

HOW PATENTS PROVIDE THE FOUNDATION OF THE MARKET FOR INVENTIONS

Daniel F. Spulber[†]

ABSTRACT

The article develops a comprehensive framework demonstrating how patents provide the foundation of the market for inventions. Patents support the establishment of the market in several key ways. First, patents provide a system of intellectual property (IP) rights that increases transaction efficiencies and stimulates competition by offering exclusion, transferability, disclosure, certification, standardization, and divisibility. Second, patent transfers constitute what the article terms “the market for innovative control” that provides incentives for efficient investment in invention, innovation, and complementary assets. Third, patents as intangible real assets promote the financing of invention and innovation. The market foundation role of patents refutes the economically incorrect “rewards” view of patents. The discussion considers how economic benefits of the market for inventions should guide IP policy and antitrust policy.

JEL: D40; O31; L10

I. INTRODUCTION

The U.S. patent system issued its first patent on July 31, 1790, which was signed by President George Washington.¹ Samuel Hopkins obtained that patent for a process of making potash, an ingredient used in fertilizer.² The over 6 million patents issued since then have supported the market development of steamships,

[†] Elinor Hobbs Distinguished Professor of International Business, Department of Strategy, Kellogg School of Management, Northwestern University, 2001 Sheridan Road, Evanston, IL, 60208. I thank Alexei Alexandrov, Justus Baron, Julie Carlson, Richard Epstein, Kirti Gupta, Steve Haber, Paul Heald, John Howells, Ron Katznelson, Scott Kieff, Zorina Khan, Mark Lemley, Robert Merges, Adam Mossoff, Ben Roin, Carl Shapiro, Ralph Siebert, Henry Smith, Mark Snyder, Richard Taffet, and Heidi Williams for helpful comments. I am grateful to Qualcomm and the Kellogg School of Management for research support. Prepared for presentation at the Inventions and U.S. Patent System Conference, Working Group on Intellectual Property, Innovation, and Prosperity, Hoover Institution, Stanford University, May 19–20, 2014, Stanford, CA. I thank participants at the Research Roundtable on Software and Business Method Patents, Searle Center on Law, Regulation and Economic Growth, Northwestern University School of Law, April 24–25, 2014, for their helpful comments. Email: jems@kellogg.northwestern.edu.

¹ Press Release, The United States Patent and Trademark Office, First U.S. Patent Issued Today in 1790 (July 31, 2001), <http://www.uspto.gov/news/pr/2001/01-33.jsp>.

² *Id.*

automobiles, electric power, electric appliances, aviation, aerospace, telecommunications, mobile communications, computers, the Internet, biotechnology, and nanotechnology. Despite these significant achievements, the U.S. patent system is facing a perfect storm of criticism from academics, politicians, judges, journalists, and industry groups, with calls for abolishing or heavily regulating patents. In this article, I suggest that the anti-patent storm in part reflects a basic misunderstanding of the purpose of the patent system. A better understanding of the contributions of patents may help calm the anti-patent storm and avoid disrupting the highly successful U.S. system of invention and innovation.

I argue in this article that patents “promote the progress of science and useful arts,” because they provide the foundation of the market for inventions.³ I develop a comprehensive economic framework for the study of patents that extends work I have done on market microstructure, the theory of the firm, invention, and innovation.⁴ Applying this framework, I demonstrate that patents support the market for inventions in several important ways: (1) by increasing transaction efficiencies and stimulating competition, (2) by establishing what I term “the market for innovative control” that provides incentives for efficient investment, and (3) by promoting the financing of invention and innovation.⁵ I show that the market foundation role of patents has important implications for antitrust and public policy toward intellectual property (IP).

Yet, for many academics, the patent system is a “failure,”⁶ in a “crisis,”⁷ and a “major wound” that should be abolished.⁸ The press tends to agree: “Abusive and frivolous lawsuits brought by holders of patents are costing the American economy billions of dollars.”⁹ Antitrust policy makers seeking “a proper balance between exclusivity and competition” argue that “[i]nvalid or overbroad patents disrupt that balance by discouraging follow-on innovation, preventing competition, and raising prices through unnecessary licensing and

³ The U.S. Constitution offers valuable guidance regarding the purpose patents in granting Congress the power “[t]o promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries.” U.S. CONST. Art. 1, § 8, Cl. 8.

⁴ DANIEL F. SPULBER, *MARKET MICROSTRUCTURE: INTERMEDIARIES AND THE THEORY OF THE FIRM* (Cambridge Univ. Press 1999); DANIEL F. SPULBER, *THE THEORY OF THE FIRM: MICROECONOMICS WITH ENDOGENOUS ENTREPRENEURS, FIRMS, MARKETS, AND ORGANIZATIONS* (Cambridge Univ. Press 2009); DANIEL F. SPULBER, *THE INNOVATIVE ENTREPRENEUR* (Cambridge Univ. Press 2014).

⁵ I discuss the market for inventions and examine some of the implications of transaction costs and other market frictions for invention and innovation in SPULBER, *THE INNOVATIVE ENTREPRENEUR*, *supra* note 4.

⁶ JAMES BESSEN & MICHAEL J. MEURER, *PATENT FAILURE: HOW JUDGES, BUREAUCRATS, AND LAWYERS PUT INNOVATORS AT RISK* (Princeton Univ. Press 2008).

⁷ DAN L. BURK & MARK A. LEMLEY, *THE PATENT CRISIS AND HOW THE COURTS CAN SOLVE IT* (Univ. of Chicago Press 2009).

⁸ Michele Boldrin & David K. Levine, *The Case Against Patents*, 27 J. ECON. PERSP. 3, 18 (2013).

⁹ Editorial Board, *Abusive and Frivolous Patent Suits*, N.Y. TIMES (April 6, 2014), http://www.nytimes.com/2014/04/07/opinion/abusive-and-frivolous-patent-suits.html?_r=0.

litigation.”¹⁰ The Supreme Court in a series of opinions has ruled claims for a wide range of subject matters as patent-ineligible.¹¹ Commentators have noted the “hostility to patents” by the Executive Branch.¹² Congress is in the midst of extensive bipartisan patent reform efforts.¹³ According to industry lobbyists, such as the Electronic Frontier Foundation, “[w]e happen to be at a special point in time when every branch of government is itching for patent reform.”¹⁴

I demonstrate that, contrary to these assertions, patents create economic benefits, because the market for inventions generates efficient incentives for invention and innovation. This is important because the market for inventions is vast. The market for inventions includes disembodied inventions in the form of licensing, cross licensing, assignments, and contractual research and development (R&D). The market for inventions also includes technologies embodied in goods and services, production processes, transaction techniques, and firms themselves.¹⁵ The market for inventions further includes financing of invention and innovation through entrepreneurial and corporate finance.

¹⁰ Fed. Trade Comm’n, *The Evolving Marketplace: Aligning Patent Notice and Remedies With Competition* (Mar. 2011), available at <http://www.ftc.gov/sites/default/files/documents/reports/evolving-ip-marketplace-aligning-patent-notice-and-remedies-competition-report-federal-trade/110307patentreport.pdf>.

¹¹ See, e.g., *Mayo v. Prometheus*, 566 U.S. 10 (2012); *Ass’n for Molecular Pathology v. Myriad*, 133 S. Ct. 2107 (2013); *In re Bilski*, 545 F.3d 943 (Fed. Cir. 2008). Judge Moore lamented this state of events. *CLS Bank Int’l v. Alice Corp. Pty. Ltd.*, 717 F.3d 1269, 1313 (Fed. Cir. 2013) (“Dissenting-in-part opinion filed by MOORE, Circuit Judge, in which RADER, Chief Judge, and LINN and O’MALLEY, Circuit Judges, join. I am concerned that the current interpretation of § 101, and in particular the abstract idea exception, is causing a free fall in the patent system. The Supreme Court has taken a number of our recent decisions and, in each instance, concluded that the claims at issue were not patent-eligible. See *Bilski*, *Prometheus*, *Myriad* (under consideration). Today, several of my colleagues would take that precedent significantly further, lumping together the asserted method, media, and system claims, and holding that they are all patent-ineligible under § 101.”).

¹² See Kevin E. Noonan, *Thoughts on the USPTO’s Patent Eligibility Guidelines (and What to Do About Them)*, PATENT DOCS: BIOTECH & PHARMA PATENT LAW & NEWS BLOG (Mar. 18, 2014), <http://www.patentdocs.org/2014/03/thoughts-on-the-usptos-patent-eligibility-guide-lines-and-what-to-do-about-them.html> (discussing concerns about executive branch opposition to patents); Lisa L. Mueller, *The Thorny Problem of Patentable Eligible Subject Matter: An Introduction*, NAT’L L. REV. (Apr. 15, 2014), <http://www.natlawreview.com/article/thorny-problem-patentable-eligible-subject-matter-introduction>.

¹³ Kristal High, *Patent Reform Movement Shines a Light on Economic Development Opportunities*, HUFFINGTON POST (March 28, 2014), http://www.huffingtonpost.com/kristal-high/patent-reform-movement-sh_b_5048578.html.

¹⁴ Adi Kamdar, *The Patent Reform We Need to See from the Senate*, ELECTRONIC FRONTIER FOUNDATION (March 31, 2014), <https://www.eff.org/deeplinks/2014/03/patent-reform-we-need-see-senate>.

¹⁵ I develop a formal model of the market for inventions with endogenous R&D and entry of inventors and producers. Daniel F. Spulber, *Competing Inventors and the Incentive to Invent*, 22 INDUS. & CORP. CHANGE 33 (2013); Daniel F. Spulber, *How Do Competitive Pressures Affect Incentives to Innovate when There Is a Market for Inventions?*, 121 J. POL. ECON. 1007 (2013); see also Ashish Arora, Andrea Fosfuri & Alfonso Gambardella, *Markets for Technology and their Implications for Corporate Strategy*, 10 INDUS. CORP. CHANGE 419 (2001) (discussing empirical

First, I show that key features of the patent system—exclusion, transferability, disclosure, certification, standardization, and divisibility—*increase transaction efficiencies and stimulate competition* in the market for inventions. These properties of patents reduce transaction costs associated with transferring, licensing, cross-licensing, combining, implementing, and developing inventions. Patents give owners rights to exclude others from making, using, or selling their inventions.¹⁶ Patents help convert inventions into transferable assets, so that inventors and adopters can transact more efficiently in the market for inventions. Patents promote disclosure of inventions, which reduces costs of search and bargaining in the market for inventions. Patents provide certification of technologies, which decreases information asymmetry in the market for inventions. Patents provide standardization in IP, which reduces the costs of contracting in the market for inventions. Finally, patents allow greater divisibility of technology, which promotes modularity and increases gains from trade in the market for inventions. Patents thus generate economic benefits that are based on more efficient transactions and greater competition in the market for inventions.

Second, I introduce the concept of *the market for innovative control*. Patent owners not only obtain residual returns from their inventions, but also have residual rights to choose how their inventions are made, used, and sold.¹⁷ The market for innovative control helps determine the value of inventions, selects the best inventions, and allocates inventions to the highest-value users. The market for inventions is a market for innovative control because patent owners have rights to develop inventions, apply inventions to produce innovations, and invest in complementary assets. The market for inventions provides incentives for the efficient organization of firms and industries in terms of the extent of vertical integration of R&D and manufacturing.

studies of the market for inventions); ASHISH ARORA, ANDREA FOSFURI & ALFONSO GAMBARDILLA, *MARKETS FOR TECHNOLOGY: THE ECONOMICS OF INNOVATION AND CORPORATE STRATEGY* (MIT Press 2001) (discussing empirical studies of the market for inventions).

¹⁶ Armen A. Alchian, *Property Rights*, in *CONCISE ENCYCLOPEDIA OF ECONOMICS* (David Henderson ed., 2008), available at <http://www.econlib.org/library/Enc/PropertyRights.html> (pointing out that the three aspects of property rights are exclusion of access, control over how the asset will be used, and transfer of the asset to others).

¹⁷ The concept of the market for innovative control is analogous to the market for corporate control. On the market for corporate control, see Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 *J. POL. ECON.* 110, 112 (1965) (“A fundamental premise underlying the market for corporate control is the existence of a high positive correlation between corporate managerial efficiency and the market price of shares of that company.”); Michael C. Jensen and Richard S. Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 *J. FIN. ECON.* 5 (1983) (“We define corporate control as the rights to determine the management of corporate resources”); Daniel F. Spulber, *Discovering the Role of the Firm: The Separation Criterion and Corporate Law*, 6 *BERKELEY BUS. L.J.* 298 (2009).

Third, I emphasize that patents facilitate the *financial separation* of inventions from their inventors, helping inventors obtain financing.¹⁸ By serving as *intangible real assets*, patents are useful for contracts that finance invention, as indicated by the use of licensing or transfer options for companies funding university research. Entrepreneurs report that patents can be important in securing financing for startups and establishment of firms.¹⁹ Patents also are important for corporate finance and appear as intangible real assets in the balance sheets of corporations. Patents affect the value of corporations in two main ways.²⁰ Patents that are “assets in place” affect the firm’s earnings either through licensing royalties or through own-use of the technology as a productive input. Patents that offer “growth opportunities” affect the firm’s expected value because they indicate the potential to invest in innovation based on the firm’s IP or to invest in invention of related technology. Financial contracts and the capital structure of firms help provide incentives for invention and innovation.

Patents are *forward-looking*—they perform most of their economic functions in the market for inventions after they are granted. The market foundation role of patents stands in stark contrast to the common view that patents provide “rewards” for inventors. The “rewards” view tends to be *backward-looking*; according to this view patents complete most of their economic functions at the time they are granted. The “rewards” view of patents is highly misleading for public policy because it does not accurately describe public and private institutions. Contrary to the “rewards” view, markets, not government agencies, determine what rewards inventors and innovators receive and market participants provide those rewards. The “rewards” view considers patents as sources of residual returns for IP owners without considering that ownership provides the basis for innovative control. Based on the “rewards” view, some researchers recommend weakening patents through antitrust, limits on litigation, compulsory licensing, government ownership, price controls, taxes, and subsidies.²¹ These regulatory approaches would stifle or eliminate the economic benefits that result from the market for inventions.

¹⁸ See Stewart C. Myers, *Financial Architecture*, 5 EUR. FIN. MGMT. 133 (1999) (discussing financial separation and entrepreneurship); Stewart C. Myers, *Outside Equity*, 55 J. FIN. ECON. 1005 (2000) (discussing financial separation and entrepreneurship); SPULBER, THE THEORY OF THE FIRM, *supra* note 4 (discussing financial separation in the theory of the firm); Spulber, *Discovering the Role of the Firm*, *supra* note 17 (discussing financial separation in the theory of the firm); SPULBER, THE INNOVATIVE ENTREPRENEUR, *supra* note 4 (discussing financial separation in the theory of the innovative entrepreneur).

¹⁹ See Stuart J.H. Graham, Robert P. Merges, Pam Samuelson, and Ted Sichelman, *High Technology Entrepreneurs and the Patent System: Results of the 2008 Berkeley Patent Survey*, 24 BERKELEY TECH. L.J. 1255 (2009).

²⁰ This follows Stewart Myers’s distinction between “assets in place” and “growth opportunities.” Stewart C. Myers, *Determinants of Corporate Borrowing*, 5 J. FIN. ECON. 147 (1977).

