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

Part 4: The Big Play: Opportunity Valuation and Settlement Strategy

by Horace A. Lowe

Systems and strategies are offered that lenders can use for an estate that is not solvent but has some net asset value and against which there may be multiple claims. The author discusses the particulars of the example case to illustrate both opportunity evaluation and settlement strategy.

Imagine a good football game. Right after the final two-minute warning, the coach of one team trots over to the opposing coach, puts his arm around his shoulder, and says, "Hey look, you know, we really don't have any kinda game plan for this two-minute drill stuff, so how 'bout you guys not use any of your, ah…fancy stuff when you get the ball. Sorta help us out a little. Know what I mean?"

"Oh, well, yeah, no problem, buddy," says the other coach.

Right. *That* ain't gonna happen.

A collector asking the estate's lawyer if the estate is solvent is pretty much the same kind of thing: no game plan for the two-minute drill. That's exactly what happened on one of the larger claims in the example case introduced in Part 1 of this series. The conversation went something like this:

"Is the estate solvent?" the collector asked the estate's lawyer.

"No," the lawyer replied truthfully.

"Oh, okay. Well, we'd really like to see if we can reach a settlement," said the collector.

"Well, sure," says the lawyer. I'll get back to you on that." It never happened.

Collecting in probate is almost always a challenge for creditors, largely because of the lack of uniformity in probate laws discussed in Part 2 of this series. Not having a game plan is a pretty sure recipe for failure.

In many cases the estate will be not only solvent but quite large, with the heirs receiving large inheritances. In those cases, there is little concern about looking out for the heirs; creditors usually will be paid 100% of their claims, assuming they have timely and properly presented claims and have been diligent to overcome any disallowance.

Collecting from insolvent estates offers an even greater challenge because of the estate personal representative's desire to preserve as much estate residual as possible for distribution to heirs. However, because these estates represent the overwhelming majority of lost collection opportunities, it is imperative that creditors and collectors of unsecured claims sharpen their opera-

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tions to minimize loss. For insolvent estates this requires sound opportunity evaluation and early settlement strategies.

Post-presentation Practices

"Yeah, baby!! We got our claim in on time, so we're in the playoffs! We're gonna get the money!" *Calm down.* This is the two-minute drill. You've still got lots of work to do.

As mentioned in Part 2, several important things start to happen following the period for presenting claims. First, the personal representative narrows down the list of potential claimants to those who have presented in a timely way. Second, the estate's lawyer starts the process of deciding who makes it to the second round—that is, which claims will or will not be allowed. Third, where appropriate, the process of settlement negotiation begins.

Accordingly, following claim presentation, the collector should proactively take steps to 1) avoid disallowance, 2) obtain available information, and 3) plan for the big play—favorable settlement. The collector should at some point soon after the presentation of claims write the estate's lawyer regarding the following, at minimum:

- Inquire as to the substantive adequacy of the claim presentation and offer to provide any additional information, documentation, or certification.
- Request that the inventory and a list of claims be provided as soon as they are available.
- Inform the estate's lawyer that the collector will be ready to discuss settlement within a certain time following receipt of the available information.

These minimal steps will help shield the collector from a frivolous disallowance, let the estate's lawyer know that the collector is on top of his game, and enhance the timely receipt of the information necessary to pursue settlement.

The Claim Priority System

The first key to opportunity evaluation and settlement strategy is to understand claim-priority classification under the applicable state probate law. This is necessary in order to take into account expenses and claims that must be paid prior to payment of unsecured claims. Table 1 sets forth the priorities under Colorado law, which is fairly typical, although some statutes include other types of claims as a higher priority, such as those for a decedent's child-support obligation.

Priority items 1, 3, 5, 7, and 8 should be included in the list of claims, along with any claims (as opposed to taxes incidental to the estate or the decedent's last personal taxes) of the state or federal governments. Administrative expenses (legal, accounting, personal representative fees, court fees, appraisal fees, and other administrative costs) can only be estimated, as they will be largely future costs—the degree of which will depend on the complexity of the estate, which can be determined from the inventory. Also, if there are any claims by governmental entities, such as liens for past-due taxes, these should be included in the list of claims as well. These are the only claims worth thinking about in evaluating the opportunity.

