Property Markets, Monopolies & Microsoft

by Stephen E. Roulac

The Court's judgement that Microsoft violated antitrust laws has profound consequences that extend beyond the computer industry. This renewed spotlight on the issues of market dominance raises questions for the advocates of consolidation in any and every industry.

Consolidation initiatives target both new and established industries. The market that Microsoft was convicted of monopolizing did not exist until very recently. Indeed, 20 years ago none of the customers who were found to have been denied market choice had even heard of multi-functional software and Internet access, let alone made the determination that they wanted to have such products. The story of rapid product development, introduction, expansion, and deep penetration, combined with Microsoft's ascension to market dominance and the status of the country's most valuable enterprise, is a telling commentary on change and innovation in the post-industrial era.

A monopoly may be illegal if the means by which the monopoly was established, and/or the power of the monopoly position, are deemed to be anti-competitive, because competitors and/or customers are injured as a consequence of the monopolist's wrongful conduct. On the other hand, some monopolies are legal. Among companies that enjoy dominant market share, but which have yet to be attacked by the Justice Department, are Western Union controlling 81 percent of money transfers; DeBeers controlling 72 percent of the diamond market; and Rawlings Sporting Goods controlling 100 percent of the major league baseball equipment market. In the residential real estate brokerage market, the National Association of Realtors effectively enjoys a monopoly position

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of market dominance. The professional sports leagues for football, baseball, and basketball are all monopolies. While their monopoly positions are a source of challenge to some, those monopolies have not been determined by the Justice Department to be illegal per se.

As noted above, the issue of market dominance monopoly will be of increasing concern to those with property involvements. Certain consolidator strategies applied to the property sector have the objective of dramatically reducing consumer choice. Large property businesses may trigger concerns that their scale represents disproportionate market power. Many business models of the new real estate technology dot.coms aim to achieve market share dominance.

Monopoly may be defined many ways, for market share is by no means the only criterion. Other criteria include business processes, technologies, intellectual property, relationships, talents of specific individuals, brands, customer relationships, and more. While monopolies seldom last for an extended period of time, during the period that the monopoly is dominant, extraordinary profits may be extracted and massive economic distortion may be imposed. How does a company consistently outperform competitors over an extended period of time, as reflected by sustaining profits exceeding what others can accomplish? Sustained extraordinary profits are frequently achieved by monopoly positions.

Monopoly involves dominance of a market, which dominance can take many forms. Regulated industries, such as communications, utilities, and transportation, long enjoyed government-sanctioned dominance of geographic markets. The deregulation of such government-protected markets has been accompanied by a redefinition of markets, whereby the tangibles of geography and distance are de-emphasized, just as the intangibles of connectivity and exclusivity are championed.

Market consolidation leading to dominance is not a new phenomenon. Evidence of consolidation leading to oligopoly — dominance of a market by a small number of firms — if not overt monopoly is pervasive in the American business sector. Within the transportation sector, there has been an inexorable move to consolidation and domination by larger companies. In the automobile sector over the twentieth century, there was a persistent consolidation within an industry that initially consisted of

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scores of competitive independents in the North American market, into a few major global players that dominate the American, European, and Asian car makers. Similarly, both the air travel and railroad industries have been consolidated into a small number of dominant large companies. The announced intention of UAL Corp to take over U.S. Airways Group could trigger the six major airlines consolidating into a business dominated by only three major airlines.

Today, the changing market structures and competitive conditions of the communications and information sectors are especially dynamic. About the time that the personal computer emerged, the telecommunications monopoly of AT&T was splintered. As the Bell system was broken into seven regional independents, two competitive long distance services, Sprint and MCI, emerged. The delivery monopoly of the U.S. Post Office was challenged by Federal Express, UPS, Airborne Express, DHL, and other delivery services, as well as fax communications and the Internet. These enterprise reorganizations exemplify the outcome of market forces and government initiative combining to convert a former monopoly to an oligopoly.

BATTLE FOR THE DESKTOP

Commencing in the early 1980s, considerable attention was devoted to the *battle for the desktop* to determine which computer brand would occupy the desktops of businesses across the land and therefore dominate the computing market. While the consequence of this *battle for the desktop* has been

much attrition of and some consolidation of the group of companies involved in making personal computers, today no single computer brand is dominant. The battle for the desktop was a battle primarily between "proprietary" systems (Apple being the best known) and "open" systems (WinTel). While Microsoft and Intel licensed their technology to all comers, Apple refused, taking on the whole panoply of vendors who offered WinTel computers—including IBM, HJP, Compaq, and almost all other PC vendors. Because the WinTel vendors were all using the same operating systems and chip, none of them could become particularly dominant over the others.

