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How Microsoft Warded Off Rival

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BRUSSELS, May 14 — At least 90 percent of the world's personal computers run on Windows software. But Microsoft wanted still more.

Last summer, Orlando Ayala, then in charge of worldwide sales at Microsoft, sent an e-mail message titled Microsoft Confidential to senior managers laying out a company strategy to dissuade governments across the globe from choosing cheaper alternatives to the ubiquitous Windows computer software systems.

Mr. Ayala's message told executives that if a deal involving governments or large institutions looked doomed, they were authorized to draw from a special fund to offer the software at a steep discount or even free if necessary. Steven A. Ballmer, Microsoft's chief executive, was sent a copy of the e-mail message.

The memo on protecting sales of Windows and other desktop software mentioned Linux, a still small but emerging software competitor that is not owned by any specific company. "Under NO circumstances lose against Linux," Mr. Ayala wrote.

This memo, as well as other e-mail messages and internal Microsoft documents obtained from a recipient of the Microsoft e-mail, offers a rare glimpse these days into the inner workings of Microsoft, the world's largest software company. They spell out a program of tactics that were carried out in recent years, ranging from steep price discounts to Microsoft employees lying about their identities at trade shows.

The Microsoft campaign against Linux raises questions about how much its aggressive, take-no-prisoners corporate culture has changed, despite having gone through a lengthy, reputation-tarnishing court battle in the United States that resulted in Microsoft's being found to have repeatedly violated antitrust laws.

Perhaps most important, certain discounts may run afoul of European market regulators, who are still investigating accusations that Microsoft abused their antitrust laws.

Discounting is a perfectly normal corporate practice. But under European law, companies that hold a dominant market position like Microsoft are prohibited from offering discounts that are aimed at blocking competitors from the market. Microsoft has been concerned with the legality of its discounts in the past, consulting a London law firm on a specific discount plan in 1998, before it was determined in court that the company had a monopoly in desktop operating systems.

In a telephone interview today, Jean-Philippe Courtois, the chairman of Microsoft's operations in
Europe, Africa and the Middle East, defended the use of the special fund described in Mr. Ayala's e-mail message, saying it was part of a strategy to be "competitive" and "relevant" in the market for big government and education deals.

"Linux is obviously a key competitor," Mr. Courtois said. Rivals use similar tactics, he said.

Sun Microsystems, for example, "is giving away StarOffice to basically governments and schools," he said. The Sun suite of programs runs on both Windows and Linux operating systems.

Mr. Courtois said that Microsoft sometimes gave software to "very low-income countries." He cited a program where Microsoft donated software in South Africa and helped train teachers to use it.

Mr. Ayala's memo said that the discounts could be offered to "developed and developing countries," and that an "initial focus" was being put on Latin America, Africa, the Middle East, India and China.

In his e-mail message, he focused on governments and large institutions buying mostly desktop software. A separate memo described a discounting program for corporate customers worldwide.

Two days after Mr. Ayala sent his e-mail message, Michael Sinneck, the executive in charge of Microsoft's services department, sent a message giving details of a program to provide corporate clients with discounts on the hourly rates charged by Microsoft's consulting business.

The memo said nearly $180 million had been allocated in the 2003 fiscal year, which ends in June, for this purpose alone. Of that, $140 million was earmarked for consulting services for server software, an area where Microsoft has a growing share of the market but still faces lively competition, particularly from big companies like I.B.M. that are promoting Linux as an alternative to Microsoft Windows.

Servers are the powerful computers used by corporations to store data, manage Web sites and perform other network tasks. The software that runs servers is the subject of one of the two antitrust cases currently open against Microsoft in the European Community. In broad terms, Microsoft is accused of illegally leveraging its overwhelming dominance of the PC software market into the server market.

European antitrust laws are generally stricter than comparable American laws, but the Microsoft practices described in the memos may raise red flags for regulators in the United States as well.

In June 2001, a federal appeals court in Washington ruled that Microsoft had violated antitrust laws by bullying business partners and rivals to thwart any competitive challenge to Windows. Later that year, Microsoft reached a settlement with the Bush administration, agreeing not to use its monopoly power in PC software, including pricing deals and contract terms, to effectively force PC makers to favor Microsoft products over competing offerings.

Among the documents is an e-mail message from an outside lawyer, Bill Allan of the London-based firm Linklaters, to Microsoft that offers a precise interpretation of European Community law on the matter of discounts, including the view that short-term discounting would be more likely to escape scrutiny. The message, from 1998, advised Microsoft that its discounts should not discriminate between clients and that discounts could not be aimed at excluding competitors from the market.

"Discounts are not per se unlawful," Charles Stark, a former antitrust official at the Justice Department and a partner at Wilmer, Cutler & Pickering in Brussels, said in an interview. "It depends on the
market circumstances and how they use them and what their impact is."

