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Unclaimed Property, What's It All About?

Unclaimed Property Generally

- Unclaimed property consists of a variety of types of tangible or intangible property which states collect from holders after a period of dormancy.
- Derives from the English system of feudal law that required unclaimed feudal lands to return to possession of the Crown
- States take custody of such property for the benefit of “lost” owners, who may claim the property from the state upon discovery. The state’s rights derive from the rights of the owner, a concept known as the “derivative rights doctrine,” which means (in practice) that the state cannot have any greater rights than the true owner
- Important unclaimed property terms:
 - Holder
 - True Owner
 - Presumption of Abandonment/Dormancy Trigger
 - Period of Dormancy
 - State of Incorporation/Organization

Early History of Unclaimed Property and the Uniform Act

- Prior to 1954, many states had some form of unclaimed property laws, but legislation was conflicting and difficult to administer and enforce
- In 1954, the first Uniform Unclaimed Property Act (the “Act”) was drafted
- Purpose was to bring consistency and predictability to unclaimed property law and give states a model to follow.
- The Act was revised in 1966
- 31 states adopted the 1954 or 1966 version of the Act and by this time nearly every state had some form of unclaimed property law
- The Act was revised again in 1981 and 1995 and most states have adopted either the 1981 or 1995 version of the Act but have added unique provisions of their own to the “model” – thus, state unclaimed property laws continue to lack uniformity
- *Texas v. New Jersey* (1965) was the first U.S. Supreme Court decision to establish unclaimed property priority rules to govern state disputes over the right to take custody of unclaimed property

Key Decisions of the US Supreme Court

- *Texas v. New Jersey*, 379 U.S. 674 (1965)
 - Established unclaimed property priority rules between states
 - Primary Rule and Secondary Rule
- *Pennsylvania v. New York*, 407 U.S. 206 (1972)
 - Affirmed the unclaimed property priority rules of *Texas v. New Jersey* and further developed federal common law on unclaimed property issues, especially regarding the business records of the holder.
- *Delaware v. New York*, 507 U.S. 490 (1993)
 - Made it clear that state laws that conflict with the unclaimed property priority rules established in *Texas v. New Jersey* are invalid, and that statistical sampling and estimation techniques are only valid if agreed upon by the holder

Texas v. New Jersey (1965)

- Sun Oil Company owed numerous small debts to creditors (i.e. owners) around the United States
- Various states asserted rights to the unclaimed debts based on Sun Oil's contacts with the respective states
 - Books and Records in Texas
 - Incorporated in New Jersey
 - Main business office in Pennsylvania
 - Last known addresses for creditors in Florida and other states
- Supreme Court rejected the “most significant contacts” test; viewing the issue of which state should take custody as being a question of “ease of administration and of equity.”
- Primary Rule – State of true owner's last known address has most superior right to take custody of unclaimed property, based on the address shown by the holder's books and records

Texas v. New Jersey, cont.

- Secondary Rule – State of holder’s corporate domicile has right to take custody of holder’s unclaimed property if:
 - Holder’s records do not show true owner’s last known address, or
 - State of true owner’s last known address, at the time the property was presumed abandoned, did not provide for the escheat of property (i.e. did not have an escheat law)
- Supreme Court established the Primary and Secondary Rules because they “involve a factual issue and are simple and easy to resolve and leave no legal issue to be decided.”

Pennsylvania v. New York (1972)

- At issue were Western Union money orders – many of which Western Union had no record of the owner’s (i.e. the sender’s) last known address
- Pennsylvania argued that the address for senders of unclaimed money orders sold in Pennsylvania should be presumed to be in Pennsylvania and that unclaimed money orders sent from Pennsylvania should be reported to the State of Pennsylvania, not the State of New York (which was Western Union’s state of incorporation)
- Supreme Court rejected use of statistical sampling and estimation to establish unclaimed property liability
- Supreme Court refused to make an exception to the unclaimed property priority rules established in *Texas v. New Jersey* by stressing the importance of consistency so as not to decide each unclaimed property case on a case-by-case basis

