WILL AMERICAN AIRLINES CEO POCKET $20 MILLION SEVERANCE PAYMENT? BAPCA § 503(C) RESTRICTIONS ON INSIDER SEVERANCE HAVE NO TEETH IN PLAN CONFIRMATION

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American Airlines CEO Tom Horton's $20 million severance payment, for stepping down as chief executive when debtor American Airlines emerges from bankruptcy and merges with US Airways, will be before the Bankruptcy Court for approval in American Airlines' proposed Chapter 11 plan of reorganization. On April 11, 2013, Bankruptcy Judge Sean H. Lane previously denied approval of the severance payment under Bankruptcy Code § 503(c) in connection with approval of the merger.[2] Judge Lane rejected American Airlines' contention that the payment could be approved as the proper exercise of the Debtors' "business judgment" and an "ordinary course of business" transaction under § 363(b)(1), and held that the strict requirements of § 503(c) applied.[3]

Added in 2005 as part of the BAPCA amendments, Section 503(c) provides that, notwithstanding § 503(b)'s allowance of administrative expenses, "there shall neither be allowed, nor paid – … (2) a severance payment to an insider of the debtor, unless—(A) the payment is part of a program that is generally applicable to all full-time employees; and (B) the amount of the payment is not greater than 10 times the amount of the mean severance pay given to nonmanagement employees during the calendar year in which the payment is made."[4] Judge Lane explained that § 503(c) added "a set of challenging standards" and "high hurdles" for payment of insider severance in place of the "business judgment" standard of § 363, and cited Senator Edward Kennedy's concern over the "glaring abuses of the bankruptcy system by the executives of giant companies like Enron Corp. and WorldCom, Inc. and Polaroid Corporation, who lined their pockets, but left thousands of employees and retirees out in the cold."[5] Judge Lane emphasized that "courts disfavor attempts to bypass the requirements of section 503(c),"[6] but noted that "Section 503(c) was not intended to foreclose a Chapter 11 debtor from *reasonably* compensating employees, including 'insiders,' for their contribution to the debtors' reorganization."[7]

There was no dispute between the parties that Mr. Horton qualified as an "insider," that the proposed payment was "severance," and that the payment did not meet the requirements of § 503(c).[8] American Airlines argued, however, that § 503(c) did not apply because the payment would be made by Newco following the merger, not by American Airlines' estates.[9] Judge Lane rejected this "legal fiction" as the proposed payment would be made without any action by Newco, an entity that will consist of 72% of the reorganized debtors' property, and the request for "allowance" of the payment "fits comfortably" within the terms and intent of § 503(c).[10] Judge Lane also declined to accept American Airlines offer to amend the agreement to require

the future board of Newco to vote on the severance payment.[11] While Newco will not be restricted by the requirements of the Bankruptcy Code to grant Mr. Horton severance compensation, no purpose would be served by the Court approving the payment if Newco could later veto such approval.[12]

Notwithstanding such ruling, Judge Lane seemed to accept the holding of the bankruptcy court in In re Journal Register Co. that § 503(c) does not apply during plan confirmation and left open the opportunity for American Airlines to seek approval of the $20 million severance in connection with their reorganization plan.[13] Judge Lane cited the heightened disclosure, notice, and hearing requirements of plan confirmation, and the opportunity for creditors to vote on a plan.[14] Moreover, payments under a confirmed plan have the "attributes of a contract" not administrative expenses of a case subject to § 503(c).[15] Judge Lane observed that, rather than being governed by § 503(c), severance payments included in a plan of reorganization would be governed by § 1129(a)(4).[16]

Section 1129(a)(4) requires that the bankruptcy court approve the "reasonable[ness]" of any payment made by a debtor for services or costs in connection with the case or plan.[17] Although the "reasonableness" test was not discussed in the American Airlines decision, the Journal Register Court held in similar circumstances that § 1129(a)(4) requires both disclosure and reasonableness considering the facts and circumstances of the payment.[18] The Journal Register Court held that the incentive plan at issue was "reasonable" in light of overwhelming acceptance of unsecured creditors who had the "opportunity to factor the payments into their decision whether to accept the Plan," the endorsement of the Creditors' Committee, and testimony of the Debtors' chief operating officer.[19] The Journal Register Court further found no suggestion that the incentive plan was "not in line with the market for compensation of the top executives of similar companies."[20]

Only fours days after Judge Lane's denial of Mr. Horton's $20 million severance payment, American Airlines filed their plan of reorganization and disclosure statement that required, as a condition precedent to the effectiveness of the plan and the merger agreement, that the proposed severance payment and benefits to Mr. Horton be approved by the Bankruptcy Court.[21]

