What Happens If You're Not Paid Under A Chapter 11 Plan

Chapter 11 reorganizations are no longer new phenomena. Of course, Chapter 11 reorganizations which have actually proposed a Plan to pay the Debtor in Possession's creditors and had the Plan approved by the creditors and/or the Bankruptcy Court are still relatively rare.

We are not aware of any statisics on how many confirmed Plans of reorganization actually result in the Debtor making the scheduled payments to its creditors according to the confirmed Plan.

Let us consider a hypothetical Chapter 11. The Debtor, after much negotiation with the Official Unsecured Creditors' Committee, succeeds in having the unsecured creditors vote as a class to accept a plan providing for payments to unsecured creditors of a 25% dividend – that is, 25% of their total claims pro rata – in annual equal installments over a period of five years.

One year after confirmation the first installment, which only represents 5% of the creditors' original claims, falls due and goes unpaid. Absent an acceleration provision in the event of such a default having been a part of the confirmed Plan, it is questionable as to whether any of the creditors can, at the time of the first payment default, sue for the entire 25% they are now owed under the Plan.

Thus, were any individual creditor to sue, that creditor could in all likelihood sue the Debtor for only 5% of the original prepetition obligation. In most cases, that 5% figure would not be significant enough to a creditor to justify a lawsuit. And, if there is no acceleration provision, and the creditor does not sue after the first default, how likely is it that a creditor would even retain any interest in suing after five years and five defaults? Filing suit is no longer prohibited by the "Stay" since that was terminated by the Order of Confirmation. The proper forum to file suit is not the bankruptcy court, but any state or federal court having jurisdiction.

If a creditor does choose to sue, its cause of action is based on its treatment under the confirmed Plan of reorganization, not its original promissory note or invoice. It is the payment promised under the Plan to which the creditor is entitled post-confirmation. Mere failure to pay by the Debtor does not in any way alter the res judicata effect of the Plan's confirmation. In our example, the Order confirming the Plan operated as a discharge of the other 75% previously owed to the general, unsecured creditors.

Thus, although some suits are filed by general, unsecured creditors of defaulting Chapter 11 Debtors who have managed to obtain confirmed Plans, such lawsuits are rare. When one considers that many Chapter 11 Plans only provide for dividends of less than 25%, some as low as 10% or 5%, it becomes even clearer why such suits are rare.

Before we leave this subject, we should point out that mere default by the debtor does not allow a creditor to move to revoke the Order of Confirmation and thus restore the debtor's full original obligation to the creditor. An Order of Confirmation may only be revoked within 180 days of its original entry, and then only upon proof that the original Order of Confirmation was obtained through fraud.