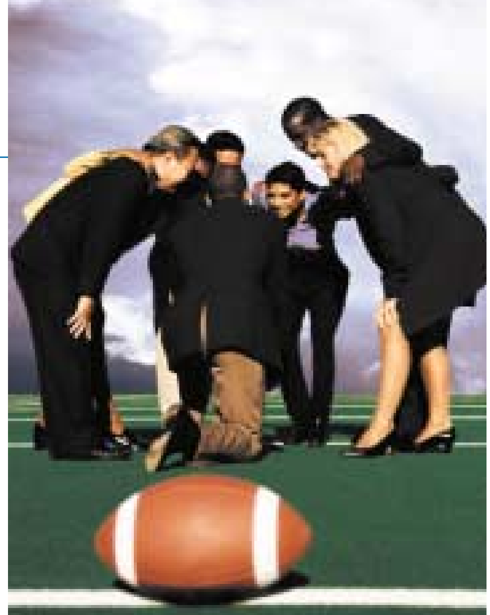

Probate Collections—Managing for the "Two-Minute Drill"

Part 3: Developing an Appropriate Game Plan

by Horace A. Lowe

Does the impact of death events currently have a place in your loan-loss-reserve analysis? Have you considered the operational risks inherent in the death of a customer—whether consumer or commercial? These topics are explored in this installment of H.A. Lowe's series on probate collections.

Prudent individuals plan for their own deaths. Careful estate plans are calculated to lead to transfer the greatest amount of wealth possible while paying the fewest dollars in estate taxes and avoiding creditors. There is every reason for lenders and collectors likewise to plan for the deaths of their debtors.

There are two levels on which lenders should consider game planning for the "two-minute drill:"

1. The appropriateness of including in loan-loss-reserve analyses the impact of death events on the collectibility of consumer portfolios (as well as commercial portfolios, to the extent commercial loans may be guaranteed by individuals).
2. The operational risks relative to dealing with the death event once it occurs in a particular account.

Should Predictable Death Events Be Included in Loan Loss Reserve Analyses?

Particularly because of the anticipated (though not yet quantified) increase in consumer debt charge-offs attributable to the aging and passing of baby boomers, national death statistics may need to be part of loan-loss-reserve analyses.

According to U.S. Census Bureau statistics, based on the 2000 census, the approximately 78 million baby boomers represented roughly 37% of that portion of the total population of legal age to contract (approximately 207,309,519) and carry debt in their own names. Prior generations (aged 55 and over) represented 28.4%, and subsequent generations (aged 18 to 35) represented 34.6%, of the total. The Centers for Disease Control's National Center for Vital Statistics notes there were approximately 260,000 deaths in 2001 among persons aged 35-54. The death rate per 100,000 within each subgroup increased dramatically with age, from 165.9 for persons aged 35-39, to 512.4 for persons aged 50-54. Further, as one might expect, the 2001 death rates increased dramatically with the age of population. For example, the death rate for persons 70-74 years of age, which is where the oldest baby boomers will be in just 15 years, was 2,878.3.

© 2004 by RMA. *Horace A. Lowe, Esq., is the principal of the law firm of H.A. Lowe & Associates LLC, Denver, Colorado. As former corporate counsel and a member of the executive management team for a global telecommunications company, Lowe has a strong interest in business solutions development and risk management.*

FAILURE TO INCLUDE DEATH EVENTS IN THE RESERVE ANALYSIS AMOUNTS TO A DECISION TO DO NOTHING ABOUT COLLECTING OTHERWISE COLLECTIBLE DOLLARS WHEN AN INDIVIDUAL DIES.

It's reasonable to assume that the demographic group with more debt than any other will die in increasing numbers as time passes. Readily available death statistics could easily support an industry-wide statistical modeling to predict the timing and effect of baby-boomer deaths (and those of other generations) in the coming years. Individual lenders could then make reasonable assumptions as to the impact of death events on the collectibility of consumer loans and commercial loans guaranteed by individuals for purposes of loss reserve analysis.

Moreover, because a death event does not render a particular account uncollectible, failure to include death events in the reserve analysis amounts to a decision to do nothing about collecting otherwise collectible dollars when an individual dies. Conversely, an appropriate inclusion of death events in the audit committee's reserve analysis could lead to a revamping of operations to minimize the risk of loss resulting from death events.

Operational Risk Management—A New Way of Thinking

A lender's decision to include death events in loss-reserve analysis as the lynchpin of effective game planning in the probate collection area will represent a fundamental change in thinking about deceased debt. During the debtor's life, he has a legal and a moral obligation to pay his just debts. Once a debtor dies, however, only the legal obligation survives him, becoming an obligation of his estate. Collectors rely on a debtor's sense of moral obligation (hence, the effectiveness of certain telephone collection techniques). Once that obligation expires with the debtor, frankly, the entire spectrum of the best collection practices becomes almost totally useless.

