PATENTS, COPYRIGHTS, AND TRADEMARKS: PROPERTY OR MONOPOLY?

ROGER E. MEINERS & ROBERT J. STAAF*

> Who could reasonably complain about a merely apparent privilege? It neither harms nor hinders any branch of industry that was previously known. The costs are paid only by those who do not mind paying them: their wants . . . are not less fully satisfied than before.
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> —Jean Baptiste Say[1]

I. INTRODUCTION

Most economists view the patent system as a desirable monopoly.[2] Few economists condemn patents as unwarranted or inefficient intrusions in the private sector. This was not always the case. As Fritz Machlup and Edith Penrose note, economists and lawyers quarreled about the desirability of patents in the eighteenth and nineteenth century.[3] For example, Jeremy Bentham and John Stuart Mill advocated patents, and Adam Smith was not opposed to them. Clark, like Bentham, believed innovations would nearly cease without patents, while Taussig and Pigou took the view that patents made little difference.[4] Hayek appears to be opposed to patents.[5]

In the Nineteenth Century, the patent debate was characterized in terms of free trade versus protectionism, with "protectionists" favoring monopoly grants to inventors, and the "free traders" against grants. The free traders lost, but not without

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* Roger Meiners is Director, and Robert Staaf is Senior Research Scholar, Center for Policy Studies, Clemson University. Both authors are Professors of Law & Economics at Clemson. The authors wish to thank the Liberty Fund for support of this research. The authors also appreciate the helpful comments and criticisms especially from Louis De Alessi, as well as Bill Dougan, Don Gordon, and Bruce Yandle. Despite these contributions, the authors recognize that they may have monopoly rights in the remaining errors.

1. 1 J. SAY, TRAITÉ D' ÉCONOMIE POLITQUE 263 (1st ed. 1803).

2. Economic writings on intellectual property generally are concerned with patents. The authors will focus on patents but note that innovations covered by patents are only one form of intellectual property. Much of the discussion on patents applies to other intellectual property, as will be reviewed later.

3. Machlup & Penrose, *The Patent Controversy in the Nineteenth Century*, 10 J. ECON. HIST. 1, 7-9 (1950).

4. A. PLANT, SELECTED ECONOMIC ESSAYS AND ADDRESSES 39-40 (1974).

5. *See* F. HAYEK, THE FATAL CONCEIT: THE ERRORS OF SOCIALISM (1989).

some battles. A bill to weaken patents passed the House of Lords in England in 1872.[6] Holland abolished patents in 1869, but reinstated them in 1910. Switzerland, which held out against patents longer than any other European country, adopted patents in 1882. Although several portions of Germany did not adopt patents and Chancellor Bismarck announced his opposition to patents in 1868, uniform patents were adopted for the entire Reich in 1877.

Although interesting scholarship on patents has been done since the Machlup and Penrose article of 1950, there does not appear to have been a significant improvement in the quality of the arguments on either side of the debate.[7] Most of the scholarship on patents in the last several decades focuses on efficiency implications or optimality conditions, except for Hayek's work and that of a few others, expressing doubts about the need to protect intellectual property.[8] Modern writers generally support patents, with caveats that there may be too little or too much invested in innovative activities, or that there are externalities. Fine tuning may be called for, such as providing a tax or subsidy, decreasing or increasing patent life, or broadening or narrowing the scope of patents, but there is no ground swell for major restructuring of institutional arrangements. Exceptions to this generalization are found in Edmund Kitch[9] and Tom Palmer,[10] who both take a property rights or institutional approach.

Following a review of traditional economic arguments for and against patent law, the authors of this Article apply the property rights approach to examine the nature of intellectual property law and, specifically, the issue of patents as monopoly. The authors then examine trade secrets, trade guilds, and trademarks which are alternatives to patents. These institutions often are based on restrictive agreements in the form of vertical restraints, and their enforceability under current antitrust laws

6. The historical information in this paragraph comes from Machlup & Penrose, *supra* note 3, at 3-6.

7. As Machlup and Penrose note, patents were subject to extensive scholarly debate for about a century. By the late Nineteenth Century, economists, having settled nothing, largely ignored the issue until it was revived around 1950. *See* Machlup & Penrose, *supra* note 3, at 29.

8. *See* F. HAYEK, *supra* note 5.

9. Kitch, *The Nature and Function of the Patent System*, 20 J.L. & ECON. 265, 266 (1977).

10. Palmer, Intellectual Property Rights: A Non-Posnerian Law and Economics Approach, 12 HAMLINE L. REV. 261 (1989).

relies on diverse legal theories.[11]

II. Traditional Arguments

The standard argument for a patent system is that innovators will not have sufficient incentive to produce innovations unless they have a monopoly (exclusive) right to the economic returns. Innovative activity often requires a substantial investment of resources. If the innovator cannot maintain exclusive rights over the use of an innovation, then competitors could copy it without incurring research and development expenditures. Because innovators would have lower expectations of recovering costs and of profiting by their efforts, there would be less innovative activity.[12]

A system of patents, copyrights, and trademarks provides innovators with exclusive rights to use innovations for a certain time period, and thus with the expectation of earning a higher return.[13] The returns that can be attributed to innovations are the difference between the competitive and the monopoly returns actually earned. The limited time of seventeen years for a patent can be thought of as an indirect regulation of the rate of return. A monopoly is granted, similar to monopoly grants to utility companies, but the rate of return is regulated with a time limit.

The patent system encourages innovations, but is perceived to have several disadvantages. The most obvious is that the holder of the right will restrict the use of the innovation to earn monopoly profits. Thus, some argue that once the innovation is produced, it will be used in a sub-optimal manner. Once in existence, innovations have many characteristics of public goods. According to some views of economic efficiency, once an innovation is produced its use should be free. Yet, it is recognized that such a policy reduces incentives to innovate.[14]

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11. *See* Appendices A and B, which provide some details of the laws discussed.

12. Some writers have asserted that most important innovations did not occur because of economic incentives—they were accidental or were discovered because some people simply like to innovate. *See* F. Machlup, The Production and Distribution of Knowledge in the United States 162-70 (1962); J. Jewkes, The Sources of Invention (1958). Although there is some truth to that, economic benefits are necessary to generate most inventive activity.

13. *See* Appendix A.

14. This argument commonly is used in favor of government subsidized research. The knowledge, once produced, can then be used without paying the researcher a royalty, and the conditions for economic efficiency will be satisfied.

Another undesirable consequence is that competitors have incentives to produce substitute innovations rather than pay for the right to use the original innovation if the estimated costs of producing substitutes are lower than the royalty rate. Producing substitute innovations could have a social cost (an externality), because the original innovation could have been used with no additional costs in the absence of legal protection. Hence, it is said, the patent system may cause an over-investment in substitute innovations.[15]

Jack Hirshleifer points out that innovations can earn returns beyond the direct return for the use of the innovation.[16] An innovator knows about an innovation first, and this information can be used to make investments that might be more valuable than other investments. Hirshleifer uses Eli Whitney's invention of the cotton gin as an example.[17] Armed with information about a superior method for processing cotton, Whitney could have invested in cotton and cotton-bearing land as well as in businesses engaged in the selling, warehousing, and transporting of cotton, not to mention other speculative activities concerning cotton, substitutes for cotton (wool), and complementary goods (textiles and machinery). Accordingly, it has been argued that the use of this insider information may be all the incentive that an innovator needs to produce an innovation. The granting of monopoly rights to the innovator may entail net social costs rather than benefits.

The argument in favor of legal protection for intellectual property to generate productive activity may seem less clear cut than it initially appeared. There may be social costs of providing monopoly rights to innovators, leading to under-utilization of important ideas; there may be over-investment in producing substitute innovations for existing innovations that are public goods; further, secondary rewards available to innovators may provide sufficient inducement to innovate, even without monopoly rights to the use of the innovations. The next section

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15. Of course, substitute (competitive) innovations limit the returns possible under patents. For an analysis of a patent pooling agreement that had zero royalties, resulting in effect in a private condemnation of patents among members of the pool, see Bittlingmayer, *Property Rights, Progress, and the Aircraft Patent Agreement*, 31 J.L & ECON. 227, 245 (1988).

16. *See* Hirshleifer, *The Private and Social Value of Information and the Reward to Inventive Activity*, 61 AM. ECON. REV. 561 (1971).

17. *See id.* at 562.

addresses the issue of why patents are considered monopolies before addressing the issues that arise from monopoly.

III. Property Rights Approach

It is curious that almost everyone refers to a patent as a monopoly. Many textbooks refer to patents as the classic monopoly. Why are patents not considered like any other exclusive private property right?[18]

All private property rights exclude and thus have a monopoly element. Contracts create rights that are exclusive and thus have monopoly elements. Individuals have exclusive rights in their labor and real property. Exclusive rights create the same incentives that patent rights create by encouraging investments in goods and services. As Adam Smith argued, patents could be justified as a means of rewarding risk and expense.[19] Moreover, simply calling some production "research and development" does not change the nature of the activity. Most economic activities involve risks and expenses. Without exclusive rights, there would be little incentive to invest in goods, services, homes, education, and contracts.

