

**Application for the initiation of proceedings
pursuant to Article 3 of Regulation 17/62 to
establish the existence of infringements of
Articles 85 and 86 of the Treaty of Rome**

filed by

The Santa Cruz Operation, Inc.

on

31st January, 1997

CONFIDENTIAL VERSION

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**THE SANTA CRUZ OPERATION, INC.'S COMPLAINT
AGAINST MICROSOFT CORPORATION**

This is an application respectfully submitted by The Santa Cruz Operation Inc. ("SCO") under Article 3 of Council Regulation No. 17 of 1962 that the Commission should by decision find that the Agreement made between the Microsoft Corporation ("Microsoft") and AT&T in January 1987 contains restrictions on competition which infringe Articles 85 and 86 and thereupon order the parties thereto to bring such infringements to an end. A copy of this agreement is attached as Annex 1.

1. THE UNDERTAKINGS

- 1.1 SCO is a software company headquartered in Santa Cruz, California, which is located forty kilometres south of the Silicon Valley. SCO has subsidiaries located in France, Germany, Italy and the UK and employs well in excess of 400 people in the European Union. In addition to sales offices located in France, Germany, Italy, the UK, Spain, Denmark, and Sweden, it maintains significant research and product development facilities in Watford, Cambridge and Leeds in the UK.
- 1.2 As described in more detail below, SCO's principal products consist of UNIX based operating system software designed to run on PCs which utilise Intel processors. SCO's yearly turnover for the financial year 1995 was approximately \$200 million with approximately \$93 million generated in the EU.
- 1.3 SCO also maintains significant customer relations within the EU selling to distributors, value added resellers and OEM.
- 1.4 Microsoft is well known to the Commission. It is the world's largest vendor of computer software and one of the most profitable undertakings in the computer industry. Its 1996 worldwide turnover was \$ 8.7 billion which earned Microsoft a profit, after taxes of \$ 2.2 billion.
- 1.5 In 1980 Microsoft licensed from another company a PC operating system which it modified and introduced in 1981 as the Microsoft Disk Operating System ("MS-DOS"). Since the mid-1980's, it has been the world's largest vendor of operating systems for PCs (and in particular Intel PCs, as defined below). More than 170 million PCs worldwide employ Microsoft operating systems.
- 1.6 Microsoft's PC operating system products currently consist of DOS, Windows 3.1x, Windows 95 and Window NT.

2. THE PRODUCTS

- 2.1 SCO's principal product is "SCO OpenServer" ("SCOOS"). SCOOS is a PC operating system based upon UNIX which is designed to operate on computers employing Intel processors. Intel processors and compatible processors which conform to the Intel instruction set (so-called Intel "clones" such as those offered by AMD and Cyrix) comprise the vast majority of the PC

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market. Approximately 90% of all PCs utilise such Intel or Intel clone processors (we refer to both PCs using Intel processors and PCs using Intel clone processors as "Intel PCs").

- 2.2 UNIX is an operating system originally developed by AT&T thirty years ago for what were then known as minicomputers. From its inception, UNIX was promoted as a non-proprietary "open operating system" and was freely licensed by AT&T throughout the computer industry. Unlike proprietary operating systems which were unique to particular hardware vendors such as IBM's MVS or Digital Equipment's VMS, UNIX was offered by many different hardware vendors and afforded the customer a degree of freedom to migrate among these different hardware platforms, which used UNIX as the operating system thus permitting existing UNIX applications to be retained with only small changes. As it has evolved, UNIX has become an extremely advanced operating system providing true multitasking (that is, allowing the processor to work on more than one program at a time); multiple user capabilities (allowing multiple users to access a single processor), tight security (allowing different classes of users to a single computer different degrees of access), advanced networking and communication capabilities; and robustness (low rates of failure or system crashes). Indeed, UNIX was the program standard around which the Internet was originally developed.
- 2.3 SCOOS adapts UNIX, originally developed for large systems, and enables it to function as the operating system for an Intel PC.
- 2.4 SCO also offers a second UNIX based PC operating system known as "UnixWare". Like SCOOS, UnixWare brings UNIX to the Intel PC platform. SCO acquired the rights to UnixWare in a recent transaction with Novell, the original developer of the program. Because SCOOS and UnixWare have certain differences between them, SCO has plans to merge the two operating systems into one program known currently by the code name "Gemini".
- 2.5 Sun Microsystems has sub-licensed UNIX from Microsoft. Using its sub-licence it also offers a UNIX for Intel PC operating system known as "Solaris X86". Solaris X86 has differences when compared to SCOOS and UnixWare such that a user of Solaris X86 has no assurance that an application program developed for it will operate with SCOOS or UnixWare.
- 2.6 SCOOS and UnixWare thus compete with the other operating systems offered on the market for Intel PCs including Windows 95, Windows 3.1, Windows NT, Solaris X86 and Novell's NetWare.

