Practical Guidance

Unclaimed Property Issues in Mergers & Acquisitions

A Practical Guidance® Practice Note by
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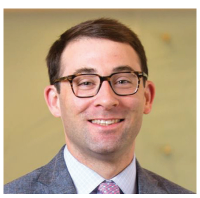

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Unclaimed property issues are often an overlooked aspect of corporate merger and acquisition deals. To the extent that these issues are addressed at all, they are typically lumped in with general tax issues. At worst (and as is often the case), the deal gets done without the buyer considering the unclaimed property implications or otherwise conducting due diligence related to unclaimed property. However, by failing to consider unclaimed property issues, the buyer is setting itself up for potential problems down the road. Unclaimed property problems can be just as significant and costly (if not more so) than other compliance and regulatory issues that are implicated by the corporate deal, including tax issues, which generally command far more time and resources to review and negotiate over the course of the deal.

This practice note discusses:

- Unclaimed Property 101
- B2B Transactions and Loyalty/Promotional Instruments
- Typical Unclaimed Property Issues of a Target Company
- How Do Unclaimed Property Issues Impact a Buyer?
- Protecting Yourself as a Buyer

Unclaimed Property 101

All 50 states plus the District of Columbia, Puerto Rico, and U.S. Virgin Islands have adopted a custodial unclaimed property, or escheat, law. Generally, these laws require "holders" of intangible property to report and remit such property to the state after a designated period of inactivity (typically either three or five years). A "holder" is typically understood to be a business that is obligated to pay or distribute the property to the owner (i.e., the debtor in a debtor-creditor relationship). *See* Delaware v. New York, 507 U.S. 490 (1993); Revised Uniform Unclaimed Property Act [RUUPA], § 102(12); Uniform Unclaimed Property Act of 1995 (1995 Act), § 1(6). However, some states have adopted statutes providing that the holder may also include a person that is in "possession" of unclaimed property belonging to another. *See* Uniform Unclaimed Property Act of 1981 (1981 Act), § 1(8). Common types of unclaimed property include uncashed checks (accounts payable and payroll checks are among the most common, along with benefits checks), accounts receivable credit balances, rebate checks, deposits, money orders, travelers checks, official checks, bank accounts, securities, investment accounts, and gift cards/gift certificates, although many states exempt such instruments under certain conditions.

The state that has the primary jurisdiction to escheat unclaimed property is the state in which the owner's last known address is located, according to the holder's books and records. This is known as the "primary" rule. If the holder does not know the owner's last known address (or if the identity of the owner is unknown), the state of the holder's domicile has jurisdiction to escheat the property. For a corporation, domicile is the state of incorporation. Thus, unclaimed property is the third largest revenue source for Delaware, the most popular state of incorporation for corporate America. This is known as the "secondary" rule. These rules, which constitute federal common law, were adopted by the U.S. Supreme Court in Texas v. New Jersey, 379 U.S. 674 (1965), and have been reaffirmed in two subsequent decisions. See Pennsylvania v. New York, 407 U.S. 206 (1972); Delaware v. New York, 507 U.S. 490 (1993). The U.S. Court of Appeals for the Third Circuit has confirmed that these common law rules are binding in disputes between private holders and states. *See* Marathon Petroleum Corp. v. Secretary of Finance for Delaware, 876 F.3d 481 (3rd Cir. 2017).

States are broadly authorized to audit holders for compliance with unclaimed property laws, and most state laws do not have traditional statutes of limitations or administrative appeal mechanisms. It is typically the case that states will require holders to produce records going back many years, usually longer than standard corporate record retention policies (e.g., 10-plus years). For example, Delaware historically conducted its audits utilizing a look-back period to transaction year 1981 (which was subsequently modified to be 1986, 1991, and then 22 years) and would estimate a secondary liability for all years for which the holder lacked records. This practice has resulted in huge assessments for Delaware-domiciled entities, even if they have little actual Delaware unclaimed property. However, a federal court held in 2016 that Delaware's estimation methodology is unconstitutional due in part to the long look-back period. *See* Temple-Inland, Inc. v. Cook, 192 F. Supp. 3d 527 (D. Del. 2016). Following this decision, Delaware rewrote its Escheats Law effective February 2, 2017, which now provides for a 10-year look-back period for audits as well as a 10-year record retention requirement, among other revisions. However, the new law continues to authorize estimation and preserves the historical methodology.

