Trademark Law and Agency Costs
[Extremely Rough Draft v.1.0]

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At the heart of trademark law is a desire to prevent fraud on consumers. But consumers do not have trademark rights. Producers do. Therefore, when a producer brings a trademark infringement suit, it essentially acts as an agent vindicating the interest of its principal, the consumer. Yet modern trademark law is full of doctrines that help the agent but harm the principal. This happens in at least two ways. First, trademark law increasingly creates opportunities to exercise exclusive rights even when there is no consumer fraud, with results that harm the consumer. Second, and perhaps even worse, trademark law often ignores the existence of consumer fraud when reducing it leads to no gain—or even a loss—on the part of trademark owners. If trademark law is to remain faithful to the principle of preventing consumer fraud, it must adopt legal mechanisms that more closely align the producer interest with the consumer interest. Fidelity to principle requires fidelity to principal.

INTRODUCTION

Consumer welfare is central to trademark law. It may not the only goal that trademark law articulates. But at its core, concern for consumers—specifically, the concern that trademarks not be used to fool consumers into buying the wrong product—is practically, descriptively, and normatively essential to trademark doctrine.

Consumers, however, do not have trademark rights. They are trademark's main constituency, but not the main players. Instead, the main players, the parties that actually have exclusive rights and are therefore entitled to sue when marks are used to fool consumers, are the producers of the goods that bear the marks. It is they who vindicate the consumer interest in avoiding fraud. What the prototypical trademark case creates, then, is an agency relationship, with the producer as the agent, acting in the interest of its principal, the consumer.

Of course, not all trademark doctrine conforms to this idea that the producer's interest derives wholly from the consumer's interest. But except in a few narrow instances, such as dilution theory, consumer welfare is at the very least a constant focus of trademark law. Certainly trademark owners wrap themselves in the flag of consumer protection when pressing their case for a particular interpretation of the law. My thesis here is that they are correct to do so, because consumer welfare is the central concern. Viewing producers as agents rather than as independent parties will actually give them the trademark rights they need without granting them rights that they don't.

Indeed, the strong version of my thesis is that when the producer's interest diverges from the consumer's interest, trademark law is simply inapplicable. The weak version is that even if this agency approach does not fully capture the entirety of trademark law, viewing that law through an agency lens reveals an array of underappreciated problems and also suggests appropriate solutions. In other words, when producer and consumer interests diverge, the scope of trademark rights deserves particularly intense scrutiny—if not automatic and outright rejection.[1]

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[1] As one can probably already infer, there is no room in my approach for theories of trademark liability that are completely unmoored from consumer deception, such as dilution liability, and I

This Article proceeds as follows. Part I explains why we can view trademark's prototypical "passing off" case as involving a producer-agent and a consumer-principal. Part II defines the agency costs—i.e., the welfare-reducing effects—that arise when there is a divergence of interests between the producer and the consumer. Such costs take two forms. The first is when third-party use of a mark does not create an appreciable threat of consumer fraud, but producers nonetheless claim trademark rights. The second is the inverse: third-party use of a mark does create an appreciable threat of consumer fraud, but producers have no interest in seeking redress through a trademark suit. Part III discusses possible ways to reduce those costs, more closely align the parties' interests, and thereby solve some fundamental problems in trademark law.

I. THE CENTRALITY OF THE CONSUMER

The most widely accepted justifications for trademark law, both descriptive and normative, are about preventing consumer fraud. Their rhetoric may not explicitly accept the idea of the producer as a mere agent for the consumer, but in effect—particularly in the core, prototypical trademark case—that is how trademark's justifications actually operate.

A. Rationales for Trademark Law

There are two traditional justifications for trademark law. Their most well-known articulation comes from the legislative history of the federal trademark statute, the Lanham Act:

> The purpose underlying any trade-mark statute is twofold. One is to protect the public so it may be confident that, in purchasing a product bearing a particular trade-mark which it favorably knows, it will get the product which it asks for and wants to get. Secondly, where the owner of a trade-mark has spent energy, time, and money in presenting to the public the product, he is protected in his investment from its misappropriation by pirates and cheats.[2]

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will say no more about such theories.

