organising 2am conference calls to discuss some aspect of the case. One Commission official who prides himself on his own work ethic remembers entering DG Comp's building at 6am one Sunday. He found Mr Huby preparing to leave after an all-night session on the case. But over the years, the three young men won the grudging respect even of the Microsoft team.

Indeed, anyone transplanted from Microsoft's corporate campus in Redmond, Washington, to DG Comp would find a number of similarities: a staff dominated by clever, scruffy young men in their thirties, an atmosphere of slight geekiness, long working hours, constant pressure to meet tight deadlines and a subtle sense of superiority over their peers in other departments.

Yet these similarities could not mask the fact that – in most respects – this was to be an uneven fight. The Commission had no more than half a dozen officials working on the case even during the busiest periods. It had a small budget to pay the occasional outside consultant and it would later have the support of its allies in the software industry. Microsoft's resources, however, were virtually limitless. It had its battle-hardened in-house legal team and enlisted the help of no fewer than four top law firms in New York and Brussels.

Over the course of the investigation, dozens of lawyers have racked up many thousands of billable hours on the group's behalf. Microsoft claims it has never worked out its total legal bill. But, with top competition lawyers charging more than €600 an hour, it must be eye-popping.

The man charged with orchestrating Microsoft's response to the Commission's challenge was Brad Smith, the group's general counsel. Mr Smith, a cheerful 48-year-old who graduated summa cum laude from Princeton, was no stranger to Europe. He had studied in Geneva, practised law in London and worked for Microsoft in Paris. Described by a Commission official as the archetypal "problem solver", his easy-going manner and understanding of the European legal and administrative tradition made him the natural man to resolve the conflict. And the company had reason to feel confident that a resolution was within reach.

Even as the European investigation was unfolding, Microsoft had seen off a threat in the US that at first made the Commission action look like a minor irritant. On June 7 2000 Thomas Penfield Jackson, a federal judge in the District of Columbia, had ordered Microsoft to be broken into two companies as a penalty for its antitrust abuses – the punishment that destroyed AT&T and John Rockefeller's Standard Oil Company in an earlier era.

But Judge Jackson's decision was overturned a year later and rivals had to content themselves with a much weaker requirement – set out in a 2002 settlement between the company and the administration of President George W. Bush – that Microsoft should divulge information about its operating system.

On the other side of the Atlantic, however, the European investigation was only just hitting its stride. From 2001 the Commission had been scrutinising not only the Sun complaint but also Microsoft's decision to integrate into Windows its Media Player software – which allows users to play music and film clips on their computers.

Mr Madero and his officials believed that packaging the two ran counter to a long-established rule that bars dominant companies from "tying" their main product to another one. The question was whether the behaviour violated Article 82 of the EU treaty – the provision that prevents companies from abusing their dominant position.

Typically, companies that face such a probe promise to change their behaviour and, in return, escape a fine and a formal ruling declaring that they acted illegally. Microsoft's Mr Smith says its own approach was clear from the outset. "The truth is that Microsoft's

strategy was to settle. For us the first priority was to have a constructive relationship with the Commission, so we decided to do everything in our power to reach a settlement.”

The group had learnt of the precise allegations against it on August 1 2000, when the Commission issued its initial “statement of objections” (SO) – in effect, the formal Commission charge-sheet. That was followed a year later by another SO, this time about Media Player.

The group contested the charges, filing responses that ran to more than 10,000 pages. But there was another issue that bothered Microsoft’s defence team: why, they wondered, did the SOs keep arriving in August, forcing lawyers, managers and software experts to cancel or curtail long-planned holidays?

The fourth SO – accusing Microsoft of failing to comply with the Monti ruling – broke the pattern...by arriving three days before Christmas 2005. One Microsoft lawyer sighed at the time: “I’ve kind of gotten used to it – but my wife hasn’t.” (The Commission insists timing was dictated by internal deadlines.)

But if the Commission’s tactics infuriated Microsoft, the bureaucrats also learnt to distrust their opponents. One manoeuvre did much to sour relations.

In early 2001, DG Comp received 48 letters from Microsoft customers – including Nato, the Irish police force, French army and German interior ministry. Their IT departments denied any “interoperability” problems between servers from different makers including Sun and Microsoft, suggesting that the Commission should back off. DG Comp’s officials found that some of the letters were identically worded – and appeared to have originated at Microsoft. “That was when we noticed that the Commission became really very, very aggressive,” one lawyer involved in the battle recalls.

The two sides finally began talking in early 2003 but it turned into a dialogue of the deaf. The Microsoft team felt stonewalled and thought the investigators were giving them no clue as to concessions they were seeking. “It was like a negotiation with ourselves,” one senior member of the group’s team complains.

