

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

40-7580

In re:)
FANSTEEL INC., *et al.*,¹)
Debtors.)
Case No. 02-10109(JJF)
Chapter 11
(Jointly Administered)

Objection Deadline: September 13, 2002 at 4:00 p.m. EST,
(By agreement of the parties)
Hearing Date: TBD (Only if Objections are Filed)

**OPPOSITION OF WASHINGTON MFG. CO. TO MOTION OF TAMA STATE BANK
D/B/A TSB LEASING INC. TO COMPEL PAYMENT OF POST-PETITION RENT
UNDER PERSONAL PROPERTY LEASE PURSUANT TO 11. U.S.C. §§ 365(d) AND
503(b)(1)(A) AND PAYMENT OF ADEQUATE PROTECTION PURSUANT TO 363(e)**

Washington Mfg. Co., one of the captioned debtors and debtors – in – possession, hereby files this opposition (the “Opposition”) to the motion (the “Motion”)² of Tama State Bank (“TSB”) for an order to compel payment of post-petition rent under personal property lease pursuant to 11 U.S.C. §§ 365(d) and 503(b)(1)(A) or payment of adequate protection pursuant to 11 U.S.C. § 363(e).

1. At issue in the Motion is a Lease, Schedules and Annex thereto, covering certain scheduled equipment (“Equipment”). The Lease is not a “true lease” under applicable law, and is rather, a disguised financing. The Lease appears to be one which merely offers a fair market value purchase option; however, the failure to exercise the purchase option is combined with a requirement that, if the purchase option is not exercised, then the term of the Lease

¹ The Debtors are the following entities: Fansteel Inc., Fansteel Holdings, Inc., Custom Technologies Corp., Escast, Inc., Wellman Dynamics Corp., Washington Mfg. Co., Phoenix Aerospace Corp., American Sintered Technologies, Inc., and Fansteel Schulz Products, Inc.

² Capitalized terms not otherwise defined have the same meaning as ascribed to them in the Motion.

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automatically will be increased. The automatic term increase transforms the purchase option into one which Fansteel reasonably would be economically compelled to exercise and makes it clear that the Lease is a financing device, not a "true lease".³

Elements of the Lease/Contract

2. The period of the Lease/Contract initially is from August 17, 2000 to August 1, 2005 ("Initial Term"). At the end of the Initial Term, there is to be a re-appraisal of the Equipment. The re-appraisal may change the useful life and fair market value from that predicted for the Equipment at the beginning of the Lease/Contract. At the end of the Initial Term, the Lease/Contract provides Fansteel with an Initial Purchase Option (as hereinafter defined).

3. If Fansteel does not exercise its Initial Purchase Option, there is an automatic Renewal Term that is the lesser of : Option "X", twelve months, or Option "Y", a theoretically indeterminant amount, which is available only if (i) at the end of such Renewal Term, together with the Initial Term, the economic useful life of the Equipment is does not exceed 80% of the redetermined economic useful life of the Equipment, and (ii) the estimated fair market value of the Equipment at the end of the Renewal Term is not less than 20% of the fair market value of the Equipment at the beginning of the Lease/Contract. Option "Y" is capped at 12 months.

³ Iowa has adopted the codification of the "economic realities" test for determining whether or not a lease is a "true lease." This test "...focuses on whether the lessee has, in light of all the facts and circumstances, no possible alternative but to exercise the purchase option . . . under this test, if only a fool would fail to exercise the purchase option, the option price is generally considered nominal and the transaction characterized as a disguised security agreement." Baterra Bank v. Subway Leasing Corp., 209 B.R. 482, 486 (Bankr. S.D. IL. 1997).