When the *battle for the desktop* commenced, the computer was far from ubiquitous, but the general perception was that computing would move from centralized, mainframe systems to decentralized, individual computers. While there were some computers on desktops, the perception was that the leadership position for computing and communication for corporate America was to be won by placing machines on desktops in spaces which to that point in time were mostly unoccupied by computers. Thus, the *battle for the desktop* more involved winning the right to put a branded system in space that had yet to be occupied by computers than convincing a user to choose a different computer than the one already being utilized.

The *battle for the desktop* was a dominant theme for much of the decade for the 1980s. Of course, this *battle for the desktop* followed the earlier *battle for the chip* and *battle for the operating system*, which involved the technologies that would *power* and *guide* the computer itself. Intel prevailed in the *battle for the chip*, and Microsoft prevailed in the *battle for the operating system*, to the point that the majority of personal computers are *Wintel* dependent—which description reflects Microsoft's Windows operating system and Intel's chip.

The *battle for the desktop* was resolved, at least to some extent, by computers morphing into laptops and moving off the desktop. All of the WinTel system vendors — IBM, Dell, Gateway, HP — plus the Windows-based software industry won as part of WinTel excelling. This separation of computing, communicating, and related productivity functions from the office is related to the migration of work primarily from 9 to 5, five days a week, in the office, to anytime—effectively 24 hours a day, seven days a week, and any place—office, home, hotel, coffee shop, train, air plane, park, etc.

More recently, crucial technology battlegrounds have moved beyond computer chips that drive computing/communicating machines, the operating systems that run them, and space for the computers on the desktop. Now, the battleground has shifted to the Internet, which is increasingly influential in commerce generally, and in communications specifically. Initially, it was the *battle for the browser*—the means by which one viewed web content. But now the browser is less crucial.

The emerging pre-eminent concern about content was a central motivation for the AOL–Time/Warner combination. In virtual commerce, companies seek to dominate market space, by capturing more attention, involvement, loyalty, and ultimately spending than the competition. The challenge is to attract and retain people's attention, described in the vernacular of having a site that draws *eyeballs* (people), and is *sticky* in motivating them to spend time at the site, which presumably will result in them being exposed to advertising and thereby more likely to click through the advertiser's site and/or to spend money on what is offered.

Significantly, while Microsoft was slow to adapt its business to the Internet, once it decided to do so, it quickly gained a market dominant position, to the point that the Justice Department pressed antitrust litigation for illegally monopolizing a market that Microsoft earlier had largely ignored.

In assessing the lessons of the Microsoft antitrust prosecution, it is important to consider that it is not "illegal" to achieve a monopoly position in a market by virtue of one's own success resulting from initiative, applied acumen, and concerted investment in brand, technology, systems, capital equipment, and people. It is an antitrust violation to achieve monopoly position through illegal means. Then, once that monopoly position is achieved, it is an antitrust violation to employ illegal means to restrict customers' choices and defeat would-be competitors.

MICROSOFT MONOPOLY?

While the evidence of the market suggests that Microsoft indeed does possess a monopoly, how the "market" is defined may be less than clear. Just as the meaning of "market" can present interpretative challenges, so, too, can assessment of whether behavior is "illegal." Such an assessment turns on the subtle distinctions between exerting one's power legitimately and responsibly, or engaging in heavy-handed and bullying behavior, or "illegal" conduct that amounts to violation of the law.

Some who favor a libertarian political philosophy might conclude that the Department of Justice employed bullying tactics in bringing the litigation against Microsoft.

Some observers suggest that Microsoft has been less-than-effective in its litigation strategy, especially its insistence that it does not have a monopoly. Were Microsoft, or any other enterprise dominating a market, to admit that it did in fact possess a monopoly, then the focus of attention is whether illegal means were employed to create that monopoly. Just as chance plays a role in the marketplace as well as the courtroom, so, too, does chance play a role in how the events are perceived. In this regard, Microsoft in its antitrust litigation during 1998 was the fortuitous beneficiary of the presidential impeachment hearings. What would otherwise have been frequent front page, headline-dominating news, was relegated to occasional coverage or mention in the back pages, when it was mentioned at all.

One bit of telling evidence of Microsoft's monopoly position is its ability to generate extraordinary financial performance relative to the competitors that it claims it does not monopolize. For example, despite the significant distraction of management attention on the antitrust litigation in which it has been ensnared for several years, Microsoft has continued to report record financial results. Notably, Microsoft's record 1998 earnings were *after* paying all of the costs of defending itself in the antitrust litigation. Intriguingly, the Microsoft legal bill of some $43 million for just one-quarter was just short of the $46.8 million in 1998 revenues reported for all of 1998 by AtHome Corp., a once highly visible Internet company that attracted considerable stock market interest.