3. THE MICROSOFT LICENSES

- 3.1 SCO's rights to create, distribute and sell UNIX software code at the time it developed SCOOS were acquired through a license chain from (i) AT&T to Microsoft (wherein AT&T as the new owner of UNIX granted a license for UNIX to Microsoft) and then (ii) Microsoft to SCO. Microsoft's original rights to UNIX were thus acquired through its non-exclusive sub-licensable license from AT&T. Pursuant to its license from AT&T, Microsoft had adapted UNIX to function on Intel PCs, naming the resulting program "XENIX". XENIX is thus a derivative work of UNIX. Later, in 1987 as a result of the agreement made that year between Microsoft and AT&T, which is described in Section 4 below, Microsoft developed another version of UNIX for Intel PCs using 386 processors based upon the then current release of UNIX, System V, and XENIX known as "System V/386 Rel. 3.2". System V/386 Rel. 3.2, also a derivative work of UNIX, depended upon AT&T's UNIX license to Microsoft.

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- 3.2 In 1988, Microsoft granted SCO a license to use System V/386 Rel. 3.2. Under this license agreement (a copy of which is attached as Annex 2), SCO was permitted to copy System V/386 Rel. 3.2, which largely consisted, of course, of UNIX code, and to modify that code, without restriction, into new products. Under the terms of this 1988 Agreement, SCO has to pay Microsoft a royalty for products sold under the Agreement.
- 3.3 SCOOS now contains the many additions and improvements which have been made over the years to the System V software originally licensed to SCO by Microsoft. Among other things, SCO has undertaken the major task of adapting the System V code to function with modern Intel processors. XENIX and System V/386 Rel. 3.2 were 1987 vintage programs designed to permit UNIX to function with Intel 286 and 386 processors (both 16-bit processors). SCO has now written SCOOS to function with the Intel Pentium, a 32-bit processor, two generations more advanced than the processor for which System V/386 Rel. 3.2 was written. So fundamental are the changes made by SCO, that SCOOS dwarfs in size the System V/386 Rel. 3.2 UNIX program licensed from Microsoft. Indeed, SCO's SCOOS contains nearly five times more code than the System V/386 Rel. 3.2. SCO has converted the program from a character based program to one employing a graphical user interface. In addition, SCO has added modern networking, Internet, and multiprotocol facilities, as well as security features and modern device drivers.
- 3.4 As a result of the chain of transactions described below, SCO has now acquired ownership of the UNIX program itself so that it no longer requires a license from anyone to produce UNIX products. In November 1989, AT&T, the original developer of the UNIX Operating System, had spun off the UNIX division as a separate company then known as UNIX System Laboratories, Inc. ("USL"). In June 1993, Novell, the vendor of the NetWare Operating System, acquired USL and hence became the owner of the UNIX program. In turn, in December 1995, Novell sold the ownership of UNIX to SCO. As a result, SCO now enjoys the right, as the owner of the UNIX program, to exploit that program without the necessity of a license from any other party. In particular, if SCO chooses to develop products based on UNIX, without any lines of Microsoft developed code, SCO will not have further need to license such products under the 1988 Agreement with Microsoft or pay royalties, thereunder, to Microsoft.
- 3.5 It is SCO's intention to develop a new highly advanced UNIX based operating system for the next generation of Intel processors. Currently, the most advanced Intel processor on the market is known as the "P6". This processor, now only at the start of its product life-cycle, is being sold in very small volumes at extremely high prices. Although they are not the most advanced processor chips currently offered for sale by Intel, various versions of the P5 processor, known as the "Pentium", account for overwhelming portions of current sales. Virtually all Intel PCs sold currently employ Pentium processors. Although SCO's new product, envisioned for the P7 processor, is technically speaking only one generation ahead of the P6, in reality it is two generations ahead of the main stream Intel PCs currently being sold. SCO's work to create the new UNIX for Intel's P7 based PCs will be a tremendous undertaking, which will involve thousands of man years of engineering time. The new product code, named "NGOS" (Next Generation Operating System), will be developed from the ground up, and will be based not upon XENIX or the SCO 1988 licensing agreement with Microsoft (System V/386 Rel. 3.2) but from UNIX itself which SCO now owns.

4. THE MICROSOFT/AT&T AGREEMENT

- 4.1 In 1987, Microsoft and AT&T entered into an agreement entitled "Development and License Agreement for Convergence of AT&T's UNIX® System V and Microsoft's XENIX® Operating System on Intel Microprocessors" (hereinafter the "1987 MS Agreement").
- 4.2 The overt objective of this agreement was to enable Microsoft to create a version of UNIX to run on the Intel 386 processor and to be compatible with 286 processors and programs written for the 286 PCs. However, the Intel 386 processor is now two generations behind the current main stream Pentium and is obsolete. It is in fact no longer sold. The 286 uses even older technology and has no commercial value at all. Few 286 PCs even remain in use. The resulting adaptation of UNIX to run on the Intel 386 was termed under the 1987 MS Agreement "Merged Product". The 1987 MS Agreement contemplated that both AT&T and Microsoft would sell the resulting Merged Product. In addition, it provided for the parties to develop future evolutions of the first Merged Product (the 386 version) for future releases of UNIX and for future generations of Intel processors. However, no such products were ever developed pursuant to the 1987 MS Agreement.
- 4.3 Notwithstanding the absence of evolution of the original Merged Product, the 1987 MS Agreement imposes significant restrictions on competition. It prohibits AT&T and its successors from selling any UNIX software for Intel processors, in either executable binary form or source code form which is not a Product under the 1987 MS Agreement for as long as the 1987 MS Microsoft Agreement remains in force.
- 4.4 The restriction on selling executable versions of UNIX for Intel PCs is found at paragraph 2(c) which reads:
- (c) *as to UNIX System Code, or a derivative work thereof, in Executable File form, after one year from acceptance of the initial Merged Product, MS and AT&T shall, except as hereinafter provided, market and distribute only Binary Compatible Product for Intel Microprocessor Based General Business Computer Systems.*
- "Binary Compatible Product" is defined in the Agreement as a "Product" which, in turn, is defined as the "Merged Product" or derivative works thereof which are governed by the 1987 MS Agreement. Binary Compatible Products are also required to run and support a listed group of application programs written for 286 Intel processor machines.
- 4.5 The restriction on source code distribution is similar and found at paragraph 2(d):
- (d) *After ninety (90) days from acceptance of the initial Merged Product, any source code license granted by AT&T for UNIX System Code for an Intel Microprocessor, or any source code license granted by MS for a derivative work of UNIX System Code for an Intel Microprocessor, shall be for Product only. Source code licenses granted by either party prior to the ninety first (91st) day after acceptance of the initial Merged Product shall continue in full force and effect.*
- Again, "Product" is a defined term in the Agreement which covers the "Merged Product" and derivative works thereof.

