

# Microsoft Manages Legal and Ethical Issues

## INTRODUCTION

When Bill Gates and Paul Allen founded Microsoft in 1975, they had no idea that their company would become the world's leading supplier of software for personal computers. With annual revenues of more than \$77 billion, Microsoft Corporation is a leader in the technology industry. Its business is based on developing, manufacturing, and licensing software and electronics, including operating systems, gaming devices, productivity software, and Internet software and services. In addition, the company's extensive social responsibility efforts focus on information technology and underserved communities around the world. Microsoft has faced legal and ethical issues that have tested its reputation; however, the company has survived the threat of a breakup, changes in its leadership, and multiple legal battles, including antitrust charges in the United States and the European Union. Today, Microsoft is still not only the world's leading distributor of computer software but is also a leader in corporate social responsibility (CSR) and philanthropy.

## ETHICS AND SOCIAL RESPONSIBILITY AT MICROSOFT

Microsoft has a positive reputation based on its brand image, product quality, history of innovation, and numerous philanthropic and educational programs. The company has consistently topped the Cision Corporate Media Reputation Index, which ranks companies based on positive coverage in the media. Microsoft has created several charitable and socially responsible programs that help the company and its employees to achieve their corporate mission, "[T]o enable people and businesses throughout the world to realize their full potential."

Microsoft's Corporate Citizenship strategy focuses on "increasing opportunities and helping solve societal challenges in communities around the world." The company emphasizes issues that Microsoft and its shareholders believe are most important for the company's global business, including strengthening economies, addressing societal challenges, promoting a healthy online ecosystem, and operating responsibly.

Microsoft's community initiatives include workforce development, disaster and humanitarian responses, and improving nonprofits' access to technology. In addition, when Microsoft employees donate to the annual giving campaign, the company matches their contributions up to \$12,000. In 2012 Microsoft and its employees donated \$100 million as well as thousands of volunteer hours to nonprofit organizations including low-income

housing developments, the YMCA, Easter Seals, Boys and Girls Clubs of America, museums, and schools.

One of the key community programs at Microsoft is Unlimited Potential (UP). UP strives to bring the benefits of information and communications technology to underserved communities around the world by transforming education, fostering local innovation, and creating jobs and opportunities. Another important program is Libraries Online, through which Microsoft provides computers, cash, and software to help link libraries to the Internet. The goal is to enable people who may not have access to computers to learn about PCs, explore the latest software, and experience the Internet. Microsoft has extended this program to include nonprofit organizations that provide veterans and their spouses with the support they need to successfully transition to civilian careers.

Microsoft also contributes to global economic growth, job creation, and innovation. The company has more than 100,000 full-time employees globally, including 41,000 international employees. In addition, Microsoft relies on a network of partners that are valuable to their own communities to generate further innovation, growth, and opportunity. It also runs programs to support start-up software companies. Microsoft estimates that these business partnerships create nearly 15 million information technology jobs globally.

Microsoft has stated that it is committed to responsible and sustainable business practices that consider the social and environmental consequences of its actions. In addition to several recycling and carbon reduction programs, the company also strives to make its products efficient. Additionally, Microsoft works with businesses, governments, and law enforcement agencies to combat cybercrime and find joint solutions to keep people safer online. To achieve the long-term interests of the company's shareholders, Microsoft takes into account the needs of other stakeholders, including employees, customers, partners, suppliers, and the many communities around the world where it does business.

Even though he stepped down from his daily role at the company several years ago, the brand name and reputation of Microsoft seems inseparable from Bill Gates, and Microsoft has benefitted from the positive public associations related to the philanthropic efforts of the Bill & Melinda Gates Foundation. The Gates started the foundation in 1994 to improve philanthropic endeavors that address global health and community needs. Warren Buffet joined Bill and Melinda Gates as a director in 2006 after donating \$31 billion in stock to the foundation. In 2010 the Bill & Melinda Gates Foundation granted \$2.6 billion to improving global health, development, and education. With a \$37.1 billion endowment, the Bill & Melinda Gates Foundation is currently the world's largest philanthropic organization.

