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Feature

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Creative Use of Chapter 11 to Pursue Patent Claims in *FastShip* (and a "Chapter Two")

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FastShip Inc. was formed in the 1990s in Philadelphia in order to exploit a patented ship hull design that promised to enable container freight vessels to traverse the Atlantic Ocean in less than half the time of conventional vessels, comparable to standard air freight but at half the cost. These ships would be part of a time-definite logistics network that had the potential to revolutionize international delivery. The possibilities for marine commerce were enormous, since a large amount of cargo that normally incurred the expense of air freight, but that did not really require a two- or three-day delivery, was expected to switch to this expedited mode of ocean freight. This potentially tremendous development was also expected to create a regional logistics/distribution center in Philadelphia.

To build a fleet of these newly designed "FastShips" would cost about $1.5 billion, likely requiring some government-backed project financing, but first the technology would have to be further validated and developed, and a company infrastructure created, all of which would cost millions of dollars. FastShip raised $40 million in successive rounds of fundraising, mostly from Philadelphia-area investors, including the Delaware River Port Authority. In most cases, investors received convertible promissory notes that were secured by the company's intellectual property (IP), as well as any proceeds of litigation that might be brought to defend it.

Despite valiant efforts by FastShip's management team over 15 years and partnerships with global financial institutions and corporations, FastShip was unable to raise the necessary project financing to launch the shipbuilding phase. Such project financing was unavailable during the Great Recession, which also doomed any further capital-raising. By 2011, the company was effectively out of money and was preparing to wind down and dissolve, hoping possibly someday to sell or license its patents.

However, just when it seemed that an unhappy ending was imminent, there was a sudden ray of hope: Lockheed-Martin had built a number of fast-moving "Littoral Combat Ships" for the U.S. Navy, which FastShip's executives and board believed infringed on FastShip's patents. Not only did these alleged infringement actions — if true — effectively prove that the technology actually worked, but the company now had legal causes of action that were potentially very valuable. (Under applicable law,[1] one cannot enjoin the federal government from infringing on a patent for defense purposes; however, such infringement requires fair compensation as effectively a "taking" of private property.)

FastShip's management and advisors went looking for patent litigation counsel to evaluate its claims and — hopefully — take the case on a contingent-fee basis, since FastShip had little remaining funds to support the litigation. Management's hopes were corroborated when Denton's patent litigation attorneys confirmed that the company appeared to have an excellent case, and agreed to undertake it on a mostly contingent-fee basis.

As is typical with such cases, substantial funds would be necessary for expenses — for experts, analysis of discovery documents and other purposes — but Dentons would not advance such funds. FastShip's team then searched for litigation financ-

1 *See* 28 U.S.C. § 1498(a).

ing, including from among the company's past investors, and through its corporate patent counsel, a fund was located that was impressed both with the company's case and the fact that it had enlisted the help (and investment via the partial contingent-fee arrangement) of a top law firm.

Typically, a standard condition of contingent-fee arrangements and litigation financing is the granting of a first lien on any proceeds of the planned litigation. This posed a difficult problem in this case: As previously noted, FastShip's investors (for the most part) held notes that were secured by the company's IP, *including any litigation proceeds from defending its patents*. These secured notes were not organized under an indenture, so there was no single party, such as an indenture trustee with whom to negotiate a restructuring of the noteholders' rights.

The noteholders consisted of more than 200 independent entities of all varieties — individuals, partnerships, trusts, etc., holding claims ranging from $15,000 to more than $1 million, each of which held a *pari passu* security interest in the only assets of significant value owned by FastShip: its IP. Their *unanimous consent* to subordinate their interests would have to be obtained in order to grant Dentons and the litigation funding source the required first lien on litigation proceeds. While those that were reached expressed support for such subordination, since it was their only hope for any recovery on their investment, many investors were difficult to locate, had moved out of the area or were deceased, etc. Things had reached an impasse.