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- 4.6 As a consequence of these restrictions, AT&T and its successors are prevented from offering any UNIX product for Intel PCs that is not based upon the original Microsoft "Merged Product" developed under the 1987 MS Agreement and that is not "Binary Compatible." That is to say, these restrictions compel AT&T and its successors to sell only Merged Product or derivative works based upon the 1987 Merged Product for so long as the contract remains in force and to ensure that it is Binary Compatible and capable of supporting old 286 application software.
- 4.7 The consequences of these restrictions on competition are enormous. First, they stifle innovation in the development of new forms of UNIX for Intel PCs free of the structures, facilities and code created for 16 bit processors and application programs no longer being sold and which are as many as five generations behind the 64 bit P7. Incorporating these facilities in a program is both unnecessary and costly. Indeed, some of the programs required to be supported have not been sold for nearly a decade. Second, they compel the payment of royalties to Microsoft where none is needed or deserved. Under the Agreement, Microsoft was to be paid a \$15 per copy royalty for each copy of a program covered by the Agreement which was sold by AT&T or its downstream licensees. By restricting competition in the development and sale of an alternative UNIX based Intel PC program, Microsoft ensured that all such software would be subject to a royalty payable to it. In effect, the provision operates like the per processor license agreements which were the subject of the Commission's earlier proceedings against Microsoft. The 1987 MS Agreement forces use of obsolete and redundant Microsoft code in circumstances where it is neither needed nor desired and it provides Microsoft with a royalty for an unnecessary product. Of course, the technical means to develop a new independent UNIX for Intel PC programs have been available at all times; the restriction on pursuing that course ensures that all such software remains under Microsoft's control.
- 4.8 The anti-competitive effect of these restrictions is magnified by the term provisions of the Agreement which keep the Agreement in force, and thus the restrictions and royalty provisions in force, until such time as neither party (AT&T and its successors or Microsoft) has commercially released a new generation product for a new Intel processor or new release of UNIX for a period of two years. The 1987 MS Agreement in every practical respect is thus everlasting. It will continue with its restrictions in force under its express terms forever unless both parties have failed to offer products for new Intel processors or new variations of UNIX. Under the terms of this provision, if AT&T's successors wished to be released from the 1987 MS Agreement, they would be required to forego offering new products to meet the market for two years. Such a two year hiatus in the offer of new UNIX software products for new Intel processors or new releases of UNIX is in all commercial respects equivalent to termination of business. In the electronics business products must advance continually or they will be spurned by the market.
- 4.9 Microsoft's 1988 Agreement with SCO does not affect the issues concerning the anti-competitive restraints created by the 1987 MS Agreement. Because it has acquired ownership of the copyright to UNIX from AT&T, SCO should be free to develop new UNIX based works without the necessity of a license from anybody. The 1988 license between Microsoft and SCO is no longer commercially viable as a basis for SCO to develop new UNIX products since paying a royalty to Microsoft to obtain UNIX rights free of development restraints is, in effect, a double payment: SCO owns UNIX, has paid for such ownership and would be placed at a competitive disadvantage were it to nonetheless proceed under a royalty bearing license that it does not need.

