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Bankruptcy Court Denies $20 Million Severance Payment to CEO of American Airlines

On March 27, 2013, Judge Sean Lane of the United States Bankruptcy Court for the Southern District of New York approved the $11 billion merger of US Airways Group and AMR Corporation effective upon confirmation of the AMR debtors' chapter 11 plan. Upon completion of the merger, a new entity – "Newco," for present purposes – will survive. In his March 27 ruling, Judge Lane declined to approve a proposed $20 million severance payment by Newco to Thomas Horton, the current Chief Executive Officer of AMR Corporation. Shortly thereafter, Judge Lane issued a written opinion explaining his reasoning for denying the proposed severance payment and in it, foreclosed an attempt to approve a severance package free from the strict standards of Section 503(c) of the Bankruptcy Code.

Background

In connection with the proposed merger, the AMR debtors sought Bankruptcy Court approval of employee compensation and benefit arrangements (the "Employee Arrangements") falling into three categories (i) Ordinary Course Changes; (ii) Employee Protection Arrangements; and (iii) the CEO severance payment. Though the US Trustee initially objected to all three Employee Arrangements, she eventually withdrew her objections to all but the CEO severance payment.

The CEO severance payment provided for the termination of Mr. Horton's employment as CEO of AMR Corporation upon the consummation of the merger. He would then be appointed chairman of the newly-formed Newco Board. Mr. Horton would receive severance compensation of $19,875,000, paid 50% in cash and 50% in common stock. The proposed severance recognized Mr. Horton's efforts in leading the AMR debtors' restructuring and enhancing the value of their estates.

In her objection, the US Trustee claimed approving the post-merger CEO severance payment would violate Section 503(c) of the Bankruptcy Code. Section 503(c) of the Bankruptcy Code restricts retention incentives and severance awards to a debtor's insiders – generally directors, officers and general partners. Section 503(c)(2) prohibits paying severance to such an insider unless the payment is part of a program generally applicable to all full time employees and the payment does not exceed 10 times the amount of average severance payments given to non-management employees during the calendar year of the payment. The US Trustee contended that as CEO, Mr. Horton was an insider and the proposed payment amounted to impermissible severance.

The AMR debtors maintained that the proposed severance payment was not subject to Section 503(c) because Newco, not the AMR debtors' estates, would make the payment after bankruptcy and after the merger. They argued that Section 363 of the Bankruptcy Code and its "business judgment" standard, not Section 503(c)(2), governed pre-approval of the arrangement. The Bankruptcy Court disagreed, finding that Section 503(c) was added to the Bankruptcy Code in 2005 to impose a higher standard than the business judgment standard on severance arrangements. Judge Lane considered the argument that these payments could be justified as post-emergence-related compensation and dismissed it as "somewhat of a legal fiction," given that the payment was clearly for work done during the bankruptcy. While the AMR debtors had argued that, as a business matter, a severance payment to a CEO was common in analogous situations, such as the mergers of United and Continental Airlines and Delta and Northwest, the Bankruptcy Court noted that those mergers had taken place outside of chapter 11 and its requirements.

The AMR debtors also offered to amend the CEO severance agreement to provide that the board of directors of Newco would have to vote in favor of the severance payment before the payment could be made. Judge Lane said that while Newco was free post closing to authorize a payment to the former CEO– because at that time Newco would only have to answer to its shareholders and not the Bankruptcy Court – he was not prepared to pre-approve the payment now. The Bankruptcy Court observed that the AMR debtors might resort to Section 1129 (a)(4) as a basis for a post-emergence payment to the CEO, but it would not comment on the prospects of success for that course of action since the AMR debtors had yet to file a proposed plan of reorganization.

Conclusion

Certainly this decision will factor into the continued grappling over how to structure compensation for executives in chapter 11. Even though the proposed severance payment to an exiting executive for a job well-done would have been made by a newly merged entity post-chapter 11, the Bankruptcy Court strictly applied the limitations of Section 503(c)(2) and declined to give the CEO the comfort of Section 363's business judgment standard during the case. Simply put, if you ask a bankruptcy court to approve any severance payment outside of a plan, it will likely apply Section 503(c). While the Bankruptcy Court in *AMR* at least held out the possibility of the AMR debtors resorting to Section 1129(a)(4) of the Bankruptcy Code to sustain the payment, it was reticent in its remarks on the scope and application of that provision, as well.

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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:

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