Microsoft also prides itself on its ethical standards. The company says, "We aim to be open about our business operations, transparent in our dealings with stakeholders, and compliant with the laws and regulations that apply to our business. We strive to exceed legal requirements by conducting our business ethically, responsibly, and with integrity." All Microsoft employees must follow the Microsoft Standards of Business Conduct and receive training in ethics and compliance. Microsoft's vendors are also subject to ethical standards under the Vendor Code of Conduct, which exists in over 35 languages. The company has

several programs dedicated to antitrust compliance and responsible competition due to a decade of legal issues surrounding its dominance of the software market.

## LEGAL ISSUES IMPACTING MICROSOFT

Microsoft is in a highly competitive and constantly evolving industry. Software firms try to protect their competitive advantage through constant innovation, and conflicts have developed between Microsoft and its competitors related to anticompetitive activities and intellectual property disputes.

### ANTITRUST ISSUES

In 1990 the Federal Trade Commission (FTC) began investigating Microsoft for possible violations of the Sherman and Clayton Antitrust Acts, which limit monopolies and anticompetitive activities. By August 1993 the FTC was deadlocked on a decision regarding possible violations and handed the case over to the U.S. Department of Justice. Microsoft eventually agreed to settle the charges without admitting any wrongdoing. Part of the settlement provided the Department of Justice with complete access to Microsoft's documents for use in subsequent investigations.

Another important part of that settlement was a provision to end Microsoft's practice of selling Windows to original equipment manufacturers (OEMs) at a 60 percent discount. OEMs received the discount only if they agreed to pay Microsoft for every computer they sold (a "per processor" agreement) as opposed to paying Microsoft for every computer they sold with Windows preinstalled (a "per copy" agreement). If an OEM wished to install a different operating system on some of its computers, the manufacturer would, in effect, be paying for both the Microsoft and the other operating system—that is, paying "double royalties." Critics argued that this practice was unfair to both consumers, who effectively paid Microsoft even when they bought a rival operating system, and manufacturers, because it made it uneconomical to give up the 60 percent discount in favor of installing a less popular operating system on some of its computers. It appears that Microsoft was using its large share of the market to squeeze out smaller companies.

Competitors claimed that Microsoft's business practices were monopolistic. A monopoly power, as defined by the Supreme Court, has the "power to control prices or exclude competition." A monopoly may engage in practices that any company, regardless of size, could legally employ; however, it cannot use its market power to prevent competition. Competitors and government regulators believed that Microsoft was acting as a monopoly power and engaging in unfair competition.

The next legal battle for Microsoft was against Apple Computer, which accused Microsoft's CEO, Bill Gates, of threatening to stop making Macintosh-compatible products if Apple did not stop developing a competing software product. Because Microsoft was the largest producer of Macintosh-compatible programs, Apple argued that it was being forced to choose between a bad deal and extinction. Apple also alleged that Microsoft would not send

copies of Windows 95 until Apple dropped Microsoft's name from a lawsuit. The two companies eventually worked out their differences, and in 1998, Microsoft bought \$150 million of nonvoting stock in Apple and paid \$100 million for access to Apple's patents. Once again, Microsoft seemed to be using its market power to force a competitor to play by Microsoft's rules.

Another legal issue for Microsoft was Sun Microsystems' trademark and breach-of-contract case against the company, accusing Microsoft of deliberately trying to sabotage Sun's Java "write once, run anywhere" promise by making Windows implementations incompatible with those that run on other platforms. Specifically, the suit alleged that Microsoft's Javacompatible products omitted features that help developers write Java code. Sun acknowledged that Microsoft had fixed some of the earlier problems but added two new alleged incompatibilities to its list.

In 1998 Sun requested an injunction that would require Microsoft either to make the Java features compatible with its tests or include Sun's version of Java with every copy of Windows sold. In 2000 the Ninth District Court of Appeals ruled that it was software developers and consumers, not Sun, who would decide the value of Microsoft's language extensions. The court ruled that the compatibility test was a contractual issue, not a copyright issue. Furthermore, Sun's motion to reinstate the injunction on the basis of copyright infringement was denied. Microsoft was allowed to support its development tools with its own Java enhancements.

After various companies, particularly Netscape Communications, continued to complain about Microsoft's anticompetitive practices, the federal government took an aggressive stand, charging Microsoft with creating a monopolistic environment that substantially reduced competition in the industry. Microsoft settled the charges in 1995 and consented to stop imposing anticompetitive licensing terms on PC manufacturers by tying its software to its operating systems.

