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July 18, 1995

Ms. Nell Miller
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Subject: Audit Issues

Reference: Your letter to me Dated July 14, 1995
Scott V. Palka's letter to you dated July 12, 1995
Our Telephone Conversation on this subject on July 13, 1995

Dear Nell,

It is apparent from your letter that I have not clearly communicated IBM's position on the issues relating to the audit. To eliminate any misunderstanding I have restated IBM's position on each of the issues below:

GTSI Systems

In July of 1993 the IBM Special Bids organization identified an opportunity to market IBM PC's to Government Technology Services, Inc. (GTSI) for redistribution to the Air Force. The requirements of this bid were that the systems be preloaded with MS DOS 6.0 and Windows 3.1 and that the systems would be marketed with the GTSI logo. To enable IBM to compete effectively for this business with the lowest possible cost, IBM entered into negotiations with Microsoft to permit IBM to take advantage of the "per system" rates in the Windows License Agreement dated June 10, 1987, as amended, for these GTSI logo'ed systems. This agreement is documented in Dave Wright's letter to John Kalb dated July 23, 1993 and is further confirmed by Irwin Drucker's letter to Dave Wright dated July 26, 1993.

When Microsoft announced Windows 3.11, GTSI requested that all future shipments under the Air Force Desktop IV bid be preloaded with Windows 3.11. In January of 1994 IBM and Microsoft completed negotiations for the License Agreement for Microsoft Windows and Microsoft Windows for Workgroups dated January 1, 1994 and IBM requested Microsoft's approval for designation of GTSI as an "Eligible Third Party" under Subsection 1(a) of this agreement to permit IBM to begin shipping Windows 3.11 instead of Windows 3.1 to GTSI. This request and Microsoft's approval is documented in my letter to Mark Baber dated January 26, 1994, in which IBM agreed to provide Microsoft with an updated list of GTSI model numbers and to report the GTSI volumes as separate line items on its quarter royalty report.

Although IBM is unable to locate a copy of the letter which identifies the new GTSI models to Microsoft, IBM paid royalties to Microsoft thoughout 1994 for GTSI systems, which were all preloaded with Windows 3.11, on a "per system" basis and separately identified these payments

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on its quarterly royalty reports as GTSI "per system" payments. At no time during 1994 did Microsoft indicate that it had not received the notification letter for GTSI; nor did it question IBM's eligibility to make "per system" payments for GTSI.

We believe that there was a clear agreement between the parties that GTSI systems would be shipped on a "per system" basis and that this was a condition of Microsoft's approval of GTSI as an "Eligible Third Party" under the terms of Subsection 1(a) the current Windows license agreement. Furthermore, we believe that the actions of both IBM and Microsoft, during the time period when IBM was shipping systems to GTSI preloaded with Windows 3.11 and reporting and paying "per system" royalties to Microsoft for these systems, are consistent with this agreement.

Effective Date of Model Designations for Per System Royalties

As you have indicated in your letter dated July 14, 1995, Section 9.22 of the Windows License Agreement states that "IBM shall provided notice of the foregoing elections to MS before each four (4) quarter period commences (or in the case of newly introduced model numbers, before the end of the first quarter of such four (4) quarter period)..." This language was subsequently amended as a result of a meeting that took place in Boca Raton between IBM and Microsoft in May of 1993 to discuss administration of the royalty provisions of the Windows License Agreement. This amendment is documented in Irwin Drucker's letter to Deb McFarlane, the IBM Account Manager, dated May 12, 1993, which states:

"Per our verbal agreement on May 11, 1993, this letter will serve to confirm that in the case where IBM is electing to pay the "per system" royalty rate for Windows as specified in Section 9.22(iv) of the referenced agreement, the four (4) consecutive calendar quarter period is not required to commence on the first day of that respective calendar quarter (ie. January 1st, April 1st, July 1st or October 1st). IBM will pay the "per system" rate effective the first date the designated system(s) begin shipping for the duration of the four quarter period."

As a result of this agreement, it has been IBM's practice to begin paying "per system" royalties at the first customer ship (FCS) of each new model and, as provided in Subsection 9.22, to provide notification n to Microsoft for new models before the end of the first quarter in which each such new model ships.

Designation Expiration

The Windows License Agreement does not contain specific provisions for what royalty rate will apply to "designated systems" at the end of the four quarter commitment period (ie. it does not specify that the royalty rate will revert to "per copy" or that IBM is required to redesignate such systems to continue to be eligible for the "per system" rate). As a practical matter, because of rapid changes in technology, very few systems ship for more than four calendar quarters before they become obsolete as a result of the announcement of new models. It has been IBM's practice to pay the "per system" royalty for designated systems for the life of the product, from FCS until the product stops shipping. Since IBM has designated thousands of models for the "per system" rate, it would be a significant administrative burden to track each model to determine when the four quarter calendar period ends and to send a new designation letter. We believe that the practice we have followed is fair to both parties and results in appropriate payments to Microsoft.

Administrative Errors

The audit has revealed that some models were not designated as "per system" due to administrative errors, although IBM paid the "per system" royalty for such models. When you consider that IBM has designated several thousand models for the "per system" rate and that for each such designation information must flow from the IBM geographic unit which creates the new model back though PC Company headquarters and contracts personnel to Microsoft, it is not surprising that there have been cases where type/model numbers have been inadvertantly omitted from notification letters, either as the result of a typing mistake when the notification letter was created or as a result of miscommunication somewhere in the process. IBM has used reasonable efforts to comply with the notification requirements and has acted in good faith in making royalty payments to Microsoft. We are in the process of revising procedures for notification to avoid such errors, but do not think it is in the interest of either party to "punish" the IBM brands, which in some cases have committed 100% of their systems to Windows, for a relatively small number of administrative errors.

Nell, IBM has no interest in stopping the audit, which is taking considerable time and resource and is disruptive to our daily operations. We want to complete the audit as soon as possible and as we discussed in our telephone conversation, IBM has been fully cooperative in providing the auditors with the information that they require to perform the audit. However, the auditors have asked IBM and Microsoft for clarification on issues which bear directly on the audit findings, and it is IBM's position that it is not useful to ignore this request until after the audit is complete, since an incorrect interpretation of the contract may distort the audit findings. If there is disagreement between IBM and Microsoft on issues relating to how the audit should be conducted or how data should be interpreted, then IBM's position is that these issues should be resolved quickly to permit the auditors to complete their work without engaging in nonproductive activity.

We believe that these issues can and should be resolved quickly with appropriate focus by both parties. I would appreciate your assistance in expediting this matter. Please give me a call if you have any questions about this letter or IBM's position on any of the issues.

With respect to your comments about the signing of the Windows 95 license agreement, we consider the Windows 95 contract negotiations to be completely separate and unrelated to the audit and are actively negotiating with Mark Baber to close a Windows 95 agreement as soon as possible.

Sincerely yours,

James R Miller

James R. Miller
Manager, Contracts Operations

cc: Bruce Claflin, IBM
Jerry Casler, IBM
Joachim Kempin, Microsoft
Mark Baber, Microsoft
Scott Palka, Ernst & Young