The Availability Of Post-Sale Contractual Restrictions In The Wake Of *Impression Products, Inc. v. Lexmark*, 581 U.S. 1523 (2017)

By Tim Scott

In *Impression Products, Inc. v. Lexmark International Inc.*, 581 U.S. ___, 137 S. Ct. 1523 (2017), the United States Supreme Court reaffirmed the patent exhaustion rule; *i.e.*, patent rights are exhausted upon the first sale of the patented item such that the patentee has no rights to impose any post-sale conditions or limitations on the use of the product, at least under the patent laws. *Id.* at 1529. In doing so, the Court left open the question of whether such conditions or limitations could be imposed as a matter of contract law. Thus, the "restrictions in Lexmark's contracts with its customers *may have been* clear and enforceable under contract law, but they do not entitle Lexmark to retain patent rights in an item that it has elected to sell." *Id.* at 1531 (emphasis added). In summarizing its decision in *Quanta Computer, Inc. v. LG Electronics, Inc.*, 533 U.S. 617 (2008) ruling that the sale of computer components exhausted the plaintiffs patent rights in those components, the Court noted that it reached that conclusion "without so much as mentioning the lawfulness of the contract." *Lexmark*, 137 S. Ct. at 1533. And it later summarized its holding by stating that "*whatever rights Lexmark retained* are a matter of the contracts with its purchasers, not the patent law." *Id.* (emphasis added).

Of course, since contract law is a matter of state rather than federal law, it is likely that the contours of a sellers right to control the use of the products it sells is likely to be developed by state courts, far away from the Supreme Court. This article approaches how those courts should address that issue; *i.e.*, while the Supreme Court left open the door to the contractual imposition of limitations on the rights of ownership, how wide is it ajar?

A. Contract Rights vs. Property Rights

The question of whether a seller may impose restrictions or limitations upon his immediate purchaser seems straightforward and to have few public policy implications. Certainly, any two parties are free to contract as they wish and to make whatever mutual promises they find to be in their interests, subject to otherwise applicable legal or public policy impediments (*e.g.*, agreements to fix prices or otherwise restrain trade or competition). A sale or purchase of a good can be accompanied by a promise not to use that good in a particular way, or only in a particular field or geography. Such a promise would be enforceable against the promisor by way of injunction or damages. While some commentators have speculated whether such restrictions are consistent with the patent laws or might be subject to a preemption or Supremacy Clause challenge (Alfred C. Server & William J. Casey, *Contract-based Post-Sale Restrictions on Patented Products Following Quanta,* 4 HAST. L. J. 561 (2013)), it would seem incongruous that a patentee would have fewer rights than the seller of a non-patented item. But in the case of a contractual restriction between seller and purchaser, the promise is personal to the promisor and only he is answerable for any breach thereof.[1]

The question of whether to allow a seller of goods to impose upon subsequent purchasers limitations or restrictions on their use of such goods is a different question. Such restrictions have been referred to as "equitable servitudes" in analogy to real property law. As the court in *Transworld Airlines, Inc. v. American Coupon Exchange, Inc.*, 913 F.2d 676, 688 (9th Cir. 1990) phrased it, it is a question of whether the restriction is viewed as matter of contract rights (personal to the promisor) or *in rem* property rights:

> Contract rights generally arise between persons in an ongoing relationship, usually commercial. Those parties deal with each other, or not, depending upon the extent to which they can satisfy each other's needs and promote each other's purposes. There may be good reason to conclude in this situation that if a contractual restriction… should for some reason become outdated, impractical, or unduly onerous, [the parties] can work it out between themselves. In contrast, property rights (at least in the typical case of tangibles) often survive all of the persons who were

1. Whatever restrictions imposed in this matter must be a part of the basis of the bargain between the parties, as the restrictions are a personal promise on the part of the purchaser rather than an intrinsic quality of the goods in question. Thus, a simple label on goods purporting to restrict their use would be insufficient in this regard, as such a label is not sufficient to constitute a promise by the purchaser. Indeed, such terms would constitute additional terms under Uniform Commercial Code §2-207 and, because such restrictions on title or use would presumably be material, they would not become part of the contract.

> involved in their creation. As a result, enforcement of restrictions on the alienation of property might often tie up a social resource long after the death of the only people with the power to remove the restraint.

Id. at 688-89. The resolution of whether post-sale restrictions should be viewed as contractual promises personal to the promisee or *in rem* property rights in favor of the seller involves the balancing of two competing considerations: (1) the right of parties to contract as they wish and to have their intentions enforced by the law, as balanced against (2) the antipathy toward restraints on alienation and the desire to facilitate the free flow of goods in commerce without the creation of externalities.