²¹ See Benjamin N. Roin, *Intellectual Property Versus Prizes: Reframing the Debate*, 81 U. CHI. L. REV. 999 (2014) (providing an overview and discussion of the literature based on the “rewards”

The market foundation role of patents offers insights into public policy toward IP. With patent protections for IP, the market for inventions determines the market value of inventions and the returns to invention, innovation, and complementary inventions. IP policy should maintain the property rights system because of its benefits for competition and transaction efficiencies. This implies maintaining the key features of the patent system: exclusion, transferability, disclosure, certification, standardization, and divisibility. In addition, to support the market for innovative control and the financing of invention and innovation, patents should have sufficient scope to provide IP protections for development of inventions and innovations. Weakening patent rights would reduce transaction efficiencies and competition, distort incentives and guidance in the market for innovative control, and reduce incentives to finance invention, commercialization, and innovation. Public policy makers should not attempt to determine rewards for inventors, because governments lack the vast amounts of information dispersed in the market place, as Friedrich Hayek understood.²²

The market foundation role of patents implies that antitrust policy should support rather than weaken IP protections. When there is a market for inventions, *competitive pressures*, both among inventors and among producers who apply inventions, increase incentives to invent and to innovate.²³ On the supply-side of the market for inventions, competitive pressures increase incentives to invent and decrease royalties for inventions. On the demand-side of the market for inventions, competition drives adopters' incentives to purchase or license discoveries, introduce economic innovations based on those discoveries, and invest in complementary activities. Weakening patents reduces incentives to participate in the market for inventions, leading inventors to protect their IP through other means such as trade secrets, R&D alliances, and vertical integration. In the absence of a market for inventions, competitive pressures tend to reduce incentives to invent and to innovate.

There are a number of important works that are related to the market foundation role of patents discussed here. Judge Giles Rich, in a series of writings, emphasizes the importance of patents for innovation. Giles Rich observes, "A time-limited exclusive right to subject matter which was neither known, nor obvious from what was known, *takes nothing from the public which it had before*. As a necessary corollary, the disclosure in a valid patent gives to the

view of patents); see, e.g., Joseph E. Stiglitz, *Economic Foundations of Intellectual Property Rights*, 57 DUKE L.J. 1693 (2008); Carl Shapiro, *Patent Reform: Aligning Reward and Contribution*, in 8 INNOVATION POL. & ECON. 111 (Adam B. Jaffe, Josh Lerner & Scott Stern eds., 2008).

²² See Friedrich Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519 (1945); Friedrich Hayek, *The Pretence of Knowledge*, 77 SWEDISH J. ECON. 433 (1975).

²³ Spulber, *Competing Inventors and the Incentive to Invent*, *supra* note 15; Spulber, *How Do Competitive Pressures Affect Incentives to Innovate when There Is a Market for Inventions?*, *supra* note 15.

public knowledge it did not possess, actually or potentially, and thereby makes for progress.”²⁴ Harold Demsetz points out that the problem of indivisibility of information is best handled by “a private property system that reduces the cost of contracting and raises the cost of free-loading while, at the same time, it provides incentives and guidance for investment in producing information.”²⁵ Robert Merges emphasizes that patents and other IP play an important role in promoting transaction efficiencies by providing protections for the disclosure of information in contract formation and by adding flexibility in contractual enforcement.²⁶

An important contribution by Edmund Kitch argues that the function of patents is to help attract resources to innovative “prospects.”²⁷ Kitch contrasts his “prospects” view of the patent system with the “rewards” view. Patents are “prospects,” because a patent generally discloses an invention *before* it is fully developed and covers *potential* innovations based on that invention. He correctly points out that patents allow owners to coordinate the search for technological and market improvements, invest in innovation based on the invention, invest in distribution and marketing of the invention, contract more readily with providers of complementary information, resources, and financing, avoid duplicating investment of other patent holders, and exercise control over the technology. This article extends Kitch’s insightful analysis and offers an economic framework for understanding the role of patents in the market for inventions.²⁸

F. Scott Kieff’s valuable discussion of patents finds that “the treatment of patents as property rights is necessary to facilitate investment in the complex, costly, and risky commercialization activities required to turn nascent inventions into new goods and services.”²⁹ Furthermore, property treatment is equally necessary to help society decide which inventive activities are worth protecting in the first instance.³⁰ Kieff critiques the “rewards” view of

²⁴ Giles S. Rich, *Laying the Ghost of the “Invention” Requirement*, 1 AIPLA Q.J. 26, 26 (1972) (emphasis in original).

²⁵ Harold Demsetz, *Information and Efficiency: Another Viewpoint*, 12 J.L. & ECON 1, 14 (1969). For a more skeptical view of the market for ideas, see Joshua S. Gans & Scott Stern, *Is There a Market for Ideas?*, 19 INDUS. & CORP. CHANGE 805 (2010).

²⁶ Patents add enforcement flexibility because infringement suits are an alternative to breach of contract. Robert P. Merges, *A Transactional View of Property Rights*, 20 BERKELEY TECH. L.J. 1477 (2005).

²⁷ Edmund W. Kitch, *The Nature and Function of the Patent System*, 20 J.L. & ECON. 265 (1977). Kitch also states “the view of the patent system offered here conceives of the process of technological innovation as one in which resources are brought to bear upon an array of prospects, each with its own associated sets of probabilities of costs and returns. By a prospect I mean a particular opportunity to develop a known technological possibility.” *Id.* at 266; see also Yoram Barzel, *Optimal Timing of Innovations*, 50 REV. ECON. STAT. 348 (1968).

²⁸ *But see* Robert P. Merges & Richard R. Nelson, *On the Complex Economics of Patent Scope*, 90 COLUM. L. REV. 839 (1990). I respond to their arguments later in the present article.

²⁹ F. Scott Kieff, *Property Rights and Property Rules for Commercializing Inventions*, 85 MINN. L. REV. 697 (2001).

³⁰ *Id.* at 703.

patents, pointing out that reward systems do not account for innovative activities after inventions have been made.³¹ He highlights both coordination and investment in commercialization: “The patent right to exclude competitors who have not shared in bearing these initial costs provides incentives for the holder of the invention and the other players in this market to come together and incur all costs necessary to facilitate commercialization of the patented invention.”³² The analysis of the market for inventions presented here encompasses the coordination and commercialization aspects of patents discussed by Kieff.

Richard Epstein emphasizes that exclusivity “seeks to maximize the gains from both the creation and dissemination of protected information.”³³ Epstein demonstrates the fundamental connections between tangible and intangible property. The limited term of exclusion for patents allows the application of rules concerning exclusion, use and disposition in real property, which also is subject to limitations such as antitrust law and the law of private and public necessity. Epstein explains that the evolution of property rights in inventions (and writings) are “a conscious extension of the classical liberal conception of property that is associated with such writers as John Locke, William Blackstone, and Adam Smith.”³⁴

Henry Smith emphasizes the modularity of IP: “The traditional view of markets has a strongly modular flavor, and one role of modular property is to support markets.”³⁵ Smith notes that a modular system involves greater interaction within modules than across modules. IP rights allow the establishment of boundaries by exclusion of others, which allows asset partitioning, greater interaction within modules, usage of local information, and grouping of complementary activities. IP rights also allow interaction and exchange of information across modular boundaries. Smith also emphasizes the reduction of transaction costs by exclusivity in property.³⁶

The article is organized as follows. Section II examines how patents improve transaction efficiencies and competition in the market for inventions. Section III considers how the market for inventions is a market for innovative

³¹ Kieff, *Property Rights and Property Rules for Commercializing Inventions*, *supra* note 29; see Henry E. Smith, *Intellectual Property as Property: Delineating Entitlements in Information*, 116 YALE L.J. 1742 (2007); Daniel F. Spulber, *Should Business Methods Be Patentable?*, 3 J. LEGAL ANALYSIS 265 (2011); James E. Daily & F. Scott Kieff, *Anything Under the Sun Made by Humans: Patent Law Doctrines as Endogenous Institutions for Commercializing Innovation*, 62 EMORY L.J. 967 (2013).

³² Kieff, *Property Rights and Property Rules for Commercializing Inventions*, *supra* note 29, at 710.

³³ Richard A. Epstein, *The Disintegration of Intellectual Property—A Classical Liberal Response to a Premature Obituary*, 62 STAN. L. REV. 455, 458 (2010).

³⁴ *Id.* at 459.

³⁵ Henry E. Smith, *Institutions and Indirectness in Intellectual Property*, 157 U. PA. L. REV. 2083, 2095 (2009).

³⁶ Henry E. Smith, *Exclusion Versus Governance: Two Strategies for Delineating Property Rights*, 31 J. LEGAL STUD. S453 (2002).

control that provides incentives for invention and innovation, promotes selection of the best inventions, allocates inventions efficiently, maximizes gains from trade, and encourages investment in complementary assets. Section IV considers how patents are useful for financing invention and innovation. Sections V and VI discuss implications for IP policy and antitrust policy. Section VII concludes the discussion.

II. TRANSACTION EFFICIENCIES AND COMPETITION IN THE MARKET FOR INVENTIONS

Patents increase the efficiency of transactions and intensify competition in the market for inventions. This is because the patent system offers a sophisticated property rights framework that combines exclusion with other mechanisms that facilitate exchange. Patents are forward-looking, because property rights support market transactions that take place after the patent is granted. The discussion in this section identifies some key elements of the patent system that are fundamental for market exchange.

A. Exclusion

The United States Patent and Trademark Office (USPTO) defines a *patent* as “an intellectual property right granted by the Government of the United States of America to an inventor ‘to exclude others from making, using, offering for sale, or selling the invention throughout the United States or importing the invention into the United States’ for a limited time in exchange for public disclosure of the invention when the patent is granted.”³⁷ Although the present discussion applies to IP generally, my focus is on *utility patents* that “may be granted to anyone who invents or discovers any new and useful process, machine, article of manufacture, or composition of matter, or any new and useful improvement thereof.”³⁸ Inventions include commercial, scientific, and technological discoveries.

The right to exclude provides property rights needed to establish a market for inventions. Patents are forward-looking because transactions, such as licensing and assignments, which are based on patents, generally take place after the patent is granted. Patents protect investment-backed expectations; inventors usually invest in developing and commercializing their inventions after the patent is granted. Patent owners invest in innovation and complementary assets after patents are granted. An inventor’s returns, if any are ever obtained, are based on the inventor’s commercialization efforts and the market value of the invention.

³⁷ *Patents*, UNITED STATES PATENT & TRADEMARK OFFICE, <http://www.uspto.gov/patents>.

³⁸ *Id.* The USPTO also grants design patents “to anyone who invents a new, original, and ornamental design for an article of manufacture” and grants plant patents “to anyone who invents or discovers and asexually reproduces any distinct and new variety of plant.” *Id.*

Patents also are forward-looking because the market value of inventions often is determined after the patent is granted. Exclusivity gives inventors have the opportunity to obtain the market value of their patents. The value of the inventor's asset is determined after the fact and depends on the demand for the invention and the supply of competing technologies. The price of inventions can be explicit for disembodied inventions. The prices of inventions can be implicit for inventions embodied in products, production processes, transaction methods, and firms. The prices of inventions change continually in response to variations in demand for inventions and the supply of alternative technologies.

Patents are forward-looking because, after the patent is granted, the patent owner invests in enforcement by defending challenges of validity, monitoring infringement, and seeking injunctions and damages for infringement. According to the USPTO, "it is up to the patent holder to enforce his or her own rights if the USPTO does grant a patent."³⁹ The patent system provides a legal framework for determining infringement and damages. Legal battles over infringement are a natural aspect of the patent system and do not in themselves indicate problems with patents.

Indeed, the legal costs of the patent system are part of the costs of operating a system of property rights. The number of patent lawsuits constitutes a tiny fraction of the number of active patents. Patent lawsuits are less than two tenths of one percent of patents in force each year from 1920 to 2010.⁴⁰ Patents are only about one percent or less of all civil law suits in U.S. District Courts for almost every year since the Second World War.⁴¹ Some studies of the patent system exaggerate litigation costs by incorrectly counting licensing, settlements, and judgments as social costs rather than economic transfers.⁴²

Many studies that are critical of the patent system tend to emphasize litigation costs without comparing these costs to the economic benefits of the patent system.⁴³ The legal costs of the patent system are relatively low in comparison to the value of IP. For example, Kevin A. Hassett and Robert J. Shapiro

³⁹ *Nonprovisional (Utility) Patent Application Filing Guide*, UNITED STATES PATENT & TRADEMARK OFFICE, <http://www.uspto.gov/patents/resources/types/utility.jsp#heading-1>.

⁴⁰ Ron D. Katznelson, *A Century of Patent Litigation in Perspective* (Working Paper, 2014), available at <http://dx.doi.org/10.2139/ssrn.2503140>.

⁴¹ This does not include the years since the America Invents Act, which increased the number of suits by separating defendants. There was a brief spike approaching 1.5 percent during the 1960s. *Id.*

⁴² See, e.g., James Bessen & Michael J. Meurer, *The Direct Costs from NPE Disputes*, 99 CORNELL L. REV. 387 (2014). Commenting on that study, David Schwartz and Jay Kesan point out that about 75% of alleged litigation costs are actually transfers (licensing, settlement, and judgment). David L. Schwartz & Jay P. Kesan, *Analyzing the Role of Non-Practicing Entities in the Patent System*, 99 CORNELL L. REV. 649 (2014).

⁴³ See, e.g., BESSEN & MEURER, PATENT FAILURE, *supra* note 6; BURK & LEMLEY, PATENT CRISIS AND HOW THE COURTS CAN SOLVE IT, *supra* note 7.

estimate that the value of the intellectual capital in the U.S. economy in 2011 is between \$8.1 trillion and \$9.2 trillion.⁴⁴

Patents generate economic benefits because appropriability of the returns to invention and innovation is critical to the development of the market for inventions. In university licensing, Gaétan de Rassenfosse, Alfons Palangkarya, and Elizabeth Webster find empirical support for the appropriability effect by showing that negotiations involving a granted patent instead of a pending patent are more likely to be successful in fields with more effective IP protections such as biotech, chemicals, medical equipment, and pharmaceuticals.⁴⁵ Lee Branstetter, Ray Fisman, and C. Fritz Foley demonstrate empirically that strengthening patent rights increases technology transfers among U. S. multinationals.⁴⁶

Paul Heald observes that exclusivity reduces the costs of transferring IP by providing asset partitioning that protects both sellers and buyers of patents from expropriation of the idea by the other party. Not only does a patent protect sellers from potential buyers who would steal the idea, it protects buyers from sellers who would use the idea or transfer it to others after the sale takes place. Heald notes that exclusivity in patents is comparable to asset partitioning provided by the corporate form of organization.⁴⁷

Economic historians have documented extensively the importance of the patent system in the establishment of the market for inventions.⁴⁸ B. Zorina Khan's study of the U.S. patent system from 1790 to 1920 finds that "[s]ecure property rights in patented inventions helped to create tradeable assets."⁴⁹ During this period, the U.S. patent system "stood out as conduit for creativity and achievement among otherwise disadvantaged groups" and "comprised a key institution in the progress of technology."⁵⁰ Khan examines the international market for inventions from 1790 to 1930 and shows that international

⁴⁴ Kevin A. Hassett & Robert J. Shapiro, *What Ideas Are Worth: The Value of Intellectual Capital and Intangible Assets in the American Economy* (Working Paper, 2014), available at http://www.sonecon.com/docs/studies/Value_of_Intellectual_Capital_in_American_Economy.pdf.

⁴⁵ Gaétan de Rassenfosse, Alfons Palangkarya & Elizabeth Webster, *How Do Patents Facilitate Trade in Technology?: Testing the Appropriation and Disclosure Effects* (Melbourne Inst. Applied Econ. & Soc. Res., Working Paper, 2014).

⁴⁶ Lee Branstetter, Ray Fisman & C. Fritz Foley, *Do Stronger Intellectual Property Rights Increase International Technology Transfer?: Evidence from U.S. Firm-Level Panel Data*, 121 Q.J. ECON. 321 (2006).

⁴⁷ Heald, *A Transaction Costs Theory of Patent Law*, 66 OHIO ST. L.J. 473 (2005).