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5. THE EFFECT ON SCO

- 5.1 Following the acquisition of UNIX from Novell, SCO wrote to Microsoft on 20th September, 1996 (copy of letter attached as Annex 3), in an effort to persuade Microsoft not to enforce the provisions of the 1987 MS Agreement. In response to SCO's letter, Paul Maritz, Group Vice President of Microsoft, wrote on 21st October, 1996 (copy of letter attached as Annex 4) that "Microsoft expects SCO to adhere to the terms of the 1987 Agreement" and expressly acknowledged Microsoft's position that "the 1987 Agreement was explicitly negotiated to be perpetual."
- SCO contacted Microsoft again on 17th January, 1996, by telephone to discuss Microsoft's position. Mr Maritz of Microsoft refused to alter the decision set forth in the October 21 letter and re-affirmed its intent to enforce the restraints and that the term of the agreement was explicitly negotiated to be perpetual.
- 5.2 The anti-competitive restrictions in the 1987 Microsoft Agreement significantly imperil SCO's development of NGOS. First, the restrictions by their express terms prevent effective product innovations to create a new product for the 64-bit P7 processors. Rather than being free to take the UNIX software that it has paid for and now owns and develop a revolutionary new UNIX operating system to run on the P7 processor, the terms of the 1987 MS Agreement constrain SCO to manipulate and adapt Microsoft's original work done for 8 and 16 bit processors. The effect impedes innovation since the requirement that AT&T and its successors utilise "Merged Product" and make products "Binary Compatible" obliges SCO to continue to incorporate obsolete software in its product offerings and to pay a royalty for the use of such unnecessary material.
- 5.3 By binding all future product evolution of UNIX for Intel PCs to its original work done for the 386 chip in 1987, Microsoft effectively secures for itself a competitive advantage for Windows 95 and Windows NT products which compete with UNIX. Although, in theory, Microsoft is subject to the same restrictions under the terms of the 1987 MS Agreement it, too, can only offer UNIX for PC software which is based upon or a derivative work of Merged Product - the restrictions have no meaning in reality for Microsoft. After it developed the so called Merged Product for the 386, Microsoft decided not to bring it to market. It has not offered for sale any UNIX for Intel PC product for years. Hence it is not restricted at all. The restriction operates only upon Microsoft's competitors like SCO who seek to sell UNIX based systems which would compete with Windows 95 and Windows NT.
- 5.4 The restrictions in the 1987 MS Agreement significantly impact SCO's NGOS in a second way. By undertaking the expense and burden of developing a new product and having paid to acquire ownership of UNIX itself, SCO should not be subject to payment of royalty to Microsoft. By enforcing a provision which requires that new products continue to be a derivative work of the Microsoft 386 Merged Product, and therefore subject to royalty, irrespective of the fact that the 386 program version is now completely obsolete, Microsoft imposes a significant technical impediment as well as a financial penalty on all its competitors and thereby achieves a competitive technical and competitive price advantage for its Windows operating system products.

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6. THE RELEVANT MARKET

- 6.1 SCO submits that the relevant market must be that for the supply of operating systems for Intel PCs.
- 6.2 PC operating systems control the operation of a computer by managing the interaction between the computer's microprocessor, memory and attached devices such as keyboards, display screens, disk drives, and printers. A PC operating system functions as the "central nervous system" of the PC. PC operating system software is designed to work with specific microprocessors, the integrated circuits that function as the "brain" of the computer.
- 6.3 The overwhelming majority of the PCs in the world today use the x86 class of microprocessors originally designed by Intel Corporation. The x86 class currently has included the Intel 286, 386, 486, Pentium (P5) and P6 as well as microprocessors manufactured by other companies that use a substantially similar architecture and instruction set ("Intel clones"). Intel has released specifications for the generation of microprocessor to succeed the P6, known, as would be expected, as the P7 and also known by the code name "Merced".
- 6.4 Because operating systems written for other types of microprocessors will not work with Intel PCs, PC manufacturers who sell Intel PCs and customers who buy such machines only use an operating system which is compatible with the architecture and instruction set of the Intel or Intel-clone microprocessor. At present there are only four suppliers of such operating system software who possess anything other than a negligible market share: (i) Microsoft with its Windows 95, Windows NT, Windows 3.1 and DOS products; (ii) IBM with its OS/2 product; (iii) SCO with its SCOOS and UnixWare products; and (iv) Novell with Netware (Netware, however, is only used in PC server environments).

7. MICROSOFT'S DOMINANCE

- 7.1 Microsoft enjoyed a dominant position in the relevant market since at least the mid-80s, retaining a market share of at least 70%, and no other competitor has had a share greater than 10%.
- 7.2 In the year Microsoft concluded the 1987 MS Agreement with AT&T, Microsoft's share for its DOS products in the relevant market measured in units shipped was 70%. Microsoft's total market share for all of its products was larger still owing to its sales of the XENIX product. The table below lists worldwide shipments by year of Intel PC operating system software from 1987 through 1996.

	1987	1988	1989	1990	1991	1992
MS-DOS	8,228	9,847	10,961	11,596	12,325	11,735
OS/2	25	65	124	800	1,500	3,000
Unix	165	282	440	625	908	1,250
Other	3,527	3,120	1,735	1,131	610	300
Total	11,945	13,314	13,260	14,152	15,343	16,285

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Worldwide Shipments of Intel PC Operating System Software Market Share Percentage						
	1987	1988	1989	1990	1991	1992
MS	69%	74%	63%	82%	80%	72%
Unix	1.4%	2.1%	3%	5.4%	5.9%	7.7%

Worldwide Shipments of Intel PC Operating System Software (in 000s)			
	1994	1995	1996
MS-DOS	7,800	3,451	2,502
MS Win 3.x	36,500	33,527	13,000
MS Win 95		19,500	47,088
MS Win NT	325	958	3,005
OS/2	3,113	4,504	7,840
SCO OS	205	232	232
UnixWare	12	13	23
Netware	760	885	967
Sunsoft Solaris X86	10	17	20
Other incl. NextStep and other Unix	1,650	2,350	2,993
Total	50,375	65,437	72,670

Worldwide Shipments of Intel PC Operating System Software Market Share Percentage			
	1994	1995	1996
MS OS Products	89%	86%	90%
SCO OS Products	0.40%	0.40%	1.40%

- 7.3 Within the EU, Microsoft's overwhelming dominance in the supply of Intel PC operating systems is similar.