Exclusivity not only is a characteristic of property rights in so-called tangible or physical objects, but also it is a characteristic of so-called human or intangible rights. Constitutional prohibitions on slavery and involuntary servitude can be interpreted as giving the individual the exclusive right to his services. Other constitutional rights, such as prohibition of illegal searches and seizures, prohibition of takings for public use without compensation, and the right of privacy, are also premised on the right of exclusion. Although freedom of speech can be interpreted as a right of the commons, those rights are limited by other rights that protect exclusivity, such as copyrights, trademarks, and the torts of libel, slander, and misappropriation.

Classifying patents as monopoly may stem from historical considerations and the fact that the exclusivity is created by government. Historically, patents referred to exclusive privileges, similar to charters, granted by the Crown. Patents had little, if any, connection with research or inventive activity. A

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18. Professor Kitch raises this issue clearly in his property rights approach to patents. *See* Kitch, *supra* note 9, at 266.

19. A. Smith, Wealth of Nations 388 (Oxford University Press 1928).

similar explanation for classifying patents as monopoly is that the rights are created by statute, not common law. Tom Palmer refers to patents and copyrights as illegitimate state-granted monopolies.[20] He argues that if patent rights had evolved under the common law, similar to trademarks, they would not be an illegitimate monopoly.[21]

Many writers seem to be unaware that patents are a combination of common law and statutory law.[22] As Chief Justice Taft noted in the *Crown Die* case:

> [T]he patent confers on such common-law right the incident of exclusive enjoyment, and it is the common-law right, with this incident, which a patentee or an assignee must have .... The Government is not granting the common-law right to make, use and vend, but is granting the incident of exclusive ownership of that common-law right, which cannot be enjoyed save with the common-law right.[23]

Because exclusive rights are created by statute, and formally recognized by a government agency (the Patent Office), it may appear that these rights are similar to other statutory restrictions such as licensing, quotas, or certificates of necessity. This is not the case. The latter statutes are designed to give the state discretion as to who may enter an industry or obtain certain property rights. They are used to redistribute resources on a continual basis, given the preferences of the legislature. The rights granted by such statutes are generally transitory and often are not subject to exchange within the market. Patents, copyrights, and trademarks (intellectual property) granted recognition by the state are essentially the same as recognition by the state of claims in real property. Those rights are subject to exploitation or expropriation by the state, but in the absence of legislative abuses, they serve to establish a system of rights that are exclusive and alienable. They are, like common-law rights, valuable not to specific groups that obtain the passage of the

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20. *See* Palmer, *supra* note 10, at 264-68. Even if there were no statutory rights in inventive activity and the activities were governed solely by common law, state intervention in terms of judicial enforcement would still be necessary.

21. The right to pass statutes in this area is one of the few directly expressed powers of Congress as provided by the United States Constitution. *See* U.S. CONST., art. I, § 8, cl. 8.

22. The right to protect, use, and market inventions are common-law exclusive rights so long as there is no publication. Trade secrets are the expression of this common-law right. The case is the same in copyright; prior to publication, when there must be statutory protection, the work is protected by common-law copyright.

23. Crown Die & Tool Co. v. Nye Tool & Machine Works, 261 U.S. 24, 36-37 (1923).

statutes, but to all current and future members of society who will have equal access to property and the enforcement of ownership rights by the judicial system.

The common-law distinction between naked restraints of trade, and those ancillary to some other agreement or purpose, is useful here in understanding patents. Within bounds, covenants not to compete are enforceable at common law, even if they restrain trade, so long as there is an ancillary agreement such as a sale of business or an employment contract.[24] Without the exclusivity created by these covenants, it would not be possible to transfer the goodwill of a firm, a consequence that would run counter to the general common-law principle favoring alienation or transfer.[25] A naked covenant not to compete without an ancillary agreement or some other purpose, besides a restraint on trade, is unenforceable.[26] Patent law is not simply a "naked restraint" creating restrictions on entry. Rather, the exclusive rights associated with patents encourage innovative activity, just as exclusive rights to trademarks encourage investments in goodwill. For example, the *Crown Die* case involved an assignment of an exclusive right in the form of an assignment of choses in action against past and future infringers without an assignment of the common-law right to the patent. The Court held that a patentee cannot assign just the exclusionary right of statute, but must also transfer or assign the common-law right.[27] This holding is consistent with the common law that a naked agreement restraining trade, without an ancillary agreement, is unenforceable.

Patents can be viewed as a part of a general private property rights scheme. Nations that have patents as a form of private property right are significantly more advanced technologically.[28] These advances are attributed to a number of factors, but private property rights are crucial. Communist countries, who do not have patents that grant exclusive rights to individuals, use prizes as an alternative.

24. The covenants must be reasonable in terms of duration and scope. *See, e.g.*, Nationwide Mutual Insurance Co. v. Hart, 73 Md. App. 406, 534 A.2d 999 (Ct. of Special App. 1988).

25. Goodwill is the market value of a name or reputation, such as IBM or Nabisco. Although everyone knows those names, they are not in the commons.

26. *See, e.g.*, 17 C.J.S. *Contracts* § 241(2) (1954).

27. 261 U.S. at 34.

28. *See* F. MACHLUP, *supra* note 12.

Machlup and Penrose provide an enlightening law and economics discussion of this monopoly-property rights issue by examining the Nineteenth-Century debate.[29] They divide the property (natural) rights position, primarily taken by the French, into four main arguments:

> Type One: A man has a natural property right in his own ideas. Their appropriation by others must be condemned as stealing . . . . Property is in essence exclusive. Hence enforcement of exclusivity in the use of a patented invention is the only appropriate way for society to recognize this right.
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> Type Two: Justice requires that a man receive . . . reward for his services in proportion as these services are useful to society. . . . The most appropriate way to secure to inventors rewards commensurate with their services is by means of exclusive patent rights in their inventions.
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> Type Three: Industrial progress is desirable to society. Inventions and their exploitation are necessary to secure industrial progress. Neither . . . will be obtained to any adequate extent unless inventors and capitalists have hopes that successful ventures will yield profits which make it worth their while to make their efforts and risk their money. The . . . most effective way for society to hold out these incentives is to grant exclusive patent rights in inventions.
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> Type Four: . . . To secure [industrial progress] at a sustained rate it is necessary that new inventions become generally known as parts of the technology of society. In the absence of protection against immediate imitation of novel technological ideas, an inventor will keep his invention secret. . . . Hence it is in the interest of society to induce the inventor to disclose his secret for the use of future generations. This can best be done by granting exclusive patent rights to the inventor in return for public disclosure of his invention.[30]

It is not necessary to become entangled in the issue of natural rights. The preceding are general arguments for private property rights and do not hinge on patent or natural rights. The arguments contain a crude semblance to the Coase theorem that rights flow to their highest valued use.

The evolution of private property has usually been told as a succession from the "tragedy of the commons." The tragedy under common rights, such as open range land, is that there

29. Machlup & Penrose, *supra* note 3. It is interesting that this article was published ten years before the publication of the Coase theorem.
30. *Id.* at 10.

will be over-grazing of the land by herders resulting in a barren range. With common land, each herdsman is able to exclude others from using the grass (establish property rights) only by getting it into the cattle's stomachs (immediate consumption). There is little incentive to invest in the range.

The same story has been told about patents. If inventions lost their exclusivity and became part of the commons, then in the short run there would be over-grazing. The inventor could not exclude others, and products that embody previously patentable ideas would now yield a lower rate of return. There would be lower returns to the activity of inventing, so that innovative minds would become less innovative. In the case of open ranges, common rights destroy what nature endows, and in the long run keeps the land barren because no one will invest to make the land fertile. Similarly, common rights would make the intellectual field of innovations less productive relative to a private property right system.

Many people have argued that exclusivity in innovations should give way to a commons. One argument was that, " 'Property in ideas, once published, is an insoluble contradiction.' He who complains about the 'theft' of his idea 'complains that something has been stolen which he still possesses, and he wants back something which, if given to him a thousand times, would add nothing to his possession.' "[31] Put differently, the criticism of exclusive rights can be interpreted as follows: There would be no over-grazing with a commons because of the public good characteristic of innovations. The tragedy is with private property rights that result in under-grazing because of exclusion. German economist Max Wirth said:

> Inventions do not belong in the category of intellectual property, because inventions are emanations of the current state of civilization and, thus, *common property*. . . . In the case of inventions . . . experience has taught us that one and the same invention can be made at the same time by two different persons: inventions are merely blossoms on the tree of civilization.[32]

31. *Id.* at 12 n.40. This argument seems to rest on a notion that only physical property should possess the right of exclusivity. It may be true that exclusivity in physical property is less costly to enforce than exclusivity in intangible property, but this hardly seems to be a valid argument. This same argument could be applied to trespass whereby the owner does not receive back his possession.

32. Wirth, *Bericht uber die Verhandlungen des sechsten Kongresses deutscher Volkswirthe zu Dresden am 14., 15., 16. und 17. September*, VIERTELJAHRSCHRIFT FUR VOLKSWIRTSCHAFT

These arguments are early versions of the public good debate. Plant observes:

> It is a peculiarity of property rights in patents (and copyrights) that they do not arise out of the scarcity of the objects which become appropriated. They are not a *consequence* of scarcity. They are the deliberate creation of statute law; and, whereas in general the institution of private property makes for the preservation of scarce goods, tending . . . to lead us "to make the most of them," property rights in patents and copyright make possible the *creation* of a scarcity of the products appropriated which could not otherwise be maintained.[33]

Plant appears to be correct if either (1) one views inventions as pure accidents and not the result of purposeful activity, or (2) one takes a strictly static view of the world that ignores future investments. Neither assumption is very useful. Scarcity in inventions includes the opportunity costs of inventors inventing or firms making expenditures on research and development. More importantly, it also includes the opportunities that *will be* foregone by inventors if there is no exclusivity in inventions. For example, to say that a new drug or a new micro-chip invention should not be excluded from those who do not pay the price set by the owner ignores the opportunity cost of other inventions that would have been produced had the right of exclusion existed. The problem of scarce resources does not disappear with public goods. Otherwise, it must follow that the income of drive-in theaters, Walt Disney World, and of almost all entertainment and books is the result of contrived scarcity.

