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## *Perspectives from FSF Scholars*

*January 18, 2011*

*Vol. 6, No. 3*

### **Property, Regulatory Policy, or Hybrid? The Elusive Status of Intellectual Property**

by

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The question that I have been asked to address concerns the correct classification of intellectual property. Is it, as the name of the subject suggests, really a form of property, or is the name a disguise under which regulatory policy travels? The answer to this question is that IP is a hybrid of both, but not one of even proportions. The proper mix in a sound governance regime inclines sharply in one direction: 90% property and 10% regulation. Some words of explanation are in order.

At the methodological level, the best way to understand intellectual property is to treat it as a part of the broader class of property relationships that embraces land, chattels, animals, and, yes, intangibles. Once the generic features of property are well understood, it becomes possible to tackle the narrower question of how to make the appropriate doctrinal and institutional adjustments that capture the distinctive features of intellectual property. Even then, that process is not complete. To be sure, the different forms of intellectual property have some common features. Nonetheless, a full explanation of how the overall system works has to take into account the very real and permanent differences between the different forms of intellectual property.

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The key rules applicable to the broad class of property rights can be summarized very quickly. The first is a private rule of decentralized acquisition, known as the “rule of occupation or first possession.” For land, that rule usually generates the proposition that possession creates, *prima facie*, ownership of property in fee simple, which means in effect that there is no future temporal element that is not embraced by original occupation. The possession, so taken, is usually defined by boundary markers and subject to recordation on a common registry.

The rules for taking chattel tend not to focus as much on the temporal dimension, as the property in question is often consumed or transformed after capture. In any event, most chattels are not subject to any system of recordation; nor are there separate ways to mark off boundaries, which makes no sense in this context. The rules of capture are clearly more complex for animals, given that they can seek to elude capture before taken into possession, or escape from possession after capture.<sup>1</sup> Nonetheless, these small variations do not conceal the central truth that unilateral actions by private parties are key to establishing the initial ownership claim. And just as these forms of property are taken by unilateral action, ownership is lost only by abandonment. The key rule, that someone who starts in possession remains in possession until that property is abandoned or taken, is one of the great tools for securing the stability of possession over time.

Long-term possession is critical for efficient asset use. Accordingly, once property is acquired, the next question asks: what is the bundle of rights that attach to the particular thing that has been subjected to private ownership? I have already mentioned the right to exclude for an indefinite time. Nonetheless, standing alone, the right to exclude doesn't do very much for the property owner. In order for exclusion to become valuable it has to be coupled with the right to use, which in the context of intellectual property goes under a somewhat grand label: the right to “practice” a patent over which one has exclusive right. Protecting exclusivity makes those use rights possible, so long as the law does not vest a veto right in someone else, as happens all too often with land use restrictions under most zoning codes.

Yet in some cases, the rights to exclude and to use may not be of great value to this particular owner, relative to their value to someone else. A complete system of property must be designed to allow that owner to secure gains from trades by either sale or by licensing. The key feature for making trade work is to reduce transaction costs through such devices as the Statute of Frauds and a recording system, which, again, is appropriate for land, for some expensive forms of personal property, and of course, for many forms of IP. If this system is implemented, it will have to develop devices for self-correction in the event that conflicts crop into the system over such matters as boundary disputes, with rules to deal with adverse possession and the rectification of errors in deeds and other legal documents.

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<sup>1</sup> See *Pierson v. Post*, 3 Cai. R. 175 (N.Y. Sup. Ct. 1805).

These broad property relationships constitute the foundations for an amazingly durable system. The question then is: how does the broader class of property relationships carry over to intellectual property? That transformation will have added levels of complexity because ideas and symbols are more elusive than tangible interests in land or chattels. But nonetheless, the basic property relationships take us far down the road to a coherent system of intellectual property rights.

The first question is what it was for land. Is society better off with a regime of private decentralized acquisition, or does it do better with some centralized public system which assigns rights without considering any efforts of private people to acquire rights for themselves? Good property lawyers do not want to run the danger of public distribution of things, but would much prefer to let individuals file and validate claims based on notions of clear boundary lines and temporal priority.