Delaware v. New York, (1993)

- At issue were unclaimed dividends, interest and other securities distributions held by intermediaries (i.e. banks and brokers) for unidentified owners
- Supreme Court again followed the priority rules established in *Texas v. New Jersey* and ordered that under the Secondary Rule, the State of Delaware had the superior right to claim the unclaimed funds, despite the fact that many of the intermediaries had their principal places of business in New York
- Supreme Court rejected a proposed unclaimed property priority rule based on the principal place of business of the holder because it was too difficult to administer and too fact specific
- Supreme Court also made it clear that “no state may supersede [the Primary and Secondary Rules] by purporting to describe a different priority under state law.”
- Therefore, any state law that conflicts with the unclaimed property priority rules established in *Texas v. New Jersey* is invalid
- Current case pending appeal in the Third Circuit Court of Appeals addressing a New Jersey unclaimed property law amendment that conflicts with the unclaimed property priority rules established in *Texas v. New Jersey*

Summary of Federal Common Law Rules

- First Priority Rule – If holder has name and address of true owner of unclaimed property, property is reported to the state of the owner's domicile.
- Second Priority Rule – If holder does not have a name and address of the true owner of unclaimed property on its books and records, property is reported to the state of the holder's incorporation (or organization for LLCs and other entities).
- No state law attempting to establish a different scheme of priority is valid (i.e. so-called Third Rule that attempts to establish an unclaimed property priority scheme based on the location of the transaction)

Holder Responsibilities - Presumption of Abandonment

- The Act and state unclaimed property laws presume property is abandoned if “it is unclaimed by the apparent owner” for a specific period of dormancy
- Period of dormancy under state unclaimed property laws varies according to the type of property (typically one, three or five years)
- Dormancy is triggered by the due and payable nature of the obligation combined with a lack of owner-initiated contact with the holder of the property regarding the property
- Period of dormancy can be tolled and restarted if owner-initiated contact takes place during the dormancy period
- **Example:** In January 2009, Worker X is living in Ohio. In June 2009, Worker X leaves his place of employment and moves out of the state before he receives his final payroll check and without leaving a forwarding address. The period of dormancy applicable to payroll checks before payroll checks are presumed abandoned is 1 year. Company Y, Worker X’s former employer and an Ohio entity, has no contact with Worker X regarding the unclaimed check from July of 2009 through July of 2010. In 2011, Company Y is responsible for reporting Worker X’s unclaimed payroll check to the State of Ohio under the Secondary Rule because Company Y does not have a last known address for Worker X.

Holder Responsibilities – Reporting Unclaimed Property Timely

- Majority of states require spring or fall reporting.
- For example, unclaimed property presumed abandoned in 2009 would be reported to the appropriate jurisdiction prior to the 2010 reporting date.
- Unclaimed property must be reported according to the priority rules set forth in *Texas v. New Jersey*
- If property reported in good faith, state with custody of the property will indemnify the holder and hold the holder harmless from damages resulting from erroneously reporting the property to that state

Where Do I Report?

- Holders are required to report according to the Primary and Secondary Rules of Escheat set forth in *Texas v. New Jersey*.
- Holders required to report to each jurisdiction where it has a record of a last known address of an owner that is owed unclaimed property according to the Primary Rule of Escheat
- Also, most holders have at least some owner-unknown property to be reported to its state of organization or incorporation under the Secondary Rule of Escheat
- Thus, a holder may be required to report to several states or, if the holder does not maintain records of last known addresses, the holder is only required to report to its state of organization or incorporation

What If I Don't Report?