4. The Lease/Contract is noncancellable⁴.

5. Schedule No. 1 to the Lease/Contract states that the "Lessor's Cost" of the Equipment is \$130,000.00. At least once, the Lease/Contract directly refers to the "Lessor's Cost" as the fair market value of the Equipment at the beginning of the Lease/Contract.⁵

6. The Lease/Contract provides that if the Equipment is "... lost, stolen, destroyed, or damaged beyond repair or such item of Equipment is confiscated or condemned, [Fansteel] shall pay [rent due at the time of the loss plus the] and the Casualty Value allocable to at the time of the loss or destruction."⁶

7. Annex A to the Lease/Contract is a chart that sets forth a time line over the initial term of the lease with associated diminishing percentages. The Casualty Value of the Equipment at the end of the Lease is 20% of its original fair market value; that is, \$26,000. Based on Annex A, it is reasonable to infer that, at the inception of the Lease/Contract, the parties predicted \$26,000 to be the fair market value of the Equipment at the end of the Lease/Contract.⁷ It further appears that TSB is employing a useful life for the Equipment of between six and seven years.

⁴ Lease/Contract §21.

⁵ The Lease Addendum, paragraph 1(B), refers to the fact that Renewal Term (b) is only available if, at the end of Renewal Term (b), there remains "... not less than 20% of the fair market value of the Equipment as of the beginning of the initial term as set forth in the Schedule." The only item "set forth at the beginning of the schedule" is the "Lessor's Cost".

⁶ Lease/Contract §9.

⁷ Such an inference—that the depreciated value of the equipment at the end of the lease term was one and the same as the predicted fair market value at the end of the lease— was also made in In Re Murray, 191 B.R. 309 (Bankr. E.D.PA 1996), aff'd, 201 B.R. 381 (E.D.PA 1996).

8. The Lease Addendum, paragraph 1(A) provides that after the Initial Term, Fansteel may exercise the “Initial Purchase Option”.⁸ The Initial Purchase Option permits Fansteel to purchase the Equipment at the greater of (a) the fair market value as reappraised at the end of the Initial Term or (b) \$26,000, which was the predicted fair market value at the inception of the Lease/Contract .

The Automatic Renewal Term/Enforcement of Purchase Terms

9. Paragraph 1(B) of the Lease Addendum provides that if Fansteel does not chose the Initial Purchase Option, or if it does not fulfill its purchase terms, then the Lease/Contract is automatically extended for a Renewal Term of either Option X or of Option Y. This language clearly indicates that the automatic renewal term is meant to take the place of a purchase—or to enforce a purchase—if Fansteel does not act accordingly.

10. RENEWAL TERM OPTION X: Under Option X, if Fansteel does not exercise the Initial Purchase Option, then TSB imposes a mandatory renewal term of twelve months at a cost of \$2,264.34 per month.⁹ This results in a cost of \$28, 249.32 to Fansteel. Thus, if the fair market value of the Equipment has not increased, and Fansteel is able to purchase the Equipment for \$26,000, then it will be saving itself \$2, 249.32 in debt to TSB. This does not include the residual value of the Equipment that Fansteel will gain. As will be discussed later, under Iowa law, the only way that the purchase option is not economonically compelling for Fansteel is if the fair market value of the Equipment, as reappraised, more than

⁸ Paragraph 2 of the Lease Addendum provides for a “Subsequent Purchase Option”, but the Subsequent Purchase Option is not relevant to this analysis.

⁹ Lease Addendum Paragraph 1(B) provides that the rent to be paid during any renewal Term is 1.7418% of \$130,000 = \$2,264.34 per month.

doubles that which was anticipated at the beginning of the Lease/Contract – because the compulsory lease renewal term must be offset against the fair market value. Taking into consideration wear and tear on the Equipment since the inception of the Contract, such a vast increase in the fair market value of the Equipment is not reasonably likely to occur.¹⁰