In October 1997 the Justice Department asked a federal court to hold Microsoft in civil contempt for violating the terms of the 1995 consent decree and to impose a \$1 million-per-day fine. This time the issue was over Microsoft's "bundling" of its Internet Explorer web browser into the Windows 95 operating system. Microsoft argued that Internet Explorer was an integral, inseparable part of Windows 95 and that it had not bundled the browser technology solely to disadvantage rivals such as Netscape. A U.S. District Court judge disagreed and issued an injunction prohibiting the company from requiring Windows 95 licensees to bundle Internet Explorer with the operating system. Microsoft filed an appeal; meanwhile, it supplied PC makers with a version of Windows 95 that did not have Internet Explorer files. However, the product would not boot, a problem that Microsoft later admitted it knew about beforehand. Consequently, the Justice Department asked the district court to hold Microsoft in contempt. Microsoft's stock price began to drop. Possibly fearing larger stock devaluation, Microsoft agreed to provide computer vendors with the most up-to-date version of Windows 95 without the Internet Explorer desktop icon.

At the same time, Microsoft denied all of the essential allegations, arguing that it had planned to integrate Internet Explorer into the Windows operating system long before rival Netscape even existed. Microsoft argued that its Internet Explorer was gaining popularity with consumers for the simple reason that it offered superior technology. In addition, Microsoft rejected allegations that the company had tried to “illegally divide the browser market” with rival Netscape and denied that it had entered into exclusionary contracts with Internet service providers or Internet content providers. Finally, Microsoft argued that it did not illegally restrict the ability of computer manufacturers to alter the Windows desktop screen that users see when they turn on their computers for the first time.

Like other software products, Microsoft products are protected by the Federal Copyright Act of 1976, which states that copyright owners have the right to license their products to third parties in an unaltered form. Microsoft asserted a counterclaim against the state attorneys general alleging that the officials were inappropriately trying to use state antitrust laws to infringe on Microsoft’s federal rights.

## MICROSOFT ON TRIAL

In 1998 the federal government, along with 20 states, charged Microsoft with monopolistic practices in the computer software business. The three primary issues raised in the lawsuit were (1) bundling the Internet Explorer Web browser with the Windows 98 operating system to damage competition, particularly Netscape Communications, Inc., (2) using crosspromotional deals with Internet providers to extend its monopoly, and (3) illegally preventing PC makers from customizing the opening screen showing Microsoft.

In August 1998, the deposition of Microsoft management began in Redmond, Washington. CEO Bill Gates was placed under oath and before a camera for 30 hours. During the deposition, Gates refused to answer most questions on his own, and it seemed that Gates was not concerned about the forthcoming trial.

The trial began on October 19, 1998, with the government accusing Microsoft and Gates of illegal bullying, coercion, and predatory pricing to undermine Netscape. Gates denied being concerned about Netscape’s increasing browser market, but memorandums and email messages presented in court suggested otherwise. Moreover, Netscape’s CEO, James Barksdale, told the court that Microsoft and Netscape executives had met in June 1995 to discuss “ways to work together.” Barksdale testified that Microsoft’s proposal at the time involved illegally dividing the market. When Netscape rejected the proposal, Microsoft supposedly used predatory pricing, along with other tactics, to “crush” the company.

By the time Microsoft began its defense in January 1999, the company’s credibility had been severely damaged. The most damaging testimony came from Jim Allchin, a Microsoft employee and computer expert often referred to as “Microsoft’s Lord of Windows.” Allchin’s testimony was supposed to demonstrate that Internet Explorer could not be separated from Windows without detrimental effects. His videotaped demonstration proved otherwise, however, when a reappearing Explorer icon made it apparent that the tape had been doctored.

This led to an effort by Microsoft to settle the case, but the two sides could not agree to the terms of a settlement. The government wanted to place government-appointed people as active members on Microsoft's board of directors, which Microsoft viewed as an attempt to take control of the company. In November 1999 Judge Thomas Penfield Jackson released his findings, a document consisting of 412 paragraphs, only four of which were favorable toward Microsoft. Jackson also named Allchin as the mastermind behind the bundling of Internet Explorer and the operating system in an attempt to destroy Netscape.