B. Equitable Servitudes as a Potential Solution

A number of courts have created, and some commentators have suggested, *in rem* property rights for the benefit of sellers through a theory of equitable servitudes. The seminal work regarding equitable servitudes on personal property is Zechariah Chafee, *Equitable Servitudes on Chattels*, 41 Harv. L. Rev. 945 (1928), exploring the historical antipathy toward such servitudes and suggesting their usefulness in accommodating then-prevalent business practices. Professor Chafee then revisited the issue in *The Music Goes Round and Round: Equitable Servitudes and Chattels,* 69 Harv. L. Rev. 1250 (1956) and, in assessing one of the few cases imposing such servitudes, *Pratte v. Balatsos*, 113 A. 2d 492 (N.H. 1955), suggested a more cautious approach.

Though not widespread, there is some authority post-dating Professor Chafee's article supporting the imposition of equitable servitudes on chattels to enforce against subsequent purchasers restrictions imposed on the use of goods at the time of their original sale. See Glen O. Robinson, *Personal Property Servitudes*, 71 U. Chi. L. Rev. 1449 (2004). Most if not all of that authority relies upon a simple analogy to real property and a rather simplistic approach of "why not" apply equitable servitudes to personal property.

The most forceful and explicit of these authorities is *Nadell & Co., Inc. v. Grasso*, 175 Cal. App. 2d 420 (1959). There, branded goods (fruit cups) were damaged in transport. The shipper sold the damaged goods on condition that they not be re-sold in retail without changing the labels on the product. This restriction was imposed to protect the brand of the company whose goods were damaged. The purchaser resold the goods, and the subsequent purchaser then disposed of the goods in retail without changing the labeling. The court found that the damaged goods were subject to an equitable servitude in favor of the original purchaser, preventing their entry into the retail market. The court relied in its reasoning upon those cases affirming the constitutionality of the various Fair Trade Acts authorizing resale price maintenance practices (since repealed); "If equitable servitudes on chattels can be sustained on the theory that the producer has a proprietary interest therein for the benefit of his business, why not the purchaser-retailer of damaged goods?" *Id.* at 431, *see also Id.* at 427-29. The court also relied on analogies to real property: "Absent any California case directly on point, and none has been cited, we can only dispose of the question by analogy to what is already settled. As they involve realty, many covenants, though personal, are enforceable in equity against subsequent grantees and assignees who acquire the land with notice." *Id.* at 430. Notwithstanding the foregoing findings, the court limited its holding to "the peculiar, and perhaps unique, facts at bar." *Id.* As at least one federal court subsequently observed, "*Nadell* is an isolated, 1959 appellate case that does not appear to have ever been cited as good law." *Sebastian Int'l, Inc. v. Russolillo,* 186 F. Supp. 2d 1055, 1074 (C.D.Cal. 2000).

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The same year that *Nadell* was decided, the Fifth Circuit issued its decision in *Tri-Continental Financial Corporation v. Tropical Marine Enterprises, Inc.*, 265 F.2d 619 (5th Cir. 1959). There, a boat was sold with a covenant that it not be used to compete with the seller on a specific route. A mortgagee of a subsequent purchaser of the boat (who acquired the boat with knowledge of the restriction) sought to foreclose on the boat free of the restrictions contained in the sale. The original seller of the boat intervened to seek to enforce those restrictions. Finding the covenant-not-to-compete reasonable in scope, the court enforced the covenant against the subsequent purchaser, relying primarily on analogies to real property and rejecting any distinction for equitable servitudes for chattels: "appellant makes too much of early and over-technical common law considerations distinguishing between covenants with respect to chattels and those with respect to land, too little of equitable considerations in dealing with both." *Id.* at 625.

In *Clairol v. Sarann Co., Inc.*, 37 Pa. D. & C.2d (1965), the plaintiff marketed a professional and retail version of its hair coloring products. The lower-priced professional version omitted any instructions for its use and was packaged in six-packs, while the retail version was individually packaged and contained instructions for use. The defendant purchased professional versions of the product, dissembled the six-packs and sold individual bottles at retail. The plaintiff was awarded an injunction. Despite finding that the plaintiff was entitled to this relief under the unfair competition law, the court went on to address plaintiff's argument that it had an equitable servitude on the professional bottles of its hair color-

ing that limited their use to a non-retail setting."Where public policy or some other determinative consideration is not involved, why should the law adopt an immutable principle that no restrictions, reservations or limitations can ever be allowed to accompany the sale of an article of personal property?" *Id.* at 451, quoting *Waring v. WDAS Broadcasting Station, Inc.,* 327 Pa 433, 444-48 (1937). Clairol has never been cited by another court for its equitable servitude ruling.[2]

