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Court to Reassess **Severance Payment** As Part of Reorganization Plan

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When American Airlines revealed its plans to merge with U.S. Airways to become the world's largest airline, the details of the transaction were widely reported. One aspect of the deal—a nearly $20 million severance payment to Tom Horton, the CEO of American Airlines—grabbed headlines. To be sure, $20 million is no small sum, even in this age of rich golden parachutes for executives of large public corporations. But the severance payment came under scrutiny not just for its eye-popping figure. Because the payment was contemplated in connection with American Airlines' Chapter 11 bankruptcy case, the Office of the U.S. Trustee, tasked with overseeing the administration of the airline's reorganization case, objected to the severance payment that, in its view, was prohibited by federal bankruptcy law.

The bankruptcy court agreed with the U.S. Trustee.[1] Approving the merger transaction, but striking down the severance payment, the court made clear that, notwithstanding American's decision to structure the payment as an obligation of a newly-formed entity following American Airlines' anticipated emergence from Chapter 11, the court could not approve the allowance of a payment that, on its face, ran afoul of the statutory limitations on the amount of severance that may be paid to insiders.[2] The payment, whether made by American Airlines or a post-merger entity, was still a severance payment and the amendment to the

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Bankruptcy Code governing allowance and payment of severance to insiders (§503(c)) that was enacted in 2005 as part of the Bankruptcy Abuse and Consumer Protections Act (BACPA) would apply.[3] The BACPA amendment reflected the intent of Congress to address concerns about excessive payments to corporate executives of bankrupt companies. Though it refused to authorize the payment, the court noted that such a payment could be proposed under a plan of reorganization and reconsidered at such time.[4] Shortly after the court issued its decision, American Airlines submitted its Chapter 11 plan of reorganization. Indeed, Horton's severance payment is back on the table as part of the airline's Chapter 11 plan, but the legal issue at plan confirmation may shift to whether the Bankruptcy Code requires a Chapter 11 plan to comply with §503(c), the same provision that the bankruptcy court has already determined the proposed severance payment violates.

Background

On Feb. 22, 2013, AMR Corporation and its affiliated debtors (the Debtors) sought approval from the bankruptcy court of a merger agreement between U.S. Airways Group and a wholly owned subsidiary of AMR created to effectuate the merger.[5] The new airline would operate under the American Airlines name.[6] U.S. Airways shareholders would receive 28 percent of the diluted equity of the merged entity (Newco), and AMR shareholders would receive the remaining 72 percent.[7] The merger agreement also provided for "severance compensation" to Horton in the amount of $19,875,000, half in cash and half in Newco common stock, payable by Newco following the merger.[8] The terms of Horton's $20 million payment were set forth in a letter agreement attached as an exhibit to the merger agreement.[9] The U.S. Trustee filed an objection to approval of the severance payment to Horton, but did not contest the merger transaction itself.[10]

'AMR' Decision

Following a hearing on the dispute, the bankruptcy court approved the merger transaction, but refused to authorize the proposed severance payment to Horton. The court found that the payment did not comply with §503(c)(2), which provides:

> [T]here shall neither be allowed nor paid—…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.

Citing to 'In re Journal Register', the court noted that the AMR Debtors could seek authorization for the severance payment under §1129(a)(4), **in connection with the confirmation** of a Chapter 11 plan.

11 U.S.C. §503(c)(2). The Debtors did not argue that the nearly $20 million severance payment to the Debtors' CEO satisfied either of these statutory conditions.

