Memorandum 89-57

Subject: Study L-3015 - Distribution of Property in Estate (Effect of Contingent and Disputed Debts)

Ordinarily, debts of the decedent are paid during estate administration and, if there is any excess after all debts are paid, distribution is made to the beneficiaries. This standard pattern may be disrupted if a debt owed by the decedent is not yet due and payable at the time when debts are ordinarily paid. Or, the decedent's liability may be contingent and the contingency may not be resolved until much later. If a creditor commences an action on a debt where the personal representative denies liability, there may be substantial delay until the liability is resolved.

Keeping the estate open and not making distributions until all contingent and disputed debt issues are settled is not a wholly satisfactory solution to the problem. For this reason existing law offers a few options:

(1) If a creditor whose debt is not yet due is willing to waive interest, the creditor may be paid immediately. Section 11425. It is not clear from this section whether the face amount of the debt may be discounted if the debt is interest-free until the due date.

(2) In the case of a contingent debt, a trust fund may be set up to cover the potential liability, the trustee to pay the debt or distribute the fund to beneficiaries, as the circumstances ultimately require. Section 11426.

(3) If neither of these two options is used, the full amount of a not due, contingent, or disputed debt must be paid into court and held until the liability is resolved. Section 11427.

These remedies are quite limited. The decedent's ultimate liability exposure on a contingent debt may be small but, until the matter is resolved, a large contingent debt can effectively tie up the estate. Likewise, there may be a disputed debt on which the alleged liability exceeds the value of the estate; in this case, no matter how unmeritorious the lawsuit appears, the full disputed amount must be held in court until the matter is resolved, which may be many years.

The staff has been concerned about this situation, and so has the State Bar. At the time the Commission distributed its tentative recommendations in this area for comment (1986), a special State Bar committee on creditor claims and final distribution (consisting of Harley Spitler, Neal Wells, and Ken Klug) expressed its dissatisfaction with the existing state of the law. The committee suggested a number of approaches it was investigating, and indicated it was planning to undertake drafting responsibility. At the time, the Commission declined to take any action on the matter.

We have now received the letter attached as Exhibit 1 from Ken Klug. Although the letter appears to be a personal letter from Mr. Klug, presumably it had its origin in the work of the special committee. Mr. Klug states that the existing law is inadequate to handle the problem, and that the problems are likely to become more acute as a result of the new requirement that actual notice be given to creditors.

According to Mr. Klug, "There is no mechanism under present law for dealing with these common situations. Estates normally have neither the ability nor right to discharge the entire indebtedness to satisfy the claim, and must therefore be kept open until the contingency which establishes the debt either occurs or fails. This may take many years. In these cases, the estate beneficiaries are not only deprived of enjoyment of their interests until the obligation is paid, but the estate expenses are increased by costs of complying with accounting and income tax filing requirements."

Mr. Klug recommends solutions designed to ensure that the creditor gets what is due, without forcing the estate to be kept open until the debt is paid. Specifically:

(1) If all parties agree that the estate be kept open, that should be an alternative.

(2) If there are approved claims that are not yet due, the court should have authority to order that the estate be closed upon making reasonable provision to pay the obligation when it becomes due.

(3) If there are contingent obligations, the court should have discretion to determine the manner in which the contingent creditor should be protected. In some cases, this may require the giving of

security, or the posting of a bond, or the deposit of funds. In other cases, it might involve nothing more than looking to other entities. The courts should have authority to fashion the appropriate protections on a case-by-case basis.

(4) Estates defending litigation should be closed upon providing a surety bond in an adequate amount. The cost of the bond should be paid by the creditor-plaintiff, to be recovered as a cost of litigation if the plaintiff is successful. As an alternative, the plaintiff and the estate may agree to security other than a bond. For example, perhaps a lis pendens or deed of trust on real property, a pledge of stock, or a deposit into escrow would be more desirable to the parties than the cost of a bond premium.

(5) Whenever an estate is closed with an outstanding claim, each heir should assume the decedent's liability to the extent of the value of the property received by that heir, similar to spousal liability under Section 13550.

