PUBLIC VERSION--
REDACTED

97-6184

IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

UNITED STATES OF AMERICA,
Plaintiff-Appellee,

v.

INTERNATIONAL BUSINESS MACHINES CORPORATION,
Defendant-Appellee,

INDEPENDENT SERVICE NETWORK INTERNATIONAL,
Intervenor-Appellant.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF FOR THE UNITED STATES

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BRIEF FOR THE UNITED STATES

QUESTION PRESENTED

Whether it was an abuse of discretion for the district court to review the uncontroverted evidence offered by the two parties to a forty-year-old antitrust consent decree, credit the reasoned views of the United States, and conclude that termination of the remaining provisions of the decree, subject to four- and five-year sunset provisions, was in the public interest.

STATEMENT OF THE CASE

This case began on January 21, 1952, when the United States filed a complaint alleging that IBM had monopolized, attempted to monopolize, and restrained trade in the electronic tabulating machine industry in violation of sections 1 and 2 of

the Sherman Act, 15 U.S.C. §§ 1-2. J.A. 37, 51-52 ¶ 45. The government and IBM ultimately settled their differences, and the court entered a consent decree on January 25, 1956 (the "Decree"). J.A. 147.[1]

Although the complaint did not allege any violation in the computer industry, the parties agreed to extend the Decree's coverage beyond tabulating machines to include computers as well (defined by the Decree as "electronic data processing machines"). J.A. 149; 96, 98-99. The Decree did not require IBM to divest any product or division. Rather, the Decree sought to encourage competition by constraining IBM's ability to exercise market power.

The heart of the Decree is sections IV[2] and V. Section IV requires IBM to offer its computers for sale, not just for lease, and on terms that are not substantially more advantageous to IBM than lease terms. J.A. 151-52, 1608-09. Section V, in turn, essentially prohibits IBM from re-acquiring machines it sells. J.A. 152, 1609-10. Together, sections IV and V were intended "to establish in the United States a used machine market which has never been heretofore." J.A. 109. To reinforce the sale requirement, a subsidiary goal of the Decree was to establish a secondary parts market for IBM computers and to

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[1]A section-by-section summary chart of the Decree's provisions, including the date of expiration or termination for each section, is found at J.A. 1608-12.

[2]Section IV is the only portion of the Decree that states its purpose expressly. J.A. 151.

establish a market for repair and maintenance services of IBM computers by independent service organizations (ISOs). J.A. 110.

Many Decree provisions were intended to be temporary and expired long ago. See J.A. 1608-12. Other provisions, relating to tabulating machines, are obsolete and do not apply to any ongoing IBM business. In the forty-plus years of the Decree's existence, the government has never filed an enforcement action against IBM, although it has investigated a number of complaints. See J.A. 1503, 1517-18.[3]

In June 1994, IBM moved to terminate all remaining provisions of the Decree with respect to all services and product lines, including service bureaus, personal computers, workstations, the AS/400 line of mid-range computer systems ("AS/400"), and the System/360...390 line of mainframe computer systems ("S/390"). J.A. 180. In July 1995, the government agreed to terminate all sections relating to IBM's service bureaus and its PC and workstation products and services. J.A. 345, 354-55. On January 17, 1996, the court terminated these provisions (the "January 1996 Order").[4] J.A. 498, 1608-12. Neither the January 1996 Order, nor the Decree provisions addressed therein, are on appeal here.

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[3]In 1969, the government did bring a separate antitrust suit against IBM, which the government dismissed in 1982; that case is irrelevant to this appeal.

[4]There was no significant objection to the January 17 terminations (one anonymous public comment was received), and the January 1996 Order was not appealed to this Court.

After the January 1996 Order, the following Decree provisions continued to apply to IBM's S/390 and AS/400 computer lines (and only those lines):

1. Section IV, which enjoins IBM's lease-only policy by requiring IBM to sell as well as lease its computers;

2. Section V(a), which restricts IBM's ability to re-acquire used IBM computers in the aftermarket;

3. Section VI, which prohibits IBM from discriminating against computer owners in favor of lessees, including VI(c), which requires IBM to sell repair and replacement parts to computer owners and ISOs;

4. Sections VII(b)-(c), which enjoin IBM from requiring purchasers to obtain maintenance services from IBM and from prohibiting customer experimentation with their computers;

5. Sections IX(b)-(c), which require IBM to furnish on a nondiscriminatory basis to owners as well as lessees the same technical manuals and informational documents that IBM supplies to its own repair and maintenance employees and that pertain to the "operation or application" of their computers;

6. Section XV, which enjoins IBM from agreeing with competitors to allocate markets or from conditioning the sale or lease of certain computers upon the purchase or lease of any other computer product; and

7. Sections XVII, XVIII, and XIX, which provide for governmental and judicial oversight of the Decree, including the power to modify or terminate.

J.A. 1608-12.

The government then conducted a thorough investigation of the likely impact on the public interest of terminating these provisions, focusing on potential effects on IBM's S/390 and AS/400 customers and competitors. The government reviewed more than 100,000 pages of IBM documents, including its strategic business plans and high-level documents analyzing the S/390 and

AS/400 markets and IBM's competitors; deposed seven IBM executives; interviewed 93 customers from various industries, and 30 of IBM's competitors; reviewed over 20,000 pages of documents submitted by government agencies, customers, competitors, and other third parties; and held extensive meetings or interviews with third-party industry and economic experts. J.A. 1613-14 ¶¶ 2-7.

The investigation revealed first that most consumers of the AS/400 and S/390 are large corporations with sophisticated knowledge about their computer systems. Although many customers said they had benefitted from the competitive environment created by the Decree, no IBM customer, and very few IBM competitors, voiced concern that Decree termination would enable IBM to exercise any significant degree of market power, particularly in the aftermarkets for spare parts and maintenance services. In fact, many customers felt they had leverage over IBM. J.A. 1561. Second, there is currently an active secondary market for spare parts and maintenance for the AS/400 and S/390 that is largely independent of the need to buy parts from IBM. ISOs instead obtain the vast majority of their parts by cannibalizing existing machines and through purchases from independent distributors. J.A. 1048 ¶ 22; 833-34 ¶¶ 6-7. Third, xxxxxxxxxxxxxxxxxxxxxxxx xxxxxxxxxxxxxxxxxxxxxxx IBM has instituted a policy of "system openness," making its computer systems more compatible with those of other manufacturers. Consistent with this, IBM has encouraged independent vendors to develop software for IBM's S/390.

J.A. 1546-47; 1587 ¶ 16. The evidence is that this policy derives from considerations independent of the Decree, and will continue after the Decree terminates. Fourth, there was no indication that IBM plans to cut off ISO access to spare parts. J.A. 1702, 1724, 1727.

Fifth, AS/400 and S/390 consumers, aided by consultants and trade publications, take the time and expense to calculate the total cost of their computers -- including the expected need and cost of future parts and maintenance service during their period of possession -- at the time of purchase so that they can accurately comparison shop (so-called "lifecycle" pricing). J.A. 1567-70 ¶¶ 10-14; 1051-52 ¶¶ 28-29; 1585 ¶ 9, 1588 ¶ 20. Sixth, the market analysis revealed that the mid-range AS/400 faces a competitive market today. J.A. 1528-29; 1566-67 ¶ 8. Seventh, although the S/390 still possesses a large share of the mainframe market, it faces strong competition from plug-compatible mainframes, mid-range computers and networks of personal computers to run particular software applications that consumers use. J.A. 1566-67 ¶ 8; 1586 ¶ 11, 1588 ¶ 20. Thus, although some users are "locked in" to using the S/390 for some purposes, only a few were locked in completely; most consumers have competitive alternatives. J.A. 1586 ¶ 12, 1590-91 ¶ 26; 1539. Moreover, the trend toward moving, or "migrating," applications off mainframes to mid-range computers is likely to continue and accelerate in the next few years. J.A. 1586 ¶ 12; 1532-35.