11. RENEWAL TERM OPTION Y: Renewal Term Option Y is only available if, (a) at the end of Renewal Term Option Y, the fair market value of the Equipment is at least twenty percent of the original fair market value (\$26,000), and (b) the Renewal Term, plus the Initial Term, does not exceed 80% of the useful economic life as reappraised. This means that the fair market value must have increased over the Initial Term, because, according to Annex A, the useful life at the end of the Initial Term was exactly 80% and the fair market value was exactly 20%. Option Y, and the requirement that the Renewal Term be the “lesser” of Option X, is perplexing. If Option Y is read by itself and not in the context of the entire Lease/Contract, Option Y could be anywhere from between one month to ten years, depending upon the results of the reappraisal and the whim of TSB. For example, if the reappraisal increased the useful life from seven years to ten years, Renewal Term Option Y could be between one and eleven months and still meet the necessary criteria for Option Y.

12. This theoretical proposition, however, does not withstand analysis under the established principle that contracts are to be construed as a whole. *See, e.g. Dickson v. Hubbell Realty Co.*, 567 N.W.2d 427, 430 (Iowa 1997); *Iowa Fuel & Minerals Inc. v. Iowa State Bd. Of Regents*, 471 N.W. 2d 859, 863 (Iowa 1991). In order for the Renewal Term to be an

¹⁰ See Iowa Code Section 37(b)(d)(1), stating that what is reasonably predictable during the life of an agreement must be determined at that time that the agreement is entered into.

enforcement of any possible default on the purchase terms (as noted above) the Renewal Term Option Y must be at least the same length as Renewal Term Option X; otherwise, TSB would not be able to recover anywhere near the value of the Equipment—which, contingent upon the terms of Option Y, has increased in value from \$26,000. Moreover, there is no logical economic reason why TSB should accept a term of less than twelve months when it is entitled to twelve months under Option X. In order to give effect to TSB's use of the Renewal Term as a punitive option for Fansteel's failure to perform under the Initial Purchase Option, it must be understood that the purpose of saying that Renewal Term should be the "lesser" of Option X and Option Y, was to provide a floor for the Renewal Term at twelve months.

13. As between TSB and Fansteel, the effect of Option Y is a nullity. It appears that the sole purpose of Option Y was to somehow further satisfy for TSB the safe harbor requirements of Internal Revenue Procedure 75-21, 1975-1 C.B. 715, which describes characteristics of a "true lease" for tax purposes. Revenue Procedure 75-21, 1975-1 C.B. 715 specifically states that in order to be a "true lease" for tax purposes, the lease term may not be for greater than 80% of the equipment's useful life and the equipment must have an amount equal to at least 20% of its fair market value present at the end of the lease term. Thus, the penalty for failing to purchase the Equipment—in the event that either Renewal Term Option is available—logically—under either option—is twelve months' rent at the renewal rate, or \$28,249.32.

The Lease/Contract Is A Disguised Security Agreement

14. The Court should deny the Motion because it is based on the assumption that the Lease/Contract is a true lease, when, in fact, it is a disguised financing. *In re Edison Brothers Stores*, 207 B.R. 801 (Bankr. D.Del 1997).

15. State law governs the determination of whether a transaction constitutes a true lease or a disguised secured transaction. *Id.* at 807, citing *In re Continental Airlines, Inc.*, 932 F.2d 282, 294 (3d Cir. 1991). Iowa law governs the Lease/Contract. Iowa Code §554.1201(b) provides that whether a transaction creates a true lease or a security interest is determined by the facts of each case.

16. Iowa Code §554.1201 (b)(3) and (4) also provides that a contract is not a true lease when consideration has been paid for the goods and the lessee (a) may not terminate the contract and (b) has an option to become the owner of the goods for nominal additional consideration upon compliance with the agreement between the parties. Both requirements exist in this situation.