⁴⁸ See B. Zorina Khan & Kenneth L. Sokoloff, *History Lessons: The Early Development of Intellectual Property Institutions in the United States*, 15 J. ECON. PERSP. 233 (2001); Naomi R. Lamoreaux & Kenneth L. Sokoloff, *Intermediaries in the U.S. Market for Technology, 1870–1920*, in FINANCE, INTERMEDIARIES, AND ECONOMIC DEVELOPMENT 209 (Stanley L. Engerman, Philip T. Hoffman, Jean-Laurent Rosenthal & Kenneth L. Sokoloff eds., 2003).

⁴⁹ B. ZORINA KHAN, *THE DEMOCRATIZATION OF INVENTION: PATENTS AND COPYRIGHTS IN AMERICAN ECONOMIC DEVELOPMENT, 1790–1920* 314 (Cambridge Univ. Press 2005).

⁵⁰ *Id.* at 221.

trade in patented inventions responded to incentives from IP protections.⁵¹ She finds that greater protections for IP rights encouraged the formation of a global market for inventions.⁵²

An indication of the benefits of IP protection is that companies conducting in-house R&D choose to obtain patents for their inventions. For example, the ten leading patent holders in the US in 2013 were corporations conducting in-house R&D: IBM (6,809), Samsung (4,675), Canon (3,825), Sony (3,098), Microsoft (2,660), Panasonic (2,601), Toshiba (2,416), Hon Hai (2,279), Qualcomm (2,103), and LG Electronics (1,947).⁵³ Extensive and growing patenting by universities and public research organizations also provides evidence of the benefits offered by the patent system.⁵⁴

The growing volume of patent applications provides some evidence that the patent system is an effective institution. Because applying for patents is costly, this provides some indication of inventors' demand for patent protection. The USPTO receives over 500,000 applications per year.⁵⁵ However, increases in the number of patents or the number of citations need not increase innovation and productivity, a phenomenon known as the "patent puzzle." Michele Boldrin and David Levine conclude based on a literature survey that "strengthening the patent regime increases patenting!"⁵⁶ However, evaluating the market value of patents for both disembodied and embodied inventions provides a better indication of the connection between patents and innovation.

B. Transferability

Transferability of patent usage and ownership contributes significantly to the establishment and operation of the market for inventions. Because they are transaction institutions, markets require legal transferability of products. John R. Commons states, "Transactions are the means, under operation of law and custom, of acquiring and alienating legal control of commodities, or legal control of the labor and management that will produce and deliver or exchange the commodities and services, forward to the ultimate consumers."⁵⁷ Technology transfers that occur through infringement, imitation, and spillovers are not market

⁵¹ B. Zorina Khan, *Selling Ideas: An International Perspective on Patenting and Markets for Technological Innovations, 1790–1930*, 87 BUS. HIST. REV. 39 (2013).

⁵² *Id.*

⁵³ Alex Barinka, *IBM Wins Most U.S. Patents for 21st Year in a Row*, BLOOMBERG (Jan. 14, 2014), <http://www.bloomberg.com/news/2014-01-14/ibm-wins-most-u-s-patents-for-21st-year-in-a-row.html>.

⁵⁴ The World Intellectual Property Organization observes a significant increase in patent applications by universities and public research organizations. WORLD INTELLECTUAL PROPERTY ORGANIZATION, *WORLD INTELLECTUAL PROPERTY REPORT: THE CHANGING FACE OF INNOVATION* (WIPO 2011).

⁵⁵ *Nonprovisional (Utility) Patent Application Filing Guide*, *supra* note 39.

⁵⁶ Boldrin & Levine, *The Case Against Patents*, *supra* note 8.

⁵⁷ John R. Commons, *Institutional Economics*, 21 AM. ECON. REV. 648, 648 (1931).

transactions. Patent owners often license patents after infringement occurs, which can convert such technology transfers into market transactions. Kieff emphasizes the importance of patents as property rights for commercialization and identifies problems with liability rules.⁵⁸

Transactions involving disembodied technology include selling patents, licensing patents, and cross-licensing patents. Patent owners may bundle knowledge transfers with patent licensing or transfers, particularly when patent owners are inventors who have tacit knowledge. The returns to selling the bundle cover the market value of the IP and the inventor's costs of codifying and communicating tacit knowledge.⁵⁹ The market for disembodied inventions includes transfers of knowledge, discoveries, ideas, and technologies that are protected by IP other than patents, including trademarks, copyright, and trade secrets. The market for inventions also includes contractual R&D and R&D consortia.⁶⁰ R&D outsourcing contracts and R&D partnership contracts specify ownership of the inventions created by the project. Employment contracts specify who owns inventions created by employees. Contracts for education and training specify ownership of information contained in courses and instruction materials.

The market for inventions also includes goods and services that embody inventions, products manufactured using inventions, and transactions techniques that apply business method inventions. Patents often provide IP protections for inventions embodied in products, production processes, and

⁵⁸ Kieff, *Property Rights and Property Rules for Commercializing Inventions*, *supra* note 29.

⁵⁹ Daniel F. Spulber, *Tacit Knowledge with Innovative Entrepreneurship*, 30 INT'L J. INDUS. ORG. 641 (2012).

⁶⁰ See Arora, Fosfuri & Gambardella, *Markets for Technology and Their Implications for Corporate Strategy*, *supra* note 15 (conducting empirical studies of the market for inventions); ARORA, FOSFURI & GAMBARDELLA, *MARKETS FOR TECHNOLOGY*, *supra* note 15 (conducting empirical studies of the market for inventions); Alfonso Gambardella, Paola Giuri & Alessandra Luzzi, *The Market for Patents in Europe*, 36 RES. POL'Y 1163 (2007) (conducting empirical studies of the market for inventions); Joshua S. Gans, David H. Hsu & Scott Stern, *The Impact of Uncertain Intellectual Property Rights on the Market for Ideas: Evidence from Patent Grant Delays*, 54 MGMT. SCI. 982 (2008) (conducting empirical studies of the market for inventions); Ashish Arora & Alfonso Gambardella, *Ideas for Rent: An Overview of Markets for Technology*, 19 INDUS. & CORP. CHANGE 775 (2010) (conducting empirical studies of the market for inventions); Carlos J. Serrano, *The Dynamics of Transfer and Renewal of Patents*, 41 RAND J. ECON. 686 (2010) (conducting empirical studies of the market for inventions); Alberto Galasso, Mark Schankerman & Carlos J. Serrano, *Trading and Enforcing Patent Rights*, 44 RAND J. ECON. 275 (2013) (conducting empirical studies of the market for inventions); Shigeki Kamiyama, Jerry Sheehan & Catalina Martinez, *Valuation and Exploitation of Intellectual Property*, OECD Sci. Tech. & Indus., Working Paper No. 2006/05, 2006) (discussing empirical studies of the market for inventions); Suma Athreye & John Cantwell, *Creating competition? Globalisation and the Emergence of New Technology Producers*, 36 RES. POL'Y 209 (2007) (discussing empirical studies of the market for inventions); Irene Troy & Raymund Werle, *Uncertainty and the Market for Reform*, Max Planck Inst. Stud. Soc'y, Working Paper No. 08/2, 2008) (discussing empirical studies of the market for inventions); Gans & Stern, *Is There a Market for Ideas*, *supra* note 25 (discussing empirical studies of the market for inventions).

transaction techniques. The market for inventions includes mergers and acquisitions (M&A) involving companies that own or embody inventions. M&A involves the purchase of a firm's assets, including their patent portfolios.

Markets are transaction institutions that are created and managed by individuals and firms.⁶¹ Markets are endogenous to the economy and involve formal and informal rules of exchange that can be characterized as "market microstructure."⁶² Firms that create markets choose profit-maximizing market designs. Firms generate and operate a wide variety of physical and virtual market places, such as stores, websites, intermediaries, and auctions. The market for inventions involves these types of institutions, as do markets for other types of goods and services and financial assets.

The market for inventions includes direct exchange between inventors and adopters of technology and intermediated exchange through a wide variety of market makers, dealers, brokers, insurers, and other specialists. Firms create and operate markets through intermediation, price adjustment, marketing, sales, communication, and other coordination mechanisms.⁶³ Because markets are endogenous, their institutional features depend on the decisions of market-making firms, the characteristics of buyers and sellers that participate in the market, and the types of goods and services that are exchanged. Market institutions can be efficient for the task at hand without necessarily resembling financial commodity markets. Firms create and operate transaction institutions in the market for inventions.

C. Disclosure

Disclosure is often portrayed as a quid pro quo—the patentee provides disclosure of the invention in return for the patent grant. However, disclosure has value to inventors and adopters as a foundation for market transactions. Disclosure provides a description of the invention, the list of claims and other information in the patent that is useful for transactions. It is not necessary for buyers and sellers to spell out all this information every time a transaction occurs. This reduces the costs of licensing and technology transfer contracts. Patents provide transaction efficiencies in a manner that is similar to other forms of ownership registration including securities, real estate, and motor vehicles.⁶⁴

Disclosure reduces potential adopters' costs of determining which technologies are available for licensing or transfer and what types of prior work has been done. This can reduce the costs of innovation for potential adopters.

⁶¹ SPULBER, MARKET MICROSTRUCTURE, *supra* note 4; SPULBER, THE THEORY OF THE FIRM, *supra* note 4; SPULBER, THE INNOVATIVE ENTREPRENEUR, *supra* note 4.

⁶² SPULBER, MARKET MICROSTRUCTURE, *supra* note 4.

⁶³ *Id.*; SPULBER, THE INNOVATIVE ENTREPRENEUR, *supra* note 4.

⁶⁴ Patent ownership also is comparable to incorporation of companies, which provides information about the name, purpose, and location of the company.

Disclosure also reduces the costs to other inventors who can learn about prior art and avoid duplicating past research. Inventors also can benefit by extending and improving existing inventions. Disclosure is also useful for potential adopters, allowing them to reduce their risk of infringement.

Disclosure also increases transaction efficiencies by reducing search costs in the market for inventions. The USPTO provides a centralized searchable database for patents. Potential adopters can reduce their costs of obtaining technology by finding out which patented technologies are available. Inventors also benefit from lower search costs, because disclosure reduces their costs of publicizing their inventions to potential adopters. For university inventions, Daniel Elfenbein finds that “although a majority of technologies are licensed prior to the receipt of a patent, a patent more than doubles the likelihood of finding a license partner.”⁶⁵

Disclosure to the USPTO also mitigates adverse selection in bargaining between inventors and adopters. Adverse selection in bargaining can result in the failure of a buyer and a seller to come to an agreement, even though the transaction would offer gains from trade. When the quality of the seller’s good is observable to the buyer but not to the seller, the seller’s offer may not be sufficient to compensate the buyer. Disclosure increases the information about inventions available to potential adopters, thus reducing asymmetry of information in negotiations between inventors and adopters.

Kieff argues that inventors have incentives to disclose their inventions accurately to the USPTO, so as to increase the likelihood that their patent will be valid if challenged in court.⁶⁶ He points out that disclosure reduces social costs by providing information about property rights, so that registration in itself generates transaction efficiencies.⁶⁷ Kieff emphasizes that the patent system promotes commercialization through incentives for accurate disclosure.⁶⁸ Deepak Hegde and Hong Luo find that information disclosure through patent publications generates transaction efficiencies in the market for inventions and accelerates commercialization of inventions.⁶⁹

D. Certification

The USPTO performs a variety of certification tasks that reduce transactions costs in the market for inventions. These tasks include patent review, which

⁶⁵ Daniel W. Elfenbein, *Publications, Patents and the Market for University Inventions*, 63 J. ECON. BEHAV. & ORG. 688, 691 (2007).

⁶⁶ Kieff, *Property Rights and Property Rules for Commercializing Inventions*, *supra* note 29; F. Scott Kieff, *The Case for Registering Patents and the Law and Economics of Present Patent-Obtaining Rules*, 45 B.C. L. REV. 55 (2003).

⁶⁷ Kieff, *The Case for Registering Patents and the Law and Economics of Present Patent-Obtaining Rules*, *supra* note 66.

⁶⁸ Kieff, *Property Rights and Property Rules for Commercializing Inventions*, *supra* note 29.

⁶⁹ Deepak Hegde & Hong Luo, *Imperfect Information, Patent Publication, and the Market for Ideas*, (Harv. Bus. Sch., Working Paper No. 14-019, 2013).

determines whether the patent satisfies various criteria that determines whether the invention is useful, novel, and non-obvious. The USPTO provides a recognized method of screening and certification that allows market participants to avoid duplicating these costs. The certification role offered by the USPTO and the courts provides generic information that supplements the important certification contributions of specialized market intermediaries.

The USPTO's patent review alleviates adverse selection in the market for inventions by certifying the disclosure of information about the invention. Certification provides potential adopters with more information about inventions than might otherwise be disclosed in transactions involving trade secrets. This reduces the effects of adverse selection, also known as the "lemons" problem, in which bad products drive out good ones. Better information reduces the likelihood that suppliers of higher-quality inventions will exit the market and suppliers of lower-quality inventions will stay in the market, possibly leading to the collapse of the market entirely. Economic analysis shows that adverse selection problems can be alleviated by intermediaries that invest in certifying the quality of goods.⁷⁰

The certification system is accompanied by *ex post* review in the courts that determines not only the validity of patents, but also implicitly provides a check on the patent system itself. The certification system also is subject to *ex post* review in the market for inventions itself. Market transactions provide indications of the performance of the certification system. Simply having a patent does not guarantee that the patent has market value—indeed, many patents do not have market value. The fact that many patents have value provides an indication of the services provided by the USPTO certification system.

Thus, licensing of patented inventions, patent transfers, and the production of goods and services that embody patented inventions provide evidence of the market value of the USPTO certification system. This serves to refute the assertions of some critics that the patent system creates "bad patents." A number of critics suggest that the USPTO's examination processes have generated patents that are invalid in terms of usefulness, novelty, and non-obviousness.⁷¹ Ron Katznelson demonstrates that various studies purporting USPTO standards to be inferior to agencies abroad are based on incorrect

⁷⁰ See Gary Biglaiser, *Middlemen as Experts*, 24 RAND J. ECON. 212 (1993); Gary Biglaiser & James W. Friedman, *Middlemen as Guarantors of Quality*, 12 INT'L J. INDUS. ORG. 509 (1994); Gary Biglaiser & James W. Friedman, *Adverse Selection with Competitive Inspection*, 8 J. ECON. & MGMT. STRATEGY 1 (1999); Daniel F. Spulber, *Market Microstructure and Intermediation*, 10 J. ECON. PERSP. 135 (1996); SPULBER, MARKET MICROSTRUCTURE, *supra* note 4.

⁷¹ See Mark A. Lemley, *Rational Ignorance at the Patent Office*, 95 NW. U. L. REV. 1495 (2001); John R. Thomas, *The Responsibility of the Rulemaker: Comparative Approaches to Patent Administration Reform*, 17 BERKELEY TECH. L.J. 727 (2002); ADAM B. JAFFE & JOSH LERNER, INNOVATION AND ITS DISCONTENTS: HOW OUR BROKEN PATENT SYSTEM IS ENDANGERING INNOVATION AND PROGRESS, AND WHAT TO DO ABOUT IT (Princeton Univ. Press 2004); Mark A. Lemley & Kimberly A. Moore, *Ending Abuse of Patent Continuations*, 84 B.U. L. REV. 63 (2004).

statistical analysis.^{72,73} Katznelson observes that “even accurate patent grant rate comparisons among national patent offices are of little probative value and should not be used as indicators of examination rigor or patentability standards.”⁷⁴

Some critics of the patent system argue that particular types of inventions generate “bad patents.” For example, Robert Merges objects to patenting software and business method inventions, because such technologies were formerly “impossible” to patent.⁷⁵ As I argue elsewhere, business method inventions reflect commercial discoveries and should not be treated differently from traditionally-defined scientific and technological discoveries.⁷⁶ Critics of these types of inventions reflect familiar biases against entrepreneurs and market transactions. There is evidence that software and business method patents are, if anything, higher in quality than other types of inventions.⁷⁷

Certification also reduces transaction costs by determining the identity of the initial patent owner. The US patent system traditionally granted a patent to the inventor that was the first to invent, which required an initial determination of the identity of the first inventor. Under the America Invents Act, the patent is granted to the first to file.⁷⁸ Although there are costs and benefits associated with either system, there are benefits to determination of the initial assignment. This reduces the costs of search in the market place by specifying the assignment of property rights.

