TRADEMARKS AND THE BOUNDARIES OF THE FIRM[†]

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ABSTRACT

Coase's theory of the firm has become a familiar tool to analyze the structure and organization of businesses. Such analyses have increasingly focused on property-based theories of the firm, including intellectual property. In previous work we have discussed the application of this model to patents, copyrights, and trade secrets. Here we take up the theory of the firm with regard to trademarks, which act as signals of firm reputation, and so have application and effects that differ substantially from other forms of intellectual property. Using the framework from our previous analyses, we examine the propensity of trademarks to lower transaction costs between firms, as well as within firms, suggesting that such doctrines will have significant effects on the size and structure of the firm.

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INTRODUCTION

Modern commerce functions in a sea of trademarks. Consumers depend upon such marks to identify goods and services and increasingly adopt the marks to communicate loyalty or allegiance to preferred brands of goods.[1] Consequently, firms spend billions of dollars each year in developing, establishing, promoting, and maintaining their trademarks in the marketplace.[2] A recognized trademark is frequently the most valuable asset held by the modern firm.[3]

In this paper we consider certain aspects of this latter dimension of trademarks: their value as assets and their place in the firm. Although trademark law traditionally contemplates the welfare and perceptions of consumers,[4] we will be largely unconcerned about the benefits or effects of trademark law on consumers, except as an indirect factor in our primary analysis. Instead, we will focus on the manner in which the legal existence of such assets, and by which the legal regime for control of such assets, may affect the size and structure of economic firms. We will argue that the law allocating the use of trademarks has an important effect, and sometimes a profound effect, on the contours and organization of firms.

In previous work we have considered how other forms of intellectual property, particularly patents, copyrights, and trade secrets, might influence the size and structure of firms, and ultimately of entire industrial sectors.[5] Our earlier analysis assessed these types

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1. Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615, 630-31 (1981); Phillip Nelson, *Information and Consumer Behavior*, 78 J. POL. ECON. 311, 313-14 (1970); George J. Stigler, *The Economics of Information*, 69 J. POL. ECON. 213, 220-24 (1961).

2. *See* Venessa Bowman Pierce, *If It Walks Like a Duck and Quacks Like a Duck, Shouldn't It Be a Duck?: How a "Functional" Approach Ameliorates the Discontinuity Between the "Primary Significance" Tests for Genericness and Secondary Meaning*, 37 N.M. L. REV. 147, 149 (2007).

3. Mira Wilkins, *The Neglected Intangible Asset: The Influence of the Trade Mark on the Rise of the Modern Corporation*, BUS. HIST., Jan. 1992, at 66, 87-88.

4. Mark P. McKenna, *The Normative Foundations of Trademark Law*, 82 NOTRE DAME L. REV. 1839, 1844 (2007).

5. *See* Dan L. Burk & Brett H. McDonnell, *The Goldilocks Hypothesis: Balancing Intellectual Property Rights at the Boundary of the Firm*, 2007 U. ILL. L. REV. 575, 575 (2007) [hereinafter Burk & McDonnell, *Goldilocks*]; *see also* Dan L. Burk & Brett H. McDonnell,

of intellectual property using the theory of the firm, particularly property-based theories of the firm.[6] However, we purposely set aside trademark law due to its differences from other forms of intellectual property, intending to take trademarks up separately. We take up that delayed inquiry here, applying to trademarks the analytical framework that we previously developed, while taking into account the unusual aspects of trademark law that differentiate them from other forms of intellectual property. We suggest here that trademarks may have purposes, and certainly have effects, not only as a signal to consumers, but also as a set of exclusive rights around which organizations will be structured. Our discussion in this Article is primarily directed to the standard law of trademark confusion, while recognizing that trademark has in the last decade begun to incorporate other theories of infringement.[7]

In following the framework we have previously employed for considering the effects that exclusive rights have upon the size and structure of firms, we consider the differential between transaction costs inside and outside the firm, recognizing that it is possible to have exclusive rights that are too strong or too weak in either dimension.[8] We briefly review this approach, as well as some salient features of trademarks, in the first section. Using this background, we then look at trademarks, first as an asset allocation mechanism that may lower the transaction costs within a firm, and then as an asset allocation mechanism that may lower transaction costs between firms. We emphasize that the asset being allocated in the case of trademarks is the reputational capital of the firm, more than the trademark itself. Under this approach we identify a variety of

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Patents, Tax Shelters, and the Firm, 26 VA. TAX REV. 981, 982-83 (2007) [hereinafter Burk & McDonnell, *Patents*] (considering the theory of the firm in the context of tax patents).

6. Burk & McDonnell, *Goldilocks*, *supra* note 5, at 577; Burk & McDonnell, *Patents*, *supra* note 5, at 983.

7. Giovanni Ramello & Francesco Silva, *Appropriating Signs and Meaning: The Elusive Economics of Trademark*, 15 INDUS. & CORP. CHANGE 937, 948-49 (2006). Specifically, an alternative model has emerged under the theory of "dilution," which deters encroachments on the distinctiveness of famous marks, and has become a statutory claim under federal law. 4 J. THOMAS MCCARTHY, MCCARTHY ON TRADEMARKS AND UNFAIR COMPETITION § 24:67 (4th ed. 2009). Dilution is a sufficiently idiosyncratic latecomer to trademarks that we reserve most of our comments about it for a future paper.

8. *See* Burk & McDonnell, *Goldilocks*, *supra* note 5, at 575, 577; *see also* Burk & McDonnell, *Patents*, *supra* note 5, at 983 (applying the same analysis to firms using tax method patents).

trademark doctrines that we believe will affect the boundaries of the firm in positive or negative ways.

I. TRADEMARKS AND THE FIRM

In order to consider the effects of trademarks on the size and structure of firms, we must first consider the points at which an analysis of trademarks might depart from our previous analyses of other forms of intellectual property. We therefore begin our discussion in this section with a brief overview of certain idiosyncratic aspects of trademark law. We then review our earlier arguments regarding intellectual property and the theory of the firm, particularly the framework we have developed for considering the effects of intellectual property on transaction costs within firms and between firms. We note several peculiarities of trademarks when analyzed under the theory of the firm; these idiosyncracies will be key to our discussion of trademarks and transaction costs.

A. Characteristics of Trademarks

Trademarks may constitute any type of word, symbol, logo, design, or even color or smell, that evokes an association with the source of goods or services.[9] The public reputation and goodwill of the source are important components of such an association.[10] Trademark rights accrue as the mark is used in commerce affixed to goods or associated with services. The mark accrues protection as consumers grow to recognize the mark and associate it with the source of goods or services.[11] The core legal regime for trademark protection is state law;[12] however, federal recognition and augmentation of these rights has become increasingly important with the development of a national and international economy. Since the early twentieth century, federal law has provided for registration of trademarks in the United States Trademark Office. Federal registration confers a number of legal advantages on the trademark

9. 1 MCCARTHY, *supra* note 7, § 3:1.
10. *Id.* § 3:2.
11. 2 MCCARTHY, *supra* note 7, § 16:1.
12. *Id.* §§ 16:1, 16:2.

holder, most especially nationwide constructive notice of the registrant's priority of use.[13]

Technically, marks that identify products come in different categories; trademarks designate goods whereas service marks designate services.[14] While trademarks and service marks are distinguishable in some respects, such as the practical requirements for legal recognition,[15] their status is for the most part legally equivalent,[16] and we will treat them as largely indistinguishable in our analysis here. Federal law also covers some other types of specialized marks, such as certification marks that are used by certifying entities to indicate goods and services meeting a particular standard.[17] For the most part we will not deal with such specialized marks here, although we will make some comments about certification marks.[18]

In order to function as a trademark, a source indicator must be distinctive; distinction is sometimes presumed and sometimes acquired via what is termed "secondary meaning."[19] Secondary meaning is the association in the minds of consumers between the mark and the source of the product.[20] Marks that are assumed to carry distinction inherently, say "Viagra" or "Sunkist," have no meaning other than to identify their associated goods.[21] Other marks, with potential for multiple associations, must earn secondary meaning from association with products in the marketplace over time.[22] This is the case for marks that describe the goods;[23] in the beginning, they may describe many goods in a given class, such as "Holsum" (a homonym for "wholesome") bread. But over time

13. *Id.* § 16:2.

14. 1 MCCARTHY, *supra* note 7, § 3:1.

15. For example, under U.S. law, trademarks must be affixed to goods; for obvious reasons, service marks need not be. *See* Lanham Act § 45, 15 U.S.C. § 1127 (2006); 1 MCCARTHY, *supra* note 7, § 4:14.

16. 1 MCCARTHY, *supra* note 7, § 4:14.

17. Lanham Act § 45, 15 U.S.C. § 1127 (2006); 1 MCCARTHY, *supra* note 7, § 4:15.

18. *See infra* notes 159-60 and accompanying text.

19. 2 MCCARTHY, *supra* note 7, § 15:1.

20. *Id.* § 15:5.

21. *Id.* § 15:150.

22. *Id.*

23. *Id.* § 11:25.

they gain secondary meaning as being associated with only a particular brand of bread from a particular source.

Some commentators have pointed out that the term "secondary meaning" is often a misnomer; frequently the primary or cardinal meaning of the mark in the minds of consumers is its association with the source of the products accompanying the mark.[24] But the designation may be ordinal more than cardinal. Certainly for fanciful marks, such as "Exxon," which have no meaning in any language other than to indicate the source of goods and services, that meaning is the first, last, and only meaning associated with the mark.[25] But in the case of descriptive marks, the term first indicates the type of goods and only later is associated with the source.[26] The same is true for arbitrary marks in a contextual sense; "apple" was first the name of a fruit, until it was later placed into the context of computer equipment, where it became associated with a particular brand of computer.

Thus, trademarks connect products to source, but it is worth noting that "source" is a somewhat circular term of art in trademark law, indicating the originator of marked goods and services to which consumers would attribute the marked products.[27] Consumers need not know the identity or location of a source to know that there is a source from which marked goods originate and to expect particular characteristics and quality of goods from that source.[28] The source of goods or services could constitute an individual, a single firm, a collection of firms, or a particular chain of supply. A source need not even be a manufacturer; it may be a distributor. Black letter trademark law is insistent that a trademark be associated with only a single source, not multiple sources.[29] This association with a unitary legal fiction has more to do with consistency and control of supply than with the organizational or legal form of a producer, but the requirement will be critical to our discussion here.

The reputational signaling function of trademarks entails something of a paradox: although rights are secured to the trademark

24. *Id.* § 15:6.
25. *Id.* § 11:4.
26. *Id.* § 15:6.
27. 1 MCCARTHY, *supra* note 7, § 3:9.
28. *Id.*
29. *Id.*

owner, they are ostensibly directed toward benefitting the public. This may not seem unusual in itself; other forms of intellectual property certainly have a public interest component. Patents and copyrights are specifically directed to promote the progress of science and the useful arts. This has been interpreted by the Supreme Court as meaning that these exclusive rights are directed ultimately to the benefit of the public, and only incidentally to the benefit of authors and inventors that are awarded the exclusive rights.[30] But trademarks have a very immediate and direct justification for consumer benefit: preventing consumers from being mistaken or defrauded by confusingly similar signals.[31]

This distinction from other intellectual property arises because trademarks are directed to quite a different set of assets than other intellectual property. Patents, copyrights, and even trade secrets are ostensibly granted as legal incentives to promote and secure investments in new knowledge, new technologies, new creative works, and new business information.[32] Trademarks, in contrast, promote and secure business reputation and goodwill by securing a mnemonic device between products and source.[33] It is possible that trademarks may indirectly contribute to investment in product innovation and improvement by ensuring that consumers will recognize those products and that consumer goodwill cannot be deceptively redirected to competing products.[34] Trademark holders may therefore be more willing to invest in product quality and differentiation.[35]

Nonetheless, courts and commentators are essentially unanimous in recognizing that trademarks serve primarily as signals rather than incentives.[36] From the standpoint of economics, trademarks are

30. *See* Sony Corp. of Am. v. Universal City Studios, 464 U.S. 417, 429 (1984); Mazer v. Stein, 347 U.S. 201, 219 (1954).

31. 1 MCCARTHY, *supra* note 7, § 2:33.

32. *Id.* § 6:3.