Based on this investigation, the government concluded that termination of the remaining Decree provisions subject to equitable sunset provisions would be in the public interest and was not likely to result in competitive abuses. J.A. 1683, 1706-07. In July 1996, the government and IBM agreed on the proposed modifications and submitted them to the district court, and the government filed a memorandum explaining why it had tentatively agreed to phase out the Decree with respect to the S/390 and AS/400. J.A. 650. The district court ordered a period of public comment on the proposal.

Seven public comments were filed. Three of those comments supported termination of the Decree with respect to the S/390 and AS/400 subject to the sunset provisions: (1) Computer Service Corporation, the only IBM customer to file a comment (J.A. 1633); (2) Amdahl Corporation, IBM's leading competitor of S/390 plug-compatible mainframes (J.A. 764); and (3) CCIA, a trade association that previously had sought to intervene in this matter, many members of which manufacture or provide computer products in competition with IBM.[5] J.A. 756. Three opposing comments came from various IBM competitors or their trade associations.[6] Appellant ISNI filed one of those opposing

[5]In addition, the Computer Dealers and Lessees Association (CDLA), members of which compete with IBM to finance computer purchases, and which originally had opposed IBM's June 1994 motion to terminate the Decree, hailed the parties' Joint Motion in the press as "a significant victory" for CDLA, competition, and consumers. J.A. 1550 n.22.

[6]In addition, the government received one anonymous comment in opposition to the proposed termination. J.A. 1634, 1554.

comments. J.A. 674. None of the commenters -- most notably, ISNI -- submitted any factual support or expert affidavits with its comments. On November 13, 1996, the government and IBM submitted lengthy responses to the public comments -- each supported by expert declarations[7] and factual declarations and exhibits. J.A. 1503, 1759 (U.S. response); 770, 1894 (IBM response).[8] That same day, the government and IBM formally filed their Joint Motion For Order Modifying 1956 Final Judgment (the "Joint Motion"). J.A. 1498. On December 18, 1996, ISNI filed a reply to the parties' responses to the public comments. J.A. 1636. Once again, ISNI's submission was devoid of any expert or fact affidavit.[9]

Chief Judge Griesa held a hearing on the parties' Joint Motion on February 13, 1997. Only ISNI, participating as an amicus curiae, appeared in opposition, and its objections quickly became the focus of the hearing. J.A. 1701-02. ISNI's objections centered on aftermarket tying. In particular, ISNI claimed that IBM would stop selling parts to ISOs and would

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[7]The government's comments were supported by two expert economists. J.A. 1564, 1582, 1823, 1841. IBM's comments were supported by one economic and one computer maintenance expert. J.A. 870, 1039.

[8]8Although ISNI complains that it originally received redacted versions of the government's and IBM's responses, ISNI Br. 4, on appeal ISNI received the full, unredacted versions of those filings in return for its agreement to abide by the protective order issued in this case. <u>See</u> J.A. 1759-2933 (filed under seal).

[9]ISNI's reply comments did include one exhibit, a copy of an IBM Information Bulletin for Customers. J.A. 1681.

institute a tie between service and either of two elements -- parts or operating systems -- for the AS/400 or S/390, and thereby exclude ISOs from competing with IBM in the service aftermarket.

At the hearing, as before this Court (ISNI Br. 8-9 & n.1), ISNI objected to the termination only of sections VI(c), VII(c), and IX(b)-(c) of the Decree. Section VI(c) requires IBM to sell repair and replacement parts on nondiscriminatory terms to IBM computer owners and ISOs for as long as such parts are available for use in leased machines; section VII(c) enjoins IBM from requiring any computer purchaser to obtain parts or maintenance from IBM; section IX(b) requires IBM to provide to computer owners at reasonable and nondiscriminatory prices the same technical manuals and informational documents it provides to IBM's own repair and maintenance employees; and section IX(c) requires IBM to provide to lessees and owners at reasonable and nondiscriminatory prices books of instruction and other documents pertaining to the "operation or application" of their computers. J.A. 154-55, 1610-11.

On May 1, 1997, the district court entered its Order granting the parties' Joint Motion (the "May 1 Order"). J.A. 24. In its accompanying opinion, the court sought to "determine whether that agreement is in the public interest" as framed by §§ 1 and 2 of the Sherman Act. J.A. 27-28 (relying on United States v. American Cyanamid Co., 719 F.2d 558 (2d Cir. 1983), cert. denied, 465 U.S. 1101 (1984)). The district court

recognized that the government and IBM had "amassed a great deal of information about the current competitive practices of IBM in the marketplace" for the S/390 and AS/400. J.A. 28.

Based on this "extensive record" (J.A. 29), the district court made specific findings. It found that "there is at the present time an active market in computer repair services, in which IBM competes with many independent repair companies." J.A. 29. Further, the court found as "the salient fact [] that a market in IBM spare parts exists, and this market is largely independent of the need of buying such parts from IBM." Id. (emphasis added). Moreover, the court found that terminating section V(a) of the Decree (not challenged by ISNI on appeal) will further "increase competition in the spare parts market." Id. (emphasis added). With respect to consumers, the court found that IBM's S/390 and AS/400 customers are "well informed about the lifetime cost of a computer (including service)," that they could exert pressure upon IBM to ensure that ISOs continue to receive parts from IBM, and that the "market as it exists today" acts as a "powerful deterrent against IBM engaging in monopolistic tactics." J.A. 30. The court also took specific notice of the fact that none of ISNI's customers joined in ISNI's objections to Decree termination. J.A. 31. Based on these findings and the record as a whole, the court concluded that termination of the remaining Decree provisions would not only not present any "material threat of violation of §§ 1 and 2 of the

Sherman Act," but would increase IBM's efficiency and would "benefit both IBM and consumers." J.A. 31-32 (emphasis added).

Under the May 1 Order, certain Decree provisions terminated immediately while others will be phased out. In general, the Decree will cease to apply to IBM's AS/400 mid-range family of products and services after July 2, 2000 (a four-year sunset provision), and will cease to apply to the S/390 mainframe series after July 2, 2001 (a five-year sunset). J.A. 25, 1608-12. Thus, after July 2, 2001, no portion of the Decree will remain in effect.

After the district court granted ISNI's request to intervene for the sole purpose of appealing the May 1 Order, J.A. 23, this appeal followed.

SUMMARY OF ARGUMENT

When fashioned in 1956, the Decree was intended to constrain IBM's market power in the new computer industry by establishing a secondary market for IBM equipment and, to support that market, an independent parts and maintenance market. Those objectives have been achieved. ISNI argues that four Decree provisions are still necessary to restrict IBM's ability to exercise market power in its AS/400 mid-range and S/390 mainframe computer systems by raising the price of maintenance services to supracompetitive levels. After conducting a thorough investigation of the market -- including interviewing over 120 IBM customers and competitors -- the United States concluded that termination of the Decree, including the provisions raised by

ISNI, was in the public interest because termination would not substantially increase the likelihood that IBM could or would exercise market power. The district court considered all of the evidence presented by the government and IBM (unrebutted by ISNI) and agreed that termination was in the public interest as shaped by Sherman Act precedent. The district court did not abuse its discretion in reaching that conclusion; thus, this Court should affirm.