Rather, the Debtors principally relied on the fact that the severance would be paid by Newco (and not from the Debtors' estate) and was therefore not an administrative expense subject to §503(c). The court rejected this argument:

> But that is something of a legal fiction. It is clear that the severance payment relates to Mr. Horton's employment at AMR, where he currently serves as CEO, and not from Newco, which does not yet exist and where Mr. Horton will take on a new position only after the merger is finalized and the proposed severance is paid. As a practical matter, moreover, the proposed severance would be paid without any action from Newco, an entity that will consist of 72% of the property of the Reorganized Debtors. In any event, the Debtors' argument fails because the statute speaks in terms of "allowance" of a payment.[11]

The court's analysis, however, did not end there. Citing to *In re Journal Register*,[12] the court noted that the AMR Debtors could still seek authorization for the severance payment under §1129(a)(4), in connection with the confirmation of a Chapter 11 plan. Specifically, the court stated that, "[b]y presenting their request as part of a proposed plan of confirmation [sic], the debtors in *Journal Register* took the proposed incentive payments outside of the coverage of Section 503 and placed them within the confines of Section 1129(a)(4)."[13] But the court could not rule on the propriety of such a severance payment under a plan, because no such plan was before it.[14]

'Journal Register' Decision

Given the court's suggestion to heed the decision in *Journal Register*, that case warrants a closer look. There, the debtors proposed a Chapter 11 plan that provided for, among other things, a post-emergence incentive program for the benefit of certain employees of the reorganized debtors, designed to award those employees upon achievement of performance objectives in connection with the shutdown of certain of the debtors' unwanted publications, reduction of expenses and consummation of the Chapter 11 plan.[15] Certain objectors to the plan argued that the plan could not be confirmed under §1129(a)(1), which requires all plans to "comply with the applicable provisions of [the Bankruptcy Code]," because the incentive programs did not comply with §503(c).[16]

The court in *Journal Register* first noted that "[t]he legislative history of §1129(a)(1) suggests that the term 'applicable provisions' means 'the applicable provisions of Chapter 11, such

as §§1122 and 1123, governing classification and contents of the plan," and cited to Second Circuit caselaw in support of that proposition.[17] Concluding that §1129(a)(1) of the Bankruptcy Code thus does not require a plan to comply with §503(c), the court stated that "[t]his would end the objection based on §503."[18] However, the court also acknowledged contrary authority, referring to decisions in which other bankruptcy courts did consider whether a plan complied with sections of the Bankruptcy Code outside of Chapter 11 to determine whether the requirements of §1129(a)(1) was satisfied.[19]

Without ruling on how to apply §1129(a)(1), the court then held that, because the incentive payments were being paid after plan confirmation and as a result of the confirmation order itself, the payments were not being allowed as administrative expenses under §503 in general.[20] As further justification for its ruling, the court also determined that, even if §503(c) were considered, the incentive payments were (i) outside the scope of §503(c)(1)[21] (the payments were not inducements for the employees to remain with the company); (ii) outside the scope of §503(c)(2) (the payments were not triggered by an employment termination event); and (iii) permissible under §503(c)(3)[22] because they were justified by the facts and circumstances of the case.[23]

Lastly, the *Journal Register* court noted that §1129(a)(4), which provides for payments under a plan on account of services in connection with a case, was an additional basis to take the incentive payment outside the scope of §503(c).[24] Such payments (typically relating to professional fees) may be approved as part of a plan under §1129(a)(4) if there has been sufficient disclosure of the payment and the payment is reasonable.[25] Applying the standard for compliance with §1129(a)(4), the court held that the incentive payments were permissible under the plan because the payments were fully disclosed and were reasonable.[26]

Thus, in *Journal Register* the court did not decide whether the proposed incentive payment had to comply with §503(c) in the context of plan confirmation pursuant to §1129(a)(1). Instead, it determined that the payment (i) was outside the scope of §503 because it was not an administrative expense (but nonetheless would have satisfied §503(c)(3)); and (ii) satisfied §1124(a)(4), the directly applicable statute.

