

Exit, Voice, & Intellectual Property
Notes for Paper
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I.1. This paper deals with the relationship between intellectual property and competition law and policy. Specifically, the main contribution is conceptualizing intellectual property as defining a regime of nonprice competition. The analytical approach for understanding intellectual property in terms of nonprice competition is derived from Albert Hirschman's famous model of exit, voice, and loyalty.

I.2. The motivation for this paper is the longstanding legal and policy question of reconciling intellectual property and competition policy. The Supreme Court's 2013 decision in *FTC v. Actavis* brought this question to forefront, offering an answer that has been interpreted as either quite narrow or game-changing. Such contrasting views represent the language of the majority and dissenting opinions and the unusual factual context for the decision. Whatever the scope of the opinion, the concept of "freedom from competition" arises in several antitrust cases involving intellectual property. Virtues of intellectual property as providing a refuge from competition contrast with claims that intellectual property is a monopoly, often a misuse of that term, perhaps a shorthand for "strong exclusionary rights." This paper provides a conceptualization of these issues that provides normative valance and operability within legal policy debates.

I.3. While ostensibly offering freedom from competition, intellectual property actually entails different forms of competition. Scholars and policymakers characterize intellectual property rights as allowing the owner to set prices above marginal cost and thereby obtaining a rent, or a monetary reward, for the legal exclusivity. This characterization of IP owner as price setter is often the basis for describing IP as a monopoly. We can see such reference in recent Supreme Court cases. Kaplow's 1984 article on the patent-antitrust interface is an example of how price setting behavior is assumed in the scholarly literature.

I.4. But even if an IP owner can set price, even if an IP owner is free from price competition, nonprice competition plays a critical role in the dynamics of innovation and intellectual property rights. Design arounds, transformative fair use, reverse engineering, trademark nominative and fair uses, and other practices and doctrines illustrate how an IP owner faces competition along dimensions other than price. The scholarly literature on product differentiation and monopolistic competition represent formal economic approaches to recognizing nonprice competition in intellectual property defined markets. The scholarly work tends to focus narrowly on copyright's access/incentive trade-off through specific models of markets. This paper is conceptually broader and is not limited to particular "market structures." Therefore, the methodology presented in this paper perhaps has broader appeal and implications.

I.5. Albert Hirschman's idea of exit, voice, and loyalty provides an attractive framework for conceptualizing nonprice competition. Hirschman's eponymous 1970 book presents the dynamic of exit, voice, and loyalty as tools in competitive struggles, especially in declining industries. The inspiration for the book came from Hirschman's study of government sponsored

industries in Nigeria, and the failure of price competition to lead to improvements in such governmentally sanctioned monopolies such as the railroads. His examples, however, also included then ongoing debates over public schools and the forces for change in government and corporate governance in the United States. To the extent intellectual property are instances of government sanctioned monopolies, Hirschman's ideas about competitive dynamics has relevance. Even if the equation of intellectual property with forms of monopolies is incorrect, the forces of exit and voice have resonance in intellectual property debates, especially as counterweights to systems of loyalty that are often associated with intellectual property.

I.5.a. Competition law interacts with intellectual property law both internal to intellectual property doctrines (exhaustion, fair use, etc) and external to intellectual property law (antitrust). My focus is on the first set of interactions. Nonprice competition can inform antitrust analysis of intellectual property practice, but I leave that in part for a later paper. Here, the role of nonprice competition in applying intellectual property doctrines is the focus.

I.6. The roadmap for the paper is as follows. Section Two of the paper lays out the ideas of exit, voice and loyalty and presents a preliminary mapping of these concepts onto intellectual property. Section Three demonstrates how the conceptual mapping in Section Two shapes actual intellectual property policy. Section Four spells out implications for future research and broader policy debates. In this set of notes, I will demarcate the specific sections within each paragraph. I will keep the numbered paragraph for each of reference and exposition.

I.7. This paper assumes the normative value of competition without exploring why competition is a good thing. Arrow's theory of competition and innovation, even with its narrow focus on what would be called trade secret law and cost-saving invention within a firm, seems intuitively correct as a general matter. Instead, this paper tries to unpack the different forces at work in competition. I leave the broader normative discussion of competition versus "freedom from competition" for another article (although I would love comments and questions on this issue as part of the discussion).

II.1.. Exit, voice, and loyalty are different forces of competition that promote change in social institutions, such as the market. They are relevant to intellectual property as competition, of the nonprice sort, shapes the dynamic of innovation and the implicit scope of intellectual property rights.