Under this Court's decision in United States v. American Cyanamid Co., 719 F.2d 558, 565 (2d Cir. 1983), cert. denied, 465 U.S. 1101 (1984), the appropriate test for approving an agreed-upon termination of this Decree is whether such termination is in the "public interest" in light of Sherman Act precedent. The government investigated the prospect that vacating the Decree might lead to harmful aftermarket tying under the analysis employed by the Supreme Court in Eastman Kodak Co. v. Image Technical Services, Inc., 504 U.S. 451 (1992), and found such a consequence unlikely because (a) the evidence suggests IBM is unlikely to engage in harmful aftermarket tying after the Decree terminates, and (b) maintaining the Decree would do little to prevent IBM from engaging in the forms of aftermarket tying that are the focus of ISNI's concern. Once the government and IBM presented their evidence, including factual and expert affidavits, and reasons for terminating the Decree, the district court did not simply defer to the judgment of the government and enter its Order. Rather, the district court considered all of

the evidence and the arguments in opposition presented by ISNI before agreeing that termination was in the public interest. The district court supported its conclusion with findings.

ISNI wants a standard whereby the Decree cannot be terminated unless the government or IBM can prove that no anticompetitive effect will result. Such certainty is neither possible nor required. Terminating a consent decree requires a predictive judgment about what will <u>likely</u> happen in a post-decree environment. Based on its investigation in this case and its experience in administering the antitrust laws, the government believes that (1) a market for parts and maintenance currently exists and that ISOs do not depend on IBM directly for parts, (2) it is unlikely that IBM would choose to stop selling parts to ISOs because such a policy would be inconsistent with xxxxxxxxxxxxxxxxxxxxxxx system openness, (3) market forces will adequately check any attempt by IBM to exercise market power, (4) the concerns expressed in <u>Kodak</u> of customer inability to engage in accurate lifecycle pricing and of customer lock-in are not substantial here, (5) any market power IBM possesses will continue to diminish rapidly during the sunset periods, (6) the antitrust laws provide ample means to stop any unlawful anticompetitive acts by IBM, and (7) in any event, the four Decree provisions to which ISNI clings would not constrain any market power IBM does possess, particularly in IBM's proprietary operating system.

It is understandable why ISOs, as IBM's competitors and direct beneficiaries of the current regulated environment, want the Decree to continue. The government finds it significant, however -- as did the district court -- that IBM's customers do not share in ISNI's concern. Rather, consumers of the AS/400 and S/390 are confident that they have enough leverage over IBM to thwart any attempt by IBM to raise maintenance prices above competitive levels. Although some of these customers felt they had benefitted from competition that the Decree in part created, they were not very concerned that Decree termination would lead to higher prices.

Simply put, the Decree has outlived its usefulness and termination of the four provisions at issue here is unlikely to increase the probability that IBM could exercise market power in hardware maintenance aftermarkets. Accordingly, this district court's conclusion that termination is in the public interest was not an abuse of discretion and should be affirmed.

ARGUMENT

INTRODUCTION

In 1956 computers were in their infancy, and the United States feared that IBM would develop and exercise its market power to the detriment of competition in this new industry as it had in the market for tabulating machines. The 1956 consent Decree was intended to constrain IBM's incipient market power in computer markets by establishing a secondary market for IBM equipment and an independent maintenance market to support that

equipment. Today, the computer market has changed dramatically. The United States, after a thorough examination of the relevant markets and an analysis of the public interest, concluded that the Decree's goals have been achieved, that there is no longer a significant risk that IBM can and will exercise market power in the markets under consideration here at the end of the sunset periods, and that the time has come to treat IBM like any other competitor.

Significantly, no IBM computer customer objected to the government's conclusion. ISNI's members, direct beneficiaries of the regulated environment created by the Decree, have a private interest in continuing the Decree's restrictions and contend that this Court may not affirm the district court's decision unless it is certain that anticompetitive abuses will not result. Such certainty can never be achieved. The record discloses no abuse of discretion by the district court. The government, as representative of the public interest in competition,[10] and IBM, as party to the Decree, reached agreement on when and how to terminate the remaining Decree provisions, thereby avoiding protracted litigation. The district court, after reviewing the arguments and record evidence presented to it by the parties (ISNI chose not to present any factual or expert testimony), independently agreed with the government that terminating the

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[10]See, e.g., United States v. Paramount Pictures, Inc., 334 U.S. 131, 177 (1948); United States v. Borden, 347 U.S. 514, 518 (1954).

Decree subject to the sunset provisions serves the public interest. That decision should be affirmed.

I. THE DISTRICT COURT APPLIED THE APPROPRIATE STANDARD AND REVIEWED ALL OF THE EVIDENCE.

The United States agrees with ISNI (Br. 9) that the appropriate standard for the district court's evaluation of the parties' Joint Motion to terminate the Decree is the "public interest." Cyanamid, 719 F.2d at 565. On appeal, this Court reviews for an abuse of discretion the district court's conclusion that Decree termination serves the public interest. United States v. Eastman Kodak Co., 63 F.3d 95, 109 (2d Cir. 1995) ("Kodak II").

Nor should there be any dispute that the "public interest" derives its substantive content from the Sherman Act's promotion of competition, as laid out in Supreme Court and Second Circuit precedent. This Court emphasized in Cyanamid that when the district court assesses whether termination is in the "public interest," that term takes its meaning from the antitrust laws, not from the court's independent notions of the general welfare, and thus that the analysis should focus on the competitive effect of termination.[11] 719 F.2d at 565 (citing NAACP v. FPC, 425 U.S. 662, 669 (1976)).

[11]In Cyanamid, the district court had erred by failing to apply the specific standard set forth in that consent decree in favor of "contemporary economic theory" not contained in precedent. 719 F.2d at 567.

Here, neither the government nor IBM asked the court, in reviewing the proposed termination of the Decree, to substitute contemporary economic theory for controlling legal principles. Rather, the parties presented evidence on the state of the relevant market to determine whether termination would be in the public interest as consistent with §§ 1 and 2 of the Sherman Act -- the same theory upon which the case was brought in 1952. The district court, in turn, analyzed the Joint Motion the same way. See J.A. 27-28 (considering the "public interest" in light of "the issues which arise under the antitrust laws which gave rise to the consent decree -- here, §§ 1 and 2 of the Sherman Act") (citing Cyanamid).

Rather, our disagreement with ISNI is about the appropriate roles for the government and the district court, where everyone agrees that competitive effect is the relevant public interest focus, but ISNI disagrees with the predictive judgments the government has made. The Cyanamid court never reached this issue. But other courts have reached it, and the law is well established that once the United States consents to a defendant's proposed decree modification, including termination, district court review is limited to whether the government has offered a reasoned and reasonable explanation for its consent and whether the modification falls within the reaches of the public interest as defined by the relevant statutes. United States v. Western Elec. Co., 993 F.2d 1572, 1578 (D.C. Cir.), cert. denied, 510 U.S. 984 (1993) ("Western Elec. II"). The government has

broad discretion in controlling and settling antitrust litigation on terms that will best serve the public interest in competition. Sam Fox Publishing Co. v. United States, 366 U.S. 683, 689 (1961); Western Elec. II, 993 F.2d at 1577 (government exercises "expert, predictive judgment[]"). Such discretion also permits the Department of Justice, the principal enforcer of the antitrust laws, to "reallocate necessarily limited resources" in a way that best serves its enforcement goals. United States v. Microsoft Corp., 56 F.3d 1448, 1459 (D.C. Cir. 1995). The government's considered judgment is entitled to some deference by the courts such that "the district court may reject an uncontested modification only if it has exceptional confidence that adverse antitrust consequences will result -- perhaps akin to the confidence that would justify a court in overturning the predictive judgments of an administrative agency." Western Elec. II, 993 F.2d at 1577.