⁷² Ron D. Katznelson, *Bad Science in Search of “Bad” Patents*, 17 FED. CIR. B.J. 1 (2008). Katznelson critiques statistical methods used in two studies: Catalina Martinez & Dominique Guellec, *Overview of Recent Changes and Comparison of Patent Regimes in the United States, Japan and Europe*, in PATENTS, INNOVATIONS AND ECONOMIC PERFORMANCE: OECD CONFERENCE PROCEEDINGS 127 (Org. Econ. Co-operation & Dev. 2004); Paul H. Jensen, Alfons Palangkaraya & Elizabeth Webster, *Disharmony in International Patent Office Decisions*, 15 FED. CIR. B.J. 679 (2005).

⁷³ Catalina Martinez & Dominique Guellec, *Overview of Recent Changes and Comparison of Patent Regimes in the United States, Japan and Europe*, in PATENTS, INNOVATIONS AND ECONOMIC PERFORMANCE: OECD CONFERENCE PROCEEDINGS 127 (Org. Econ. Co-operation & Dev. 2004); Paul H. Jensen, Alfons Palangkaraya & Elizabeth Webster, *Disharmony in International Patent Office Decisions*, 15 FED. CIR. B.J. 679 (2005).

⁷⁴ Katznelson, *Bad Science in Search of “Bad” Patents*, *supra* note 72, at 29.

⁷⁵ Robert P. Merges, *As Many as Six Impossible Patents Before Breakfast: Property Rights for Business Concepts and Patent System Reform*, 14 BERKELEY TECH. L.J. 577 (1999) (combining a discussion of the USPTO patent examination process with a presumption that software and business method inventions will lead to bad patents, although these are entirely different questions).

⁷⁶ Spulber, *Should Business Method Inventions Be Patentable?*, *supra* note 31.

⁷⁷ John R. Allison & Emerson H. Tiller, *The Business Method Patent Myth*, 18 BERKELEY TECH. L. J. 987 (2003).

⁷⁸ Kieff, *Property Rights and Property Rules for Commercializing Inventions*, *supra* note 29 (suggesting that a rush to file under the first-to-file rule can lead to inadequate disclosure, resulting in patents being more likely to be found invalid and reducing incentives for commercialization).

E. Standardization

Standardization is an important feature of the patent system that has not received sufficient attention. Although each invention is different, patents have consistent features. Patents are standardized documents with an application number, a bar code, an application date, a date of the grant, names of inventors, names of assignees, a title, an abstract, citations to prior patents, and formal specification of claims. Patents are standardized in terms of duration, which is generally 20 years from the time the application is filed. The patent application procedure and examination process are standardized.⁷⁹ There is a complex set of rules that apply to all patent applications and patent grants.⁸⁰ In addition to these rules, there are standardized legal procedures for patent owners seeking injunctions and damages for infringement.

The patent system provides a set of rules governing licensing and transfer of ownership.⁸¹ According to the USPTO, an assignment must include “all of the bundle of rights that are inherent in the right, title and interest in the patent or patent application.”⁸² A patent licensing agreement “transfers a bundle of rights which is less than the entire ownership interest, e.g., rights that may be limited as to time, geographical area, or field of use.”⁸³ The USPTO maintains public records on assignments.

In general, standardization can improve the efficiency of markets. Standardization allows buyers and sellers to focus their attention on the idiosyncratic features of the transaction at hand. Standardization allows for economies of scale in transactions. Also, standardization allows buyers and sellers to make comparisons with other transactions, thus facilitating competition. Standard definitions of terms lowers the costs of communication and negotiation.

The patent system offers a standard vocabulary that is common usage in market transactions. Patent numbering and public records of patents and applications offer a highly convenient system for asserting IP; it is sufficient for a company to state the patent number or application number on a product or its packaging. Under the America Invents Act, companies have the option of virtual marking by listing a website with patent information. This lowers transaction costs by separating patent marking from product manufacturing and distribution.⁸⁴

⁷⁹ See *Manual of Patent Examining Procedure (MPEP)*, UNITED STATES PATENT & TRADEMARK OFFICE, <http://www.uspto.gov/web/offices/pac/mpep/index.html>.

⁸⁰ *United States Code Title 35—Patents*, UNITED STATES PATENT & TRADEMARK OFFICE, http://www.uspto.gov/web/offices/pac/mpep/consolidated_laws.pdf.

⁸¹ *301—Ownership/Assignability of Patents and Applications*, UNITED STATES PATENT & TRADEMARK OFFICE, <http://www.uspto.gov/web/offices/pac/mpep/s301.html>.

⁸² *Id.*

⁸³ *Id.*

⁸⁴ Corey McCaffrey, *The Virtues of Virtual Marking in Patent Reform*, 105 NW. U. L. REV. 367 (2011).

In the market for inventions, standardization in patents simplifies licensing contracts, technology transfer agreements, and other transactions. The patent document is part of the agreement, and the technology does not have to be fully described each time a transaction occurs. Prices and other contract terms adjust to reflect the unique features of the technology itself and the purposes of the agreement between the buyer and seller. Standardization offered by patents facilitates financial transactions, including the financing of invention and innovation, entrepreneurial finance, and corporate finance.

Standardization in patents reduces transaction costs associated with the development and adoption of technology standards. Patents provide a means for IP owners to convey information to standards organizations. Companies with patents that read on a standard can readily declare patents “essential” to a standard by communicating the patent numbers to the organizations. Companies that develop new technologies related to existing standards can obtain patents for those standards and report those to standards organizations. Companies seeking to adopt technology standards can determine what IP may be relevant to the standard by observing what patents are declared “essential.” Patents serve as standard building blocks for technology standards.

Conversely, technology standards are useful to patent examiners in determining the novelty of inventions. Willingmyre observes, “Standards, publicly available draft standards, and publicly available discussions during standards setting can be a rich source of information about ‘prior art.’”⁸⁵ Willingmyre points out that the “public pair” database at the USPTO contains useful references to technology standards and standard setting meetings.⁸⁶

F. Divisibility

Patents are useful for the divisibility of technology into discrete units. Although there is considerable debate over whether patents should be broader or narrower, patents serve to define boundaries between inventions. This has important benefits for transactions in the market for inventions. Modularity of technologies enhances competition by allowing component-level rivalries without the need to recreate entire systems.

Patents necessarily impose boundaries on inventions as spelled out in patent claims and the specifics of the technological descriptions. There are numerous transaction advantages of the resulting divisibility. The most important benefit of discreteness is that buyers and sellers can enter more easily into transactions that only involve a specific technology. The technology can meet the particular purposes of the adopter without having to purchase a host of costly technologies that they might not need.

⁸⁵ George T. Willingmyre, *Patent Challenges for Standard-Setting in the Global Economy: Lessons from Information and Communications Technology*, NAT'L ACAD. SCI. 1, 10 (2012), <http://sites.nationalacademies.org/PGA/step/IPManagement/>.

⁸⁶ *Id.* at 16.

Patents as discrete inventions are the building blocks for collections of inventions. Patents can be combined to form a patent portfolio. Firms can assemble a portfolio of patents with different technologies to meet their production needs. Buyers can license or purchase patents from different patent owners. Patent bundling offers transaction efficiencies by providing convenience to buyers and sellers. Because they represent discrete inventions, the particular needs of buyers and sellers can be satisfied by choosing the best combination of patents.

By offering divisibility, patents promote efficiency in the organization of firms and industries. A firm need not conduct R&D on all the technologies necessary to produce a product or service. Instead, firms can specialize in a particular type of R&D. Then, buyers can assemble the technologies they need through the market for inventions. In this way, patents help foster *modularity* of technologies, which allows the separation and combination of different parts of a technology platform.

Modularity of technologies generates efficiencies from specialization and division of labor. Different companies can focus on invention, innovation, and manufacturing. Also, companies can focus on different types of R&D. For example, in the computer industry different firms can focus on R&D in software, microprocessors, memory, and screens. This type of specialization improves inventors' knowledge and experience in comparison with what would occur if firms needed to be proficient in all technologies used to produce a particular product.

III. THE MARKET FOR INNOVATIVE CONTROL

Because patents provide protections for developing inventions and creating innovations, the market for innovative control generates efficient investment decisions. The residual returns from licensing, selling, or using patented inventions are only part of patent ownership. Patent owners exercise *residual rights of control*, because they can exclude others from making, using, or selling the invention.⁸⁷ These rights are transferable so that the market for innovative control provides incentives for efficient investments in invention, innovation, and complementary assets. The concept of the market for innovative control is useful because it helps explain patent transfers and what types of firms acquire patents.

A. The Market for Innovative Control and Incentives for Investment

How well patent owners manage innovation affects the market value of patents. The market for innovative control thus provides incentives for patent

⁸⁷ The patent does not grant rights of control because the patent owner is subject to whatever legal and regulatory restrictions might apply. The patent owner thus exercises residual rights of control in commercializing and developing the patented invention.

owners to develop and commercialize inventions and create innovations that are desirable for consumers and producers. After patents are awarded, patent owners can improve the technology, commercialize the invention, and generate innovations based on the invention, as Kitch observed.⁸⁸

Patents provide incentives for efficient invention and innovation because ownership is transferable. Competition among potential adopters helps the market for innovative control allocate patented inventions to the highest-value users. Patent owners have incentives to transfer their IP when others can increase its market value.

The market for innovative control provides valuable guidance for investment in invention and innovation. The market for innovative control determines the returns to invention, commercialization, and innovation. What matters are innovations—that is, the *outputs* of development, commercialization, and application of inventions—rather than the level of inventive and innovative efforts—that is, the *inputs* of R&D and the innovative process. Simply subsidizing invention or rewarding inventive efforts could produce more efforts, but not necessarily better inventions and innovations. Government subsidies or rewards for invention in the absence of IP protections would not provide incentives for development, commercialization or application of inventions, which are essential for diffusion of technology and innovation.

The interaction of demand and supply in the market for innovation control determines the market value of inventions. Inventors compete to supply producers with inventions, and producers compete to obtain inventions or develop their own inventions.⁸⁹ The market value of an invention reflects competition from both substitute and complementary inventions on the supply side of the market for inventions. The market value of inventions depends on the stock of inventions and anticipation of future discoveries that may enhance the demand for particular inventions or render those inventions obsolete. The market value of an invention also reflects the returns to applying inventions obtained by adopters on the demand side of the market for inventions.

A patented invention is an intangible real asset with potentially valuable control rights. The market value of patents is subject to random shocks due to randomness in the outcomes of the development process, in the costs of the development process, and in market valuations of the outcomes of innovation. The market value of the asset also can depend on the extent of the claims in the patent.⁹⁰ The patent owner can invest in development and commercialization,

⁸⁸ Kitch, *The Nature and Function of the Patent System*, *supra* note 27.

⁸⁹ Spulber, *Competing Inventors and the Incentive to Invent*, *supra* note 15; Spulber, *How Do Competitive Pressures Affect to Innovate When There Is a Market for Inventions?*, *supra* note 15.

⁹⁰ Although the emphasis here is on development of the invention, the framework is sufficiently general to include randomness in the legal and regulatory process. This could include randomness in the legal patent validity as discussed in Mark A. Lemley & Carl Shapiro, *Probabilistic Patents*, 19 J. ECON. PERSP. 75 (2005).

so that the probability distribution of the market value of the patent depends on the level of investment. The patent owner can choose among various investment projects with random outcomes, so that the probability distribution of the value of the patent also depends on the choice of projects.

The market for innovative control provides guidance to inventors regarding investment in R&D and the choice of R&D projects. Because market values of individual inventions differ, the returns to producing inventions through R&D depend on how the resulting inventions will be valued in the market. The expected returns to different directions in R&D will depend on scientific and technical opportunities and the potential market value of successful outcomes. Efficient levels of investment in R&D will be targeted to particular areas on the basis of expected returns to different types of inventions.

The market for innovative control also provides guidance on how much to invest in commercialization and how to commercialize particular inventions. Commercialization of inventions requires investment in communication, marketing, and sales efforts. Patent owners also need to identify potential adopters who might license or purchase their inventions. Patent owners need to choose among different methods of commercialization including transfers, licensing, cross-licensing, services, and contract R&D. In addition, patent owners must monitor potential infringement and if necessary invest in the legal costs of obtaining damages and injunctions. The market for inventions contains many types of transactions including embodied inventions. This implies that limited licensing does not indicate market failure, contrary to some studies.⁹¹

Patents are important for commercializing inventions through licensing. Using data from the Securities Data Corporation (SDC), Bharat Anand and Tarun Khanna find significant licensing activity in the chemicals, computers, and electronics industries.⁹² Ashish Arora, Marco Ceccagnoli, and Wesley Cohen apply extensive survey data on research labs in the U.S. manufacturing sector and show that patent protection of IP supports the market for

⁹¹ MARCO CECCAGNOLI, ALFONSO GAMBARDILLA, PAOLA GIURI, GEORG LICHT & MYRIAM MARIANI, SANT'ANNA SCH. ADVANCED STUD., STUDY ON EVALUATING THE KNOWLEDGE ECONOMY—WHAT ARE PATENTS ACTUALLY WORTH?: THE VALUE OF PATENTS FOR TODAY'S ECONOMY AND SOCIETY: FINAL REPORT FOR LOT 1 (2005), http://ec.europa.eu/internal_market/indprop/docs/patent/studies/patentstudy-report_en.pdf; ALFONSO GAMBARDILLA, PAOLA GIURI & MYRIAM MARIANI, SANT'ANNA SCH. ADVANCED STUD., STUDY ON EVALUATING THE KNOWLEDGE ECONOMY—WHAT ARE PATENTS ACTUALLY WORTH?: THE VALUE OF PATENTS FOR TODAY'S ECONOMY AND SOCIETY: FINAL REPORT FOR LOT 2 (2006), http://ec.europa.eu/internal_market/indprop/docs/patent/studies/final_report_lot2_en.pdf; Paola Giuri, Myriam Mariani, Stefano Brusano, Gustavo Crespi, Dominique Francoz, Alfonso Gambardella, Walter Garcia-Fontes, Aldo Geuna, Raul Gonzales, Dietmar Harhoff, Karin Hoisl, Christian Le Bas, Alessandra Luzzi, Laura Magazzini, Lionel Nesta, Önder Nomaler, Neus Palomerias, Pari Patel, Marzia Romanelli & Bart Verspagen, *Inventors and Invention Processes in Europe: Results from the PatVal-EU Survey*, 36 RES. POL'Y 1107 (2007).