The *legal* obligation resides in an estate, represented in most cases by a person who has every incentive to avoid paying creditors. Thus, it may be best to think of a *pre-death consumer claim* as a unique opportunity, within a unique marketplace, to add cash to the lender's balance sheet, rather than a receivable that it is entitled to collect. That concept forces lenders to think in terms of managing processes to make the most of each opportunity, just as any successful business in any industry does.

Typically, by the time unsecured creditors are paid in the ordinary course out of probate, lenders will have written down or written off the receivable under applicable accounting procedures and regulations. Irrespective of and wholly apart from loss reserve analysis, adding cash to the balance sheet makes all the sense in the world. Applying a few market concepts simplifies the approach to collecting in probate. Table 1 summarizes

Table 1
The Marketplace Concept

1. Opportunity	2. Competition
Lenders generally create a universal marketplace of deceased debt simply by lending money to consumers, all of whom will die at some point. Upon death, each creditor's claim is merely that creditor's opportunity to participate in the marketplace of dollars held by the decedent's estate.	State probate laws subordinate unsecured consumer creditors to other claimants of a higher priority. Each creditor competes with others within the same priority classification for a limited pool of cash.
3. Strategy	**4. Operations**
Each creditor has a strategy for taking advantage of the opportunity. Strategic decision occurs within every industry organization. The continuum of possible strategic decisions includes the decision to 1) do nothing, 2) place deceased accounts for collection, 3) sell deceased accounts along with other aged receivables, or 4) develop more or less sophisticated strategies to collect deceased debt in-house or through affiliates.	Each creditor will have more or less successful operations, depending on the sophistication of its strategy. Operations must follow and be designed to optimize achievement of, strategic objectives. The creditor having the best overall strategy and operations will distinguish itself and outperform the competition.

the author's marketplace concept.

The marketplace analogy is perfect because, over time, the best overall strategy and operations will lead to better overall bottom-line performance. In the case of any particular estate, assuming there is net asset value in the estate, the creditor who performs best operationally will distinguish itself and outperform the competition, such performance being measured by the relative percentages of the amounts of the claim collected by the respective creditors.

Strategic considerations. The risk manager should ask questions and seek answers within the framework of the particular institution, to determine its current strategic decision. For example: What is the institution's policy with respect to aged receivables? Does the institution routinely group aged accounts for sale or assignment for collection, without distinguishing between deceased debt and "troubled" debt? What other criteria for assignment or sale do the institution deem significant? Does the institution handle troubled debt in-house or through a subsidiary? Either way, does the institution track deceased debt as a separate category? Does the lender have a method of readily analyzing historical performance patterns of an account that suddenly stops performing? If the lender handles its own collection operations, how efficient and effective are those operations? What are the institution's benchmarks for measuring performance?

An institutional risk analysis around such questions could prove very helpful in devising a more sound strategy for managing deceased debt. For example, a policy of either placing or selling debt at, say, 90 or 120 days aging, without distinguishing between deceased debt and other consumer debt is tantamount to a decision to do nothing about deceased debt. That may not be the best decision, because that approach does not take into account that the reason for the "bad debt" as to any particular account may not be inability to pay.

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As time passes, the chance increases that good old "Freddie Debtor" borrowed money and now, well, Freddie's dead, so he hasn't paid anybody for awhile. But if Freddie left a large, solvent estate and the lender bundled his account with other "bad debt" and sold it, that was not a sound decision. And, the decision to do nothing will become even less sound with the passage of time.

The key is to adopt a risk management philosophy that uses the necessary balance sheet reserve for bad debt but also optimizes bottom-line performance on the income statement by adding cash to the balance sheet. In the example case introduced in Part 1, the single unsecured creditor who got it right took about a 70% write-down several months following the decedent's death and then, a few weeks later, successfully negotiated the collection of about 45% of its original claim through early settlement. That is good strategy and good execution.

Operational Risk Management—A Few Things Worth Thinking About

Part 2 of the series offered five parameters of probate laws that are most directly pertinent to the probate collection process. Each parameter offers its own unique challenges and opportunities for risk management professionals, particularly for those whose institutions lend in multiple jurisdictions. Here are some helpful tips for a few of these challenges.

Notice of the opportunity. Part 2 of the series alluded to a continuum of four scenarios wherein a debtor's death makes things a little weird.