Albert Schaffle, a Nineteenth-Century German economist, argued that "intellectual property is neither control of a thing nor of an idea but rather 'control of a market' for things embodying an idea."[34] That is, a patent is said to give control of a market. Control of a market implies that the owner faces a downward sloping demand curve and searches for a price to maximize profits. On the other hand, it can be argued that exclusive rights in a home or labor does not give the holder control of a market. Owners of these rights are said to be price

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UND KULTURGESCHICHTE, Erster Jahrgang (1863), III, 222 (cited in Machlup & Penrose, *supra* note 3, at 13-14) (emphasis added).

33. A. PLANT, *supra* note 4, at 36 (emphasis in original).

34. Machlup & Penrose, *supra* note 3, at 12 (quoting A. SCHAFFLE, DIE NATIONALOKONOMISCHE THEORIE DER AUSSCHLIESSENDEN ABSATZVERHALTNISSE 113-114 (Tubingen 1867)).

takers. There are several difficulties with this monopoly-versus-competition argument. First, not all patents result in control of a market. Substitutes are likely to exist or patents will induce innovations that will lead to substitutes. Second, someone who has exclusive rights to a large tract of land or who has exclusive rights to his services, such as Michael Jackson, or who has exclusive rights to a trademark are also likely to control a market or face a downward sloping demand curve. Third, as discussed above, a downward sloping demand curve is normally necessary to recover the investment cost of the patent. It is only in a purely short run static sense that these investment costs are fixed costs and therefore irrelevant. These kinds of distinctions lead to the same difficulties that antitrust law has encountered in defining market power. Market power is also not likely to be a useful concept to characterize patents.

The Nineteenth-Century debate recognized the exclusion issue more clearly than most recent literature. Proponents of patents argued that private property rights (the market) will not reward inventors in excess of the social value of inventions, such that there will always be net social benefits. Adversaries of the patent system argued that prizes could be substituted for exclusive rights as a reward for inventive activity. The prize system, which is the only reward used in communist countries and is also common in non-communist countries, is somewhat arbitrary, creates considerable uncertainty, is subject to special interest rent-seeking, and can result in the value of the prizes having little to do with the social value of innovations.

There is another argument against the statutory grant of exclusion that does not rely on a public goods argument. The argument is that the market will privatize the commons. This is undoubtedly true. For example, a herder can privatize an open range by getting grass into his cows' mouths, effectively excluding other cows from the range. The problem with over-grazing is not that there is no privatization, but that there is no incentive to invest (forego consumption) in the range, nor is it possible to determine if there might be better uses of the range. That is, the inability to exclude completely means the absence of transferability either in today's market or through time to higher valued uses. The right of transferability, present and future, is key. It is premised on exclusivity, as the Coase theorem emphasizes.

Individual entrepreneurs have incentives to invent ways to convert a commons into private property. For example, consider radio advertising, an accidental innovation that led to a quasi-privatized radio spectrum.[35] A technology that produces a good or service in the commons, such as broadcast signals, will always be dominated by a technology of the same cost that produces the same good or service as a private good. Indeed, the private good technology can be more expensive than the public good technology and still dominate. Video cameras and players, burglar and fire alarms, books, and computers are private good technologies that compete with public good technologies of TV signals, services of police and fire departments, and the services of schools. In a world of private property (exclusive and transferable) rights, there is a bias to convert a public good technology into a private goods technology.[36]

Hirshleifer's discussion of exploiting insider information is another way to privatize inventive activity indirectly.[37] Although one can think of ingenious ways to privatize returns to an invention in the commons, such as the radio spectrum, the primary question remains, why not create exclusive rights directly rather than indirectly? Communist countries have more common rights than most non-communist countries. There are numerous stories about how these commons are privatized. Few economists would argue that market arrangements such as advertising or standing in line are preferred to direct allocation of exclusive rights in the radio spectrum or pairs of shoes. In part, this may be a transaction cost argument in the Coase sense. That is, there are higher transaction costs in getting the radio spectrum into its highest valued use through the advertising market compared to direct ownership of the spectrum. Exclusive rights allow one to enter a public market and announce the invention. Alternatives such as trade secrets face problems of exchange, namely, it is costly to protect and to disclose the secret.[38] That is, with trade secrets (as well as with common-law copyrights) there is exclusivity, how-

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35. *See* Palmer, *supra* note 10.

36. Staaf, *Privatization of Public Goods*, 41 PUB. CHOICE 435 (1983).

37. *See* Hirshleifer, *supra* note 16.

38. This is not to criticize trade secrets, because they are private property arrangements. However, their use seems to result from limitations in patents as the property right determinant (such as the seventeen-year life limitation and restrictions on patenting processes). Beyond that, trade secrets step in where patents do not apply.

ever there is limited transferability, and thus limited exchange compared to patents.

Statutory law does not always yield results associated with rent-seeking and collective decisionmaking. States have statutes regarding the establishment of titles to real property. These statutes generally complement the common law, and do not serve simply to transfer income from one group to another. Legislatures can expropriate rights to real property, but the basic statutes concerned with recording and recognizing of titles to property are either beneficial to the workings of the common law or are benign.[39]

The patent, copyright, and trademark statutes are similar to statutes that provide for the registration and recognition of ownership in land. If a deed is not recorded, then loss of exclusive rights in the land occurs upon a subsequent recorded transfer by the original owners. Like real property law, the details of intellectual property law have been left to the courts. Effectively there is a common law of intellectual property, constrained by limits imposed by statutes. There are, of course, costs of determining what rights fall under a patent. There are also costs of determining rights in parcels of land. But these are identification problems, not "monopoly problems." The problem with the patent statute is not that the statute exists, but that the legislature can tinker with it. This problem is not, however, peculiar to patents—all common-law rights are subject to invasion by the legislature.

When the westward expansion began in the United States, the land west of the original States was the property of the federal government. In the Nineteenth Century it was the subject of great political wrangling as politicians invented legislation to sell or give the land away to make their constituents happy. For example, the Homestead Act allowed people to claim land out of the commons and obtain private title to that land.[40] The same result undoubtedly could have been accomplished with lower transaction costs by some other claiming scheme. How-

39. At common law the question of priority of title was usually a question of time. The basic doctrine considered first in time to be first in right. Statutes have since modified the common law by giving the person who records title rights to the property even though later in time. *See* C. SMITH & R. BOYER, SURVEY OF THE LAW OF PROPERTY (3d ed. 1981).

40. Homestead Act of 1862, 43 U.S.C. 161 *et. seq.* (1862), 12 Stat. 392 (repealed 1976).

ever, whatever defects existed in the methods of privatizing the commons were trivial when compared to the benefits of avoiding the tragedy of the commons. The fact that this was done by statute rather than by operation of the common law is irrelevant.

This is not an argument that intellectual property statutes are optimal. Perhaps the duration of patents should be similar to the duration of title to land. The important point is that there is great value in having a stable rule of law that provides for exclusion and alienation of property. So long as Congress does not tamper with the patent statute, and the courts refrain from radically changing their interpretation of patent rights, market incentives will permit mutual gains from exchange within legal constraints.

The abolition of patent law would give rise to the same public good arguments for supporting innovations that are already used for supporting the environment, national defense, highways, and electro-magnetic frequencies. Further government intervention, including the establishment of a government agency, would be promoted to regulate the commons. Economists would propose more pricing schemes and subsidies (prizes) to ape the market. For example, Coase, discussing the Federal Communications Commission, said:

> It is not easy to understand the feeling of hostility to the idea that people should pay for the facilities they use. It is true that this attitude has been supported by the argument that it was technologically impossible to charge for the use of frequencies, but this is clearly wrong.[41]

Proposals to drop the current intellectual property statutes in favor of what would emerge from the operation of the common law are unrealistic. Politicians would allocate the commons via the rent-seeking legislative process, for example, by greatly expanding the National Science Foundation.

A commons is a rejection of market allocation based on exclusivity in favor of a collective allocation process. Generally, the creation of a commons from exclusive and transferable rights is based on arguments about an alleged market failure. Thus, once a commons argument is accepted, it is difficult to argue for market allocation. The cure may be worse than the

41. Coase, *The Federal Communications Commission*, 2 J.L. & ECON. 1, 24 (1959).

illness.[42] The next section considers implications of privatization by the market, and the confusion between so-called market failure and the effects of statutory restrictions on the market.