Western Europe Operating System Shipments (in 000s)			
	1994	1995	1996
MS-DOS	2,184	759	286
MS Win 3.x	9,490	8,046	2,695
MS Win 95		6,533	11,827
MS Win NT	55	147	752
OS/2	1,304	1,901	1,803
Unix	111	118	123
Total	13,144	17,504	17,486

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Western Europe Operating System Shipments <i>Market Share Percentage</i>			
	1994	1995	1996
MS OS Products	89%	88%	89%
Unix	0.8%	0.7%	0.7%

7.4 Substantial barriers to entry and expansion exist in the relevant market. One barrier to entry and expansion is the considerable time and expense required to develop, test, and market and now PC operating system. Other interrelated barriers to entry and expansion include:

- (a) the absence of a variety of high quality applications that run on a new operating system, and the difficulty of convincing independent software vendors ("ISVs") to develop such applications;
- (b) the lack of a sizeable installed base of users; and, of course
- (c) the difficulty in convincing computer vendors to offer and promote a non Microsoft PC operating system, particularly one with a small installed base and relatively few applications designed to run on it.
- (d) for SCO the constraints imposed by the 1987 Agreement.

7.5 These barriers magnify and reinforce each other because the value of an operating system to a consumer is directly related to two factors: the availability of a variety of high quality applications that run on that system, and the number of users who use that operating system and thus are able to share information and work with the system without additional training. ISVs, in turn, tend to develop applications for operating systems with a large installed base of users, and consumers gravitate towards operating systems with a large base of applications.

8. MICROSOFT'S INFRINGEMENT OF ARTICLES 85 AND 86

8.1 Infringements of Article 85

Article 85(1) prohibits, inter alia, all agreements between undertakings which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition within the common market. In particular, Article 85(1) expressly prohibits agreements which:

- directly or indirectly fix purchase or selling prices or any other trading conditions;
- limit or control production, markets, technical development or investment; or
- make the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.

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SCO submits that the 1987 MS Agreement infringes Article 85(1) in three ways: (i) it requires the copyright owner of UNIX, which is one of only two viable competitors to Microsoft's products, to include unwanted and unnecessary code and facilities in new versions of UNIX for Intel PC products which are costly to create and maintain. This constitutes a impediment to development and places such products at a competitive technical disadvantage to Microsoft's Windows products, (ii) it forces the copyright owner of UNIX to pay royalties for the foregoing unwanted, unnecessary and undesirable code and facilities, placing UNIX products at a competitive price disadvantage to Microsoft's Windows products, and (iii) the imposition of these competitive restraints is perpetual. Each of these infringements is discussed below.

8.1.1 The Infringements

(1) The restriction on technical development

As explained at Paragraph 4 above, the effect of paragraphs 2(a) and 2(c) of the 1987 MS Agreement is that AT&T and its licensees and successors are prevented from offering any UNIX products for Intel PCs that are not "Binary Compatible" and not based upon the original Microsoft "Merged Product" or derivative works based upon the 1987 Merged Product for so long as the 1987 MS Agreement remains in force. The practical effect of this Clause is that all UNIX products for Intel PCs must be compatible with application programs written for the obsolete 286 and 386 Intel processors.

A similar restriction was considered by the Commission in the Video Cassette Recorders¹ case which involved a number of German undertakings which had agreed that in manufacturing and distributing video cassette recorders and video cassettes they would observe exclusively the technical standards applicable to the VCR system developed by Philips and would refrain from offering other systems. In defending its agreement, Philips asserted that the requirement that its standard be exclusively adopted was the "quid pro quo" for the royalty free licenses it granted, and the only way that the VCR system could be assured of a firm foothold on the market was to make it impossible for its licensees to change over to another manufacturer's system while the agreement was in force.

In assessing the case the Commission held.

"Paragraph 2 of the basic agreement required the parties to observe the technical standards laid down in Annex J for the manufacture and distribution of video cassette record[er]s and video cassettes. As these standards were for the manufacture of VCR equipment, the parties were obligated to manufacture and distribute only cassettes and recorders conforming to the VCR system licensed by Philips. They were prohibited from changing to manufacturing and distributing other video cassette systems, Sony's U-MATIC, for example, as long as these obligations continued. They were not even allowed to use other systems at the same time. This constituted a restriction of competition under Article 85(1)(b) which was designed to limit the technical development, production and sale of other video cassette systems."

(emphasis supplied)

The Commission's reasoning in the Video Cassette Recorders case may be similarly applied to the limitation on technical development under the 1987 MS Agreement. In the Video Cassette Recorders case, for example, parties were obliged to manufacture and distribute only cassettes and recorders conforming to the VCR standard licensed by Philips; similarly, under the 1987 MS Agreement a standard for all Intel PC UNIX software is imposed by the requirements that such software offered be

¹ OJ 1978 L47/12 [1978] 2 CMLR 160

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the UNIX copyright holder or its successors be based upon "Merged Product" and be "Binary Compatible". Furthermore, in the Video Cassette Recorders case the Commission commented that the restrictions of competition were particularly marked in view of the pre-eminent market position held by Philips. Such a consideration must equally apply to Microsoft given its undisputed dominance of the market for operating systems since at the time it entered the 1987 MS Agreement with AT&T it possessed a 70% share of the relevant market and now enjoys a share of nearly 90% of the market.

