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Did the Per Se Rule on Tying Survive 'Microsoft'?

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Tying arrangements can have seriously anticompetitive effects. Many years ago, the A.B. Dick Company used its control of the mimeograph machine to dominate the market for mimeograph paper,[1] and patents on film projectors were used to cartelize the entire motion picture industry.[2] These actions were instrumental to the congressional decision to pass section 3 of the Clayton Act, which governs tying of commodities.

So effective were tying arrangements in eliminating competition in these and other instances that the Supreme Court was able to state in 1949, with apparent assurance, that "tying agreements serve hardly any purpose beyond the suppression of competition,"[3] – justifying the per se prohibition of tying it had articulated two years earlier in *International Salt Co. v. United States*.[4]

There was a problem, however, with the *International Salt* analysis. Simply put, the Court's reasoning – and the per se rule for tying itself – were clearly wrong.

One of the many important aspects of the recent decision by the Court of Appeals for the District of Columbia in *United States v. Microsoft Corp*.[5] is its contribution to the erosion of the per se tying rule. In rejecting application of the per se rule to "platform software products," the court of appeals carved out what might be called a "technology exception" to that rule, reasoning that, in the "pervasively innovative" platform software industry, traditional per se analysis risks condemning ties that may be welfare enhancing and procompetitive. In spite of the court's protestations to the contrary, however, the rationale it articulated for abandoning per se condemnation applies well beyond just the software industry.

Modern Tying Standard

Judicial analysis of tying arrangements has evolved considerably since the early Supreme Court cases applying the per se rule to tying arrangements. Over time, courts (as well as commentators) have increasingly recognized the many procompetitive benefits of tying, such as improving quality, lowering costs, facilitating new entry, and increasing price competition. In order to allow such welfare enhancing tie-ins to escape condemnation, courts have become more willing to undertake the type of market analysis inimical to the traditional per se rule, such as weighing efficiency justifications and evaluating the market impact of tie-ins.[6] The resulting tying doctrine "is unique in that the courts simultaneously declare tying unlawful per se and hear justifications as a matter of course."[7]

Tying doctrine today is governed largely by the decision in *Jefferson Parish Hospital District No. 2 v. Hyde*.[8] The Supreme Court there unanimously upheld an arrangement in which a hospital required its surgical patients to use the services of a firm of anesthesiologists with whom it had an exclusive contract. A 5-4 majority concluded that the per se rule against tying should still apply; the four concurring justices urged abandonment of the per se label.

Writing for the Court, Justice John Paul Stevens narrowed the scope of the per se prohibition in two important respects. First, the Court established as a threshold element to an unlawful tying arrangement a showing that there is significant market power in the tying product market, such that the power is of "the degree or the kind" that enables the seller of the tying product to "force" customers to purchase the tied product.[9]

Second, the Court imported an efficiency analysis into the traditional test for determining whether there are in fact two separate products being unlawfully tied. In determining whether or not there are two separate products, the Court required proof that "there is a sufficient demand for the purchase of [the tied product] separate from [the tying product] to identify a distinct product market in which it is efficient to offer" the two separately.[10]

The '*Microsoft*' Ruling

The district court in *Microsoft* concluded that the bundling of Internet Explorer (the "tied" product) with the Windows operating system (the "tying" product) was unlawful per se. The court of appeals reversed, holding that in tying arrangements involving "platform software products," the rule of reason rather than per se analysis should apply.[11]

Notwithstanding its attempt to limit the force of its ruling to the platform software industry, the court of appeals articulated a compelling rationale for discarding the per se rule against tying altogether. In substance, the court's analysis demonstrates that, to identify those tying arrangements that harm competition, a market analysis to measure net efficiencies is indispensable, and the *Jefferson Parish* "demand" test provides a poor proxy to measure such efficiencies under the guise of a per se analysis.