[2] S. REP. NO. 79-1333 (1946), *reprinted in* 1946 U.S.C.C.A.N. 1274, 1274. Sixty-five years later, the federal government continues to cite these same two rationales in its trademark policy pronouncements. *See* USPTO, *Trademark Litigation Tactics and Federal Government Services*

The first of these two justifications has come to be known as the "consumer protection" rationale. If there were no trademark law, an unknown soft drink manufacturer could freely use Coca-Cola's COKE trademark on its product. And if that happened, consumers would be defrauded; they would buy the unknown's soda, under the mistaken impression that it was Coca-Cola's. Trademark law prevents this conduct from occurring and thereby protects consumers from fraud.

The Lanham Act's second justification is the "producer incentive" rationale. In the preceding COKE example, it is not just the consumer who is happy that fraud has been prevented. Coca-Cola is equally happy, if not more so, because every time a consumer is fooled into buying someone else's product, thinking that it's COKE, Coca-Cola loses a sale (and may suffer a hit to its reputation as well). So by prohibiting fraud on consumers, trademark law assures Coca-Cola that others cannot free-ride on its mark, which in turn gives the company the confidence it needs to invest in making itself and its products the best they can be.

Yet presenting these two justifications as separate rationales for trademark law obscures an underlying commonality: both arise from the need to ensure that consumers are able to distinguish one producer's goods from those of its competitors. This ability on the part of consumers obviously underlies the first rationale for trademark protection, because trademark's exclusive rights prevent one producer from passing off its products as those of another. But consumers' ability to accurately distinguish producers' goods also underlies the second rationale; to the extent that trademark law incentivizes investment in high-quality products and building a reputation, it does so because Coca-Cola knows that its investment in quality cola will not be undermined by low-quality competitors (the "pirates and cheats") attempting to defraud consumers into buying their shoddy goods instead of real COKE. In the end, both rationales are rooted in consumer protection.

The same is true of a third, related rationale: that trademark law exists to promote economic efficiency. This rationale, which is particularly popular in the scholarly literature, touts the reduction of consumer search costs as the primary benefit of trademark law.[3] Producers also benefit under this approach,

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to Protect Trademarks and Prevent Counterfeiting, April 2011, at 4-5.

[3] The standard explanation of the search cost rationale is William M. Landes & Richard Posner,

in that they have an incentive to invest in maintaining a consistent level of quality—but this producer benefit is ancillary to the main goal of reducing consumer search costs.[4] In a sense, then, the economic efficiency rationale simply restates the Lanham Act's two justifications, but more explicitly places consumer welfare at the forefront.

This is not to say that protecting consumers has always been the articulated *goal* of trademark law. Many authorities state that it is,[5] but Mark McKenna has argued that trademark law instead developed to protect *producers* from the fraudulent diversion of sales—a form of unfair competition law, with a focus on competitors, not customers.[6] For present purposes, however, this disagreement doesn't matter; under either view, consumer fraud is the *sine qua non* of trademark liability. Even if the articulated goal is to protect producers from unfair competition, the act that makes the competition unfair is fraud on the consumer. Indeed, consumer fraud is the "unfair" conduct that makes it possible to situate trademark protection within unfair competition law.[7]

For all practical purposes, then, trademark law's true target is consumer fraud.[8] Note that this use of the term "fraud" to describe trademark's primary concern is both deliberate and important, because fraud involves not only

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Trademark Law: An Economic Perspective, 30 J.L. & Econ. 265, 269 (1987) (identifying "reducing consumer search costs" as the main benefit of trademark law).

[4] *See* Landes & Posner at 269 ("The benefits of trademarks in reducing consumer search costs require that the producer of a trademarked good maintain a consistent quality over time and across consumers."). Of course, reducing consumer search costs is not so laudatory if the same doctrine raises other consumer costs by a greater amount—e.g., by facilitating monopoly pricing. More on this later, in Part ___.