This standard does not amount to merely "rubber stamping" an agreed-upon termination; everyone agrees that such abdication by the district court or this Court would be inappropriate. Cyanamid, 719 F.2d at 565; J.A. 27 ("the court cannot grant the joint motion simply because the Government and IBM have reached an agreement"); Microsoft, 56 F.3d at 1458. Rather, the district court was required to make an "independent determination" of the public interest. Microsoft, 56 F.3d at

1458.[12] Yet that "independent determination" also must recognize the "flexibility of the public interest inquiry: the court's function is not to determine whether the resulting array of rights and liabilities 'is the one that will best serve society,' but only to confirm that the resulting 'settlement is "within the reaches of the public interest."'" United States v. Western Elec. Co., 900 F.2d 283, 309 (D.C. Cir.) (per curiam) (emphases in original) (citations omitted), cert. denied, 498 U.S. 911 (1990) ("Western Elec. I"). In other words, the "court's role in protecting the public interest is one of insuring that the government has not breached its duty to the public in consenting to the decree." United States v. Bechtel Corp., 648 F.2d 660, 666 (9th Cir.), cert. denied, 454 U.S. 1083 (1981); see also Western Elec. I, 900 F.2d at 307 ("public interest test directs the district court to approve an uncontested modification so long as the resulting array of rights and obligations is within the zone of settlements consonant with the public interest today") (emphasis in original); United States v. Loew's Inc., 783 F. Supp. 211, 213-14 (S.D.N.Y. 1992) (applying test to decree termination).

Here, the district court made that independent determination. Examining the record evidence through the

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[12]Microsoft arose in the context of judicial disapproval of an initial consent decree under the Tunney Act. 56 F.3d at 1457-58. Although the extant case concerns terminating an existing decree, Cyanamid recognized that the Tunney Act "provides useful guidance to the courts in deciding how modification procedures should be addressed." 719 F.2d at 565 n.7.

appropriate statutory lens, Chief Judge Griesa concluded that the phasing out of the remaining Decree provisions "present no material threat of violation of §§ 1 and 2 of the Sherman Act." J.A. 31; see also id. at 29 ("[t]he extensive record submitted on this joint motion supports [the government's] conclusions"). The district court did its job. See Western Elec. II, 993 F.2d at 1578 (issue for the district court is "whether the Department's views were well enough substantiated that it (the Department) could reasonably conclude that [the modification] was in the public interest").

Now, on appeal, the task of this Court is to determine whether the district court "exercised its broad discretion in a proper manner." Kodak II, 63 F.3d at 109. The district court's findings merit review only for clear error. Hirschfeld v. Spanakos, 104 F.3d 16, 19 (2d Cir. 1997). The evidence submitted by the government and IBM (unrebutted by ISNI at its own choosing), the transcript of the February 13 hearing on the parties' Joint Motion, and the district court's May 1 Order are sufficient bases for this Court to affirm.

II. THE DISTRICT COURT DID NOT ABUSE ITS DISCRETION IN TERMINATING SECTIONS VI(c), VII(c), AND IX(b)-(c) OF THE DECREE AS IN THE PUBLIC INTEREST.

ISNI's primary challenge to termination of sections VI(c), VII(c), and IX(b)-(c) is based on the speculation that in the absence of these provisions, IBM will cut off ISOs, tie parts

to service,[13] and thereby be able to raise maintenance prices above competitive levels. Relying on the Supreme Court's decision in Eastman Kodak Co. v. Image Technical Services, Inc., 504 U.S. 451 (1992), ISNI claims that IBM will exploit its alleged market power in parts for the S/390 and AS/400 by tying those items to the receipt of allegedly overpriced IBM maintenance services. The government agrees that Kodak provides a useful analogy, but a comparison between Kodak and this case only highlights their differences and helps explain why termination of the Decree is in the public interest.

This case is distinguishable from Kodak in several important respects. First, IBM, unlike Kodak (see id. at 472), currently exercises no market power in parts. Indeed, ISNI was unable to demonstrate to the district court that ISOs depend on IBM even for critical parts. Second, Kodak had clearly taken steps to cut off the supply of parts to ISOs, and customers had complained; here, however, it is unlikely that IBM will choose to cut off ISOs from parts, and no customers appear worried that Decree termination will result in supracompetitive prices for service. Third, the Kodak Court expressed concern that market

[13]ISNI also contends that IBM may tie its proprietary AS/400 and S/390 operating systems to maintenance services; that argument is addressed at pp. 42-44 below. At times it is unclear whether ISNI contends that an operating system is a type of "part." Compare ISNI Br. 11 (referring to "parts (including operating systems)"), with id. 25 (alleging that IBM could refuse to sell "critical parts or to lease the operating systems") (emphasis added). To the extent ISNI is suggesting that an operating system is a "part" under section VI(c) of the Decree, it is simply wrong. Operating systems do provide IBM with an additional potential avenue of tying, but they are not "parts."

forces might not be able to constrain Kodak's power because of the possibilities that consumers were unable to engage in lifecycle pricing at the time of purchase and that Kodak might be able to profitably exploit its "locked in" customers. Here, however, consumers are able to engage in lifecycle pricing and, for the most part, are not locked in to their IBM equipment.

A. The Kodak Holding.

In Kodak, a group of ISOs alleged that Kodak had illegally tied the sale of replacement parts for its copiers to the service of such equipment. Kodak, 504 U.S. at 461-62. Because Kodak's parts were unique and Kodak restricted the availability of its parts to ISOs, the ISOs could not perform repairs on Kodak machines. The Court found that copier parts and service were two distinct products and that Kodak had in fact tied the availability of parts to service. Id. at 462-63. The only remaining question, then, was whether Kodak's tie was illegal. Kodak argued that as a matter of law and economics it could not exercise "appreciable market power" in parts because there was healthy competition in the underlying market for copiers. Id. at 464. In deciding that the ISOs' allegations survived summary judgment, the Court held that competition in the equipment market (the copiers themselves) did not, as a matter of law, preclude the possibility of market power in the aftermarkets of parts and service. Id. at 471. The Court remanded the case to develop a record whether competition in the equipment market

in fact constrained Kodak's market power in parts.[14] Id. at 466 (no "actual data on the equipment, service, or parts markets"); id. at 474 (no evidence on information supplied by competitors); id. at 475 (no information on lifecycle costs); id. at 479 (no evidence of "actual economic impact" of Kodak's service and parts policy); id. at 486 (Court cannot reach "conclusions as a matter of law on a record this sparse").

This case already has a full record from which the government and district court drew important factual conclusions about "the economic reality of the market at issue." Id. at 467. The government agrees that, as in Kodak, AS/400 and S/390 parts and service are distinct products. Here, however, there is a flourishing parts market and it is unlikely IBM will cut off ISOs or tie parts to service in the future.[15] Moreover, even if IBM were tempted by such a strategy, IBM could not profit from it because market forces would check its behavior. The district court rightly agreed with these assessments. J.A. 29 ("[t]he extensive record submitted on this joint motion supports [the government's] conclusions").