IV. Alternatives to Patent Law

A. *Introduction*

The rights given by patent law appear to be so strong that they have been limited by another set of constraints, the antitrust laws. As a general rule, the courts will enforce patents, copyrights, and trademarks when the firm is vertically integrated and there are no contractual agreements, or when such rights are completely assigned or transferred.[43] On the other hand, if the owners of intellectual property contract outside the firm, using licenses or partial assignments that include restrictive terms, the courts may hold the contracts to be unenforceable vertical restraints.[44]

Thus, the courts' interpretation of antitrust statutes, in cases where patents are an issue, have limited the transfer of exclusive rights. Judicial decisions have led to fewer contractual forms of organizations and more vertical integration within individual firms. If patent statutes were interpreted with an emphasis on property rights rather than on monopoly rights, however, fewer restraints on contractual organization might have evolved. Namely, the law of secrecy, combined with the law of contract, might have allowed the development of institutions that would have provided profits for the successful inventor.[45] The following discussion provides an example of arrangements that might exist without patent and antitrust laws as we know them.

42. For example, suppose a prize system were initiated. What incentives exist for the grantor or prize selector to choose the most valued or useful ideas if there is no exclusive right to capture the benefits? Thus, this problem on the supply side of a prize system is likely to carry over to the demand for prizes. The federal government found little demand for patents that were not restricted and carried no royalties.

43. *See, e.g.*, United States v. General Elect. Co., 272 U.S. 476 (1926).

44. *See* R. Choate, Patent Law: Trade Secrets-Copyrights-Trademarks, at ch. 8 (1973) (on limitations on patentees' rights imposed by antitrust law and the misuse doctrine). The courts seem to believe that the monopoly under a patent or trademark can be enlarged or extended by price restrictions, restraints on field of use, tying clauses, licensing, and vertical restraints in general. *See, e.g.*, Rohm & Haas Co. v Dawson Chemical Co., 599 F.2d 685, 688 (5th Cir. 1979), *aff'd*, 448 U.S. 176 (1980).

45. Holcombe & Meiners, *Market Activity Versus Government Protection of Innovative Activity*, 5 Soc. Sci. Rev. 1 (1983).

B. *Trade Secrets*

The right to make, use, or sell an invention is a common-law right. The patent statute does not confer that right; it merely allows an inventor an exclusivity which the common law did not provide.[46] In some cases, an alternative to statutory exclusivity is to keep the idea or invention as a (trade) secret.[47] That is, contracts that the courts will enforce, such as non-disclosure contracts, can serve as a substitute for exclusion under patent law. The Supreme Court has recognized the viability of this protection for non-patentable and patentable material.[48]

Contract and tort law provide the basis for the protection of trade secrets. Individuals may contract for the amount and type of secrecy they want, subject to liability for breaches so long as the contract is legal. Tort law also protects trade secrets[49] with great breadth of coverage.[50]

The standard for applying common-law remedies to trade secrets is less stringent than that for patents. The subject matter must merely be secret. It need not meet all the standards of subject matter for patentable material. No agency decides whether the idea, material, process, or invention qualifies. Coverage has included, among other things, news releases, plans for doing a radio program, methods of conducting business (particular forms were involved), customer lists, credit ratings, blueprints, tables of data, and chemical processes.[51] But once a

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46. *See* Crown Die & Tool Co. v. Nye Tool & Machine Works, 261 U.S. 24, 36 (1922).

47. Rights for property covered by copyright law are much the same. What is not covered by the Copyright Act is protected by the common law of copyright, which is similar to trade secret law. Once common law copyright material is made public, it is then in the public domain unless it has been registered under the Copyright Act. Once material is copyrighted under the Act (beginning at the moment one inscribes the copyright symbol on the material), it can be revealed to the public but is protected by the rights granted by the statute. Obviously, unlike a secret formula or some other invention that may be hidden yet still be exploited, most written work must be exposed to all to be exploited.

48. Kewanee Oil Co. v. Bicron Corp., 416 U.S. 470 (1974).

49. *See* RESTATEMENT OF TORTS, ¶ 757 (1938).

50. Comment B to Paragraph 757 of the *Restatement of Torts* states:

> A trade secret may consist of any formula, pattern, device or compilation of information which is used in one's business, and which gives him an opportunity to obtain an advantage over competitors who do not know or use it. It may be a formula for a chemical compound, a process of manufacturing, treating or preserving materials, a pattern for a machine or other device, or a list of customers.

Id. (Comment B).

51. *See id.*

trade secret is published, exclusivity is lost and it is in the public domain.

There are numerous limitations to trade secrets. First, many formulas, inventions, or processes are discoverable by analyzing the product. Second, trade secrets, *per se*, are difficult to market or transfer because disclosure is required. Third, under patent law, an independent discovery of another's trade secret is patentable with exclusive rights owned by the discoverer. On the other hand, there are advantages to trade secrets. First, there can be perpetual life of the secret. And second, because there is limited disclosure, there may be lower enforcement costs compared to infringement suits for patents that must be fully disclosed.

No doubt the law of secrecy would be much more expansive if there had not been exclusivity under patent law. Without a patent statute, trade secrets would have been more important, the law concerning them would have developed more than it has, and entrepreneurs would have adopted various techniques to protect their innovations and to prosper from them. In the absence of patents, the bias toward private good technologies would encourage the development of secret, rather than public, technologies.

There are several known success stories in which the use of patents was not important. These may help us understand how a world without patents could operate. In some cases, such as Coca-Cola and Smith's Brothers cough drops, trade secrecy has provided a century of protection far superior to the limited returns which would have been offered by patent law.[52] At the time of invention, seventeen years of protection may appear long to the inventor, but as in the case of Coca-Cola, the returns under a patent would have been a minute fraction of the returns generated by secrecy. Other industries, such as the production of customer lists, rely on the law of secrecy for protection. The growth of that industry would seem to confirm the possibility of prosperity in the absence of patent protection. Whether the growth would have been greater with patents is impossible to determine.

Some firms rely on secrecy because they expect a relatively short life for their products. By keeping the product secret until

52. Of course, both of these products are covered by trademark law that may provide more protection than the trade secrets do.

marketed, the firms gain enough lead time over competitors so that patent protection is not worthwhile. The firms invest in advertising and marketing to protect a share of the market. The lead time over competitors may be extended by trademark law that creates exclusivity in the product rather than in an innovation.

C. *Trade Guilds*

In *Fashion Originators' Guild of America, Inc. v. Federal Trade Commission*,[53] an antitrust case, the Supreme Court ordered the Fashion Originators' Guild of America (Guild) "to cease and desist from certain practices found to have been done in combination and to constitute 'unfair methods of competition' tending to monopoly."[54]

About 12,000 retailers nationwide had signed agreements with the Guild not to carry copies of registered clothing designs. The 176 manufacturers of women's garments belonging to the Guild in 1936 sold over 38% of all women's garments wholesaling for $5.75 or more, and over 60% of those at $10.75 and above. Similarly, some producers of textiles agreed to sell their products only to those manufacturers who belonged to the Guild.[55]

The Guild maintained a Design Registration Bureau for garments. A similar organization existed for textiles. Guild employees visited retail stores to see if the agreements were being violated either by cooperating retailers who might sell copies of registered designs, or by manufacturers who might be selling to non-cooperating retailers. Following a detailed procedure for trial and appeal within the Guild, a retailer or manufacturer who violated the contract could be fined.[56]

In addition to protecting members from the copying of original designs, the Guild undertook other activities: establishing advertising restrictions on members, regulating some of the contractual terms that members could offer customers, regulating days on which special sales could be held, and restricting members from doing business with certain firms.[57] The Court

53. 312 U.S. 457 (1941).
54. *Id.* at 460.
55. *Id.* at 461-462.
56. *Id.* at 463.
57. *Id.*

found that the Guild violated the Sherman Act by restricting competition in the women's garment industry.

Guild demonstrates the potential of the market to produce alternatives to patents. The Guild was a way to establish exclusivity for its members, yet there was free entry by non-members into both dress manufacturing and retailing. Indeed, a substantial proportion of both manufacturers and retailers remained out of the Guild. Because of the agreements not to copy the original designs of each other, Guild members were afforded some degree of protection for their investments in innovative activity. Original designs had an exclusive outlet in the retail market, allowing for market segmentation. The private exclusionary right of Guild members was not as great as the exclusionary right that a holder of a patent has over his innovation. *Guild* illustrates a general difficulty in attempting to create exclusivity by contract.

Trademark law, like trade guilds, has also run afoul of antitrust law. Until 1977, the courts held most exclusive agreements to be *per se* illegal.[58] Today, a rule of reason is used to weigh the benefits of inter-brand competition against the costs of restrictions on intra-brand competition resulting from vertical restraints.[59] Thus, it is possible that some of the vertical restraint aspects of the Fashion Originator's Guild case might be decided differently today.

D. *Trademarks*

A trademark is a name, sign, symbol, or device attached to goods offered for sale in the market, so as to distinguish them from similar goods. It also identifies the goods as being made, worked on, imported, selected, certified, or sold by a particular trader.[60] Like patents, trademarks are also creatures of the common law. Unlike patents, however, the common law confers exclusivity on the trademark owner. Federal and state trademark statutes merely fortify the common-law right to a trademark by conferring a statutory title to the owner.

The property in a trademark lies with its use; it is nothing more than a privilege, valuable because of its exclusivity. In adopting it one takes nothing from, and in abandoning it re-

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58. United States v Arnold, Schwinn & Co., 388 U.S. 365 (1967).
59. Continental T.V., Inc. v GTE Sylvania, Inc., 473 U.S. 36 (1977).
60. 87 C.J.S. *Trademarks* § 1 (1954).

turns nothing to, any store of common or public property. It is not an article of commerce in the sense that it may be consumed by the purchasing public. It is property only when used to indicate the origin or ownership of goods. It is property only in the sense that trade reputation or goodwill is a property right. A trademark is merely an instrumentality for the protection of that property right.[61]

It is curious that the common law provides exclusive rights for trademarks but not for patents. Patent law is designed to encourage investment in innovations; trademark law is designed to encourage investments in goodwill. There is an analogy in that the contractual alternative to patents is a trade secret agreement; the contractual alternative to trademark law is a covenant not to compete.

