IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

40-7580

In re:	)	Chapter 11
	)	
FANSTEEL, INC., *et al.*,[1]	)	Case No. 02-10109 (JJF)
	)	
Debtors.	)	Jointly Administered
	)	
	)	**Objection Deadline: November 26, 2002 at 4:00 pm**
	)	**Hearing Date: TBD**

OBJECTION TO DEBTORS' MOTION FOR ORDER APPROVING EMPLOYEE RETENTION AND INCENTIVE PROGRAM FOR KEY EMPLOYEES [RE: D.I. 554]

The Official Committee of Unsecured Creditors' of Fansteel, Inc. (the "Committee"), by its attorneys, respectfully objects to the Motion for Order Approving Debtors' Employee Retention and Incentive Program for Key Employees Under 11 U.S.C. §§ 105(a) and 363(b) [RE: D.I. 554] (the "Motion") filed by Fansteel, Inc., *et al.*, the debtors and debtors-in-possession herein (the "Debtors"). In opposition to the Motion, the Committee respectfully states as follows:

INTRODUCTION

1. Ten months after filing for bankruptcy, the Debtors suddenly have decided that unless they immediately institute lavish insider giveaways, their business and the success of their reorganization will be at great risk. To that end, the Motion sets forth a superficial argument supported by inapplicable case law, which provides inadequate grounds for the extraordinary relief that the Debtors request. The Debtors' Motion must fail, first of all, because it is far too vague. However, even if detail were added, the basic premise of the Motion, that the Debtors

[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 Schultz Products, Inc.

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must institute a system of insider rewards in order to survive, is not based upon a sound exercise of the Debtors' business judgment.

ARGUMENT

2. On November 7, 2002, almost ten months after they filed their Chapter 11 petitions, the Debtors filed their Motion seeking the Court's approval of a key employee retention and incentive program (the "Retention Program"). The Debtors have targeted 25 employees (the "Key Employees") as vitally important to their continued operations and reorganization, without actually identifying those employees by name. The Retention Program would provide a stay bonus (the "Stay Bonus") to each of the Key Employees in the event that the employee continues to work for the Debtors. The first payment would be made in one month, on December 31, 2002, and subsequent payments would be made on December 31, 2003 and upon confirmation of a plan of reorganization. The Retention Program would also provide a severance payment (the "Severance Payment") in the event that the Debtors terminate any of the Key Employees. If approved, the Debtors would pay roughly $1.6 million in additional compensation to the Key Employees in the form of the Stay Bonus alone. The Motion fails to provide a figure as to the potential liability the Debtors would incur by agreeing to make the Severance Payments.

Standard of Review

3. Pursuant to Section 363(b) of the Bankruptcy Code, "[t]he trustee, [or debtor] after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate." 11 U.S.C. § 363(b). The Debtors bear the burden of demonstrating that use of the estates' property, other than in the ordinary course of business, will assist their reorganization. *See, e.g., Dai-Ichi Kangyo Bank, Ltd. v. Montgomery Ward Holding Corp. (In re*

Montgomery Ward Holding Corp.), 242 B.R. 147, 153 (D. Del. 1999); *see also In re Regensteiner Printing Co.*, 122 B.R. 323, 326 (N.D. Ill. 1990). The Debtors must prove that a sound business purpose justifies the Debtors' employee incentive program, particularly where, as here, the incentive program will result in significant administrative expenses. *Montgomery Ward*, 242 B.R. at 155; *see also Mark IV Properties v. Club Dev. & Mgmt. Corp. (In re Club Dev. & Mgmt. Corp.)*, 27 B.R. 610, 612 (9th Cir. BAP 1982) ("[B]usiness judgment is not a statutory ground for allowance of administrative expenses incurred out of the ordinary course of business"). Accordingly, this Court must independently determine the reasonableness of compensation paid by a Chapter 11 debtor-in-possession, including compensation paid to its employees. *See, e.g., In re Allegheny Internat'l, Inc.*, 131 B.R. 24, 29 (W.D. Pa. 1991).

There Is No Business Justification for the Retention Program

4. In order to satisfy the business judgment test, the Debtors must demonstrate that the use of $1.6 million of estate funds to compensate affected employees is reasonable, given the circumstances of these cases and the market rates of compensation of comparable employees. *In re Phoenix Steel Corp.*, 110 B.R. 141, 143 (Bankr. D. Del. 1989); *see also Regensteiner Printing*, 122 B.R. at 325; *In re Heberman*, 122 B.R. 273, 287 (Bankr. W.D. Tenn. 1990); *In re Crouse Group, Inc.*, 75 B.R. 553, 559 (Bankr. E.D. Pa. 1987). Moreover, because the Debtors propose to use estate property for the benefit of insiders - officers of the Debtors, these transactions are subject to particular scrutiny by the Court. *See, e.g., In re W.A. Mallory Co., Inc.*, 214 B.R. 834, 837-38 (Bankr. E.D. Va. 1997); *Regensteiner Printing*, 122 B.R. at 326.