17. “Nominal” consideration is defined by Iowa Code Section 37(b)(d)(1) as including consideration that “...is less than the lessee’s reasonably predictable cost of performing under the lease agreement if the option is not exercised.” Another test for nominality is the cost of the option compared to its fair market value. James J. White and Robert S. Summers, 4 Uniform Commercial Code (1995) §21.3(h). White and Summers set forth the standard that “... anything less than 50 percent of the projected fair market value at the option date smells of nominality and anything above 50 percent should normally be accepted as not nominal.” *Id.*

18. Moreover, Iowa Code Section 37(b)(d)(1) states that “*Reasonably predictable*” and “*remaining economic life of the goods*” are to be determined with reference to the facts and circumstances at the time the transaction is entered into.” At the time that Fansteel entered into this Lease/Contract, the predicted fair market value of the Equipment at the end of the Lease/Contract is \$26,000. As noted above, in view of the wear and tear, as well as the gradual obsolescence of machinery, at the time of entering into the Lease/Contract, it was not reasonably likely to expect that the fair market value of the Equipment should double at the end of the Lease/Contract.

19. The price of the mandatory Renewal Term--\$28,249.32—should be offset against Initial Purchase Option. Thus, for example, if the fair market value were to increase by 20%, then the price of the Initial Purchase Option would be $20\% \times \$26,000 = \$31,200$, less the price of the mandatory Renewal Term--\$28,249.32= \$2,950.68. Clearly, such a purchase option is nominal within White & Summers’ definition of “nominal”.

20. In sum, it was reasonably predictable, at the time of entering the Lease/Contract, that Fansteel would exercise its Initial Purchase Option and avoid the penalty imposed by the mandatory extra year because (a) compliance with the Initial Purchase Option, at the then foreseen fair market value would cost Fansteel less than the mandatory extra term, and (b) under any reasonably foreseeable increase in fair market value after reappraisal, the purchase price would be nominal when offset by the mandatory Renewal Term.

TSB Has Not Carried Its Burden To Prove That It Is Entitled To Adequate Protection Payments

21. Unless TSB accepts the above premise that Annex A sets forth the depreciation on the Equipment during the life of the Lease/Contract, then it has not carried its burden of proof that it is entitled to adequate protection.

22. Section 362(d)(1) of title 11 of the United States Code (the "Bankruptcy Code") provides that the Court may grant relief from stay, "for cause, including the lack of adequate protection of an interest in property of such party in interest." Because there is no clear definition of what constitutes "cause" within the meaning of Bankruptcy Code § 362(d)(1), relief from stay on this basis is discretionary and must be determined on a case by case basis. *See In re MacDonald*, 755 F.2d 715, 717 (9th Cir. 1985).

23. What constitutes "adequate protection" is set forth in Bankruptcy Code §361, which provides:

[W]hen adequate protection is required . . . of an interest of an entity in property, such adequate protection may be provided by --

(1) Requiring the trustee to make a cash payment or periodic cash payments to such entity, to the extent that the . . . use . . . under section 363 of this title . . . results in a decrease in the value of such entity's interest in such property;

(2) Providing to such entity an additional or replacement lien to the extent that such . . . use . . . results in a decrease in the value of such entity's interest in such property; or

(3) Granting such other relief . . . as will result in the realization by such entity of the indubitable equivalent in such entity's interest in such property.

11 U.S.C. §361.

24. Neither Bankruptcy Code § 361 nor any other provision of the Bankruptcy Code defines the nature and extent of the "interest in property" for which TSB is entitled to be

adequately protected. However, the statute plainly provides that a qualifying interest demands protection only to the extent that the use of the creditor's collateral will result in a decrease in "the value of such entity's interest in such property." 11 U.S.C. §§ 361, 363(e). *See also, In re South Village, Inc.*, 25 B.R. 987, 989-90 & n.4 (Bankr. D. Utah 1982); O'Toole, *Adequate Protection and Post-Petition Interest in Chapter 11 Proceedings*, 56 Am. Bankr. L.J. 251, 263 (1982).