Mr. Stark, who has not seen the documents, pointed out that under European law "pricing behavior can be viewed differently by a dominant firm than by a nondominant firm."

Asked whether the discounting program for server software consulting was legal in Europe, given Microsoft's position, Mr. Courtois, the Microsoft executive, said that consulting was a "break even" business.

"We are not a global services company," he said. "We need to compete against the big guys."

Mr. Courtois cited I.B.M. and Oracle as companies with large consulting businesses.

The Microsoft documents show the preoccupation among top managers with countering the open-source movement, a group of programmers who want the software that runs computers to be offered free of charge. The codes behind open-source software are developed openly by independent teams of programmers, allowing companies to customize their programs and paying for services to make the software perform better. This is in stark contrast to Microsoft, which keeps most of its source code secret — although governments and some corporations are increasingly allowed to view the code.

Linux, the biggest open-source threat to Microsoft, has a tiny share of the market for personal computer software. But Linux was installed in 26 percent of the large data-serving computers sold last year that power corporate networks and the Internet, according to International Data, a market research company. Microsoft's Windows was the operating system on 44 percent of the servers.

The server market is one area where Linux appears to have some momentum. The use of Linux is also being supported by a handful of Microsoft rivals and encouraged by many governments, especially in Europe, as a cheaper and perhaps more secure alternative to Windows software. The French, for example, have a Web site that recommends Linux systems for government departments.

Mr. Ballmer, Microsoft's chief executive, once referred to Linux's licensing as "a cancer that attaches itself in an intellectual property sense to everything it touches."

In the face of this competition, the Microsoft documents show the significant resources the company devotes — and the unconventional tactics it sometimes uses — to combat Linux.

Chris O'Rourke, a Microsoft employee, described attending LinuxWorld, a trade fair in California, where he "purported to be an independent computer consultant" working with several public school districts, according to an e-mail message he sent on Aug. 20, 2002.

"In general, people bought this without question," Mr. O'Rourke wrote. "Hook, line and sinker."

He said his goal was to glean intelligence about the competition. His guise, Mr. O'Rourke said, "got folks to open up and talk." Mr. O'Rourke did not respond to a fax and voice mail message seeking comment.

Another employee, Todd Brix, said in an e-mail message that he attended a Linux conference in June 2001 in San Jose, Calif., pretending to be an "ambivalent OEM." Original equipment manufacturers, or O.E.M.'s, are companies like Hewlett-Packard and Dell Computer that buy Windows software
licenses.

Reached at his office on Tuesday, Mr. Brix said that when attending such a show, "you don't broadcast that you're a Microsoft person."

"You don't disguise that fact," he said. "You just don't lead with your chin."

In his message, Mr. Brix described the technical issues discussed at the show and said the tone of the meeting "was an even mix of Local Union hall teamster gathering, Christian Scientist revival and Amway sales conference."

Of all the Microsoft tactics described in the internal messages, the two discount programs appear to be the most aggressive — and perhaps the most legally questionable.

Mr. Ayala sent his memo at 8:17 a.m. on July 16, 2002. In addition to Mr. Ballmer, the recipients included two Microsoft vice presidents — James Allchin and Jeffrey S. Raikes — along with some of the company's top lawyers and the general managers of Microsoft's operations in Asia, Europe, Africa and the Middle East.

Mr. Ayala wrote that in today's "difficult economic environment" some institutions and companies were focusing on cheaper software."

"It is important," he continued, "that we have a way to address large PC purchases that involve low-cost/no-cost competitors in the education (and government) sectors, especially in emerging markets."

The solution, he wrote, was to "tip the scales" toward Microsoft in these deals by using the special fund, which he called the Education and Government Incentive Program.

The fund was to be used "only in deals we would lose otherwise," Mr. Ayala said.

When he wrote the memo, Mr. Ayala was a quite high-level executive at Microsoft, reporting directly to Mr. Ballmer. He was in charge of sales and marketing and responsible for roughly 22,000 of the more than 50,000 Microsoft employees.

In March, Mr. Ayala was transferred to lead a new division that focuses on small and medium-size companies. This new push is one of Microsoft's top priorities. Mr. Ayala was not available to comment.

In his separate e-mail message, Mr. Sinnecke, the Microsoft services executive, wrote that the consulting fund would be used to cover the difference between the "discounted customer rate and the standard services billing rate per hour."

Reached this week, Larry Meadows, marketing manager for Microsoft's services group at company headquarters in Redmond, Wash., said the fund could be used "anywhere it needs to be."

"There's not really a limit to say that you can use it only in certain geographies," Mr. Meadows added.

He said the funds would be used again in the next fiscal year that begins in July.