FastShip's advisors proposed a creative solution: a bankruptcy proceeding, using part of the litigation funding as a superpriority debtor-in-possession (DIP) loan under § 364(d) of the Bankruptcy Code, in order to fund the bankruptcy process, then utilizing a liquidating reorganization plan to be filed soon after the petition date to prime all of the pre-petition secured creditors. The liquidating plan would seek the support of the pre-petition noteholders for a quick exit from chapter 11, as well as the establishment of a liquidating trust to pursue the patent litigation against the Navy. The DIP loan would be rolled into the post-confirmation litigation financing, with the DIP lender/litigation funding source, along with Dentons, receiving a post-confirmation first-lien position on any litigation proceeds.

No funds would be distributed to creditors upon plan confirmation, which is quite unusual among liquidating chapter 11 cases. Instead, the creditors' sole hope of any meaningful recovery would be the recovery under the litigation to be pursued post-confirmation. The liquidating plan would also specify the "waterfall" according to which any proceeds of the patent litigation would be distributed, so that there could be no confusion resulting from the successive rounds of financing in which FastShip had engaged during its history.

Management and the company's board were understandably concerned about a bankruptcy proceeding. How would this look to the many investors who had entrusted funds to the company, believing in its technology and its future, pursuing the dream of increasing employment in Philadelphia? In many cases, these investors were well known in the Philadelphia community, and the company's problems had already resulted in worrisome articles in the press. Management was justly concerned about the impact of a bankruptcy proceeding upon their own reputations, especially with a complicated resolution that was not easily explainable to non-lawyers. The age-old stigma of bankruptcy had reared its ugly head: How could the message be delivered effectively that, in this case, bankruptcy was being utilized in a unique way as a valuable planning tool, and was the only hope for a recovery for the stakeholders? Despite the risks and downsides to the company's management, they recognized their fiduciary duty and resolved to pursue the bankruptcy route as the only alternative available, even though they did not receive any compensation during the proceedings.

Working with its advisors[2] and led by the company's senior executives, the company's investors were educated (both before and after the filing of the bankruptcy proceedings) by an explanation of the situation: Only a bankruptcy proceeding would preserve any hope of a recovery on the $40 million that had been loaned/invested by noteholders and shareholders. There would be no "haircut" for investors for the time being, and depending on the outcome of the patent litigation, their investment might be recouped.

FastShip and its subsidiaries filed for chapter 11 in Delaware on March 20, 2012,[3] and made a very quick but well-directed trip through the bankruptcy process, with the order confirming the joint liquidating second amended plan entered on June 28, 2012, a scant three months later. Do not be misled, however; the brevity of the case does not equate to a laconic stroll through "Bankruptcy 101." Rather, the speed was dictated by very limited available funds, even while unique and interesting issues were at play.

During the first-day hearings, the court was keenly interested in this novel use of chapter 11. Unlike the landmark *Johns-Manville* case[4] (the largest bankruptcy case ever filed at its time), which was intended to *prevent* uncontrolled litigation and channel it in an organized way, the *FastShip* court was told that this case was intended to *enable* litigation. The planned patent-infringement action was the stakeholders' only hope of recovery, and the chapter 11 proceeding was necessary in order to subordinate all of the pre-petition secured noteholders and provide the intended patent litigators and litigation funders with a required first lien on the hoped-for litigation proceeds. The court was also fascinated by FastShip's business plan and marine technology, engaging in an extended colloquy with the company's CEO.

No one objected to either the interim or final funding orders, owing to the successful efforts of the debtors' advisors to fully inform the creditor body. Throughout this process, the court and Office of the U.S. Trustee (OUST), which took on added involvement since an unsecured creditors' committee was not formed, clearly understood that the purpose behind the bankruptcy proceeding was to monetize the company's claims against the Navy so as to be able (it was hoped) to provide a distribution to creditors and shareholders. This education process was very helpful, as the court and OUST each then understood the need for moving forward

2 Obtaining debtors' counsel was problematic, as the company needed experienced bankruptcy counsel. However, many of the large Philadelphia law firms represented one or more of the company's investors or creditors, effectively conflicting them out of any such representation.

3 *In re FastShip Inc., et al.*, No. 12-10968 (BLS) (Bankr. D. Del. 2012). The authors served as financial advisor/liquidating trustee (Mr. Brownstein) and debtors' counsel (Mr. Lemisch) in the case.