In addition, it should be noted that, having limited the technical development of all UNIX for Intel PC software, Microsoft decided to abandon its own original Merged Product (XENIX), an action which the Commission may view as aggravating an already serious restriction of competition.

SCO further asserts that, even ignoring the fact that the 1987 MS Agreement was never notified and cannot therefore qualify for an exemption pursuant to article 85(3), the technical development limitation included in the 1987 MS Agreement could not benefit from an exemption pursuant to Article 85(3) for the same reasons as those given by the Commission in the Video Cassette Recorders case. In considering the applicability of Article 85(3) to the Philips agreement, the Commission concluded:

[N]o significant improvement in production or distribution was achieved since compliance with the VCR standards led to the exclusion of other, perhaps better, systems. Such an exclusion was particularly serious in view of the pre-eminent market position enjoyed by Philips.

Similarly, no benefit can be said to flow to the consumer from the 1987 MS Agreement. Even at the time that the limitations on technical progress were imposed, such limitations were unnecessary and not at all indispensable for the development of a common Merged Product for the two original undertakings. If the object was to jointly develop a common merged product, a simple joint development agreement would have sufficed. It was unnecessary to the achievement of that goal to impose a perpetual covenant not to develop a separate competing product. In any event, there has been no economic or technical advantage gained from the restraints contained in the 1987 MS Agreement. To the extent that the restrictions were designed to create a single version of UNIX for Intel PCs, so as to prevent incompatible different versions from being offered by different vendors, that has not occurred. Microsoft itself ceased selling its XENIX program shortly after the 1987 MS Agreement was concluded. Accordingly, it lost its commercial interest in insuring that its XENIX program would be compatible with AT&T's UNIX program for Intel PCs. Moreover, Microsoft itself sub-licensed its version of UNIX for Intel PCs, XENIX, without imposing conditions that would prevent its sub-licensees from modifying the program, so as to make it incompatible with XENIX. For example, Microsoft licensed Sun Microsystems, as a sub-licensee, to UNIX for Intel. The resulting Sun product, Solaris X86 has no assured compatibility with other UNIX for Intel PC operating systems. In similar fashion, Microsoft's 1988 license agreement with SCO contains no restrictions of any kind on future changes or modifications that the licensee, SCO, may make in the program. SCO is thus left free under the 1988 license to change the licensed program to one which is incompatible with XENIX (and hence one which no longer would be a "Merged Product" or "Binary Compatible" under the 1987 MS Agreement). As follows, SCOOS, UnixWare and Solaris X86 (all UNIX for Intel PC products) do not have insured compatibility with each other. Thus, Microsoft's own licensing practice with companies, other than AT&T, permits those undertakings to diverge from "Merged Product" and "Binary Compatible" products. The only party restrained is AT&T and its successors. Accordingly, there is no UNIX compatibility or standardisation purpose achieved by the 1987 MS Agreement restraints.

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The only effect of the continued enforcement of the restraints in the 1987 MS Agreement is to place Intel PC UNIX products at a competitive disadvantage when compared to Windows 95 and Windows NT. Whereas Microsoft is free to innovate and change its Windows product line as it sees fit and price them as it chooses, the copyright owner of UNIX is required to include unnecessary features for a common product that no longer exists and bear a royalty charge for the required inclusion of such features.

For these reasons the 1987 MS Agreement can be distinguished from the X/Open Group case² where the Commission's decision to exempt an agreement which sought to establish an open industry standard was based largely on the benefits which flowed to the consumer from the notified agreement. Unlike the 1987 Microsoft Agreement, the X/Open agreement merely allowed the competitive undertakings to develop a common, standard product. There were no restraints which prevented the parties from developing products outside the agreement.

(2) *The forced royalty payment*

The terms of the 1987 MS Agreement compel the payment of royalties to Microsoft for the use of Microsoft code which SCO does not desire to use. Under the Agreement, Microsoft was to be paid a \$15 per copy royalty for each copy of a program covered by the Agreement which was sold by AT&T or its downstream licensees. By restricting competition in the development and sale of an alternative UNIX based Intel PC program, Microsoft ensured that all such software would be subject to a royalty to it. (Of course, the technical means to develop a new independent UNIX for Intel PC program[s] have been available at all times but the restriction on pursuing that course ensures that all such software remains under Microsoft's control.

The principle that royalties should only relate to products which a licensee desires to use in order to gain some form of advantage was alluded to in the *Windsurfing International Decision*³ where the Commission made the following statement:

"If the calculation of royalties, when payable on the basis of individual sales, is not linked to the products covered by the licensed invention, there is a danger of the licensee's production, as compared with that of competitors, having to bear costs for which the licensee is not compensated through the advantages conferred by exploitation of the product."

Although this statement refers to the method used by *Windsurfing International* for calculating the royalties, the principle is clear that the royalties must relate to the advantages conferred by exploitation of the product so that a party is not hindered by unnecessary costs not faced by competitors. SCO believes that the 1987 MS Agreement breaches this principle in two ways. First, there are no current advantages to using the Microsoft code in UNIX products. Indeed, as explained at Paragraph 8.1.1(1) above, the forced inclusion of the Microsoft code in UNIX products is a technical liability, and secondly, the royalty of US\$ 15/copy charged to publishers of UNIX products for a "product" which brings with it no advantage (i.e. Microsoft code), is not one borne by developers of products competing with the UNIX operating system. Indeed, there is one competitor to UNIX operating systems, Microsoft, which rather than being hindered by the forced royalty, is the beneficiary of its income.