More fascinating than what Microsoft reported, however, is what it may not have reported. Knowing the company was under intense scrutiny during its high-stakes antitrust litigation, management's objectives would hardly seem to be inclined towards blow-out numbers. Certainly, to keep the Wall Street investment community happy, Microsoft management is motivated to meet projections. But why, rationally, would they be motivated to exceed projections so dramatically? What benefit is there to reporting nearly a billion dollars more in profit than Wall Street anticipated?

One possible answer as to why Microsoft reported the outstanding numbers that it did, is that what

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was reported is *after* substantial deferrals and the most conservative possible income realization accounting treatments. Expressed another way, if Microsoft were not putting on the financial reporting brakes, its profits could well have been dramatically greater than what were actually reported. At a time when Microsoft would rationally be motivated to minimize its market dominance and superiority, as reflected by the ultimate measure—profitability, it reported business results dramatically greater than the competition.

When a company such as Microsoft consistently outperforms its competitors, sustaining substantially above average profits that far exceed the profitability of other enterprises over an extended period of time, the inescapable conclusion is that such superior profits are achieved by virtue of its monopoly position. Microsoft's profits are telling.

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IMPLICATIONS FOR REAL ESTATE

The essence of real estate rests on monopoly. A central tenet of real estate — more applicable to

commercial than residential properties — is that every location and every property are unique, there are no others like it. The entrepreneurs and/or investors who can control that property, then possess a monopoly on that unique asset. Property owners seek to create demand for the property interests they control, that is greater than the supply of those property interests. While such dominant control outcomes can be realized through many strategies and circumstances, the essential question is whether the conduct that leads to market dominance is legal or illegal.

The Microsoft antitrust litigation has both strategic implications for and direct applications to real estate. The Microsoft story offers possible lessons for real estate companies. Real estate consolidators who seek market dominance might consider whether their desired outcome is characterized only by the perception of positive upside or whether there might also be some downside. One risk is to be so successful that the Justice Department determines that the consolidated enterprise must be broken up into two or more separate companies. While this risk might perhaps be perceived to be more theoretical than real, when Microsoft was in its early years, few if any perceived the eventual scale and dominance Microsoft would ultimately achieve.

With the proliferation of innovative technology-based business models and real estate dot.com enterprises, many people are betting their careers and venture investors their dollars on their ability to create a virtual monopoly on a specific application. Indeed, many of the business models have viability, *only* after a substantial if not virtual monopoly share of their market is achieved. There is no question that there will be many casualties in the quest to dominate the new property goods and services markets. But will the winners also be casualties, forced by the Justice Department to give up their hard-earned share of market dominance?

BATTLE FOR PROPERTY CONTROL

Those who advocate the consolidation of real estate market ownership assert that a very small number of major national and international enterprises will own and control the spaces in which businesses work and people live. This *battle for property control* is very different than the *battle for the desktop*, since many companies own their space rather than rent. Other than demand to be generated by companies that have yet to be formed, the *battle for property control* involves companies that already use office space in one form or another. Thus, the battle to dominate the office space market involves *substitution and replacement* more than it does convincing someone to adopt a new product offering.

Already, in certain geographic regions, major property enterprises are dominant landlords—to the point that a tenant seeking space in that particular region has very few options other than the dominant property owner. As a case in point, the San Jose Airport office sub-market is dominated by Spieker Properties, which controls the vast majority of the inventory of business space.

With increasing sensitivity to monopoly, this does not necessarily mean that a real estate owner cannot insist that his offering is unique. Antitrust exposure may exist, however, if that owner links access to that property to some other contractual arrangement. This linking of getting access to one thing by having to buy another, in antitrust terminology is called *tying*, which is central to the Microsoft litigation. The Justice Department lawyers argued successfully that Microsoft tied access to certain critical computer and Internet capabilities to its product.

Two real estate examples illustrate *tying* in application. A mobile home park owner who limits access to renting the park space only to those persons who buy a mobile home from him is engaging in *tying*. The office building landlord who makes the lease available only to those who agree to utilize his controlled telecommunications and Internet providers may be engaging in illegal tying.

Real estate is an especially prominent segment of an economy that has witnessed explosive growth of public control and ownership. Those who advocate consolidation of property control, achieved via securitization, suggest that a very small number of enterprises may control each major property category. If the consolidators achieve their stated objectives, such centralized control could transform the real estate markets from a lack of economic concentration to a market structure characterized by oligopoly if not monopoly.

