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Expert Analysis

Unclaimed Property: an Often Hidden And Potentially Substantial Liability

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While the term "escheat" may conjure images of feudal lords or the monarch reclaiming property for which there is no known heir, today, a second image should sit beside it—that of a multibillion-dollar source of revenue for the states. CNN recently reported that states, federal agencies and other organizations collectively hold more than $58 billion in unclaimed cash and benefits.[1] The Wall Street Journal reported last month that Delaware's unclaimed property program has brought in $1.24 billion over the past three years alone, representing "its third largest revenue source behind income and franchise taxes over that time."[2] New York's revenue report estimates collecting $785 million in 2012 and projects more for the future, while California's website reveals that it is currently in possession of more than $6.1 billion in unclaimed property.[3]

In this time of declining taxpayer revenues, it is perhaps not surprising that states around the country are ramping up their efforts to collect unclaimed property. In connection with these efforts, the states—often acting in groups assisted by third-party auditors—may vigorously probe into companies' policies and practices in handling unclaimed property. Further complicating the situation, companies must comply with the laws and annual reporting requirements of each of the 50 states concerning a wide variety of potentially escheatable property. Additionally, although similar, the laws of each state may vary, some state requirements are not clearly defined, and there is limited case law to provide guidance.

Moreover, state statutes have long statutory look-back periods and can be immune from their state's respective statutes of limitation. For example, Delaware's unclaimed property statute permits the state to claim property that was escheatable as far back as 1981. And, if a company does not retain the necessary accounting records to support its (and its subsidiaries') position or accurately reflect actual abandoned property liability, many state statutes permit them to use estimation techniques to fill in the gaps.

In the wake of these complexities, escheat liabilities can often be hidden and substantial. Indeed, companies that have, for whatever reason, failed to comply with the unclaimed property reporting requirements of the 50 states may run into demands not only for payment of the principal claim, but also for interest payments (as high as 12 percent compounded per year) and penalties which, given the look-back period, could be staggering.[4]

Noncompliance

There are a wide range of reasons why companies are not fully compliant with escheat laws and/or have a limited understanding about escheat exposure. They may fail to recognize filing requirements that could mandate reports be filed in all 50 states and/or may fail to appreciate the breadth of property interests captured under escheat laws. Consequently, many companies are unprepared when they receive an unexpected multi-state audit letter that can result in tens of millions of dollars of liability. Additionally, while companies may be aware of the risks they face for failing to report or underreporting their unclaimed property, they may be unaware of certain amnesty programs and other potential cost-effective means for resolving this problem.

Audits

There is no specific formula for how a company is selected for audit. Among

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other methods, states or private auditors may benchmark a company against its competitors to determine whether a company appears to be reporting unclaimed property within an industry range. Certain "red flags" can also trigger an audit, e.g., if a company has not filed annual unclaimed property reports with each of the 50 states or has gaps in its annual reporting to states. States may also target particular industries to audit. But one thing is for sure; an audit by one state can quickly expand to include multiple states.

Most states retain private outside auditors (who generally work on commission) to conduct audits on behalf of the state. Furthermore, because most businesses hold property that may be reportable to several states, the private auditor may inform the other states of the impending audit and see if they wish to be included in the process.

Potential unclaimed property holders are of particular interest to those states in which a company is incorporated or a large percentage of its customers or "owners" of the unclaimed property reside, based on the company's records. Interest in these particular targets is a product of the seminal cases decided by the U.S. Supreme Court, *Texas v. New Jersey* and *Delaware v. New York*.[5]

In these cases, the court enunciated a two-tier priority scheme for reporting and having claim to intangible unclaimed property. In the first instance, unclaimed property is to be reported to, and may be first claimed by, the state of the owner's last known address as shown by the holder's books and records. If the owner's address is unknown or if there is an incomplete address, the unclaimed property is reported to, and may be claimed by, the company's state of incorporation. Thus, states will have the most incentive to track the companies that are either incorporated in their state or have a large customer presence in their state.[6]