Mr. Klug develops his arguments on these points in some depth, and also provides a working draft to implement his suggestions. The Commission should read Mr. Klug's material and make a decision whether this is a matter the Commission wishes to devote its resources to. If so, the staff will work with the material provided by Mr. Klug to develop a draft of a tentative recommendation for the Commission to consider on this matter.

Respectfully submitted,

Nathaniel Sterling
Assistant Executive Secretary

THOMAS, SNELL, JAMISON, RUSSELL AND ASPERGER
A PROFESSIONAL CORPORATION
ATTORNEYS AT LAW

HOWARD B. THOMAS
WILLIAM N. SNELL
T. NEWTON RUSSELL
PAUL ASPERGER
CHARLES E. SMALL
ROGER E. FIPPS
JAMES E. LAFOLLETTE
SAMUEL C. PALMER, III
JAMES O. DEMSEY
ROBERT J. TYLER
JOHN G. MENGSHOL
KENNETH M. KLUG
GERALD D. VINNARD
JOHN J. McGREGOR
WILLIAM A. DAHL
STEVEN M. McCLEAN
JEFFREY P. KANE
BRUCE D. BICKEL
E. ROBERT WRIGHT
DAVID M. GILMORE
DONALD P. ASPERGER
JANET L. WRIGHT
RUSSELL O. WOOD
DAVID A. DIAMOND
SCOTT R. SHEWAN
DANIEL W. ROWLEY
MICHAEL JENS F. SMITH
DAWRENCE W. RICE, JR.
ANDREW M. CUMMINGS

2445 CAPITOL STREET
POST OFFICE BOX 1461
FRESNO, CALIFORNIA 93716
TELEPHONE (209) 442-0600
TELECOPIER (209) 442-5078
ABA/NET 2715

CONFERENCE OFFICES:
DELANO
MERCED
MODESTO
VISALIA

OLIVER M. JAMISON, OF COUNSEL
FENTON WILLIAMSON, JR., OF COUNSEL
PHILIP H. WILE, OF COUNSEL

February 17, 1988

Mr. John H. DeMoully
Executive Secretary
California Law Revision Commission
Suite D-2
4000 Middlefield Road
Palo Alto, California 94303-4739

FEB 22

Re: Creditors Claims

Dear John:

With the new requirement of Probate Code §9050 that notice be given to creditors of whom the personal representative has actual knowledge, problems caused by contingent and disputed creditor's claims are likely to become more acute.

1. Contingent obligations, or obligations not yet due. Contingent obligations can arise in many ways. An example is where the decedent may have guaranteed the obligation of another. In such cases, the decedent's obligation is contingent upon the failure of a third person to meet the obligation. It is not uncommon for shareholders of closely held corporations to guarantee bank loans to the corporation. Bank loans may be millions of dollars, but the decedent's share of the corporation may be worth much less than that. A similar situation occurs where a decedent may have concurrent liability (as where the decedent is a partner in a general partnership and is equally liable with all other partners for all partnership liabilities); or where a decedent is joint maker on a promissory note and has joint and several liability. In all such cases, creditors will file claims in the estate, but it is a rare situation where the estate is called upon to pay a disproportionate amount of the debt.

There is no mechanism under present law for dealing with these common situations. Estates normally have neither the ability nor right to discharge the entire indebtedness to satisfy

the claim, and must therefore be kept open until the contingency which establishes the debt either occurs or fails. This may take many years. In these cases, the estate beneficiaries are not only deprived of enjoyment of their interests until the obligation is paid, but the estate expenses are increased by costs of complying with accounting and income tax filing requirements.

A similar problem arises where the decedent was indebted on an installment obligation. Even if the creditor is adequately secured, he may file a creditors claim to preserve a right to a deficiency judgment. Suppose the decedent owned farmland worth $700,000 encumbered by a mortgage of $200,000 payable over 10 years at 6% interest. (There are still many old loans out with low interest rates.) The estate does not have sufficient cash to pay off the loan or make a deposit under Probate Code §11426. The farmland can be distributed subject to the loan, but what happens to the decedent's personal liability? The heir may not be creditworthy.

