

The State of Unclaimed Property

Duff & Phelps in coordination with the Financial Executive Research Foundation¹ conducted a survey of financial officers across a broad range of industries on a series of unclaimed property issues. The survey provided valuable insight from those companies that were subject to past unclaimed property audits or participated in Voluntary Disclosure Agreements (“VDAs”) offered by the states. The survey also gauged the willingness of companies to participate in the State of Delaware’s new VDA which became effective in July, 2012.

Executive Summary

Duff & Phelps conducted a survey of financial executives in conjunction with the Financial Executives Research Foundation on a series of unclaimed property issues. Over 100 companies from a cross-section of industries responded to the survey. Key observations from the survey results were:

- Larger companies were audited more frequently than smaller sized companies, resulting in assessments that were \$1 million or greater.
- Public companies do not have a higher percentage of state initiated audits than private companies
- Not surprisingly, the majority of companies previously audited were incorporated in Delaware
- The single most frequent response why the majority of companies have not participated in a prior VDA is that they believed they were fully compliant with the unclaimed property reporting requirements.
- Almost 100% of companies that believe they are compliant were unaware of the states VDA initiatives, and in particular the new Delaware VDA Program
- Companies that have been audited are those most aware of the new Delaware VDA Program
- A large majority of companies that are aware of the new VDA program in Delaware do not anticipate participating in the program.
- General unfamiliarity still remains regarding unclaimed property provisions, as companies are not entirely familiar with unclaimed property reporting rules (Nexus provisions do not apply)
- A significant number of companies in Delaware believe they are in compliance with reporting rules, which contradicts evidence presented by public sources that less than 5% of companies are reporting;
- A large percentage of surveyed companies have not participated in a VDA program and have not been selected for audit. Of the companies selected for audit, 100 percent resulted in liability, with 65 percent resulting in a liability in excess of \$100,000.

1. The Financial Executive Research Foundation (FERF) is the non-profit 501(c) (3) research affiliate of Financial Executives International (FEI). FERG researchers identify key financial issues and develop impartial, timely research reports for FEI members and non-member alike. Financial Executives International is the leading advocate for the views of corporate financial management. Its 15,000 members hold policy-making positions as chief financial officers, treasurers and controllers at companies from every major industry.

Overview of Unclaimed Property

While the laws regarding unclaimed property date back to feudal times, “modern” unclaimed property provisions have been part of all state statutes for decades. Compliance with these laws has been increasing steadily over the years, in part because of several factors including:

1. Increased multi-state audit activities by the states who have engaged contingent fee firms to audit on their behalf. These audits can extend as far back as 20-30 years and often involve estimation of liability for years in which accounting records no longer exist to evidence compliance²
2. Awareness of large audit settlements through the media and national press has led many to enter into voluntary disclosure of outstanding liabilities.
3. Financial statement risk whereby failure to report and remit unclaimed property may result in a material misstatement under FAS 5 and/or be a reflection of poor internal controls subject to increased attention by external auditors in a post Sarbanes-Oxley environment.

Although not a tax, from a revenue generation perspective unclaimed property collections provide a rare opportunity for states to increase revenues while at the same time stabilizing taxes on either consumers or businesses. Many states use unclaimed property collections to offset budget shortfalls. Some specifically earmark unclaimed property collections to directly offset state pension and education revenue deficits. Collections of unclaimed property generate considerable revenue for the states to hold in custody until claimed by the true owner as evidenced from the following:

- \$38 billion is currently safeguarded by state treasurers and other agencies on behalf of over 120 million accounts³
- Delaware, among the most aggressive states, collected \$375 million from unclaimed property and is budgeted to collect over \$500 million in 2013.⁴

Despite the large amounts collected, the actual returns to property owners historically are less than 2 percent. Delaware returned just \$18 million or 4.8 percent of its collected funds.⁵

What is Unclaimed Property?