33. *Id.*; *see also* Qualitex Co. v. Jacobson Prods. Co., 514 U.S. 159, 163-64 (1995).

34. William M. Landes & Richard A. Posner, *Trademark Law: An Economic Perspective*, 30 J.L. & ECON. 265, 280 (1987).

35. William M. Landes & Richard A. Posner, *The Economics of Trademark Law*, 78 TRADEMARK REP. 267, 271 (1988).

36. *See, e.g.*, *Qualitex*, 514 U.S. at 163-64; WILLIAM LANDES & RICHARD A. POSNER, THE ECONOMIC STRUCTURE OF INTELLECTUAL PROPERTY LAW 168 (2003).

generally viewed as signals that lower consumer search costs.[37] Stated differently, the purpose of granting exclusive rights in trademarks is not to produce better trademarks, or at least not necessarily to produce better trademarks; the rights granted in the sign or symbol are not intended to promote progress in the indicia they cover.[38] Rather, protecting trademarks has generally been viewed as a means to foster associations in the minds of consumers between the mark, as a signal, and a certain source of goods or services. Thus, trademark law contains a substantial component of consumer protection, and this has long been recognized as an important function of trademarks—deterring the deception or defrauding of consumers by "passing off" one type of goods for another.[39]

This also means that, acting as signals, trademarks are in some sense a step removed from the assets they secure. Like other forms of intellectual property, trademarks entail a right to exclude, a property right.[40] Like other forms of intellectual property, trademarks are instrumental; they exist primarily to secure exclusive rights in socially desirable intangible assets.[41] But the expectation is that a patent or copyright will produce better inventions or creative works; such exclusivity is intended to promote progress in the artifacts actually covered by the exclusive right. The exclusive rights in trademarks preserve consumer signals and business goodwill associated with the indicia covered by trademark rights.[42] In other words, the designator secured by trademark rights may have value as an asset, but its value depends on the reputational asset behind it.

There has been some movement in recent years toward treating trademarks themselves as property rather than as signals.[43] This has been most apparent in the context of sports sponsorships, where

37. *See* LANDES & POSNER, *supra* note 36, at 168.

38. *See* Ramello & Silva, *supra* note 7, at 941.

39. 1 MCCARTHY, *supra* note 7, § 3:6.

40. *See* Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972).

41. *See* Ramello & Silva, *supra* note 7, at 941.

42. 1 MCCARTHY, *supra* note 7, § 2:15.

43. Mark A. Lemley, *The Modern Lanham Act and the Death of Common Sense*, 108 YALE L.J. 1687, 1687-88 (1999).

courts have extended trademark protection to the use of team logos on various types of apparel and goods, even though the logos have no real bearing on the source of the goods.[44] Consumers likely do not believe that team logos indicate the source of the caps or t-shirts on which the logos appear; the logos are rather valued simply for themselves, as indications of team loyalty or personal affiliation. Treatment of trademarks as independent property is also apparent in claims for dilution.[45] Dilution recognizes that the value of certain famous marks will be diminished if they are used too often in the marketplace; unauthorized but nonconfusing uses can be restricted by the mark owner in order to preserve the mark's distinctiveness.[46]

Despite these trends, an important strain of consumer protection remains the mainstay of trademark doctrine. And as a consequence, to the extent that trademarks constitute a property right, they are an unusual property right.[47] The exclusive rights under trademark law are in substantial measure dependent upon the perception of consumers: trademark owners have a right to exclude others from using the mark only to the extent that consumers are likely to be confused by similar marks, only to the extent that consumers perceive the mark as associated with a given source, and only to the extent that consumers do not incorporate the mark into the language as part of common speech.[48] This might seem to make trademark law consumer oriented rather than business oriented; nonetheless, trademarks remain a key asset for modern firms.

B. The Theory of the Firm

The standard property-based conception of the firm that we have previously relied on holds that firms exist because of the savings in transaction costs generated by a hierarchical production structure.[49] Beginning with Coase, the theory of the firm developed to explain why market transactions are not used as the mechanism to coor-

44. *See, e.g.*, Nat'l Football League Props., Inc. v. Witchita Falls Sportswear, Inc., 532 F. Supp. 651 (W.D. Wash. 1982); 1 MCCARTHY, *supra* note 7, § 3:4.

45. *See* Lemley, *supra* note 43, at 1698-99.

46. *See* Lanham Act § 30, 15 U.S.C. § 1112 (2006); 4 MCCARTHY, *supra* note 7, § 24:67.

47. Ramello & Silva, *supra* note 7, at 944.

48. 1 MCCARTHY, *supra* note 7, §§ 2:14, 2:15.

49. Burk & McDonnell, *Goldilocks*, *supra* note 5, at 587.

dinate all productive activity.[50] Coase postulated that in some instances, entrepreneurial fiat direction would be less costly than market negotiations due to the transaction costs of the market.[51] In such cases, competitive pressures will tend to compel the formation of firms as market participants organize themselves to minimize inefficiencies or face displacement by competitors that have organized themselves into firms.[52]

Commentators expanding upon Coase's insight have identified opportunism as one of the key transaction costs associated with bargaining in the marketplace.[53] Parties to a transaction cannot anticipate all future contingencies, and it would be prohibitively expensive for them to try. As a consequence, any contract they negotiate will be incomplete.[54] One or the other party may attempt to take advantage of unforeseen developments; in particular, a party to a contract may attempt to "hold up" the other party, extorting additional concessions once resources have been committed to a project and cannot be easily recommitted to another venture.[55] Such relationship-specific resources, by virtue of their tailoring to a particular project, increase the efficiency of projects, but at the same time create the potential for opportunism.[56] Generalized resources may be more easily recommitted to new uses but are less well suited to any given project.[57] Thus, in the face of possible "hold-ups," there may be an undesirable incentive to avoid asset specificity.

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50. *See* R. H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937), *reprinted in* R. H. COASE, THE FIRM, THE MARKET, AND THE LAW 33, 35-41 (1988).

51. *Id.* at 40.

52. OLIVER E. WILLIAMSON, THE MECHANISMS OF GOVERNANCE 233-34 (1996).

53. OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING 30 (1985) [hereinafter WILLIAMSON, ECONOMIC INSTITUTIONS]; Oliver Hart, *An Economist's Perspective on the Theory of the Firm*, 89 COLUM. L. REV. 1757, 1765 (1989). As Harold Demsetz points out, Coase appears to regard opportunism as only one of the costs that might impel the formation of firms. HAROLD DEMSETZ, THE ECONOMICS OF THE BUSINESS FIRM: SEVEN CRITICAL COMMENTARIES 20 (1995).

54. Oliver D. Hart, *Incomplete Contracts and the Theory of the Firm, in* THE NATURE OF THE FIRM: ORIGINS, EVOLUTION, AND DEVELOPMENT 138, 141 (Oliver E. Williamson & Sidney G. Winter eds., 1991).

55. WILLIAMSON, ECONOMIC INSTITUTIONS, *supra* note 53, at 76, 133-34; *see also* Lloyd Cohen, *Holdouts and Free Riders*, 20 J. LEGAL STUD. 351, 362 (1991) (describing the "hold-out" problem).

56. *See* Benjamin Klein et al., *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297, 298 (1978) (discussing asset specificity).

57. Dan L. Burk, *Intellectual Property and the Firm*, 71 U. CHI. L. REV. 3, 6 (2004).

When transaction costs, including the threat of hold-up, are comparatively high, firms may attempt to avoid a market transaction by integrating production functions within the firm.[58] When market transactions are comparatively low, firms will tend to "disintegrate," outsourcing production functions.[59] Thus, the theory of the firm helps predict and explain the size and structure of firms. Such predictions are dependent on understanding the factors that may raise or lower transaction costs, including the legal and regulatory regime under which a firm operates.

Thus, law becomes an important consideration in determining the structure of firms. In particular, one of the "gap-fillers" that offers a fallback resolution for unforeseen and unnegotiated contingencies is a property rule: property, including intellectual property, is allocated to a title holder in the absence of some contractual provision to the contrary. Property rules may lower uncertainty in the marketplace, which in turn lowers transactions costs. When the cost of a production transaction in the market is lowered relative to the cost of production by managerial fiat, firms will be more likely to "buy" an input than to "make" the input; that production function need not be brought within the structure of the firm, and so the firm will be smaller than it might be otherwise. Independent firms that supply the given input are also more likely to arise. Property rules, by lowering market transaction costs, can facilitate these outcomes. All other factors being equal, property rules should tend to produce smaller firms that outsource production functions.

Property defaults may be especially important where valuable information is at issue. Unlike the situation where a dispute arises over physical assets, and possession of those assets can form the basis for allocation of its use, physical possession of information is less certain. Information may be embodied in tangible form, but once such information is disclosed, both parties effectively have access to its use. This may create a reluctance to disclose valuable information, as Kenneth Arrow observed in his famous Information Disclosure Paradox.[60] Intellectual property rules may help break the

58. Burk & McDonnell, *Goldilocks*, *supra* note 5, at 613.

59. *Id.*

60. Kenneth J. Arrow, *Economic Welfare and the Allocation of Resources for Invention*, *in*

disclosure impasse by allocating legal rights in disclosed information.[61]

Additionally, given that many of the contracts that define the firm are contracts with employees, the theory of the firm applies as well to employment situations addressing allocations of property within the firm, that is, between the firm and employees. Employee contracts, like vendor, customer, or business alliance contracts, will necessarily be incomplete.[62] Not every situation will be anticipated; in particular, situations when employees might shirk their duties or behave opportunistically may not be anticipated in the employment contract. Employee opportunism may affect transaction costs within the firm, pushing them toward the costs of negotiation in the marketplace. As with transactions between firms, property defaults can lower such costs by allocating resources between firm and employees in situations that might otherwise be unclear.

Moreover, we have observed in previous work that while property rights work to lower transaction costs up to a point, beyond that point excessive property rights, or property rights in the wrong configuration, can work to increase transaction costs.[63] Commentators in a variety of fields have observed that fragmented rights may create a prohibitive anticommons that impede a business's freedom to operate.[64] Clearing a large number of licenses or obtaining a large number of permissions itself generates transaction costs.[65] Owners of fragmented rights may also be inclined to "hold out" for an excessive share of the gains from trade; when all the holders of fragmented rights engage in such strategic behavior, negotiation becomes impossible.[66] In a similar fashion, property rights that secure a firm's assets against employee opportunism can, at some point, impose excessive restrictions on employee innovation and incentive. Property rules can hamper or

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NAT'L BUREAU OF ECON. RES., THE RATE AND DIRECTION OF INVENTIVE ACTIVITY 609, 614-16 (1962).

61. *See* Burk & McDonnell, *Goldilocks*, *supra* note 5, at 600-01.

62. *See* Hart, *supra* note 53, at 1765.

63. Burk & McDonnell, *Goldilocks*, *supra* note 5, at 614-17, 619.

64. MICHAEL HELLER, THE GRIDLOCK ECONOMY: HOW TOO MUCH OWNERSHIP WRECKS MARKETS, STOPS INNOVATION, AND COSTS LIVES (2008).

65. Lee Anne Fennell, *Common Interest Tragedies*, 98 NW. U. L. REV. 907, 927 (2004).

66. *Id.* at 926-29.

restrict an employee's ability to function well in her job, increase job dissatisfaction, and even deter recruitment of employees who fear that their best work and most valuable skills will be cemented to the firm and no longer portable to new job opportunities. When multiplied over myriad employees, this drag on employee mobility could potentially hamper the circulation of ideas and talent in entire sectors, stifling the development of innovative industries.