[5] *See* Mark P. McKenna, *The Normative Foundations of Trademark Law*, 82 NOTRE DAME L. REV. 1839, 1844-46 (2007) (cataloging the conventional wisdom on this topic).

[6] *See* McKenna, *Normative*, at 1843 ("Trademark law traditionally was intended only to prevent competitors from dishonestly diverting customers who otherwise would have gone to the senior user of a mark.").

[7] Anglo-American trademark law also has its historical roots in consumer fraud. *See* FRANK I. SCHECHTER, THE HISTORICAL FOUNDATIONS OF THE LAW RELATING TO TRADE-MARKS 6-9 (1925) (demonstrating that the foundational case of *Southern v. How* was probably brought by a consumer against a producer rather than by one competing producer against another).

[8] *See* McKenna, *Normative*, at 1857 (noting that producers in early English cases "were making claims based on injuries to their own interests that resulted indirectly from deception of consumers"). To be fair, McKenna also posits a category of cases in which producers' interests are not coterminous with consumers', *see id.* at 1866-73, but none of those cases involved the diversion of sales from a trademark owner through fraudulent use of its mark. In other words, they are all cases in which consumer welfare is defined more broadly than here.

deception but also a resulting injury.[9] The more common term in trademark parlance is "consumer confusion," but it is inaccurate to say that trademark law developed to prevent confusion. After all, confusion alone does not necessarily lead to any harm to consumers or diversion of sales from producers. Only when the confusion gives rise (or threatens to give rise) to an actual injury—here, the mistaken purchase of a good bearing another's mark—do trademark's rationales give rise to the need to protect anyone, consumer or producer.[10]

In short, the interests of consumers and producers may not be identical, but for trademark law's purposes they are coterminous. If we help consumers avoid the fraudulent use of trademarks, we help the producer avoid the unfair diversion of sales and thus provide an incentive to invest in high-quality goods. Solve the fraud problem and we solve the trademark problem.

B. Rightsholder as Agent

If a proper understanding of trademark law views consumer interests and producer interests as coterminous, then a producer that asserts trademark rights can be seen as an agent of the defrauded consumer. The producer's own interests are served as well, of course, because the defendant has fraudulently diverted its sales. But that confluence of interests simply underscores how ideal an agency relationship it is; a perfect convergence of agent interest and principal interest is the ultimate goal of any agency arrangement.

One question bears asking before we accept this theory, however: why does the agency relationship not run the other way? Why are consumers not the

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[9] *See* RESTATEMENT (SECOND) OF TORTS § 525 (1977) (defining cause of action for fraudulent misrepresentation). **[Question for readers: I use "fraud" because I want to emphasize the need for a consumer *injury*, and fraud has injury as an element—but fraud also has *intent* as an element, and I don't believe that trademark does or should. So is there a better term than "fraud"? "Swindle"?]**

[10] *See generally* James Gibson, *Risk Aversion and Rights Accretion in Intellectual Property Law*, 116 YALE L.J. 882, 890-91 (2007) (arguing that "courts should inquire into consumer motivation: does the confusion actually make a difference to consumers?"); Mark A. Lemley & Mark McKenna, *Irrelevant Confusion*, 62 STAN. L. REV. 413, 414 (2010) (arguing that "trademark law needs to refocus on confusion that is actually relevant to purchasing decisions"); Mark P. McKenna, *A Consumer Decision-Making Theory of Trademark Law*, 98 VA. L. REV. 67, 72 (2012) (arguing that "courts should find trademark infringement only when the defendant's use of the plaintiff's trademark creates a risk that consumers will be deceived into buying goods or services they otherwise would not have or refraining from buying what they otherwise would have").

agents of producers? After all, if consumers are defrauded, they can bring a claim for fraud, which should also serve to redress the diversion of sales that injures the producer. Indeed, under that approach, we would not need trademark law at all.