A principal distinction between patents and trademarks is that the value of a patent is that most innovative activity can remain undisclosed to competitors and to the buying public, whereas the essence and value of a trademark is directly related to its level of disclosure. Although covenants not to compete exclude former owners from eroding the goodwill of a firm, they do not exclude competition. Transaction costs, such as those involved in the 12,000 agreements in the *Guild* case, would be very high if one were to attempt to exclude competitors from using the trademark. It is perhaps this characteristic of disclosure that led the common law to the position that exclusivity could not be contracted for, as is possible in many cases of patents.

It has been said that a trademark gives its owner something in the nature of a monopoly, not in the article sold under the trademark, but of that article as sold under the trademark.[62] This monopoly is as complete as the monopoly created by a patent[63] and is not forbidden by any act of Congress.[64] Interestingly, there has been little criticism by economists of trademark law as monopoly. Perhaps this is because trademark exclusivity is not a statutory right. Another reason may be that trademark law evolved from the common law of unfair compe-

61. *Id.* § 2.

62. *See id.* § 18.

63. *See, e.g.*, United Shoe Machinery Corp. v. Compo Shoe Machinery Corp., 56 F.2d 292 (C.C.P.A. 1932); Le Blume Import Co. v. Coty, 293 F. 344, 349 (2d Cir. 1923).

64. *See* Coca Cola Co. v. J.G. Butler & Sons, 229 F. 224 (E.D. Ark. 1916).

tition and is viewed as a measure protecting consumers. The latter argument can be summarized as follows.

A trademark would have zero value in a world of perfect information because consumers could determine variations in quality and performance among products at no cost.[65] In practice, of course, the quality of many products cannot be determined before purchase without cost.[66] Moreover, enforcing the seller's statements about quality or warranties entails costs that can exceed the value of the purchase if such statements should be deceptive. Under these circumstances, a firm may have an incentive to be deceptive and sell a product of lower quality than it advertised. If a consumer receives a product of a quality at least as high as promised, then the consumer will continue to purchase from the seller. If quality is not as high as claimed, consumers may buy less from the deceptive firm. But if a firm can receive a high quality price for a low quality product, it has an incentive to be deceptive. In equilibrium, only producers whose quality can be determined prior to purchase will survive; that is, their product quality, high or low, is not deceptive. Consumer information and enforcement costs will place an upper limit on the range of quality products available in the market.

A price premium over and above the costs of production (including a normal profit) can create incentives for firms to produce high quality products. These price premiums represent the return to investments in brand-names or trademarks. Trademark investments take the form of specific capital, which has a very low or zero salvage value in alternative uses (opportunity cost). Thus, the returns to investments in brand-name capital (trademarks) depend on repeat sales. If future sales are not realized because the trademark loses its reputation value because the firm is deceptive, then the salvage value of the trademark capital will be very low.

Specific capital investments signal information to consumers about what firms have at stake if quality is deceptive. The capi-

65. The discussion is based on Klein & Leffler, *The Role of Market Forces in Assuring Contractual Performances*, 89 J. POL. ECON. 615 (1981); *see also* Klein, Crawford & Alchian, *Vertical Integration, Appropriable Rents and the Competitive Contracting Process*, 21 J.L. & ECON. 297 (1978); Knoeber, *An Alternative Mechanism to Assure Contractual Reliability*, 12 J. LEGAL STUD. 333 (1983).

66. For other products, generally not associated with a trademark, consumers can determine quality prior to purchase at a low cost (for example, fresh vegetables, lumber, grains, etc.).

tal at risk can be viewed as a "performance bond" that is forfeited if future sales are not realized. Investments in trademarks serve to insure market performance of quality assurance claims that would *not* be necessary in a world of costless enforcement of quality claims. In addition to brand-name advertising, other forms of specific investments may be made such as luxurious storefronts, thick carpeting, and ornate displays, all of which yield little direct service to consumers.[67]

The price premium or specific quality-assuring capital investments for any good depends on a number of factors. The more frequently a good is purchased, the less quality assurance capital is required because consumers can discipline a deceptive seller more quickly. Thus, durable goods require higher quality assurance investments. Because the quality assurance argument is premised on a market enforcement mechanism, the cost of legal enforcement relative to the cost of non-performance is important. For example, the consequential damages that may be realized by a defective drug may explain why low priced "generic" drugs in the United States, despite legislation intended to promote them, have not been successful against higher priced brand-name drugs.[68]

Thus far, the discussion has assumed a firm fully integrated from the manufacturing stage to final retail. Naturally, it is difficult to bring a successful antitrust action so long as a trademark (or patent) is used exclusively within a firm or transferred (assigned) in its entirety.[69] Antitrust difficulties arise when a trademark (or patent) owner licenses or partially assigns use of the trademark, then attempts to control its use by means of vertical restraints. Nevertheless, trademark licensing and vertical restraints are often necessary because vertical integration (for

67. For example, the frequent use of noted personalities in commercials may be attributed to consumer perception of the high cost of these endorsements rather than their being more effective in presenting advertisements. Pepsi Cola made no secret of the fees paid for Michael Jackson's commercials. Alternatively, noted personalities have their own reputation value at stake if the product is deceptive. Finally, local advertisements often refer to other expensive advertisements, such as "advertised on 'The Tonight Show,'" to indicate the "stock" of capital at risk. Klein & Leffler, *supra* note 65, at 631, 632.

68. *Id.* at 632.

69. Coase makes a distinction between transactions organized within the firm and transactions across markets. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937). This distinction has antitrust implications. The former transactions are seldom challenged, whereas the latter are often challenged under antitrust statutes. This is the case even with so called monopoly grants such as patents and trademarks.

reasons discussed in the economics literature) can be inefficient.[70]

Retailers will invest in specific trademark capital only if they are provided with some assurance that they will receive a return on their investments. The manufacturer will want to set a retail price that maximizes returns, given its costs, including a return on specific investments undertaken at all levels. Although resale price maintenance (RPM) is illegal in the U.S.,[71] most trademark goods have manufacturer suggested retail prices.

A manufacturer's alternative to setting the price margin directly is to grant exclusive territories to prevent erosion of retailer price margins by intra-brand competition. The manufacturer, however, can act opportunistically, such as by reducing the manufacturers suggested retail price or increasing the price to retailers once they have made specific investments in the trademark. Given the potential for opportunistic behavior, retailers want assurances that their margins will be maintained over time.

Retailers may also engage in opportunistic behavior. Exclusive territories that restrict intra-brand competition are used to prevent one retailer from free riding on the quality assurance investments or services of other retailers. Suggested manufacturer retail prices and, therefore, price premiums are maintained by restricting intra-brand competition. Retailers' price premiums and their specific capital investments serve an additional function beyond quality assurance to consumers. Retailer investments also serve as a means by which the distributor can enforce its vertical restraint agreements. A retailer will weigh the benefits of free riding by failure to advertise, failure to provide services, or failure to maintain suggested retail price as agreed, against the cost of termination that results in forfeiture of future premiums.

Lower quality products diminish the reputation value of a trademark if consumers are deceived by the "passing off" of

70. On the high cost of integration in general, see Rubin, *The Expansion of Firms*, 81 J. Pol. Econ. 936 (1973). For an analysis of one type of vertical restraint as a hybrid of transactions within and between firms, see Rubin, *The Theory of the Firm and the Structure of the Franchise Contract*, 21 J.L. & Econ. 223 (1978). For a general analysis of the organization of economic activity, see Alchian & Demsetz, *Production, Information Costs, and Economic Organization*, 62 Am. Econ. Rev. 777 (1972).

71. However, it is clear that the Supreme Court does not care much about it. *See* Business Electronics Corp. v Sharp Electronics Corp., 485 U.S. 717 (1988).

counterfeit goods as authorized goods. Consumers who receive lower quality products will perceive them as deceptive in quality. If authorized products cannot be distinguished from counterfeit products, consumers will either stop purchasing the trademark good regardless of its source or will not pay a price premium. An additional effect in passing off cases, besides a loss in consumer welfare, is a decrease (shift) in demand and therefore lower prices and price premiums for trademark products. The market value of the trademark will fall and the lower premium will mean fewer quality assurance investments in the future.

The legal analyses focus on whether so-called anti-competitive measures, such as vertical restraints that create exclusive markets, are permitted to encourage and protect trademark investments. As a general rule, there is a balancing of the competition argument and the protection of trademark investments argument.[72] Different countries not only assign different weights to these two factors, but also have different interpretations as to how these factors enhance or diminish consumer welfare.[73]

In the United States, the vertical restraints associated with trademark goods fall under the rule established in *Continental T.V., Inc v. GTE Sylvania*.[74] In *Sylvania*, the Court balanced intra-brand competition, which is diminished by vertical restraints or parallel import restrictions, with inter-brand competition, which can be increased by vertical restraints or parallel import restrictions. This approach is liberal in the protection of trademark investments and narrowly defines the anticompetitive effects of vertical restraints, compared to the ap-

72. It is beyond the scope of this Article to examine in detail the laws of various countries as they apply to the gray market. There is, however, a common analysis applied to gray markets that exists in most countries despite different legal terminology. *See* Staaf, *The Law and Economics of the International Gray Market: Quality Assurance, Free Riding, and Passing Off*, 4 INTELL. PROP. J. 191 (1988).