This observation that property rights may lower both inter- and intra-firm transaction costs up to a point, but then increase those costs beyond that point, leads to what we call the "Goldilocks hypothesis."[67] For both types of transactions, there is a certain level of property right protection that minimizes inter- or intra-firm transaction costs.[68] Rights that are weaker or stronger than the optimal level will increase costs and may lead to substitution away from either inter- or intra-firm transactions, depending on which kind of transaction has a more suboptimal level of legal regime.[69]

We have previously applied this framework to consider the role of copyright, patent, and trade secrecy law in shaping the boundaries and structures of firms. The framework applies to trademark law as well. However, trademarks affect firm boundaries and structures somewhat differently than other forms of intellectual property. The role of trademarks under the theory of the firm has not gone altogether unremarked. Oliver Hart, one of the primary originators of the property rights theory of the firm that underlies our use of the theory of the firm in this and previous articles, points out that firms need to own some sort of tangible or intangible property other than workers' human capital in order to provide a "glue" that holds the firm together.[70] Without such glue, there is nothing to keep workers with the firm.[71] Workers work for a firm in order to get access to some sort of asset that makes their activity more valuable than it would be on its own.[72] Some of these assets are hard physical assets—machines, buildings, and so on. Others are soft intangible assets, such as patents and client lists. Hart lists

67. Burk & McDonnell, *Goldilocks*, *supra* note 5, at 577.
68. *Id.* at 620.
69. *Id.* at 620-24.
70. OLIVER HART, FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE 57 (1995).
71. *Id.* at 56-57.
72. *Id.* at 57.

a firm's name or reputation among the latter.[73] Intriguingly, though, he notes that name or reputation does not fit as straightforwardly within his economic model as other assets and that further work needs to be done to explain the value of firm reputation.[74]

Some progress in this direction has been provided in the growing literature on the reputational assets of firms.[75] Changes in firm management are often undetectable to consumers, especially if the firm continues to operate under the same name or using the same mark. If consumers are unable to detect changes in management, then one might expect the development of adverse selection—a classic "market for lemons" in which the only trademarks available are those associated with poorly managed firms—and, knowing this, only poorly managed firms would offer their trademarks for sale on the market.[76] Alternatively, one might expect a market for trademarks to be subject to a form of "moral hazard," in which poor managers acquire good marks in order to purvey substandard goods or services to unsuspecting consumers.[77] But the literature analyzing the potential for such effects suggests that robust markets for reputation can emerge, and that trademarks can in fact serve as a point of stability for firm reputation whether observable or unobservable transitions in management occur.[78]

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73. *Id.*

74. *Id.* at 56 n.1; *see also* Oliver Hart, *Norms and the Theory of the Firm* 17-18 (Harvard Inst. of Econ. Research, Discussion Paper No. 1923, 2001), *available at* http://www.economics.harvard.edu/pub/hier/2001/HIER1923.pdf (identifying the origins of the firm's reputational assets as an open question).

75. *See, e.g.*, Hendrick Hakenes & Martin Peitz, *Observable Reputation Trading*, 48 INT'L ECON. REV. 693 (2007); David Kreps, *Corporate Culture and Economic Theory*, *in* PERSPECTIVES ON POSITIVE POLITICAL ECONOMY 90 (J. Alt & K. Shepsle eds., 1990); Steven Tadelis, *What's in a Name? Reputation as a Tradeable Asset*, 89 AM. ECON. REV. 548 (1999). For an overview, see Heski Bar-Isaac & Steven Tadelis, *Seller Reputation*, 4 FOUNDATIONS & TRENDS MICROECON. 273 (2008).

76. *See* Bar-Isaac & Tadelis, *supra* note 75, at 275-76; *see also* George A. Aklerof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970) (describing how market uncertainty can be expected to drive out high quality products).

77. *See* Bar-Isaac & Tadelis, *supra* note 75, at 276-77.

78. *See* Hakenes & Pietz, *supra* note 75; Tadelis, *supra* note 75. *But see* Howard P. Marvel & Lixin Ye, *Trademark Sales, Entry, and the Value of Reputation*, 49 INT'L ECON. REV. 547, 548 (2008) (finding in a dilution model that trademark selling lowers overall welfare). Although the law draws a distinction between trademarks and trade names, the literature on firm reputation for the most part fails to draw this distinction. In this Article, we focus on the rules governing trademarks, recognizing that the analysis as applied to the firm may

Trademarks present an unusual situation with regard to property "defaults" because of their distinctive exclusion and disclosure qualities noted above: trademarks are (usually) not goods in themselves, but instruments for conveying the reputation or goodwill of a firm.[79] The issue with regard to trademarks is less the misappropriation of the trademark itself, but rather the misappropriation of the goodwill represented by the mark. Such reputation may be seen as a production factor for either goods or services. In a business alliance where a trademark is one of the production factors supplied by one party, there is potential for misappropriation, but such defection is unlike the "hold-up" that can occur after disclosure of an idea or trade secret—these factors can be appropriated as soon as they are disclosed to the contracting partner. Trademarks require public recognition, which entails public disclosure of the mark in order to be effective—there are no secret trademarks.[80] In this sense, trademarks are somewhat like patents or published copyrighted works; trademark licensees are never bargaining for disclosure.

As we have indicated, property-based theories of the firm consider the firm as a repository of residual property rights in cases of hold-up or bargaining breakdown.[81] Thus, a firm's investment in an asset depends heavily upon the project specificity of that asset, that is, the degree to which it can be redeployed to a different project when business conditions change. Assets that are highly project specific are difficult to redeploy to a new purpose and place the firm in danger of hold-up: once firms have invested in a project specific asset, that investment will be lost if the specific project fails, and a business partner can use the threat of such a loss to demand additional concessions once the assets have been committed.

Trademarks are simultaneously highly specific and yet eminently redeployable assets. The differential qualities of trademark redeployment depend upon the intersection of the physical instantiation of the mark, the rights that have been perfected in the mark, and the goodwill associated with the mark. In one sense the redeploy-

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extend to other reputational devices.

79. *See supra* text accompanying notes 10-11.

80. *See supra* text accompanying notes 10-11.

81. *See supra* text accompanying notes 63-65.

ment of a trademark is trivial; it takes only the signature on a license or the submission of registration documents to move a logo, name, or catch phrase from one owner to another. Or, in precisely the kind of misappropriation that trademark law is intended to prohibit, it may be equally trivially easy to affix an unauthorized label or logo to goods that do not originate from the trademark owner.

The rights and use of a mark may therefore seem to be a nonspecific asset. This is less true of the physical embodiment of the mark. For example, in the general course of business, commercial airliners or vehicles may be fungibly redeployed among carriers for the purpose of carrying passengers or cargo—hence a firm is more likely to lease than to own such assets. But repurposing such assets is not entirely costless; ownership of an aircraft may be changed with the stroke of a pen, but altering the livery of the aircraft may be somewhat more expensive. The use of the aircraft is fungible, but the branding is not and may be costly to change.

Conversely, sale of the trademark that does not include sale of the asset may require a costly branding change—the physical asset has not changed hands, but the owner can no longer display the identifiers that now belong to another entity. This is a common problem of "specific assets" in the trademark area. One of the parties to a trademark license may have invested in specialized assets bearing the trademark or trade dress. Employee uniforms, neon signage, restaurant décor, even buildings distinctively shaped like a hotdog or bearing the "golden arches" may be expensive physical instantiations of the mark that are hard to repurpose if a business relationship falls apart.

Trademark licensing does not seem altogether unusual in these respects. Versions of the problem are familiar to any redeployment of business assets; they often must be moved to a new location or altered to fit a new configuration. Sale or transfer of other types of intellectual property also often involves separate transfer of rights along with the transfer of a physical asset as might occur with the sale of a patented machine or the licensing of a text or computer program protected by copyright. But in the case of trademarks, a third characteristic of the mark may make redeployment difficult, that is that the goodwill associated with the mark may be "stickier"

than the mark itself. Such goodwill exists in the minds of consumers rather than in a legal document or registration,[82] and consumers may naturally resist purchasing a familiar commodity at a new location or hearing an otherwise familiar advertising slogan in the mouth of a new spokesman.

Certainly some other types of intellectual property may also protect reputational interests.[83] For example, we have previously noted that copyright assists in structuring transaction costs within the firm.[84] Copyright's "work made for hire" doctrine serves to allocate control of firm assets within the firm, automatically assigning to the firm control over employee work product.[85] However, the doctrine does so by the mechanism of designating the firm as author.[86] In copyright, authorship encompasses both an allocational and a reputational function. In such cases, the reputational interest associated with the work may be of little interest to the firm, but of considerably higher value to the actual author, such that ownership and attribution might be bifurcated.[87]

In the case of trademarks, it is the firm's reputational interest that is the primary consideration. This suggests that the reputational association of the mark deserves special consideration. Some previous commentary has suggested that trademarks, comprising a property type of rule, should facilitate outsourcing of production; that because of the residual rights in trademarks, trademark holders will be more willing to "buy" rather than "make" products bearing the mark.[88] While not necessarily disagreeing with this previous analysis, we find the emphasis misplaced. In our previous consideration of intellectual property and the firm, we have applied a residual rights theory to analyze the role of exclusive rights in partitioning assets associated with the firm.[89] We believe the same approach is applicable to the exclusive rights associated

82. *See* 1 MCCARTHY, *supra* note 7, § 15:5.

83. *See* Laura A. Heymann, *The Birth of the Authornym: Authorship, Pseudonymity, and Trademark Law*, 80 NOTRE DAME L. REV. 1377, 1392-94 (2005); Greg Lastowka, *The Trademark Function of Authorship*, 85 B.U. L. REV. 1171, 1214 (2005).

84. Burk & McDonnell, *Goldilocks*, *supra* note 5, at 610.

85. *See* 17 U.S.C. § 201(b) (2006).

86. *See id.*

87. *See* Burk, *supra* note 57, at 14-15.

88. David J. Brennan, *The Trade Mark and the Firm*, 3 INT. PROP. Q. 283 (2006).

89. Burk & McDonnell, *Goldilocks*, *supra* note 5, at 581.

with trademarks, but neither the mark nor the products to which the mark is affixed are the relevant assets. Rather, it is the partition of goodwill and reputation associated with the firm that is at issue in considering the effect of trademark law on the size and structure of the firm. Trademarks serve as a trigger or signal for such goodwill; allocation of the trademark and its use will help to partition such goodwill, but allocating the mark is only a means to that end.

Additionally, focusing solely on the external effects of trademark law neglects the potential for trademarks to lower transaction costs within the firm and concomitantly neglects the cost differential between transaction costs inside and outside the firm. As in the case of inter-firm transactions, the situation for intra-firm transactions involving trademarks differs somewhat from those involving inventions, know-how, or creative works. Opportunistic employees may take the firm's know-how to a new job or appropriate firm technology to their own uses in starting a new business. But opportunistic employee behavior will seldom involve surreptitious pilfering of a trademark because, in order to function as a signal, trademark use must be largely open and notorious.

As we have seen in our review of the theory of the firm above, it is the comparison of costs of transacting between and within firms that matters. If trademarks lower both sets of costs, then to assess the effect on firm integration or dis-integration, one must consider which set of costs trademark law might lower more. Thus, in the next set of sections we consider both kinds of transactions in turn, starting with the effects of trademarks on intra-firm transactions. Our testbed for analyzing the effects of trademarks on the boundary of the firm will be situations in which reputation is a key asset and there is potential for hold-up by one or both parties to a transaction. We will be looking for ways in which trademark law allows allocation or redeployment of resources in ways that mitigate hold-up or otherwise lower a firm's transaction costs.

II. INTRA-FIRM EFFECTS

Having highlighted several important features of trademark law, we now turn to the effects of trademarks on transactional costs within the firm, that is, in the transactions between the firm and its personnel. The positive reputation associated with a trademark is due to the work of many persons associated with the firm owning that mark over time. A variety of persons within a firm may help or hurt the reputation of the business, and at the same time the actions of the firm may affect the personal reputation of its employees. Individual employees may try to appropriate to themselves some of the positive reputation produced by a mark. Firms, in turn, may not always appropriately compensate their employees for the work they have done in helping to build the value of the firm's marks. Both sides may attempt to take advantage of the other. An important task for the law is partitioning goodwill or reputation of the firm as an asset from the personal goodwill or reputation of the employee.

This allocation problem is well known in many other areas of business law.[90] The separation of personal goodwill and firm goodwill is a distinction appearing in tax, bankruptcy, and business association law; all have recognized a distinction between the personal goodwill of an employee and the business goodwill of the firm.[91] For example, when partners in a law practice dissolve the practice, each is entitled to a share of the partnership's professional goodwill as an asset of the business, but goodwill is only an asset of the business to the extent that it is separate and distinct from the reputation of the individual partner.[92] In taxing corporate value or distributions, tax court decisions similarly distinguish the personal ability and reputation of individual employees from corporate intangible assets.[93] These decisions suggest that personal goodwill can sometimes be reduced to a corporate asset by means of an

90. *See* Thomas O. Wells & Daniel Lambert, *Sale of Personal Goodwill—The Executive's Parachute*, FLA. BAR J., Mar. 2005, at 31, 34-35.