Well, what about federal and state estate taxes and any estate income taxes? Forget about them. The timing of the estate tax events will be downstream from the settlement negotiation in most cases, since the federal estate tax return is not due until nine months following the date of death. Basically, the state law priority schemes tell us simply that we have to pay the state and federal governments some of the estate's money (like we didn't already know that).

The federal estate tax scheme says that, for the most part, the federal government will wait until the pre-death creditor claims are dealt with, either through claim bars, disallowance, settlement, or reserve provision, before the estate even has to file a return, if at all.

In addition, the overwhelming majority of estates don't pay any estate tax. Where estate taxes

Table 1
Claim Priority under Colorado Law

1	Property held by decedent in trust.
2	Administrative costs & expenses.
3	Funeral expenses.
4	Taxes, debts with preference under federal law.
5	Medical/hospital expenses of decedent's last illness.
6	Taxes, debts with preference under state law.
7	Department of Health medical assistance claims.
8	General unsecured creditor claims.

are to be paid, the federal estate tax law provides a 100% deduction for debts of the decedent in calculating the taxable estate, so the money will be there to collect those debts. Moreover, if the estate turns out to be insolvent, there surely won't be any federal estate tax anyway.

Any estate income tax need not be taken into account, because if there is an income tax, it only means the estate will have been enhanced by income from assets like stocks and any going concern held by the estate. Such enhancement should be available to pay creditors and also should be reported to creditors by the personal representative in a supplemental inventory, which is a good reason for collectors to periodically request such supplemental information.

Personal income tax liability of the decedent typically will be negligible relative to the gross probate estate.

So, the collector need only be concerned about competition from actual claims against the estate in valuing the opportunity—not any general state or federal tax liabilities.

The "Pain Ratio" and "Pain Threshold" Analysis

The second key to opportunity valuation and settlement is to understand what the author calls the personal representative's "pain ratio" and the creditor's "pain threshold." These are not radical new concepts; rather, they derive from the probate laws' requirement that, where the estate is insolvent, claimants of the same priority classification must share in available funds on a pro rata basis.

The pain ratio, for any particular priority class of claims, is merely the ratio of *net cash available* to the aggregate amount of claims within that priority classification. Multiplying the pain ratio times the amount of any particular claim yields that creditor's pain threshold—the dollar amount that would be due that creditor, assuming all remaining funds would be paid to all claiming creditors. A settlement negotiated below that figure causes "pain" to that creditor. Conversely, if the personal representative pays more than that figure, it could lead to "pain" for the personal representative, as that payment would constitute an illegal preference and fiduciary breach.

From the estate's perspective, net cash available is derived at any point in time by taking gross cash available (cash on hand and reasonably certain future cash from income or the sale of assets) and subtracting reasonable reserves for future costs of estate administration, actual or estimated state and federal taxes, if any, payment of allowed claims to higher-priority creditors, and appropriate provision for any unliquidated or contingent claim of the same or a higher priority. Determination of net cash available, of course, assumes there will be no distribution to heirs and devisees, although the whole point of the estate's settlement strategy is to ensure that there will be and to optimize that amount.

Pain ratio analysis is a bit tricky for the creditor simply because, unlike the estate, the creditor will not have real-time access to estate financial information. The author's recommended approach for creditors, using the inventory and the list of claims, is discussed in greater detail below.

Early Settlement of Claims

Many states, such as Colorado, allow the personal representative to compromise and pay claims even prior to the statutory time for payment of creditors, if doing so benefits the estate. In other states, claims against insolvent estates are subject to special rules and/or proceedings. Where early settlement is permissible, it can be a mutually beneficial goal for both the estate and creditors, as discussed below.

If the personal representative pays an early settlement to one creditor wihout requiring the payee to post security for the return of the funds, other creditors could hold the representative personally liable if there are insufficient funds to pay their claims. The problem here is that creditors will want "clean" settlements, meaning they do not want to have to post security for the return of the funds if the payment turns out to have been preferential. On the other hand, the creditor's principal incentive for settling at all is the time value of money, which is negated if the creditor has to await the statutory time for payment to collect the settlement funds. In a particular case, the choice may come down to either posting security or negotiating the settlement figure downward to give the personal representative cushion against a potential preference claim.