- In the first scenario, where the debtor is not in default, the creditor faces the most risk because the creditor probably will not obtain notice of a debtor's death in time to present a timely claim.
- In the second scenario, a lender's representative will

already be engaged with a debtor attempting to work out a payment structure or enforce a security interest. The representative will notice a sudden cessation of communications and probably will have sufficient information to proactively ask a family member (or other relevant contact) about the debtor's status.

- In the third scenario, litigation and trial, the lender's lawyer, who is in the debtor's jurisdiction, will notice a missed court date and be in a position to follow up and obtain actual and prompt notice of a death.
- In the fourth scenario, bankruptcy, the debtor's death will be made known by the debtor's bankruptcy counsel. And, of course, at that stage the creditor's death really would not matter so much, since the bankrupt estate stays in bankruptcy following death.

There are things the lender can do to ensure that the responsible account manager receives actual notice in the first scenario. For example, every lender should be organized so that a particular contact (e.g., probate administrator) be designated for receipt of notices to creditors. Every monthly statement to a debtor could include a request to estate representatives to direct a notice to the designated contact at a specific address and mail stop in the event of the debtor's death. This would tend to minimize the incidence of late receipt of notice and, thus, late claim presentation. It also could strengthen the lender's position in the event of a claim bar for late presentation. Assume that a personal representative failed to adhere to the request and instead mailed notice to a lender's general address, resulting in a claim bar for late presentation. The lender would be in position to argue that the personal representative failed to provide notice in a manner reasonably calculated to provide actual notice under the circumstances. That is the constitutional standard for due process relative to claim bar statutes.

The risk manager also should examine whether internal mail delivery procedures are adequate. Consider whether, for example, it's possible to direct that mail addressed to "Probate Administrator" be given priority delivery within the internal system.

Claim presentation: The court or the personal representative. Part 2 of the series asked when it may be appropriate to file an action against the estate in court, as opposed to presenting it to the personal representative, and also discussed some of the downsides to presenting a claim to the personal representative.

Considering the factors discussed in Part 2, it is important to note that presenting a claim to the personal representative is akin to appointing the personal representative (or, more precisely, the personal representative's counsel) "mini-judge" for purposes of initial claim determination. Thus, the lawyer who would be the creditor's adversary had the claim been filed in court becomes the "judge" of the claim, complete with a high probability of bias against creditors and a relatively commensurate likelihood of disallowance.

By contrast, a civil proceeding not only affords an objective forum for claim determination, it can provide the optimal leverage for early settlement. If the opportunity is sufficiently large and it appears that the estate has some net asset value, then a civil proceeding may be a very effective means to obtain an early and favorable settlement. The personal representative will have an incentive to compromise early on to avoid further depletion of the estate by incurring legal costs to the estate. In an appropriate case, early settlement and payment are preferable to waiting perhaps a year or more for payment, given the time value of money.

Presumably, creditors opt for determination of claims by the personal representative because they quite reasonably wish to avoid the cost of a legal proceeding. Also, obviously, there are other costs of a civil proceeding, such as the direct costs involved in making personnel available to testify in depositions and in court, along with the usual costs of litigation.

However, as noted in Part 2, an agreement is binding on the personal representative to the same degree that it was binding on the decedent during his or her lifetime. Virtually all creditor/debtor agreements contain clauses that would support an award of attorneys' fees to the creditor in the event of legal proceedings to collect, and there is no reason such clauses could not be enforced in a civil proceeding brought by the creditor in probate. If the opportunity is sufficiently large, the possibility of

enforcing such a clause should be considered in determining whether to file a civil proceeding in the probate court, which, unlike the personal representative, does have the authority to award attorneys' fees. It would seem that the specter of having to pay such costs would provide substantial leverage against the estate for purposes of early settlement.

Of course, lenders must first establish a monetary threshold at which it is no longer deemed prudent to commit resources to pursue an opportunity. And, of course, below that threshold, using a legal proceeding should never be considered. As a rule of thumb, if an opportunity approaches or exceeds six figures, a legal proceeding may be best.

Collectors also need to consider, to the extent of available information, the likely degree of the estate's insolvency. In many cases, the estate inventory will be available prior to the expiration of the time to present claims. If not, the collector should contact the personal representative and request disclosure of that information, to the extent it is available.

The collector also should inquire about the extent and nature of the relationship between the personal representative and the decedent. Kinship or a marital connection would weigh in favor of a proceeding in court.

The bottom line is that the greater the opportunity, the more important it becomes to carefully analyze the proper approach. In most cases, it probably will be appropriate to forego civil proceedings and present the claim to the personal representative.

Once that decision is made, it is important for collectors to fully transition out of the "collector mentality," meaning the aggressive manner that often colors collectors' dealings with debtors during life. Collector mentality can be counterproductive in dealing with the mini-judge if the claim is presented to the personal representative. Lawyers understand the importance of making sure to not antagonize the judge or the jury in a trial or other proceeding. That concept is no less important when dealing with the mini-judge deciding the creditor's claim.