'AMR' Severance: Potential Issues

Shortly after the *AMR* decision was issued, the Debtors filed their Joint Chapter 11 Plan dated April 15, 2013 (the Plan), which provides that the same letter agreement containing the terms of Horton's severance payment is to be approved as a condition to the effectiveness of the Plan.[27]

Consideration of the severance payment to Horton at plan confirmation raises an interesting situation: The payment that was just expressly stricken down as violative of §503(c)(2) may well be deemed permissible by the same court now that the payment is presented as part of a Chapter 11 plan. As such, in order for the payment to be approved as part of the Plan, the bankruptcy court will have to make a specific ruling that §1129(a)(1) does not require the Plan to comply with §503(c). To be sure, there is a fair amount of case law to support this position. Yet, *Journal Register* itself recognizes that some bankruptcy courts have required a plan to comply with Bankruptcy Code provisions outside of Chapter 11, such as §§524, 327, 330 and 554.[28] Moreover, in another high-profile case, a court has considered §503(c) in the context of plan confirmation, and found that the severance payments proposed in that case violated §503(c)(2) and thus would have to be stricken from the plan for failing to comply with §1124(a)(4).[29] In addition, it could easily be argued that the plain language of §1129(a)(1), which requires a plan to comply with all applicable provisions of "*title* 11" and not just "*Chapter* 11," on its face contemplates consideration of all applicable provisions of the Bankruptcy Code, and not just those relating directly to formulation of a Chapter 11 plan.

It is likely that a party-in-interest, perhaps the U.S. Trustee, will object to confirmation of AMR's Plan on the basis that the severance payment provided for in Horton's letter agreement is an end-run around the legislative intent of §503(c). With so much at stake, the bankruptcy court's confirmation decision will be sure to attract a great deal of attention.

1. *In re AMR*, ___B.R.___, 2013 WL 1749923 (Bankr. S.D.N.Y. April 11, 2013).
2. Id. at *8.
3. Id.
4. Id. at *7.
5. Id. at *1.
6. Id..
7. Id.
8. Id. at *3.
9. Id.
10. Initially, the U.S. Trustee also objected to certain other employee compensation arrangements contemplated by the merger agreement in addition to Horton's severance payment, but those objections were later resolved when additional information concerning those arrangements was disclosed by the Debtors.
11. *AMR*, 2013 WL 1749923 at *8.
12. 407 B.R. 520 (Bankr. S.D.N.Y. 2009).
13. *AMR*, 2013 WL 1749923 at *7.
14. Id. at *8 ("[T]he Debtors here seek the Court's approval of this severance payment now, notwithstanding the fact that the Debtors' expected effective date of the merger (and plan) is some six months away").
15. *In re Journal Register*, 407 B.R. at 527.
16. Id. at 535.
17. Id. (citing *Kane v. Johns-Manville (In re Johns-Manville)*, 843 F.2d 636, 649 (2d Cir. 1988)); see also *In re 20 Bayard Views*, 445 B.R. 83, 94 (Bankr. E.D.N.Y. 2011) ("Bankruptcy Code Section 1129(a)(1) requires that '[t]he plan compl[y] with the applicable provisions of this title.' 11 U.S.C. §1129(a)(1). Courts interpret this language to mean that a plan must meet the requirements of Bankruptcy Code Sections 1122 and 1123").
18. Id.
19. Id.
20. Id.
21. Section 503(c)(1) provides that payments to insiders of the debtor for the purpose of inducing such person to remain with the debtor's business are not authorized unless (A) the payment is essential to the retention of the person because the person has another comparable job offer, (B) the services provided by the person is essential to the debtor's business, and (C) either (i) the amount of the payment is not greater than 10 times the average amount paid to nonmanagement employees for similar purposes, or (ii) if no such payments were made to nonmanagement employees, then the amount of the payment is not greater than 25 percent of any similar payment made to such insider during the prior calendar year. 11 U.S.C. §503(c)(1).
22. Section 503(c)(3) is something of a catch-all provision that provides that other non-ordinary course payments, including post-petition payments to officers, managers or consultants, are not authorized unless they are justified by the facts and circumstances of the case. 11 U.S.C. §503(c)(3).
23. *In re Journal Register*, 407 B.R. at 536-37.
24. Id. at 537.
25. Id. (citing 7 Collier on Bankruptcy at ¶1129.03[4]).
26. Id.
27. Plan at 87.
28. *In re Journal Register*, 407 B.R. at 535.
29. *In re TCI 2 Holdings*, 428 B.R. 117, 172-73 (Bankr. D.N.J. 2010).