Microsoft's principal defense against the tying allegation was that Windows and IE are not in fact separate products, as required by *Jefferson Parish*, but rather a technologically integrated single product much as, for example, a spell checker technologically integrated into word processing software. The court of appeals interpreted the *Jefferson Parish* separate products analysis as a "rough proxy for whether a tying arrangement may, on balance, be welfare-enhancing, and unsuited to per se condemnation."[12]

The court also concluded, however, that this proxy was too "rough," in that it allowed important productive integrations to be condemned too easily as a per se unlawful tie:

> *Jefferson Parish* does not endorse a direct inquiry into the efficiencies of a bundle. Rather, it proposes easy-to-administer proxies for net efficiency. In describing the separate-products test we discuss efficiencies only to explain the rationale behind the consumer demand inquiry. To allow the separate-products test to become a detailed inquiry into possible welfare consequences would turn a screening test into the very process it is expected to render unnecessary.[13]

In defending the per se result reached in the district court, the government argued that the Jefferson *Parish* separate products test was sufficient to take account of the claimed technological benefits of integrating IE with Windows. Because that test looks not just to the existence of separate demand, but also to the efficiency of separately providing the two products, the Antitrust Division argued that it would by implication capture any technological benefits of integration by measuring whether any such benefits would be lost if IE and Windows were provided separately.[14] The court of appeals flatly rejected this contention, stating:

> If integration has efficiency benefits, these may be ignored by the *Jefferson Parish* proxies. Because one cannot be sure beneficial integration will be protected by the other elements of the per se rule, simple application of that rule's separate-products test may make consumers worse off.[15]

Ultimately, the D.C Circuit found that the consumer demand and industry custom inquiries applied in *Jefferson Parish* were "backward-looking and therefore systematically poor proxies for overall efficiency in the presence of new and innovative integration."[16] In its harshest, if somewhat veiled, criticism of *Jefferson Parish*, the court acknowledged that the analytical framework of *Jefferson Parish* not only has the potential to ignore welfare-enhancing efficiencies, but may in fact "make consumers worse off."[17]

The court of appeals' dissatisfaction with *Jefferson Parish* was also apparent in applying another aspect of the *Jefferson Parish* separate products test: examining the conduct of other competitors in the market. Microsoft argued that it was the only company that required non-removal of its browser from its operating system because it alone had invested the resources to fully integrate IE into the Windows operating system. The court acknowledged the potential impotence of *Jefferson Parish*'s separate products test in the face of new technology: "Microsoft's implicit argument — that in this case looking to a competitive fringe is inadequate to evaluate fully its potentially innovative technological integration, that such a comparison is between apples and oranges — poses a legitimate objection to the operation of *Jefferson Parish*'s separate products test for the per se rule."[18]

After finding the *Jefferson Parish* separate products test inappropriate in the platform software context, the circuit court next addressed the broader question of why the per se analysis should not be applied "off the shelf" in this case. The principal reason was what the court claimed to be the lack of "judicial experience" with the platform software industry — especially with regard to the "sufficiently novel" efficiency justifications Microsoft raised, such as the claim that the bundling of IE with Windows not only benefited consumers, but also competitors, because such a tie-in made Windows a better applications platform for third-party software.

In characterizing the industry as "pervasively innovative," the court also expressed concern that tying in such markets may produce efficiencies that "the Supreme Court had not factored into the per se rule as originally conceived."

Net Efficiency Gains

The D.C. Circuit's considerable effort to confine its tying ruling to software ultimately fails. Its reasoning logically leads only to the conclusion that it was unwilling to expressly articulate: that the measuring of net efficiency gains of a tie-in should be a prerequisite to striking it down, and tying therefore should always be analyzed under the rule of reason. The following passage is instructive:

> We do not have enough empirical evidence regarding the effect of Microsoft's practice on the amount of consumer surplus created or consumer choice foreclosed by the integration of added functionality into platform software to exercise sensible judgment regarding that entire class of behavior.[19]

How, absent a full-blown market analysis, is the quantification of consumer surplus on the one hand, or market foreclosure on the other, possible? Substitute "widgets" for "platform software," and the logic is equally compelling — absent such a market analysis, courts risk results that might ultimately make consumers worse off.

The court of appeals' reliance on the unique aspects of software integrations and the judiciary's "lack of experience" with them as a justification for a "platform software" exception to the per se rule is unconvincing. In fact, in another portion of the opinion, the circuit court rejected Microsoft's argument that the "technologically dynamic" aspects of the affected markets warranted a more lenient application of monopolization doctrine than would otherwise be applied.[20]

The Supreme Court has explicitly instructed that lack of judicial experience with a particular industry — as opposed to a type of practice — does not justify carving out an exception to an otherwise applicable per se rule. In *Arizona v. Maricopa County Medical Society*,[21] the Court said that "the argument that the per se rule [against price fixing] must be rejustified for every industry that has not been subject to significant antitrust litigation ignores the rationale for per se rules, which in part is to avoid 'the necessity for an incredibly complicated and prolonged economic investigation into the entire history of the industry involved.'"[22]

The *Microsoft* court itself acknowledged, with an apparent wink, that its reasons for rejecting the per se rule "may at times appear to have broader force" than platform software — although it formally cautioned against reading its decision as "setting a precedent for switching to the rule of reason every time a court identifies an efficiency justification for a tying arrangement."[23]

The "broader force" of the court of appeals' reasoning, however, is little tempered by arguments that the software industry is sufficiently "novel" and unique to merit a special carve-out from the per se rule against tying. The court of appeals persuasively articulated the harm that per se condemnation of tying entails, but nothing in its reasoning argues against the existence of those same risks in traditional brick and mortar industries.