² OJ 1987 L35/36 [1988] 4 CMLR 542

³ OJ 1983 L229/1 [1984] 1 CMLR 1

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(3) *The perpetual term of the Agreement*

The anti-competitive effect of the restrictions imposed on SCO in limiting the technical development of UNIX products and imposing a forced royalty payment is reinforced by the term provisions of the 1987 MS Agreement which keeps it in force until such time as neither party (AT&T and its successors nor Microsoft) has commercially released a new generation product for a new Intel processor or new release of UNIX for a period of two years. The 1987 MS agreement thus in every practical respect is permanent. A two year hiatus in the offer of new UNIX software products for new Intel processors or new releases of UNIX, necessary to release AT&T or its successors from the 1987 MS Agreement, is in all commercial respects equivalent to termination of business. It is well known in the electronics industry that such a failure to advance product offerings would cause the customer base to migrate irrevocably to other competitive up-to-date operating system products, in this circumstance undoubtedly those offered by Microsoft.

SCO submits that the 1987 MS Agreement contains restrictions which must be viewed as perpetual in that Microsoft, in correspondence with SCO, has acknowledged that the provisions were intended to be so.

8.1.2 *Non-applicability of the relevant block exemption*

The 1987 MS Agreement does not benefit from any block exemption regulation, and in particular falls outside the know-how Block Exemption Regulation (Regulation 556/89) which was in force at the time the 1987 MS Agreement was entered into, and the new Technology Transfer Block Exemption Regulation (Regulation 240/96), which replaced Regulation 556/89 when it came into force on April 1, 1996. Although the agreements in question may have fallen outside the ambit of these Regulations, the general principles set out therein must be applicable in the assessment of similar types of licence agreement.

(1) *Block Exemption Regulation 556/89*

Article 3 of Regulation 556/89 sets out a list of obligations, the inclusion of any or more of which in a licence agreement, will render the block exemption inapplicable. This list includes a prohibition under Article 3(10) of agreements, such as the 1987 MS Agreement, whose initial duration is automatically prolonged by the inclusion of new improvements.

(2) *Block Exemption Regulation 240/96*

Article 3(10) of Regulation 556/89 is repeated in Article 3(7) of the new Technology Transfer Block Exemption Regulation, which came into force on April 1, 1996.

8.1.3 *Non-notification of the Agreement*

Although the 1987 MS Agreement contains several provisions which SCO submits must fall within the scope of Article 85(1) and require individual exemption under Article 85(3), no such notification appears to have ever been made. It should be noted that SCO was never at any time a direct party to any agreement with respect to the restrictive provisions entered into, nor the infringements of Article 85 created by the 1987 MS Agreement. The duty to notify the agreement to obtain an exemption was on the parties to it and SCO was not a party to the 1987 MS Agreement.

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8.1.4 Effect of non-notification on the 1987 MS Agreement

Since, as explained above, certain provisions of the 1987 MS Agreement infringe Article 85(1) and it does not fall within the scope of any of the Commission's block exemptions, the anti-competitive provisions of the 1987 MS Agreement are automatically void pursuant to Article 85(2) and the Commission is entitled to impose fines on the participating undertakings and third parties are able to sue in the national courts for damages, an injunction or both.

However, although SCO believes that the anti-competitive provisions of the 1987 MS Agreement are automatically void pursuant to Article 85(2), there is nevertheless a strong Community interest for the Commission adopting a formal Decision in this case.

8.1.5 The 1987 MS Agreement falls outside of the spirit of the EC Undertaking and the US Consent Decree

In addition to the apparent infringements of Article 85, the 1987 MS Agreement appears to be in breach of, if not the terms, at least the spirit of the undertaking that Microsoft gave the EC Commission and the Department of Justice in 1994 (the "Undertaking")

The Undertaking applies specifically to Microsoft's unfair practice of making its MS-DOS and Windows technology available on a "per processor" basis which required PC manufacturers to pay a fee to Microsoft for each computer shipped, regardless of whether or not the computer contained Microsoft operating system software. The Commission alleged that this arrangement gave Microsoft an unfair advantage by causing a manufacturer selling a non-Microsoft operating system to pay at least two royalties - one to Microsoft and one to its competitors - thereby making a non-Microsoft unit more expensive. The Commission concluded that the effect of such an arrangement was that, "the ability of rival operating systems to compete has been impeded, innovation has been slowed and consumer choices have been limited". Consequently, under the Undertaking Microsoft is prohibited from entering into any per processor licenses.

The forced purchase of unwanted Microsoft code under the 1987 MS Agreement has much the same effect as the per processor licenses: licensees are forced to pay a royalty for code they do not wish to use and which constitutes a limitation on the innovative development of the products and, because of the mandatory royalty payment, makes a non-Microsoft product more expensive. The 1987 MS Agreement thus breaches the spirit of the ban on per processor licenses.

Similarly, the Department of Justice and EC Commission alleged in their joint investigation into Microsoft's practices that its contracts were too long, and therefore prohibited Microsoft from entering into any licenses with terms longer than one year, although licensees may renew their licenses for another year on the same terms. The term of the 1987 MS Agreement is, as explained above, perpetual and thus also appears to breach the spirit, if not under the exact terms of the Undertaking.