5. Here, the Debtors have failed to state a sound business purpose for approving the Retention Program. Indeed, the Debtors have offered no business justification other than general allegations that employees may leave if they are not paid the proposed extraordinary bonuses.

The Debtors have failed to provide any analysis of the market rates of compensation of comparable employees in comparable markets. The Debtors have failed to provide any analysis of the necessity of each employee to the reorganization effort. In short, the Debtors have proffered vague generalizations in place of evidence of a sound business purpose.

The Debtors Cannot Afford the Retention Program

6. In difficult economic times, extraordinary bonuses are reserved for those who achieve extraordinary results. Under the Debtors' existing employee incentive program which was implemented prepetition, bonuses are tied to specific performance goals. *See* Motion at ¶ 14. The Debtors now seek to supplement that goal-driven program with an employee giveaway. Moreover, these employee gifts will be given while the Debtors' economic condition is getting worse, rather than improving. The Debtors' operating losses for the period January 1, 2002 to September 30, 2002 are in excess of $5 million. In fact, the Debtors' operating loss for the month of September alone was in excess of $1 million. Where, as here, a company is losing millions of dollars, there can be no justification for giving away millions more based solely on vague concerns that purportedly critical employees may take other jobs. Simply put, these Debtors cannot even afford this retention program. By failing to address where they will find the extra cash for the employee gifts, the Debtors may be asking for permission to give away something that they cannot deliver.

The Retention Program Lacks Specificity

7. Even if the Debtors could afford their proposed generosity, the Debtors have failed to disclose the specific identities of the lucky recipients, where they work, what they do, or even how much they will each receive. The Debtors have provided no explanation of how they chose the winners or who participated in the selection process. The Debtors request that their

Motion be granted without providing any specificity that would allow this Court to make a reasoned decision as to the sound business justification supporting the Retention Program.

The Retention Program Is Unnecessary

8. The only reasonable inference to be drawn from the Motion is that the Retention Program is unnecessary. The Debtors' cases have been pending for nearly ten months. If the Key Employees desired and were able to find employment elsewhere, they would have had ample time and opportunity in the ten months since the Petition Date to have done so. At this point of the reorganization, providing the Key Employees with Stay Bonuses and potential Severance Payments is not only gratuitous, but also irresponsible, in light of the Debtors' significant operating losses. Approval of the Retention Program will only further decrease the likelihood that the Debtors' creditors will receive any meaningful recovery.

9. Moreover, the Debtors and their advisors formulated the Retention Program with no input from the Committee. Where, as here, the support of the Committee is a key element of the Debtors' reorganization efforts, there should be appropriate review with the Committee in developing a retention program.

The Key Employees Are Replaceable

10. Furthermore, the Committee believes that the 25 individuals selected by the Debtors as Key Employees may be replaceable or may not be necessary to the Debtors' continued operation and/or reorganization. There is no showing that if these Key Employees were to leave, the Debtors' reorganization efforts would be severely harmed. Moreover, the cases cited by the Debtors involved large companies that needed some form of an employee retention program due to unusual and unique circumstances. *See Montgomery Ward*, 242 B.R. at 152; *In re America West Airlines, Co.*, 171 B.R. 674, 677 (Bankr. D. Ariz. 1994).

11. In *Montgomery Ward*, this District Court approved an employee retention program only after noting that the bankruptcy court "found that the [retention] programs were 'absolutely essential' because of the unique problems confronting the Debtors." *Montgomery Ward*, 242 B.R. at 152 (emphasis supplied). The "unique problems" referred to in *Montgomery Ward*, related to the Debtors' national notoriety and infamy as a failing business in the ultra-competitive retail industry. *Id.* The court noted that without the proposed retention program, the debtors would assuredly have faced a mass exodus of top-level employees to their competitors, which would have led to the debtors' liquidation. *Id.*

12. Similarly, in *America West*, the court approved an employee retention program that the debtor termed as a "success bonus plan" due to the unusual history of the debtor's case. *America West*, 171 B.R. at 678. This history included a bankruptcy filing, two years of substantial losses, substantial employee layoffs and across-the-board salary reductions. *Id.* at 675. After all of this turmoil, the Debtor turned the corner and reported its first net profit in over two years, due in large part to the diligent efforts of its entire work force. *Id.* In addition, the court found that the debtor "reorganized in only three years in an industry where the Bankruptcy Code itself presents a delay in emerging from bankruptcy because of its air craft leasing provisions." Id. at 676. In order to reward their work force and improve morale, the Debtors proposed a success bonus plan, whereby each and every employee that contributed to the debtor's miraculous turnaround would receive a bonus. *Id.* at 678. The court found that "the proposed bonuses will aid in continuing the momentum the Debtor has gained up to, and through the confirmation process."