II.2. Exit refers to the movement of consumers and other participants within a particular organization in response to unfavorable decisions made by owners or managers within the organization. In the case of governmental organizations or voluntary associations, the exit can take the form of movement from the jurisdiction (moving to another state, disassociation with a homeowner's group). In the case of for profit entities, exit takes the form of refusing to buy from a particular company or switching to a competitor. Competition analysis often focuses on entry of new firms. The strategy of exit is a corollary to the entry of new firms. Exit will sometime be limited if new firms do not enter, and the viability of new firms will result on attracting customers that often would arise from exit of incumbents.

II.3. Exit occurs within the exclusive rights provided by intellectual property through brand switching, designing around a patent, reverse engineering a trade secret, developing expressive works that build upon without copying existing works of authorship, or through accessing different channels of distribution. The availability of exit depends upon the scope of intellectual property rights. The exit strategy also depends on the availability of alternatives for reasons other than the scope of intellectual property rights, such as institutional limitations and scope of the marketplace. In many instances, exit may not be an option, for example, in the case of pharmaceuticals or software products. At a broader level, one may not be able to exit the institutions of scientific investigation and research or of expressive fields, such as book publishing or art exhibition.

II.4. Voice often can serve as an alternative to exit when the latter is not feasible. Voice is often described as change from within an organization. It can involve changing leadership or expressing dissenting viewpoints with the goal of fomenting change. Hirschman describes voice as “political” while exit is “economic.” However, voice can also have an economic dimension, such as through advertising or through the production of mainstream or alternative media. Exit, too, can have a political dimension, such as an economic boycott by consumers for disagreement with corporate investment policies. The particular label does not matter for understanding the competitive force or the institutional and organizational context within which the force operates. Exit entails a refusal to deal with an entity. Voice, by contrast, assumes an ongoing communicative relationship with an entity.

II.5. Voice within intellectual property systems include the use of trademarked or copyrighted works in the form of protest. Recognizing voice as a strategy may explain why fair use in copyright is more permissive when it is critical of the copied work rather than a third work or a broader social issue. But restrictions on voice, even when aimed at issues broader than the work at hand, can be undesirable within an intellectual property system. The difficulty is in drawing boundaries on voice through intellectual property rights. Nonetheless, voice can have well-defined domains. For example, contracting can be a form of voice, and restrictions licensees, such as licensee estoppel, may be suspect from the perspective of voice. Furthermore, litigation is one channel for voice, and access to litigation can be important in supporting voice as a competitive force on intellectual property.

II.6. The dynamic between exit and voice is complicated. Exit is effective if the high value customers leave a particular organization. But they may often leave behind less well-positioned individuals to exercise voice. Therefore, exit may undercut voice. At the same time, voice may facilitate access as individuals who may have low value for the organization put pressure through voice on high value members to exit, which might put additional pressure on the organization to change. Policymakers and scholars need to consider the interplay between exit and voice in assessing particular policies.

II.7. Loyalty is another competitive force but one that works counter to exit and voice. Loyalty is the strategy often used by an existing entity to cement relationship with members in order to forestall change. At the same time, loyalty may be the key competition lever as organizations compete for members. Loyalty can work through emotional, cultural, and pecuniary appeals. However, the lever can be subject to cognitive biases and inertia, as existing members may

downplay the need for change in order to obtain short term gains. Furthermore, loyalty may be won through superficial, short-run changes that do not address the underlying source of the discontent leading to exit and voice.

II.8. Intellectual property systems are systems of loyalty. We can see this in the notion of trademark and branding. Copyright also illustrates a large element of loyalty through author-affinities and fandom. Patent licensing is a form of loyalty, especially through the use of most favored nation clauses and exclusivity provisions. Trade secrets operate to create within firm loyalty by making it difficult for existing employees to leave for other alternatives. The heart of my argument is that intellectual property serves to prevent exit and voice through these mechanisms of loyalty. The goal of intellectual property policy is to allow room for exit and voice as competitive forces that can lead to change and innovation.

III.1. Exit and voice provide the primary impetus for nonprice competition. Loyalty acts to limit exit and voice by bonding individuals who might provide alternatives to the status quo from either leaving to pursue these alternatives or engaging in advocacy to pursue these alternatives from within. These concepts map onto different types of intellectual property.

III.2. In this paper, I assume that nonprice competition is a key driver of individual invention, market innovation, and technological change. Intellectual property operates within a world of nonprice competition and shapes its contours. Intellectual property rules shape the mechanisms of nonprice competition as a facilitator of invention and innovation. Two implications follow from this claim. First, even if intellectual property precludes competition (by establishing a price-setting monopoly), nonprice competition still exists. Second, the design of intellectual property policy is to facilitate nonprice competition.