73. McKeough, *Intellectual Property Protection and Freedom of Competition: Competing Policies Under the Treaty of Rome: Copyright*, 1 INTELL. PROP. J. 237 (1985).

74. 433 U.S. 36 (1977). Technically courts are to balance the increase in inter-brand competition against the decrease in intra-brand competition. However, vertical restraints have been attacked on grounds other than antitrust, such as unfair bargaining, unconscionability, and penalty clauses. State franchise statutes and regulations also impose constraints on vertical restraint agreements. Thus, the prevention of free riding off the services of others is not just a simple matter of contract. The terms of these agreements and their enforcement are subject to constraints imposed by antitrust law, common-law principles, and state statutes.

proach taken by the European Economic Community.[75]

Sylvania permits vertical restraints or restrictions on intrabrand competition as a way to maintain retailer price margins. This creates incentives for retailers to invest in quality assurance, or the provision of services in order to increase interbrand competition. The most common vertical restraints are exclusive territories (ET) and resale price maintenance (RPM).[76] Explicit RPM agreements are now *per se* violations of U.S. antitrust law.[77] Since *Sylvania*, ETs have been examined under a "rule of reason."

Some of the legal theories used to protect trademarks can be illustrated by cases involving the international gray market.[78] The gray or parallel market is the selling of genuine trademark goods by unauthorized distributors. England, Canada, and other British Commonwealth countries have used the common-law doctrine of "passing off" in gray market cases.[79]

The Supreme Court of Canada, in *Consumers Distributing Co. v. Seiko Time Canada Ltd.*,[80] denied the exclusive Canadian distributor of Seiko watches injunctive relief against parallel importation.[81] The plaintiff introduced a novel extension of the passing off doctrine by arguing that it sold a composite product: a product that included not only the physical watch, but also a warranty, an instruction booklet, point-of-sales service, and after-sale service. The defendant did not provide these extra benefits. The plaintiff argued that because the defendant's customers did not receive the whole Seiko product, confusion was created about Seiko products.

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75. *See* Staaf, *supra* note 72.

76. *See* T. Overstreet, Resale Price Maintenance: Economic Theories and Empirical Evidence (1983); Easterbrook, *Restricted Dealing is a Way to Compete*, (1984).

77. In Dr. Miles Medical Co. v. John D. Park & Sons Co., 220 U.S. 373 (1911), the Supreme Court held RPM agreements invalid as violations of the Sherman Antitrust Act, ch. 647, 26 Stat. 209 (1890) (codified at 15 U.S.C. § 1 *et. seq.* (1982)). RPM agreements were later excluded from the provisions of the Sherman Act by the Miller-Tydings Act, ch. 690, 50 Stat. 673 (1911). Non-signers were excluded under the McGuire Act, ch. 745, 66 Stat. 631 (1952). Both the Miller-Tydings Act and the relevant portion of the McGuire Act were repealed by the Consumer Goods Pricing Act of 1975, Pub. L. No. 94-145, §§ 2-3, 89 Stat. 801 (1975).

78. *See* Staaf, *supra* note 72.

79. Passing off is defined as consumers being deceived or confused by a seller passing his product off as that of another.

80. 1 S.C.R. 583, 10 D.L.R. (4th) 161 (1984).

81. See Barrigar, *Grey Marketing in Canada: The Seiko Case*, 1 Intell. Prop. J. 109 (1985), for a legal analysis; *see also* Knopf, *Seiko v. Consumers Distributing: More Shades of Grey Marketing Law*, 1 Intell. Prop. J. 337 (1985); Hayhurst, *Importation of Grey Goods into Canada*, 2 Intell. Prop. J. 23 (1985).

At trial, the defendant consented to an injunctive order to inform its customers that it was not an authorized Seiko dealer and that the Seiko watches it sold were neither purchased from nor guaranteed by the plaintiff. The Supreme Court of Canada held, *inter alia*, that there was no evidence that there would be deception or confusion among defendant's customers, assuming the injunctive order was obeyed. The Court denied the plaintiff's request for a permanent injunction that would have prohibited the defendant from selling Seiko watches in Canada.[82]

Unlike *Sylvania*, *Seiko* focuses on consumer welfare loss resulting from deception or confusion caused by parallel imports, rather than the possible consumer loss from having less competition if parallel imports are restricted. Moreover, the passing off doctrine does not incorporate the possible pro-competitive effects (for example, inter-brand competition) of restricting parallel imports.

The EEC Court of Justice's interpretation of the Treaty of Rome can be classified as pre-*Sylvania*, whereby vertical restraints within the Common Market are often considered *per se* illegal with the assumption that they are anti-competitive.[83] For example, a recent Court of Justice decision required a manufacturer to honor warranties on parallel sales.[84] Franchise agree-

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82. *See also* Crew, *Parallel Importing: Grey Market Clouds Down Under?*, 2 INTELL. PROP. J. 1 (1985) (analysis of gray markets in Australia and New Zealand).

83. *See* Waelbroeck, *The Effect of the Rome Treaty on the Exercise of National Industrial Property Rights*, 21 ANTITRUST BULL. 99 (1976); Jecies, *Encumbered Industrial Property Rights*, 21 ANTITRUST BULL. 1 (1976); Loewenheim, *Trademarks and Free Competition Within the European Community*, 21 ANTITRUST BULL. 727 (1976). Article 85 of the Treaty of Rome prohibits agreements within the common market that restrict competition. Export restrictions in private agreements are generally proscribed. *See* Kinkeldey, *Pitfalls of Trademark Licensing in the EEC*, 72 TRADEMARK REP. 145 (1982).

Article 85(1) of the Treaty of Rome lists types of agreements that may prevent, restrict, or distort competition, such as price-fixing, restrictions on production, and sharing of markets or sources of supply. Although some market analysis is usually required, the Court of Justice has said that "by its very nature, a clause prohibiting exports constitutes a restriction on competition, whether it is adopted at the instigation of the supplier or of the customer since the agreed purpose of the contracting parties is the endeavour to isolate a part of the market." Miller International Schallplatten Gmbh v. E.C. Commission, 1978 E. Comm. Ct.J. Rep. 131, 22 Comm. Mkt. L.R. 334. Moreover, the EEC does not have to show that trade between member states is actually affected, but only that it *may be* affected, so that an export ban to a non-member may also be a violation. *See* C.S. KERSE, EEC ANTITRUST PROCEDURE (1981).

84. "[O]btaining products by means of parallel imports should not be restricted .... [It is] essential for parallel imports to be fully covered by the manufacturer's normal guarantee. A guarantee scheme under which a supplier of goods restricts the guarantee to customers of his exclusive distributor places the latter and the retailers to whom he sells in a privileged position as against parallel importers and distributors and must

ments that have exclusive territories are also scrutinized.[85] The Treaty of Rome takes precedence over domestic law in the area of parallel imports. In France a cause of action by an authorized seller against a parallel seller may be brought under unfair competition as interference with contractual relations, such as a sole distributorship.[86] But while a trademark owner or registrant may be able to prevent unauthorized competitors within his own country from selling trademark goods whose source is within the country, it may not be able to do so with regard to products imported from another country.[87] The decisions of the Court of Justice seem to severely limit exclusive territories

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therefore be regarded as having the object or effect of restricting competition . . . ." The court noted that restrictions may be justified in cases involving "technically sophisticated, high quality products" which require expert servicing. ETA Fabriques d'Ebauches SA v. DK Investment SA, 1985 E. Comm. Ct. J. Rep. 3933, 3943-44.

85. If the franchisor guarantees the franchisee exclusive use of the trade name within a certain territory, "the franchisor must not only refrain from establishing itself in the territory but must also secure undertakings from the other franchisees not to open another shop outside their own [territory]." Such agreements result "in a kind of market partitioning between the franchisor and the franchisees or among the franchisees and thus restricts competition within the network." Franchise distribution contracts which contain provisions dividing markets "are *per se* capable of affecting trade between member-States, even if they are concluded between enterprises established in the same member-State, to the extent that they prevent the franchisees from setting themselves up in another member-State." Pronuptia de Paris GmbH v. Pronuptia de Paris Irmgard Schillgalis Hamburg, 1986 E. Comm. Ct. J. Rep. 353, 45 Comm. Mkt. L.R. 414.

Some restrictive agreements are exempt from the prohibitions of Article 85. For example, patent holders may prevent the importation of products made in another member state by the holder of a compulsory license. *See* 49 ANTITRUST & TRADE REG. REP. 455 (1985).

86. *See* Jecies, *supra* note 83, at 11.

87. Article 85 deals with undue restriction of competition within the common market and Article 86 with the abuses of a dominant position within the common market. Most parallel import cases are brought under Article 85. *But see* Articles 5 (2), 177, 30 and 36. For example, Article 30 prohibits all quantitative restrictions. Under Article 10(1), products coming from third countries are entitled to free circulation in the member states if import formalities have been complied with and appropriate custom's duties have been levied. It is generally conceded in member states that the Treaty of Rome takes precedence over conflicting national laws. In addition, national courts may decide cases on the basis of the Treaty of Rome. *See* C.S. KERSE, *supra* note 83, at ch. 10.