In addition to these decisions, some commentators have supported the concept of imposing equitable servitudes on chattels. Most prominent among these is Glen O. Robinson, "Personal Property Servitudes," 71 U. CHI. L. REV. 1449 (2004). Professor Robinson argues that the power to restrict use is intrinsic to the power to transfer, fundamental to the concept of property rights, and the "right" of a secondary purchaser to unfettered title should not trump the right of the initial owner to limit the rights that he transfers. *Id.* at 1462. He concludes that "translating servitude principles from real property to personal property thus seems to me reasonably straightforward" and then devotes the balance of his effort to intellectual property applications and attempts to refute the various arguments regarding why personal property servitudes should not be allowed.

C. The Flaws of Applying Equitable Servitudes to Personal Property

Both the cases and the commentators rely for their arguments on a too-easy analogy to real property, ignoring the critical distinctions between that and personal property. There are at least four distinctions critical to the present issue: (1) real property is immovable and unique; (2) real property, in general, constitutes a significant investment in capital; (3) real property is the subject of recording statutes; and (4) real property generally does not change hands with any rapidity. These distinctions have real and practical consequences.

Because real property is unique, it requires investigation as to what is being purchased. One does not simply buy "40 acres" like one would purchase a crescent wrench. Rather, each 40 acres is different than another, requiring some investigation as to its unique qualities. Personal property is much less so, though with increasing sophistication and expense (televisions, automobiles, heavy machinery) additional investigation is required in order to determine the qualities of what is purchased. Even at the highest levels, it is difficult to conceive of any truly unique personal property (with the possible exception of art, as to which there are entire industries devoted to determine the qualities and provenance of what is purchased). Second, because, in general, the purchase of real property is a significant capital expenditure, the risk of that expenditure merits the additional investigation required in order to choose wisely. Third, the investigation into what rights are or are not granted in connection with the purchase of real property are facilitated by the recording statutes of each state. These statutes significantly decrease the time and expense of determining those rights. Fourth, commerce does not depend upon the rapid and easy transfer of real property. Indeed, if property holdings were frozen in their current state, it is not difficult to conceive of the economy progressing largely unaffected. By contrast, if the transfer of personal property were eliminated, or severely restricted, our economic systems (and most others) would be in jeopardy of immediate collapse. For these reasons, among others, a simple analogy to real property in order to create equitable servitudes on personal property are not sufficient.

The better view is that equitable servitudes on chattels are both detrimental and unnecessary. In *Optimal Standardization in the Law of Property: the Numerus Clausus Principle,* 101 YALE L. J. 1 (2000), Professors Thomas Merrill and Henry Smith observe that the common law has implicitly adopted, as a rule of construction rather than as normative law, the civil law principle of *"numerus clausus"* (in English, "the number is closed"), a principle which limits the form of ownership, whether of real property or personal property, to a set of pre-defined and standardized forms.[3] Implicitly employing the *numerus clauses* principle, the courts

> treat previously-recognized forms of property as a closed list that can only be modified by the legislature. This behavior cannot be attributed to any explicit or implicit command of the legislature. It is best described as a norm of judicial self-governance. Jurisprudentially speaking, the *numerus clausus* functions in the common law much like a canon of interpretation, albeit a canon that applies to common-law decision-making rather than statutory or constitutional interpretation, or like a strong default rule in the interpretation of property rights."

Id. at 11.

Applied to personal property, "the available forms of personal-property ownership are more limited than with respect to real property… And, although the case law is

2. The other case cited by Professor Robinson as having imposed equitable servitudes on personal property is inapposite. *Transworld Airlines, Inc. v. American Coupon Exchange, Inc.*, 913 F.2d 676 (9th Cir. 1990) (discussed at Robinson, *supra* at 1458) expressly declined to analyze restrictions on airline travel awards as property rights and instead analyzed them as contract rights, finding that restrictions on the assignability of such contract rights were well recognized by the common law.

3. Thus, in real property, the form of ownership must be in a fee-simple absolute, a fee-simple defeasible, the fee tail, the life estate and the lease.

rather thin, it also appears that one cannot create servitudes in personal property. This, at least, is the position adopted by the English Court of Chancery in the nineteenth century, and American precedent is largely, if not quite exclusively, in accord." *Id.* at 18, *citing* Zechariah Chafee, Jr., *Equitable Servitudes on Chattels*, 41 HARV. L. REV. 945, 977-80 (1928); Zechariah Chaffee, Jr., *The Music Goes Round and Round: Equitable Servitudes and Chattels,* 69 HARV. L.REV. 1250 (1956).