25. The phrase "value of such entity's interest," although not defined in the Bankruptcy Code, was addressed by the Supreme Court in the landmark decision of *United Savings Association of Texas v. Timbers of Inwood Forest Associates, Ltd.*, 484 U.S. 365, 108 S.Ct. 626 (1988). For the meaning of "value of such entity's interest," the Supreme Court was guided by Bankruptcy Code § 506(a), which defines a creditor's allowed secured claim:

The phrase "value of such creditor's interest" in § 506(a) means "the value of the collateral." We think the phrase "value of such entity's interest" in § 361(1) and (2), when applied to . . . means the same.

Id. at 630 (citations omitted). *Timbers* teaches that a secured creditor is entitled to "adequate protection" only against diminution in the value of the collateral securing the creditor's allowed secured claim. Under *Timbers*, therefore, where the "value of the collateral" is not diminishing by its use, sale, or lease, the creditor's interest is adequately protected. Accordingly, to obtain relief from stay under Bankruptcy Code § 362(d)(1), the secured creditor has the burden of proving that its collateral is declining in value, and the amount of that decline. 11 U.S.C. §362(d)(1).

26. Unless TSB concedes Fansteel's position that the chart on Annex A indicates a diminution in fair market value, TSB has not provided any evidence of alleged diminution of the value of the equipment; therefore, TSB is not entitled to any adequate protection because it will not have borne its burden of proof. *See, Understanding the Basics of Bankruptcy & Reorganization 2001*, Practising Law Institute (2001) at 250.

Request for Administrative Costs other than Rent Payments

27. Among its requests for relief, the Motion requests that the Court permit administrative costs other than rent payments. Such costs are inappropriate when there is a good faith dispute as to the nature of the Lease/Contract. The court in *In re Circuit-Wise*, 277 B.R. 460 (Bankr.D.Conn. 2002) found that while a dispute was going on as to whether or not an agreement was a "true lease", no lease payments need be made. Logically, under of *Circuit-Wise*, if there is no obligation to make rent payments, nothing in the nature of a penalty should be levied for lack of payment.

28. This position is analogous to that taken by Judge Walsh of this District in *In re Hechinger Investment Company of Delaware*, 2001 Bankr. Lexis 148. In *Hechinger*, Judge Wash analyzed that, because the Bankruptcy Code relieves the debtor of equipment lease payments for the first sixty days after the filing for a bankruptcy, failure to make such payments is not a breach of the underlying agreement and no penalties may be assessed for failure to make such payments.

29. Here, Fansteel has not made payments under the Lease/Contract because, in good faith, it believes that this agreement should be recharacterized as a disguised financing.

Conclusion

30. The Debtors respectfully submit that the Lease/Contract should be recharacterized as a financing. Once the lease is recharacterized, Fansteel will make adequate protection payments according to the depreciation values set forth on Annex A. Alternatively, if the Court does not recharacterize the Lease/Contract as a financing, Fansteel will make past post-petition rent payments and resume current payments.

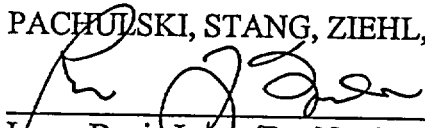
WHEREFORE, the Debtors respectfully request that the Court deny the Motion and grant the Debtors such other and further relief as the Court may deem just and proper under the facts and circumstances of these cases.

Dated: September 13, 2002

SCHULTE, ROTH & ZABEL LLP
Jeffrey S. Sabin (JSS 7600)
919 Third Avenue
New York, New York 10022
Telephone: (212) 756-2000
Facsimile: (212) 593-5955

and

PACHULSKI, STANG, ZIEHL, YOUNG & JONES P.C.



Laura Davis Jones (Bar No. 2436)
Rosalie L. Spelman (Bar No. 4153)
919 North Market Street, 16th Floor
P.O. Box 8705
Wilmington, Delaware 19899-8705 (Courier 19801)
Telephone: (302) 652-4100
Facsimile: (302) 652-4400

Counsel for Fansteel, Inc., et al.,
Debtors and Debtors in Possession