91. *See id.*

92. *See* Thompson v. Thompson, 576 So. 2d 267, 270 (Fla. 1991).

93. Martin Ice Cream Co. v. Comm'r, 110 T.C. 189, 207-08 (1998); Norwalk v. Comm'r, 76 T.C.M. (CCH) 208, No. 20685-96, 1998 WL 430084, at *8 (July 20, 1998).

employment agreement, such as a noncompetition agreement that would prevent the employee from servicing clients with whom she has a personal relationship from her previous firm when she leaves for a new firm.[94] But absent such an instrument, the personal relationships of an employee with clients reside only with the employee and have no taxable value to the employer.[95] Similarly, in the context of bankruptcy law, the ability of employees to transfer customers to a new employer has been held to constitute a matter of personal goodwill, and not a corporate asset subject to the claims of creditors.[96]

Trademark law may similarly attempt to draw lines between personal and business reputation. How the line gets drawn affects the incentives of both firms and their employees to invest resources in creating a strong reputation. We have previously noted the effect of intellectual property regimes to specific intangible assets developed by employees for the firm, and the more general personal assets that the employee should retain claim to in the labor market.[97] Where trademarks are concerned, such a bifurcation is far less simple, as the primary legal justification for trademark law is to preserve and to signal reputation.[98] Where employee reputation and firm reputation are bound up in the same signal, accommodating both interests may be difficult or impossible. And where the interests of an employee and the interests of the firm diverge, it will sometimes be unclear how to partition personal from business reputations. We next examine several such situations in which personal and business reputation are intertwined, and consider the functioning of trademark law in setting defaults to allocate reputation between the firm and its employees.

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94. *See Martin Ice Cream Co.*, 110 T.C. at 207; *Norwalk*, 76 T.C.M. (CCH) 208, 1998 WL 430084, at *8.

95. *See Martin Ice Cream Co.*, 110 T.C. at 207-08; *Norwalk*, 76 T.C.M. (CCH) 208, 1998 WL 430084, at *8.

96. *See* Corrugated Paper Corp. v. E. Container Corp., 185 B.R. 667, 671 (Bankr. D. Mass. 1995).

97. *See* Burk & McDonnell, *Goldilocks*, *supra* note 5, at 591-600; Burk, *supra* note 57, at 8-9.

98. *See supra* text accompanying note 42.

A. The Closely Held Mark

The first situation we consider in which personal and business reputation coincide occurs where the identifying mark of the business coincides with the personal name or identifier of an employee. Some businesses adopt as their mark the name, likeness, or personal attributes of a given individual. The person from whom the mark is derived will often be the founder of the business or a celebrity whose creative output comprises the major product or service purveyed by the business. Hewlett-Packard, Lucasfilm, and the Jonas Brothers all owe their business designators to the personal names of founding entrepreneurs, but these designators are now firm assets in addition to being personal names.

In this Article we refer to such marks as being "closely held," in much the same way that businesses that have their governance associated with a particular manager may be "closely held." Here we use the term not so much in the sense of ownership or decision making—although businesses with closely held marks are perhaps more likely to be closely held in the corporate sense—but in the sense that the goodwill and reputation of the firm may be tightly associated with the reputation and public perception of the founder. Because the closely held mark refers to both the firm and the eponymous founder, the overlapping reputational interests present a series of potential issues when it becomes necessary to differentiate between the use of the mark to refer to the firm and the use of the name to refer to the individual.[99]

1. Personal and Business Reputation

Perhaps the most common situation in which personal and business reputation requires partitioning is the scenario in which an entrepreneur launches a business under a closely held mark such as a personal name, then leaves or sells that business and desires to establish a second business in the same product market under the same or similar name. This is a scenario in which the public is most likely to be aware of changes in firm management.[100] For example,

99. *See* Ramello & Silva, *supra* note 7, at 946.

100. *See supra* notes 75-78 and accompanying text.

in 1973 entrepreneur Steve Herrell launched Steve's Ice Cream stores in the Boston area, offering premium ice cream and innovative "mix in" ingredients that were added to the ice cream as selected by customers at the time of purchase.[101] Herrell sold the business in 1977, but quickly reentered the same market with a new chain of stores, offering the same products and services, again in the Boston area.[102] Unable to use his first name, which had been conveyed as a mark with the sale of the initial ice cream chain, Herrell called his new stores "Herrell's Ice Cream."[103]

In some cases, the reputation and goodwill of the firm may rest almost entirely on the personal reputation of a founding entrepreneur, such that a change in the founder's reputation may impact the eponymous firm. This was dramatically illustrated in the recent history of Martha Stewart Living Omnimedia, a business built around the talents and personality of its founder, Martha Stewart.[104] The products and reputation of the firm were so closely bound up with the personality of Martha Stewart that there was considerable trepidation as to whether the firm would survive when its founder was convicted and served prison time on false statements and obstruction of justice charges.[105]

The Martha Stewart example suggests how the reputation and goodwill of a firm may be impacted by the activity of a key employee. But sometimes the reputational impact may run the other direction. For example, if Bill Marriott founds a hotel chain branded with his name, subsequent decisions by the officers and directors of the firm may reflect on Marriott the founder even if he no longer in fact has decisional authority, due to having been out voted or even having been bought out. For example, if Marriott is a member of a religious denomination that forbids the consumption of coffee and alcohol, as well as discourages the viewing of pornography,[106] his

101. *See* Herrells.com, History of Harrell's, http://www.herrells.com/design/index.php?lv=28 (last visited Oct. 12, 2009).

102. *See id.*

103. *See id.*

104. Andrew Ross Sorkin, *Will a Short Sentence Prove Sweet for Stock?*, N.Y. TIMES, July 18, 2004, at C6.

105. *See id.*

106. Which in fact he is, being a member of the Church of Jesus Christ of the Latter-Day Saints ("Mormons"). See *Marriott Asked Not To Show Adult Movies*, YAHOO! NEWS, Apr. 10, 2008, http://news.yahoo.com/s/ap_travel/20080410/ap_tr_ge/travel_brief_marriott_adult_

reputation and standing in his religious community could be affected if the hotel chain bearing his name begins to offer coffee, alcohol, and adult pay-per-view movies to its guests. Similarly, if Walt Disney cedes control of his eponymous firm to officers who decide to produce more risqué, less family-friendly entertainment, the general public may mistake this business decision for a reflection of the tastes or motives of the individual whose name has become associated with the business.[107]

While the effects in these examples are limited to largely ethical or moral reputational capital, they could also affect the employee's business reputation or earning potential. Such issues might occur with regard to a change in a business's target audience or a reduction in product quality once the founder of a particular business cedes a name mark to a firm. For example, if Debbie Fields relinquishes the "Mrs. Fields" mark for freshly baked cookies to the corporation, and the new officers decide to change the ingredients of the product or move into the market for preserved, packaged cookies produced for grocery store shelves, the downgrade in quality may be a calculated business strategy on the part of the firm, but it may also have an effect on Debbie Fields's personal reputation, either as a business founder or as a baker.[108]

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movies. During his presidential campaign, Marriott's fellow Mormon conservative Mitt Romney was also criticized for failing to curb hotel room pornography while serving on the board of the Marriott corporation. *See* Glen Johnson, *Romney Criticized for Hotel Pornography*, WASH. POST, July 6, 2007, http://www.washingtonpost.com/wp-dyn/content/article/2007/07/05/AR2007070501305.html; Ben Weyl, *Romney's Ties to Marriott's Porn and Mormonism Could Pose Problem for Iowa Social Conservatives*, IOWA INDEP., July 15, 2007, http://iowaindependent.com/560/romneys-ties-to-marriotts-porn-and-.mormonism-could-pose-problem-for-iowa-social-conservatives. Bill Marriott recently faced the reverse problem when his church endorsed California's Proposition 8 legislation to prevent same-sex marriage, and he attempted to distinguish Marriott corporate policy from his own affiliations. Marriott on the Move, The Facts About Marriott and California's Proposition 8, http://www.blogs.marriott.com/default.asp?item=2284808 (Nov. 11, 2008, 16:17:19 EST).

107. In fact, the Disney corporation created a differently named subsidiary, Touchstone Pictures, to insulate the family oriented Disney brand from the release of movies such as *Splash*, which contained brief nudity and adult situations. *See* Wade Sampson, Ron Miller and Touchstone (Nov. 29, 2006), http://www.mouseplanet.com/8170/Ron_Miller_and_Touchstone.

108. See Amanda Gaines, *Mrs. Fields: We're Back*, RETAIL-MERCHANDISER, Dec. 18, 2008, http://www.retail-merchandiser.com/index.php?option=com_content&view=article&id=251:mrs-fields-were-back&catid=107:current&Itemid=298 (discussing unsuccessful packaged grocery retail product).

These tensions have implications for firm governance. If the namesake of a corporation continues to control the business, sometimes the namesake may want to pursue goals that are incompatible with maximizing the firm's profits. Minority shareholders may object. Corporate law sometimes has to deal with such questions concerning possible divergences in interest between a corporation and its namesake. The general rule is that courts will not allow a corporate director or officer to gain financially at the expense of the corporation as that would violate the duty of loyalty.[109] However, if the namesake is pursuing other goals that he strongly believes in at the expense of profit maximization, courts will usually allow such actions via their application of the business judgment rule.[110] A prototypical example is *Shlensky v. Wrigley*.[111] In that case, a minority shareholder of the Chicago National League Ball Club (a.k.a. the Cubs) sued concerning the club's refusal to install lights so that the Cubs could play night games.[112] Philip Wrigley was the President and 80 percent owner of the team.[113] The team was not named after Wrigley, but Wrigley Field, the site of the dispute, was. The plaintiffs complained that Wrigley was pursuing goals other than profit maximization.[114] Specifically, they alleged that Wrigley personally had a traditionalist belief in baseball as a daytime sport and that he was concerned with possible effects on the surrounding neighborhood.[115]

The court would have none of it. It noted that concern for the neighborhood might conceivably be in the club's best long-run interest and refused to second-guess Wrigley.[116] The court said that unless the club's conduct at least bordered on fraud, illegality, or conflict of interest, the court would abstain from reviewing the club's decision.[117] Such a standard obviously gives the controlling shareholder wide leeway to pursue whatever goals he likes without

109. *See supra* notes 106-08 and *infra* notes 113-15 and accompanying text.
110. *See infra* notes 118-23 and accompanying text.
111. 237 N.E.2d 776 (Ill. App. Ct. 1968).
112. *Id.* at 777.
113. *Id.*
114. *Id.* at 778.
115. *Id.*
116. *Id.* at 780.
117. *Id.*

having to closely justify each decision as maximizing financial returns to the business.

Courts do not always defer to the controller's will in such cases, though. The most famous example is *Dodge v. Ford Motor Co.*[118] Ford Motor was a phenomenally successful business dominated by its founder and namesake, Henry Ford.[119] Ford made public statements about the importance of making the fruits of the new industrial system widely available to workers and consumers, hence his desire to reduce the price of the cars he sold.[120] The Dodge brothers were minority shareholders.[121] They complained about Ford's refusal to declare a special dividend paying out the company's huge accumulated profits and also about Ford's plans to build a huge new plant at River Rouge, Michigan.[122]

The court followed the usual business judgment rule course of not second-guessing the decision to build a new plant;[123] however, it did order the corporation to pay out a special dividend, even though dividend decisions are normally committed to the board's discretion.[124] In doing so, the court said:

> The record, and especially the testimony of Mr. Ford, convinces that he has to some extent the attitude towards shareholders of one who has dispensed and distributed to them large gains and that they should be content to take what he chooses to give. His testimony creates the impression, also, that he thinks the Ford Motor Company has made too much money, has had too large profits, and that, although large profits might be still earned, a sharing of them with the public, by reducing the price of the output of the company, ought to be undertaken. We have no doubt that certain sentiments, philanthropic and altruistic, creditable to Mr. Ford, had large influence in determining the policy to be pursued by the Ford Motor Company.[125]

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118. 170 N.W. 668 (Mich. 1919).
119. *See id.* at 671.
120. *Id.* at 683-84.
121. *Id.* at 669.
122. *Id.* at 671.
123. *Id.* at 684.
124. *Id.* at 685.
125. *Id.* at 683-84.