The authors suggest that the *numerus clausus* principle arose from concerns regarding restraints on alienation and, more specifically, the increase in information costs that would burden the market for personal property subject to non-standard forms of ownership. "When individuals encounter property rights, they face a measurement problem. In order to avoid violating another's property rights, they must ascertain what those rights are. In order to acquire property rights, they must measure various attributes, ranging from…use rights, to the attendant liabilities of the owner to others (such as adjacent owners) Whether the objective is to avoid liability or to acquire rights, an individual will measure the property rights until the marginal costs of additional measurement equal the marginal benefits." *Id.* at 26. To the extent that new forms of ownership are allowed, then all market participants must investigate the form of ownership governing the property at issue. "The need for standardization in property law stems from an externality involving measurement costs: Parties who create new property rights will not take into account the full magnitude of the measurement costs they impose on strangers to the title." *Id.* at 26-27. The authors posit a hypothetical watch seller who sells rights to a watch for only a given day a week, Monday. Once such forms of ownership are allowed for chattels, "anyone else buying a watch must now also investigate whether any particular watch does not include Monday rights. Thus, by allowing even one person to create an idiosyncratic property right, the information processing costs of all persons who have existing or potential interests in this type of property go up." *Id.* at 27. Moreover, "because property rights are *in rem*, all those who might violate property rights, accidentally or not, must know what they are supposed to respect. An indefinite set of types of rights will raise the cost of preventing violations through investigation of rights." *Id.* at 32. "Standardization reduces the cost of measuring the attributes of such rights." *Id.* at 33.

Precisely these concerns led to the adoption of Section 2-403 of the Uniform Commercial Code. That section provides that a good faith purchaser of goods receives good title to those goods, even from one with limited or voidable title. Similarly, 2-403(2) provides that a merchant entrusted with goods gives him the power to transfer all rights of the entruster to a buyer in the ordinary course of business. As relevant here, the provision is best illustrated by the decision in *Johnson & Johnson Products, Inc. v. Dal Intern. Trading Co.,* 798 F.2d 100 (1985). There, plaintiff J&J sold goods to defendant Dal based upon a promise that they would only be distributed in Poland. Dal subsequently sold the goods through intermediaries to Quality King, which imported them into the United States for sale there. Plaintiff sought to enjoin their distribution in the United States on the basis of the representation made in the original purchase that the goods would only be sold in Poland. The court denied the relief, finding that there was insufficient evidence that Quality King knew or had reason to suspect that there was any flaw in its title. It reasoned:

> The purpose of the good faith purchaser doctrine, codified in Sections 2–403 and 2–102 of the UCC, is to promote commerce by reducing transaction costs; it allows people safely to engage in the purchase and sale of goods without conducting a costly investigation of the conduct and rights of all previous possessors in the chain of distribution. Gilmore, The Commercial Doctrine of Good Faith Purchase, 63 YALE L.J. 1057, 1057 (1954) (The good faith purchaser "... is protected ... to the end that commercial transactions may be engaged in without elaborate investigation of property rights and in reliance in the possession of property by one who offers it for sale ..."); Farnsworth, Good Faith Performance and Commercial Reasonableness under the Uniform Commercial Code, 30 U.CHI.L.REV. 666, 671 (1963) ("Authority happens to favor the subjective test [of good faith purchase] in order to promote the circulation of goods and commercial paper."); Hawkland, Curing an Improper Tender of Title to Chattels: Past, Present and Commercial Code, 46 MINN.L.REV. 697, 721 (1962); 3 ANDERSON ON THE UNIFORM COMMERCIAL CODE 569–570 (3d ed. 1983). The imposition on a purchaser of a duty to investigate is thus fundamentally at odds with the rationale underlying these two sections of the UCC. Accordingly, in the absence of clear and controlling precedent so requiring, we are unwilling to sanction the imposition of such a duty on one in the position of Quality King.

Id. at 104 (emphasis added). *See also United States v. Lavin*, 942 F.2d 177, 186 (3d Cir. 1991) ("the good-faith purchaser exception developed over time in order to promote finality in commercial transactions and thus to encourage purchases and to foster commerce").

