

Contract and Coordination Failure: Mandatory Terms in Intellectual Property Licenses

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ABSTRACT

This paper investigates whether any of the user rights granted by intellectual property (IP) law should be treated as mandatory terms by contract law. American law generally prefers a laissez-faire approach to IP license terms, but in a few cases it has refused to enforce contract terms that purport to abrogate a user right. For example, courts refuse to enforce patent royalties that continue after a patent has expired, and contract terms that preclude a licensee from challenging the validity of the licensed patent. Courts have split on the question of whether copyright law preempts enforcement of contract terms that prohibit reverse engineering. We also consider the status of copyright licenses that restrict fair use.

We provide a normative account that supports curtailing freedom of contract in select cases. Our analysis builds on the economics literature on naked exclusion and contracting with externalities. We explain that social costs are imposed by certain license terms because a collective action problem prevents buyers from mounting coordinated resistance to those terms. We endorse relatively deferential oversight of IP license terms through an optimal mix of antitrust and the preemption and misuse doctrines from patent and copyright law.

The generic argument for licensor freedom starts with the familiar argument favoring contractual freedom. Simply put, a licensor and licensee can be trusted to agree to license terms that are part of a mutually beneficial agreement. Thus, a court should not be concerned about whether a particular term favors one party or the other. A second facet of the argument notes that intellectual property owners deserve special consideration because contract freedom maximizes the value of licenses and therefore the value of the underlying patent or copyright. More valuable patents and copyrights should induce the creation of more and better inventions and works of authorship.

We advance a generic counterargument that favors limited restrictions on license terms. Our counterargument explains that a licensee might rationally agree to license terms that cause a social loss. The loss arises when the license terms restrict certain licensee actions that generate positive externalities for other (potential or actual) licensees. A licensor has an incentive to chill the generation of positive externalities when the licensee action disrupts the licensor's ability to extract profit from the transaction. A licensee might agree to restrictive terms because it is only too happy to act as a free rider. Any one licensee gives up the opportunity to provide a public good in

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exchange for a relatively minor concession from the licensor. In aggregate, licensees and society suffer from this collective action problem. The social losses can be avoided if the licensees coordinate their negotiations with the licensor, but such coordination is difficult, thus we use the term coordination failure to describe this failing of laissez-faire contracting.

The law and economics literature probably lacks a unified analysis of this topic because intuition suggests a licensor should encourage licensees to engage in activities that generate positive externalities. This intuition is typically correct. Positive externalities that increase the value of a license should benefit the licensor who can capture some of the value associated with the externality through a higher license fee. A problem arises for the licensor though when the externality undermines the licensor's bargaining power. If the decline of bargaining is sufficiently great, then the licensor would prefer to give up the value enhancing effects of the externality.

To make a persuasive case that certain license terms should be mandated or prohibited we first must show our argument applies to some important license practices. We do this in Section II. Second, we must explain how the courts can identify cases of coordination failure. We do this in Section III. Finally, we must argue effectively that IP based incentives will not suffer too much, and that the costs from overbreadth and rent-seeking are tolerable. We do this in Section IV.