

Breaking Up is Hard to Do

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Lucian Bebchuk and David Walker

The US Supreme Court's decision last week not to take the Microsoft antitrust case on direct appeal allows for a thorough - and much needed - review by the appeals court. This review should consider a substantial cost of the break-up proposal that has thus far been ignored.

Discussion of the break-up has focused on costs arising from separating Microsoft's operations, patents and people into separate entities. It has been assumed that dividing the securities of the separated companies among former Microsoft shareholders would be straightforward. This is wrong.

Although neither the government nor the trial court seems to have realized it, distributing these securities without imposing significant costs on some shareholders or causing a substantial transfer of value among shareholders would be very tough indeed.

The government has suggested to the trial court that the securities can be distributed using conventional spin-off techniques, as was done in the AT&T break-up. In a conventional spin-off, however, shareholders receive a fraction of shares of the new companies equal to their fraction of shares in the old company.

But this approach will not work in the Microsoft case because the break-up order also prohibits any shareholder with more than 5 per cent of the shares from owning stock in more than one of the Microsoft offshoots. This restriction, which would apply to Bill Gates and probably also to Steve Ballmer and Paul Allen, aims to prevent so-called "covered shareholders" from wielding influence in both companies.

Given the restriction, there are two ways of implementing the break-up order. First, Microsoft could undertake a conventional spin-off and require covered shareholders to sell their shares in one of the two companies immediately. The problem is that these shareholders would face a big financial penalty. A conventional spin-off enables shareholders to continue to defer taxes until they sell their holdings. If covered shareholders were forced to sell their shares in one of the offshoots immediately, they would lose the opportunity to defer billions of dollars in taxes.

Of course, some people believe that Mr Gates, in particular, deserves to be penalized for running a company that violated the antitrust laws. Yet he was

not personally charged in the indictment, and the government has argued that the break-up would not impose penalties on Microsoft's shareholders - beyond the elimination of monopoly profits. Clearly, large penalties on individual shareholders should not be imposed unless a judicial decision finds them warranted.

A second method for complying with the break-up order would be to distribute securities in such a way that the covered shareholders end up with shares in only one of the offshoots. This approach would take care of the fire-sale discount and tax problems, but it introduces a valuation problem. True, an expert could be hired to estimate the value of the offshoots. But given the unique nature of these companies and the uncertainties surrounding their birth, estimating their value would be difficult and speculative. Even a small error could result in a transfer of billions of dollars between the covered shareholders and the rest.

The relative value of the companies also could be determined based on their post-break-up market values. But shareholders such as Mr Gates might have better information than the market regarding these companies. Thus, permitting them to choose the offshoot in which they remain might enable them to obtain a disproportionate share. Furthermore, giving the covered shareholders shares in only one offshoot could concentrate their investments into a much smaller company and impose on them risk-bearing and liquidity costs.

An alternative worth considering would require amending the break-up order, but would be consistent with its goals. Under this method, the securities would be distributed pro rata as in a conventional spin-off, and covered shareholders would be allowed to hold shares in both companies. To prevent them from wielding influence in both companies, however, they would be precluded from exercising their voting power in the offshoot of their choice. To this end, trustees could be appointed to vote their shares in proportion to the voting of other shares in any corporate ballot. If a covered shareholder sold his shares, however, the buyer would acquire normal voting rights.

This method would still impose costs on the covered shareholders, but it might turn out to be the method with least cost and least risk for Microsoft's shareholders. If a break-up is to be pursued, the government and the courts should consider this alternative and, more generally, seek to address these substantial - thus far overlooked - problems. Moreover, these problems should be weighed when deciding whether to have a break-up at all.

*Mr Bebchuk is Friedman Professor of Law, Economics and Finance at Harvard Law School.
Mr Walker is Olin Fellow at Harvard Law School.*