The answer is that here, as in all worthwhile agency relationships, the agent can vindicate the parties' common interests more efficiently.[11] When a third-party use of a mark fools consumers into buying the wrong product, the injury to any individual consumer is usually too small to justify the expense of filing a fraud suit. In contrast, the producer who has rights in the mark can essentially aggregate all the consumer injuries into a single high-value trademark infringement claim, because every defrauded consumer represents a lost sale to the rightsholder. This is the essence of trademark law—allowing the producer to step into the collective shoes of the defrauded consumers and assert their rights through an infringement claim.

II. AGENCY COSTS IN THE PRODUCER-CONSUMER RELATIONSHIP

The classic formulation of welfare-reducing agency costs comes to us from Michael Jensen and William Meckling. They break agency costs down into three subcategories. The first is "bonding costs," which represent the cost of compensating the agent for abandoning its own interest in favor of the principal's. The second is "monitoring costs," which represent the ongoing cost of making sure the agent is in fact acting in the principal's interest. And the third subcategory accounts for those instances in which even a bonded and monitored agent puts its own interests before the principal's; any resulting welfare reduction is called the "residual loss."[12]

Applying this formulation to the prototypical "passing off" trademark case, we find the agency costs to be negligible. If, as I have argued, the interests of the producer-agent and consumer-principal are coterminous, then the producer would not need any significant bonding payments; the specter of diverted sales

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[11] Note also that the agency costs that are our central concern can arise even if neither party is technically acting as agent for the other, as long as they share the same goal—here, the elimination of third-party use of the producer's mark to induce fraudulent sales. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, ___ (1976) ("[A]gency costs arise in any situation involving cooperative effort . . . by two or more people even though there is no clear-cut principal-agent relationship.").

[12] Jensen & Meckling at ___.

already gives it enough reason to sue competitors that use its mark to deceive consumers.[13] Nor would it require any real monitoring, because it would automatically pursue the consumer interest when it pursues its own. Finally, the producer would not cause any residual loss, because the happy convergence of its interest and the consumer interest would foreclose any opportunity to act for itself alone.

The prototypical case is admittedly idealized, but is not a fantasy. Many trademark cases—perhaps most—target the successful passing off of a competing product through use of the plaintiff's mark. That said, there are other uses of trademark rights that do not fit within this idealized model, and they therefore generate agency costs. Generally speaking, these costs arise in two ways. The first is when third-party use of a mark does not create an appreciable threat of consumer fraud, but producers nonetheless claim a trademark violation. Expansive merchandising rights are the best example. The second represents the inverse: third-party use of a mark does create an appreciable threat of consumer fraud, but producers have no interest in seeking redress through a trademark suit. Examples include certain forms of trademark abandonment. I discuss each of these instances in turn.

A. Overeager Agents: Rights Without Fraud

Trademark's principal-agent relationship works well when producers use their exclusive rights to reduce the incidence of consumer fraud. If, however, producers use their exclusive rights even when consumer fraud is absent, they can no longer be said to be acting as consumers' agents, and their assertion of trademark rights is more suspect.

The best example of this divergence of interests is merchandising rights. Suppose a consumer is the market for a t-shirt that says DENVER BRONCOS on it. She probably does not care whether it is "official" merchandise made under license from the trademark owner (the NFL). She just wants to express her allegiance to the team.

So if our Broncos fan were to buy the t-shirt from an unlicensed producer,

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[13] Litigation costs would be a deterrent to filing suit, of course, but no more so than they would be if the principal-consumer had to file suit itself, which means they should not be considered agency costs. (In fact, total litigation costs should be lower for the agent-producer, because it can redress multiple instances of fraud in one trademark infringement suit.)

she would not be defrauded. Confused, maybe—she might *think* it's "official" merchandise—but remember, she doesn't *care* whether it's official. She is happy with her purchase as long as the shirt features the team's logo. She is therefore not defrauded; the use of the trademark worked no injury upon her.

Nevertheless, trademark law characterizes the unlicensed sale as infringement. [Quick summary of history of those rights, some doubt from early cases, occasional protests from aesthetic functionality angle, but basically overwhelmed by producer industry. So producer interest paramount, which means agency costs.]