Real estate demand is closely linked to the technologies of transportation, information, and communications—which are simultaneously *demand stimulants* and *demand substitutes*. Therefore, considering the evolution of market structure and market concentration within these sectors of economic activity can be instructive in comprehending prospective future directions and structures of the real estate markets.

MONOPOLY LESSONS FOR REAL ESTATE

By virtue of physics and uniqueness, real estate inherently involves elements of monopoly in the property markets. Because each property is unique, only one party can occupy or own it. An owner who controls a particular property that another covets, has — for purposes of that transaction — a monopoly on that tangible opportunity. Until and unless the prospective purchaser shifts her attention elsewhere, the property owner possesses a monopoly. This theory has application beyond a particular property.

Though economic theory holds and history teaches that monopolies will not persist forever, over the periods they do persist, extraordinary economic dislocation can occur. If power corrupts, and absolute power corrupts absolutely, then the monopolist who dominates a market can distort absolutely what would otherwise have transpired — in both the public and private sectors. Amongst those whose interests are damaged are 1). customers of products of present, former, and would-be competition; 2). prospects and opportunities of those who worked, aspired to work, and formerly worked in such competing and would-be competing firms; and 3). those who invested or would invest capital in those companies.

Many of the emerging real estate technology dot.com business models aspire to — and in some instances depend upon — achieving a scale and market dominance that, in relative terms, might rival what Microsoft has achieved in its markets. Indeed, these business models mandate capital investments and market coverage that can only be justified and maintained by a volume of business that would dwarf, if not render insignificant, the offers of competing enterprises. If these real estate technology dot.com companies are to meet their objectives, they must necessarily achieve market dominance that could raise questions of oligopoly and perhaps even monopoly.

The battle for control of the market for property goods and services represents both a threat and an opportunity for all professionals and companies with property involvements. As important as new offers, new concepts, and new approaches may be, those who overlook fundamental strategic issues shall do so at their peril. Specifically, for global property involvements, seven crucial questions in formulating effective strategies need to be addressed:

1. Where will demand be?
2. How does a local-oriented business service a global market?
3. What is the location of work and sales?
4. What are the implications of the information economy for property demand?
5. How will governance forms evolve?
6. What are the opportunities and implications of new forms of real estate ownership?
7. Which theory of town development planning will dominate?

Thoughtful answers to these questions extend thinking well beyond the *battle for property control.*

Consideration of the issues concerning markets, monopolies, and Microsoft leads to several direct applications to significant real estate decisions:

1. The transition from a business traditionally dominated by direct involvement to a securitized dominant form of equity and debt financing can involve no small amount of peril. Indeed, the rules of the game for direct real estate are very different than those for securitized real estate. As a case in point, while the use of inside information is not illegal concerning direct real estate transactions, when real estate is in the securitized form, different rules, specifically the rules of corporate securities, apply.

2. The premise of *fair dealing* is the foundation for transactions that do not give rise to legal problems. Although acquiring a dominant position in a particular market is not in itself illegal; what is illegal is the use of inappropriate means to acquire that position, or to exercise the power of that dominant position. Indeed, the extensive litigation concerning wrongful conduct involving environmental contamination and pollution; inappropriate activity by lenders; self-dealing by general partners and control parties of real estate entities; and inappropriate practices in violation of fiduciary responsibilities, carry significant liability damages.

3. Merely buying properties in a pattern resulting in an enterprise being the dominant owner in a market is neither wrong nor illegal. What may lead to a violation of competitive practices is the finding that those acquisitions were made via transactions that precluded fair consideration of other owners' interests and objectives.

4. Comprehension of market performance and definition is crucial to assessing questions of market

dominance and performance causation. Multiple factors influence the definition of markets for property-related services. As those forces that influence the definition of property markets are subject to dynamic realignment, appreciation of subtlety and complexity are required.

5. Changing spatial patterns of how and where people live, work, learn, and play are realigning business strategies. These new business strategies lead to enterprises electing different strategies for the places and spaces in which they do business, which in turn leads to new approaches to the corporate real estate function.

Fighting the *battle for property control*—as interesting as it may be—without adequately considering these five lessons as well as the implications of the answers to the seven crucial questions listed above, can lead to very disappointing outcomes. Specifically, a strategy that wins a particular battle may contribute to losing the larger war.

Just as the *battle for the desktop* is impacted by the transformation of the form and portability of computing and communicating, so also is the *battle for property control* largely impacted by the transformation in how and where people live, work, and play. Worrying about desktops proved to be not the only crucial question for the computer industry. Perhaps there is a similar lesson for those with real estate involvements who aspire to dominate their markets. REI25

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