Trademarks and the Cosean Firm

Dan L. Burk*, Laura Heyman†
& Brett McDonnell‡

The Cosean theory of the firm explains the size and structure of the firm in terms of transaction cost economics. Because market transactions are costly, areas of entrepreneurial activity will emerge within which it will be more efficient to coordinate production by executive fiat rather than by bargained-for exchange. Coase and the successors who built upon his original insight predict that the boundary of the firm will be determined based upon the relative cost of transactions within the firm and between firms. 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 needed inputs within the hierarchy of the firm. Firms will vertically integrate or dis-integrate depending on which option yields the lowest transaction cost structure.

Property rights have emerged as an important consideration in lowering transactions costs between firms. In previous work, two of us (DLB and BHM) explored in detail the role of intellectual property rights in lowering transactions costs both within firms and between firms.[1] That work suggests that the optimal intellectual property regime for a given firm must consider the interplay between both internal and external transactions of costs. In some instances, a weak property regime will do too little to prevent employees or business partners from misappropriating the firm's knowledge assets. In other instances, a strong property regime will overly hamper employee entrepreneurship within the firm, and negotiations between firms. Thus, to strike the proper balance of transaction costs between firms and within firms, intellectual property regimes must be calibrated "just right."[2]

That work focused on patent, copyright, and trade secrecy, deferring discussion of trademarks because of the differences between trademarks and other forms of intellectual property, which we believed required separate treatment. Because the primary legal justification for trademark law is to preserve and to signal reputation, trademarks perform a different allocational function than other intellectual property. Here we take up the discussion of trademarks as they relate to the size and structure of the Coasean firm. We argue that trademarks (and trade dress) may not only effect the internal allocation of transaction costs, but also the costs between firms in the market, by preventing "hold-ups" and allocating residual rights where contracts are incomplete.

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* Professor of Law, University of California,Irvine.
† Assistant Professor of Law, Marshall-Wythe School of Law, College of William & Mary
‡ Professor of Law, University of Minnesota.
[1] *See* Burk & McDonnell, *supra* note 7 at __ .
[2] *Id.* at __.

Trademarks are (usually) not a good in themselves, but an instrument for conveying the reputation or goodwill of a firm. 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. In this sense, trademarks are somewhat like patents or published copyrighted works; trademark licensees are never bargaining for disclosure.

Trademark ownership prevents a 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 that licensee is able to act opportunistically, the trademark may constitute residual rights, although only quasi-property rights. Thus, trademarks may facilitate certain types of outsourcing or "dis-integration" of production functions. For example, trademarks play a key role in franchising, a hybrid contractual arrangement in which a local business is not fully integrated into a parent firm, but is often extensively overseen by the licensor.

Trademarks may also play a role in allocating intra-firm transaction costs, by defining the reputational assets of employees and the firm. Where employee reputation and firm reputation are bound up in the same signal, accommodating both interests may be difficult or impossible. Such intertwined reputation may occur, for example, in what we might call the "closely held" corporation, not so much in the sense of ownership or decisionmaking, 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. In a recent illustration, allegations of insider trading revealed the extent to which the enterprises founded by Martha Stewart were tied to her personal fortunes and reputation.

Trademarks may also partition resources between the firm and less prominent employees. Firms are represented by individuals, and 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. Goodwill is therefore the result of joint effort by the employee and the firm. 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, or on the other hand depriving the employee of an important resource for personal income development. Either error invites one of the parties to underinvest in the resource. Trademark law partitions goodwill associated with the firm's indicia from the personal goodwill associated with particular employees.