- ✧ Every state has an unclaimed property law that requires holders to remit unclaimed property to the state if unclaimed property is owed.
- ✧ Despite this legal obligation, many holders have taken the position that they are not required to report unclaimed property
- ✧ Most business models (i.e. business that use vendors, have customers, and have employee turnover) generate some type of unclaimed property
- ✧ State of organization or incorporation has legal authority to audit the company at any time. So it is likely that the lack of unclaimed property reporting will be discovered at some point.
- ✧ Failure to report can subject the holder to fines and penalties from each jurisdiction that it should have reported to.
- ✧ If the failure to report unclaimed property is deemed willful, then the holder can receive additional fines as well as penalties up to 25% of the value of the unclaimed property owed.
- ✧ Accordingly, most often not reporting unclaimed property results in additional unclaimed property liability than the company originally would have had if it had reported as required by law.

Who Can I Turn to for Help?

- Recent increased state regulation with respect to unclaimed property reporting has caused many holders to seek out advocates to assist with unclaimed property compliance
- Advocates include law firms, compliance firms and audit defense firms
- Advocates can assist with voluntary compliance and updating procedures and policies to ensure future unclaimed property compliance
- Detailed record-keeping and preparation is best defense to an unclaimed property audit
- If a holder believes it is out of compliance, hiring an advocate before an audit is initiated can avoid time, energy and expense

Current Trends and Issues – Unclaimed Property

- * Budget shortfalls and economic downturn have caused state authorities to seek out alternate sources of funding
- * Unclaimed property audits have increased exponentially over the past 10 years
- * Use of contract auditors that seek out audit subjects and conduct the audits on behalf of the state for a contingency fee has made it incredibly easy for a state to audit multiple entities at the same time
- * State laws and the Act permit state authorities to examine the records of holders doing business in the state to determine if the holder is in compliance with the state's unclaimed property law
- * The holder must permit the state to review its books and records related to unclaimed property in order to determine if the holder is in compliance with unclaimed property laws
- * State unclaimed property laws routinely permit the use of statistical sampling and estimation techniques to determine unclaimed property liability – use of statistical sampling has been a great benefit to states
- * Recent Fifth Circuit Court of Appeals decision has deemed unclaimed class action settlement proceeds as subject to state unclaimed property laws
- * Third Circuit Case addressing the ability of the State of New Jersey to presume that all gift cards sold in the State of New Jersey have a New Jersey owner if the owner's name and address are not recorded at the point of sale

Unclaimed Property Audit 101

What to Expect and What to Do

State Unclaimed Property Audits: What to Expect?

- As mentioned earlier, state unclaimed property laws permit state authorities to audit holders subject to its jurisdiction to determine if the holder is holding unclaimed property that should have been reported to the auditing state.
- No particular rhyme or reason as to how audit subjects are selected, some factors could include:
 - * Meager reporting history
 - * Voluntary Disclosure or Amnesty Reporting
 - * Size of Company
 - * Type of Company
 - * Gap in reporting history
 - * Significant increase in amount reported from one year to the next
 - * Public merger or acquisition
 - * State of incorporation
- Additionally, contingent fee audit firms solicit states to audit large companies irrespective of reporting history because of potential for large contingent fee
- Audits can take between two and five years to complete or longer if audit findings are subject to dispute

Types of Property At Issue in an Audit

- General ledger items such as outstanding payroll and vendor checks, accounts payable, etc.
- Credit balances on receivables (customer overpayments and unidentified remittances)
- Gift Cards, Gift Certificates and Merchandise Credits
- Uncashed dividend and interest checks
- Unclaimed inventory or Goods Received/Invoice Received
- Retained Asset Accounts or other client trust accounts
- Insurance proceeds (i.e. death claim payouts and annuity payments)

Contingent Fee Audits

- Audit firm solicits state to audit on behalf of the state using state's audit authority
- Audit firm contracts with state authority(ies) to conduct audits on behalf of that state or states
- Many audit firms represent multiple states in the same audit
- Auditor reviews books and records of audit subject to determine if unclaimed property is owed to auditing state or states
- Auditor receives percentage (usually 10-15%) of property "located" during the audit that should have been reported to a particular state
- Contingent fee audit benefits the state because state does not have to use state employees to conduct the audit
- Contingent fee audit benefits the auditor receives potentially large contingent fee
- Questionable whether auditor can be "impartial" when auditor has a direct financial interest in the outcome of the audit

Receipt of Notice of Intent to Audit – What to Do and How to Prepare?