But Article 85(3) sets out four conditions that must be satisfied for an agreement to be exempted from the prohibition in Article 85(1): The agreement must "(a) contribute to improving the production or distribution of goods or to promoting technical or economic progress; and (b) allow consumers a fair share of the resulting benefit. It must not (c) impose restrictions which are not indispensable; and (d) afford the possibility of eliminating competition in respect of a substantial part of the products in question." *Id.* at 10. Regulation 19/65 gave the EEC Commission power to grant group or block exemptions for certain categories and for certain agreements relating to industrial property rights. "Reg. 67/67 contains the block exemption for exclusive dealing agreements." By April 1980, some 25,000 notified agreements were settled on the basis of the block exemption under Regulation 67/67. *See id.* at 11.

and limit the property rights associated with trademarks as a means of fostering competition.

A number of legal concepts have been used to argue against vertical restraints. One concept is the principle of "exhaustion." Property rights in the form of a trademark are exhausted "once the goods have been placed in the channel of commerce by the original owner or with his consent."[88] The principle of "exhaustion" rests on a notion that once there is "sale" of a good, all rights of the seller terminate. To hold otherwise would create a continuing property interest that is more like a "lease" or "license" than a "sale," that is, an exchange of rights including the right of transfer.

"Another concept is . . . treating parent corporations, their subsidiaries, affiliates and licensees as a single entity . . . ."[89] This view, in effect, prevents a separate legal entity such as a licensee from having separate or "territorial" rights independent of those of the manufacturer or licensor.[90] A related concept is "not allowing the owner of the property rights [such as a licensee] to enforce his ownership of the rights if the prospective purchaser is led to believe that the goods emanate from a multinational corporation or from a single source [licensor] other than the proprietor of the industrial property rights."[91] For example, unless the authorized seller has a separate trademark identifiable by the prospective purchaser, he cannot exercise any rights against a parallel seller.

The Court of Justice and individual European countries have also used the concept of derivative trademark rights. The owner "of 'derivative' trademark rights cannot enforce his national trademark against [anyone] deriving title or obtaining goods from the same original owner or [anyone] who obtained title from the original owner."[92] Therefore, so long as a parallel seller has lawfully obtained title to trademark goods, an authorized seller or owner of the trademark is not able to enforce its rights against the parallel seller.

88. Jecies, *supra* note 83, at 50. This argument is similar to the common law on patents. Once the invention or innovation is disclosed, exclusive rights to it are exhausted.

89. *Id.*

90. This concept has also been called the principle of "universality." United States custom regulations can be interpreted as a version of the single entity concept. Custom regulations are discussed in Appendix B.

91. Jecies, *supra* note 83, at 50.

92. *Id.* at 51.

Court decisions in Switzerland, Germany, Japan,[93] Austria, Italy, and the EEC Court of Justice disregard legal concepts, such as strict territoriality, separate legal entities, and independent rights by the licensees in relation to trademarks.[94] It has been argued that vertical restraints that partition national markets conflict with the essential aim of the EEC, which is the integration of the national markets into a uniform market. It is in this sense that some laws, especially in Europe, are pre-*Sylvania* with an emphasis on the anti-competitive effects of vertical restraints rather than the pro-competitive effects. Appendix B contains a summary of efforts to ban parallel imports into the United States on the basis of the Lanham Trademark Act and the 1930 Tariff Act.

As the above summary of laws in various countries reveals, there is little uniformity in defining the rights and liabilities of the parties with respect to the issue of exclusivity. In principle, the United States affords protection to authorized sellers because of its anti-trust or competition laws, while little protection is given in European countries to authorized sellers because of its competition laws.[95] As the gray market cases reveal, the enforcement of trademarks involve a variety of different legal theories based on property, tort, and competition principles.

V. SUMMARY & CONCLUSIONS

There is no international consensus as to what property rights are associated with patents, copyrights, and trademarks. This Article started with an inquiry, debated in the Eighteenth and Nineteenth Centuries, concerning the issue of whether pat-

93. Japanese custom regulations initially prevented importation of goods that might infringe on Japanese trademark rights. This provision was changed; thus parallel imports of genuine goods cannot be prevented or held up by the Japanese custom authority. However, Japan's "Fair Trade Commission Guide Lines" attempts to prevent parallel imports of genuine trademark goods by making the importation an act of unfair competition. *See id.* at 47. For a brief discussion of Japan and EEC enforcement policies see Baumol & Ordover, *Use of Antitrust to Subvert Competition*, 28 J.L. & ECON. 227, 259-263 (1988).

94. *See* Jecies, *supra* note 83, at 51. It is also likely that these principles may also apply to members of the European Free Trade Area (EFTA) such as Austria, Finland, Iceland, Norway, Portugal, Sweden and Switzerland when these countries trade with EEC members.

95. After K Mart Corp. v. Cartier Inc., 485 U.S. 176 (1988), only U.S. trademark holders will receive protection from parallel imports under 19 C.F.R. § 133.21(c)(3). Foreign trademark owners selling in the U.S. for all practical purposes have not and will not receive protection under the Tariff Act of 1930.

ents are simply property rights or monopoly rights. (The same issue carries over to copyrights and trademarks.) The authors' conclusion is that there is no basis to classify intellectual property as the grant of monopoly rights, unless numerous other rights that involve exclusion, such as home ownership or labor services, are classified as monopoly rights. The courts generally treat intellectual property as any other property, so long as transactions related to these rights are organized within the firm.

Some economists are preoccupied with the alleged monopoly or public good characteristics associated with intellectual property. At one extreme are what might be called institutional economists, such as Plant, who argue that patents are simply a contrived scarcity. These economists confuse public goods with free (non-scarce) goods. The difficulty with this argument is that taking away the right of exclusion results in the tragedy of the commons, unless some other exclusionary process evolves to compensate individuals for innovative activity or the development of goodwill. The most likely alternatives to private property are prizes or public provision. The difficulty with alternatives to private property is that there is no assurance that the value of the innovation or goodwill will exceed costs.

At the other extreme are economists who discuss optimality and efficiency conditions within an institutional vacuum. They accept the monopoly argument and suggest ways that the patent system could be regulated to become more efficient. This extreme is similar to the view of utility regulation. In return for the monopoly privilege, the patent owner is assumed to consent to regulation of returns, such as by a limited patent life. There are other policy recommendations such as narrowing or expanding the scope of a patent claim, antitrust exemptions for joint research ventures, and tax-subsidy schemes. This public policy discussion has had little influence on intellectual property law, which remains largely a body of law dealing with the private enforcement of property rights.

When there are intellectual property right transactions across firms or markets, however, the courts often switch their interpretation of these rights from property to monopoly, thereby exposing firms to antitrust liability. There is a view that the monopoly (the property right) can be expanded beyond what would exist within a firm when there are transactions be-

tween firms. This view results in a bias against firm specialization and encourages internal transactions by way of vertical and horizontal integration. The distinction between "within" versus "across" firms is not derived from intellectual property law, which originates in the common law, but rather from a distinction made in interpretations of antitrust statutes. The Supreme Court decision in *Sylvania* represents a major departure in balancing the property interest of a trademark with market restrictions associated with vertical restraints. Most other advanced countries are inclined to give greater weight to market restrictions and discount property interests. These differences in interpretation of intellectual property rights favor American consumers.

APPENDIX A: *BRIEF SUMMARY OF PATENT LAW*

Because the patent system has been with us since the founding of the Republic, it is difficult to imagine what might have emerged without such a system. The United States Constitution provides:

> That Congress shall have Power . . . To promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries.[96]

The first patent statute was passed in the early years of the Republic.[97] The statutes have been amended numerous times since the 1790s, but in practice the interpretation by the courts has been most important in determining the effect of the law. As in other areas of law, different federal courts have different standards. The federal courts of appeals interpret these statutes differently than the U.S. Court of Customs and Patent Appeals.

Title 35 of the *United States Code* states the basic requirements for obtaining a patent, but the area is broad and the fringes are unclear. Chapter 10 establishes the subject matter requirement: The subject of the patent must be a thing or way of doing something; it must be new; the thing must exist or the way of doing something must be possible given existing technology; and the invention must be non-obvious to one having ordinary skill in that art. Chapter 11 says that a person is entitled to a patent if (1) he invented the subject matter; (2) the application was made within one year of any publication describing the invention or commercial use; (3) the application sets forth the best mode of practicing the invention known at the time of application; and (4) the claims of the inventor distinguish the invention from what already exists and specify distinguishing elements of the invention.

Other important elements of patent law are: The first to file wins the patent unless a later applicant can prove that he was the first to invent; the monopoly right conferred on the inventor is limited to 17 years and to the invention described in the claims approved by the Patent Office; international treaties make patents effective in major commercial countries.

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96. U.S. CONST., art. 1, § 8.

97. *See* 69 C.J.S. *Patents* §§ 2-4 (discussing the historical development of patent laws).

The Patent Office governs issuance of patents. Inventors must follow the procedures established by that office for their claims. Claims are filed through a patent attorney who is authorized to appear before the Patent Office. The attorney will search the subject matter to eliminate duplication and to narrow the scope of the claim. The Patent Office examiner examines the claim and studies existing patents to look for infringements. The patent is issued or rejected. A rejection can be appealed to a board within the Patent Office. If rejected by the board and an appeal is desired, the claimant is likely to appeal to the U.S. Court of Customs and Patent Appeals. Appeal from there is to the United States Supreme Court.