⁹² Bharat N. Anand & Tarun Khanna, *The Structure of Licensing Contracts*, 48 J. INDUS. ECON. 103 (2000).

technology licensing and the provision of specialized technology services.⁹³ The market for inventions includes not only domestic markets but also international transactions related to IP; royalty and licensing fees in international transactions grew faster than global GDP reaching \$2.8 billion in 1970, \$27 billion in 1990, and \$180 billion in 2009.⁹⁴

B. Explaining Patent Licensing and Transfers

The concept of the market for innovative control helps to explain why there are patent transfers. Firms have incentives to acquire patents as a means of adding value to the patent. Firms add to the market value of patents when they can improve on the invention, commercialize the invention more effectively, or better develop innovations based on the patent. Firms also have incentives to acquire patents when they can realize economies of scale and scope in the management of IP. Firms also provide additional incentives to acquire patents when they can offer greater capabilities in the management of IP than existing owners. Producers acquire patents that they can apply in developing innovations in products, production processes, or transaction methods.

The concept of the market for innovative control also is helpful in understanding the many types of firms that buy or sell patents. Different types of firms are needed for different types of technologies and for different tasks involved in invention, commercialization, and innovation. Christopher Cotropia, Jay Kesan and David Schwartz point out that many types of companies engage in patent transactions, including universities, individual inventors, mass patent aggregators, failed start-ups and operating companies, patent holding companies, operating companies, IP holding companies owned by operating companies, and technology development companies.⁹⁵

Different business models are an important aspect of the market for innovative control. Because the market for innovative control helps to allocate patents to the highest-value users, the types of firms that acquire patents will be those that provide the greatest market value. In a well-functioning market for innovative control, the business model of the acquiring firm will be the best suited to efficient management of that IP, all other things being equal. Restricting IP rights on the basis of the business model of the firm that owns the patent would create inefficiencies in the market for innovative control.

⁹³ Ashish Arora, Marco Ceccagnoli & Wesley M. Cohen, *Ideas for Rent: An Overview of the Market for Technology*, in FINANCING INNOVATION IN THE UNITED STATES, 1870 TO THE PRESENT 365–403 (Naomi R. Lamoreaux & Kenneth L. Sokoloff eds., MIT Press 2007).

⁹⁴ This is according to the World Intellectual Property Organization. WORLD INTELLECTUAL PROPERTY ORGANIZATION, WORLD INTELLECTUAL PROPERTY REPORT, *supra* note 54, at 9.

⁹⁵ Christopher A. Cotropia, Jay P. Kesan & David L. Schwartz, *Unpacking Patent Assertion Entities (PAEs)*, 99 MINN. L. REV. 649 (2014).

The market for innovative control also allows the entry of specialized intermediaries who can invest in commercialization, innovation, and complementary assets.⁹⁶ The allocation of patents in the market for innovative control implies that there should not be regulatory restrictions on patent transactions and ownership that are based on the characteristics of companies acquiring patents. Various commentators critically refer to some types of firms that acquire patents as “patent trolls,” “patent monetizing entities” (PMEs), “non-practicing entities” (NPEs), or “patent assertion entities” (PAEs). Some types of firms that acquire patents have a particular expertise as market intermediaries.⁹⁷ Market intermediaries perform many types of activities that reduce various types of transaction costs, including search costs, bargaining costs, moral hazard, adverse selection, and contracting costs.⁹⁸ Intermediaries in the market for innovative control reduce transaction costs by evaluating patent quality, handling licensing transactions, or marketing and reselling patents. Intermediaries in the market for innovative control can act as market makers, bringing buyers and sellers together, clearing markets, and adjusting prices.⁹⁹

The market for innovative control also promotes efficiencies in the organization of firms and industries. Weaker IP protections increase transaction costs for inventors and innovators. Inventors and innovators will have incentives to replace patent protections with other mechanisms including trade secrets, contracts and vertical integration.¹⁰⁰ With stronger IP protections, inventors and innovators can make decisions about transactions, outsourcing, and vertical integration based on other business considerations. The market for innovative control generates differences in patent transfers across industries depending on technologies. Carlos Serrano shows that there are surplus enhancing patent transfers and finds that higher rates of transfers occur in information and communications technology (ICT) and the pharmaceutical and medical industries.¹⁰¹ In some industries, consortia form to exercise innovative

⁹⁶ See Tomoya Yanagisawa & Dominique Guellec, *The Emerging Patent Marketplace* (OECD Sci., Working Paper No. 2009/09, 2009), available at <http://dx.doi.org/10.1787/218413152254>; Andrei Hagiu & David B. Yoffie, *The New Patent Intermediaries: Platforms, Defensive Aggregators, and Super-Aggregators*, 27 J. ECON. PERSP. 45 (2013).

⁹⁷ See James F. McDonough, *The Myth of the Patent Troll: An Alternative View of the Function of Patent Dealers in an Idea Economy*, 56 EMORY L.J. 189 (2006).

⁹⁸ See SPULBER, MARKET MICROSTRUCTURE, *supra* note 4.

⁹⁹ See *id.* (discussing market intermediaries); Sannu K. Shrestha, *Trolls or Market-Makers? An Empirical Analysis of Nonpracticing Entities*, 110 COLUM. L. REV. 114, 160 (2010) (“NPEs can serve a valuable role in enhancing innovation by identifying and acquiring high value patents and thereby funding and encouraging some of the most successful inventors.”). Andrei Hagiu and David Yoffie identify different types of patent intermediaries. Andrei Hagiu & David B. Yoffie, *The New Patent Intermediaries: Platforms, Defensive Aggregators, and Super-Aggregators*, 27 J. ECON. PERSP. 45 (2013).

¹⁰⁰ See Ashish Arora, *Contracting for Tacit Knowledge*, 50 J. DEV. ECON. 233 (1996); Ashish Arora & Robert P. Merges, *Specialized Supply Firms, Property Rights and Firm Boundaries*, 13 INDUS. & CORP. CHANGE 451 (2004); Heald, *A Transaction Costs Theory of Patent Law*, *supra* note 47.

¹⁰¹ Serrano, *The Dynamics of the Transfer and Renewal of Patents*, *supra* note 60.

control. For example, in 2011 Nortel Networks sold about 6000 patents and patent applications for \$4.5 billion to a consortium of companies that included Apple, EMC, Ericsson, Microsoft, RIM, and Sony.¹⁰²

As with securities markets, the market for innovative control allows separation of ownership and control. The patent owner can obtain returns from the patented invention while delegating control over innovation to licensees who employ the technology. The patent owner does not need to undertake all the transactions needed to apply the invention, but instead can rely on others to manage the IP. Delegation of control to licensees also provides benefits from specialization and division of labor. The patent owner can obtain returns from licensing, and the licensees can apply their expertise to developing, commercializing and applying the invention.

The market for innovative control promotes gains from trade in inventions. Because patents offer divisibility, as well as exclusivity and transferability, companies can engage in specialized R&D and exchange technologies in the market for innovative control. This allows a division of labor in invention, commercialization, innovation, and manufacturing. Specialization allows companies to take advantage of economies of scale and scope and to build capabilities and expertise. Market exchange of patented inventions generates gains from trade by selection of the best inventions and matching inventions with specialized firms.¹⁰³ The market for innovative control also interacts with the market for corporate control. M&A, including hostile takeovers, provides a mechanism for acquiring patented inventions and improving the management of IP. There is some evidence that complementarities in innovation capabilities help explain M&A.¹⁰⁴

C. Investment in Complementary Assets

The market for innovative control also provides incentives to invest efficiently in *complementary assets*. Assets that are complementary to inventions include human resources, absorption of inventions, IP, product design, capital equipment, marketing, sales, procurement, and establishment of new firms. Patent protections allow companies to make investments in those complementary assets that are specific to particular inventions rather than in generic complementary assets. Invention-specific investment can generate greater economic returns than generic investment.¹⁰⁵

¹⁰² Charles Arthur, "Nortel Patents Sold for \$4.5bn," *The Guardian*, July 1, 2011, <http://www.theguardian.com/technology/2011/jul/01/nortel-patents-sold-apple-sony-microsoft>.

¹⁰³ Daniel F. Spulber, *Innovation and International Trade in Technology*, 138 J. ECON. THEORY 1 (2008); Daniel F. Spulber, *The Quality of Innovation and the Extent of the Market*, 80 J. INT'L. ECON. 260 (2010).

¹⁰⁴ Jan Bena & Kai Li, *Corporate Innovations and Mergers and Acquisitions*, 69 J. FIN. 1923 (2014).

¹⁰⁵ See David J. Teece, *Profiting from Technological Innovation: Implications for Integration, Collaboration, Licensing, and Public Policy*, 15 RES. POL'Y 285 (1986) (discussing the

The following example illustrates how patents help the market for innovative control guide investment in complementary assets. Inventors at Amazon Technologies obtained patent number 8,615,473 B2 for a “[m]ethod and system for anticipatory package shipping:”

According to one embodiment, a method may include packaging one or more items as a package for eventual shipment to a delivery address, selecting a destination geographical area to which to ship the package, shipping the package to the destination geographical area without completely specifying the delivery address at time of shipment, and while the package is in transit, completely specifying the delivery address for the package.¹⁰⁶

The basic invention is the discovery that the delivery address can be specified after shipping has begun. This type of invention is valuable for a major e-commerce company such as Amazon.com because it can improve the speed and efficiency of shipping. Amazon’s services depend on the quality of shipping, which also constitutes a significant part of the company’s costs.

The Amazon patent specifies not only the basic invention but also looks ahead to innovations that will be introduced to the market based on that invention. Among the 24 claims, the patent contemplates different embodiments of the invention, including multiple computer systems that will communicate with each other, with one computer system initiating the shipment and the second computer system determining the destination and communicating with the first computer system.

Implementing a complex shipment system as envisioned in Amazon’s patent will require investment in complementary assets, including computer software and hardware and machinery in the company’s warehouses. To get some idea of the extent of this investment, consider that Amazon has spent over \$5 billion on its facilities in five years, operates 40 fulfillment centers, and has plans to build more. Amazon’s fulfillment center in Phoenix, Arizona covers an area greater than 28 football fields.¹⁰⁷

Amazon’s patent allows it to exclude others from making, using, or selling its business method invention. Amazon’s incentives to develop better shipping techniques are based on the market returns to improved shipping services and the lower costs of more efficient shipping technologies. Amazon has incentives to offer products and services based on its basic invention because of the market returns to developing and implementing its invention. Amazon has incentives to invest in complementary assets such as computers, fulfillment

importance of complementary assets in innovation); David J. Teece, *Reflections on “Profiting from Innovation,”* 35 RES. POL’Y 1131 (2006) (considering the extensive follow-on literature on complementary assets).

¹⁰⁶ U.S. Patent No. 8,615,473 (filed Aug. 24, 2012).

¹⁰⁷ Megan Rose Dickey, *Mind-Blowing Facts About Amazon’s Giant Shipping Operations*, BUS. INSIDER, Nov. 26, 2012, <http://www.businessinsider.com/amazon-fulfillment-center-tour-2012-11?op=1>.

centers, and specialized equipment to realize the full returns to its invention and related innovations. As illustrated by Amazon's shipping method patent, patents protect market incentives for invention, commercialization, and innovation. The market for innovative control provides guidance for what types of inventions to pursue and the direction of subsequent investments in development, innovation, and complementary assets.

IV. FINANCING INVENTION AND INNOVATION

Patents facilitate financing of invention and innovation in two critical ways. First, patented inventions serve as intangible real assets that allow a separation of the invention from the inventor, which is necessary for obtaining financing. In turn, financing helps inventors achieve financial separation between their innovative decisions and their personal consumption and saving decisions. Second, patents reduce the transaction costs of financing for entrepreneurial entrants and established companies, thus generating greater invention and innovation.

A. Patents and Financial Separation

Separation of the invention from the inventor is critical for financing of invention and innovation. Inventors create inventions by applying effort, knowledge, ingenuity, capabilities, insights, and scientific observations. If R&D is successful, the discovery may be valuable in commercial applications or as an input to further R&D. The discovery is the knowledge of the inventor, whether explicit or tacit, so it can be difficult to separate the discovery from the inventor.

The patented invention is an intangible real asset that embodies the inventor's discovery as well as subsequent development of the invention. The separation of the invention from the inventor is analogous to the creation of a firm by an entrepreneur. Stewart Myers observes, "The company starts up with human capital. As and if it succeeds, an intangible real asset is created: the technology is embodied in product design; the production process used, and in the product's reputation with customers."¹⁰⁸ Myers points out that "[t]his real asset separates from the people who created it and can in due course be appropriated by financial investors. The venture could not raise outside money otherwise."¹⁰⁹ The patented invention is a real asset that separates from the inventor who creates it.

By separating inventions from inventors, patents facilitate the financing of R&D for independent inventors, specialized firms, and corporations. Stuart Graham, Robert Merges, Pam Samuelson, and Ted Sichelman find that startups patent to obtain financing as well as to seek a competitive advantage and

¹⁰⁸ Myers, *Financial Architecture*, *supra* note 18, at 134.

¹⁰⁹ *Id.*; see also Stewart C. Myers, *Outside Equity*, *supra* note 18.

deter infringement.¹¹⁰ Pere Arqué-Castells shows that investment by venture capitalists (VCs) funds the development of inventions and increases patenting by startups.¹¹¹ Studies using aggregate industry data tend to show that VC funding tends to increase patenting.¹¹²

By separating inventions from inventors, patents also facilitate the financing of commercialization and innovation. Commercialization is costly because inventors must invest in communicating the discovery to others by codifying it in the form of technical reports, diagrams, blueprints, computer code, statistical analyses, and mathematical formulas. The inventor incurs costs of developing the invention in the form of models, prototypes, equipment, materials, chemical compounds, and biological matter. Financing also allows inventors to innovate by investing in the development of new products, new manufacturing technologies, or new transaction methods. Invention, commercialization, and innovation may be inefficient if inventors do not have sufficient funds to invest in these activities. The inventor may not be able to carry out R&D projects in an efficient way or may not be able to undertake R&D at all. The inventor may not be able to effectively commercialize an invention. Also, the inventor may not be able to develop innovations based on the invention due to limited resources.

Because patents facilitate financing, they allow for another type of separation—that is, financial separation between inventors' innovative decisions and inventors' personal consumption and saving decisions. When inventors have sufficient resources for invention, commercialization or innovation, the conditions of the Fisher Separation Theory apply.¹¹³ Investment projects can be managed efficiently to maximize net present value. In a two-period setting, for example, the optimal investment equates the expected marginal return to investment to the per-unit cost of investment. The optimal investment level is independent of the preferences or endowment of the inventor.

When inventors do not have sufficient resources for invention, commercialization, or innovation, the conditions of the Fisher Separation Theory no longer apply. The inventor cannot achieve the optimal investment level. The inventor's investment decisions are financially intertwined with the inventor's personal consumption and saving decisions.¹¹⁴ Suppose that the inventor is financially constrained and does not have sufficient funds to efficiently invest in innovation. Also, suppose that the inventor cannot obtain financing to develop

¹¹⁰ Graham, Merges, Samuelson & Sichelman, *High Technology Entrepreneurs and the Patent System*, *supra* note 19.

¹¹¹ Pere Arqué-Castells, *How Venture Capitalists Spur Invention in Spain: Evidence from Patent Trajectories*, 41 RES. POL'Y 897 (2012).

¹¹² *Id.*

¹¹³ IRVING FISHER, *THE NATURE OF CAPITAL AND INCOME* (Macmillan 1906); IRVING FISHER, *RATE OF INTEREST: ITS NATURE, DETERMINATION AND RELATION TO ECONOMIC PHENOMENA* (Macmillan 1907); IRVING FISHER, *THE THEORY OF INTEREST: AS DETERMINED BY IMPATIENCE TO SPEND INCOME AND OPPORTUNITY TO INVEST IT*, (Macmillan 1930).

¹¹⁴ See SPULBER, *THE INNOVATION ENTREPRENEUR*, *supra* note 4.

and commercialize the invention. The innovator will be forced to underinvest in innovation, and, if a minimum level of investment is needed, the innovator may be unable to develop the innovation at all. An inventor who cannot transfer the invention to others and is financially and liquidity constrained faces interconnected consumption and investment decisions. The inventor's investment in innovation will reflect his marginal utility of consumption, subjective discount rate, and initial endowment.