8.2 Article 86

Article 86 provides that any abuse by one or more undertakings of a dominant position within the Commission market or in a substantial part of it shall be prohibited as incompatible with the Common Market insofar as it may affect trade between Member States. In particular Article 86 states that, inter alia, the following practices may constitute abuse:

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- directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions;
- limiting production, markets or technical development to the prejudice of consumers;
- applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage; and
- making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.

It is SCO's assertion that Microsoft's behaviour towards SCO infringes Article 86.

8.2.1 Microsoft's dominance of the relevant markets

The relevant market is that for the supply of operating systems for PCs Microsoft possesses overpowering dominance, with nearly a 90% market share. Moreover, as shown in the tables set out under Sections 7.2 and 7.3 above, Microsoft's dominance has been increasing: in 1994 its share was 89% and in 1995 86%, whilst SCO's products accounted in 1994 for 1.40% of the market, having risen from a 0.40% market share in 1995. As indicated above, it has already been recognised that Microsoft occupies a dominant position in the relevant market. In its press release of July 15, 1994, the Commission stated that Microsoft enjoyed "a virtual unchallenged leadership" in the above market.

8.2.2 Microsoft's abuse of its dominant position

The concept of abuse for the purposes of Article 86 was defined in *Hoffman LaRoche*⁴ as:

"[A]n objective concept relating to the behaviour of an undertaking in a dominant position which is such as to influence the structure of a market where, as a result of the very presence of the undertaking in question, the degree of competition is weakened and which, through recourse to methods different from those which condition normal competition in products or services on the basis of transactions of commercial operators has the effect of hindering the maintenance of the degree of competition still existing in the market or the growth of that competition."

Under this definition, as well as the express prohibitions set out in Article 86, Microsoft's behaviour towards SCO also serves to strengthen its existing dominant position by permanently excluding the owner of the UNIX copyright from competing with Microsoft's own products.

(1) Maintenance of the 1987 MS Agreement

The Agreement in question constitutes a severe limitation on the technical development of all UNIX software for Intel PCs since they require that all such UNIX products be Binary Compatible and be based upon Merged Product. Such limitation imposed on its licensees by a dominant undertaking falls clearly within the express prohibition of Article 86(b). The effect of these provisions of the 1987 MS Agreement, which are expressly referred to in *Hoffman LaRoche*, is that it has enabled Microsoft to reinforce its dominant position in the market for the supply of operating systems while at the same time

⁴ Case 85/75 ECR 461

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imposing a technical disability upon one of only two real competitors to Microsoft in the relevant market.

Similarly, the obligation of SCO to use Microsoft code in its products for which it then becomes obligated to pay Microsoft a royalty infringes the express prohibition under Article 86(a) on directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions on competitors. As explained under Section 4 above, SCO does not wish to use the Microsoft code in its UNIX for Intel PC products and gains no advantage in doing so. Instead the royalty it is obliged to pay to Microsoft merely forces SCO to sell its products at a higher price than would be necessary if the Microsoft royalty was not payable.

(2) *Refusal to waive the anti-competitive provisions of the 1987 MS Agreement*

SCO has endeavoured to persuade Microsoft to forego enforcing the anti-competitive restraints found in the 1987 MS Agreement. Not only did Microsoft re-affirm its intent to impose the Agreement's technical and price restraints, but it acknowledged that it intended that these restraints continue in perpetuity.

(3) *Microsoft's position on SCO's Board*

Not only does Microsoft hold a 10% share of SCO but one of its officers also occupies a place on SCO's board of directors. Although Microsoft's director is excluded from discussion at SCO relating to competing products, he nevertheless has access to a broad range of information which SCO would not wish to be disclosed to a competitor and it is therefore arguable whether his mere presence on the SCO board constitutes an "abuse" especially when one considers the conflicting fiduciary duties he faces as a director both of Microsoft and of SCO.

However, the "abuse" is most apparent from the way that Microsoft has sought in the past to use its shareholding in SCO. For example, Microsoft has in the past threatened to force SCO to buy back Microsoft's 10% shareholding at a time SCO did not have the funds available to make such a purchase. When informed that SCO did not have the available funds to make the purchase, Microsoft threatened to dump SCO's stock in the market, an action which would have been likely to needlessly depress the share price of SCO's stock so as to harm SCO's other shareholders. The threat was only withdrawn at the eleventh hour.

9. THE REMEDIES

SCO seeks the following remedies from the Commission:

- a Decision declaring that the 1987 MS Agreement is caught by 85(1) and was not notified and that its requirements with respect to the future UNIX for Intel PC products are therefore automatically void pursuant to Article 85(2) and the issuance of a permanent cease and desist order to prevent the imposition and enforcement of these or similar provisions; and

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- A declaration that the existence of the 1987 MS Agreement strengthens Microsoft's dominance in Intel PC operating system market and is therefore abusive, which is further evidenced, as discussed above, by Microsoft's refusal/failure to waive the restrictive provisions of the 1987 MS Agreement on request; and that Microsoft should be enjoined from taking any action legal or otherwise to enforce the restrictive provisions of the 1987 MS Agreement.

SCO is at the disposal of the Commission to furnish any further information that it may require.

31st January, 1997
Brobeck Phleger & Harrison

31st January, 1997
Allen & Overy, Brussels

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