



Unclaimed Property ADVISORY ■

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Spotlight on Delaware Unclaimed Property Law

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All 50 states and the District of Columbia have enacted, and enforce, laws providing for the reporting and remittance of unclaimed property. Over the past few years, states’ administration of their unclaimed property/escheat laws have received increased attention from the media, business and political community. Such attention is well deserved, considering the states’ aggressive posture toward the pursuit of unclaimed property—arguably with the goal of raising revenue, rather than reuniting owners with their property. Delaware’s administration and enforcement of its unclaimed property laws has been of particular interest.

Under the jurisdictional priority rules set forth by the U.S. Supreme Court in *Texas v. New Jersey*, 379 U.S. 674 (1965), unclaimed property first escheats to the state of the last-known address of the apparent owner of the property, as shown in the holder’s (i.e., the company’s) books and records. The Supreme Court provided a secondary priority rule generally applicable to property with respect to which no record of any address exists on the holder’s books; for this purpose the holder’s state of domicile (generally, its state of incorporation) is allowed to claim the property. As a result, because Delaware is a preferred state of incorporation for many companies, its unclaimed property audit program is particularly active.

Delaware’s Historical Unclaimed Property Enforcement

As noted above, the Delaware Division of Revenue/Delaware State Escheator has been particularly active in pursuing unclaimed property audits, which are often extremely labor-intensive for companies due to the scope of the review and the audit practices employed by the state. For example, Delaware employs third-party contract audit firms, which are paid in part on a contingency-fee basis, to conduct the audits.

Further, Delaware-initiated audits for Delaware-formed entities involve the examination of a holder’s records dating back to 1981; companies rarely possess records for this full time period. As a result, “extrapolation” or “estimation” techniques are employed by Delaware to determine a Delaware-formed company’s abandoned property liability in situations where that company no longer has the necessary records to identify the actual amount of its liability. Because there are obviously no owner names and addresses associated with such an estimated liability, Delaware will claim the entire amount under the jurisdictional priority scheme.

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The New Voluntary Disclosure Program

Most recently, however, the focus of the attention of Delaware's administration of its unclaimed property laws has shifted from the audit practices of the Division of Revenue and its third-party auditors to a more holder-friendly development—the enactment of the Secretary of State's new unclaimed property voluntary disclosure program in 2012 pursuant to Delaware Senate Bill 258, which granted the Delaware Secretary of State (as opposed to the State Escheator) a limited three-year window to enter into voluntary disclosure agreements (VDAs) with holders of unclaimed property (hereinafter, the "new VDA program").

In short, the new VDA program presents an opportunity for a company to come into compliance with the law on a more favorable basis than the old VDA program, which was administered by the State Escheator's office, and certainly on a more favorable basis than would be the case if the company were audited.

One of the most significant benefits of the new VDA program is a shortened look-back period. In contrast with the 1981 look-back period utilized on audit, companies who enter the new VDA program by June 30, 2013, and complete the VDA and submit the applicable payment by June 30, 2015, will qualify for a 1996 look-back period. (Note: Originally, a holder was required to complete the VDA by June 30, 2014, in order to qualify for the 1996 look-back period.)

However, the Delaware legislature amended the VDA law in 2013 to extend the completion deadline to June 30, 2015. See Del. Code Ann. tit. 12, § 1177(b)(1) (as amended by H.B. 2, 147th Gen. Assem. (Del. 2013)). Holders who enter the new VDA program after June 30, 2013, but before June 30, 2014, and that still complete their VDA by June 30, 2015, will qualify for a shortened look-back period to 1993.

In response to the enactment of Senate Bill 258, the Division of Revenue (within which the Delaware State Escheator is housed and through which unclaimed property audits are initiated and conducted) agreed to a moratorium on the issuance of unclaimed property audit notices, beginning in July 2012. During the moratorium, the Secretary of State's office conducted an extensive outreach campaign, in which it sent letters to more than 500 Delaware-incorporated companies believed to be out of compliance with Delaware's unclaimed property laws.

The purpose of these letters was to inform companies that the new VDA program existed, and that the door was open for registration and participation. Importantly, the Secretary of State sent follow-up letters in mid-January 2013 to the same group of companies (with the exception of those that had already applied to participate in the new VDA program) reinforcing the potential risk of not responding to this invitation.

Delaware's Recently Renewed Audit Efforts

The moratorium on audits is now over, and the State Escheator has now resumed sending out audit notices. We were informed that two batches of audit notices were sent out by the State Escheator/Division of Revenue in early February and mid-February, and we have become aware that companies are indeed receiving them. We expect to hear about many more audit notices reaching companies in the coming days and weeks.