The market for innovative control addresses problems resulting from the inventor's liquidity or financing constraints. These problems are readily solved if the inventor can transfer the invention to buyers that do not face such constraints. Buyers that are not subject to these constraints will be willing to pay up to the maximum value of the innovative project. Buyers can develop the innovation efficiently either through investment of their own funds or by obtaining financing for the costs of innovation.

Patents thus generate gains from trade by facilitating the financial separation of inventors' innovative decisions and personal consumption and saving decisions. Inventors who face liquidity and financing constraints will be made strictly better off by transferring the invention to others than by developing innovations themselves. Innovators who acquire inventions benefit by investing efficiently in developing and commercializing inventions.

B. Patents and the Financing of Innovation

Patents also can reduce the transaction costs of financing invention and innovation. Independent inventors and specialized firms can obtain financing for the invention by offering to license or transfer the patent to a company that provides financing. Companies that fund research can obtain an option to license or purchase the inventions after they are patented. If the inventor or specialized firm has already obtained a patent, the patent can serve as collateral for financing to develop the invention and to innovate based on the invention. Nathan Myhrvold recommends the creation of patent-backed securities and suggests that "the business of invention would function better if it were separated from manufacturing and developed on its own by a strong capital market that funded and monetized inventions."¹¹⁵

Patents are intangible real assets that contribute to the market value of the firm. The patent provides IP protections for an investment project with uncertain market value V . Suppose that the firm's assets consist of a patent with expected market value EV . Corporations obtain financing based on their patents. In the balance sheet of a firm financed by debt and equity, the market value of debt and equity equals the expected market value of the firm's intangible real asset, EV .¹¹⁶

¹¹⁵ Nathan Myhrvold, *Funding Eureka!*, HARV. BUS. REV. 1, 3 (Mar. 2010).

¹¹⁶ The market value of the asset can be represented by a random variable V that is distributed according to a probability distribution $F(V)$. The random variable V can be viewed as an

Patented inventions can represent what Myers refers to as “assets in place.”¹¹⁷ Patents that are “assets in place” contribute to the market value of the corporation. The market value of patent ownership reflects the value of own-use of technology, the benefits of cross-licensing, and earnings from licensing. Studies show that patent ownership by corporations contributes significantly to their market value.¹¹⁸ For example, IBM earns about \$1 billion annually from licensing revenues.¹¹⁹ Carol Robbins estimates that in 2002, US corporations reported about \$67 billion in earnings from IP protected by patents and trade secrets.¹²⁰ David Abrams, Ufuk Akcigit, and Jillian Popadak study the effect of patent ownership on the value of companies based on licensing revenues of specialized patent intermediaries.¹²¹

Patented inventions also can represent assets that Myers refers to as “growth opportunities.”¹²² This is because the company can develop the invention, innovate based on the invention, and invest in complementary assets. Also, the company can develop new technologies that extend their patented inventions. Myers points out that assets that are “growth opportunities” can function as call options because they involve investment decisions under uncertainty.¹²³ In this way, patented inventions that are growth opportunities can function as call options.

The capital structure of the firm can affect incentives for investment in invention and innovation. Myers shows that equity financing is best for inducing firms to maximize expected value of projects.¹²⁴ This is because debt financing could cause the firm to avoid some projects that have positive expected value.

investment project. The probability distribution of the value of the asset $F(V)$ can be generalized in various ways. The outcome of the investment project can depend on the level of investment and random shocks.

¹¹⁷ Myers, *Determinants of Corporate Borrowing*, *supra* note 20.

¹¹⁸ See THE ECONOMIC VALUATION OF PATENTS: METHODS AND APPLICATIONS (Federico Munari & Raffaele Oriani eds., Edward Elgar Pub. 2011) (discussing the financial valuation of patents); WILLIAM J. MURPHY, JOHN L. ORCUTT & PAUL C. REMUS, PATENT VALUATION: IMPROVING DECISION MAKING THROUGH ANALYSIS (Wiley 2012) (discussing the financial valuation of patents); Bronwyn H. Hall, *The Stock Market's Valuation of R&D Investment During the 1980's*, 83 AM. ECON. REV. 259 (1993) (discussing the stock market value of R&D investment); Bronwyn H. Hall, Grid Thoma & Salvatore Torrisi, *The Market Value of Patents and R&D: Evidence from European Firms*, 8 ACAD. MGMT. ANN. MEETING PROC. 1 (2007) (discussing the stock market value of R&D investment).

¹¹⁹ Barinka, *IBM Wins Most U.S. Patents for 21st Year in a Row*, *supra* note 53.

¹²⁰ Carol A. Robbins, *Measuring Payments for the Supply and Use of Intellectual Property*, in INTERNATIONAL TRADE IN SERVICES AND INTANGIBLES OF THE ERA OF GLOBALIZATION 139–171 (Marshall Reinsdorf & Matthew J. Slaughter eds., Univ. of Chicago Press 2009).

¹²¹ David S. Abrams, Ufuk Akcigit & Jillian Popadak, *Patent Value and Citations: Creative Destruction or Strategic Disruption?* (Univ. of Pennsylvania, NBER Working Paper No. 19647, 2013).

¹²² Myers, *Determinants of Corporate Borrowing*, *supra* note 20.

¹²³ *Id.*

¹²⁴ *Id.*

Equity financing provides incentives for efficiency in the choice of R&D projects as well.

Debt financing is useful as an incentive mechanism for inducing effort. Michael Jensen and William Meckling argue that with moral hazard, debt financing gives managers incentives for more efficient performance in comparison to equity financing.¹²⁵ Joaquín Poblete and Daniel Spulber show generally that the optimal contract with moral hazard and limited liability takes the form of debt.¹²⁶ This is because debt-style contracts serve to concentrate payments to the agent in the best states, which induces efficient levels of effort. Poblete and Spulber extend this analysis to R&D and show that debt-style contracts are the optimal contract for inducing R&D effort.¹²⁷

Investment in R&D by companies provides evidence that the exclusivity provided by patents protects investment-backed expectations. Carol Corrado, Charles Hulten, and Daniel Sichel consider average annual capital spending from 2000 to 2003 and estimate that companies invested approximately \$640 billion in R&D and development of computer software.¹²⁸ Investment in IP contributes significantly to the market value of companies. Hassett and Shapiro find that 10 of the 24 industries they study hold intellectual capital equal to one-half or more of their total market value and accounts for a significant share of market value in practically every industry.¹²⁹

The role of patents as intangible real assets further shows that patents are not “rewards” for inventors. Inventors are no more rewarded by patents than companies are rewarded by registering securities. Indeed, patented inventions are intangible real assets that are analogous to *financial assets* in various ways. Inventors seeking patents must make filings and disclosures to the USPTO including a description of the invention and information showing that the invention is useful, novel, and non-obvious. Firms selling securities must register those securities with the Securities and Exchange Commission (SEC) and make various disclosures including a description of the security, an explanation of the company’s properties and business, information about the company’s management, and certified financial statements.¹³⁰ Just as each patent is different, so each corporate security is different—Procter & Gamble stock is not the same as ExxonMobil stock.

¹²⁵ Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

¹²⁶ Joaquín Poblete & Daniel F. Spulber, *The Form of Incentive Contracts: Agency with Moral Hazard, Risk Neutrality, and Limited Liability*, 43 RAND J. ECON. 215 (2012).

¹²⁷ Joaquín Poblete & Daniel F. Spulber, *Managing Invention and Innovation: From Delegated R&D to Implementation* (Kellogg Sch. Mgmt, Working Paper No. 2014-048, 2014).

¹²⁸ Carol Corrado, Charles Hulten & Daniel Sichel, *Intangible Capital and U.S. Economic Growth*, 55 REV. INCOME & WEALTH 661 (2009).

¹²⁹ The exception is regulated utilities. See Hassett & Shapiro, *What Ideas Are Worth*, *supra* note 44.

¹³⁰ See *The Laws That Govern the Securities Industry*, U.S. SECURITIES AND EXCHANGE COMMISSION, <http://www.sec.gov/about/laws.shtml>.

V. PUBLIC POLICY TOWARD IP

The present analysis of the market for inventions has implications for public policy toward IP. The design of IP policy should consider the patent system overall, which includes the market for inventions and other private institutions, such as industry consortia and standard-setting organizations (SSOs). The patent system also includes public institutions, which in the U.S. involves all three branches of government. The Congress establishes the rules of the system through legislation such as the 2011 America Invents Act (AIA). The executive branch reviews patent applications and grants patents through the USPTO, which is an agency of the Department of Commerce. Finally, the judiciary adjudicates legal cases involving patent grants and patent infringement. Patent law encompasses a rich set of legal precedents including many Supreme Court decisions.

A. The Market Foundation View vs. the “Rewards” View of Patents

The market foundation role of patents refutes the notion that patents are government-provided “rewards” for inventors. The “rewards” view is a mischaracterization of the purpose and institutions of the patent system. The market foundation role of patents and the “rewards” view suggest substantially different public policies toward IP.

At first glance, it is easy to see why many believe that patents are “rewards” for inventors. The USPTO states, “A patent is an intellectual property right granted by the Government of the United States of America.”¹³¹ Because some patented inventions are quite valuable in the market place, one might well be tempted to conclude that the U.S. government has given a valuable property right to the patentee. Yet the meaning of the word “grant” in this context is not an award, gift, donation, or subsidy. Rather the word “grant” indicates that the government recognizes the inventor’s right to exclude others from making, using, or selling the invention.

The government does not transfer a valuable asset to inventors, but instead recognizes the ownership of the asset by the inventor. The inventor’s efforts, not the government patent grant, generate the invention. The patent grant is based on the features of the invention, the details of the application, and is contingent on whether the invention is useful, novel, and non-obvious. The patent certifies that the inventor meets criteria such as the first-to-invent, or now, the first-to-file.

The “rewards” view of patents is inconsistent with the institutions of the patent system. The returns received by the patent owner are provided by market participants, not by the government. The patent grant does not involve any asset or monetary transfers from the government to the patentee. The

¹³¹ *Patents*, UNITED STATES PATENT & TRADEMARK OFFICE, <http://www.uspto.gov/patents>.

patent grant does not specify the market value of the patented invention, which is determined by the features of the invention and by demand and supply in the market for inventions. In addition, the patent owner's returns are generated by investment in developing, commercializing, and applying the invention. Many of these investments are made after the patent is granted.

The "rewards" view suggests that anticipation of obtaining patents provides incentives for invention. Inventors would not devote effort and make investments in R&D unless they expected to obtain economic returns. However, patent owners only receive the market value of the patented invention net of the costs of invention and commercialization. Inventors bear the risks associated with invention and commercialization. The inventor's R&D project may not succeed and the invention may not meet the criteria for patentability. The patenting process itself is costly and many applicants do not receive patents. Even if the inventor receives a patent, most patents have little if any market value. The patent grant does not provide incentives; rather it provides the basis for further developing the invention, commercializing the technology, and introducing innovations to the market.

The patent grant is not designed to provide a reward for any particular type of invention, as if it were a "prize" for winning a contest, a government subsidy, or an employer bonus.¹³² The patent grant is not a financial reward designed to induce some type of inventive behavior or level of effort. Also, the grant of a patent by the USPTO is not based on the costs of R&D or the efforts of the inventor in making the discovery.¹³³ The patent grant does not reward the inventor for disclosing the invention. As already noted, disclosure provides benefits to both patentees and potential adopters by reducing transaction costs in the market for inventions. Disclosure identifies the features of the invention and helps to guard against infringement.

B. The Scope of Patents

An important implication of the market foundation role of patents is that patent claims should be viewed prospectively. This confirms and extends Kitch's argument that patents should have sufficient scope to encourage further invention and innovation and to foster coordination.¹³⁴ Patents not only recognize creative work, they provide IP protections for future creative work. The patent's claims extend beyond the completed work because inventors and patent owners plan to develop the invention and to invest in innovation. Patents do much of their work after they have been granted. As already noted, the terms of transactions in the market for inventions provide guidance

¹³² See Roin, *Intellectual Property Versus Prizes*, *supra* note 21 (overviewing and discussing the literature that discusses "prizes" for inventors).

¹³³ Spulber, *Should Business Method Inventions Be Patentable?*, *supra* note 31.

¹³⁴ Kitch, *The Nature and Function of the Patent System*, *supra* note 27.

on how to develop the invention, what innovations will apply the invention, what types of complementary assets should be obtained, and financial investments in invention and innovation.

Patents must be sufficiently broad as to provide guidance to inventors, innovators, and investors through the market for innovative control. This policy recommendation contrasts with the “rewards” view of patents, which suggests that patent scope should be narrow to limit the returns to inventors receiving the patent and to open the way for other patents to give additional rewards to future inventors. For example, Robert Merges and Richard Nelson argue that the scope of patents should be constrained, because “[i]n many industries the efficiency gains from the pioneer’s ability to coordinate are likely to be outweighed by the loss of competition for improvements to the basic invention.”¹³⁵ Merges and Nelson are concerned that broad patent scope will discourage “subsequent inventions that not only substitute for the initial invention, but also improve on it in some way.”¹³⁶

The market foundation role of patents supports broader patent scope because patents are forward-looking. Patents increase transaction efficiencies in the market for invention, provide innovative control, and facilitate financing of invention and innovation. These functions encourage competition—property rights increase entry into the market for inventions. Greater financing of invention and innovation increases entrepreneurial entry and competition in the market. Patents can cover development, commercialization, and innovation without ruling out improvements offered by others. Also, the patent examination process and the courts limit the scope of patent claims. Patent owners have incentives to limit the scope of their claims to increase the likelihood that the USPTO will grant the patent. Patent owners also have incentives to limit the scope of claims to reduce the risk that patents will be challenged and found invalid in the courts.

C. Incremental Inventions, “Patent Hold-Up,” and “Patent Thickets”

Another common critique of patents that is based largely on the “rewards” view is that IP rights block incremental inventions.¹³⁷ This concern is applied to both individual patents and to sets of complementary patents, referred to as patent hold-ups, patent thickets, patent logjams, or the anti-commons. Little if any evidence is advanced for these policy concerns.

¹³⁵ Merges & Nelson, *On the Complex Economics of Patent Scope*, *supra* note 28.

¹³⁶ *Id.* at 870; *see also* Robert P. Merges & Richard R. Nelson, *On Limiting or Encouraging Rivalry in Technical Progress: The Effect of Patent Scope Decisions*, 25 J. ECON. BEHAV. & ORG. 1, 22 (1994) (“Inventors are coming up with inventions that the broad prospect holder is challenging in court. The danger is that competitors will be harassed out of the field. There is every reason to believe that this would diminish not only the energy devoted to developing the prospect but also cut down on the diversity and creativity of the development.”).

¹³⁷ *See* Merges & Nelson, *On the Complex Economics of Patent Scope*, *supra* note 28.

