Opting Out of Liability Rules

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Kristelia García, *Super-Statutory Contracting*, __ **Wash. L. Rev.** __ (forthcoming, 2020), available at SSRN.

Economic activities often conflict: a rancher's stray cattle may reduce the value of a neighboring farmer's crops, or a tech company's file-sharing app may reduce the value of music labels' records. When conflicts arise, society needs to decide which party's interest to protect, and whether to do so with a property right or a liability rule. The law and economics literature teaches that lawmakers should devise entitlements while taking into account post-allocation transaction costs, with the goal of ensuring that resources end up in the hands of parties who put them to their most productive use.

Scholars have accordingly debated the relative performance of property rights and liability rules. In a seminal article, Rob Merges famously argued that one should not worry too much about transaction costs accompanying property rights. Should these prove prohibitive (as in the case of radio stations who need to license rights to many musical compositions that they wish to play over the air), and the property right choice inefficient, IP owners are likely to "contract into liability rules";[1] that is, they will privately arrange liability-rule-based licensing schemes (such as ASCAP) to lower licensees' costs of access.

In a wonderful new article, Kristelia García reviews recent market dynamics that lend support to the mirror-image argument; namely, that one should not overstate the arguable inefficiencies of liability rules.

Through a series of case studies of privately ordered deals, she shows how time and again IP owners have opted out of their statutorily-dictated liability rule protections and have in effect transformed them contractually into either property rights or differently delineated liability rules. Importantly, García argues, this form of private ordering has resulted in a stronger form of protection than that allocated to IP owners statutorily. Examples include YouTube's Content ID agreement (allowing content owners to prevent infringing uploads ex-ante rather than only remove them ex-post under section 512 of the Copyright Act); or the 2012 Big Machine-Clear Channel Communications deal (creating a new terrestrial public performance right protected by a negotiated-rate liability rule where none exists statutorily). Analyzing these deals, García concludes that a new and additional consideration – right holders' "perceived control", i.e. their ability to grant or withhold permission to use their work and to set terms for its use—should guide lawmakers' choice between property rights and liability rules.

Where does García's article leave us? It seems that when transaction costs become substantial and may hinder owners' ability to profit from their entitlements, they would rationally engage in market and institutional innovation in order to reduce transaction costs and get licensing deals done. They would do so regardless of whether the initial entitlements allocated were property rights or liability rules. Either way, when the initial entitlement proves inefficient, IP owners are expected to contract around the statutory default. This tends to suggest that the choice between property rights and liability rule protection, while important, should not be overstated (especially in an age where parties' ability to contract around statutory defaults is aided by technological advancements in detecting, measuring and charging for use). This realization should not come as a surprise, but merely as a reminder of the Coase

Theorem that whenever transaction costs are zero, bargaining will lead to the efficient result regardless of the initial allocation of entitlements.

As we approach a zero transaction costs world (or some attainable lower bound), should we care about the property right vs. liability rule debate? Even if transaction costs are zero, the legal rule still affects the division of surplus between the transacting parties. As I have shown elsewhere,[2] in cases where parties make investments ex-ante (i.e. at a time prior to transacting, so the investments cannot be subject to negotiation), the ex-post division of surplus affects their ex-ante incentive to invest. Thus, the choice between property rights and liability rules in IP should be made primarily in light of its effect on parties' ex-ante incentives to invest rather than in view of ex-post transaction costs.

Be that as it may, García's article eloquently reviews recent deals in which IP owners engaged in contractual and institutional innovation to contract around inefficient default liability rules and at the same time managed to assert greater control over their content. It is an enjoyable and worthwhile read that makes an important contribution to a longstanding and venerable debate.

1. Robert Merges, *Contracting into Liability Rules: Intellectual Property Rights and Collective Rights Organizations*, 84 **Cal. L. Rev.** 1293 (1996). In a subsequent article, Mark Lemley has shown that parties can also contract around inefficient liability rules, see *Contracting Around Liability Rules*, 100 **Cal. L. Rev.** 463 (2012).
2. Dotan Oliar, T*he Copyright-Innovation Tradeoff: Property Rules, Liability Rules, and Intentional Infliction of Harm*, 64 **Stan. L. Rev.** 951 (2012).

Dotan Oliar, *Opting Out of Liability Rules*, JOTWELL (May 14, 2020) (reviewing Kristelia García, *Super-Statutory Contracting*, __ **Wash. L. Rev.** __ (forthcoming, 2020), available at SSRN), https://ip.jotwell.com/opting-out-of-liability-rules/.