Shlensky and *Dodge* are frequently discussed in the literature on the proper objectives of a corporation. Although the prevailing view is that the proper objective of corporations is to maximize the financial returns to its shareholders, many point out that the business judgment rule in practice allows corporations to pursue different objectives (for example, helping employees, consumers, or the community in which they are located) without judicial interference.[126] *Dodge* is the leading citation for the proposition that maximizing return to shareholders is the proper objective of a corporation. On the other side, scholars often point to *Shlensky* as an example of the business judgment rule shielding decisions that pursue goals other than maximizing profit.

While these cases frequently appear in discussions of the proper goals of a corporation, it is quite interesting to note that they both occur in the context of a controlling shareholder whose name appears either in the corporation's name or on the location that is the source of the dispute. In the *Ford* opinion, there is language indicating that the court feared Ford's proposed expenditures were too closely tied to his personal reputation as a progressive employer.[127] It seems that decisions diverging from profit maximization may be particularly likely in such circumstances. Wealthy control persons like Ford and Wrigley see their companies as extensions of themselves. While they obviously care about money, they care about other values as well and are willing to use their corporations to advance those other values even (sometimes) at the cost of lowered profits.

2. The Law of the Closely Held Mark

In a situation such as the Steve's/Herrell's ice cream store scenario,[128] the departure of a founding entrepreneur to found a new firm in the same line of business as his previous firm holds the potential of pitting personal goodwill and reputation of the entrepreneur against the business goodwill and reputation conveyed with the sale of the earlier business. Customers associate a certain

126. John H. Matheson & Brent A. Olson, *Shareholder Rights and Legislative Wrongs: Toward Balanced Takeover Legislation*, 59 GEO. WASH. L. REV. 1425, 1449-50 (1991).

127. *Dodge*, 170 N.W. at 683-84.

128. *See supra* notes 101-03 and accompanying text.

reputation and degree of goodwill with the initial firm, but this may be difficult to disentangle from the founder's personal reputation.[129] To the extent that the initial firm relies upon the personal reputation of the founder, and to the extent that customers are aware of the founder's presence at the new firm, that goodwill will follow the founder and may be transferred to the new firm. This leaves the question as to whether any goodwill separate from the founder's personal reputation was conveyed with the sale of the initial firm, and if so, whether the founder can avoid carrying the initial firm's business goodwill to the new firm.

Presumably, we would want innovative entrepreneurs to apply their talents to founding new businesses in a competitive market; we generally hold that the public is better off with a choice of ice cream shops rather than a monopoly by one chain. The personal reputation of the founder of the initial business as a successful entrepreneur and innovator may be critical to attract capital to establish new ventures. If the founder's personal reputation is locked too tightly to her first established business, the only outlet for the founder's new ideas will be within the structure of the existing firm. This results in either the suppression of such initiatives or in the inefficient growth of the firm from the addition of new divisions and subsidiaries that optimally should have been new ventures entirely. Indeed, entrepreneurs may be wary of situations where their reputations may become firm assets if they know they may be hampered from embarking on future ventures. Such a rule might hamper development of entrepreneurial ventures in the first place.

But neither would we want a rule in which the founder of the firm was able to walk away at any time with the eponymous mark, which may be an asset that is critical to the firm's operations. Such a rule would allow the founder to engage in hold-up of the firm, even after having assigned the asset to the firm, threatening the firm's very existence. Similarly, in the other examples we have sketched, we would expect to draw some distinction between the actions of the firm and the actions of the eponymous founder of the firm in order to preserve the value of the asset to each of them. This militates in favor of a "goldilocks" median for trademarks; too much control over

129. *See* Ramello & Silva, *supra* note 7, at 946.

the closely held mark detrimentally motivates investment by the employee, whereas too little control detrimentally motivates investment by the firm.

Trademark law is consistent with this analysis in several respects. First, trademark law has long forbidden licensing of trademarks "in gross," a term that refers to licensing of the trademark alone, without the associated business reputation or goodwill triggered by the mark.[130] Trademark licenses must transfer rights in the mark alongside business reputation or goodwill.[131] The rule confirms that the critical asset transferred by a trademark license is not merely the signal, but the reputation signaled. Thus, to retain trademark protection, a personal name cannot be transferred unless accompanied by business reputation; where one goes the other goes.

Black letter trademark doctrines also reflect the goldilocks approach that we have suggested would best minimize transaction costs. Courts have long held that where a personal name has become a mark and has been sold with a business, the named individual has a heightened duty to avoid subsequent confusion through disclaimers or other notices if she continues in the same or similar line of business.[132] At the same time, courts have shown considerable reluctance to curtail an individual from using her own name in pursuing a livelihood.[133] Thus, cases hold that an employee with personal reputation in a line of business can still truthfully use his personal name as a name, for example, to advertise that he is now associated with a competitor to his former eponymous firm.[134] Trademark cases also distinguish "closely held mark" situations from inadvertent eponymy. Courts have been somewhat reluctant to issue an injunction against a good faith junior user who happens to have the same personal name that another business uses for a trademark.[135] This is not the case where the bearer of the personal name has sold the name with an eponymous business and then

130. 3 MCCARTHY, *supra* note 7, §§ 18:1, 18:2.

131. *Id.*

132. *See* Goldwyn Pictures Corp. v. Goldwyn, 296 F. 391, 400 (2d Cir. 1924); Ralph Bros. Furniture Co. v. Ralph, 338 Pa. 360, 363 (Penn. 1940); 2 MCCARTHY, *supra* note 7, § 13:10; 3 MCCARTHY, *supra* note 7, § 18:33.

133. *See* Sardie's Rest. v. Sardie, 755 F.2d 719, 725 (9th Cir. 1985); Abraham Zion Corp. v. Lebow, 593 F. Supp. 551, 567 (S.D.N.Y. 1984); 2 MCCARTHY, *supra* note 7, §§ 13:8, 13:9.

134. *See* Madrigal Audio Labs., Inc. v. Cello, Ltd., 799 F.2d 814, 823 (2d Cir. 1986).

135. 2 MCCARTHY, *supra* note 7, § 13:9.

wishes to use the name again in a new competing business; injunctions issue more freely in such situations.[136] Conversely, some courts have suggested that it constitutes a type of fraud for the purchaser of a personal name mark to represent that the bearer of the name is still affiliated with the business, especially in cases when the abilities or qualifications of the individual would be important to consumers.[137]

Similar rules apply when personal names are involved in the dissolution or bankruptcy of a firm. In cases where a personal name is used in a business, a name that denotes personal reputation is not considered an asset that can be transferred involuntarily in bankruptcy.[138] Typically, there must be some showing that the name has become a mark and that it functions as an indicator of source before it is considered a firm asset that can be acquired in bankruptcy.[139] In some cases where a personal name mark is acquired as part of a business, a disclaimer must be used, indicating that the named individual is no longer associated with the business in order to avoid confusion.[140]

In each of these situations, trademark law employs the requirement of secondary meaning to separate out the reputation of the firm. Federal registration will be denied to marks that are "primarily ... a surname."[141] Personal names are not considered inherently distinctive and must accrue secondary meaning through use before they can be considered trademarks.[142] The key consideration is whether the public perceives the word to constitute a personal name or a designator of source. A personal name having gained secondary meaning associated with the firm is now associated with the source of goods and services rather than only with the person carrying the name. Trademark law attaches only when marks such as "Ford," "Marriott," and "Disney," that may once have designated a business

136. *See, e.g.*, Osgood Heating & Air Conditioning v. Osgood, 75 U.S.P.Q.2d (BNA) 1432, 1434, 1437 (W.D. Tex. 2004).

137. *See Madrigal Audio Labs.*, 799 F.2d at 825 n.5; Lyon v. Lyon, 246 Cal. App. 2d 519, 528, 54 Cal. Rptr. 829, 834 (Cal. Ct. App. 1966); Gracey v. Maddin, 769 S.W.2d 497 (Tenn. Ct. App. 1989).

138. *See* 3 MCCARTHY, *supra* note 7, § 18:31.

139. *Id.*

140. *See supra* note 132 and accompanying text.

141. 15 U.S.C. § 1052(e)(4) (2006); *see also* 2 MCCARTHY, *supra* note 7, § 13:29.

142. 2 MCCARTHY, *supra* note 7, § 13:2.

owner or proprietor, become marks associated with automobiles, hotels, and entertainment rather than with their originators' personal names.

The legal form of firm governance may be important to the allocation of closely held marks. For example, the problem of separating personal and business reputation arises with some frequency in entertainment, where the trademark of a musical group is closely associated with one or two founding musicians and where groups may break up or change membership with considerable frequency.[143] In determining assignment of musical group marks, an important factor appears to be the form of business association chosen to hold the mark. In cases of partnership, courts appear more likely to attribute goodwill in the name to personal goodwill and will allow departing members to continue using the name of their former group.[144] When a corporate form is chosen for the group's business transactions, courts appear more likely to hold that trademark rights vest and remain in the corporation.[145]

McCarthy argues that questions of multiple trademark ownership cannot be solved by simple reference to rules of corporate and partnership law, but rather require a focus on trademark policies regarding source and quality.[146] While not disagreeing with this observation, we note that the division between personal goodwill and source goodwill may lend itself to one business form or another. We can at least see a few possible justifications for the distinction between partnership and corporate forms in these cases. Different choices of organizational form may suggest different intentions of the group members at the time of formation. Corporations may be understood to have a more formal and distinctly separate existence from their shareholders and employees than partnerships have from their partners. That may signify a desire for the band to have an existence distinct from that of any of its individual members.

This understanding of the difference between partnerships and corporations reflects real legal differences. Indeed, under the old

143. *See id.* § 16:45.

144. *See* Fuqua v. Watson, 107 U.S.P.Q. (BNA) 251, 251-52 (N.Y. Sup. Ct. 1955).

145. *See, e.g.*, Brother Records, Inc. v. Jardine, 318 F.3d 900, 909 (9th Cir. 2003); Five Platters, Inc. v. Purdie, 419 F. Supp. 372, 383 (D. Md. 1976); Rare Earth, Inc. v. Hoorelbeke, 401 F. Supp. 26, 42 (S.D.N.Y. 1975).

146. 2 MCCARTHY, *supra* note 7, § 16:45, at 16-91.

Uniform Partnership Act, partnerships were not conceived of as legal entities distinct from their partners, although this is no longer true under the Revised Uniform Partnership Act.[147] Even under the newer law, though, partners retain the ability to withdraw from the business and take their share of the business's assets with them,[148] which is not possible in a corporation.

B. Employee Goodwill

The examples discussed so far contemplate corporate reputation that is intertwined with that of founders or celebrity employees of the firm. However, these effects are not limited to the closely held trademark, where the reputation of a prominent, typically founding employee must be differentiated from that of the firm. This type of intertwined employee and firm reputation is relatively common for smaller businesses or sole proprietorships. It is less common for large firms, when the majority of employees may be publicly anonymous. Intertwined reputation, however, may become an issue with regard to rank and file employees such as sales personnel who routinely represent or act on behalf of the firm. Such situations can arise where the employee's personal name is not the name of the firm, but the employee's face and behavior are, at least in limited situations, the public face and behavior of the firm.

These possibilities, to some extent, parallel certain situations identified by Lester and Talley in trade secrecy, where an asset such as a customer list is the result of joint effort by the employee and the firm. Customers may be attracted and retained by the personality and behavior of the sales personnel, as well as by the quality of goods, prompt delivery, and other services provided by the firm.[149]

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147. REVISED UNIF. P'SHIP ACT § 201 & cmts. (1997), 6 U.L.A. 91 (2001).

148. *See id.* § 601 & cmts. (discussing partnership dissociation). Under the old Uniform Partnership Act, when a partner wrongfully left a partnership and the remaining partners continued the business, the departing partner got her share of the value of the partnership less any damage caused. *See* UNIF. P'SHIP ACT § 38(1) (1914), 6 U.L.A. 487 (2001). Interestingly for our analysis here, in calculating the value of the business, the value of the business's goodwill was excluded. *See id.* § 38(c)(II). That is not true in the Revised Act. REVISED UNIF. P'SHIP ACT § 602(c).