4 *See In re Johns-Manville Corp.*, Nos. 82-11656, 82-11676, (Bankr. S.D.N.Y. 1982). *Johns-Manville* and its progeny became the model for channeling injunctions, codified at 11 U.S.C. § 524(g), to allow a company to reorganize even while litigation against the company goes on apart from the reorganized company.

quickly. They also understood that this bankruptcy proceeding was the last —and only — option to derive any value from the patents for the creditors and shareholders.

There were several risks. Debtors' counsel had advised the company that the most serious potential stumbling block was a lack of cooperation among the creditor/shareholder body (many secured creditors were also unsecured creditors and shareholders), as the increased costs from any court battles would quickly outstrip the limited bankruptcy budget and cause the case to fail. Further, from a legal perspective, the court would be asked to bless a liquidating plan that would be based solely on the success of future litigation, something that might arguably render a plan infeasible.[5] The efforts of the company's financial advisor and management team in keeping the creditors/investors fully informed of the issues and the process, both before and after the bankruptcy filing, were instrumental in avoiding the formation of an unsecured creditors' committee (which would have created administrative claims far outstripping the minimal bankruptcy budget) and in limiting any significant objections throughout the bankruptcy proceedings.

No objections were raised at the confirmation hearing regarding plan feasibility. The debtors still owned certain patents and other IP that could eventually be licensed or sold, so there were theoretically assets besides the anticipated patent litigation, but their value was indeterminate prior to their vindication through the litigation. Even if a specific objection had been raised, the obvious and presumably persuasive response (of which the court and OUST were each completely aware) would have been that if the plan were not confirmed, all creditors and shareholders would almost certainly be "guaranteed" to get nothing meaningful, whereas if the plan was confirmed, the stakeholders then had a chance to recover something significant.

Further, while the plan did not provide for a "guaranteed" distribution to any creditors — including general unsecured creditors (other than certain priority and administrative creditors required to be paid on the plan's effective date) — it also did not provide for any ongoing enterprise from which an unsecured creditor or shareholder interest might obtain value ahead of a more senior interest (*i.e.*, it did not run afoul of the "absolute priority rule").[6] The plan's "waterfall" distribution scheme specifically provided that as each class was paid in full, the class immediately inferior to such class would then get paid.

Finally, the plan provided for all assets to be liquidated, either through a sale (the remaining patents and intellectual property) or through the patent litigation against the Navy. No matter how it was to be liquidated, the distribution of all assets would be in accordance with the priorities established by the Bankruptcy Code, which are very consistent with that which would occur outside of a bankruptcy under Delaware state law[7] (except for certain bankruptcy-related administrative claims and distribution to the litigation funding source).

The bankruptcy process was expeditious and went exactly as planned, with the debtors filing their plan and disclosure statement less than two months after the petition date. The creditors voted nearly unanimously in support of the plan, and no objections were raised about the lack of any distribution to creditors upon plan confirmation. The plan was approved approximately three months after the petition date.

The positive outcome of this case was only possible because of the work by the debtors' management and advisors, who (both before and after the bankruptcy was filed) communicated regularly with creditors and shareholders to educate them about the process and the rationale behind it, as this was the only way to realize value from the company's claims against the Navy. As a result of these efforts, objections were minimal and were resolved without undue legal rancor.

Soon after the plan's effective date, all of the debtors' assets were transferred into a liquidating trust (or to FastShip LLC, a subsidiary of the liquidating trust). FastShip LLC filed suit against the U.S. Government in the U.S. Court of Federal Claims on Aug. 1, 2012, only 134 days after the petition date.[8]

The *FastShip* patent-infringement case in the U.S. Court of Federal Claims proceeded through laborious and extensive discovery, with more than 1 million pages of documents produced. As a technology-intensive case, the trust was fortunate to have the case assigned to a judge with an engineering background, who held a hearing on the record for each side's expert to explain how the technology worked (admonishing them not to argue liability, under the pain of being held in contempt!).