From the creditor's viewpoint, the creditor may have extended credit based on the decedent's ability to pay or on the decedent's integrity. It is unfair to the creditor to allow distribution of the estate and require the creditor either to look to heirs for payment, or to stand in line with all other unsecured creditors of the heir. But it is also unfair to force the estate to be kept open until the debt is paid.

I recommend that:

(a) where there are approved claims which are not yet due, the court should have the authority to order the estate be closed upon making reasonable provision to pay the obligation when it comes due; and

(b) where there are contingent obligations, the court should have discretion to determine the manner in which the contingent creditor should be protected. In some cases, this may require the giving of security, or the posting of a bond, or the deposit of funds. In other cases, it might involve nothing more than looking to other entities. (Example: the decedent has guaranteed the debt of another, but there are other guarantors or assets which provide adequate protection for the creditor.) The courts should have the authority to fashion the appropriate protections on a case-by-case basis.

2. Rejected creditors' claims involving pending litigation. Present law may result in estates being kept open for many years during litigation. Creditors of a decedent who are engaged in litigation are in a better position than they were while the decedent was alive, because the estate is tied up in probate until the litigation is resolved. This is especially true in some of the more complicated business-related cases (such as where the decedent was a stockholder and joined as a defendant in a securities fraud case). Thus, although the decedent could have enjoyed the use of his property during litigation, the beneficiary is denied the enjoyment of the property. This is unfair to the beneficiary, and works to the psychological advantage of the creditor. Keeping the estate open during litigation affects not only the beneficiary but also the Probate Court, whose active case load is thereby increased; and the executor and the attorney, who typically cannot be paid more than 3/4 of the statutory fee until the estate is closed. Sophisticated persons can set up their affairs to avoid delays caused by disputed debts (e.g. by living trusts); less sophisticated persons can get their families caught in a probate trap. It is worth noting that surviving spouses who utilize the summary procedures of §13550 can enjoy their devises during litigation, whereas those who consent to administration are deprived of full enjoyment while pending litigation delays distribution.

On the other hand, it would be inappropriate to allow the estate to be closed and distributed without providing some protection for the creditor-plaintiff.

Estates defending litigation should be closed upon providing a surety bond in an adequate amount to be agreed upon by the parties, or if they are unable to agree, then in an amount determined by the court. The cost of the bond should be paid by the creditor-plaintiff, to be recovered as a cost of litigation if the plaintiff is successful. As an alternative to the bond, the plaintiff and the estate (i.e., the heirs who are the real parties in interest) may agree to security other than a bond. For example, perhaps a lis pendens or deed of trust on real property, a pledge of stock, or a deposit into escrow would be more desirable to the parties than the cost of a bond premium. If the parties cannot agree, then a bond would be appropriate protection, so long as the bond premium is treated as a cost of litigation to be assessed against the losing party.

Generally, I favor a policy which encourages and allows for the closing of estates, so long as the claimant

remains protected. The above recommendations should be available if the claimant and the estate are unable to agree on another remedy. If all parties agree that the estate be kept open, that should be an alternative. Whenever an estate is closed with an outstanding claim, each heir should assume the decedent's liability (if any) to the extent of the value (on date of distribution) of the property received by that heir, similar to spousal liability under §13550.

These suggestions could be implemented by repealing Probate Code §§11425, 11426 and 11427 and by enacting provisions I have tentatively numbered §§11430-11434 attached to this letter. If the Commission agrees that the law could be improved in this area, I would be happy to assist.

Very truly yours,

Kenneth M. Klug

Division 7, Part 9

Chapter 2.5 Contingent and Disputed Debts.

§11430. Definitions. As used in this chapter:

(a) "Contingent debt" means an allowed or approved creditor's claim, in either a fixed or an uncertain amount, which will become a debt of the decedent upon the occurrence of a stated event. Contingent debt includes a secured debt for which the decedent was personally liable, and for which the decedent's estate may become liable if the security becomes insufficient to satisfy the debt.

(b) "Disputed debt" means a rejected creditor's claim on which the holder of the claim has brought suit against the personal representative.