That rule, of course, cannot be universal, for it only specifies how a regime of private property gets up and running. But there is also the antecedent question, for IP and for land, to figure out which things should be treated as common property that cannot be owned, like the air, and which things are private, like land. (Water perches uneasily between the two stools as a mixed regime.<sup>2</sup>) The same distribution applies to patents and copyrights, for there is no good reason to let general language, ideas, or general physical laws become subject to any form of IP protection.

So there are certain restrictions on the kinds of things that can be reduced to patent or copyright. But once those are settled, the next question asks: exactly what is the payoff with patent or copyright ownership? An answer to that question depends on the three dimensions of property relationships—duration of ownership, exclusivity and use, as well as alienation. The greatest difference is on this first dimension; namely, that it is most unwise to follow the land example and assume that all intellectual property rights, especially patents and copyrights, should be infinite in duration.

There are good economic reasons for these differences. It is near suicidal to think of patents in particular as a permanent form of ownership. For physical property, for example, if I own land which falls into the public domain after 20 years, what follows is a free-for-all through which the land becomes completely useless through overconsumption by rivalrous users. On the other hand, if a chemical formula or machine design goes into the public domain, that cycle of destruction does not take place. The use of the once-protected item by one person does not degrade its use by anyone else.

Given that critical difference, it is clear that the costs of opening up private property to common use are far greater with land. So with patents and copyrights we have to face this question: what is their optimal duration? If the law were to grant patentees only one second of exclusive, no rational private party is going to invent anything

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<sup>2</sup> For discussion, see Richard A. Epstein, *Playing By Different Rules? Property Rights in Land and Water* (Lincoln Inst. Working Paper, 2010), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1719688](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1719688).

that others could instantly expropriate. So the duration has to be longer, but still not infinite. Finding an intermediate ground is not easy to do, but an all-purpose guess of a patent life at around 20 years is probably not too far off the mark.

But even adjustments will then have to be made to take into account the interaction of patents with other systems of regulation. The most famous clash involves the interaction between the system of patent approval on the one hand and the FDA process for drug approval on the other. The patent itself only grants the exclusive right to sell. It does not allow the patentee to escape other restrictions imposed on sale for reasons of health or safety. Thus, the current system of food and drug regulation could allow a patented pharmaceutical to be tied up in administrative review without the ability to receive revenue as the patent clock winds down. Remember, it is not a viable economic alternative to go through the FDA process before the patent is secured, at which time huge sums could be wasted if the patent is not issued and the compound falls into the public domain.

Here is one of those cases where regulation really matters, for the patent system has to accommodate the delayed permission for use driven by other parts of the law. The response now in place is the Hatch-Waxman Act of 1984,<sup>3</sup> which extends patent life for as much as five years to offset the period that the patent is in lock-down mode before the FDA, lest the entire value of the patent dissipate while administrative proceedings drag on. Right now the regulatory system is too complex because the Hatch-Waxman extensions are not year-for-year equivalents for the loss of exclusive rights to market, and the whole system is larded with technical provisions that invite too much game-playing. Yet there is no question that the new scheme was an enormous spur to invention at the outset of the patent and did much (although far from everything) to insure the smooth transition to generic status at the expiration of the patent.

Two other key general features of private property also apply to patents and copyrights. One is their exclusivity and use, and the other is the general right of alienation by way of sale and license. In dealing with both use and license, there is no reason, once the appropriate adjustments are made with respect to term, why the traditional rules that deal with injunctions and licenses should not carry over almost entirely in dealing with the various areas associated with patent and copyright protection.

If I wanted to identify out two black marks on the current patent jurisprudence, the first would be the U.S. Supreme Court's ruling in the *eBay v. MercExchange*<sup>4</sup> with its somewhat dismissive treatment of injunctions. The second would be the Supreme Court's ruling in *Quanta Computer v. LG Electronics*,<sup>5</sup> with its unduly narrow view on the role of licensing.

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<sup>3</sup> Drug Price Competition and Patent Term Restoration (Hatch-Waxman) Act of 1984, Pub. L. No. 98-417, 98 Stat. 1585 (codified as amended in scattered sections of 21 U.S.C. and 35 U.S.C.).

<sup>4</sup> *eBay Inc. v. MercExchange, L.L.C.*, 547 U.S. 388 (2006).

<sup>5</sup> *Quanta Computer, Inc. v. LG Electronics, Inc.*, 553 U.S. 617 (2008).