- Typically, audit begins with notice of intent to audit sent to audit subject from contract auditor
- Notice will request opening meeting
- First step, contact advocate (or advocates) to assist with audit, advocate can assist with:
 1. Communication between audit subject and auditor
 2. Internal review of reporting history and potential liability
 3. Legal issues surrounding document production and settlement.
- Second step, determine employees that are responsible for unclaimed property reporting and locate relevant records related to unclaimed property
- Third step, begin internal review of unclaimed property reporting history and potential sources of unclaimed property with or without advocate assistance

Opening Meeting/Requested Records/Record Review

- Opening meeting usually done via conference call but could be onsite
- Attendees will be audit subject's unclaimed property team and two to four contract auditors
- Typically there is no audit agreement that governs scope of the audit and how disputes will be resolved
- Discussion will revolve around what types of records the audit subject has and what operating systems that the audit subject uses to retain records
- Scope of audit (years covered) and general nature of information requests will be discussed as well as timeliness of responses
- Records requests will cover all unclaimed property reports and other records that could impact unclaimed property reporting for all years covered in the scope of the audit
- Records requests will include general ledger items, bank reconciliation statements and other bank account information
- If records are kept electronically, auditor may not need to be onsite to review records

Record Review/Audit Findings

- Auditor will meticulously review records provided and unclaimed property reports filed to attempt to locate property that should have been reported or gaps in unclaimed property reporting procedures that could result in unclaimed property failing to be reported
- Auditor will attempt to paint the bleakest picture possible and will include disputed funds in its audit findings
- Auditor will prepare a list of audit findings and an amount owed to each state participating in the audit
- Audit subject and its advocate will be provided an opportunity to review and rebut audit findings
- Statistical sampling may be recommended for years where no records exist and no reports were filed

Voluntary Disclosure in Lieu of Audit

- Voluntary disclosure of unclaimed property that should have been reported is also available to holders who are seeking to be in full compliance with state unclaimed property laws
- Many states permit voluntary disclosure through a Voluntary Disclosure Agreement (VDA)
- Typical VDA terms permit the holder to remit delinquent unclaimed property voluntarily in exchange for the state's waiver of interest and penalty for late reporting
- VDAs are typically not available after a Notice of Intent to Audit is received – thus VDAs must be sought prior to the receipt of a Notice of Intent to Audit
- Some states, such as Delaware, will allow voluntary disclosure but will also seek to conduct an audit after the property reported under the VDA is remitted
- Nevertheless, if your company is aware that you have delinquent unclaimed property, the VDA process is the best approach to removing that liability from your company's books
- Hiring an advocate to assist with the VDA process is recommended in order to facilitate communications with state regulators and calculation of property to be submitted

Holders' Rights in the Unclaimed Property Audit Context

Know When to Hold'em, Know When to Fold'em

Audits Regulated by State and Federal Law

- State statutes that permit examinations contain limitations on how the audit may be conducted, but many auditors do not adhere to statutory requirements
- Both auditors and state authorities may misstate or misrepresent the law, whether intentional or unintentional
- Federal law limits an audit to a review of the holder's "books and records" kept in the ordinary course of business
- Auditors will often request reports and other data compilations to be prepared at the holder's time and expense when such reports are not kept in the ordinary course of business
- It is the responsibility of the holder and the holder's advocate to ensure that the holder's rights are protected and that the law is followed

Receiving the Audit Notice

- Audits usually initiated by Delaware, Florida, Texas or state of incorporation
- Standard language notifying you of selection for audit and the name of the auditor that will contact you
- Respond Timely – Refer auditor to your advocate
- Important to be aware of legal rights and not be influenced by intimidation tactics
 - Threat of imposition of interest and penalty
 - Circumvention of management; directly to CFO or CEO
- Don't Panic - Audit should be conducted on holder's timeline; the state authority and auditor will be reluctant to initiate a lawsuit
- Auditor may accuse the holder of delay

