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Mortgage Servicers Should Review Escheat Compliance

By **Kendall Houghton, Nanci Weissgold and Michael Giovannini**

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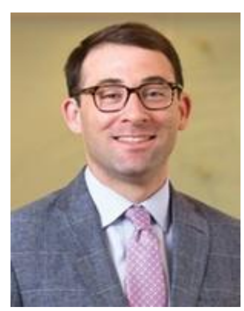
Several significant developments have transpired in the world of unclaimed property law that could have a significant impact on mortgage servicers' compliance efforts. As a result, states have taken (and will continue to take) steps to reform their unclaimed property laws, which will force members of corporate America to take a hard look at their internal compliance programs. In the meantime, we expect states to continue their rigorous enforcement of these laws.

Kendall Houghton

Nanci Weissgold



Michael Giovannini

Overview of Unclaimed Property Laws

All 50 states plus the District of Columbia, Puerto Rico and the U.S. Virgin Islands have adopted some form of custodial unclaimed property, or "escheat," law. These laws generally apply to any fixed and liquidated obligation by a holder to pay money that has not been satisfied, including obligations represented by uncashed checks and unclaimed credits, as well as other specific types of intangible property enumerated in a state's law.

The "holder" of unclaimed property, which is generally the business that has the obligation to the owner (such as a mortgage servicer or subservicer), is required to annually report the property to states. The U.S. Supreme Court has established that the state with the primary right to escheat property is the state of the owner's last known address. If the holder does not have an address for the owner, the state with the secondary right to escheat the property is the holder's state of domicile. Reporting is required if the property has remained unclaimed for the dormancy period (typically three or five years). Any action or communication by the owner to the holder serves to toll the running of the dormancy period.

Even though there are at least four versions of a uniform unclaimed property act, including the 2016 Revised Uniform Unclaimed Property Act, the specific requirements of state unclaimed property laws vary considerably. For example, states do not have uniform dormancy periods, and some states exempt property such as gift cards/gift certificates while others expressly escheat this property. Finally, although a majority of states require reports to be filed by Nov. 1, many states do not, and some states distinguish between types of holders for this purpose (e.g., financial organizations may have a different reporting deadline than other corporations). Note that the uniform unclaimed property acts typically define “financial organization” or other relevant term narrowly — “savings and loan association, building and loan association, savings bank, industrial bank, bank, banking organization, or credit union” — but a handful of states (such as Kentucky) have broader definitions that could apply to other types of financial services providers or investment companies.

One aspect that is consistent among states is that most of them regularly conduct compliance examinations of holders, typically through third-party contract auditors that are paid on a contingency-fee basis. These audits are usually conducted by a single auditor on behalf of multiple states, and a single audit can include as many as 40 or more states. It is also becoming increasingly common for one holder to be audited by multiple states at the same time by different auditors. States typically reserve the right to impose penalties and/or interest on any items of unclaimed property identified during an audit that are considered to be late.

The internal responsibility for ensuring compliance with unclaimed property laws often falls to a company’s tax department, and unclaimed property resembles tax in many ways. However, unclaimed property is not a tax. Many states do not have actual statutes of limitations on assessments, and the states that do often can issue an assessment 10 years or more after a report is filed. In addition, many states impose interest and penalties on the failure to file, and/or to timely file, escheatable property, and these fines can be material (e.g., California imposes 12 percent interest per annum, without a cap; Delaware imposes interest that can be as high as 50 percent of the assessed value of the nonfiled or late-filed property). Adding insult to injury, many states do not have specific statutory mechanisms for appealing an unclaimed property assessment.

Why the Mortgage Servicing Industry Should Take Note

Like most industries, members of the mortgage servicing industry have the potential to be holding at least some property that would be considered escheatable as unclaimed property under a state’s laws. Items like uncashed refund checks and dormant escrow accounts are two specific types of property that could lead to some exposure. For example, a servicer sends a borrower a check for a refund of unearned insurance premiums and the check is returned as undeliverable because the borrower no longer resides at that address. Or, if a borrower dies and there are no apparent successors, a mortgage servicer may not have an address to return remaining funds in a borrower’s escrow account. In addition, mortgage servicers could potentially be the holders of other general property types, such as uncashed payroll checks, uncashed vendor checks and customer deposits/overpayments. Any publicly traded mortgage servicer will also potentially be the holder of unclaimed shares of stock or dividends, even if the property is administered by a third-party transfer agent.