Unclaimed property can result from both tangible and intangible property. The current unclaimed property laws impacting most US businesses relate primarily to intangible property. The types of unclaimed property subject to reporting by the states has expanded over the years, and with new business practices such as internet sales, gift cards, rewards and consumer daily deal programs it is likely to continue into the future. Common reportable unclaimed property currently includes:

- Unclaimed wages and vendor checks
- Uncashed dividend or interest checks
- Unredeemed rebates and unused gift cards/certificates
- Unlocated owners of stocks and bonds
- Unredeemed vendor credits
- Credit balances on accounts receivable
- Unclaimed deposits or lay-aways
- Third party payments in the form of employee benefit or payroll plans

Current Environment

Unclaimed property collections have become big business for the states. One merely has to look to the increased use of contract auditors by the states to gauge the focus placed on unclaimed property collections. Less than 15 years ago few states engaged such firms, while today virtually all states engage contract auditors to enforce perceived under reporting. These contract auditors typically perform the audits on behalf of multiple jurisdictions, often up to 40+ states, and derive a fee based on or in some manner tied to the results they achieve.⁶ Any corporate holder, who has been the unfortunate recipient in rapid succession of unclaimed property notices by multiple states, can attest to the surprise and then the unanticipated resources that are required to address the auditor's requests. These audits typically extend for long periods of time (see survey results beginning on page 3) and tie up internal personnel from multiple functional areas within a business including treasury, accounts payable, accounts receivable, payroll, shareholder services and tax to name a few. It is not unusual for the cost of both the internal resources and external advisors/consultants to range in the hundreds of thousands of dollars or more to conclude an unclaimed property audit.

2. Most state unclaimed property laws do not include any statutes of limitations. Delaware audits as standard practice extend to 1981 and interest and penalties can equal or exceed the amount of the actual liability.
 3. See NAUPA website: www.naupa.org
 4. Delaware Fiscal Notebook 2012, 2013 editions
 5. Many states use unclaimed property to supplement their general revenue collections. Some states apply unclaimed property collections to fund specific activities, (e.g.) Illinois uses unclaimed property collections to fund its government pension liability, while North Carolina uses unclaimed property collections to fund college tuition programs.
 6. Kelmar Associates, LLC, for example has over 250 professionals and serves as auditor for numerous states including Massachusetts, Michigan, New Hampshire and Tennessee. Most notable, they serve as the primary auditor for the State of Delaware. Other specialty audit firms include Verus Financial LLC which conducts audits on behalf of 20+ states focused on the insurance industry, and ACS Unclaimed Property Clearinghouse (UPCH), which is now a subsidiary of Xerox Corporation and audits on behalf of approximately 40 states.

Survey of Financial Executives

The survey of senior financial executives included responses from over 100 companies from a cross section of industries including:

- Banking/Financial Services,
- Consulting/Employment Services,
- Distribution,
- Insurance,
- Manufacturing,
- Technology,
- Wholesale and
- Other.

Of the companies involved, 31 percent had revenues in excess of \$1 billion and 17 percent had revenues between \$500 million and \$1 billion annually. Approximately 41 percent of the respondent companies were publicly traded and nearly 52 percent of respondents were incorporated in the State of Delaware.

Based on the responses from businesses that have been audited, over 35 percent responded that the audit extended for periods ranging between 2 and 5 plus years and 34.5 percent responded that the audits were still in progress.

States are actively pursuing select industries and companies that are perceived to not be in compliance or “under” reporting unclaimed property on a regular basis.⁷

The survey revealed that of the companies subject to audit, over 75 percent of the audits were conducted by third party audit firms.

Examples of select industries subjected to scrutiny by contingent fee auditors working on behalf of the states include the insurance industry⁸ as well as consumer product companies that issue rebates for goods/services purchased.⁹