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[14]On remand, when facts were required, the ISOs dropped their tying claim but won a substantial judgment on monopolization and attempted monopolization claims, which was mostly upheld on appeal. Image Technical Servs., Inc. v. Eastman Kodak Co., 1997 WL 549134 (9th Cir. Aug. 26, 1997) (petitions for rehearing pending). Here, ISNI asks this Court "to address only the tying claim" against IBM. ISNI Br. 18.

[15]Section XV of the Decree prohibits ties. J.A. 161, 1612. The United States has never filed an enforcement action against IBM for violating the Decree, including the anti-tying provision. Section XV will terminate at the end of the sunset periods and is not on appeal here.

B. The District Court Was Well Within Its Discretion In Finding No Significant Risk To The Competitive Spare Parts And Service Markets In The Proposed Phase-Out Of Sections VI(c), VII(c), and IX(b)-(c).

The district court specifically found that "there is at the present time an active market in computer repair services, in which IBM competes with many independent repair companies." J.A. 29; see also J.A. 1956, 1958 ¶ 6 (ISOs maintain hundreds of S/390 and thousands of AS/400 systems). Moreover, contrary to the impression created by ISNI that ISOs buy significant quantities of AS/400 and S/390 parts from IBM, the district court also found as "the salient fact [] that a market in IBM spare parts exists, and this market is largely independent of the need of buying such parts from IBM." J.A. 29 (emphasis added).

We do not understand ISNI to dispute these findings. In any event, the findings are correct and well supported by the record. See, e.g., J.A. 1039, 1047 ¶ 21 (used parts are "widely available and far cheaper than new parts"); 1616, 1617 ¶ 7; 1738. ISOs obtain the vast majority of S/390 and AS/400 parts they need by cannibalizing existing machines or by purchasing the parts from independent suppliers that cannibalize existing machines. J.A. 29; 1048 ¶ 22 (used machines and parts are "widely available on the market for only a tiny fraction of the original purchase price"); id. (there are "hundreds of firms . . . that purchase and sell used parts for all types of computers manufactured by IBM"). xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx

xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx[16] xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx. Nor is there record evidence that ISOs buy critical parts from IBM,[17] nor a realistic possibility that IBM would attempt to "corner the market" on parts by buying up all existing S/390 or AS/400 machines; the government agrees with IBM that such a strategy would be prohibitively expensive due to the sheer volume of used machines in the market. J.A. 770, 827; 1554. Thus, there is no evidence that IBM currently exercises any market power in parts.[18]

To the extent that, in future generations of AS/400 and S/390 equipment, IBM becomes the sole source of parts that ISOs find critical, ISNI would have the parties and this Court

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[16]As the reliability and durability of the AS/400 and S/390 continues to improve, the need for any maintenance at all continues to decline. See J.A. 1039, 1049-51 ¶¶ 23-27.

[17]At the hearing, ISNI's counsel attempted to persuade the district court that ISOs bought certain critical parts from IBM, especially on an emergency basis, but counsel was unable to point to any evidence in the record that supported his assertion. See J.A. 1751-53. xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx

[18]ISNI suggests that the existence of a competitive parts market is somehow "irrelevant" because when section IV(b) expires in 2001, IBM may revert to a lease-only policy and thus eventually make used machines unavailable as a source of parts. ISNI Br. 24 n.8. Far from being "irrelevant," the existence of a market today means that ISOs are in no present danger of being driven out of the market. Although the creation of a market for parts is no doubt attributable in part to the Decree, that does not mean, as ISNI contends, that continuation of the Decree is necessary to maintain competition, and that is the proper focus here. ISNI's decision not to appeal the termination of section IV(b) (ISNI Br. 8-9 & n.1) means that nothing in this appeal will affect IBM's right to adopt a lease-only policy, and at least suggests that ISNI thinks that IBM is not likely to adopt such a policy.

speculate that IBM, once freed of the shackles of sections VI, VII, and IX, will seek immediately to destroy ISO competition by refusing to sell parts to them. As the district court noted, there is not the "slightest bit of evidence" to substantiate ISNI's fear. J.A. 1683, 1724.[19] IBM told Chief Judge Griesa that it had no plans to stop selling parts to ISOs. J.A. 1702, 1727. The judge expressly credited what he described as IBM's "very serious" representation. Id. at 1727.

Moreover, other record evidence supports the view that IBM will continue to sell parts to ISOs in the absence of the Decree. First, cutting off ISOs would be inconsistent with xxxxx xxxxxxxxxxxxxxxxxxx system openness. See J.A. 1503, 1545-47. (xxxxxxxxxxxxxxxxxxxxxxxxx). xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx IBM has made its S/390 operating systems "POSIX-compliant"[20] so that software

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[19]This section addresses only the likelihood that IBM will attempt to cut off the ISOs. Whether the market would permit IBM to profit in such an attempt is a different question, and one addressed at pp. 30-41 below.

[20]POSIX is the set of industry standard interfaces for UNIX, a non-IBM operating system of choice for many computer systems. UNIX can run on a wider variety of equipment than other operating systems. As a consequence, the term "UNIX" has become synonymous with "open systems" because it enables various computer platforms to be connected and interoperate. For further explanation of UNIX, see J.A. 1529 n.19, 1544; 870, 882-83 ¶ 23.

applications on the S/390 can be more compatible with other systems -- at the risk that customers will take advantage of the compatibility by migrating existing applications off the S/390 to other computer systems. J.A. 1582, 1587 ¶ 15; 1571 ¶ 19. In addition, IBM now encourages independent software vendors (ISVs) to develop software applications for its S/390 and AS/400 systems, and supplies them with the necessary technical information to develop IBM-compatible applications, even though many of these products directly compete with IBM products. J.A. 1546-47; 1587 ¶ 16, 1592 ¶ 30. In encouraging ISVs, IBM again makes it easier for customers to switch their applications from IBM equipment to other manufacturers' equipment. In addition, IBM lowered the price of S/390 systems (J.A. 1546; 1587 ¶ 14 (new CMOS processor "dramatically reduces the cost of mainframe computing")), all in an effort to make the S/390 more appealing to a larger base of customers. IBM benefits from "the availability of efficient providers of service and software." J.A. 1592 ¶ 30; 1573-74 ¶ 24. Continuing to deal with ISOs xxxxx xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx bolsters the government's belief that IBM would not pursue a policy of harming consumers by cutting off parts to ISOs.

Second, even if IBM were to xxxxxxxxxxxxxxxxxxxxxxx xxxxxxxxxxxx try to cut off parts to ISOs, the district court is correct that customers might very well force IBM to continue to supply parts to ISOs. J.A. 30. The large businesses and institutions that own or lease IBM's S/390 and AS/400 equipment

also own or lease large amounts of non-IBM computer equipment that also need service. J.A. 1045 ¶ 18. Many of these consumers prefer dealing with a single firm that can fix all of their equipment -- not separate firms for separate brands of equipment. This provides IBM with an additional incentive to ensure that ISOs that service other manufacturers' systems can also service IBM products. Thus, as long as sufficient numbers of consumers demand ISOs, they can ensure that IBM continues to sell parts to ISOs. See J.A. 1045-47 ¶¶ 17-20; 1564, 1573-74 ¶ 24; 1586-87 ¶ 13 (customers have forced IBM to change behavior before); 1519 n.9 (ISNI member states that many customers do not want service from equipment manufacturers).