Further, because unclaimed property is not a tax, the concept of "substantial nexus" found in the state and local tax arena does not apply. To the extent past-due unclaimed property is discovered during an audit, it must be escheated, and the states generally are authorized to impose penalties and/or interest. Many audits are conducted by contingency fee third-party audit firms on behalf of states, which are paid a percentage of the amount of past-due unclaimed property that is uncovered during the audit.

B2B Transactions and Loyalty/Promotional Instruments

There are many common misconceptions associated with unclaimed property laws in the business community, two of which we will discuss here. The first is the idea that states do not require property that is owed by a business to another business to be reported (i.e., a "B2B" transaction). This is not correct under most state statutes, at least as a categorical matter; most states do not expressly recognize an exemption for B2B transactions. On the other hand, approximately 15 states currently do have some type of B2B exemption, though the scope of these exemptions varies (and some may be eliminated with the adoption by states of RUUPA, as will be the case in Illinois effective January 1, 2018). *See* Ethan D. Millar & Michael M. Giovannini, "B2B or Not to Be?," 68 State Tax Notes 279, Apr. 22, 2013. In addition, several B2B exemptions are construed by states as "deferrals," as they require an ongoing business relationship between the holder and the owner.

Another general misconception is the idea that loyalty or promotional instruments are universally exempt from escheatment. This also is not necessarily the case, and the analysis can be highly fact dependent. One example is in the context of prepaid incentive and promotional/loyalty cards that are distributed to consumers for no direct monetary consideration. If the issuer of the cards has been paid money by the business customer (which subsequently distributes the cards to its customers/employees), states will generally consider the cards to have been "issued for consideration" irrespective of whether the ultimate consumer pays anything for the cards, because the issuer has received payment from the business. That said, an increasing number of states—including those that have adopted RUUPA—have enacted express exemptions for "loyalty cards," which are generally defined as cards for which the consumer pays no money that can be redeemed for goods or services and cannot be monetized.

States that do not have an explicit exemption will analyze such cards under the laws generally applicable to gift cards or stored value cards. Most states' laws explicitly address gift certificates, gift cards, and similar property, as do the 1981 Act and 1995 Act. 1981 Act, § 14 ; 1995 Act, § 2(a)(7). A majority of states depart from the Uniform Acts and provide that such instruments are exempt from escheat, though many exemptions are premised on the instrument not imposing an expiration date or any post-sale fees. Some states explicitly require the escheat of gift certificates and similar instruments, including Delaware (though loyalty cards are exempt), Georgia, New Jersey (loyalty cards are exempt), and New York. In RUUPA, which 12 states have currently adopted in some form, the treatment of "gift cards" as exempt or escheatable is at the option of the adopting state (though "stored-value cards" are escheatable). A majority of states that have adopted RUUPA have opted to exempt gift cards, with the exceptions being Colorado and D.C.

Typical Unclaimed Property Issues of a Target Company

A target company in a corporate deal could have a perfect record of unclaimed property compliance – it could have a long history of filing reports with its state of incorporation and other states, and it could have robust policies and procedures and strong internal controls in place to ensure that all potential unclaimed property is dealt with in accordance with state requirements. In our experience, however, that is rarely the case. Further, given the above traps for the unwary and other complexities inherent in unclaimed property law, the likelier scenario is that the target has at least some unclaimed property exposure that may or may not rise to a level of materiality, depending on the size of the deal. Most typically, a target company may have one or more of the following issues:

- The target has never filed unclaimed property reports, or has filed such reports only recently/sporadically.
- The target only files reports in a handful of states or possibly just in its state of incorporation.
- The target universally treats property relating to B2B transactions as exempt in all states or writes off such balances pursuant to contractual terms or industry practice. In this regard, it is worth noting that states often take the position that they do not have to respect such contractual terms or industry practices in connection with the administration of their unclaimed property laws based on so-called "anti-limitations" provisions, which provide that the expiration of a contractual period of limitation on the owner's right to claim property does not prevent the property from being presumed abandoned. Not all states have adopted such provisions. However, even in the absence of such a provision, a state may seek to ignore a contractual limitations period based on a common law doctrine prohibiting "private escheats."
- The target issues gift certificates/gift cards and is incorporated in a state (like Delaware, Georgia, New Jersey, or New York) that escheats such items regardless of whether they impose an expiration date/dormancy fees.
- The target routinely writes off small accounts receivable credit balances and takes such amounts into income.
- The target voids checks representing amounts that are otherwise owed to the customer/vendor/employee after 90 or 120 days and does not reissue them unless the payee comes forward to claim the amount (or perhaps does not reissue them at all).
- The target is currently under audit by one or more states, or has received notice of such an audit.
- The target has complicated accounting practices that give the appearance of unclaimed property.
- The target is currently participating in one or more state voluntary disclosure agreement programs, pursuant to which the target will be required to conduct a self-review of its own records to determine whether it has any past-due property owed to the state(s).

How Do Unclaimed Property Issues Impact a Buyer?

Depending on how the particular deal is structured, the buyer could be liable for (i.e., assume) all of the target's unclaimed property liability, regardless of whether such liability is known at the time of the acquisition or arises at some point in the future (based on pre-existing transactions or activity). For example, in a stock deal, all historic and future unclaimed property liability of the target would generally be assumed by the buyer, unless some provision of the purchase agreement expressly carved out such liability. In an asset deal, the answer is usually less clear, and it depends in large part on the terms of the purchase agreement. It is possible that the seller retains the liability or otherwise provides for indemnification for the liability (deliberately or by accident), but it is also possible that some or all of the liability has been assumed by the buyer. Like other aspects of a corporate transaction, the devil is in the details.

The following provisions of the purchase agreement may be instructive and should be reviewed carefully in connection with any merger or acquisition:

- **Definition of "taxes."** To the extent acquisition documents speak to unclaimed property liability, the agreements often lump "unclaimed property" into the definition of taxes, such that unclaimed property liabilities would theoretically be treated similarly to tax liabilities as far as indemnification and reps and warranties are concerned.
- **Concept of "excluded liabilities."** To the extent that the buyer is not assuming any liabilities related to the operation of the business prior to the effective date of the agreement, the buyer could be effectively carving out historical unclaimed property obligations of the target. On the other hand, these terms are typically not defined specifically enough to expressly include or exclude unclaimed property liabilities. Thus, it may be a matter of interpretation. For example, if a buyer is assuming outstanding accounts receivable, but the agreement does not spell out whether accounts receivable credit balances are included, it would be unclear whether the unclaimed property liability related to such credit balances was assumed.
- **Breach.** To the extent the seller represents that it is compliance with applicable law, it is not often contemplated that such rep would include compliance with state unclaimed property laws – again, since such laws are often viewed similar to taxes. Nevertheless, when reviewing or drafting such provisions, it is important to consider compliance with state unclaimed property laws.
- **Indemnification.** Even if the buyer is assuming some or all of the target's unclaimed property liabilities, it may be the case that the buyer would have recourse against the seller in the event the buyer is assessed by a state. But, unclaimed property liabilities often remain unknown for a long period of time, lying dormant until the company is audited by a state. Then, the audit must progress over its life cycle, which can be 3 or more years. Thus, where there is a material concern with unclaimed property exposure, it is important to anticipate that and negotiate accordingly. It is also worth considering establishing an additional amount in escrow, which can be claimed after the deal is agreed to in principle when/if the unclaimed property liability is quantified.

Protecting Yourself as a Buyer

First and foremost, buyers should ensure that unclaimed property subject matter experts are involved in a deal from its inception (not at the last minute). The unclaimed property team should include not only outside counsel or consultants, but also the buyer's internal unclaimed property compliance team. In this regard, buyers should implement a due diligence process that expressly seeks information regarding unclaimed property. In particular, a buyer should draft a set of detailed due diligence requests aimed at determining the potential exposure related to unclaimed property. Buyer's counsel should insist that these requests are treated seriously by the seller/target, and that the buyer has an opportunity to discuss the responses and follow up as necessary.