149. Gillian L.L. Lester & Eric L. Talley, *Trade Secrets and Mutual Investments* 1-2 (U.S.C.L. Sch., Olin Research Paper No. 00-15; Geo. L. & Econ., Research Paper No. 246406, 2000), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=246406.

Allocating such a resource when the employee parts ways with the firm treads the line between, on the one hand, depriving the firm of an asset in which it has invested, and on the other hand, depriving the employee of an important resource for personal income development.[150] Either error invites one of the parties to underinvest in the resource.

As in the case of the closely held mark, trademark law may serve to partition the reputational investment of the firm from that of the rank and file employee. It does not, of course, operate in isolation. Trade secrecy or agency law might keep a departing employee from appropriating the employer's customer lists, and contractual noncompetition agreements might geographically or sectorally separate an ex-employee from the former employer. Many employers will impose such employee noncompete agreements to prevent former employees from working in the same geographic area, business sector, or product line for a period of time after separation from the firm. But noncompete agreements, like all contracts, are incomplete, and trademark law defaults may play a significant role in separating the reputational capital of the employee from that of the firm in situations when both are investing in relational assets.

We expect that such employee reputational situations are most likely to arise in service or sales, for example, when the personal relationships developed by a sales representative become an important factor in the firm's business in a geographic or marketing sector. Customers may be choosing to deal with a firm based on the quality and reputation of the product branded by the firm; but they may also be choosing to deal with the firm because of the personality, the personal reputation, and even the personal promises or assurances of the firm's representative.[151] It may be difficult to partition the results of these factors when the employee and the firm part ways.

The relative importance of firm representatives' reputation and firm brand reputation will likely vary depending upon the goods and services purveyed. The sale of branded and recognized products by a firm representative presents a very different situation than that of a representative selling unbranded staple articles of commerce.

150. *Id.* at 2.

151. *See* Ramello & Silva, *supra* note 7, at 947.

A purchaser looking for information about the product might rely on personal reputation, on firm reputation, or on some combination. We would anticipate, for example, that a sales representative's reputation would be most important in the case of unbranded products—say, a fungible product such as grain—when the lack of a mark leaves a buyer with little information about the origin or quality of the good, and so pushes the customer toward increased reliance on the personal reputation of the purveyor of the goods.

As the signal conveyed by the mark on the goods becomes stronger, the purchaser will tend to care less about the reputation of the firm representative. The needed information is derived from the associations connected with the mark and because the employees in such cases become more fungible, any sales representative will do. Indeed, the two reputation sets stand in something of an inverse, reciprocal relationship; the stronger the branded reputation of the product, the less important the reputation of the employee, but the weaker the branded reputation of the product, the more important the reputation of the employee. This phenomenon may contribute to the demise of local "mom and pop" businesses as nationally branded businesses move into an area.

The importance of this trademark effect will also depend upon the goods and services in question. Economists divide goods into categories based upon the information that a buyer can derive from interaction with the goods.[152] The quality of some goods, called "inspection" goods, can be readily ascertained by direct experience of sight, touch, or smell before purchase, such as fruit purchased from an open stand.[153] The quality of other goods cannot be immediately ascertained, but must be experienced over time after purchase, such as the reliability of an automobile ignition.[154] Such experience goods require the purchaser to place a degree of trust in the vendor because the quality of the goods will only be fully known after purchase.[155] Even if some recourse is available, such as a warranty or guarantees against defects found after purchase, the seller must

152. WILLIAM A. LANDES & RICHARD A. POSNER, THE ECONOMIC STRUCTURE OF TORT LAW 284 (1987) [hereinafter LANDES & POSNER, TORT LAW].

153. *Id.*

154. *Id.*; *see also* Nelson, *supra* note 1, at 311-12.

155. *See* Michael R. Darby & Edi Karni, *Free Competition and the Optimal Amount of Fraud*, 16 J.L. & ECON. 67, 68-69 (1973).

be made to honor the guarantee. Finally, some goods, such as legal or medical services, may never be fully understood or assessed by the purchaser and therefore are known as "credence" goods because consumers must fully rely on the representations of the expert seller to know the quality of what they are purchasing.[156]

Trust mechanisms are likely to be more important for categories of goods that the consumer cannot personally evaluate; the consumer is more vulnerable to fraud or deception in the cases of experience or credence goods. Reputation or a personal relationship with a vendor might induce the consumer to trust the representations made regarding the quality of credence goods. Alternatively, trademarks that convey the reputation of the firm might induce consumers to rely upon the representations regarding these goods. Thus trademarks in general are expected to be most useful and important in the case of experience or credence goods, especially the latter.[157]

Trademarks are also most likely to serve as a substitute for personal reputation in the purchase of these goods. Trademarks may therefore diminish the value of a given employee to the firm as the trademark replaces some of the information that would otherwise be conveyed to customers by personal information. The corollary is that a given employee is less likely to be able to engage in costly hold-up of the firm because the firm is less reliant on the personal reputation developed by a given employee. Additionally, to the extent that a given employee becomes largely fungible and easily replaceable, trademarks will tend to encourage such replacement if an employee attempts to extract additional surplus from her employment agreement. Employees who know that they are replaceable will be less likely to impose either type of cost on the firm. This will tend to lower the internal transaction costs of firms, creating an incentive for firms to grow and rely less often on the market.

At some point, however, there may be offsetting costs to this trend; the diminution of employees' personal capital may lead to less interesting and satisfactory work environments and less investment

156. LANDES & POSNER, TORT LAW, *supra* note 152, at 284-85; Darby & Karni, *supra* note 155, at 68-69.

157. *See* Tom W. Bell, *Virtual Trade Dress: A Very Real Problem*, 56 MD. L. REV. 384, 406-08 (1997).

in interpersonal skills and reputation that otherwise might be portable to future employment. The inability to attract employees could cause such firms to remain smaller than is optimal. The "goldilocks" principle again predicts an optimum degree of trademark protection that prevents an employee from using personal reputation to hold up the firm, while still allowing the firm to attract desirable employees.

III. INTER-FIRM EFFECTS

We have suggested several ways in which the presence of trademark rights may lower the internal transaction costs of firms, primarily in dealings with their own employees. But the theory of the firm predicts that the boundary of the firm will be drawn based upon the differential between internal and external transaction costs—the differential will determine whether firms negotiate production contracts with other firms in the market or produce those factors within the hierarchy of the firm. Firms will vertically integrate or disintegrate depending on which option yields the lowest transaction cost structure. Trademarks and related regimes may affect not only the internal allocation of transaction costs, but also the cost between firms in the market by preventing "hold-ups" and allocating residual rights when contracts are incomplete.[158]

A. Bargaining Defaults

Property-based theories of the firm hold that property rights lower transaction costs when the parties to a bargain may defect by misappropriating tangible or intellectual assets. Trademark ownership prevents a somewhat different kind of defection by a contracting party, such as using substandard methods or materials—capitalizing on the reputation built up by the trademark owner without making a concomitant investment in maintaining the reputation. Should a license fail to provide for some instance of such defection, so that a licensee is able to act opportunistically, the trademark may constitute residual rights in the owner's reputation, preventing misappropriation of reputational assets.

158. *See* Ramello & Silva, *supra* note 7, at 945.

The most striking inter-firm instance of this effect may arise in the case of certification marks, which are used to indicate that goods meet a particular set of standards specified by a group of producers.[159] In this case, the "source" of the marked goods is not a particular firm, but rather a collection of firms that have agreed upon, and conform to, a particular set of product specifications. The mark acts as a coordinating feature, ensuring that no given producer shirks on the specification, much as industry standards function to ensure compliance with specifications.[160] Absent the mechanism of product compliance marking, it might be necessary to integrate such firms into a single firm. Instead, manufacture of comparable goods is facilitated by the mark into a production structure that is almost fully "dis-integrated" into independent producers.

As in the case of certification marks, or of more conventional bilateral trademark licensing, we might primarily expect to see trademark law lowering transaction costs by specifying the proper placement of a mark on goods and services—either keeping the mark off of goods that do not originate with the source or requiring the mark to appear on goods that do originate from the source. Surprisingly, legal rules authorizing the *omission* of a trademark from products may be important to facilitate outsourcing of production and firm differentiation. This is apparent in the recent Seventh Circuit decision in *Bretford Manufacturing Inc. v. Smith System Manufacturing Corp.*[161] The defendants in the case developed a prototype display of office furniture cobbled together from parts that included pieces from a competitor's products.[162] The plaintiff competitor alleged that the display of the prototype to potential buyers constituted "reverse passing off,"[163] that is, that the defendant had passed the plaintiff's products off as its own—in this case by not affixing the plaintiff's mark to the furniture parts.[164]

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159. 15 U.S.C. § 1127 (2006).

160. *See* Hendrik Hakenes & Martin Peitz, *Umbrella Branding and External Certification*, 53 EURO. ECON. REV. 186 (2009).

161. 419 F.3d 576 (7th Cir. 2005); *see also* Roho, Inc. v. Marquis, 902 F.2d 356, 360 (5th Cir. 1990).

162. *Bretford*, 419 F.3d at 578.

163. *Id.*

164. In the standard trademark scenario, the defendant infringer passes its own goods off as those of the plaintiff trademark owner, but a reverse infringer passes off another's goods

Trademark law certainly allows multiple marks to appear on a product, including marks indicating the source of components or ingredients.[165] But as a general rule, components of industrial products are not marked as to their source, and a rule requiring such marking would be burdensome, possibly prohibitive to the assembly of component products. Industrial products typically entail myriad components from myriad sources, and consumers generally neither know, nor care to know, the source of those components. The *Bretford* opinion by Judge Easterbrook noted, for example, that automobile components very seldom have any visible source markings, with rare exceptions such as those on tires and perhaps on the radio or other entertainment systems.[166] The marked components are, significantly, most frequently the components over which consumers have some choice, allowing them to upgrade the car stereo or tires from the standard options.

Easterbrook's opinion, in other words, attempts to forestall the development of a trademark licensing anticommons, where the manufacturers of office furniture, consumer electronics, automobiles, and countless other multicomponent industrial products would be required to label every component of their assembled products in order to avoid the legal implication that they were attempting to pass individual components off as their own products. The burden of avoiding reverse passing off, let alone the cost of physically labeling every nut, bolt, capacitor, and cable would likely prompt massive integration. Manufacturers could avoid the "reverse passing off" claim by moving component production in-house, so that a single label for the assembled product would suffice. Relieving manufacturers of liability for reverse passing off of components facilitates outsourcing of component manufacture, permitting contractual disaggregation of component production.

In certain instances, multicomponent products may conspicuously indicate the brand or source of certain components, for example, branded kitchenware touting "Teflon" coatings or computer laptops displaying brand stickers for "Intel Inside" or "NVIDIA" graphics cards. Although at one time separate marks on the same products

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as his own. *See* 4 MCCARTHY, *supra* note 7, § 25:6.

165. *See* Saul Lefkowitz, *Double Trademarking—We've Come a Long Way*, 73 TRADEMARK REP. 11, 20 (1983).

166. *Bretford*, 419 F.3d at 580.

raised questions of source, trademark law has developed to allow such marking so long as the component mark indicates a separate source and the holder of the mark retains control over the quality and use of the independently designated component.[167] In some cases, such control may counsel monitoring or oversight of the quality of the final product incorporating the separately marked component or ingredient. This in turn militates in favor of licensing the component mark, along with the component, under a quality control agreement.[168]

Such departures from the general norm of component anonymity are likely to have been specially negotiated, presumably in those cases in which identification of the components has some value to consumers at least sufficient to make the additional effort worthwhile to the manufacturer. The holding of the *Bretford* case sets a default rule that product components need not be marked, a default that can be varied by contract if there is sufficient surplus in the deal to overcome the transaction costs of such negotiating.[169] For comparison, we could imagine the alternative Coasean counterfactual where component marking is required, and the assembling manufacturer is permitted to contractually opt out of marking. Bargaining analysis running back to Coase's classic article *The Problem of Social Cost* argues that in the absence of transaction costs, the right to demand component marking, or the right to eschew marking, could equally well be assigned to the relevant party in the transaction, leaving the other party to negotiate departure from the default.[170] Of course, transaction costs will exist for such bargaining, meaning that the sensible default would be the one that minimizes negotiation costs relative to the value generated by negotiated departures from the default. Easterbrook's *Bretford* reasoning essentially designates *not* marking components as the most likely low-cost default, from which there will be occasional situations valuable enough to negotiate a component marking agreement.[171]

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167. *See* 1 MCCARTHY, *supra* note 7, § 7:8.
168. *See* Lefkowitz, *supra* note 165, at 24.
169. *Bretford*, 419 F.3d at 580-81.
170. R. H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).
171. *Bretford*, 419 F.3d at 580-81.