The officials, meanwhile, were growing wary of what they saw as Microsoft’s waiting game – offering minuscule concessions while shying away from any solution that would address the Commission’s real concerns.

The stalemate continued until December 2003, when Mr Monti asked Philip Lowe, DG Comp’s director-general and its most senior civil servant, to head the final stage of negotiations. A deal, if there was to be one, had to be signed before May, Mr Monti insisted. He knew the accession of 10 countries to the EU on May 1 risked complicating matters.

Mr Lowe, a wiry Briton with a penchant for German poetry, had been chef de cabinet to Neil Kinnock when the former UK Labour party leader he was a Commission vice-president. One of the most respected officials in Brussels, Mr Lowe had been fascinated by the technical and legal complexities of the Microsoft case and was keen to be involved. Microsoft’s lawyers were equally happy to deal with him, discovering that, thanks to his seniority and natural diplomacy, he took a more flexible and creative approach. He also got on well with Mr Smith.

All through January, February and early March, Microsoft and the Commission met and – to everyone’s surprise – made substantial progress. Microsoft’s team felt upbeat. In just over two months, the group had managed to go a long way towards addressing the Commission’s concerns about interoperability and Media Player.

The question of how to avoid future clashes had been set to one side but Microsoft reasoned that the Commission’s remaining concerns on that score would not pose an insurmountable obstacle to a deal. As they approached the weekend of March 13-14, Mr Lowe and Mr Smith agreed it was time for the most senior men on each side to meet for one last round of negotiations. That meant bringing Mr Ballmer to Brussels.

The Commission had originally hoped that Bill Gates would fly in to lead the final stage of talks – a move that would have served as a powerful illustration of its authority over even the richest man in the world. But Mr Gates, who had taken a very visible role in the company's antitrust battles in the US, stepped down as chief executive in January 2000.

Instead, Mr Monti had to be content with a telephone conversation with the billionaire at 7pm on Monday March 15. It was a conference call that also included Mr Ballmer – who joined the discussion at Chicago airport en route to Brussels – as well as Mr Smith and a small group of top Commission officials.

After weeks of growing optimism in the Microsoft camp, however, Mr Monti's message was ominously stark. He would negotiate with the company the next day and, if need be, on Wednesday as well. Should the two sides fail to reach an agreement, he hoped they would find "some language" to prevent a damaging public spat. But on one point he would not be budged: there would be no talks beyond Wednesday night.

After five years in which mistrust had been tempered by a reluctant mutual admiration for the passion both sides had brought to the case, there was no mistaking the ultimatum.

Microsoft had exactly 48 hours to cut the deal on which its future depended.

The second part of this article follows on Friday

When Microsoft and Brussels went separate ways

By Tobias Buck in Brussels, FT.com site
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Steve Ballmer, Microsoft's hard-charging chief executive, grasped for the first time just how much trouble he was in not long after lunch on March 16 2004.

Hours earlier, as the software giant's five-year battle with the European Commission entered its endgame, he had landed in Brussels from the US to lead the final stage of negotiations.

His team was in high spirits, confident it was just a whisker away from an agreement that would allow the company to escape both a massive fine and a ruling that denounced its behaviour as anti-competitive. All the CEO would have to do, his high-priced legal talent was sure, was put his name to a deal.

But suddenly Mario Monti, the European Union's competition commissioner who had issued a settle-or-else ultimatum the previous day, had raised the stakes once more.

To avoid punishment, the company had thought, it needed simply to agree measures to address the two main concerns thrown up by the Commission's probe.

To that end, it was prepared to license potentially sensitive information about its operating system to rival companies keen to develop server software that would function smoothly with its Windows operating system. It was also prepared to create a level playing field in the market for media player software - by carrying three rival sound-and-vision products alongside the group's own Windows Media Player.

The optimism evaporated, however, when corporate chief and commissioner met in the competition directorate's sleek new building in a quiet Brussels side-street. The outcome would provide salutary lessons for executives worldwide about how to handle regulators who seek to trammel their business ambitions in the name of the public interest.

As they sat down together in Mr Monti's private conference room, the contrast between the Italian and the American could hardly have been greater: Mr Monti, an ascetic man who spoke with professorial precision and never departed from his written brief, faced Mr Ballmer, a ruddy-complexioned, beefy-handed extrovert known for having the loudest voice

in any room he occupied and possessor of an enthusiasm and self-belief that tended to drive all before it.

But now it was Mr Monti who was calling the shots. First he demanded a succession of small improvements to Microsoft's offer. Mr Ballmer accepted them without a murmur.