The following is a basic due diligence checklist of questions that a buyer could issue regarding the target (i.e., the "Company"):

- Does the Company currently file any unclaimed property reports?
- Has the Company historically filed any unclaimed property reports?
- With which states are reports filed?
- Has the Company been audited for unclaimed property compliance or entered into voluntary disclosure agreements or similar arrangements to resolve its unclaimed property liability with any state(s) for any prior year(s)?
- Does the Company have any current reserves for unclaimed property issues?
- Does the Company have any unclaimed property policies and procedures?
- What is the Company's policy for voiding checks?
- Are stale dated checks written off to an income or expense account (e.g., bad debt, miscellaneous income, etc.)? If not, what happens to these amounts?
- What is the Company's policy regarding customer overpayments/credit balances?
- Are there any customer credits on the Company's books that have been outstanding for greater than 3 years?
- Has the Company ever retained outside consultants to review its unclaimed property compliance or identify

and quantify potential unclaimed property exposure, or has the Company ever undertaken an internal review of unclaimed property compliance or potential unclaimed property exposure?

- Please confirm that no type of property that could be considered unclaimed has been taken into income by the Company or any affiliated entities.
- What is the availability of records identifying last-known address for potentially escheatable property? What years are available?

In sum, it is critical for buyers in a corporate deal to be savvy regarding potential unclaimed property issues, which virtually every company will have to some extent. A buyer should use the due diligence process as a way to identify and address these issues before they become the buyer's problem down the road.

Related Content

For more information on due diligence in M&A transactions, see the following Practice Notes:

- Due Diligence Basics in M&A Deals
- Due Diligence Review Tools in M&A Deals

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Matthew P. Hedstrom is a partner and leads the firm's State & Local Tax Practice. He focuses his practice on state and local tax planning and controversy and addresses clients' multistate tax issues, including state income tax apportionment, tax base, business/nonbusiness income determinations, telecommunications and sales/use tax nexus, sourcing and taxability issues and unclaimed property matters. Matthew also advises clients on the state and local tax implications of restructuring, mergers, acquisitions and dispositions, including multistate compliance, voluntary disclosure, planning, audit defense and legal opinions. He also has tax controversy experience at the audit, administrative and appeals level in several jurisdictions.

Matthew has been published on a wide variety of state tax topics in different journals, including *State Tax Notes* and *Journal of Multistate Taxation and Incentives*. He regularly speaks on state and local tax matters and has spoken at events hosted by Council On State Taxation (COST), the Tax Executives Institute (TEI), New York University's Summer Institute in State and Local Taxation and Bloomberg BNA, and the Unclaimed Property Professionals Organization. Matthew is also the editor of the State and Local Tax Edition of the American Bar Association's *Tax Lawyer*.

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Michael Giovannini is a partner with Alston & Bird's Unclaimed Property and State & Local Tax Teams. As a member of the Unclaimed Property Team, Michael concentrates on providing comprehensive advice and guidance to clients regarding multistate unclaimed property planning issues, representing clients in unclaimed property audits and state voluntary disclosure agreements, and other compliance initiatives. Michael's practice includes extensive experience with gift card laws and the structuring of gift card programs, consumer protection, and other areas of regulation. He has represented regional and national banks and financial services companies, including broker-dealers and mutual funds, health care companies, and private investment firms. Michael also advises clients on the unclaimed property implications associated with cryptocurrency and other emerging technologies.

Michael counsels on complex sales, use and corporate income tax issues, and providing practical planning services for various state and local tax issues, with emphasis on sales and use tax issues associated with online sales, cloud computing, and digital goods. He has representative experience advising clients on apportionment, nexus, and unitary business principles, as well as in disputes with state revenue departments at both the administrative and judicial levels, and in multistate voluntary disclosure agreement initiatives.

He is a regular contributor to the Alston & Bird Tax Blog and various national publications. He frequently speaks at local, regional, and national tax and unclaimed property conferences.