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Microsoft

August 15, 1995

I'll set-up call to discuss this today at 3

$ 25M
$ 25M
$ 25M; OS/2 + MS

Tony Santelli
General Manager
Power Personal Systems
Route 100
Somers NY 10589

Via facsimile 914-766-3339

Dear Tony,

Thank you for your letter and your phone call on Monday which gave us more insight but not a total satisfactory solution:

You basically emphasized that IBM would like to complete the Windows 95 license by Wednesday in order to protect, in particular, your consumer business after Labor Day. As much as I would like to do the same, let me list the obstacles and propose a hopefully mutually agreeable solution:

Because of the great discrepancies revealed in the recent software audit, we are of the strong belief that IBM and Microsoft need to complete the audit to Microsoft's' satisfaction before returning to business as usual and licensing additional software products to IBM. Unfortunately, due to the current timing, this could lead to a delay in our ability to conclude the Windows 95 agreement. In addition, I understand that there are still some outstanding issues in the licensing terms for Windows 95. While we should challenge both negotiation teams to come up with the right language to resolve the outstanding issues just as we were able to do last week for issues including 12(d), let me take this opportunity to make you a proposal how to conclude the audit to our satisfaction:

When I talk about the "audit", I am referring to the LANMAN, OS/2 and WINDOWS audit for the 93/94 period we are currently investigating. In addition we have notified you of our decision to start an MS-DOS extension audit and are considering to extend the other audits to their inception periods.

As I understand our conversation yesterday morning, you are offering us 10M$ in escrow until the audit findings are concluded and the amounts owed by IBM are determined. Microsoft would then pay you back any amounts that were not owed. In a way this does not conclude the audit to our satisfaction since we have a different opinion on the amounts possibly due and we have a real concern that we might wind up haggling over the payment amounts at the end of the process. I would rather propose the following. First, we agree to stop the audit completely and you pay us in addition to what you paid us already and the 4.2M$ discovered in the WINDOWS audit, a settlement amount of 25M$. This will include all possible interest charges and penalties we might assess. If you agree, we would not insist on the further audits or audit MS-DOS extensions as described above. Nevertheless you would agree to use our current audit team to improve your reporting in the future to ensure that, in particular proper WINDOWS 95 reporting, but also all other royalty reporting, would be improved as fast as possible. I think you would agree that this approach should cause both of us less disruptions and pave the way to enhance the relationship.

PENGAD-Bayonne, N.J.
GOVERNMENT EXHIBIT
2138

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In case it becomes necessary to continue with the audit, here are some additional points that we hope you will consider in connection with the possible outcomes for the audit:

1. The methods used in the Additional License (AL) Survey for Windows 3.x and OS/2 are being questioned by our people and we might use our right to call for an end user survey to really clarify the situation. This will unfortunately take time to conduct and might delay the conclusion of the audit significantly.

2. I disagree with your statement that you don't owe us a royalty for encrypted product. IBM cannot copy and distribute our products without paying us for them. I have personally seen several times how easy it is to crack encryption code and would urge IBM to discontinue this practice.

3. Regarding the audit findings. As of today, we are showing close to 20.6M$ having being found by your self audit and/or our auditors. If I apply the comparable "error" rate to the not yet audited years, I would expect IBM might owe us at least an additional 6-7M$. What troubles me about this number though, are comments such as IBM statements in Information Week (08/07/95 p.88) of about 650,000 OS/2 servers installed, whereby only 341,000 OS/2 servers have been reported to us. This alone could constitute more then 45M$ to Microsoft.

Another issue is the inflated OS/2 numbers some IBM people have been discussing in public. As we have mentioned before, we are at a loss to reconcile IBM's public comments with the royalty reports that have been submitted to Microsoft. I believe it is in both our interests to clarify how many copies of OS/2 and LANMAN have been sold (excluding upgrades) and how many copies have been given away as promotional copies not necessarily being in use. Since it is IBM's public comments that have created much of our anxiety over the accuracy of the royalty reports and IBM's ability to properly and timely report royalties, we feel that a press release by IBM to set the record straight should definitely be part of any settlement of the audit. It would not hurt if the same press release states how many WINDOWS copies have been shipped by IBM in the same time period.

Last but not least let me come back to one of my key points in our discussion. If you believe that the amount I am asking for is too much, I would be willing to trade certain relationship improving measures for the settlement charges and/or convert some of the amounts into marketing funds if IBM too agrees to promote Microsoft's software products together with their hardware offerings. You mentioned your willingness to install a Windows NT support center - again this will be seen as a most welcome gesture but not as a significant event knowing that some of the funding might come out of the MDA and IBM is fighting NT sales fiercely in the market place. I was looking for more commitment and more impact to demonstrate our industry responsibility to our mutual customers. Is there a chance you can try one more time to convince your management team that we should not be at an impasse over the audit and that it would be in both our interests to settle this one way or the other as described above?

Please call me at your earliest convenience. I look forward to hearing from you soon.

Best regards,

Joachim Kempin
Sr. Vice President
OEM Sales

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