Chart 1: Industry Results

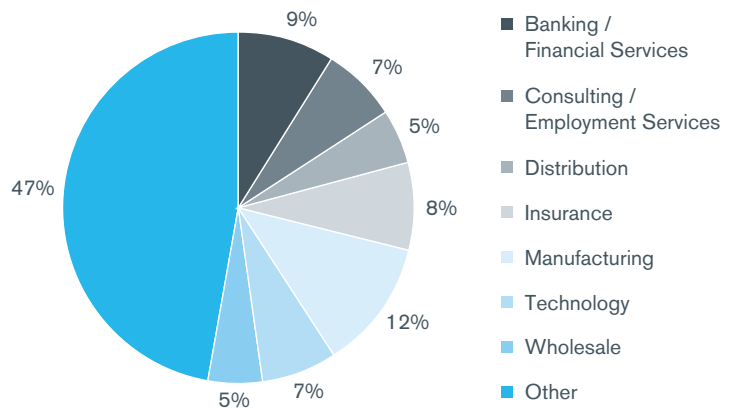


Chart 2: Survey Respondents Annual Revenue

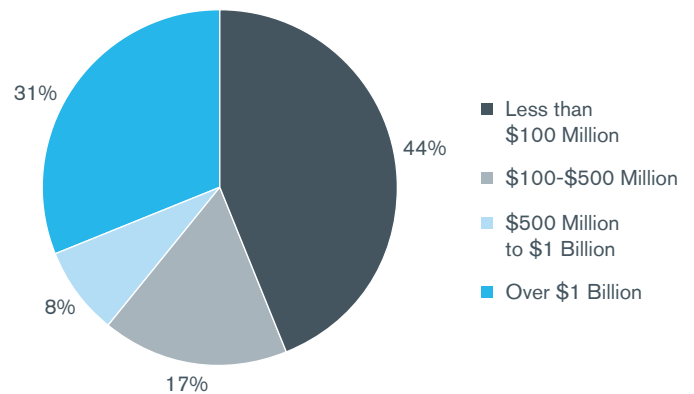


Chart 3: Duration of the Audit Results

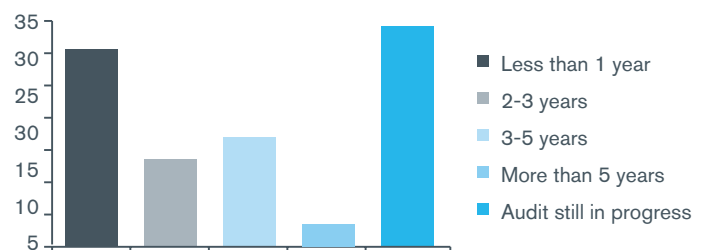
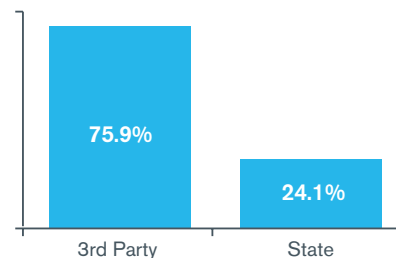


Chart 4: Auditor Results



7. See e.g., “Delaware’s General Fund Revenue Portfolio A report submitted in fulfillment of Senate Joint Resolution N. 5, 144th General Assembly, “Dept. of Finance, Office of Management and Budget, Controller General Office, 66 (February, 2008).

8. See article “Multistate unclaimed property enforcement actions against life insurance companies “by R. Denvin, A. Lindquist, C.J. Moll III, T. Van Dongen, B.R. Marsh, J.M. Wong, Association of Corporation Counsel, Lexology, April 12, 2013

9. See article “Consumer Rebates: New Ruling May Expand Manufacturers’ and Retailers’ Unclaimed Property” by Robert Peters, Journal of Multi-State Taxation (April, 2009). See also Fitzgerald v. Young Am. Corp. No. CV 6030 (Iowa Dist. Ct. for Plk Cnty, Jan, 09, 2009)

Many of the state audit techniques have drawn close scrutiny from corporate lobby and special interest groups. Most notable are the questionable practices by Delaware which currently serves as legal home to over 800,000 businesses. Delaware, like many states, initially enacted its unclaimed property laws as a consumer protection mechanism to reunite Delaware residents with dormant bank account balances, uncashed paychecks and other unclaimed property. Due to the nature of how the unclaimed property laws are administered, the state's enforcement efforts over the past decade have expanded far beyond the mere collection of unclaimed payroll and vendor checks paid to Delaware residents. In fact, based on statements directly attributable to the state's unclaimed property administrator, it is believed that less than 5 percent of the 800,000 companies incorporated in Delaware are compliant with the state's unclaimed property provisions.