Then Mr Monti dropped what Microsoft saw as a bombshell (an interpretation the Commission rejects). The company had to agree not to integrate further programs of its own into Windows unless it also offered an "unbundled" version that did not contain the new program. Consumers would be served by nothing less, he insisted.

Mr Ballmer and Brad Smith, Microsoft's general counsel, felt blind-sided. They believed the demand went beyond anything mooted in the months of discussions the team had held with Mr Monti's subordinates. Microsoft, they told the commissioner, could not sanction a deal that would severely limit the company's ability to improve its flagship product. "They said: 'Any wording of this kind goes against our fundamental business model of developing an integrated system'," one Commission official recalls.

Mr Ballmer and Mr Smith asked to meet alone with Philip Lowe, the competition department's top civil servant who for months had headed its negotiating team, and Mr Monti. According to two participants, the Microsoft executives took the gloves off - warning that if the case came to court, big legal weaknesses would be exposed and supporters in the industry would desert the Commission. "You will have to face this battle alone," Mr Smith told Mr Monti.

According to people present, he added: "I want you to know that at the moment you have a bunch of companies asking you to do this but at the same time they are coming to us, asking for a settlement, asking for money. By the time this goes to the court, every one of these companies will abandon you. They will all settle with us." (His prediction proved accurate: Sun, Novell, RealNetworks and the Computer and Communications Industry Association representing numerous other makers, all settled their disputes with Microsoft - forcing the group to pay out more than \$5.3bn in the process.)

Mr Monti stood his ground. The Commission, he told the two men, had joined battle with Microsoft not to help the company's rivals but to uphold the law and, ultimately, defend the interests of European consumers. He told a deflated Microsoft delegation they must draft a new "letter of commitments" to present to the Commission the next morning.

Mr Ballmer, Mr Smith and other lawyers worked on the letter deep into the night. At 2am Bill Gates, the company's billionaire founder, endorsed the new offer by telephone. But when talks resumed it was immediately obvious that for Mr Monti it was too little, too late. One senior Commission official says: "On the future, [Microsoft] basically said: 'We will consult you'."

It was irresistible force versus immovable object. The Commission was determined that Microsoft should accept real constraints on its future ability to integrate elements into the Windows package. With equal adamance, Microsoft opposed an outcome that would undermine the very strategy on which the group's success had been built.

When the two sides parted later that Wednesday, the Microsoft team was all but certain that the battle had been lost. The next day, they knew it for sure. There was a last meeting between Messrs Monti, Lowe, Ballmer and Smith. The atmosphere, one participant recalls, was "cordial" and there were even some jokes. Mr Ballmer winced when he learned the official ruling would probably be issued on March 24 - his 48th birthday. "I am not sure that is what you wanted as a present," Mr Monti told him.

Fortunately, perhaps, the two sides were unaware that this was to be the warmest meeting for months. Soon afterwards, they began to argue over the precise meaning of Mr Monti's ruling and the obligations it imposed on Microsoft, in what turned into a pernicious cycle of mutual obfuscation and incomprehension.

Everyone has a theory about why Microsoft failed to secure a deal. In private, several members of Microsoft's defence team do not hide their anger, alleging that the Commission was bent from the start on ruling against them. One says: "We were tried and convicted when the process was started. That's our feeling. The rest was just formality."

A senior Microsoft attorney couches his criticism of the Commission in the form of "regrets". Above all, he regrets that the Microsoft team did not insist on negotiating with high-level Commission officials earlier. "If we had started talking in June 2003 [with Mr Lowe] we might just have been able to make more progress," he adds.

Naturally, officials at DG Comp, the Commission's directorate-general for competition and state aid, recall the negotiations very differently. Officials maintain it took Microsoft until the beginning of 2004 - only weeks before the final ruling - to make a meaningful offer. "Everything they did, they did too late. They were playing poker games," one member of the case team declares.

Arguably, the negotiations had been bedevilled from the start by a clash of cultures. Microsoft approached the Commission as if theirs was a disagreement between equals. Yet the Commission felt towards Microsoft as a judge towards a thief caught red-handed - the notion of negotiating with the group on level terms was preposterous.

Microsoft's decision to employ tactics similar to those it would have used with suppliers or customers annoyed a regulator charged with defending the public interest.

The Commission, meanwhile, never believed its job was to grease the wheels of a deal. DG Comp had identified a problem, which Microsoft could choose to resolve by coming forward with a solution. If not, it would be resolved through the imposition of a formal ruling. Since the end would be the same, DG Comp had no preference as to means.