> THE PERSONAL REPRESENTATIVE IS GOING TO BE THE COLLECTOR'S PRIMARY SOURCE OF INFORMATION, THE IMPORTANCE OF WHICH CANNOT BE OVERSTATED. SO ALWAYS BE NICE TO THE PERSONAL REPRESENTATIVE AND HIS OR HER LAWYER.

There are important areas of discretion on the part of the personal representative in most states. For example, in Colorado, a personal representative has the discretion (under certain circumstances) to 1) waive a defense based on a statute of limitation, 2)consent to an extension of time within which to commence proceedings on contingent or unliquidated claims, and 3) later allow a previously disallowed claim. The personal representative is far more likely to honor a request to exercise his or her discretion if the collector has acted professionally and courteously. Also, the personal representative is going to be the collector's primary source of information, the importance of which cannot be overstated, as discussed below. So always be nice to the personal representative and his or her lawyer.

Creditors must understand the implications of electing to have their claims decided by the personal representative and need not default to that decision. Creditors and collectors should establish commercially reasonable and legally sound criteria for making the decision about whether the claim should be presented to the personal representative or tried in a civil proceeding. Thinking of the claim as an opportunity rather than a debt makes it easier to take the right approach.

Obtaining important information. In a recent article, "Information: the Creditor's Best Weapon," creditor rights attorney Harold Stotland aptly notes, "[i]nformation is vital, not just for the enforcement of judgment, but in every stage of the collection process." That is no less true in probate collections, yet a very common mistake creditors and their counsel make in probate is failing to obtain information that not only is extremely important but is in most cases required by the probate laws.

Once having presented timely claims, creditors often merely ask whether the estate is solvent, rather than analyzing the fact of solvency or the degree of insolvency themselves. In non-probate collections, the creditor needs information about funds available and other claims against the estate and the creditor's position vis à vis other creditors, such as relative claim amounts, superior liens, and so forth.

Basically, the same information is necessary in probate collections to estimate the value of the opportunity (which is not necessarily the same as the amount of the claim). Creditors need to know if the estate is solvent, that is, if there are sufficient assets to pay all costs of administration and all predeath and postdeath claims against the estate. If so, then the value of the opportunity is equal to the amount of the claim. If the estate is not solvent, then the creditor needs to carefully analyze the value of the opportunity to make informed decisions about whether and how to pursue the opportunity.

Most of the information creditors need is typically required in the estate inventory and list of claims presented. The inventory will set forth the gross estate value (GEV), including all the decedent's assets, and the amount of any encumbrances. Net asset value (NAV) is determined by simply subtracting the total encumbrances from the GEV. To estimate the value of the opportunity, the creditor then must estimate administrative costs, including estate taxes (income and transfer), legal fees, accounting fees, and personal representative compensation.

Many state laws require the personal representative to provide a list of claims to any creditor upon request. Even if such a list is not required expressly, a fiduciary acting in good faith will provide a list upon request. The list should inform the creditor about the existence, amounts, and nature of all claims against the estate. Further, to be useful at all, the list of claims should provide the name of each claimant, the amount of each claim and the nature of each claim including its basis, its priority under applicable law (or sufficient information to determine such priority), and whether or not the claim is contingent or liquidated or is wholly or partially insured. The extent to which a claim is secured by estate property should, of course, be determinable from the inventory. If not, call the estate's lawyer and ask for the information.

Such a degree of diligence in obtaining information is absolutely essential. It is the only way a creditor or collector can ascertain the value of the opportunity and know whether and how to pursue it. It is no accident that, in the example case introduced in Part 1, the only creditor who collected at least a good portion of its claim was also the only creditor who requested a copy of the inventory and a list of claims.

IT IS NO ACCIDENT THAT, IN THE EXAMPLE CASE INTRODUCED IN PART 1, THE ONLY CREDITOR WHO COLLECTED AT LEAST A GOOD PORTION OF ITS CLAIM WAS ALSO THE ONLY CREDITOR WHO REQUESTED A COPY OF THE INVENTORY AND A LIST OF CLAIMS.

Coming Up

Part 4 of the series will discuss in greater detail how to use available information to enhance the successful exploitation of an opportunity, both before presenting the claim and after the end of the period for presentation of claims. Things to consider include what the estate lawyer is thinking, opportunity evaluation techniques, and early settlement strategies.

As demonstrated in Part I, the marketplace is growing and will grow significantly during the baby-boomerang period. The prudent risk manager will begin now to invest appropriate resources in the development of a winning game plan for the "two-minute drill." ❒

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