On June 7, 2000, Judge Jackson ordered Microsoft to split into two independent companies—one company to sell Windows and the other to sell everything else. Jackson offered several grounds for his dramatic decision, the first being simply that Microsoft would not admit to any wrongdoing. He also stated that the intent of his decision was to prevent Microsoft from insulting the government by refusing to comply with antitrust laws. Jackson said he found Microsoft to be “untrustworthy” as a result of its past behavior, including sending defective Windows software when ordered to unbundle the Internet browser from the operating system. Jackson further indicated that he was trying to prevent Microsoft from bullying its competitors. First, the split was intended to reignite competition in the industry. Second, dividing Microsoft into two companies could potentially spur some innovation that had been stifled by the size and force of the software giant. Third, the split might rejuvenate some of the “dead zones” in the industry, such as word processing, spreadsheets, databases, and email. Fourth, and perhaps most importantly, reducing Microsoft's power in the industry would hopefully renew creativity among software engineers.

Gates and other Microsoft executives viewed the idea of splitting the company into two as the equivalent of a “corporate death sentence.” They countered that rather than spur innovation, the split would stifle it by making software development more complex; it would be more difficult to effectively integrate two or more programs across two businesses. They further argued that separate marketing of software would drive up prices for consumers. Finally, Microsoft saw the split as causing a delay in product completion and introduction. Gates began appearing in national television ads and meeting with President Clinton and members of Congress. Microsoft also took out full-page advertisements in newspapers across the country, publicly defending its record and touting its success. Regardless, by April 28, 2000, the company's stock had reached a 52-week low.

Microsoft appealed Judge Jackson's decision, thereby suspending the implementation of the ruling. Although the Department of Justice had wanted the Supreme Court to review the case, bypassing the District of Columbia Circuit Court of Appeals, the Supreme Court declined the case. In June 2001 a federal appeals panel agreed with Jackson's ruling that Microsoft had violated antitrust laws, but reversed his breakup order and returned the case to the lower court for a new remedy. In November 2001 the U.S. government and nine states reached an agreement with Microsoft on a tentative settlement, although nine other states continued to hold out for stricter remedies and stronger enforcement.

Finally, on November 1, 2002, U.S. District Judge Colleen Kollar-Kotelly approved most of the provisions of the settlement, thus barring Microsoft from retaliating against computer

manufacturers, permitting customers to delete desktop icons for some Microsoft features, and requiring the company to disclose specific technical data to software developers. Kollar-Kotelly included a provision in the settlement that made independent Microsoft board members responsible for its compliance efforts instead of the technical committee that Microsoft had sought to oversee compliance. Although the company's stock rose on the news of the final settlement, some critics expressed concern that the decision failed to eliminate Microsoft's virtual monopoly over some aspects of the computer industry.

Thus, in lieu of a breakup into two different businesses, Microsoft was ordered to change its business practices. To ensure Microsoft's compliance with the original judgment in the antitrust case, reviews of Microsoft were regularly conducted for a period of five years from the original judgment decided in 2002. Although some portions of the original judgment expired in 2007, others did not expire or were extended until 2011 in order to open the browser market.

#### MICROSOFT'S LEGAL ISSUES CONTINUE

Microsoft has continued to have legal problems stemming from antitrust issues as well as several patent infringement cases since 2002. In addition to the antitrust case in the United States, Microsoft paid record fines to the European Union (EU) related to antitrust rules because it bundled its software with its Microsoft Windows operating system. Microsoft had been under scrutiny by the EU since 1998, when the two battled over the bundling of Windows Media Player with its Windows operating system. Microsoft's lawyers argued that the simple act of bundling applications in one product is not an abuse of market dominance, especially since most users use more than one type of media player. From 2004 to 2007, however, the EU forced Microsoft to pay \$2.4 billion for abusing its dominant market position against rival software makers, including RealNetwork, developers of the Real Audio player. In 2008 the EU fined Microsoft an additional \$1.4 billion for failing to comply with the 2004 antitrust ruling. Additionally, the EU began another antitrust investigation but dropped the case after Microsoft agreed to offer consumers a choice of rival web browsers and also agreed to make its products compatible with other products of the software industry.

Microsoft's battle with Sun Microsystems also continued beyond the original antitrust case. However, in 2004, the two companies agreed to work together to improve interoperability of their products while still remaining competitors in the industry. The ten-year agreement also resolved previous litigation, with Microsoft paying Sun \$700 million to resolve pending antitrust issues and \$900 million to resolve patent infringement issues. In addition, each company agreed to pay royalties to the other for each other's technology.