With respect to the *eBay* case, the correct rule was the one that used to be in the U.S. Court of Appeals for the Federal Circuit. That rule established an overwhelming presumption in favor of granting injunctions as the exclusive remedy to patent infringement unless there is something that the patentee did by way of laches (unreasonable delay) or misconduct that justifies some forfeiture of rights.

In this area, the hostility toward injunctions has led courts to think that damages should be the dominant remedy. What these courts have overlooked is the flexibility that is available for injunctions. One easy fix is to adopt the practice that judges often take in land use cases of simply delaying the enforcement of injunctive relief for, say, six months. That period allows the infringer either to bargain or design around a particular patent rather than have a court license the wrong in perpetuity by forcing an evaluation of present and future damages, which is difficult to do. There is, of course, a counter-principle that warns against the use of an injunction against an insignificant patent that is just part of larger mosaics. In these cases damages should be modest, and the delay should afford ample opportunities to design around the patent if the parties cannot negotiate a license.

So this mixed system of remedies for patent violations, common in the land cases, should carry over to this situation. Otherwise, what will emerge is a very strange and untenable situation. If, for some reason, a patentee decides it is not optimal to practice a patent immediately, it may not be able to license it instantly. If the rule is that infringers may always resist an injunction when the patent is not in active use, it forces the patentee to create licenses before it is wise to enter into them. Just as with land, it is wise to give these injunctions in all cases, so as to allow the licensor to optimize his licensing revenues. The transactions will take place quickly enough. Patents are wasting assets, and no patentee will be happy to let them decay if there are better economic opportunities available.

It is critical to note the major difficulty if the injunction is not the preferred remedy. Suppose there are an unlimited number of intruders with respect to a given patent. At this point the patentee will have to bring an unlimited number of damage actions under complex formulas that raise factual issues that impact the ability to give accurate valuations. To put it mildly, the standard formulas for damages are less than informative, whether measured by the restitution standard of the benefits received by the wrongdoer, or the tort standard of harm caused to the patent holder.

The whole point of an injunction is to stabilize the property relationships so that when the property owner issues voluntary licenses on either an exclusive or a nonexclusive basis, those licensees know with certainty what they are getting. They need not worry about unauthorized competition that could undercut their good behavior in playing by the rules. Weak remedies allow those interlopers to profit from their own wrongs.

When it comes to deciding what licenses are valid the correct rule is pretty simple. Generally speaking, all licenses in whatever forms ought to be presumptively acceptable. The only institutional constraint that really matters is whether or not certain cross-licensing agreements or the pooling agreements create a genuine antitrust risk. In dealing with this risk, the Department of Justice has done a fine job by allowing the pooling of complementary patents, which is needed to overcome the double marginalization problem in which successive patents seek to overreach. Yet the pooling of substitute patents has none of those efficiencies, but is really a way to cartelize a market.

Unfortunately, in the *Quanta* case, the Supreme Court showed a lack of understanding of how the particular license before it fit into a general scheme of property rights. The Court applied a so-called “exhaustion rule” to the licenses.<sup>6</sup> Under that exhaustion rule, the intellectual property owner exhausts rights in the property, such as a patent, following first licensed use of the property. This judicial ruling makes it very difficult to enter into complex licensing arrangements.

The particulars of the *Quanta* case are instructive of the difficulty. LG Electronics wanted a peculiar form of license with respect to its own trading partner, Intel. LG required Intel to provide notice to third-party purchasers of microprocessors using LG patents, but not to collect fees from them. LG knew that when Intel sold microprocessors that some third-party purchasers had already paid LG fees under some general blanket license. LG did not want to collect second fees from those who had already paid. The LG-Intel deal was a sensible way of making sure that licensees who have paid once don't have to pay twice.

These issues are not trivial. The rules on protection and disposition lie at the heart of any well-organized property system. The mistakes mentioned above are not on some trivial points. They all go to the basic structure of the law on injunctions and licenses in the patent area. The selection of the wrong rules has created a massive misallocation of resources in a vital sector of the economy. The mistakes were made by judicial decision. The corrections could easily come in the same fashion. Make those adjustments, and the situation for intellectual property will improve once it is again folded back into the general rules of property that have worked so long and so well with land and other tangible assets.

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<sup>6</sup> See *Quanta*, 553 U.S. at 628-30.

thanks to Isaac Gruber, University of Chicago Law School, Class of 2012, for his usual expert research assistance.