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Security Interest vs. License Agreement: Low Tech Precautions for the High Tech Investment

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In this exciting age of startups, the market is brimming with opportunities for individuals and entities alike to invest in emerging companies. Today's rapid rate of technology development justifies investors' eagerness to take an interest in innovative companies, hoping to find the next "unicorn." Notwithstanding the fast pace of the tech industry, it remains important for investors to conduct due diligence before kicking funds into any business, especially when bargaining for a security interest or license. The Sixth Circuit's recent decision in *Cyber Solutions International LLC v. Pro Marketing Sales Inc.*[1] provides a reminder that failure to take basic precautions, as simple as conducting a lien search, could result in grave consequences and perhaps the total loss of an investment.

The Facts in the Cyber Solutions Case

In *Cyber Solutions*, two lenders claimed ownership over microchip encryption technology known as Tamper Reactive Secure Storage (TRSS) developed by Priva Technologies, Inc. Lender number one, Pro Marketing Sales, Inc. provided Priva a secured loan during its early stages developing the technology that preceded TRSS, known as Secured Key Storage Integrated Circuit (SKSIC). As is typical in secured lending arrangements, Pro Marketing's security agreement with Priva provided Pro Marketing a first-position lien on all assets owned and to be acquired by Priva, including intellectual property.

Within three years of obtaining financing from Pro Marketing, Priva filed for chapter 11 bankruptcy in Michigan. As part of Priva's reorganization, it sought to develop assets it could use to pay its debts. During this time, Priva negotiated a Design Service and Intellectual Property License Agreement with lender number two, Cyber Solutions International, LLC. Pursuant to the license agreement, in exchange for two payments of $200,000 from Cyber Solutions, Priva would provide Cyber Solutions an exclusive license to and other rights in the technology that started out as SKSCI but, thanks to Cyber Solutions' investment, became a "second-generation SKSIC product" known as TRSS.

When Priva sought approval by the bankruptcy court of its license agreement with Cyber Solutions as part of its plan of reorganization, Pro Marketing objected, arguing that the license provided to Cyber Solutions was subordinate to Pro Marketing's lien under the security agreement. The bankruptcy court approved the license agreement but acknowledged that the court would not stop Pro Marketing from foreclosing on Priva's IP; hence, Cyber Solutions assumed the risk with its investment in IP that was secured by a prior lien. Priva continued to develop TRSS during its bankruptcy.

Subsequently, Priva's plan of reorganization did not reach fruition, and cash shortages forced Priva to convert its case to a Chapter 7 Liquidation. Priva agreed to allow Pro Marketing to foreclose on all its IP, including TRSS, and terminated its agreement with Cyber Solutions. In turn, Cyber Solutions filed suit against Pro Marketing seeking a declaration that the license agreement was enforceable and possession of the TRSS technology. Its position was that

TRSS was not within the scope of Pro Marketing's lien. Cyber Solutions was unsuccessful.

The Sixth Circuit's Ruling

The Sixth Circuit Court of Appeals interpreted the security agreement and the license agreement by their respective plain meaning. Unsurprisingly, the security agreement broadly defined the scope of intellectual property included as collateral securing its loan: "'all rights, priorities and privileges relating to' copyrights, trademarks, patents and trade secrets, 'as well as mask works fixed in semi-conductor chip products.'" On the other hand, the license agreement with Cyber Solutions provided for Priva to assign to Cyber Solutions "all right, title and interest in and to any and all updates, modifications, or improvements" to Priva technology funded by Cyber Solutions. The license agreement also included a provision acknowledging the existence of liens on Priva's pre-TRSS technology.

The court read the assignment provision as a recognition that rights to the technology belonged to Priva before they could be assigned because before intellectual property rights are in a position to be assigned, ownership must reside in the assignor. Thus, the initial acquisition by Priva of rights in its own IP meant that TRSS fell within the broad definition of collateral in the security agreement and was subject to foreclosure by Pro Marketing. The court also held that Priva lacked the authority to grant Cyber Solutions superior rights in the TRSS technology via a license agreement because the security agreement with Pro Marketing prohibited the transfer of any interest in the collateral without the prior written consent of Pro Marketing, which had not been obtained. Finally, the court considered the acknowledgment provision as a sign that Cyber Solutions assumed the risk of the consequence the court dealt.

Warnings and Considerations to Avoid Start-Up Risks

Cyber Solutions is a good reminder of caveat emptor or "buyer beware." Not everyone has the sort of warning that Cyber Solutions had before taking a security interest or rights in IP; by virtue of Priva's status as a bankruptcy debtor, information regarding its capital structure, including its secured debt, was publicly available. Plus, the license agreement included a term referencing Pro Marketing's lien. Investors should seek out and pay attention to information indicating that another party might have greater rights to the property they seek, be it IP or something else.

There are a number of measures a party negotiating a security or licensing agreement can take to prevent a *Cyber Solutions*-like outcome. A simple first step is to conduct a title search on the counterparty's property to determine whether the desired property already is subject to liens. Whether the results cause the investor to abandon the prospective transaction should depend on the value of the asset at stake and the extent that it is encumbered. A party that wishes to continue with a transaction despite preexisting liens could try to contract around them. For example, the investor could approach the prior lienholder to negotiate a carve-out of rights in favor of the investor. After all, additional investment in the asset may benefit a prior lienholder.

If the potential counterparty is in bankruptcy, such as Priva, an investor or group of investors might seek to provide the debtor company debtor-in-possession (DIP) financing. DIP financing arrangements frequently include priming liens that, as the name indicates, prime prebankruptcy secured lenders' liens over the debtor's assets during the bankruptcy case. DIP lenders can negotiate for postbankruptcy rights in, or even purchase of, the debtor company through the bankruptcy plan. With their money on the line during the reorganization, DIP lenders' say and approval typically are influential during the bankruptcy process. Alternatively, an investor could negotiate with the debtor and its secured lenders to purchase IP or other assets free and clear of liens from the bankruptcy estate.

To avoid assuming risks beyond the startup success rate, before taking a financial stake in (possibly) the next big thing, investors should arm themselves with information, obtain legal advice, and be prepared to negotiate an interest on favorable terms.

1. Cyber Solutions International LLC v. Pro Marketing Sales Inc., 634 Fed. App. Appx. 557 (6th Cir. 2016).