Third, the equitable sunset periods agreed to by the parties and ordered by the district court will protect the ISOs' ability to stay in business. IBM must continue to sell AS/400 parts until July 2000 and S/390 parts until July 2001. This gives ISOs ample opportunity to stock up on any parts they lack to service those computers, including parts for IBM's current-generation processor, the CMOS. J.A. 1592-93 ¶ 32; see also J.A. 1047-48 ¶ 21 (ISOs are capable of maintaining current-generation mainframes). In addition, virtually all of IBM's current maintenance contracts will expire during the sunset periods, giving ISOs an opportunity to woo away new customers. This will ensure the competitiveness of the ISOs for several

years after the Decree terminates.[21] Similarly, the sunset periods will permit any consumers who are concerned about post-Decree events to enter into long-term service contracts that will guarantee them today's competitive prices.[22] This ability alleviates one of the concerns raised in Kodak. See Lee v. Life Ins. Co. of Am., 23 F.3d 14 (1st Cir.) (lock-in not a problem if consumer can recoup "unamortized investment" in the equipment), cert. denied, 513 U.S. 964 (1994).

Finally, the maintenance market in Europe, where the Decree does not apply, is probative of what to expect domestically when IBM is freed of the Decree. Even without the protections of the Decree, according to IBM's experts, ISOs compete in Europe today, J.A. 1044-45 ¶¶ 14-16, 1053-54 ¶ 32; 903 ¶ 50, and IBM has not attempted to buy up or dry up the independent parts market in Europe.

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[21]The sunset periods also provide sufficient time for ISOs to recoup their investments in parts, personnel, and training made in reliance on the Decree and to plan for a post-Decree environment. J.A. 1575 ¶ 28; 1592-93 ¶¶ 32-33. Such equitable considerations are valid factors in the calculus of determining the public interest. See Cyanamid, 719 F.2d at 567.

[22]ISNI simultaneously argues that maintenance prices will increase post-Decree, yet that permitting customers to enter into long-term maintenance contracts is undesirable because they will miss out on consistently dropping maintenance prices. ISNI Br. 48. ISNI cannot have it both ways. The fact that customers currently enter into long-term maintenance contracts is evidence that customers are in the best position to decide whether such contracts are in their interests. See J.A. 1585-86 ¶ 10, 1589 ¶ 21.

C. It Is Unlikely That IBM Would Profit From Any Attempt To Raise Parts Or Maintenance Prices Above Competitive Levels.

Even if after the year 2001 IBM were to control critical parts and tie their availability to service so as to exclude ISOs, it is unlikely it would be able to significantly raise the price of maintenance service. The present case is readily distinguishable from the facts and hypothetical suggested by the Kodak Court. To begin, and in contrast with Kodak, where two of the largest customers of service and parts opposed Kodak, see id. at 479 n.28, no AS/400 or S/390 customer has voiced concern, either in a public comment or privately during the government's investigation, that Decree termination would permit IBM to exercise market power. Indeed, several customers felt confident that they had leverage over IBM. J.A. 1561. An examination of the "economic reality," id. at 467, shows why this is so.

IBM would be unable to sustain a "small but significant and nontransitory increase"[23] in maintenance prices without suffering losses in future equipment sales that would outvalue the increase in maintenance fees. When Kodak offered the same rationale, the Supreme Court suggested two reasons that might "undermine" (504 U.S. at 476) Kodak's claim: customers' inability to gauge the total cost of ownership at the time of

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[23]This is the standard the United States Department of Justice and Federal Trade Commission use to define relevant product markets. See U.S. Dept. of Justice & FTC, Horizontal Merger Guidelines § 1.12 (rev. Apr. 8, 1997).

purchase ("lifecycle pricing"), and customers' inability to switch to a substitute product in the face of an increase in maintenance prices ("lock-in"). The Court denied summary judgment to Kodak in order to develop a factual record on these issues. Id. at 486. In this case, there is a factual record, and it supports our position.

1. The district court rightly found that mid-range and mainframe computer owners engage in accurate lifecycle pricing.

The district court found that "IBM's customers are generally well informed about the lifetime cost of a computer (including service) and there are strong indications that they are quite willing to purchase non-IBM computers if the lifetime costs of IBM machines should become excessive." J.A. 30. Thus, prospective computer purchasers will be able to thwart excessive IBM service prices by buying rival computers with lower overall costs. As the Seventh Circuit put it, "[c]ompetition among manufacturers fully protects buyers who accurately calculate life-cycle costs." Digital Equip. Corp. v. Uniq Digital Tech., Inc., 73 F.3d 756, 762 (7th Cir. 1996).

ISNI's attempts to avoid the force of this finding are unpersuasive. Relying on Kodak, but offering no evidence, it argues that lifecycle pricing is not possible. ISNI Br. 34-35. This plainly misreads Kodak. Although the Supreme Court noted that "[l]ife-cycle pricing of complex, durable equipment is difficult and costly," 504 U.S. at 473, it also expressly

recognized that, even with respect to copiers, "there likely will be some large-volume, sophisticated purchasers" with the desire, ability, and resources to engage in accurate lifecycle pricing. Id. at 475. Ultimately, the Supreme Court cautioned only that "it makes little sense to assume, in the absence of any evidentiary support, that equipment-purchasing decisions are based on an accurate assessment of the total cost of equipment, service, and parts over the lifetime of the machine." Id. at 475-76 (emphasis added).

ISNI's claim that the district court's finding is clearly erroneous (Br. 33) is also insubstantial because the district court had before it abundant evidentiary support, including the affidavit of an expert on lifecycle pricing. See J.A. 1039. Mid-range and especially mainframe computers are expensive pieces of equipment. Depending on the configuration, the AS/400 often sells for several hundred thousand dollars, while a new S/390 often runs in the millions of dollars. J.A. 1528-29; 770, 793. Individuals or even small businesses do not buy mainframe computers; large corporations do. The record is replete with evidence that these consumers are very sophisticated, have the ability, and take the time to determine the total cost of ownership based on the length of time they will need the machine. J.A. 1567-70 ¶¶ 10-14; 1051-52 ¶¶ 28-29; 1585 ¶ 9, 1588 ¶ 20; 924 ¶ 81. In addition, IBM and its rival manufacturers, trade publications, and consultants all supply

lifecycle cost information upon which purchasers rely.[24] J.A. 1617-19 ¶¶ 8-12, 15; 924-25 ¶ 81. Thus, the level of customer sophistication seen in this portion of the computer market is far above that found in Kodak. For example, Kodak pointed out that the federal government did not engage in lifecycle pricing when buying copiers. 504 U.S. at 475. When buying mainframe computers, however, the government does. J.A. 1617-19 ¶¶ 4-15.

ISNI attempts to downplay this evidence by suggesting that these consumers do not estimate lifecycle costs "accurately." ISNI Br. 33. The district court, however, found that consumers estimate lifecycle costs accurately enough to find and switch to rival manufacturers' computers if service costs are too high. That is all that matters. Customer omniscience is not possible or required: "our economy is not one of perfect information, a factor that alone should not invoke antitrust condemnation." PSI Repair Servs., Inc. v. Honeywell, Inc., 104 F.3d 811, 820, 819 (6th Cir.) (rejecting similar argument by ISOs that too many variables precluded accurate lifecycle pricing), cert. denied, 117 S. Ct. 2434 (1997).