The estate's settlement perspective. The appropriate settlement strategy for the well-advised personal representative targets the largest claim first, with a view toward obtaining a settlement amount that is significantly below the target's pain threshold. The settlement process should start with the largest claim for several reasons.

- If successful, no other creditor nor any heir can complain, as they will all benefit from enhancement of the estate by avoiding the unpaid portion of the debt to the settled creditor. After giving effect to the settlement of the largest claim, both the pain ratio and the pain thresholds are increased for the remaining creditors.
- Larger claims typically will be the stronger claims and the creditor will be represented by counsel. Settling makes far more sense than litigating, from a fiduciary perspective.
- By settling the larger claims, the personal representative diminishes the number of "interested persons" who might want to formally review the personal representative's and counsel's handling of the affairs of the estate, thus further benefiting the estate by avoiding the costs of such proceedings.

Estate settlement strategy illustrated. Figures 1 and 2 are worksheets derived from those prepared by the estate's lawyer in the example case introduced in Part 1 of this series. Figure 1, the Phase 1 strategy, shows that the initial pain ratio was 62.8%. The goal was to leave as much distributable cash in the estate as possible. The lawyer simply evaluated the strength of each claim based on its merits and assumed the estate could settle for the percentages and dollar amount objectives stated in Figure 1. Thus, the lawyer derived a plan to save distributable cash of $116,500 through negotiated settlements with the creditors.

The Phase 1 strategy was to settle with Creditor H, having the largest claim, first. The pain threshold for Creditor H was $70,236.79. The 25% settlement target (or $27,960.42) represented the lawyer's low-range estimate of where Creditor H might settle. In reality, since Creditor H was represented by competent counsel, the lawyer also established an upper limit that was yet below the pain threshold. The upper limit was 55%, or about $60,000. Any greater amount pushed the estate too close to potential preferential payment.

Figure 2, the Phase 2 strategy, assumes the success of Phase 1 at the 25% target level and shows that the new pain ratio as a result of the Phase 1 settlement is 84.87%. Although estimated net cash available decreased from about $190,000 to about $162,000, note that each remaining creditor's pain threshold increased significantly as a result of the Phase 1 settlement. Note also that the net distributable cash remained the same— $116,500.75.

The estate settlement strategy emphasizes the goal of meeting or exceeding the stated objective in the case of each creditor in order to meet or exceed the net distributable cash objective.

The creditor's settlement perspective. The creditor's objective should be to obtain as great a deal as possible considering all circumstances. Assuming the personal representative is well advised, the creditor will not be able to cause pain to the personal representative, as the personal representative will never settle above the pain threshold. The creditor's principal goal should be to use the available information to minimize the pain and add cash to the balance sheet, taking advantage of the time value of money.

Evaluating the Competition

Given the estate's settlement perspective, as discussed above, knowing who your competition is and where you stand relative to the competition is important. Here are two tips:

1. Simply list all of the claims in descending order by dollar amount. If your claim is at or near the top, then you probably have a good chance of negotiating a good early settlement.
2. Examine the basis of each competing claim as it is described in the list of claims. If you do not understand the basis of any claim, call the estate's lawyer and ask for his or her understanding of the basis of the claim. Irrespective of the dollar amount, it is important to understand the relative strengths and weaknesses of the competing claims. For example, a contingent claim

