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Generalized Freedom to Operate

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Freedom to operate (FTO) refers to the ability of a company to develop, produce, and market products without legal liabilities for infringement on intellectual property rights (IPRs) held by third parties. Establishing FTO is an integral part of the process of innovation in today's IPR-rich environment. Prior to committing funds to develop a product, a firm must identify valid third-party IPRs, the infringement-related risk that proceeding with the development of the product entails, and strategies to manage the risk. In current practice, firms establish FTO through an opinion based on patent search (an activity for which an industry has been called into existence because of patent proliferation), through a cross-licensing agreement between parties holding patent portfolios that might trigger infringement depending on the precise nature of a prospective commercial undertaking, by acquiring patent rights, or through a similar but less costly stratagem of defensive publishing (which in theory prevents others from acquiring patents).

The risk of being sued for infringement of intellectual property is, however, only one of many risks faced by firms whose value depends on their intangible assets when they enter products into domestic and international markets. For the modern multinational enterprise, the ability to protect intangible assets and to recoup investments when entering foreign markets influences decisions as to *how* to operate in various countries.

In their production decision, firms choose whether to conduct specific activities in-house, to out-source domestically or off-shore at arm's length, to invest abroad and obtain inputs

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through intra-firm trade, to license production of inputs to firms abroad or to enter into joint ventures. In marketing their products, they face a similar range of options. The various decisions combine to define the boundaries of any given firm; this insight invokes a massive literature starting with Coase (1937).

Importantly, the choices made by firms depend not only on technical considerations concerning the nature of the production and marketing processes but on considerations concerning the institutional environment in which the products are developed, produced and marketed.

Technical considerations include, for example, economies of scale in production (which point to concentrating production activities in one location), location of key inputs (either raw materials or technically skilled personnel), production costs (including transportation and border costs in case of off-shored activities that form part of the firm's value chain), the role of tacit information (i.e., information that cannot be codified for purposes of out-sourcing), and issues of process management (just-in-time delivery, coordination of activities, etc.). The extensive literature on governance of global value chains (GVCs) explores these issues in depth (see, e.g., Sturgeon, 2007, for an accessible summary).

Institutional considerations include the ability to write contracts that capture quasi-rents and to have the contracts enforced (Antras, 2003; Antras and Helpman, 2004; Antras and Helpman 2008), the ability to prevent knowledge spillovers in destination countries that reduce profits (Blomström and Kokko, 2003), and assurance against *de jure* or *de facto* expropriation by foreign governments (Azzimonti and Sarte, 2007).

The institutional context generally imposes additional constraints on firms' freedom to choose an optimal form of organization over and above those based on the technical constraints alone. Accordingly, the international institutional context can be said to restrict firms' freedom to operate globally in much the same way that third-party IPRs restrict firms' freedom to operate in product development in the narrow traditional sense of this term. By the same token, changes to the institutional context that remove institutional constraints expand firms' freedom to organize their international engagement on an optimal basis.

The concept of freedom to operate thus generalizes readily to cover the various features of an institutional setting that create risk to the value of a firm, ranging from leakage of trade secrets, to IPR infringement, to de facto expropriation of a profitable line of business through regulatory change or competition from a state-owned enterprise.

Viewed through this lens, modern trade and investment agreements like the Trans-Pacific Partnership can be conceptualized not only as reducing transactional costs of international business but as expanding what might be termed the "generalized freedom to operate" (GFTO) through their disciplines on intellectual property, investment (including freedom of capital flows and investor-state dispute settlement), state enterprise (e.g., through imposing on governments the principle of competitive neutrality when engaging in commercial activity), and government procurement.

Expanded GFTO implies additional cost reductions because it frees firms to choose the most cost-effective means of organizing their international engagement, whether by extracting value from their knowledge assets in the form of cross-patenting in the destination country, licensing of technology to firms in the destination country, joint ventures, FDI, or exports of high technology goods that could be reverse engineered.

From conventional economic analytical perspectives, measures in trade and investment agreements that build in these protections unlock FDI by raising the institutional quality of destination countries (Alfaro et al., 2003). Investing firms obtain access to new profit streams from new markets; destination countries benefit from the inflow of capital and positive spillovers from the presence of multinational firms on suppliers and customers, although they face risk of FDI crowding out domestic suppliers and minimizing horizontal spillovers to potential domestic competitors.

If there is imperfect substitutability across modes of international engagement, which is almost certainly the case, an improvement in the institutional setting that permits mode switching would expand firms' profits and thus the rate of return on their capital.

In this way, GFTO enhances the value of the intangible assets of firms operating internationally as traders, as participants in GVCs, or as foreign investors, including the value of their capital based on profit expectations, a consideration pertinent to the inclusion of investor-state dispute settlement mechanisms in trade and investment agreements. This asset valuation gain can dominate the cost-benefit calculus. The market valuation of an increase in the rate of return on capital is based on the present value of the discounted future stream of earnings. This is an order of magnitude greater expressed as a percentage of the value of capital stock as the increase in the rate of return, expressed the same way. Market cap in turn represents competitive advantage for firms in M&A activity where the big swallow the small.

GFTO explains how the chapters of trade and investment agreements that cover intellectual property, competition policy, investment, and government procurement combine to create commercial flexibility to choose optimal forms of international operation, in the broader sense implied by Balsillie (2016).

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