Confidentiality Issues/Protection of Customer and Vendor Information

- Holder has right to protect proprietary and customer information from public disclosure
- Typically auditor will provide a form confidentiality agreement to govern confidential information shared between the parties
- Prudent to have your advocate review that confidentiality agreement to ensure it is proper in scope
- Holder has a right to refuse to proceed with the audit until the holder is assured its confidential and proprietary information is protected
- Contract auditor may attempt to bully the holder into providing information relevant to the audit before the confidentiality agreement is signed

Reviewing Qualifications and Financials of Auditor

- Holder has right to ensure that the auditors who will be on its campus are qualified
- Many holders request to review resumes of auditors and some holders have requested criminal background checks because that is required of all visitors to the holder's campus
- Financials of auditor may be requested to ensure holder can stand behind breach of confidentiality that results in damage to the holder, such as disclosure of trade secret or customer lists
- Contract auditor may balk at some of these requests but the holder has the right to request any information that is relevant to the auditor's presence at the holder's offices.

Statistical Sampling and Estimation and Holder Approval of Methodology

- Most state unclaimed property laws permit the use of statistical sampling and estimation for unclaimed property audits in the absence of holder records
- Remember – unclaimed property is actual property that was presumed abandoned in a particular year – so conceivably a holder could have reporting years where no unclaimed property was owed
- Because unclaimed property is actual property and not estimated property, federal common law disapproves of the use of statistical sampling and estimation because such formulas are not based on actual holder records
- Statistical sampling and estimation benefits the auditing state because it allocates unclaimed property across all reporting years that the holder does not have records, even if the holder did not have unclaimed property to report in a given year (See *CA, Inc. v. Delaware Dept. of Finance*)
- In practicality, most states use some form of statistical sampling and estimation; however, the holder has a right to review and approve the sampling and estimation methodology to be used prior to its implementation

Statistical Sampling, cont.

- It is almost a given that detailed records will not be available for the entire period of the audit and thus some form of sampling or modeling will have to be employed to cover the years where records are not sufficient.
- When considering an alternative to “bridge the gap” for missing records, you should use a sampling or modeling approach that complies with generally accepted sampling rules
- It is suggested that you run your proposed sampling plan by the state prior to proceeding with the sample to avoid the risk of rejection later
- Many jurisdictions require that the sample plan be provided prior to commencement of your analytical work
- A properly performed stratified random sample is the most defensible

Conducting Internal Unclaimed Property Audit

- Conduct internal audit (or hire advocate to do so) while auditor reviews responses to information requests
- Important to understand areas of potential exposure to further develop defense strategy
 - Determine which issues lead to the most exposure and spend most time pushing back on those issues
- Understand reporting requirements and exemptions (e.g., business-to-business exemptions in some states)
- Consider hiring an advocate to assess areas of exposure based on records and information technology issues
- Review past reports and filing history if any
- Customer contact procedures and records

Administrative Review and Challenge of Audit Findings

- After the contract auditor has completed its review of the holder's books and records, the auditor will submit his findings to the holder and to the auditing state
- The holder has the right to challenge the auditor's calculations, formulas and findings
- Challenge is usually made to the auditing state through the state's administrative review process
- If administrative review process fails, most states permit challenge to proceed through state court
- Important for holder to raise all concerns regarding calculations and formulas during the audit process so a court would not deem those objections waived

Legal Issues in Administration of Unclaimed Property Laws

What Holders Need to Know

Legal Issues in Unclaimed Property

- Use of Third Party Auditor
 - Contingent compensation conflict of interest
 - Private money-making fishing expedition as opposed to necessary public function
 - Lack of meaningful regulations applicable to private auditors
 - Target selection criteria – Auditor selection of target and reaching out to participating states
 - Adding additional participating states to the audit after the confidentiality agreement has been signed
 - Conducting more than one audit simultaneously
- Confidentiality of holder records
- Lack of established procedures and scope
 - How long is the look back period?
 - No established protocols for manner of audit
 - State may choose not to accept audit results and audit the holder again with its own employees (or accept the results of the audit but retain the right to audit within 5 years)
- Need of Audit Protocol Agreement to limit scope and define dispute resolution procedure

Legal Issues, cont.