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[24]The ability of competitors and consultants to supply consumers with the necessary information is one of the questions of fact left open by the Supreme Court in Kodak. See 504 U.S. at 474.

2. The ability of IBM's mid-range and mainframe computer customers to migrate computer software applications to other equipment effectively protects against any possible effort by IBM to charge supracompetitive prices for service by tying.

All customers, whether large or small, buy computers to do specific tasks. Although every computer system has hardware (the physical equipment such as memory chips, keyboards, etc.) and operating system software (which interacts with software applications and runs the machine internally), it is the application software programs that people use -- whether the program does modest word processing at home or runs an entire airline reservation network. Application software decisions determine hardware purchasing decisions. Businesses have greater software needs than families, and so they buy more powerful computers. But neither the computer nor the applications software market is static: there is a constant development of new application software and a constant desire of the makers of all sorts of computers to improve their machines to run as much software as possible. Similarly, consumer demand for new software grows annually.

The ability of IBM customers to switch, or "migrate," software applications to non-IBM equipment is thus an important protection against any IBM effort to engage in anticompetitive tying. As a practical matter, computer consumers' applications divide into two categories: "locked-in" applications and

"unlocked" applications.[25] J.A. 1586 ¶ 12; see Kodak, 504 U.S. at 477 (the degree of lock-in for any particular user is a question of fact). Customers with unlocked applications include not only new customers (e.g., companies that are just establishing an in-house computer capability), but also customers who are replacing their current equipment (if they have alternatives that use the same operating system) and, more importantly, existing customers that are adding new applications to their existing computer systems or are considering migrating certain applications off one computer system to a different computer system.

If IBM tries to exploit these customers with high service costs, they can and will retaliate by using other firms' equipment to run these applications. These customers may also have certain locked-in applications -- applications that must run on a specific operating system or for which it would be prohibitively expensive to migrate to another computer platform. Importantly, however -- and this is the point ISNI misses -- as long as the customer has some unlocked applications, it will be able to constrain IBM's ability to exercise market power in locked applications.

IBM, like all equipment manufacturers, wants to maximize the number of customer applications that run on its machines. Computers have as many uses as there are software applications. The greater the number of applications a customer

[25]Lock-in is a concern to current owners of equipment because they "will tolerate some level of service-price increases before changing equipment brands." Kodak, 504 U.S. at 476.

runs on its S/390, for example, the more likely that customer will soon need an upgrade to its S/390 or to replace the existing S/390 with a new and more powerful S/390 altogether. Thus, equipment manufacturers want to maximize both the number of applications that can run on their machines[26] and the number of applications that customers do run on their machines. If a customer feels exploited by IBM's aftermarket pricing -- or fears such exploitation in the future[27] -- it will stop adding applications to its existing IBM equipment and will try to migrate existing applications off its AS/400 or S/390 to a different computer platform. J.A. 1570 ¶ 16, 1571 ¶ 18, 1572 ¶ 21 ("interest in marketing incremental products to their established customers limits IBM's incentives for opportunistic behavior"); 1588 ¶ 20. IBM does not want to be left with a dwindling installed base of existing customers and ever fewer applications running on those computers. See J.A. 1546 (xxxxxx xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx); 1570 ¶ 16, 1572 ¶ 21; 1588 ¶ 20, 1592 ¶ 31.

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[26]This is why IBM's cooperative approach toward ISVs makes sense. See p.27 above. An equipment manufacturer benefits whenever the pool of software that can run on its equipment increases.

[27]Such fear may arise either by anticipating a change in IBM's policy toward customers or by knowing of others who are currently exploited. ISNI speculates that customers do not know when they are being exploited or when others are exploited. ISNI Br. 46. Once again, however, the record evidence is to the contrary. J.A. 1573 ¶ 23 (noting that consumers can compare maintenance costs from one manufacturer to another and rely on trade publications to provide price information).

A customer's ability to exert leverage over a manufacturer, then, will increase with the customer's ability to choose among different manufacturers' equipment not only when deciding how to replace current equipment, but also when deciding where to place a new application or where to migrate an existing application. Thus, equipment manufacturers compete at the application level. The government's investigation revealed that the AS/400 faces a competitive market today. J.A. 1528-29; 1566-67 ¶ 8. Moreover, most mid-range customers interviewed felt that computers made by IBM's competitors were good substitutes for the AS/400, and <u>none</u> of IBM's AS/400 competitors voiced concern that Decree termination would enable IBM to exert any market power. J.A. 1529. All evidence indicates that competition in the mid-range market will continue to intensify dramatically during the sunset period, especially because the price/performance ratio in mid-range platforms continues to increase rapidly. J.A. 1519. Similarly, most existing AS/400 customers are not locked in to their AS/400 to run their existing software. Switching off the AS/400 is relatively easy because many applications are off-the-shelf products that can more simply be migrated to other platforms. J.A. 1538. In short, almost all mid-range customers have entirely unlocked applications. ISNI does not seriously challenge these conclusions, and does not offer any concrete example of how IBM could exploit its AS/400 parts position to raise maintenance prices above competitive levels. AS/400 customers simply do not face a <u>Kodak</u>-type problem.

A competitive analysis of mainframes leads to the same conclusion. The IBM S/390 faces "substantial competition" on both a systemwide and application-specific basis.[28] J.A. 1566-67 ¶ 8; 1586 ¶ 11, 1588 ¶ 20; 1531-32. Systemwide competition to S/390 equipment comes from plug-compatible mainframes (PCMs) manufactured by Amdahl and Hitachi. These computers use the same operating system as the S/390 and are complete substitutes for the S/390 equipment. J.A. 1531. Thus, consumers who need a new mainframe, including those who are replacing their current S/390 equipment, have only unlocked applications.[29]

Importantly, and a fact that ISNI ignores, even consumers that do not have current plans to replace their S/390 still exert a significant check on IBM's exercise of market power. This is because most S/390 customers have a mixture of locked and unlocked applications. Virtually all mainframe consumers already have other, smaller platforms of mid-range and/or personal computer systems. Many new applications can be

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[28]ISNI mischaracterizes the government's position as relying solely on <u>future</u> competition to constrain IBM (ISNI Br. 12, 42); rather, the government believes that IBM faces competition and market constraints <u>today</u>, which will only intensify during the sunset periods.

[29]Thus, ISNI's statement that the number of <u>new</u> buyers of mainframes is neither large nor expected to grow significantly, ISNI Br. 36, is true but irrelevant. Most new mainframes are sold to existing mainframe consumers. These consumers are either adding additional mainframe capacity or are replacing their older mainframe equipment. The relevant fact is that these customers have a choice between the S/390 and a PCM. J.A. 1572 ¶ 21.

run on either mainframe or mid-range systems,[30] and more and more existing applications can be economically moved off mainframes to mid-range computers. The number of unlocked applications for mainframes is already large and predicted to grow steadily. J.A. 1586 ¶ 12; 1538-39. This is due in part to the marked increase in the power of mid-range computer systems, but also due to IBM's decision to "open up" its S/390 system. See pp. 26-27 above. As a result, fewer and fewer applications must be run on mainframes, and this trend will only accelerate during the sunset period. There is no question that IBM feels tremendous pressure to continue to make the S/390 more attractive to users. Thus, IBM has continued to innovate -- increasing the speed, capacity, and reliability of the S/390; has successfully repositioned the S/390 as a server, not just as a mainframe computer system; and has cut the price of the S/390 in recent years. J.A. 1520, 1546, 1548. These are all signs that IBM is striving to make the S/390 more competitive, not to take advantage of market power. See J.A. 1567 ¶ 8 (xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx xxxxxxxxxxxxxxxxxxxxx).