The bargaining surplus that might prompt a marking agreement ultimately derives from the consumer; variations from the default will most likely be negotiated where there is some value to the consumer from them. We expect that component marking is likely most valuable to consumers in the case of credence goods, such as "Intel Inside" computers, where the average consumer is unlikely to disassemble a computer to check for a preferred brand of microprocessor chip and would be unlikely to recognize one microprocessor from another even if he were to "check under the hood." In such cases, the additional component marking supplies branding information that may be relevant to assessing the quality and desirability of hidden features.

The *Bretford* decision implicated the question as to what iteration of an item in modern industrial production is a "product" that should properly be marked as to source. Consumers may recognize a given brand of automobile, Ford or Toyota or BMW, as deriving from a particular source, but typically that source has assembled parts from other sources that are unknown to consumers. One point in the chain of production is indicated as the repository and beneficiary of product reputation.

Reverse passing off requires a false designation of origin, and *Bretford* essentially holds that the "origin" of a multicomponent product in commerce is the assembler.[172] This, in turn, implies an assumption that an organic "product" comes into being at a particular point in the vertical supply chain. This question in some ways parallels the familiar antitrust problem of "tying" products together, requiring purchase of one product in order to buy another.[173] Under some circumstances, tying may be an antitrust violation, but in general the law does not question the existence of a unified "product" even if it comprises components that could be disaggregated.[174] It is generally an unexceptional requirement that a consumer buy the left shoe in order to buy the right shoe, or the carburetor in order to get the chassis, or the operating system in order to get the compiler.

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172. *Id.* at 581.

173. 9 PHILIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 1700a (2d ed. 2004).

174. *See* 10 PHILIP E. AREEDA, EINER ELHAUGE & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 1740, at 150-51 (2d ed. 2004).

Other trademark doctrines might also be viewed as intended to minimize the type of transaction cost anticommons effect that we have identified in our earlier work. For example, courts have tended to treat the business goodwill that is symbolized by a mark as an indivisible asset.[175] One prominent commentator has noted that the division of goodwill is, in effect, a version of trademark assignment "in gross," that is, of separately assigning the mark from the reputation it indicates.[176] Divided uses of marks could lead to a type of reputational anticommons where competing holders of partial rights engage in fragmented and competing uses, resulting in consumer confusion. Treating the mark as indivisible effectuates the general policy of having a single legal entity controlling the mark in order to vindicate the public interest in identifying source and prevent consumer confusion from fragmented or conflicting uses of the mark.

For similar reasons, the United States Patent and Trademark Office, although recognizing that a joint venture may be a separate single legal entity that can hold a trademark, has been wary of trademark registrations by joint owners.[177] Uses of a mark by a controlled subsidiary corporation inure to the benefit of the parent corporation,[178] and generally only one company, the parent, can register the mark federally as its owner. Upon dissolution of a joint venture, some courts have prevented either party from using a mark owned by the venture even if the venture agreement provided for both parties to use the mark upon dissolution.[179]

The rule regarding reputational unity is not limited to supply or outsourcing, but also extends to chains of distribution. In general, mere distributors or dealers of a marked product do not, simply by handling goods, accrue rights in the trademark affixed by a manufacturer or producer.[180] Unquestionably there are distributor marks

175. 2 MCCARTHY, *supra* note 7, § 16:40.

176. *Id.* § 16:44.

177. Patricia Kimball Fletcher, Comment, *Joint Registration of Trademarks and the Economic Value of a Trademark System*, 36 U. MIAMI L. REV. 297, 299 (1982).

178. 2 MCCARTHY, *supra* note 7, at § 16:37; *see also* K-Mart Corp. v. Cartier, Inc., 486 U.S. 281, 283 (1988) ("[The] parent corporation—not the ... subsidiary whose every decision it controls— ... better fits the bill as the true owner of any property that the subsidiary nominally possesses.").

179. *See, e.g.*, Durango Herald, Inc. v. Riddle, 719 F. Supp. 941, 951-52 (D. Colo. 1988).

180. 4 MCCARTHY, *supra* note 7, § 25:31 (noting that use of mark by licensee builds up no

that embody the reputation and goodwill of the distributor, and a distributor may be entitled to a separate mark indicating the distribution source. But accrual of distribution goodwill does not entitle the distributor to use the product mark. And, as the *Bretford* decision suggests, it is doubtful that the last link in a distribution chain need accommodate multiple marks absent some agreement to the contrary.[181]

B. Franchise Structure

Our discussion of trademarks and firm structure would not be complete without some discussion of franchising, which is perhaps the most apparent and notable example of the effect of trademarks on business organization. Previous commentators have noted several implications of the franchise structure under the theory of the firm.[182] Much of this literature focuses on the antitrust implications of franchise agreements, which frequently include procurement or tying arrangements that have in the past posed challenges to competition law.[183] We do not propose to recapitulate this previous work, but we note that surprisingly little of this analysis has directly addressed the role of trademarks or trademark law. The influences at work in franchising are diverse, but trademarks have been called the key or central feature of franchising systems.[184] Thus, in this final section we propose to highlight several observations regarding the particular influence of trademarks on franchising structures.

The centrality of the franchise trademark is reflected in both law and economics. Looking first at legal doctrine, there are many legal definitions of the term "franchise," but the leading national

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rights in trademark as against licensor).

181. Bretford Mfg. Inc. v. Smith Sys. Mfg. Corp., 419 F.3d 576, 581 (7th Cir. 2005).

182. *See, e.g.*, Alan J. Meese, *Antitrust Balancing in a (Near) Coasean World: The Case of Franchise Tying Contracts*, 95 MICH. L. REV. 111, 113 (1996) [hereinafter Meese, *Antitrust Balancing*]; Alan J. Meese, *Monopolization, Exclusion, and the Theory of the Firm*, 89 MINN. L. REV. 743 (2005); Paul H. Rubin, *The Theory of the Firm and the Structure of the Franchise Contract*, 21 J.L. & ECON. 223 (1978); D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1478 (2002).

183. *See, e.g.*, Benjamin Klein & Lester F. Saft, *The Law & Economics of Franchise Tying Contracts*, 28 J.L. & ECON. 345 (1985); Meese, *Antitrust Balancing*, *supra* note 182.

184. *See, e.g.*, David Gurnick, *Intellectual Property in Franchising: A Survey of Today's Domestic Issues*, 20 OKLA. CITY U. L. REV. 347, 347 (1995).

definition may well be that of the Federal Trade Commission's franchise rule. That definition has three elements, the first of which states: "The franchisee will obtain the right to operate a business that is identified or associated with the franchisor's trademark, or to offer, sell, or distribute goods, services, or commodities that are identified or associated with the franchisor's trademark."[185]

Thus, the trademark is situated at the heart of the legal definition of franchising. Moreover, the second element of the definition focuses on the fact that "[t]he franchisor will exert or has authority to exert a significant degree of control over the franchisee's method of operation."[186] We shall see that this franchisor control focuses on maintaining the value of the trademark.

As for the economics of franchising, we earlier noted Oliver Hart's observation that a firm needs some sort of property to serve as its "glue."[187] A trademarked product or business format is the glue at the heart of a business franchise.[188] Commentators on the economics of franchises have noted the value of standardization—a customer contemplating a franchised product is assured a standardized level of product quality anywhere in the nation, or perhaps even anywhere in the world.[189] This is not to say that the franchise product is necessarily of better quality than that of an independent producer, but the franchised product is a known quantity.[190] The signal for consumer recognition of the standard is the trademark; the signaling of source and known quality is the common theme of trademark law and of franchising.[191]

In our previous work on intellectual property and the theory of the firm, we focused on how intellectual property affects the optimal boundaries of firms, assuming that the boundary of the firm, although variable, was relatively sharp.[192] Certainly the relevant laws governing franchise relationships, including trademark law, contract law, specialized laws aimed at franchises, and a variety

185. 16 C.F.R. § 436.1(h)(1) (2008).

186. *Id.* § 436.1(h)(2).

187. *See supra* note 70 and accompanying text.

188. *See* Giovanni Ramello, *What's in a Sign? Trademark Law and Economic Theory*, 20 ECON. SURVEYS 547, 553 (2006).

189. *See* Klein & Saft, *supra* note 183, at 349.

190. *Id.*

191. *See id.* at 349-50.

192. Burk & McDonnell, *Patents*, *supra* note 5, at 991.

of other kinds of laws, will affect how the firm's boundaries are drawn.[193] But franchises present an unusual profile with regard to the theory of the firm, lying neither wholly within nor wholly outside a firm structure.[194] The franchisee controls many functions of the franchise, such as hiring, day to day operations management, financing, and location.[195] The franchisor typically dictates other functions, such as marketing, procurement, and decor.[196]

This combination of independence and oversight presents a puzzle as to why the business should not be either wholly owned by the franchisor or wholly independently owned by the local entrepreneur. If internalizing operations to secure oversight and control of the business assets is important to the franchisor, one might expect the franchised stores to be wholly owned by the franchisor.[197] If maximum flexibility for innovation in operations is important, one might expect the franchised store to be wholly independent.[198] Franchises seem to have one foot in the firm and one foot out of the firm.

The hybrid franchise structure may be best explained by considering that certain business functions may have lower transaction costs if internalized; other functions may have lower transaction costs if divorced from the firm.[199] For example, advertising may best be developed and coordinated centrally, on a national basis, rather than by fragmented and possibly conflicting advertising campaigns conducted at the local level.[200] National advertising may not be tailored to local markets, but given the nature of mass media, centralized advertising offers benefits from economies of scale and promotes uniformity.[201] On the other hand, hiring may best be done

193. Thomas M. Pitegoff, *Franchise Relationship Laws: A Minefield for Franchisors*, *in* BUILDING FRANCHISE RELATIONSHIPS 140, 144 (Ann Hurwitz & Rochelle Buchsbaum Spandorf eds., 1996).

194. *See* Rubin, *supra* note 182, at 225.

195. Rupert M. Barkoff & Andrew C. Seldon, *Introduction* to FUNDAMENTALS OF FRANCHISING, at xvii, xvii-xviii (Rubert M. Barkoff & Andrew C. Seldon eds., 3d ed. 2008).

196. *Id.*

197. *See* Richard E. Caves & William F. Murphy II, *Franchising: Firms, Markets, and Intangible Assets*, 42 S. ECON. J. 572, 584 (1976).

198. *Id.*

199. *See* Rubin, *supra* note 182, at 231.

200. *Id.*

201. Stigler, *supra* note 1, at 213, 220-24 (analyzing the economics of advertising).

locally by an entrepreneur who knows the local labor market, rather than being centralized.[202]

Consideration of franchising forces one to realize that the boundaries of the firm can be porous. Franchise organizational structures have a hybrid form, in some ways looking like one firm and in others like a network of firms contracting with each other.[203] Indeed, franchises themselves display a range of increments of ownership and control; some franchise agreements specify franchisor oversight for nearly every business function, while others leave extensive latitude to the franchisee.[204] This suggests that as a general matter the "make or buy" decision is not in fact binary, but rather takes different forms along a continuum from fully integrating a production function within the firm to fully arm's length negotiations for production.[205]

Even within a given franchise system, the choice of business arrangement is not either/or, to franchise or to own. Most franchise systems will have some company-owned establishments.[206] Which establishments are company-owned depends presumably on a differing balance of incentives for the employee versus the franchisee relationship.[207] For instance, some commentators have related that Standard Oil was willing to franchise its fuel station operations to owners not located on the major interstate highways, but the company always directly owned fuel stations located on the interstates.[208]

The explanation for this differential policy has to do with free riding and repeat business. Motorists passing through on the interstates were likely transient, one time customers whom the business would never see again.[209] In that situation, there existed

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202. Rubin, *supra* note 182, at 231.