Figure 1

PR's Pain Ratio: 62.80%

CREDITOR Account (No.)	Amount	Pain Threshold	Settlement Targets	Settlement Objectives (%)	Settlement Objectives ($)
Creditor A	$35,225.35	$22,121.59	$35,225.35	25%	$8,806.34
Creditor B	$35,135.00	$22,064.85	$35,135.00	25%	$8,783.75
Creditor C	$500.00	$314.00			
Creditor D	$6,275.00	$3,940.71			
Creditor E	$16,358.46	$10,273.15	$16,358.46	10%	$1,635.85
Creditor F	$33,454.07	$21,009.22	$33,454.07	20%	$6,690.81
Creditor G	$344.24	$216.18			
Creditor H	$111,841.66	$70,236.79	$111,841.66	25%	$27,960.42
Creditor I	$129.99	$81.63			
Creditor J	$6,704.00	$4,210.13			
Creditor K	$56,910.56	$35,739.95	$56,910.56	10%	$5,691.06
Creditor L	$500.00	$314.00			
Total Unsecured Non-Priority Claims	$303,378.33				
		Target Claims Total	$288,925.10	Settlement Objective Total	$59,568.22
Estate Income	$416,599.35				
Disbursements	$148,777.35				
Gross Cash Available		**$267,822.00**			
Reserves for Admin Costs					
Legal	$(30,000.00)				
Accounting	$(7,000.00)				
Pers. Representative	$(30,000.00)				
Reserve for Federal Taxes					
Reserve for Medical Claims	$(10,299.80)				
Reserve for State Taxes					
Total Reserves		**$(77,299.80)**			
Esimated Net Cash Available		$190,522.20			
Compromised Claims Paid	$59,568.22				
Other Unsecured Claims Paid	$14,453.23				
Total Unsecured Claims Paid		**$74,021.45**			
Net Distributable Cash		**$116,500.75**			

Figure 2

PR's Pain Ratio: 84.87%

CREDITOR Account (No.)	Amount	Pain Threshold	Settlement Targets	Settlement Objectives (%)	Settlement Objectives ($)
Creditor A	$35,225.35	$29,896.60	$35,225.35	25%	$8,806.34
Creditor B	$35,135.00	$29,819.92	$35,135.00	25%	$8,783.75
Creditor C	$500.00	$424.36			
Creditor D	$6,275.00	$5,325.74			
Creditor E	$16,358.46	$13,883.82	$16,358.46	10%	$1,635.85
Creditor F	$33,454.07	$28,393.27	$33,454.07	20%	$6,690.81
Creditor G	$344.24	$292.16			
Creditor H (settled)					
Creditor I	$129.99	$110.33			
Creditor J	$6,704.00	$5,689.85			
Creditor K	$56,910.56	$48,301.36	$56,910.56	10%	$5,691.06
Creditor L	$500.00	$424.36			
Total Unsecured Non-Priority Claims	$191,536.67				
		Target Claims Total	$177,083.44	Settlement Objective Total	$31,607.80

Estate Income	$416,599.35		
Disbursements	$176,737.77		
Gross Cash Available		**$239,861.58**	
Reserves for Admin Costs			
Legal	$(30,000.00)		Settlement Limits
Accounting	$(7,000.00)		
Pers. Representative	$(30,000.00)		
Reserve for Federal Taxes			
Reserve for Medical Claims	$(10,299.80)		
Reserve for State Taxes			
Total Reserves		**$(77,299.80)**	
Est. Net Cash Available		$162,561.78	
Compromised Claims Paid	$31,607.80		
Other Unsecured Claims Paid	$14,453.23		
Total Unsecured Claims Paid		**$46,061.03**	
Net Distributable Cash		**$116,500.75**	

for $50,000 may not be as strong as a $25,000 claim for unsecured credit card advances. But you wouldn't know that without understanding clearly what the contingency is. Don't be afraid to call the estate's lawyer or even the competing claimant and talk about it.

Evaluating the Opportunity

The initial goal of opportunity evaluation is to gauge whether or not the claim is worth pursuing in a particular case. The collector needs to know 1) how much cash is (or will be) available to pay creditors, 2) who the competition is, and 3) the collector's position relative to the competition.

Using available information. Creditors are at a bit of a disadvantage because the estate's lawyer and personal representative have complete, detailed, and up-to-date information about the estate's finances on a continuous basis. At best, by contrast, the inventory and a list of claims give collectors a mere snapshot of estate assets, liabilities, and encumbrances as of the date of death. Nonetheless, collectors can and should use the information to evaluate their positions.

The following illustrates how to make the necessary reasonable assumptions and estimates, and appropriate calculations, using the information from the inventory and the list of claims in the example case. It may be helpful for the reader to follow each step of the process by referencing the Settlement Strategy for Creditor H, Figure 3.

Step 1: Determine the estate's net asset value. The inventory reflects that the gross probate estate value (GPEV) was $1,602,953.75. Encumbrances on assets totaled $1,094,022.25, leaving a net asset value (NAV) of $508,931.50. NAV is the amount of unencumbered property of the estate that can be used to satisfy the estate's obligations.