However, the history of patents demonstrates that the patent system has accommodated a continual stream of both major inventions and incremental inventions. As Adam Mossoff observes, “From the sewing machine to automobiles to airplanes to radios, incremental innovation is omnipresent in the historical evolution of science and technology.”¹³⁸ George Selgin and John Turner explain how James Watt’s steam engine patent did not prevent subsequent innovations, but “may actually have hastened the development of the high-pressure steam engine by inspiring Richard Trevithick to revive a supposedly obsolete technology so as to invent around them.”¹³⁹

The many contributions of patents to the development of inventions and the introduction of innovations are well documented. Ron Katznelson and John Howells find that “court decisions upholding Edison’s patent generated a surge of patent filings in the incandescent lamp classes.”¹⁴⁰ In the early aircraft industry, Katznelson and Howells find “plentiful evidence of robust US aircraft developments in 1912–1916, the period of the alleged patent hold-up.”¹⁴¹ In the early radio industry, Howells and Katznelson demonstrate that the diode patent was followed by extensive and vigorous development of the later triode technology.¹⁴²

Mark Lemley defines broad categories of technologies as individual inventions and concludes that there were many simultaneous inventors:

Any elementary school student can recite a number of canonical American invention stories. Thomas Edison invented the lightbulb from his famous home laboratory in Menlo Park, New Jersey. Alexander Graham Bell invented the telephone, again from his home invention laboratory, and famously used the phone to call his assistant, saying “Come here, Watson, I need you.” Orville and Wilbur Wright invented the airplane from their bicycle shop, taking it to Kitty Hawk, North Carolina to put it in the air. The list of lone genius inventors goes on and on: Samuel Morse and his telegraph, Eli Whitney and his cotton gin, Robert Fulton and his steamboat, Philo Farnsworth and the television, and so on.¹⁴³

Lemley suggests that incentives for invention, commercialization, or disclosure are not good descriptions of the patent system.¹⁴⁴ Instead, based on

¹³⁸ Adam Mossoff, *The Rise and Fall of the First American Patent Thicket: The Sewing Machine War of the 1850s*, 53 ARIZ. L. REV. 165, 205 (2011).

¹³⁹ George Selgin and John L. Turner, *Strong Steam, Weak Patents, or the Myth of Watt’s Innovation-Blocking Monopoly, Exploded*, 54 J.L. & ECON. 841, 841 (2011).

¹⁴⁰ Ron. D. Katznelson & John Howells, *Inventing-Around Edison’s Incandescent Lamp Patent: Evidence of Patents’ Role in Stimulating Downstream Development and Competition 1* (Working Paper, 2012), available at <http://j.mp/Inventing-around-Edison>.

¹⁴¹ Ron D. Katznelson & John Howells, *The Myth of the Early Aviation Patent Hold-Up—How a U. S. Government Monopsony Commandeered Pioneer Airplane Patents*, INDUS. & CORP. CHANGE (forthcoming 2014) (manuscript at 3), available at <http://icc.oxfordjournals.org/content/early/2014/03/03/icc.dtu003.full.pdf>.

¹⁴² John Howells & Ron D. Katznelson, *The Coordination of Independently-Owned Vacuum Tube Patents in the Early Radio Alleged Patent “Thicket”* (Working Paper, 2014), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2450025.

¹⁴³ Mark A. Lemley, *The Myth of the Sole Inventor*, 110 MICH. L. REV. 709 (2012).

¹⁴⁴ *Id.*

simultaneous invention, Lemley argues that racing is the best description of the patent system.”¹⁴⁵

Howells and Katznelson observe that the problem with Lemley’s analysis stems from his overly broad description of inventions.¹⁴⁶ In practice, there were many inventors of what Lemley refers to as “the lightbulb,” because such technologies typically consist of many inventions. However, the patent system grants patents to inventors for specific inventions not broad technological categories. Howells and Katznelson demonstrate that Lemley’s evidence for simultaneous invention is historically inaccurate.¹⁴⁷ Howells and Katznelson conclude, “But the *direct* purpose of the patent system that Lemley ignores, and from which the other incentives naturally flow, is to encourage *investment* in new inventions *once they have been made and disclosed*.”¹⁴⁸

A related criticism of patents on the basis of the “rewards” view is that IP rights are unnecessary because incremental inventions would occur anyway. According to this view, rewards from patent ownership must be “excessive” because inventors have sufficient incentives to develop inventions with weaker IP rights. Indeed, Lemley suggests that inventors develop distinct inventions “because of an accident or error in the experiment rather than a conscious effort to invent.”¹⁴⁹ Who needs patents if inventors are just stumbling over inventions? Carl Shapiro suggests that when public knowledge advances rapidly, incremental improvements are “in the air.”¹⁵⁰ Shapiro further argues that independent invention is more likely for inventions that are “easily achieved.”¹⁵¹

The market foundation role of patents emphasizes that patents provide transaction efficiencies, innovative control, and financing. These economic benefits are present regardless of whether or not the initial invention was “in the air” or “easily achieved.” In practice, it is difficult if not impossible to distinguish between inventions that are easy or hard to obtain. Inventions often involve a complex mixture of inspiration and hard work. It is also not feasible

¹⁴⁵ Lemley argues that inventors may be racing for patents even if racing is not observed. *Id.* at 751 (“[E]ven among the majority of cases in which we have no evidence of an explicit race, that doesn’t mean that there was no race.”). The notion that the function of the patent system is racing is a variant of the “rewards” view of patents, as inventors race to obtain the patent. Although racing may occur, the market foundation role presented here emphasizes that competition in the market for inventions, which occurs after patents are granted.

¹⁴⁶ John Howells & Ron D. Katznelson, *A Critique of Mark Lemley’s “The Myth of the Sole Inventor”* (Working Paper, 2011), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2123208.

¹⁴⁷ *Id.*

¹⁴⁸ *Id.* (manuscript at 14) (emphasis in original).

¹⁴⁹ Lemley, *The Myth of the Sole Inventor*, *supra* note 143, at 711.

¹⁵⁰ Shapiro, *Patent Reform*, *supra* note 21, at 117; see also Lemley, *The Myth of the Sole Inventor*, *supra* note 143.

¹⁵¹ Shapiro, *Patent Reform*, *supra* note 21, at 117.

to distinguish between inventions that are breakthroughs or “in the air” for the purpose of regulating royalties.

Criticisms of the patent system based on the “rewards” view suggest that patents are granted for inventions that fail the tests of being useful, novel, and non-obvious.¹⁵² These issues have to do with the functioning of the patent examination process and can be addressed through improvements in management and organizational design. However, such administrative issues differ from the question of whether patents support exchange in the market for inventions.

Some complaints about the patent examination process are the product of hindsight. Many inventions that were once useful, novel, and non-obvious no longer are, as technological change reveals alternatives and makes past inventions not only obsolete but quaint by comparison. Rapid technological change can speed up change in subjective perceptions of past inventions.

Another common criticism of patents based on the “rewards” view is that patents restrict innovation by discouraging the use of patented inventions. According to this argument, patent owners can “hold up” infringers by threatening injunctions and damage remedies for infringement.¹⁵³ Infringers are said to be unaware of the patents and surprised by legal claims. The “hold-up” argument further assumes that infringers are locked in to the technology because of high costs of designing around the patented technology and the costs of switching to a new technology. The “hold-up” argument concludes that patent owners will take advantage of these costs to increase royalty demands in license negotiations.

The theoretical “hold-up” argument tends to ignore incentives for coordination through the market for inventions.¹⁵⁴ Patent owners and producers have incentives to contract before any infringement occurs and before producers make complementary investments. Evidence for this comes from extensive investment and industry growth that occurs after licensing and cross-licensing of inventions.

Even after infringement is discovered, patent owners and producers have incentives to negotiate licensing agreements. Patent owners do not have incentives to seek excessive royalties because they benefit from producers’ marketing and sales efforts that increase usage of the patented invention. Patent owners also benefit from producers’ making investments in new products, production processes, and transaction techniques that apply the inventions. Patent owners would not wish to discourage investments in innovation and complementary

¹⁵² See, e.g., *id.* Shapiro recommends applying the “independent inventor defense” in infringement cases, which would eliminate or substantially weaken the exclusion function of patents. *Id.* at 131.

¹⁵³ See, e.g., Joseph Farrell, John Hayes, Carl Shapiro & Theresa Sullivan, *Standard Setting, Patents, and Hold-Up*, 74 ANTITRUST L.J. 603 (2007).

¹⁵⁴ Daniel F. Spulber, *Innovation Economics: Technology Standards, Competitive Conduct and Economic Performance*, 9 J. COMPETITION L. & ECON. 777 (2013).

assets. Also, in practice, producers can develop alternative technologies, license substitute technologies, or pursue alternative activities that do not require the infringed technology. These activities are affected by royalties; excessive royalties would discourage use of the patented invention and encourage the search for alternatives. Market forces including competition from past, present, and future inventions constrain royalties.

D. Public Goods and the Market for Inventions

Critics of the patent system often point out that inventions are “public goods.” Consumption of inventions is “non-rivalrous” in the sense that multiple firms can apply the same invention. Unlike eating a cake, which must be divided among consumers, many firms can use the same invention without depleting the original resource. For example, Joseph Stiglitz states, “I want to emphasize that efficiency *in use* means knowledge should be freely available. The problem is that intellectual property rights circumscribe the use of knowledge and thus, almost necessarily, cause inefficiency.”¹⁵⁵ Again applying the “rewards” view, Stiglitz observes, “The patent system can only be justified, given all its costs, in terms of dynamic efficiency: the benefits that result from an enhanced pace of innovation.”¹⁵⁶

The non-rivalrous or public good nature of inventions by no means implies that technology cannot be allocated efficiently by a system of property rights. Access to patented technology can readily be sold and distributed to multiple users through licensing, cross-licensing, subscriptions, and other types of contracts. There are many types of markets for goods and services that are non-rivalrous but excludable. Markets have long existed for printed matter such as books, newspapers, magazines, and journals, and other types of analog and digital media. Markets also allocate access to shows and movie presentations. All types of video and audio programming are sold and distributed through cable television or streaming over the Internet. Access to other types of content, including news, technical information, education, e-books, games, movies, music, and applications programs (apps), is sold and distributed over the Internet.

The non-rivalrous or public good nature of inventions also does not imply that such goods should be freely available. There are marketing, distribution, sales, and other types of transaction costs for information goods such as inventions. There are also costs of communication and codification of technological information, particularly when the inventor has tacit knowledge that is difficult to transmit to potential adopters.

Even if distribution and transaction costs are zero, inventions should not be freely available because patent owners incur costs of developing the invention,

¹⁵⁵ Stiglitz, *Economic Foundations of Intellectual Property Rights*, *supra* note 21, at 1700 (emphasis in original).

¹⁵⁶ *Id.* at 1706.

creating innovations, and investment in complementary assets. The best way to recover these costs is through a price system. Simply labeling technology as a public good does not imply that inventors should rely on government subsidies obtained from general taxation. Also, labeling technology as a public good does not imply that firms employing the technology should receive it at no cost. Efficiency is achieved by the “user pays principle.” Firms have incentives to make efficient technology adoption decisions and efficient R&D investments when they pay for technology. If there are efficiencies from lower per-unit royalties, access to technology can be sold using a combination of lump-sum and per-unit royalties.

Some critics of the patent system apply inappropriate benchmarks to the market for inventions. These benchmarks are based on the theoretical market model in neoclassical economics, which assumes “rivalrous” consumption. According to Troy and Werle, for example,

[f]undamental and strategic uncertainty related to patent trading—a specific decontextualized institutional form of knowledge property—has prevented functioning markets for patents from emerging. Apparently, patent transactions are not made in perfect, anonymous neoclassical markets. Also, if we define markets less rigidly as institutional fields constituted by sellers and buyers, intermediaries and regulators, sharing rules, standards, and norms which govern transactions, we can hardly speak of a market for patents.¹⁵⁷

This argument is based on the unrealistic definition of markets as centralized auctions, such as organized financial exchanges. The authors also rule out transactions involving intermediaries, regulators, standards, and norms. This definition not only eliminates financial exchanges but also practically any market, because practically any market has a microstructure with these features.¹⁵⁸ Criteria that define almost all markets out of existence should certainly not be applied to patents and are misleading for public policy.

Markets rarely conform to the neoclassical economics paradigm of homogenous goods, anonymous trading through an exogenous auctioneer, price-taking behavior, or rivalrous consumption. This combination of features is absent from practically all markets, and certainly should not be a normative standard applied to the market for inventions. Many markets involve highly differentiated products. For example all properties in commercial and residential real estate differ in terms of combinations of location and building features. Even securities markets have submarkets for the stocks of individual companies. For example the New York Stock Exchange has specialists that make the market for the stock of individual firms. Many markets involve an absence of anonymity such as labor markets or markets for outsourcing contracts. Many markets involve price-setting by sellers or price negotiation between buyers and sellers.

¹⁵⁷ Troy & Werle, *Uncertainty and the Market for Reform*, *supra* note 60 (manuscript at 20).

¹⁵⁸ SPULBER, MARKET MICROSTRUCTURE, *supra* note 4.

VI. ANTITRUST POLICY TOWARD PATENTS

The present analysis of the market for inventions has implications for antitrust policy. Protection of IP and antitrust policy are complements, because protecting IP promotes competition in the market for inventions and in markets for goods and services that embody or are manufactured with patented inventions. Conversely, antitrust policy that favors competition in the market for inventions and in product markets will increase incentives to innovate. This implies that both patent policy and antitrust policy should favor stronger IP rights. Patent policy and antitrust policy should avoid making exceptions to protections of IP rights. Policy makers thus should avoid restrictions of IP rights for arbitrarily-selected cutting-edge technologies such as software, business methods, or biotechnology.

A. Patents and Competition

The many varieties of competition in the market for inventions and related markets refute the common misconception that patents give their owners an economic monopoly. For example, Kenneth Arrow's classic analysis states "[w]ith suitable legal measures, information may become an appropriable commodity. Then the monopoly power can indeed be exerted."¹⁵⁹ Boldrin and Levine argue that patents provide "a monopoly as a reward for innovation" and that there is "little doubt that granting a monopoly for any reason has the equally ill consequences we associate with monopoly power."¹⁶⁰ The patent as monopoly argument has been refuted by John Stuart Mill, Judge Giles Rich, Edmund Kitch, Daniel Spulber, and others.¹⁶¹

¹⁵⁹ Kenneth J. Arrow, *Economic Welfare and the Allocation of Resources for Invention*, in *THE RATE AND DIRECTION OF INVENTIVE ACTIVITY* 609, 615 (Princeton Univ. Press 1962); see also WILLIAM D. NORDHAUS, *INVENTION GROWTH, AND WELFARE: A THEORETICAL TREATMENT OF TECHNOLOGICAL CHANGE* (MIT Press 1969); William D. Nordhaus, *The Optimum Life of a Patent: Reply*, 62 *AM. ECON. REV.* 428 (1972); F. M. Scherer, *Nordhaus' Theory of Optimal Patent Life: A Geometric Reinterpretation*, 62 *AM. ECON. REV.* 422 (1972); Richard Gilbert & Carl Shapiro, *Optimal Patent Length and Breadth*, 21 *RAND J. ECON.* 106 (1990).

¹⁶⁰ Boldrin & Levine, *The Case Against Patents*, *supra* note 8, at 7.

¹⁶¹ JOHN STUART MILL, *PRINCIPLES OF POLITICAL ECONOMY, WITH SOME OF THEIR APPLICATIONS TO SOCIAL PHILOSOPHY* (William J. Ashley ed., Longmans, Green & Co. 7th ed. 1909) (1848); Giles S. Rich, *The Relation Between Patent Practices and the Anti-Monopoly Laws*, 24 *J. PAT. OFF. SOC'Y* 241 (1942); Giles S. Rich, *Are Patent Rights Grants of Monopoly?*, 15 *W. NEW ENG. L. REV.* 239 (1993); Kitch, *The Nature and Function of the Patent System*, *supra* note 27; Edmund W. Kitch, *Elementary and Persistent Errors in the Economic Analysis of Intellectual Property*, 53 *VAND. L. REV.* 1727 (2000); Spulber, *Innovation Economics*, *supra* note 154. John Stuart Mill observes that "the condemnation of monopolies ought not to extend to patents." Fritz Machlup & Edith Penrose, *The Patent Controversy in the Nineteenth Century*, 10 *J. ECON. HIST.* 1, 7 (1950) (citing JOHN STUART MILL, *PRINCIPLES OF POLITICAL ECONOMY, WITH SOME OF THEIR APPLICATIONS TO SOCIAL PHILOSOPHY* 932 (William J. Ashley ed., Longmans, Green & Co. 7th ed. 1909) (1848)).