The Supreme Court authority appears to adopt this approach in addressing the copyright exhaustion and patent exhaustion principles. That is, the difficulty with the Court's suggestion that contract law may provide an avenue for a seller to impose upon subsequent purchasers restrictions or limitations on the use of a product it

sells is that the entire rationale that it used to reaffirm the patent exhaustion rule applies equally to such *in rem* restrictions. That rationale depended almost exclusively on the "common law's refusal to permit restraints on the alienation of chattels" and is focused on the informational and other costs that are imposed by continuing *in rem* interests in personal property. *Lexmark*, 137 S. Ct. at 1532. As the Court noted, "such conditions have been 'hateful to the law from Lord Coke's day to ours' and are "obnoxious to the public interest.'" *Id.*, *quoting Straus v. Victor Talking Machine Co.*, 243 US. 490, 501 (1917). "'The inconvenience and annoyance to the public that an opposite conclusion would occasion are too obvious to require illustration." *Id.*, quoting Keeler, 157 U.S. at 667. The Court nonetheless gave an illustration; it used as an example a used car seller whose business would become untenable if the patentees of the various components of such cars could maintain some patent rights in those components after sale, creating the threat of liability to the used car seller and at a minimum imposing on him the burden of investigating his rights to trade in such cars. Such a rule would "clog the channels of commerce." *Id.* Thus, patent exhaustion "reflects the principle that, when an item passes into commerce, it should not be shaded by a legal cloud on its title as it moves through the marketplace." *Id.* at 1534.

This same rationale was expressed in even stronger terms and with many more exemplars in the copyright exhaustion decision of *Kirtsaeng v. John Wiley & Sons, Inc.,* 568 U.S. 519, 538 (2013), which would appear to likewise invalidate any attempt by a seller to give some form of limited or restricted title to a buyer to limit what use the buyer can make of the purchased goods. *Kirtsaeng's* interpretation of the Copyright Act is grounded in the common law rather than in statutory construction. "The 'first sale' doctrine is a common-law doctrine with an impeccable historic pedigree. In the early 17th century, Lord Coke explained the common law's refusal to permit restraints on the alienation of chattel…A law that permits a copyright holder to control the resale or other disposition of a chattel once sold is similarly 'against Trade and Traffi[c], and bargaining and contracting." *Id.* at 538-39. Moreover, "the 'first sale' doctrine also frees courts from the administrative burden of trying to enforce restrictions upon difficult to trace, readily movable goods. And it avoids the selective enforcement inherent in such effort." *Id.* at 539. The Court illustrated its concerns with two examples, the first of which is a library that loans books to its customers:

> How, the American Library Association asks, are the libraries to obtain permission to distribute these millions of books? How can they find, say, the copyright owner of a foreign book, perhaps written decades ago?...And even where addresses can be found, the costs of finding them, contacting owners, and negotiating may be so high indeed.

Id. at 541. Similarly,

> Technology companies tell us that 'automobiles, microwaves, calculators, mobile phones, tablets and personal computers contain copyrightable software programs or packaging…A geographical interpretation would prevent the resale of, say, a car, without the permission of the holder of each copyright on each piece of copyrighted automobile software….Without that permission a foreign car owner could not sell his or her used car.

Id. at 542. The Court continued with similar examples for retailers and museum directors and concluded that "these examples…help explain *why* Lord Coke considered the 'first sale' doctrine necessary to protect 'Trade and Traffi[c] and bargaining and contracting' and they help explain *why* American copyright law has long applied that doctrine." *Id.* at 543 (original emphasis). *See also Lexmark*, 137 S. Ct. at 1532.

All of the evils that the *Kirtsaeng* court observed with respect to abdication of the first sale doctrine would likewise apply with equal force to the application of equitable servitudes to personal property. Equitable servitudes on personal property would have the same implications for librarians, technologists, and used car dealers. They would likewise burden "Trade and Traffi[c], bargaining and contracting" and impose enormous informational and investigatory costs on businesses and others seeking to "protect [themselves] from hidden lawsuits." There is no distinction in this regard between the restraints imposed by copyright or patent law and the restraints imposed by private contracts that attempt to attach *in rem* limitations or restrictions on personal property as it moves through commerce. As the Court in Lexmark stated, "patent exhaustion reflects the principle that, when an item passes into commerce, it should not be shaded by a legal cloud on title as it moves through the marketplace." *Lexmark*, 137 S. Ct. at 1534.

These negative consequences are exacerbated by the fact that personal property rights are a matter of state law, and, unlike real property, personal property moves across state lines. If some state laws allowed the creation of equitable servitudes on personal property, and others did not, it would never be clear what law might apply to a given piece of personal property or whether any given restriction would or would not apply to it. Moreover, any state enactments of a statute that authorized equitable servitudes in order to advantage producers or manufacturers in its state might implicate the Dormant Commerce Clause.