Step 2: Estimate administrative costs and other expenses. These costs and expenses will vary depending principally on the complexity of the estate and also the laws of the particular state. Many factors bear on complexity, and of course, every case will be different. The following describes a fairly reasonable estimation of such costs and expenses in the example case.

—General administrative costs. In general, larger estates that include several different types of property or involve multiple claims against the estate will require more time and resources for administration and settlement.

In estimating administrative costs at the time of estate planning, the general rule of thumb is to estimate these costs at 3-5% of the gross estate, applying the lower percentage to larger estates. A variation of that rule of thumb can yield a reasonable estimate of general administrative expenses during probate. The collector is concerned with, and typically will have information limited to, the gross probate estate—which does not include certain items that are included in the gross estate, such as life insurance, annuities, and other directed beneficiary assets. Thus, it may be best to use a higher percentage range—perhaps 10-13%—as a rule of thumb.

The example case inventory reveals a fairly complex estate that was not the subject of sophisticated estate planning. There were four real properties in Colorado, including one that was under water, one that was under contract for sale at the time of death, and another that involved a complex cross-lease arrangement with a leasehold interest in a real property owned by a third party. There were several timeshares located outside the country. The inventory reflects that the estate also included a professional practice that had to be disposed of, and that the decedent was involved in ongoing litigation at the time of death that had to be completed to marshal the assets involved. Using the higher end of the range, 13% seems reasonable and yields an estimate of administrative costs of $208,383.99.

The analysis of expenses also should assume that nonliquid assets of the estate will be liquidated for the purpose of paying the estate's obligations. Of course, the cost of selling any such assets, such as real estate commissions, should be taken into account.

—Real estate commissions. In the example case, looking at the three Colorado real properties in which there was some equity, the total appraised and contract (with respect to one property) value was $854,000. Assuming they were all sold at their stated valuations, the inventory reveals there would have been approximately $200,000 of equity in the aggregate, giving effect to encumbrances. Thus, it would make sense for the estate to consummate the contracted sale and to place the other two on the market, whereas that might not be the case with respect to the upside-down property.

There would be real estate commissions to deduct from the aggregate sale prices. Assuming a standard commission rate of about 7% and further assuming that in each case the estate would pay half of the total commissions (or 3.5%), that would amount to total commissions of $28,890.

—Repairs and maintenance. It also might be reasonable to expect that buyers of these properties would require certain repairs, maintenance, or even upgrades as conditions to closing. It seems reasonable therefore to allow $7,000 per property for those items. This yields $21,000.

Thus, total estimated expenses (TEE) amount to $259,273.99.

Step 3. Determine the allowance for superior claims. In the example case, the final list of claims presented totaled $315,023.20, of which several claims totaling $10,299.80 were in priority classification 5 (hospital and medical expenses of last illness). Thus, total superior claims (TSC) equaled that amount.

Step 4: Determine net cash available. Again, NCA conceptually is based on the assumption that in the case of an insolvent estate, the heirs/devisees will receive nothing. Theoretically, all cash available, following full payment of administrative expenses and all claims of higher-priority classification, will be paid pro rata to the unsecured general creditors.

Determine NCA by subtracting from NAV the aggregate of superior claims and total estimated expenses.

NCA = NAV - (TSC + TEE)

or

NCA = $508,931.50 - ($259,273.99 + $10,299.80) = $238,727.71.

Step 5: Calculate the pain ratio and pain threshold. The pain ratio (PR) is simply the percentage expression of the result obtained by dividing NCA by the total of all claims (TC) within the unsecured non-priority classification that includes your claim.

PR = NCA ÷ TC or PR = $238,727.71 ÷ $303,378.33 = .7869 or 78.69%.