Advocates of the “rewards” view of patents typically conclude that patents are “excessive” because rewards exceed the inventor’s contribution to social welfare. For example, Stiglitz states, “The fundamental problem is that under the patent system the rewards do not correspond to the marginal social returns.”¹⁶² Similarly, Shapiro argues, “The core problem with the current U.S. patent system explored here is that ... the patent system predictably provides excessive rewards to patent holders. The term ‘excessive rewards’ is defined here to mean rewards that exceed the patentee’s actual contribution to economic welfare.”¹⁶³

There is no empirical evidence for the assertion that patent owners systematically earn “excessive” rewards. In any case, there is no intrinsic value of an invention that departs from its market value. Economic analysis has long identified the value of goods and services as being given by market prices. Competition in the market for inventions strongly suggests that patent owners earn market rewards. A patent does not confer an economic monopoly because access to the market for inventions, markets for products, or financial markets remains unimpeded.

The standard Nordhaus argument is simply wrong because it *assumes* that a patent confers an economic monopoly on their owners.¹⁶⁴ This now standard assumption in the economics and law literatures is inconsistent with reality. Competition in the market for inventions and in the product market that applies inventions means that a patent owner does not receive monopoly rents. This invalidates the standard analysis of patent policy that is based on the economic monopoly assumption.

The standard Nordhaus-style conclusion is that the duration of a patent should be just sufficient for a period of monopoly rents to cover the costs of invention. Even within this overly simplistic framework, it should be noted that more intense competition would dissipate economic rents and therefore would extend the optimal duration of a patent. The duration of a patent is not simply adding up monopoly rewards such that they exactly equal the cost of an invention.

The Nordhaus-style analysis is incorrect for more fundamental reasons. The inventor’s incentives depend on anticipation of the market value of the invention. Patents serve to promote competition among inventors. Greater patent duration increases incentives to enter the market, all other things being equal, which increases competition among inventors. By reducing transaction costs in the market for inventions, patents reduce the costs of entry and operation in that market, also increasing incentives to enter the market and increasing competition among inventors.

Competition in the market for inventions *limits* inventors’ rewards. Entry of inventors and competition in the market for inventions improves the quality of

¹⁶² Stiglitz, *Economic Foundations of Intellectual Property Rights*, *supra* note 21, at 1706.

¹⁶³ Shapiro, *Patent Reform*, *supra* note 21, at 112.

¹⁶⁴ NORDHAUS, INVENTION GROWTH, AND WELFARE, *supra* note 159; Nordhaus, *The Optimum Life of a Patent*, *supra* note 159.

the best inventions. Entry of inventors also increases competition among inventors, which dissipates economic returns to inventors. This suggests that policy makers may wish to strengthen patent protections and increase their duration to increase competition in the market for inventions. A Nordhaus-style analysis will miss the beneficial effects of inventor entry because it assumes that all patents are economic monopolies.

A patent faces competition from past, present, and future inventions. For example, the USPTO issued 276,788 patents in 2012. Patents filed on or after June 8, 1995 have a term of 20 years from the time of filing, so the stock exceeds two million patents. Table 1 shows the number of patents issued in the US from 1963 to 2012.

A patented invention also faces *potential* competition from future inventions. Thus, a patent does not create a barrier to entry into the market for inventions because any other patented invention can enter the market for inventions. Any invention that is novel and thus does not infringe on patented inventions can enter the market for inventions.

A patented invention faces additional competition from inventions that are not protected by IP rights, including inventions that were patented but whose term has expired. For example, patented pharmaceuticals face competition from generics. A patented invention faces competition both within and across the patent categories established by the USPTO. This is because the patent categories have to do with the properties of the inventions, which need not correspond to adopters' uses for inventions. For example, a computer software invention, such as an email program, can compete with a computer hardware invention, such as a fax machine.

The patent system, by creating transferable assets from inventions, translates market competition into incentives for invention, commercialization, and innovation. When there is a market for inventions, competition among inventors increases incentives for invention and innovation.¹⁶⁵ Additionally, when there is a market for inventions, competition among adopters increases incentives for invention and innovation. Without such protections, companies resort to secrecy and vertical integration, which can cause competitive pressures to reduce incentives to invent and to innovate.¹⁶⁶

B. Antitrust Policy and the Market for Inventions

Antitrust policy toward patents should consider their role as the foundation of the market for inventions. This immediately eliminates the false conflict

¹⁶⁵ Spulber, *Competing Inventors and the Incentive to Invent*, *supra* note 15; Spulber, *How Do Competitive Pressures Affect Incentives to Innovate when There Is a Market for Inventions?*, *supra* note 15.

¹⁶⁶ Heald points out that even with vertical integration, IP protections from patents lower costs in comparison to maintaining trade secrets. Heald, *A Transaction Costs Theory of Patent Law*, *supra* note 47.

Table 1. U.S. patent statistics chart calendar years 1963 to 2012

| Year of Application or Grant | Utility Patent Grants, All Origin Total | Design Patent Grants | Plant Patent Grants | Reissue Patent Grants | Total Patent Grants |
|-------------------------------------|--|-----------------------------|----------------------------|------------------------------|----------------------------|
| 2012 | 253,155 | 21,951 | 860 | 822 | 276,788 |
| 2011 | 224,505 | 21,356 | 823 | 1,029 | 247,713 |
| 2010 | 219,614 | 22,799 | 981 | 947 | 244,341 |
| 2009 | 167,349 | 23,116 | 1,009 | 453 | 191,927 |
| 2008 | 157,772 | 25,565 | 1,240 | 647 | 185,224 |
| 2007 | 157,282 | 24,062 | 1,047 | 508 | 182,899 |
| 2006 | 173,772 | 20,965 | 1,149 | 519 | 196,405 |
| 2005 | 143,806 | 12,951 | 716 | 245 | 157,718 |
| 2004 | 164,290 | 15,695 | 1,016 | 298 | 181,299 |
| 2003 | 169,023 | 16,574 | 994 | 421 | 187,012 |
| 2002 | 167,331 | 15,451 | 1,133 | 460 | 184,375 |
| 2001 | 166,035 | 16,871 | 584 | 480 | 183,970 |
| 2000 | 157,494 | 17,413 | 548 | 524 | 175,979 |
| 1999 | 153,485 | 14,732 | 420 | 448 | 169,085 |
| 1998 | 147,517 | 14,766 | 561 | 298 | 163,142 |
| 1997 | 111,984 | 11,414 | 394 | 277 | 124,069 |
| 1996 | 109,645 | 11,410 | 362 | 279 | 121,696 |
| 1995 | 101,419 | 11,712 | 387 | 316 | 113,834 |
| 1994 | 101,676 | 11,095 | 499 | 317 | 113,587 |
| 1993 | 98,342 | 10,630 | 442 | 332 | 109,746 |
| 1992 | 97,444 | 9,269 | 321 | 360 | 107,394 |
| 1991 | 96,511 | 9,569 | 353 | 263 | 106,696 |
| 1990 | 90,365 | 8,024 | 318 | 370 | 99,077 |
| 1989 | 95,537 | 6,092 | 587 | 317 | 102,533 |
| 1988 | 77,924 | 5,679 | 425 | 244 | 84,272 |
| 1987 | 82,952 | 5,959 | 229 | 245 | 89,385 |
| 1986 | 70,860 | 5,518 | 224 | 260 | 76,862 |
| 1985 | 71,661 | 5,066 | 242 | 276 | 77,245 |
| 1984 | 67,200 | 4,938 | 212 | 300 | 72,650 |
| 1983 | 56,860 | 4,563 | 197 | 362 | 61,982 |
| 1982 | 57,888 | 4,944 | 173 | 271 | 63,276 |
| 1981 | 65,771 | 4,745 | 183 | 365 | 71,064 |
| 1980 | 61,819 | 3,949 | 117 | 285 | 66,170 |
| 1979 | 48,854 | 3,119 | 131 | 309 | 52,413 |
| 1978 | 66,102 | 3,862 | 186 | 364 | 70,514 |
| 1977 | 65,269 | 3,929 | 173 | 410 | 69,781 |
| 1976 | 70,226 | 4,564 | 176 | 422 | 75,388 |
| 1975 | 72,000 | 4,282 | 150 | 378 | 76,810 |
| 1974 | 76,278 | 4,304 | 261 | 435 | 81,278 |
| 1973 | 74,143 | 4,033 | 132 | 314 | 78,622 |
| 1972 | 74,810 | 2,901 | 199 | 275 | 78,185 |
| 1971 | 78,317 | 3,156 | 71 | 246 | 81,790 |
| 1970 | 64,429 | 3,214 | 52 | 269 | 67,964 |
| 1969 | 67,559 | 3,335 | 103 | 233 | 71,230 |
| 1968 | 59,104 | 3,352 | 72 | 186 | 62,714 |
| 1967 | 65,652 | 3,165 | 85 | 196 | 69,098 |
| 1966 | 68,405 | 3,188 | 114 | 179 | 71,886 |

Continued

Table 1. *Continued*

| Year of Application or Grant | Utility Patent Grants, All Origin Total | Design Patent Grants | Plant Patent Grants | Reissue Patent Grants | Total Patent Grants |
|-------------------------------------|--|-----------------------------|----------------------------|------------------------------|----------------------------|
| 1965 | 62,857 | 3,424 | 120 | 246 | 66,647 |
| 1964 | 47,375 | 2,686 | 128 | 200 | 50,389 |
| 1963 | 45,679 | 2,965 | 129 | 198 | 48,971 |

Source: *Calendar Year Patent Statistics (January 1 to December 31)*, UNITED STATES PATENT & TRADEMARK OFFICE, <http://www.uspto.gov/web/offices/ac/ido/oeip/taf/reports.htm>.

between patents as monopoly rewards for inventors and antitrust as rent control. The antitrust policy objectives of promoting competition and consumer welfare complement the market foundation role of patents.

Nor does a patent create barriers to entry in product markets. Any product that uses other patented inventions or that uses any technology that does not infringe on the patented invention can enter the product market. Thus, producers that offer products applying a patented invention face competition in the product market. Competition in the product market from firms using other technologies limits the economic returns to a particular invention.

A patented invention faces competition both from inventions that are substitutes and from inventions that are complements. The economics definition of substitute (complementary) products refers to those products whose demand increases (decreases) with an increase in the price of the other products. Products are economic substitutes if some buyers are willing to switch some of their consumption from one good to another in response to changes in the relative prices. The concept of economic substitutes only requires products to be comparable rather than identical, which is referred to as perfect substitutes. Products are economic complements if some buyers derive benefits from joint consumption. Buyers can derive benefits from consuming a selection of complementary products, so that joint consumption of all complementary products is not necessary, in contrast to perfect complements.

Competition and entry of substitutes in the market for invention limits or eliminates the market power of inventions. When inventions are vertically differentiated—that is, buyers can rank inventions consistently on the basis of quality—buyers' willingness to pay for a particular invention is limited by the incremental contribution of that invention to their profits. Inventions other than the best invention are not adopted and inventors need not recover their costs of invention. Buyers will tend to apply the best invention, and royalties are less than or equal to the incremental benefits of the best invention as compared to the best alternative. This outcome corresponds to dominant designs or to technology standards based on the best technology. The best technology is subject to change as new inventions continue to enter the market.

When inventions are horizontally differentiated, multiple technologies may be adopted in the market for inventions. Edward Chamberlin's model of monopolistic competition is useful for characterizing competition in a particular segment of the market for inventions. This model features price setting by suppliers and competitive entry.¹⁶⁷ Although suppliers have pricing power, entry dissipates rents. With up-front fixed-fee royalties, the equilibrium royalty will equal the cost of invention divided by the number of licenses offered by every inventor plus licensing costs. A similar argument can be made when inventors charge a royalty based on the units of output sold by adopters.¹⁶⁸ Even if inventors have pricing power, entry of substitute inventions drives inventors' economic profits toward zero.

Even in the absence of substitutes, inventions compete for economic rents with complementary inventions. The entry of additional complementary inventions tends to diminish the returns to each invention when adopters of the inventions have a given total benefit. This is the case even when complementary inventions are necessary for adopters to produce final products. When complementary inventions are not necessary, competition among inventions constrains the returns to a particular invention based on its incremental contributions to the final products. The presence of substitutes for individual complementary inventions and substitutes for entire technology platforms provide competitive pressures that limit royalties.¹⁶⁹

VII. CONCLUSION

The economic benefits of patents derive from their major contributions to the formation of the market for inventions. The U.S. patent system offers many important features that contribute to transaction efficiencies and increase

¹⁶⁷ EDWARD CHAMBERLIN, *THE THEORY OF MONOPOLISTIC COMPETITION* (Harvard Univ. Press 1933).

¹⁶⁸ Consider Chamberlinian competition among inventors who enter the market to supply different inventions. Suppose that an inventor incurs fixed costs k to produce a new invention, to obtain a patent, and to commercialize the invention. Suppose that an inventor incurs a distribution cost c to license the invention to each licensee, which can be positive or equal to zero. Inventors offer an up-front fixed fee royalty of R to each licensee. Let $D(R)$ be the total number of adopters per invention at a symmetric equilibrium when all inventors offer the same royalty. Let $D'(R)$ be the slope of each inventor's demand when all inventors offer the same royalty. Given the royalties charged by other inventors, each inventor chooses a royalty that maximizes profit taking as given the royalties set by other inventors. For each inventor, the marginal revenue from licensing equals the cost of licensing to an adopter, c , $D(R) + RD'(R) = c$. Inventors conduct R&D and continue to enter the market until each inventor earns a zero profit. The royalty per license equals the average cost of invention and licensing, $R = k/D(R) + c$. Together, these conditions determine the royalty charged by each inventor and the number of inventors that enter the market for inventions.

¹⁶⁹ Anne Layne-Farrar, Jorge Padilla, and Richard Schmalensee consider competition from substitute inventions within categories of complementary technologies. Anne Layne-Farrar, Jorge A. Padilla & Richard Schmalensee, *Pricing Patents for Licensing in Standard-Setting Organizations: Making Sense of FRAND Commitments*, 74 ANTITRUST L.J. 671 (2007).

competition. The patent system provides IP protections that support the market for innovative control. The patent system facilitates financing of invention and innovation. The market foundation role of the U.S. patent system has a proven record of performance, having fostered significant technological change and economic growth.

The market foundation role of patents presents a complex but realistic analysis of invention and innovation. The “rewards” view of patents does not take full account of either public or private institutions that form the patent system. Critics of the patent system often highlight the legal costs of the patent enforcement. The legal costs of the patent system should not be viewed as a reward to inventors, but instead can be better understood as a cost of deterring infringement. Such costs cannot be taken in isolation; they must be weighed against the benefits of generated by the market for inventions.

The analysis in this article suggests that public policy toward IP should be based on long experience with markets for all types of goods, services, and financial assets. Economic understanding of how market mechanisms contribute to allocative and dynamic efficiency extends readily to invention and innovation. The market for inventions, whether in the form of disembodied technology or discoveries embodied in products, services, or production processes, offers efficiencies that are closely related to how markets perform in other areas of the economy. Private ordering offers a variety of institutions such as licensing, cross-licensing, transfers, and contractual R&D for addressing the specific features of invention and innovation.

Antitrust policy toward IP should be based on the tradition of promoting competition and economic efficiency in other types of markets. The market foundation role of patents shows that stronger IP rights increase competition, innovation, and consumer welfare. Antitrust policy most effectively promotes innovation, competition, and transaction efficiency when it recognizes the market foundation role of patents.