[Scale of the agency costs; exclusive merchandising rights might reduce some search costs for some consumers, but that total consumer costs likely rise though reduction of competition.]

[Related examples via sponsorship/affiliation confusion.]

B. Absent Agents: Fraud Without Rights

The preceding subsection asserted that trademark's principal-agent relationship breaks down when a third-party use of a mark does not defraud consumers, but producers exercise exclusive rights anyway. In this subsection, we consider the inverse proposition: when third-party use of a mark *does* defraud consumers, but producers fail to use their exclusive rights to put a stop to it. This likewise represents a breakdown in the principal-agent relationship and generates unacceptable agency costs.

This scenario can occur in a wide variety of settings. Consider, for example, when one producer accuses another of passing off, but the case is not airtight. Perhaps the marks are not identical, or the products are not identical, or the geographical overlap in markets is limited. Given the cost and uncertainty inherent in prosecuting such a case, the parties may well enter into a settlement that allows the defendant to continue to use the mark in exchange for some compensation to the plaintiff. If, however, the defendant's use does in fact lead to real instances of passing off, then the settlement serves the producer's interest but not the consumer's; the producer is compensated for lost sales, but consumers continue to be defrauded.

Such a settlement essentially treats the trademark as a right in gross. The same is true of other examples of this kind of agency cost. Consider the disposition of a trademark when the rightsholder goes bankrupt. Unless the rightsholder plans to reorganize and resume operations, the mark will likely be sold to the highest bidder (or seized pursuant to a security interest), so as to generate funds to pay creditors. A recent example is the bankruptcy of Hostess, originator of the TWINKIE mark. No one involved in the Hostess transaction—creditor, debtor, or buyer—cares that consumers might be unaware that the TWINKIE they are now buying is made by an entirely different producer. Supposedly neutral parties like the bankruptcy trustee or judge are unlikely to want to rock the boat and reduce the corpus of the estate by opposing the sale. And trademark doctrines like abandonment, which are designed to protect consumers in these circumstances, require an agent for the consumer to bring the case. Only if a third party happens to want to adopt the TWINKIE mark will such an agent appear—and it will have to explain why a transaction blessed by a bankruptcy court was in fact illegitimate.

These infirmities in assignment and licensing are not fringe issues in the life of a trademark. A recent study of thirty-five years of federally registered trademarks found that almost one third had been affected by some transaction over their life, with more than one in five changing ownership and more than one in ten being subject to a security interest.[14] And similar agency costs can arise outside of such transactions. Consider concurrent use. Ghostwriters. Even laches doctrine, which might forbid a rightsholder to bring a suit even when consumer fraud is clear.

III. Reducing Trademark's Agency Costs

The classic conception of agency costs—bonding costs, monitoring costs, residual loss—contemplates a much more direct connection between agent and principal, such as a contractual relationship or employment within a firm, than we see in the trademark context.[15] Nevertheless, for the Rights Without Fraud cases it is relatively easy (setting aside public choice concerns) to have principals-consumers "pay" bonding and monitoring costs indirectly, through the government's formulation of trademark rights that reduce the reach of trademark rights until they properly align producer and consumer interests.

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[14] Stuart J.H. Graham et al., *The USPTO Trademark Assignment Dataset: Descriptions, Lessons, and Insights*. USPTO Working Paper No. 2014-2 (April 1, 2014), *available at* http://ssrn.com/abstract=2430962.
[15] *See* Jensen & Meckling at ___.

Fraud Without Rights cases are a harder nut to crack, because it's not a matter of reducing rightsholders' ability to sue. Instead, we need to increase that ability—or, where the doctrine is already largely correct, provide more of an incentive to use it. Here the agent may need to be a monitoring agency, such as the FTC. Or we might abandon the agency model altogether, in favor of consumer class actions.

CONCLUSION

Even in rough draft, this article is both beautifully written and utterly convincing. Everyone else can stop doing trademark scholarship now.[16]

[16] *See* Orin S. Kerr, *A Theory of Law*, 16 GREEN BAG 2D 111, 111 (2012).