Then simply multiply that percentage times the amount of

Figure 3
Settlement Strategy: Creditor H

Step 1. NAV Calculation	
GPEV	$1,602,953.75
Encumbrances	$(1,094,022.25)
NAV (GPEV - Encumbrances)	$508,931.50
Step 2. Total Estimated Expenses	
Estimated Admin. Expenses	$208,383.99
Estimated Real Estate Comm. ($635000 X .035)	$29,890.00
Real Estate Repairs & Maintenance	$21,000.00
Total Estimated Expenses (TEE)	$259,273.99
Step 3. Allowance for Superior Claims	
Total Superior Claims (TSC)	$10,929.80
Step 4. NCA Calculation	
NCA (NAV - (TSC + TEE)	$238,727.71
Step 5. Pain Ratio & Pain Threshold Calculation	
Pain Ratio (NCA ÷ TC)	78.69%

Creditor	Claim Amount	Pain Threshold
H	$ 111,841.66	$ 88,007.95
K	56,910.56	44,782.79
A	35,225.35	27,718.75
B	35,135.00	27,647.65
F	33,454.07	26,324.93
E	16,358.46	12,872.43
J	6,704.00	5,275.36
D	6,275.00	4,937.78
C	500.00	393.45
L	500.00	393.45
G	344.24	270.88
I	129.99	102.29
Total Claims (TC)	$ 303,378.33	

your claim to yield the pain threshold (PT). Looking at Figure 3, assume you are creditor H, with a claim of $111,841.66.

PT = $111,841.66 x .7869 = $88,007.95

This is Creditor H's initial opportunity evaluation from an economic perspective.

Using the Valuation in Settlement Negotiations

Once a creditor has valued the opportunity, is the valuation precise? No. Are you going to collect that amount? No. Then why should you do all this work? Good question.

The whole point of opportunity valuation (other than to decide whether to pursue it) is to give the collector a well-reasoned starting point for discussions with the estate's lawyer. To have a prayer of collecting a fair settlement, the collector needs to be able to do more than ask whether the estate is solvent. It would sound a lot better, for example, if the collector could say, "We believe we should be able to collect at least $80,000 on our original claim, and here are the reasons why."

The collector must have a starting point with teeth in it. Make the estate's lawyer do his or her work. Ask for an explanation of why your estimated pain threshold is wrong. In the process, you very likely will obtain more detailed information about the estate's affairs than will your competitor, who merely relies on the good graces of the estate's lawyer. That will enable you to go back and make refinements to your calculations and update your opportunity valuation.

Remember also that creditors have leverage. A creditor is an "interested person" in the estate with the right to inquire into the affairs of the estate at the end of the day. Use that leverage to your advantage. Make the estate's lawyer tell you what the realities are. In fact, you just might be able to obtain the lawyer's own settlement strategy if you keep the pressure up.

At the same time, the collector must bear in mind the position of the personal representative. Even with superior knowledge about the estate, the personal representative also has fiduciary obligations that necessarily exert downward pressure on the early settlement prospects toward the lower end of the potential settlement dollar range. Therefore, irrespective of the creditor's initial valuation of the opportunity, it may be expedient to accept significantly less in order to walk away with an acceptable, clean settlement.

Ultimately, in the example case, Creditor H settled with the estate for about 45% of the original claim amount. That's a big play in the two-minute drill, and Creditor H did not accomplish that by merely asking if the estate was solvent. Creditor H knew what the circumstances were, put together a sound game plan, and executed it quite well.

Of course, the calculations in this article are merely an example. A collector could make any number of reasonable assumptions based solely on the information in the inventory and list of claims. And, obviously, each opportunity will present its own circumstances. There are conceivably far more variable circumstances, costs, expenses, and vagaries than those presented in the example case that could be pertinent to opportunity evaluation. For example, some cases will involve family allowances and spousal elective shares that will further diminish NAV and NCA, as well as *inter vivos* and testamentary trusts that may or may not be reachable by creditors, and so on.

Whatever the case may be, it is extremely important to undertake more than a cursory evaluation of the opportunity. Knowledge is the engine of success, and information is the key to the ignition. The collector cannot know whether an estate is solvent or not, nor the degree of insolvency, without an independent examination of the pertinent information and proper evaluation of the opportunity.

Finally, the more complex the estate appears to be from the initial examination of the inventory and list of claims, the more important it becomes to consult with an attorney who is familiar with such matters. The next part of the series discusses in greater detail the art and science of relationship management with respect to lawyers—a particularly thorny issue for national and regional lending institutions. ❐

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