Any company is at risk of being audited or assessed for unclaimed property regardless of industry and compliance history, and the mortgage servicing industry is no exception. Companies that are domiciled in Delaware are particularly at risk of being audited by the state. Delaware has been one of the most aggressive states in enforcing its unclaimed property laws. Traditionally, Delaware conducted its audits back to 1981 and would estimate a liability for holders that predictably failed to maintain records for that long. However, in June 2016, the Delaware district court issued a momentous decision in Temple-Inland Inc. v. Cook, which dealt a substantial blow to a traditional source of Delaware’s large unclaimed property revenue stream by ruling that the estimation of unclaimed property liability violated Temple-Inland’s substantive due process rights. Recent legislative changes enacted through Senate Bill 13 have made Delaware’s Escheats Law more holder-friendly — e.g., the lookback period for audits is now “only” 10 report years, and holders have the opportunity to choose to proceed under a voluntary disclosure agreement (VDA) rather than audit.

Although Delaware has made numerous holder-friendly reforms to its laws in recent months, other states are picking up where Delaware's aggressive practices left off. Among other things, the outsourcing of states' enforcement efforts to contingency-fee contract auditors is at an all-time high. These audits can span multiple years, cost hundreds of thousands of dollars (or more) in legal and consulting fees, and result in potentially large assessments of unclaimed property, which could have a significant impact on a company's profit and loss.

Potential Defenses to Escheatment

Fortunately, there are several defenses to escheatment that a mortgage servicer (or any other holder) could potentially rely on, at least in certain states. However, one common misconception is that states do not require the escheat of obligations arising from business-to-business (B2B) transactions. Although a handful of states do indeed provide an exemption for B2B property, a majority of states do not, including several major states like California, New York, Delaware, Georgia and New Jersey, and a few states with B2B exemptions (such as Texas) only allow a holder to "defer" the reporting of B2B property until the holder and the owner no longer have an active business relationship. The existing B2B exemptions also vary greatly, and several expressly do not apply to uncashed checks.

Another common misconception is that states exempt "de minimis" property. However, that simply is not the case across the board: currently only four states — Arizona ($50, but must be B2B property), Florida ($10), Idaho ($50) and Michigan ($25) — have enacted such an exemption.

Despite these misconceptions, some generally available defenses to escheatment include the following:

- The property does not represent a "fixed and certain" obligation, or a liquidated interest, owed to the owner.
- The owner has failed to satisfy a condition precedent to receiving the property.
- The holder (e.g., the mortgage servicer) has claims against the owner that can be set off against the unclaimed property.
- The "voluntary payment" doctrine — that is, the owner voluntarily remitted the funds to the holder without a mistake of fact.
- The owner no longer has the contractual ability to recover the funds (though many states have enacted a so-called "anti-limitations" provision, which purports to override statutory and contractual limitations periods).
- Constitutional defenses, including that the escheatment would constitute a takings clause or due process clause violation.

A holder should carefully review its specific facts to determine whether there is any defense available to an escheatment obligation.

Strategies for Mortgage Servicers to Mitigate Risks

Mortgage servicers should first determine which individuals or departments "own" the company's compliance process. That team can effectively conduct an internal compliance self-review in order to gauge current levels of escheat compliance and to identify sources of exposure, which in turn can yield effective risk management strategies. A self-review process may be undertaken independently or in conjunction with the defense of an unclaimed property audit.

An abbreviated list of best practices to effectively manage an audit defense or internal self-review includes:

- Assign a "lead" in-house counsel or project management professional to oversee the self-review and/or audit defense process and allocate ample time and resources to this person.

- Manage internal expectations regarding the duration and work required to conduct the internal self-review and to establish best practices – these projects tend to require several months to a year (or more) to complete, depending on the size and complexity of the organization.

- If under audit, execute an effective confidentiality and nondisclosure agreement with the audit firm – in an age where data privacy and security are highly regulated at both the federal and state levels, and any security incident involving a company's confidential data (including personal/financial data of employees, shareholders and customers) could be catastrophic, it is of paramount importance to manage these risks in a contractually outsourced compliance examination.

- The company should consider a potential VDA strategy in conjunction with its audit defense strategy, which would apply to non-audit states; VDAs offer shortened periods of liability and typically a waiver of interest and penalties.

- Review underlying business practices and transactional models implemented by the company/affiliated group, which may be the source of escheat exposures (e.g., whether and how contingent obligations are recorded, what terms and conditions pertain to transactions and instruments, contractual limitations periods to assert claims to property).

The best compliance functions, in our experience, combine active monitoring of state law changes with reviewing and updating the company's compliance policies and procedures. Although one size will not fit all, the key is that at least some type of compliance function be put into place as soon as practicable given the rapid changes occurring in the unclaimed property legal landscape.

Kendall L. Houghton and Nanci L. Weissgold are partners in the Washington, D.C., office of Alston & Bird LLP. Michael M. Giovannini is a senior associate in the firm's Charlotte, North Carolina, office.