D. Potential Alternatives to Equitable Servitudes

The goals sought to be accomplished by equitable servitudes on chattels may be accomplished, to some extent though not completely, through less burdensome and more traditional means. First, personal contracts between the seller and the immediate purchaser are adequate to impose restrictions on the purchaser's use or disposal of personal property. If the seller in such a case sought to bind subsequent purchasers, he might include a requirement that the purchaser include such restrictions in any contract for the sale of the goods and an indemnification provision by which the buyer would be required to indemnify the seller for any use of the property beyond that authorized in the sale contract. In such cases, a purchaser who thereafter used the property in an unauthorized manner, or who sold the property without such restrictions in place, would be answerable in damages to the seller (assuming damages could be proven). To the extent that such a purchaser conditioned his sale with the same restrictions, he would have a claim over against his purchaser, and so on. In this manner, each person in the chain of title would be answerable to the party with whom he chose to conduct business, and would bear the risks of the choices he or she made in this regard. There is, however, little likelihood of the initial purchaser obtaining an injunction against a subsequent purchaser's use of a product under this indemnification structure.

Alternatively, or in addition to an indemnification right, the seller might condition his sale upon being named as a third party beneficiary in any subsequent sales contract, thereby giving himself standing to directly pursue the subsequent purchaser who violated the restrictions. See Jiang Bian, *The Supreme Court Says Conditional Sales and Foreign Sales Cannot Avoid IP Exhaustion and What Should IP Owners Do? An Analysis of the Supreme Court's IP-Exhaustion Jurisprudence*, 53 *les Nouvelles* 73, 81 (March 2018). This approach would have the advantage of making an injunction a possibility, at least against a subsequent purchaser who knowingly violated a contractual restriction that was contained in his purchase agreement with his seller.

Each of the foregoing potential solutions involves personal contractual promises incident to the transfer of title. It is the transfer of title that was critical to the Court's conclusions in *Lexmark*. Thus, a "sale transfers the right to use, sell and import because thatse are the rights that come along with ownership" (*Lexmark* at 1534) and "exhaustion occurs because, in a sale, a patentee elects to give up title in exchange for payment." *Lexmark* at 1538. It is possible, therefore, to avoid some of the implications of *Lexmark* if a transaction is structured so as not to transfer title. The two most obvious possibilities in this regard are the license and the lease.

A license to use, even to consume, can impose any number of restrictions, many of which have been unchallenged by any court or commentator.[4] *See e.g., E. Bennet & Sons v. National Harrow Co.*, 186 U.S. 70, 72 (1902); *United States v. General Electric Co.*, 272 U.S. 476, 488 (1926); *DSC Communications Corp. v. Pulse Communications, Inc.,* 170 F.3d 1354 (Fed.Cir. 1999); *Krause v. Titleserv, Inc.*, 402 F.3d 119, 124 (2d Cir. 2005); *Vernor v. Autodesk, Inc.*, 621 F.3d 1102, 1103 (9th Cir. 2010). (The potential limitations on the restrictions imposed by licenses has been addressed by others; see, *e.g.*, Molly Van Houweling, *The New Servitudes,* 96 GEO. L.J. 885 (2007).) The advantage to the use of a license to impose such restrictions, as contrasted with an equitable servitude, is that it alerts the licensee that it is not getting title but is instead getting less than full rights to the product. It therefore triggers a need to investigate further and incur the informational costs without burdening all participants in the market with the same informational risks and expenses. Any violation of license terms would empower the seller to sue for breach or enjoin the immediate purchaser's use outside the stated restrictions.

Whether such a license would be effective to restrict the use of downstream licensees or purchasers is more problematic. While the licensor may protect itself to some extent by requiring that any sub-licensee be bound by the restrictions of the initial license, its protection against unauthorized *sales* by a licensee is less fulsome. Some commentators have suggested that *Lexmark's* discussion of *General Talking Pictures Corp. V. Western Elec. Co.,* 305 U.S. 124 (1938) held that unauthorized sales do not exhaust the patents and therefore leave open the possibility of infringement actions against purchasers who acquire title in unauthorized transac-

4. Any effort to construct the transaction as a lease or a license must, of course, properly reflect the attributes of such transactions. As the Supreme Court noted, simply labeling a sale as a "license" is ineffective. *Bauer & Cie v. O'Donnell*, 229 U.S. 1, 16 (1913):

> The patentee had no interest in the proceeds of the subsequent sales, no right to any royalty thereon, or to participation in the profits thereof. The packages were sold with as full and complete title as any article could have when sold in the open market, excepting only the attempt to limit the sale or use when sold for not less than one dollar. In other words, the title transferred was full and complete, with an attempt to reserve the right to fix the price at which subsequent sales could be made. There is no showing of a qualified sale for less than value for limited use with other articles only, as was shown in the Dick case. There was no transfer of a limited right to use this invention, and to call the sale a license to use is a mere play upon words.