Types of Property

As noted above, states are commencing audits against companies to investigate whether companies are compliant in reporting and escheating a variety of potential unclaimed properties. The most common types of properties that we have observed being examined in multistate audits include: (i) unclaimed (unreturned) customer overpayments, also known as "accounts receivables"; (ii) uncashed vendor checks and unclaimed inventory or rebates;[7] (iv) unclaimed (unused or partially unused) gift certificates or discount cards; (v) unclaimed insurance products (such as unclaimed life insurance benefits, retained asset accounts and annuities); and (vi) unclaimed securities (such as shares held in inactive stock accounts, unpaid dividends, un-exchanged shares and unclaimed mutual fund shares).

We briefly discuss below three areas of escheat exposure that have received recent attention: mergers and acquisitions; the life insurance industry; and unclaimed equity properties, such as inactive securities accounts.

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Mergers and Acquisitions

Understanding escheat exposure has become an important topic in mergers and acquisitions. Companies involved in business combinations (especially when publicly announced) may provide logical targets for state investigations. An acquiring company faces great exposure as it may inherit all the potential escheat liability of the acquired company. In light of the enhanced scrutiny of unclaimed property, we have noticed that historical unclaimed property compliance procedures and responsibility for current and future escheat liabilities have taken on greater significance in the negotiations of mergers and acquisitions. It is essential that an acquirer conduct appropriate due diligence to understand the seller's unclaimed property exposure and negotiates adequate protection from unexpected liabilities, including those that can surface after the deal.

In addition to the risk of acquiring various potential escheat liabilities, unclaimed shares or other property resulting from share purchases, stock swaps or other transactions in which former shareholders fail to claim their exchange property can also result in potential unclaimed property liabilities.

Insurance Products

Unclaimed life insurance benefits have been a particular target of various escheat efforts in recent years. In several high-profile matters, certain states have obtained large settlements related to life insurance policies on which years of premiums had been received by the insurers, but for which no benefits were paid out upon the insured's death. At the heart of many of these cases was the lack of a consistent practice in the insurance field requiring that companies issuing life insurance policies, annuity contracts and/or retained asset accounts, perform regular comparisons of insureds or account holders to the Social Security Death Master File (DMF) in order to identify payable claims and beneficiaries, and potential unclaimed death benefits.[8] Part of the notoriety associated with these audits has been the practice on the part of certain companies that issued both life insurance and annuities, of using the DMF to ascertain when to cease making annuity payments, but not for the purpose of determining the death of a life insurance policy holder and paying out on those policies.

In most instances, the insurance policy put the onus on the beneficiaries to provide proof of death as a condition to a benefit payment. In the absence of a beneficiary coming forward, the benefits were not distributed. And, in the

absence of a required DMF cross-check to verify an insured's death, companies were not escheating the unclaimed proceeds. The insurance companies' position was that they had complied with insurance regulatory laws, which did not require such confirmatory measures, and the terms of their policies which contained certain conditions precedent to their payment obligation.

While there are few cases on this issue, in 1948, the U.S. Supreme Court held in *Connecticut Mut. Life Ins. v. Moore*,[9] that unclaimed life insurance proceeds were escheatable even though certain conditions to payments were not met by the policy holder's beneficiaries. Accordingly, the states have taken the position that regardless of the condition precedent to payment and the companies' compliance with insurance law, the proceeds—dating back 20-plus years—in addition to accrued interest and penalties, were escheatable.

Moreover, the practical and public relations considerations attendant to a company arguing (whether to the state or in court) that its annuity department reviewed the DMF in tracking its continued responsibility for annuity payments but its life insurance division or department did not review the DMF with respect to its potential life insurance payments,[10] and the added risk of severe penalties and interest, spearheaded several notable settlements.