Implications

Although the court of appeals persuasively articulated why the per se rule against tying is inconsistent with basic objectives of antitrust policy, the decision's outcome is problematic. By dancing around the per se rule to avoid a harsh result in the *Microsoft* case, the court may be perpetuating some of the very policy errors its decision sought to avoid. As the Supreme Court has said on several occasions, lower courts — even a prestigious court of appeals sitting en banc — lack power to overrule prior Supreme Court decisions.[24]

A stark adherence to the per se precedents in *Microsoft*, however, coupled with a candid discussion of the problems associated generally with the per se rule, might have hastened the day when the Supreme Court will have to face up to the necessity of overruling some of its own prior precedents.

That day will still come — eventually. But with the disposition in *Microsoft*, it may not be for years.

Confronted with a similar anachronism, the per se rule against vertical maximum price fixing, the U.S. Court of Appeals for the Seventh Circuit in *Khan v. State Oil Co.*,[25] took a different approach. Writing for the court there, Judge Richard Posner dutifully applied the per se rule while carefully explaining its shortcomings and requesting the Supreme Court to put it to rest. Within a year, the Supreme Court unanimously did just that.[26]

Given the case's overall importance, the D.C. Circuit in *Microsoft* might have reasonably concluded that an expeditious outcome to the case itself — rather than an invitation to certiorari — was more in the national interest. But if that was indeed the court's rationale, it is difficult to ascertain from the text of the decision.

Conclusion

So what now — especially for those of us who have to deal with the per se tying rule on a daily basis? Until the Supreme Court revisits its *Jefferson Parish* ruling, corporate counselors must still assume that, if the per se criteria of that case are met, the client's bundling arrangements may be found illegal — irrespective of whatever efficiency justifications there might be.

Although the Supreme Court has recently recognized that the "categories of analysis of anticompetitive effect are less fixed than terms like 'per se,' 'quick look,' and 'rule of reason' tend to make them appear,"[27] the risk-averse business will have to forego a means of marketing and distribution that might well yield substantial consumer benefits.

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(1) *Henry v. A.B. Dick Co.*, 224 U.S. 1 (1912).
(2) *Motion Picture Patents Co. v. Universal Film Mfg. Co.*, 243 U.S. 503 (1917).
(3) *Standard Oil Co. v. United States*, 337 U.S. 293, 305-06 (1949).
(4) 332 U.S. 392, 396 (1947).
(5) — F.3d — (D.C. Cir. 2001) (en banc).
(6) See, e.g., *United States v. Jerrold Electronics Corp*., 187 F. Supp. 545 (E.D. Pa. 1960), aff'd per curiam, 365 U.S. 567 (1961); *Betaseed, Inc. v. U & I Inc*., 681 F.2d 1203 (9th Cir. 1982).
(7) 10 P. Areeda & H. Hovenkamp, *Antitrust Law* ¶ 1760, at 354 (1996).
(8) 466 U.S. 2 (1984).
(9) Id. at 17-18.
(10) Id. at 21-22.
(11) *Microsoft*, slip. op. at 69.
(12) *Microsoft*, slip op. at 74.
(13) Id. at 75.
(14) Brief for the United States, p. 105.
(15) Slip op. at 77.
(16) Id. at 76-77.
(17) Id.
(18) Slip op. at 76.
(19) Slip op. at 85.
(20) Slip op. at 11-13.
(21) 457 U.S. 332 (1982).
(22) Id. at 351 (citations omitted).
(23) Id. at 86.
(24) See, e.g., *Thurston Motor Lines, Inc. v. Jordan K. Rand, Ltd.*, 460 U.S. 533, 535 (1983).

(25) 93 F.3d 1358 (7th Cir. 1996).
(26) State Oil Co. v. Khan, 522 U.S. 3 (1997).
(27) *California Dental Ass'n v. FTC*, 526 U.S. 756, 779 (1999).