203. *See* Larry E. Ribstein, *Limited Liability Unlimited*, 24 DEL. J. CORP. L. 407, 414 (1999).

204. *Id.*

205. Robert W. Emerson, *Franchise Contract Clauses and the Franchisor's Duty of Care Toward its Franchisees*, 72 N.C. L. REV. 905, 921-22 (1994).

206. Caves & Murphy, *supra* note 197, at 581.

207. *Id.* at 584.

208. *See* Meese, *Antitrust Balancing*, *supra* note 182, at 119-20; Keith K. Wollenberg, Note, *An Economic Analysis of Tie-in Sales: Re-examining the Leverage Theory*, 39 STAN. L. REV. 737, 754-55 & n.114 (1987). Other commentators have noted similar strategies by other franchisors. *See* Klein & Saft, *supra* note 183, at 348 n.15, 350.

209. Meese, *Antitrust Balancing*, *supra* note 182, at 119.

an incentive for an independent business owner to skimp on products or services, as he would likely never see a dissatisfied customer again.[210] Standard's national reputation would be damaged by such local diminution of quality; an independent interstate operator could essentially free ride on Standard's national reputation.[211] Consequently, Standard exercised direct ownership over those businesses in order to prevent such opportunism.[212]

Off of the interstate, however, filling stations were likely to see customers from the local area rather than transient customers passing by on their way elsewhere.[213] The probability of localized patronage militated against a filling station skimping on services, as such activity would be penalized through the development of a poor local reputation and the loss of repeat local business.[214] Less oversight was necessary for such stations; they did not need to be brought under central control. Thus, Standard was able to allow stations off the interstate to be independently owned because the probability of repeat business served as a natural check on the temptation to cheat.[215]

This anecdote illustrates how localized shirking can be avoided by vertical integration, resulting in direct oversight of production and quality control.[216] However, integration may be undesirable when local control has some comparative advantage over centraliza-

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210. Klein & Saft, *supra* note 183, at 350; Meese, *Antitrust Balancing*, *supra* note 182, at 119.

211. Meese, *Antitrust Balancing*, *supra* note 182, at 119-20.

212. *Id.*

213. *See* Wollenberg, *supra* note 208, at 754 n.114.

214. *See id.*

215. *Id.*

216. Klein & Saft, *supra* note 183, at 350 & n.20; *see also* James A. Brickley & Frederick H. Dark, *The Choice of Organizational Form: The Case of Franchising*, 18 J. FIN. ECON. 401 (1987) (discussing the factors that lead to direct ownership or franchising within the same firm). It is worth noting that Brickley and Dark did not find empirical evidence of increased direct ownership along interstate highways, perhaps because other organizational factors offset the transient customer problem. *See id.* at 418-19. Some commentators have argued that a combination of direct ownership and franchising also promotes other benefits. *See, e.g.*, Frank A. Scott, *Franchising vs. Company Ownership as a Decision Variable of the Firm*, 10 REV. IND. ORG. 69 (1995) (arguing that mixed direct ownership and franchising secures firm profit margins); Shira B. Lewin-Solomons, *Innovation and Authority in Franchise Systems: An Empirical Exploration of the Plural Form* (Cambridge Working Papers in Econ., Paper No. 0015, 2000), *available at* http://www.econ.cam.ac.uk/dae/repec/cam/pdf/wp0015.pdf (arguing that mixed direct ownership and franchising serves to promote innovation).

tion.[217] It appears that franchises are more likely to use franchisee-owned establishments in circumstances where local effort and initiative are particularly important.[218] Conversely, when franchisor effort is particularly important and/or the temptations of franchisee free riding on brand reputation are particularly high, franchisors will be more prone to use company-owned establishments.[219] Thus, smaller units located further from headquarters are more likely to be franchised. Similarly, companies with more valuable brands tend to have lower levels of franchising.[220] Franchising charts a middle course between direct oversight and arm's length bargaining, but at some elevated degree of risk to each party.

As the Standard Oil "highway problem" suggests, the particular form of the franchise relationship will be structured with regard to potential hold ups between franchisor and franchisee. Previous commentators have emphasized that both franchisors and franchisees face serious incentive problems within their relationship.[221] For franchisors, the major issue is quality control.[222] The franchise's trademark is valuable, but if local franchisees let quality slip, the product's or business's reputation will suffer.[223] It is not the franchisees, however, who will bear the full cost of the reduction in reputation; this loss is imposed on everyone within the system.[224] Hence franchisees will be tempted in a variety of ways to increase their own short term profit by shirking on product or service quality and effectively "free riding" off of the investment of the franchisor and other franchisees in the system.[225] If all franchisees do this, of course, everyone in the system will lose as the value of the trademark diminishes.[226]

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217. Caves & Murphy, *supra* note 197, at 574-75.

218. *Id.*

219. *Id.* at 584.

220. ROGER D. BLAIR & FRANCINE LAFONTAINE, THE ECONOMICS OF FRANCHISING 114-15 (2005).

221. Gillian K. Hadfield, *Problematic Relations: Franchising and the Law of Incomplete Contracts*, 42 STAN. L. REV. 927, 949-50 (1990); Klein & Saft, *supra* note 183, 349-51.

222. Klein & Saft, *supra* note 183, at 349-51.

223. Hadfield, *supra* note 221, at 949-50.

224. Klein & Saft, *supra* note 183, at 349-50.

225. *See* James M. Treece, *Trademark Licensing and Vertical Restrains in Franchising Arrangements*, 116 U. PENN. L. REV. 435, 465-66 (1968).

226. Hadfield, *supra* note 221, at 949-50.

Franchisors, in turn, may face a temptation to defect at the expense of franchisees. Franchisees invest large amounts of financial and human capital into the business. Much of this investment is franchise specific: it is worthless or much less valuable outside of the franchise business.[227] This investment subjects franchisees to opportunistic exploitation by franchisors.[228] Franchisors may try to terminate valuable franchises and convert them to company control, or in a variety of more subtle ways they may try to force franchisees to take actions that increase the overall mark's value to a small degree, but at a high cost to franchisees.[229]

The central question is what law can, does, and should do to address both of these kinds of opportunism. It is important to note that many private contractual and market based mechanisms exist to deal with these issues.[230] Franchise agreements, for instance, are quite lengthy and deal extensively with quality control. As for franchisor opportunism, many argue that market mechanisms such as reputation should prevent this.[231] But there may be reasons why such mechanisms work imperfectly. These mechanisms may provide room for the law to help police franchisor or franchisee opportunism.[232] Hadfield, for instance, argues that the contractual duty of good faith should be used to help police franchisor opportunism.[233] If courts go either too far or not far enough in providing such protections, some franchises may respond in ways that move them from the organizational structure we would observe at the optimal level of legal rules. For instance, if Hadfield is right that the law does not adequately protect franchisees from franchisor opportunism, then we might observe less franchising than would be optimal, as some potential franchisees choose not to get into a business perceived to be exploitative, or as others withdraw.

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227. On the importance of firm-specific investment, see Oliver E. Williamson, *The Logic of Economic Organization*, *in* THE NATURE OF THE FIRM 90, 99-100 (Oliver E. Williamson & Sidney G. Winter eds., 1991).

228. Hadfield, *supra* note 221, at 952-53.

229. *See id.* at 951-52.

230. *See, e.g.*, Klein & Saft, *supra* note 183, at 345 (describing the use of tying for quality control).

231. *See, e.g.*, BLAIR & LAFONTAINE, *supra* note 220, at 271-75; Rubin, *supra* note 182, at 232.

232. Hadfield, *supra* note 221, at 992.

233. *Id.* at 984-90.

Similarly, absent some protection from hold up, franchisors will be more likely to vertically integrate, either buying local vendors outright, or resorting to more restrictive forms of franchising than would be optimal.[234] Clearly, contract provides some degree of assurance against franchisee free riding. But if contracts are incomplete, trademark law provides a default when the franchise deal goes sour: use of the trademark reverts to the trademark owner and the franchisee is unable to continue free riding off the goodwill in the mark.[235] Thus, previous commentators have noted that the need to invest in physical instantiation of trademarks or trade dress can create project specific assets that function as a type of bonding mechanism.[236] A franchise requirement that the franchisee invest in specialized uniforms, packaging, décor, or architecture prevents the franchisee from easily defecting from the licensing agreement because he cannot repurpose such items without violating the franchisor's trademark.

Optimally, the franchisee should also receive some legal assurance that it will be able to repurpose its independently acquired local reputational assets in a different venture if held up by the franchisor. Some limitation to trademark rights is necessary to keep franchisors from overreaching. Cases considering franchise dissolution contemplate this problem, forbidding former franchisees from continuing to use the previously licensed mark while also holding that the franchisor has no interest in purely local reputation and cannot, for example, prevent the former franchisee from continuing to use the same method or style of business.[237]

Other aspects of trademark law also support the hybrid franchise structure. For example, trademark law requires that trademark owners police the use of the mark, not only externally for uses of confusingly similar marks, but also internally with regard to quality of goods or services associated with the mark.[238] This means that a trademark owner must exercise continuing oversight over licensees

234. *Id.* at 997-98.
235. Meese, *Antitrust Balancing*, *supra* note 182, at 136-37.
236. *See* Klein & Saft, *supra* note 183, at 346-47.
237. *See* 3 MCCARTHY, *supra* note 7, § 18:67.
238. *Id.* § 18:42.

of the mark in order to prevent variations in associated goods or services.[239] Failure to do so may result in loss of the mark.

This rule necessitates some oversight of trademark franchise operations, at least with regard to the quality and uniformity of the goods or services produced by the franchisee. But a large part of the typical franchise agreement focuses on quality control.[240] Contracts often specify the products to be sold, hours of operation, operating procedures, product standards, information systems to be used, and similar matters.[241] Franchise agreements may also specify many of the inputs to be used in making the product or service.[242] To ensure that franchisees comply with these terms, franchisors must engage in extensive inspection efforts.[243] Trademark oversight is in fact the explanation—or justification—for much of the franchisee oversight in franchise agreements.

Trademark thus provides the legal justification for a range of control over the franchise, running the gamut from franchises that are nearly corporate subsidiaries to franchises that are effectively independently owned outlets for the product. The trademark provides residual rights against local defection, although some commentators worry that trademark law may in fact provide the franchisor with too much leverage.[244] Thus, while franchising presents an intermediate form when relationships are hard to characterize as either inter- or intra-firm, the essence of a Coasean approach to the firm still applies in explaining the franchise form and how it responds to various legal rules.

CONCLUSION

We have now considered ways in which trademark law affects intra-firm transactions, ways in which trademark law affects inter-firm transactions, and ways in which trademark law affects transactions that are hard to characterize as either inter- or intra-firm in the hybrid organizational form of franchising. It has long

239. *Id.*
240. BLAIR & LAFONTAINE, *supra* note 220, at 125-32; Hadfield, *supra* note 221, at 940-44.
241. BLAIR & LAFONTAINE, *supra* note 220, at 126-27.
242. *Id.* at 131-32.
243. *Id.* at 134.
244. Hadfield, *supra* note 221, at 991-92.

been understood that trademark law gives the owners of products or services associated with a mark the incentive to make investments that increase the reputational value of those products or services as the trademark right discourages free riding on that reputation. However, these discussions have generally reserved the question of what type of person or entity owns the trademark. We can now see that at least sometimes this black box approach obscures important questions. When a firm owns a trademark, internal incentives will help determine how the mark's value is developed. Moreover, the existence of trademark law and some of its doctrinal details will help determine what transactions occur within firms and what transactions occur between firms.

As we have emphasized in past work, intellectual property does not operate in a vacuum, and is likely to be only one of a variety of influences that shape the size and structure of firms. In some cases it may not even be a major influence. This caveat will be as true of trademarks as it is of other forms of intellectual property. In the modern economy, however, the recognition and reputation associated with a trademark is frequently the most valuable asset associated with a business. Consequently, we expect that in many cases, trademarks will have a profound influence on the boundaries of those firms. And in some cases, such as franchising industries, trademarks and their associated costs may be critical in shaping the structure of entire economic sectors.