§11431. Court Order. If it appears to the satisfaction of the court that a contingent or disputed debt has not been paid, the court may make an order pursuant to this Chapter on petition by any person interested in the estate.

§11432. Contingent Debts. If the estate is in all other respects ready to be closed, the court may make an order deter-

mining the manner in which the contingent debt shall be paid if it becomes due. If the court finds that all interested persons have agreed to the manner of providing for payment of a contingent debt and that the agreement reasonably protects all interested persons, the court shall approve the agreement. If the court finds that all interested persons do not agree to the manner of providing for payment of a contingent debt, the court may do any of the following:

(a) Order that the administration of the estate be continued until the contingency upon which the debt is founded either occurs or fails.

(b) Order that the amount of the debt which would be payable if the contingency were to occur be paid into court. The amount paid into court shall remain there, to be paid to the creditor if the contingency occurs, or to be distributed if the contingency fails.

(c) Order distribution of the estate to the persons entitled thereto under the terms of the decedent's will or by intestate succession. The court may order distribution of the estate only if each distributee files with the court an Assumption of Liability as provided in §11433. The court may impose any other conditions upon the interested persons as the court deems just, including that the distributees give a security interest in all or part of the estate distributed, that the distributees provide a surety

bond in an amount to be determined by the court, or that the distributees deposit funds in an amount to be determined by the court.

(d) Appoint a trustee to whom the funds shall be paid with the direction to the trustee to invest the funds as authorized by the court, and to make payments as ordered by the court. Upon completing the payments as provided in the order, any excess funds shall be paid according to the decree of distribution.

(e) Make any combination of the above orders as the court deems appropriate.

(f) Modify any order made pursuant to this section.

§11433. Assumption of Liability.

(a) Before the court makes an order pursuant to Subdivision (c) of Section 11432, each distributee shall file with the court a signed and acknowledged agreement assuming personal liability for the contingent debt of the decedent and consenting to jurisdiction within this state for the enforcement of the contingent debt if the contingency occurs. The personal liability of each distributee shall not exceed the fair market value at the date of distribution, less the amount of any liens and encumbrances, of the portion of the estate distributed to the distributee. If there is more than one distributee, the personal liability shall be joint and several.

(b) Any contingent debt that is established may be enforced against each distributee in the same manner as it would have been enforced against the decedent if the decedent had not died. In any action based upon the debt, the distributee may assert any defense, cross-complaint, or setoff which would have been available to the decedent if the decedent had not died.

(c) Any applicable statute of limitations is tolled during the period from the approval of the contingent creditor's claim until thirty days after the decree of distribution becomes final. The signing of an agreement pursuant to Subdivision (a) shall neither extend nor revive any limitations period.

§11434. Disputed Debts. If the estate is in all other respects ready to be closed, the court may make an order determining the manner in which the disputed debt shall be paid if it becomes established. If the court finds that all interested persons have agreed to the manner of providing for payment of a disputed debt and that the agreement reasonably protects all interested persons, the court shall approve the agreement. If all interested persons do not agree to the manner of providing for a disputed debt, the court may do any of the following:

(a) Order that the administration of the estate be continued until the debt is either established and paid or not established.

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(b) Order that the amount of the debt which would be payable if the debt were to be established be paid into court. The amount paid into court shall remain there, to be paid to the creditor if the debt is established, or to be distributed if the debt is not established.

(c) Order distribution of the estate to the persons entitled thereto under the terms of the decedent's will or by intestate succession. The court may order distribution of the estate only if the distributees provide a surety bond in an amount to be determined by the court, not to exceed the fair market value on the date of distribution of the estate distributed, less the amount of liens and encumbrances. The cost of the bond shall be recoverable from the unsuccessful party as a cost of litigation.

(d) Appoint a trustee to whom the funds shall be paid with the direction to the trustee to invest the funds as authorized by the court, and the trustee shall make payments as ordered by the court. Upon completing the payments as provided in the order, any excess funds shall be paid according to the decree of distribution.

(e) Make any combination of the above orders as the court deems appropriate.

(f) Modify any order made pursuant to this section.