While there does not appear to be any pattern inherent in the list of companies that have received one of the new Delaware audit notices, it is clear that those that received the Secretary of State's outreach letters were assessed to be "high risk" from an unclaimed property standpoint. This category consists of both (a) companies that are domiciled in Delaware, and (b) large companies with significant multistate operations, regardless of their precise Delaware footprint. Audit notices also tend to be issued by industry. We are currently seeing a focus on the financial services industry, for example, although we are aware that audit notices have also been sent to companies in the retail, entertainment and consumer products manufacturing industries as well.

For those companies that have not already come into compliance with Delaware's unclaimed laws, now is likely going to be the time to do so, voluntarily or otherwise. If you have already received an audit notice, you will be forced to consider your past compliance on audit. If you have not yet received an audit notice, there may still be an opportunity to enter the new VDA program and take advantage of the more favorable terms that it offers, including the significantly reduced look-back period.

A company that has received a Delaware audit notice must allocate resources and prepare for what will likely be a lengthy, time-consuming and labor-intensive process. Other states are typically invited to join Delaware-mandated audits, and typically do, rendering them multistate examinations. The specific issues related to any particular company will vary depending on industry (e.g., insurance, financial services, consumer products/services) and specific profile, including past compliance and unclaimed property policies and procedures; however, every audit will involve a lengthy and thorough examination process, and companies should be ready to explain and defend their existing unclaimed property policies and procedures.

Also, companies should be prepared for disputes regarding the proper application of Delaware's (and other participating states') laws and regulations, and various legal issues, including the treatment of shared services entities, impact of third-party administrators; the treatment of acquired and divested entities; scoping of years previously audited or subject to a VDA; and, the impact of redomestication of the years under review. In addition, companies should be prepared to consider whether any applicable legal defenses apply, such as federal preemption of state escheat laws.

Considering Whether to Participate in the New VDA Program

If you have not yet received an audit notice, you should consider (or reconsider) whether to apply to participate in the new VDA program. Since its enactment in 2012, the Secretary of State has made remarkable strides in establishing and implementing the program. The Secretary of State has hired the law firm of Drinker Biddle & Reath LLP to administer the program and be the point of contact for holders and their representatives.

The administrator has in turn drafted (and is in the process of revising) "implementing guidelines" to describe with more particularity the substantive methods that would be employed and the standards that would be utilized in reviewing holder VDA submissions. In addition, our initial interactions with the administrator—which have been significant—have thus far been extremely productive and collaborative. We remain confident that the new VDA program will provide companies with a positive forum in which to come into compliance with Delaware's unclaimed property laws, and most importantly, will enable companies to resolve audit issues on terms far more favorable than those that would be available on audit.

In light of the expiration of the audit moratorium and the Division of Finance's already vigorous revival of its audit program, companies that have not already received an audit notice should take a careful second look at the new VDA program's terms and conditions, as well as its potential benefits, if they previously decided that the cons outweighed the pros. While companies should always carefully consider a decision of this magnitude, time is of the essence and the ramifications of being subject to an audit, rather than coming into compliance through the new VDA program, are significant.

If your company does not intend to enter the new VDA program, we recommend that you prepare for the possibility of a Delaware-initiated audit by doing at least the following things:

- Review and understand your company's internal policies and procedures by entity, business activity, and property type (e.g., payroll, customer accounts and unused customer deposits and credit balances, uncashed vendor checks, employee benefit payments and reimbursements, uncashed rebates, gift cards and other forms of prepayment, and any other liabilities that became due and payable but have not been satisfied);
- Identify general ledger accounts tied to most common property types;
- Understand accounting practices and whether any items that were owed but unclaimed have been reversed to income, and the basis for such practices and the availability of documentation to support those practices;
- Review and understand your company's prior unclaimed property compliance history, including prior audits and voluntary disclosure agreements;
- Review and understand your company's prior mergers, acquisitions and dispositions and their impact on successor liability;
- Assess potential areas of weakness/exposure, and consider whether remediation is possible; and
- Identify relevant third parties that will be essential to the administration of the audit, for example, payroll providers, benefit providers and contractors with whom your company or its stock transfer agents or exchange agents contract for SEC "lost shareholder" searches, pre-escheatment shareholder location services, or unclaimed property due diligence and reporting.

Conclusion

In sum, given the growing importance of unclaimed property as a source of state operating revenues and continuing media attention to this topic, we anticipate that Delaware and other states will become more aggressive in their unclaimed property administration and enforcement efforts in the near term. It also will not be uncommon for a company to have to defend multiple audits being conducted by different third-party contract auditors at the same time.

The new VDA program offers a unique (and possibly once-in-a-corporate-lifetime) opportunity for a company to come into compliance with Delaware's unclaimed property laws on terms that are more favorable to holders than either audit or the old VDA program. Your company should therefore carefully consider whether navigating the new VDA program will be in its best interest and will lead to smoother sailing for the future.

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