III.3. The connection between nonprice competition and intellectual property is apparent in different areas of intellectual property. Before proceeding to the examples, it is valuable to set forth the general structure of my argument. Intellectual property rights are exclusive rights that facilitate different types of loyalty. However, loyalty impedes nonprice competition. Therefore, the design of intellectual property rights should facilitate exit and voice. This section shows how this view of intellectual property informs actual intellectual property doctrine and can guide policy reform.

III.4. Trade secret law best illustrates the dynamic of exit, voice, and loyalty in promoting nonprice competition. From the nineteenth century to the 1930's, trade secret law in the United States evolved into a form of property owned by the firm. Such developments reflected the development of the corporate form and the increased proprietary nature of tacit knowledge within a firm. Employee inventorship gave way to assignments through contract and rules that facilitated firm management of valuable business knowledge.

III.5. After World War Two, trade secret law shifted towards recognition of employee ownership and the values of competition and employee mobility within trade secret regimes. The 1960 Pennsylvania Supreme Court decision, *Wexler v. Greenberg*, illustrates the germ of start-up culture that is paramount today. At the same time the over half a century since the *Wexler* decision has witnessed some reversals from the role of exit in trade secret law.

Inevitable disclosure, the use of contractual restrictions such as grant back clauses, and the ongoing debates over invention assignment agreements illustrate pushback from the values of exit towards ones of loyalty, preserving ownership and management within the firm of tacit knowledge.

III.6. Developments in trade secret law over a century illustrate a movement from loyalty to exit and a return to loyalty. Nonprice competition, as a normative basis for court decisions, advanced and then retreated in some areas. The benefits of nonprice competition for trade secret regimes are apparent, however, and the role of trade secret as a means of imposing loyalty has become less salient and perhaps undesirable. The challenge to firms and to social policy is recognizing some need for cohesion within a firm. As managers and employees view firms as mere platforms for individual mobility, the benefits that arise from the firm are potentially lost. An important legal basis for firm loyalty, however, need not be trade secret law. Instead, corporate law doctrines such as the rule against usurpation of corporate opportunities may facilitate firm loyalty without interfering with the benefits of nonprice competition for invention and innovation. A combination of a fairly open trade secret regime, one that facilitates competition, with a strict fiduciary duty regime may provide the appropriate balance between loyalty and exit.

III.7. Trademark law also illustrates the dynamic of exit, voice, loyalty. By contrast with trade secret law, trademark law provides a specific mechanism for loyalty. Within the trade secret law, the bond of loyalty is between the employer and the employee. Within trademark law, the bond is between the firm and the customer. Such a conception of trademark law is consistent with the traditional search cost rationale for the law. But the conception of trademarks as loyalty mechanisms goes beyond the traditional rationale. As a promoter of loyalty, trademarks aid not only in the location of goods, but also in developing connections among consumers and between the consumer and the trademark owner.

III.8. Nonprice competition through exit and voice can place limits on the exclusionary rights of the trademark owner and facilitate innovation. Interbrand competition is a canonical form of nonprice competition as consumers can switch brand loyalties based on the bundle of amenities that a competing brand can provide. Brand switching is an example of exit. A competitor is free to attract consumers through many means, falling short of copying the trademark owner's mark. Exit to counterfeit brands poses an interesting challenge for the loyalty theory of trademarks. Under traditional search cost theory, counterfeits undermine the value of the trademark by attracting consumers to poor quality products or services. Under the loyalty theory, consumers are demonstrating an element of loyalty to the brand by buying cheaper substitutes for products that may not otherwise be affordable. Counterfeits expand the brand, admittedly at the cost of quality in some instances. Counterfeit marks are not, therefore, an unalloyed negative under a loyalty theory of trademarks. This possibility may explain why trademark owners sometimes countenance counterfeit products in some markets, especially in the developing world.

III.9. Voice, in addition to exit, facilitates nonprice competition in the trademark regime. Those who are dissatisfied with a brand can express concerns through the use of the trademark itself. Such use is protected as nominative fair use. Use of a protected mark to criticize the mark can also be a form of classical trademark fair use. Exclusions from trademark infringement, such as fair use, build on the communicative aspect of marks, especially as tools for exercising voice.

III.10. One unexplored implication of voice in trademark law is the treatment of comparative advertising. While a consumer can make use of a mark to exercise her voice, the use of a mark by a competitor is controversial. Comparative advertising, however, may be an exercise of nonprice competition through voice. Because of this important role for comparative advertising, courts and legislatures should be more facilitating of comparative advertising against claims of unfair competition or trademark infringement. Effectively, comparative advertising may complement voice by consumers and may serve as a conduit for communication between competitors and consumers.