Microsoft was by no means the first US group to misread the Brussels regulator. General Electric famously failed to realise at first that its takeover bid for Honeywell required Commission approval, and later made things worse through its none-too-subtle lobbying tactics. Even European companies are regularly bewildered by the complex procedures and awesome powers of DG Comp - a problem felt all the more keenly by executives from the other side of the Atlantic.

And yet, despite these differences, the two came surprisingly close to agreeing terms. Mr Monti notes approvingly that the group never resorted to the heavy-handed approach GE deployed. Yet he is clear about why agreement between the two sides proved impossible.

Ultimately, he says, "it was really about a crucial aspect of their business model that was incompatible with competition law and consumer interest". Compromise - for either side - was just not an option.

It is now more than two years since Mr Monti issued his ruling - years in which relations between the two sides have become more fractured than ever. He left office in November 2004 and now serves as president of Italy's respected Bocconi university and an "international adviser" to Goldman Sachs, the investment bank. He is considered a potential Italian finance minister.

Today the EU competition directorate is headed by Neelie Kroes, a former Dutch transport minister and businesswoman. Microsoft had hoped her arrival would mark a fresh start.

But the complexity of Mr Monti's ruling swiftly came back to haunt the new commissioner.

Through much of 2005, the officials in Brussels and the lawyers at Microsoft found themselves in a stand-off as frustrating as the one they had experienced ahead of Mr Monti's ruling. At its heart was a disagreement over how much technical information Microsoft was obliged to surrender to rivals.

The group says it was waiting for the Commission to say exactly what it should do. However the team at C3, the DG Comp electronics unit headed by Cecilio Madero, a Spanish ex-

banker, thought their opponent was trying to stall the process. They felt Microsoft had failed to draw up "complete and accurate" interoperability information as required by the ruling.

The case is continuing but the Commission appears poised to impose fresh fines on the group - they will be levied until it is satisfied that Microsoft has fully complied with the 2004 ruling. Brussels has threatened to impose a daily penalty of up to €2m.

Every conflict produces winners and losers, yet in the case of the six-year antitrust battle between the Commission and Microsoft the two are not easy to distinguish.

True, Microsoft singularly failed in its drive for a negotiated settlement and has failed ever since to draw a line under the costly battle with Brussels. But the Commission has little cause for celebration. Even DG Comp's supporters in the software industry admit the two remedies imposed by the Commission over Media Player and interoperability have failed to achieve their desired effect.

More than two years after Mr Monti's ruling, no more than 1,400 versions of unbundled Windows have been shipped to PC manufacturers and consumers. As many observers predicted at the time, a failure to force Microsoft to price the bundled and unbundled versions differently meant there was little incentive for anyone to buy Windows without Media Player. The interoperability remedy, on the other hand, proved so complex that, far from resolving the case, it has spawned an entire new one.

To date, no company has taken out a licence on Microsoft's technical documentation (showing, in Microsoft's mind, how pointless the order was and, in the Commission's view, how successful the group has been in torpedoing it).

In the meantime, Microsoft's share of both the media player and server market has continued to increase. Despite the Commission's efforts, the group's use of its monopoly power in operating systems to conquer adjacent markets has been wildly successful.

Much hangs on the outcome of the appeal hearing that opens next week at the European Court of First Instance - not only for the Commission but for Mr Monti personally.

Although he is still widely admired in Brussels for his integrity and intellect, Mr Monti also presided over several other highly controversial rulings, some of which were thrown out by European courts. Critics see that as an embarrassment but supporters believe it smacks of personal courage. One lawyer says: "Mario Monti had all these negative court cases against him. He was on the ropes and then he took on the biggest company in the world. That is impressive."

Even some Commission officials glumly acknowledge, though, that the balance of power may have tilted against the regulator. Microsoft, some say, is simply too big, too powerful and able to fight on too many fronts simultaneously to be curbed by Brussels.

"If they are successful in even half the things they are trying to do, I believe Microsoft will become a real problem. You cannot have so much power in so few hands," one DG Comp official laments.

Already, the group's rivals are complaining that Microsoft is busy stamping out the next competitive threat - the challenge posed by internet-based applications. Again, they have turned to the Commission, filing a complaint to Brussels in late February. Mr Madero's C3 unit is once more leading the charge. The software industry is again lining up behind the two camps. Law firms are being hired and more complaints may be filed.

To the officials and lawyers who fought each other almost to a standstill in the five years from December 1998 it must all provide an unsettling sense of *déjà vu*. Throughout the long days and nights they worked on the case, they knew they were taking part in something momentous: the biggest antitrust fight in European history.

But the real war, it seems, may have only just begun.