Accordingly, a license should, at a minimum, expressly reserve ownership to the licensee, restrict the power of the licensee to sell or dispose of the item, and should prohibit certain uses. DSC, *supra* at 1363; Vernor, *supra* at 1104-06, *MDY Indus., LLC v. Blizzard Entm't, Inc and Vivendi Games, Inc.*, 629 F.3d 928, 931-35, 954 (9th Cir. 2010).

tions (Jiang Bian, *The Supreme Court Says Conditional Sales and Foreign Sales Cannot Avoid IP Exhaustion and What Should IP Owners Do? An Analysis of the Supreme Court's IP-Exhaustion Jurisprudence,* 53 *les Nouvelles* 73, 81 (March 2018)). That appears to be too broad a reading. While it is true that Lexmark reaffirmed *General Talking Pictures,* it was careful to note in so doing that in that case, the purchaser knew that its purchase was beyond the scope of the license granted to its seller and was therefore unauthorized. And *General Talking Pictures* itself expressly noted that because the purchaser took with notice of the unauthorized sale, "we have consequently no occasion to consider what the rights of the parties would have been if the amplifier…had 'passed into the hands of a purchaser in the ordinary channels of trade.'" 305 U.S. at 127.

There can be little doubt of what the answer would be were the Court to consider the question today. While the licensor might well retain rights against its licensee for the unauthorized sale and rights against an unauthorized purchaser who took with knowledge of the restrictions on the licensee, the licensor would have no rights against a good faith purchaser for value of a good that entered the stream of commerce.[5] The notion that such goods could enter commerce with licensor's rights attached to them runs counter to the entire line of reasoning of *Kirtsaeng* and *Lexmark*, runs afoul of Uniform Commercial Code Section 2-403, and implicates the same concerns of informational costs that Merrill and Smith describe. It is, in a word, no different than an equitable servitude.

Another alternative is to structure a transaction as a lease rather than a sale. Leases of personal property are governed by Article 2A of the Uniform Commercial Code.[6] As with a license, there do not appear to be any impediments to limiting or restricting the immediate lessee's use of the leased property to defined fields of use or geographies. And, as with a license, the lease may provide that any sub-lessor will be bound by the restrictions in the original lease agreement. The lease structure, like the license, does not provide complete protection against misuse by a downstream purchaser, though perhaps incrementally better protection than the license structure. Where a lessee sells the goods to a buyer in the ordinary course, the lessee passes good title free of the lease to such a buyer, at least where the seller is a merchant dealing in goods of that kind. UCC 2A-305. Whatever restrictions were imposed by the lease agreement are therefore eliminated as to such a buyer. Where, however, the seller is not a merchant dealing in goods of those kind, the seller can only pass the leasehold interest, not actual title to the goods, thereby preserving the restrictions of the lease. *Id.* and *official comment*.

The foregoing may be summarized in tabular form as follows:

E. Application of Potential Alternatives to the Facts of Lexmark

The relative efficacy of the various structures identified above can best be appreciated by their application to the fact pattern in *Lexmark*.

In *Lexmark*, the seller had enforceable contracts with its immediate purchasers, and the parties in Lexmark so stipulated. Lexmark, 816 F.3d 721, 728 (Fed. Cir. 2016). For perhaps obvious reasons—numerosity and goodwill—Lexmark chose not to sue its own customers or end-users for breach of their obligation to return the cartridges to Lexmark. Those contractual restrictions were therefore practically ineffective, as would be an indemnification provision in those same contracts. Moreover, a third-party beneficiary provision might have provided the ability to obtain injunctive relief, but only if the Lexmark immediate purchasers had imposed upon the secondary purchasers the obligation to return the cartridges or not to re-fill, which they obviously did not do. There might, however, be a *potential* claim for interference with contract; the Federal Circuit opinion describes that the defendant Impression Products acquired the cartridges from a third party who replaced the Lexmark microchip with a new chip that allowed the cartridges to be re-filled. *Id.* If Impression had knowledge of the restrictions placed upon the cartridges by Lexmark and knew or participated, directly or indirectly, in the affirmative action of employing "methods to counteract the effect of the microchips" to enable the cartridges to be re-used, then Impression Products might be exposed to a claim of interference with contract or conspiracy to interfere with contract. See Restatement (Second) Of Torts §766.