ISNI points to the amount of S/390-specific applications and asserts, without foundation, that it is prohibitively expensive for consumers to migrate off the S/390

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[30]Electronic mail is a prime example. Originally, large e-mail systems were run entirely on mainframes. Today, most e-mail systems are run on mid-range platforms. When a customer decides it wants to add an e-mail system, it can buy an application that will run on its mainframe, or it can buy an application that will run on its mid-range computer. That ability to shop forces IBM to remain competitive.

system. ISNI Br. 30-33, 37. ISNI is correct that it is unlikely many consumers will migrate <u>all</u> of their applications off their S/390 systems immediately. However, the government's investigation revealed a considerable number of S/390 customers who have or who are considering migrating <u>some</u> applications from their S/390 to another platform. J.A. 1535, 1540. The threat of this application-specific migration is enough to exert competitive pressures on IBM; xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx. J.A. 1570-71 ¶¶ 16, 17, 19; 1534. Migration of applications off mainframes to smaller computers or networks of smaller computers is a frequent occurrence and growing rapidly, especially when, as inevitably happens, customers' existing computers age or their computing needs grow. J.A. 1532-35; 1586 ¶ 12. This helps explain why many of the 93 customers we interviewed felt they have leverage over IBM and are not worried about any attempt by IBM to raise maintenance prices above competitive levels. J.A. 1561. Thus, unlike <u>Kodak</u>, lock-in does not appear to be a significant problem here.[31]

It is also true, however, that a few existing S/390 customers are locked in to the S/390. These customers have solely locked-in applications and have no plans to add new

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[31]ISNI is also incorrect (Br. 22, 28) that the district court did not consider the lock-in issue. The district court was fully aware of lock-in as a potential problem, <u>see</u> J.A. 1733, but ultimately was unpersuaded by ISNI's arguments on this point.

applications or to replace their S/390 equipment, which they could use as leverage over IBM. Our investigation reveals that this class of customers is small and will continue to decline during the sunset period; they are not a significant portion of the mainframe market. J.A. 1539; 1586 ¶ 12, 1590-91 ¶ 26 ("there may be few or no unprotected locked-in customers" by the end of the sunset period). IBM's concern for its reputation will act as some additional check on its willingness to exploit these customers.[32] Nevertheless, to the extent that IBM can identify these customers, they are potentially susceptible to aftermarket exploitation.[33] Even so, concern for this small group of locked-in customers does not justify deciding this appeal in ISNI's favor, because continuation of the Decree provisions raised by ISNI are unnecessary and will not prevent such exploitation from occurring, as explained below.

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[32]Such reputational concerns are not easily dismissed. ISNI Br. 45-46. As two experts have explained, IBM has considerable goodwill tied up in its reputation, and any exploitation of one group of customers is likely to be discovered by other groups and will tarnish IBM's image in their eyes. J.A. 1570 ¶ 16, 1572-73 ¶¶ 22-23; 1589 ¶ 23. Because IBM must compete vigorously for these other customers' business, IBM is less likely to risk their business by taking advantage of a small minority of locked-in customers.

[33]ISNI suggests that customers will not know when they are being exploited. ISNI Br. 46. Again, however, the record evidence is to the contrary. See J.A. 1573 ¶ 23.

D. The Sherman Act Provides Effective Protection Against Any IBM Effort To Exercise Market Power Anticompetitively.

For all the reasons already explained, it is highly unlikely that IBM will engage in anticompetitive tying to raise prices in the maintenance business once the Decree provisions finally expire in July 2001. J.A. 31. If, however, IBM should choose to engage in such conduct, it would face the powerful threat of liability under the antitrust laws.

The expiration of the Decree, after all, does no more than release IBM from a 41-year-old consent decree that has outlived its usefulness. IBM is most assuredly not receiving any exemption from the antitrust laws. If, after the Decree terminates, IBM engages in any anticompetitive activity that would violate the antitrust laws, it would immediately be liable to suit. For example, should IBM engage in anticompetitive tying -- be it to parts or operating systems -- the United States could bring an action for injunctive relief both to stop the illegal conduct and to get other, broader prophylactic relief. See United States v. Loew's, Inc., 371 U.S. 38, 53 (1962) ("[t]o ensure [] that relief is effectual, otherwise permissible practices connected with the acts found to be illegal must sometimes be enjoined"); see also United States v. Loew's Inc., 783 F. Supp. 211, 214 (S.D.N.Y. 1992) (terminating decree and finding it "significant[]" that the Justice Department could again bring suit if necessary).

Also, IBM would be liable to a host of potential private treble damage actions. See Microsoft, 56 F.3d at 1461 n.9 ("decree does not preclude [third party] from bringing its own private antitrust suit against Microsoft to gain the specific relief it seeks"). Injured service competitors, such as ISNI, could sue. Equally important, IBM customers injured by the tying could also sue. Given the deep pockets and legal sophistication of IBM's mainframe and mid-range customers, this threat is particularly serious. Moreover, any plaintiff, whether government or private, would have the advantage of the Supreme Court's rulings that at least certain tying arrangements are not merely unlawful under the Sherman Act, but unlawful per se. See, e.g., Jefferson Parish Hosp. Dist. No. 2 v. Hyde, 466 U.S. 2, 12-16 (1984).

The effectiveness of the threat of litigation as a deterrent against tying is made all the more powerful by the incentive it gives to IBM to exercise any market power it might have in other ways that it is likely to find less costly -- and that are not now prohibited by the Decree. For example, IBM could exploit its unquestioned market power in S/390 and AS/400 operating systems software[34] simply by raising the license fees

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[34]IBM is the sole supplier of such operating systems. IBM's market share for its suite of S/390 operating systems is approximately 80% -- even consumers who use PCM equipment from other manufacturers tend to use IBM's S/390 operating system. J.A. 1531. Computers today will not run without an operating system.

for those systems to supracompetitive levels.[35] Operating systems did not even exist in 1956, and nothing in the entire Decree (not just sections VI(c), VII(c), and IX(b)-(c)), which ISNI has raised here) would bar such action.[36] If IBM wants to exploit market power, it will do so through its operating system, not through parts or maintenance services, and nothing in the Decree can stop it. That IBM has chosen not to exploit its operating system in this way provides yet another illustration of the fundamental point: that the market and the antitrust laws effectively constrain IBM, even in the absence of the Decree.

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[35]All parties agree that IBM is able to alter the terms of its operating system licensing agreements on short notice. J.A. 1526, 1718-20.

[36]Although the United States has interpreted the Decree so as to prohibit IBM from discriminating in the licensing of it operating system between purchasers and licensees (section IV), and from tying any other product or service to the license of its operating system (section XV), the Decree would not prevent exploitation of market power through an increase in the licensing fee. Moreover, ISNI has not appealed the termination of sections IV or XV.

CONCLUSION

For the foregoing reasons, the judgment of the district court should be affirmed.

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CERTIFICATE OF SERVICE

I hereby certify that on this 7th day of November, 1997, I caused two copies of the foregoing Brief For The United States to be served by Federal Express (for Saturday delivery) on:

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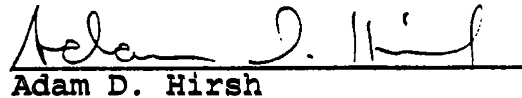

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