The merger has the "overwhelming support" of the unsecured creditors' committee, ad hoc groups of creditors, and the American Airlines' labor unions, and will result in $8 billion in value being distributed to the Debtors' stakeholders.[22] It is unlikely that the $20 million severance payment to Mr. Horton would be a roadblock to acceptance amongst the voting creditors and equity holders. Nonetheless, the United States Trustee will have the opportunity to continue its fight against the payment. At confirmation, American Airlines will not receive the benefit of their "business judgment" in entering the agreement, and Judge Lane likely will consider whether $20 million in severance to Mr. Horton is "reasonable" under § 1129(a)(4) in light of the circumstances.[23] The Court may examine severance packages given to other CEOs

inside or outside of bankruptcy to aid its "reasonableness" inquiry.[24] Congresses' clear intent to limit insider severance pay in § 503(c), although not directly applicable in confirmation, may color Judge Lane's review of the reasonableness of the proposed severance and whether the Court will disallow or reduce any portion of the $20 million payment.

Section 503(c) has no teeth in light of the plan exception set forth in Journal Register and seemingly adopted by Judge Lane. American Airlines will be watched to see how high a hurdle the "reasonableness" requirement of § 1129(a)(4) sets for insider executive compensation in bankruptcy in the context of plan confirmation.

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[1] This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to the author.
[2] See Memorandum of Decision, In re AMR Corp., No. 11-15463-SHL (Bankr. S.D.N.Y. April 11, 2013) [Dkt. No. 7587] (the "Bankruptcy Decision").
[3] Id. at p. 11-20; see also id. at p. 19 ("[P]rior to the enactment of Section 503(c), compensation payments outside the ordinary course were governed by the business judgment standard of Section 363(b). … Section 503(c) was specifically enacted to change that practice by establishing a higher standard to justify retention or severance payments to insiders during the pendency of bankruptcy cases.") (citing In re Dana Corp., 358 B.R. 567, 576 (Bankr. S.D.N.Y. 2007) and In re Velo Holdings, Inc., 472 B.R. 201, 209 (Bankr. S.D.N.Y. 2012)).
[4] 11 U.S.C. § 503(c)(2).
[5] See Bankruptcy Decision, p. 13 (citing In re Dana Corp., 358 B.R. at 575 and In re Global Home Prods., LLC, 369 B.R. 778, 783-84 (Bankr. D. Del. 2007)).
[6] Id. (citing In re Velo Holdings, Inc., 472 B.R. at 209.
[7] Id. (citing Dana Corp., 358 B.R. at 575 (emphasis in original)).
[8] Id. at p. 15.
[9] Id.
[10] Id. at 17-18, n. 14.
[11] Id. at 18-19.
[12] Id. at 19.
[13] Id. at 15-17 (relying on In re Journal Register Co., 407 B.R. 520, 535-38 (Bankr. S.D.N.Y. 2009) (ALG)).
[14] Id. at 15-16 (citing Journal Register, 407 B.R. at 536-37).
[15] Id. at 16 (citing Journal Register, 407 B.R. at 535-36).
[16] Id. at 16 ("By presenting their request as part of a proposed plan of confirmation, the debtors in *Journal Register* took the proposed incentive payments outside the coverage of Section 503 and placed them within the confines of Section 1129(a)(4).") (citing Journal Register, 407 B.R. at 537).
[17] 11 U.S.C. § 1129(a)(4) (requiring that "[a]ny payment made or to be made by the proponent, by the debtor, or by a person issuing securities or acquiring property under the plan, for services or for costs and expenses in connection with the case, or in connection with the plan and incident to the case, has been approved by, or is subject to the approval of, the court as *reasonable*.") (emphasis added)
[18] Journal Register, 407 B.R. at 537.
[19] Id. at 538.
[20] Id.
[21] See Proposed Disclosure Statement for Debtors' Joint Chapter 11 Plan, In re AMR Corp., No. 11-15463-SHL (Bankr. S.D.N.Y. April 11, 2013) [Dkt. No. 7632] (the "Disclosure Statement").
[22] See Bankruptcy Decision, pp. 5-6.

[23] Id. at p. 20, n. 16 ("To the extent that the Debtors subsequently invoke Section 1129(a)(4) as a basis to justify a post-emergence payment to Mr. Horton, the Court today does not have a view on that issue. It is premature to consider such a request without a proposed plan of reorganization and an appropriate record.").

[24] Id. at p. 19-20 (stating that analogous severance payments made in the mergers of United/Continental and Delta/Northwest occurring outside of the Chapter 11 context have no bearing on the satisfaction of Section 503(c)'s requirements, although the "two examples may inform the Court as to market salaries for a severance payment in major airlines mergers."