Pretrial discovery was delayed when a mass shooting occurred at the Washington Navy Yard in September 2013, where much of the government's documents had been stored, and the location was shut down as a crime scene. A further delay occurred when it was determined that an offshore litigation expert was necessary, requiring the liquidating trustee to make a detour to the U.S. Department of State's Directorate of Defense Trade Controls in order to obtain an ITAR license, which is essentially an arm's-trading license, covering "any person or company who intends to export or to temporarily import a defense article, defense service, or technical data."[9]

After more than four years of preparation, the case culminated in a 10-day trial in the fall of 2016. Final briefs and arguments were filed in early 2017; in May 2017, the court found in favor of the plaintiff.[10] The government immediately appealed the decision to the U.S. Court of Appeals for the Federal Circuit,[11] and the plaintiff also appealed the part of the court's decision dealing with calculation of damages and how many allegedly infringing ships should be included in that calculation. The appeal is currently pending.

5 *See In re Bendig*, 74 B.R. 47, 49 (D. Conn. 1987) (dismissing chapter 11 petition where debtor's only assets were potential claim for malpractice against his former attorneys and questionable equity in his residence); *In re Roma Grp. Inc.*, 165 B.R. 779, 780 (Bankr. S.D.N.Y. 1994) (dismissing case where "debtors had no property, no businesses, no employees and no assets other than the causes of action asserted in their adversary proceeding"); *In re Bock*, 58 B.R. 374, 379 (Bankr. M.D. Fla. 1986) ("[T]here is no way to establish the feasibility of a plan [that] is to be funded solely from the possible recovery of a lawsuit yet to be filed."); *In re Golden Ocala P'ship*, 50 B.R. 552, 558 (Bankr. M.D. Fla. 1985) (dismissing chapter 11 petition and attendant adversary proceeding where debtor's only asset was potential claim for fraudulent conveyance).

6 11 U.S.C. § 1129(b)(2)(B)(ii) and (C)(ii).

7 *See* 8 Del. C. § 281; *Cox v. Sellers*, 28 A.2d 679, 682 (Del. Ch. 1942).

8 *FastShip LLC v. USA*, Case No. 1:12-cv-00484-CFL (Ct. Fed. Claims 2012).

9 "International Traffic in Arms Regulations," U.S. Department of State, *available at* ecfr.gov/cgi-bin/retrieveECFR?gp=&SID=f9c41b6d286dfc78af1d6c6081e6d23e&mc=true&n=pt22.1.120&r=PART&ty=HTML#se22.1.120_11.

10 Much of the court's opinion and order were filed under seal since the case record included facts and documents that had been designated secret for military defense reasons.

"Chapter Two"?

Among the voluminous documents produced by the government as part of the discovery process were emails and other items revealing that two of the government contractors, Lockheed Martin and Gibbs & Cox, may have violated the terms of nondisclosure agreements that they had executed with FastShip in the early 2000s. Although those firms had been shielded in the patent-infringement action against the Navy before the U.S. Court of Federal Claims,[12] it now appeared that the trust had potential new causes of action for trade secrets appropriation.

Inasmuch as there had as yet been no recovery from the patent infringement action, the trust lacked the funds to pursue this new litigation, so a return trip to the U.S. Bankruptcy Court for the District of Delaware was required to extend the term of the trust under the plan-confirmation order while the trust once again lined up counsel and litigation financing. The trade secrets case was filed on April 28, 2017, in the U.S. District Court in New Jersey[13] (the venue having been specified in the allegedly breached nondisclosure agreements), and it is currently pending.

In the meantime, the creditors and stakeholders of FastShip — having invested in the 1990s in a revolutionary maritime shipping technology — hope for an outcome from either or both cases that will finally provide a return on their investment. Depending on the outcome, this case may have demonstrated that it is possible for a small company with no cash but having the right management team that cares about its fiduciary responsibilities, coupled with capable advisors, a good "story" and the will to win, can protect the interests of its investors against the largest of adversaries, even the U.S. Government. abi

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11 *FastShip LLC v. U.S.*, Case Nos. 17-2248, 17-2249 (Fed. Cir. 2017).

12 28 U.S.C. § 1498; *see, e.g., Sevenson Envtl. Servs. Inc v. Shaw Envtl. Inc.*, 477 F.3d 1361, 1362-63 (Fed. Cir. 2007).

13 *See FastShip LLC v. Lockheed Martin Corp., et al.*, Case No. 17-02919 (NLH) (D.N.J. 2017).