If the holder of a patent believes the patent has been infringed, he can bring suit in federal court. In the majority of such cases, the patent is held invalid. Many courts, including the Supreme Court, seem to believe that the Patent Office is too lenient in the application of the patent criteria. The reader may agree with this judgment, given that patent 3,936,384 is for religious soap (a bar of soap with a prayer embossed in it), patent 3,953,031 is for a plastic coated horseshoe stake (to eliminate the clank of a steel horseshoe), and another is for an electric flagpole (to make Old Glory wave in the absence of wind).

APPENDIX B: *BRIEF SUMMARY OF LEGAL EFFORTS TO BAN PARALLEL IMPORTS TO THE UNITED STATES*

In the United States, opponents of gray markets have attempted to have the U.S. Customs Service enforce a ban on gray market imports by challenging a Customs Service regulation implementing section 526 of the 1930 Tariff Act, which prohibits importing

> into the United States any merchandise of foreign manufacture if such merchandise . . . bears a trademark owned by a citizen of, or by a corporation or association created or organized within, the United States, and registered in the Patent and Trademark Office by a person domiciled in the United States . . . unless written consent of the owner of such trademark is produced at the time of making entry.[98]

This provision was originally enacted as section 526 of the Tariff Act of 1922.[99] This 1922 Act was enacted in response to the court of appeals decision in *Bourjois & Co. v. Katzel*,[100] which refused to enjoin the parallel importation of goods bearing the same trademark that a domestic company had previously purchased from an independent foreign manufacturer.

The Customs Service regulation provides that "[f]oreign-made articles bearing a trademark identical with one owned and recorded by a citizen of the United States or a corporation or association created or organized within the United States are subject to seizure and forfeiture as prohibited importations."[101] But gray market goods manufactured abroad are permitted entry under a "common control" exception:

> The restrictions . . . do not apply to imported articles when:
> (1) Both the foreign and the U.S. trademark or trade name are owned by the same person or business entity; [or]
> (2) The foreign and domestic trademark or trade name owners are parent and subsidiary companies or are otherwise subject to common ownership or control . . . .
> [and an authorized use exception]:
> (3) The articles of foreign manufacture bear a recorded trademark or trade name applied under authorization of the U.S. owner . . . .[102]

98. 19 U.S.C. § 1526(a).
99. 42 Stat. 975 (1922).
100. 275 F.2d 539 (2d Cir. 1921), *rev'd*, 260 U.S. 689 (1923).
101. 19 C.F.R. § 133.21(b) (1987).
102. 19 C.F.R. § 133.21(c) (1987).

An association of trademark holders and two of its members brought suit seeking a declaration that 19 C.F.R. § 133.21(c)(1)-(3) is invalid because it is inconsistent with section 526 of the 1930 Tariff Act and seeking an injunction against its enforcement.[103] The United States, the Secretary of the Treasury, and the Commissioner of Customs were sued. K Mart and 47th Street Photo intervened as defendants. They argued that the regulation was inconsistent with section 42 of the Lanham Trade-Mark Act,[104] which prohibits imports bearing marks that copy or simulate U.S. trademarks. This issue never reached the U.S. Supreme Court. The District Court upheld the regulation.[105]

The Court of Appeals reversed, holding that the regulation was an unreasonable administrative interpretation of section 526.[106] The U.S. Supreme Court granted certiorari to resolve a conflict among the courts of appeals.[107]

The U. S. Supreme Court affirmed the Court of Appeals in part and reversed in part. The Court held that the common control exception of the Customs Service regulation[108] is consistent with section 526 of the 1930 Tariff Act. A different majority of the Court, however, held that the authorized-use exception[109] is inconsistent with section 526.[110]

Many U.S. trademark registrants are subsidiaries of a foreign manufacturer and therefore fall under the common control exception.[111] But gray market imports can be banned by the foreign manufacturer if it establishes an independent U.S. entity as the U.S. trademark registrant even after *K Mart*. Vertical restraints are necessary to "control" or restrict downstream sup-

103. *See* Coalition to Preserve the Integrity of American Trademarks v. United States, 598 F. Supp. 844 (D.D.C. 1984).

104. 15 U.S.C. § 1124 (1946).

105. *See* 598 F. Supp. at 853.

106. *See* Coalition to Preserve the Integrity of American Trademarks v. United States, 790 F.2d 903 (D.C. Cir. 1986).

107. *See* United States v. Coalition to Preserve the Integrity of American Trademarks, 479 U.S. 1005 (1986). *Compare* 790 F.2d at 907-16, *with* Vivitar Corp. v. United States, 761 F.2d 1552, 1557-1560 (Fed. Cir. 1985), *aff'g* 593 F. Supp. 420 (Ct. Int'l Trade 1984), *cert. denied*, 474 U.S. 1055 (1986), *and* Olympus Corp. v. United States, 792 F.2d 315, 317-319 (2d Cir. 1986), *aff'g* 627 F. Supp. 911 (E.D.N.Y. 1985), *cert. denied*, 486 U.S. 1042.

108. 19 C.F.R. § 133.21(c)(1)-(2).

109. 19 C.F.R. § 133.21(c)(3).

110. *See* K Mart Corp. v. Cartier, Inc., 485 U.S. 176 (1988).

111. *See* 19 C.F.R. § 133.21(c)(1)-(2).

pliers from free-riding off the trademark.[112]

Common control means effective control in policy and operations and is not necessarily synonymous with common ownership.[113] The restrictions imposed on parallel imports by the Tariff Act of 1930 were essentially eliminated by the Customs Service's regulations. The *K Mart* decision is of little benefit to trademark registrants, except to U.S. trademark registrants who authorize foreign firms to use their trademarks and can now have U.S. Customs block imports of goods bearing their trademark. Most of the gray market in the United States, however, would appear to be imports of foreign manufacturers who have a U.S. subsidiary or control the U.S. trademark registrant. This recent litigation has little to do with the policy arguments over competition discussed earlier. Indeed, the intent of Congress in passing section 526 of the Tariff Act of 1930 appears to have been to provide protection for truly domestic firms in response to *Katzel*. The *K Mart* decision was based on the Court's interpretation, albeit with considerable disagreement, as to the intent of Congress in passing the Tariff Act of 1930.

Violations of the Lanham Trademark Act have also been alleged in an attempt to stop gray market imports. Section 42 of the Act provides that "no article of imported merchandise which shall copy or simulate . . . a [registered] trademark . . . shall be admitted to entry at any customhouse of the United States . . . ."[114]

While section 42 is effective in enjoining counterfeit goods, the issue in gray market cases centers around the good being "genuine" and therefore not a copy or simulation. This issue has not been resolved and there are conflicting holdings, such as *Katzel*[115] and *Guerlain*.[116] Recent cases dealing with the issue

112. *See* United States v. Guerlain, Inc., 155 F. Supp. 77 (S.D.N.Y. 1957), *vacated and remanded*, 358 U.S. 915 (1958), *dismissed with prejudice*, 172 F. Supp. 107 (S.D.N.Y. 1959) (an independently U.S.-owned trademark registrant was considered to be controlled by the foreign manufacturer because of a unilateral termination clause). *But see* Bell & Howell: Mamiya Co. v. Masel Supply Co., 548 F. Supp. 1063 (E.D.N.Y. 1982), *vacated and remanded*, 719 F.2d. 42 (2d Cir. 1983) (the foreign manufacturer indirectly owned a substantial share of stock in the U.S. company and controlled the board of directors but the court stated the regulations were not applicable because the foreign and domestic trademark owners were not under common ownership or control).

113. *See* 19 C.F.R. § 133.2(d)(2).

114. 15 U.S.C. § 1124 (1946).

115. Bourjois & Co. v. Katzel, 275 F.2d 539 (2d Cir. 1921), *rev'd*, 260 U.S. 689 (1923).

116. United States v. Guerlain, Inc., 155 F. Supp. 77 (S.D.N.Y. 1957), *vacated and remanded*, 358 U.S. 915 (1958), *dismissed with prejudice*, 172 F. Supp. 107 (S.D.N.Y. 1959).

of genuine goods are *Monte Carlo Shirt, Inc. v. Daewoo International (America)*,[117] *El Greco Leather Products Co., Inc. v. Shoe World, Inc.*,[118] *Parfums Stern, Inc. v. United States Customs Service*,[119] and *DEP Corp. v. Interstate Cigar Co., Inc.*[120]

Finally, a gray market case in 1984 before the International Trade Commission,[121] under section 337 of the Tariff Act of 1930, recommended preventing gray market imports. The recommendation was disapproved by the President. The disapproval was based, *inter alia*, on the Commission's interpretation of section 42 as being at odds with Treasury's interpretation. It thus appears that future litigation of gray market cases in the United States will focus on section 42 of the Lanham Trademark Act.

117. 707 F.2d. 1054 (9th Cir. 1983).
118. 599 F. Supp. 1380 (E.D.N.Y. 1984).
119. 575 F. Supp. 416 (S.D. Fla. 1983).
120. 622 F.2d 621 (2d Cir. 1980).
121. *See Report to the President on Certain Alkaline Batteries, Inc.*, No. 337-TA-165, USITC (1984).