In 2004 software maker Novell filed a private antitrust lawsuit against Microsoft, accusing the company of withholding technical information about Windows that would help its WordPerfect and Quattro Pro Programs work with Microsoft's operating systems. The company said that Microsoft's anticompetitive behavior harmed its business in the 1990s. The case was dismissed in 2010, but Novell appealed and later won the right to sue Microsoft on one antitrust claim. In 2013 the federal appeals court dismissed Novell's

complaint that Microsoft had engaged in anticompetitive behavior by undercutting its WordPerfect program.

In 2007 Google, Inc., considered reopening state and federal government antitrust action against Microsoft after Microsoft released its new Windows Vista operating system. Google claimed that Vista would put other software companies at a disadvantage since the indexing system on Vista makes it difficult to use other indexing software. Microsoft disputed Google's charges and claimed that it worked closely with federal officials to ensure compliance. Since users could still run alternative software in addition to Microsoft's software, U.S. antitrust officials refused to consider reopening the antitrust case.

Additionally, from 2007 to 2011, Canadian software company i4i accused Microsoft of patent infringement, resulting in a \$290 million penalty for Microsoft. The decision, the largest ever American patent infringement verdict, barred Microsoft from selling Microsoft Word 2003 and 2007. Microsoft filed a series of appeals, arguing that the standard in patent infringement should be lowered so that patents become more vulnerable to legal challenges, which could increase innovation and competition. The case reached the Supreme Court in 2011. The Supreme Court agreed with the lower courts, and Microsoft was forced to pay \$290 million in damages.

A more recent issue involves allegations that Microsoft might have bribed foreign officials in Russia and Pakistan to secure contracts. News of the alleged bribes were provided by anonymous tipsters from Russia and Pakistan. The U.S. government launched an investigation into Microsoft in 2013, but at the end of the year the government had not charged the company with wrongdoing.

## CONCLUSIONS

Industry experts believe that the software market is much more competitive today than in 2001. Part of this change undoubtedly stems from the shift in Microsoft's behavior, but the real difference may have been new developments in technology, as downloading alternative browsers has become much quicker, simpler, and more popular. Microsoft also became more cautious in its business practices, which led to less aggressive innovation and expansion in the software market. Although Microsoft continues to lead the software industry, its dominance is no longer unchallenged.

As Microsoft competes with other companies such as Apple and Google, it must continuously devise new ways to remain competitive. One problem it must overcome is slower sales of its two staple software products, the Windows operating system and Office suite, as new PC sales drop. To guarantee growth outside of its software distribution, Microsoft continues to improve the capacity of its own search engine, Bing, and has modernized Microsoft Office by making a free online version. It also continues to find ways to deliver technology to the younger generation of consumers. Newer Microsoft product lines include its mobile operating system Windows Mobile; Windows 8; Microsoft Surface Tablets to compete against the iPad; Windows Phone 8; and an upgraded Kinect, a motion-based gaming system for Xbox One. In 2011 Microsoft acquired Skype, a voice-over-IP

service and instant messaging organization for \$8.5 billion. Microsoft appeared to have a large amount of confidence in its acquisition as it paid 32 times the adjusted earnings of Skype.

However, Microsoft faces a number of challenges. It has gone through a massive reorganization effort that included consolidating eight Microsoft businesses into four. This reorganization is meant to increase collaboration between units and compete against Google and Apple in the mobile and Internet markets. This reorganization will require a cultural change to be effective. Additionally, CEO Steve Ballmer, who had occupied the executive position for more than ten years, announced his retirement in 2013. Some critics have accused the company of lagging behind its rivals in technology and engaging in missteps, such as purchasing online ad publishing firm aQuantive, that lost the firm billions in write-offs. Microsoft is going through a transition period and must make important strategic decisions to maintain its competitive advantages.

By realizing its own potential not only in developing new technology but also in corporate citizenship, Microsoft can grow while remaining a trustworthy company in the eyes of consumers and the software industry. Improving the way the company handles relationships with customers and competitors will allow Microsoft to move forward in its mission to enable people and businesses throughout the world to realize their full potential.

## QUESTIONS

1. What unique aspects of the software industry created the opportunity for Microsoft's monopoly and anticompetitive practices?
2. Discuss the role of Microsoft's leadership and corporate culture in generating a large volume of ethical and legal issues.
3. How do Microsoft's social responsibility and philanthropic efforts relate to its reputation and ability to overcome its legal problems?

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