III.11. Copyright and patent also serve as mechanisms for promoting loyalty, and limitations on exclusionary rights under copyright and patent laws can facilitate exit and voice. Copyright, like trademark, governs expressive activities but ones that go beyond promoting brand loyalty. However, fandom under copyright regimes parallels branding under trademark. Copyright doctrines, such as fair use and first sale, facilitate nonprice competition through exit and voice. The challenge is finding ways to promote exit and voice within digital copyright regimes. The broad recommendation is to have digital copyright mirror traditional copyright rules as much as possible.

III.12. Patent, perhaps less obviously, serves as a mechanism for promoting loyalty. Paralleling trade secret, patents are a mechanism for cementing loyalty within the firm by making it more difficult employees holding within firm knowledge to exit. Licensing also acts as a mechanism for loyalty by in some instances aligning the interests of the licensee with that of the patent owner. The role of exit in licensing regimes comes into play through the treatment of patent remedies, of FRAND, and of standard setting organizations.

III.13. Voice is also a pertinent mechanism for nonprice competition in patent law. Challenges to patent validity rely on the mechanism of voice. Debates over licensee estoppel rest on the appropriate timing for the exercise of voice: during the licensing negotiation phase or afterwards. Administrative procedures for patent review also facilitate voice. Legal doctrines such as standing shape how and when voice can be exercised in the courts. Finally, the theory of voice can inform the understanding of experimental use as a limitation on patent rights. When experimental use facilitates voice as a challenge to a specific patent, the law should countenance such a limitation. However, experimental use simply facilitates private gain, patent law should not allow an experimental use defense.

IV.1. The theory of nonprice competition presented here has three broad implications for intellectual property law: (i) understanding the boundary between intellectual property and competition policy; (ii) shedding light on intellectual property in development policy; and (iii) developing a broader understanding of the political economy of intellectual property.

IV.2. Framing intellectual property within the terms of nonprice competition opens up our understanding of the relationship between intellectual property and competition law doctrines. For those who see intellectual property as problematic because of the possibility of monopoly-like price setting, nonprice competition suggests that the threat of IP as monopoly may be limited. But this argument should not be the basis for complacency on the scope of IPR's. The stronger counterargument is that intellectual property needs to be policed from the perspective of

both price competition and nonprice competition. The arguments in this paper provide a more workable balance between intellectual property and competition law, suggesting an overlap and harmony in shared goals of promoting invention, innovation, and access. Such a view may aid in going beyond the narrow debate between the majority and dissent in the *Actavis* decision.

IV.3. Criticisms of the exit and voice framework may parallel that made of the raising rival's cost approach to antitrust enforcement. Both approaches focus in a potential mix of qualitative and quantitative analysis on the ease of entry into a particular market. The problem, however, is that in many instances entry barriers may be desirable since they are a consequence of a firm providing a more innovative product than a competitor. I would argue that the exit/voice approach goes beyond the raising rival's cost approach by identifying specific mechanisms within a coherent theoretical framework for promoting nonprice competition. This framework does not rely on market definition, a target of criticism within antitrust analysis, and rests on both qualitative and quantitative information about competitive dynamics within which an entity operates. Therefore, the exit/voice approach serves to prove a theoretical bridge between intellectual property and competition law that can be applied to a complex factual context.

IV.4. Hirschman's theory of exit and voice arose through his study of development and the failures of market driven policies in developing countries. The dynamics of nonprice competition often undermined attempts at liberalization through price competition. The approach present here as applied to intellectual property can be a basis for understanding the relationship between intellectual property and development. While often debated in terms of attracting foreign direct investment for large capitalized firms (that often will have some price setting capabilities in a market economy), the role of intellectual property in promoting development also encompassed the promotion of indigenous innovation and of start-up businesses that compete in distribution and manufacturing. The exit/voice framework is instructive in how to design national intellectual property regimes that foster development through nonprice competition.

IV.5. Looking beyond developing countries, the exit/voice framework illuminates the political economy of intellectual property in developed countries, especially the interplay between incumbent firms and business models and new entrants with alternative technologies and practices. Hirschman's framework can serve as predictive model to explain industry responses and the influence on the law. Furthermore, the framework can be valuable in examining nonprice competition as a normative virtue in the design of intellectual property regimes.

V. Nonprice competition is a critical driver for invention and innovation. This paper develops a framework for thinking about nonprice competition in intellectual property regimes based on Hirschman's famous book, "Exit, Voice, and Loyalty." Future research will explore some of the specific areas of intellectual property doctrine and policy in more depth. An important, unanswered question is the virtue of competition in promoting innovation. I leave this normative question for a future paper. This article lays the foundation for how nonprice competition operates in intellectual property systems and makes the case for addressing intellectual property policy through the lens of exit, voice, and loyalty.