Had Lexmark licensed its customers to use the cartridges with certain restrictions and subject to an obligation to return them, the outcome would be largely the same, though with different remedies. Such a license

5. As noted above, a restrictive label on the property is insufficient by itself to impose restrictions on a purchaser's resale or use of that property. See note 1, *supra*. But such a label affixed to the property as part of a licensing transaction may be sufficient to provide notice to subsequent purchasers, thereby defeating a claim that such subsequent purchasers were good faith purchasers. Whether a label would be sufficient in this regard depends upon its language and its prominence, among other things.

6. As with the license structure, care must be taken to establish that the lease is not simply a disguised sale. That is, the lessor must retain a residual interest in the leased property, and the goods must be leased for a defined period of time. UCC 2A-103(a)(10) and *comment* (j). If the term of the lease is for the useful life of the product, then the transaction may well be characterized as a sale with a security interest. Id., UCC 2A-201(37). This hurdle may well be problematic for consumables; even assuming the term requirement were met, there will be no residual interest and the lease will correspond to the useful life of the product such that the transaction will likely be characterized as a sale with the retention of a security interest.

would seem to meet the Supreme Court's criteria in *Bauer & Cie*, 229 U.S. at 16; Lexmark would have reserved ownership to itself and Lexmark priced the restricted cartridges lower than the unrestricted cartridges. *Lexmark* at 1529-30. For the same reasons it would not sue on the purchase contract, Lexmark would likewise not sue its customers for breach of the license. With respect to secondary purchasers, however, the license provides a potential advantage. That advantage depends upon whether the defendant might qualify as a purchaser in good faith. If Impression Products purchased the cartridges from the supplier and did not know the origin of the cartridges or the activities of the supplier, it would appear to satisfy the requirements of such a good faith purchaser and thus take free of the license restrictions. Uniform Commercial Code Section 2-403. In such circumstances, the license would add nothing to the purchase contract in terms of downstream enforcement. If, however, Impression Products knew of the restrictions and knew or participated in the modifications of the cartridges, it would appear not to be a purchaser in good faith. In that circumstance, the fact pattern would fall squarely within *General Talking Pictures* and the Impression Products would be exposed to infringement claims and potential injunctive relief.

Finally, the transaction might be structured as a lease arrangement. Under this structure, the customer would purchase the toner and lease the cartridge until the toner is exhausted. Lexmark's residual interest would be in the now-empty cartridge. Lexmark would still not sue its own customers, and its remedies against downstream purchasers would depend upon whether any link in the chain of downstream purchasers was a merchant dealing in goods of that type. Clearly, the supplier which acquired the cartridges from the immediate purchasers did not acquire from a merchant dealing in goods of that type and therefore took subject to the lease obligations. UNIFORM COMMERCIAL CODE Section 2A-305. It appears, however, that the supplier to Impression Products was such a merchant dealing in goods of that type and if, therefore, Impression Products qualifies as a purchaser in good faith, it would take free of the license restrictions. If, however, Impression Products was complicit with the supplier and did not qualify as such a purchaser, it would remain bound by the lease terms. In those circumstances, there would be no infringement claim but instead an action to recover the cartridges and potentially an injunction.

In all three alternative structures, the outcome is dependent upon the extent to which the defendant knew of the contractual restrictions and knew of and/or participated in the circumvention of the technological means of enforcing the obligation to return the cartridges (*i.e.*, the replacement of the microchips). The outcome of that factual inquiry determines the exposure to claims of interference and the defendant's status as a good faith purchaser and therefore its ability to take free of the restrictions. In each case, a good faith purchaser takes free of the restrictions imposed at sale, while a complicit purchaser is exposed to either tort claims of interference, claims of infringement, or claims for breach of a lease agreement to which it is bound. Among these, the license structure provides a potentially wider range of remedies and should therefore be more attractive to parties seeking to enforce such restrictions. ■

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	Three Methods of Post-Sale Restrictions		
	Title Transfer	**No Title Transfer**	
	Contractual Promises	***License***	***Lease***
Actions	• Place restrictions in sales contract. • Include indemnification provision. • Provide a third-party beneficiary requirement (optional).	• Reserve ownership to licensee. • Restrict power to sell or dispose. • Prohibit certain uses.	• Retain a residual interest in leased property. • Lease goods for definite time.
Damages Against Immediate Purchaser	Yes, for unauthorized use or unrestricted sale	Yes, for unauthorized use or unrestricted sale	Yes, for decreased value of reversionary interest
Limits on Subsequent Purchaser's Use	No	Yes	Yes
Notice to Subsequent Purchaser to Investigate	No	Yes	Yes
Downstream Protection via Injunction or Damages	No, unless third-party beneficiary provision accompanies each contract in chain of title	Yes, but only against knowing purchasers, not good faith purchasers for value	Yes, but only against purchasers from nonmerchant lessees, not from merchant lessees