- Auditor may seek to include property types in the audit that are not subject to escheat (i.e. GR/IR and unclaimed inventory)
- Auditor may use threats of lawsuits or other sanctions in order to get the holder to agree to calculation methods or production of records and reports that are not permitted by federal common law
- Auditor may misrepresent applicable law in order to get unsophisticated holder to agree to a quick settlement that is inflated
- Important to engage advocate at the beginning of the process – will save time and money in the long run
- Based on our experience, holders that respectfully but forcefully seek to assert their legal rights have had good outcomes

Recent Trends in Property Types Covered by Audits

- Auditors continue to cast a wide net with respect to unclaimed property audits
- In the past, audits were limited to uncashed checks and unpaid benefits – trend is moving toward reviewing ever general ledger account to determine whether that account could contain unclaimed property
- Suspension Accounts
- Disputed Accounts/Payments held subject to resolution of litigation
- Unclaimed Inventory
- Retained Asset Accounts or client trust accounts
- Insurance proceeds and annuity payments
- Employee Benefit Plans not subject to ERISA

Property Owed to Foreign Last Known Addresses

- Holders who conduct business abroad will often hold unclaimed property owed to foreign last known addresses
- Property owed to foreign last known address is not subject to custody of any U.S. State
- International principal of “comity” requires that U.S. law defer to the law of the nation where the true owner resides
- Some states, such as Delaware, will attempt to collect property owed to foreign last known addresses despite having no legal authority to do so
- Uniform Act explicitly excludes property owed to foreign last known addresses

Statute of Limitations Issues

- Technically, there is no statute of limitations that governs unclaimed property reports, therefore some states attempt to “look back” to records for 20 years or more
- Most states limit the “look back” period to 10 years but threaten to look back further if the holder is “uncooperative”
- Delaware has recently proposed legislation to limit look back period to 1995 as opposed to 1981 (Delaware H.B. 229)
- Look back period is important because state will seek to impose interest and penalty for years where holder does not have records. Thus, the shorter the look back period the better.

Derivative Rights/Interest and Penalty

- State only has “derivative right” to receive what true owner was supposed to receive
- State may charge interest and/or penalty if property was not reported timely
- State may also waive interest and penalty if failure to report property was unintentional
- State will use threat of the addition of interest and penalty in order to get the auditor to settle on an amount higher than what is actually owed
- Holder’s advocate can assist with addressing interest and penalty issues and possibly have some interest and penalty waived

Potential Outcomes – Audit, Settlement or Litigation?

- Based on exposure identified by self-review, decide whether audit or settlement is most beneficial
- Outcome of internal review is critical to understanding the holder's overall exposure to unclaimed property liability
- Consider Challenging Procedures and Results of Audit
- At minimum, do not move forward with the audit until audit protocols and procedures are in place and mutually agreed upon
- Beware of being forced into making a payment prior to the closure of the entire examination as Delaware typically likes to force a payment on those sections of the audit that are completed (e.g., accounts payable) while the audit of other property types are still in process
- A premature payment could jeopardize your leverage!
- Holder could also choose to litigate disputed issues – requires balancing test of benefit vs. risk and estimation of legal fees

Voluntary Disclosure and Amnesty Programs

- VDA agreements are a good way to avoid interest and penalty for late property
- While such agreements are supposed to be confidential, holders who enter into VDAs with one or more states should expect to receive inquiries from other states as state administrators sometimes share information about VDAs
- If your company is aware it has unclaimed property that has not been reported, hiring an advocate to approach a state to begin the VDA process will be beneficial
- Holders should also be aware of state amnesty programs that waive interest and penalty for property reported late

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