13. In contrast, the Debtors' businesses are a conglomeration of relatively small, disparate manufacturing facilities facing the same problems as other small manufacturing

companies, rather than unusual or unique circumstances. Other than stating that the Debtors are thinly staffed and have a need for full-time employees, the Debtors do not provide any reasons or evidence that the Key Employees are irreplaceable. There is no mention of any particular abilities, functions, or expertise that would make the Key Employees necessary to the Debtors' operations or reorganization efforts. Moreover, the Debtors make broad allusions to the prospect that critical employees will find new jobs, but fail to acknowledge that their employees face a depressed job market, in contrast to the robust employment prospects that faced Montgomery Ward and America West employees in the 1990s.

The Retention Program Harms the Debtors' Reorganization Efforts

14. As opposed to the employee retention programs in *Montgomery Ward* and *America West*, not only is the Debtors' Retention Program not essential to address a unique problem confronting the Debtors, but approval of the Retention Program may actually harm the Debtors' reorganization efforts. The Retention Program as proposed by the Debtors would restrict the reorganization options available to the Debtors and their estates by inhibiting the Debtors' ability to realistically sell any of their businesses and operations. The Retention Program will dramatically increase the Debtors' liabilities. If the Debtors sell a business, these new liabilities will either reduce the purchase price a willing buyer will pay or will have to be paid out of the sale proceeds, thereby decreasing the funds available to pay unsecured creditors. Either prospect weighs heavily against the relief requested in the Motion.

CONCLUSION

The Retention Program proposed by the Debtors is unacceptable and does not arise from a sound exercise of the Debtors' business judgment for several reasons. First, the Motion fails to demonstrate the true necessity of such a lavish giveaway when the bankruptcy

case is already ten months old. There is no credible support for the claim that employees will leave without the Retention Program or that any employees who are planning to leave are truly so critical that their departure will significantly impair the Debtors' ability to reorganize. In addition, the Debtors' poor financial performance since filing for bankruptcy calls into question the Debtors' ability to perform under the Retention Program while also indicating that the Debtors should be devoting their attention to issues other than employee retention. The Retention Program also is inappropriate because it will impair the Debtors' reorganization options by unnecessarily creating large administrative claim obligations that will reduce amounts available for unsecured creditors. Finally, even without all of those flaws, the Retention Program is far too vague to even be considered. The Debtors do not name the key employees who would receive the Stay Bonus or give any details as to why these gifts are appropriate. The terms of the proposed Severance Program are even less detailed. Under other circumstances, the Debtors' generosity toward their employees might be commendable, but in the context of a Chapter 11 case with poorly performing debtors, the lavish insider giveaways that the Debtors propose cannot be justified and this Court should deny the Motion.

WHEREFORE, the Committee respectfully requests that the Court deny the Motion and grant such other and further relief as is just and proper.

Respectfully submitted,

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KRLSWILM 40527v1

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FOR THE DISTRICT OF DELAWARE

In re	)	Chapter 11
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FANSTEEL, INC., *et al.*, [1]	)	02-10109 (JJF)
	)	
Debtors.	)	(Jointly Administered)

AFFIDAVIT OF
PATRICIA A. JACKSON, PARALEGAL

STATE OF DELAWARE:
SS:
NEW CASTLE COUNTY:

I, Patricia A. Jackson, certify that I am, and at all times during the service of process, have been, an employee of Klett Rooney Lieber & Schorling, P.C., not less than 18 years of age and not a party to the matter concerning which service of process was made. I certify further that the service of the attached:

OBJECTION TO DEBTORS' MOTION FOR ORDER APPROVING EMPLOYEE RETENTION AND INCENTIVE PROGRAM FOR KEY EMPLOYEES [RE: DOCKET NO. 554]

was made on November 26, 2002 on the following parties on the attached Service List by Hand Delivery on City of Wilmington, Delaware addresses and by First Class United States Mail, postage prepaid, on all others.

Patricia A. Jackson

SWORN AND SUBSCRIBED before me this 26th day of November, 2002.

NOTARY

BARBARA J. ROST
NOTARY PUBLIC, STATE OF DELAWARE
MY COMMISSION EXPIRES ON JUNE 14, 2006

[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.

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File an answer to a motion:

02-10109-JJF Fansteel Inc. and HBD Industries, Inc.

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The following transaction was received from Landis, Adam G. entered on 11/26/2002 at 4:38 PM EST and filed on 11/26/2002

Case Name: Fansteel Inc. and HBD Industries, Inc.
Case Number: 02-10109-JJF
Document Number: 593

Docket Text:
Objection to Motion *for Order Approving Employee Retention and Incentive Program For Key Employees [Re: D.I. 554]* Filed by Official Committee of Unsecured Creditors. (Attachments: # (1) Affidavit of Service) (Landis, Adam)

The following document(s) are associated with this transaction:

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