For example, among others, John Hancock Life Insurance Company, Prudential Financial Inc., MetLife, and American International Group have entered into multistate settlements, paying hundreds of millions of dollars in unclaimed property liabilities. There may very well be more to come. As California's Controller John Chiang announced in a press release attending California's $20 million-plus settlement with John Hancock: "I am prepared to pursue all actions necessary—including litigation—to bring the rest of the industry into compliance."[11]

Unclaimed Securities

Another area in which we have observed states' interest concerns whether companies have appropriately reported and escheated securities held in inactive securities accounts, including mutual funds. While each state has its own rules and laws, certain states have placed the burden on the company to demonstrate evidence of account activity to avoid escheatment. For example, certain states require a company to put forth evidence that an account is not inactive, such as written communications from shareholders to the company regarding the shares, documents establishing that mailings have not been returned or evidence that the shareholder is cashing dividend checks.

As a result, the Securities Transfer Association has expressed concerns that passive investors may face escheatment of their shares. In response, on May 10, 2012, Delaware issued a letter clarifying its interpretation of when a stock account is presumed inactive and provided details of particular evidence it would consider sufficient to demonstrate activity by the account holder. Among other things, Delaware advised that sufficient activity would include such things as an owner increasing or decreasing the amount of the investment in the account or corresponding in writing either by mail or electronically via the Internet.[12]

On top of this, there is also some tension between state unclaimed property laws and laws enacted by the Securities and Exchange Commission (SEC). The SEC has specific rules regulating transfer agents which specify when a security holder may be considered truly "lost." See SEC Rule 17Ad-17. The SEC rules also provide clear guidelines on the requirements for transfer agents to perform defined database searches for the lost security holders before escheatment. These rules appear to conflict with certain states' interpretation of their unclaimed property rules, and there is uncertainty as to which laws should be followed.

Take-Away

What once was a limited and often overlooked legal field, unclaimed property can lead to considerable financial exposure for companies. We have seen first-hand the complications unclaimed property audits can cause, and the liabilities they can inflict. As states are becoming increasingly vigilant with respect to ensuring unclaimed property compliance, companies should endeavor to become fully informed about their actual and potential exposure (including that of their subsidiaries) to avoid unexpected and potentially significant liabilities.

1. See Melanie Hicken, "$58 Billion Unclaimed: Is Some of It Yours?" (Jan. 27, 2013) (noting that amounts to roughly $186 for every U.S. resident), http://money.cnn.com/2013/01/24/pf/unclaimed-money/index.html?hpt=hp_t3.
2. See Vipa Monga, "Delaware Targets Unclaimed Property," The Wall Street Journal (Jan. 29, 2013).
3. See http://assembly.state.ny.us/Reports/WAM/2012revenue/2012revenue.pdf ; http://sco.ca.gov/upd.html.
4. Each state has separate provisions for penalties and interest, and this can add up quickly.
5. See *Texas v. New Jersey*, 379 U.S. 674 (1965); *Delaware v. New York*, 507 U.S. 490 (1993).
6. See, e.g., *N.J. Ret. Merch. Ass'n v. Sidamon-Eristoff*, 755 F.Supp.2d 556, 621 (D.N.J. 2011) (noting that "it is the location of the purchaser's last known address that determines what state has the right to escheat").
7. See, e.g., *Staples v. Cook*, 35 A.3d 421 (Del. Ch. 2012) (holding that Staples Inc. was required to escheat certain unclaimed rebates to the state of Delaware).
8. For example, the state of New York's insurance department has requested a special report pursuant to Section 308 of the New York Insurance Law mandating that insurance companies (including their subsidiaries) cross-check their insurance policies with the DMF.
9. 333 U.S. 541, 686. (1948).
10. Florida's Insurance Commissioner stated in a Wall Street Journal article that "it is hard for me to get my arms around the concept that a company would use a database to terminate an annuity, but fail to use that same database to investigate whether a claim exists on a life policy." http://online.wsj.com/article/SB10001424052748703367004576289423732099868.html.
11. http://www.sco.ca.gov/eo_pressrel_9934.html.
12. http://www.stai.org/pdfs/delaware-division-of-revenue-letter.pdf.

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