Jurisdiction over Unclaimed Property Collections

Delaware's right to the collection of unclaimed property from all entities incorporated or organized in the state is based on a trilogy of decisions issued by the US Supreme Court stemming back to 1965. Under these series of decisions, the Supreme Court established a set of priority rules setting forth which state has jurisdiction over collection of unclaimed property. Under the 1st or primary priority right, the Court granted the state in which the last known address of the owner of the property is resident as having jurisdiction over the unclaimed property. However, if the address of the property owner is not known, or it has been determined records do not exist to adequately research potential items of unclaimed property, then under the 2nd priority rule, the state in which the "holder" or obligor maintains their corporate domicile, is deemed to have jurisdiction over the property.¹⁰ It is this provision that has enabled Delaware, among the smallest states in the country, to collect vast sums of money from unsuspecting corporate entities through the use of estimation techniques.¹¹ Many corporate holders and holder advocate groups have asserted that Delaware has abused its authority under these rules in its overly aggressive pursuit of unclaimed property from entities incorporated in the state.

One such group, Council on State Taxation ("COST"), which is a non-profit trade association representing over 600 corporations engaged in interstate and international business, has been among the most vocal advocates against Delaware's audit practices. COST has claimed that "Delaware issues unrealistic, grossly inflated assessments, including interest and penalties, and then bullies the corporate holder of the property until the holder settles for a somewhat egregious amount."¹²

Our survey results appear to confirm this assertion. Of the companies that were audited, and incorporated in Delaware, over 31% had a settlement which resulted in a liability in excess of \$1 million.¹³

Voluntary Compliance Programs

In part due to complaints similar to those espoused by COST, as well as in an effort to accelerate collections of unclaimed property, many states have initiated Voluntary Compliance Programs or VDAs. These include formal programs which provide holders with the opportunity to come forward voluntarily and self-assess any amounts of unclaimed property due for prior years in exchange for abatement of interest and penalties and a reduced "look-back" period in which a liability can be assessed. Oftentimes, these programs include a sunset date, after which a corporation that does not come forward voluntarily and is subsequently audited is put on notice that interest and potential penalties will be assessed. Other voluntary compliance or disclosure programs are open ended which enable companies to come forward voluntarily without a sunset date.¹⁴

The success of such programs is debatable. For example, in 2011 the State of Michigan announced a VDA program intended to enroll holders which have not historically reported and remitted unclaimed property to the State. In exchange for abatement of interest and penalties companies that were not in compliance with Michigan's unclaimed property were granted, "one final opportunity to comply with reporting requirements."¹⁵ Among the few conditions were that the applicants not be under audit and complete the submission by July 1, 2012 in order to avert interest and penalties. Thousands of companies expressed interest and submitted intent to comply with Michigan's program. Despite considerable media, the actual number of participants and funds collected fell short of expectations.¹⁶ Based on an unnamed source at the Michigan Dept of Treasury, of the 17,000+ applicants less than 2,000 reported an amount in excess of zero and the aggregate amount collected was less than \$16 million.

Corporate holders that attempted to voluntarily comply with Delaware's unclaimed property provisions and avert audit scrutiny have historically met with mixed results. Two examples stand out, CA, Inc. and Staples. In both instances the holders did not fare well in their intention to resolve past liabilities expediently with a minimum amount of controversy. CA, Inc. voluntarily entered into Delaware's VDA program that was in existence at the time, and in conjunction with its advisors initially self-determined its liability at \$700,000. After several years of back and forth with the state CA, Inc. re-computed its liability to be \$2.3 million. Delaware disagreed, initiated an audit and after over five years of further controversy ultimately through litigation the two parties resolved their differences settling at \$17.6 million.¹⁷

10. The principal cases include *Texas v. New Jersey*, 379 U.S. 674 (1965), *Delaware v. New York*, 507 U.S. 490 (1993) and *Pennsylvania vs. New York*, 407 U.S. 223 (1972).

11. Based on legislation passed by Delaware in 1995 and confirmed in 2012, Delaware's unclaimed property administrators and its auditors may use "reasonable" estimation techniques to determine liabilities for which adequate books and records no longer are available.

12. "Once a Friendly Locale to Business, The Modern State of Delaware is a Bully" *Forbes.com*, May 19, 2013, Doug Lindholm, President & Executive Director of COST.

13. It should be noted that respondents were not asked to indicate the actual amount of the audit settlement, merely to indicate the range of settlement, \$1 million and greater being the largest range of responses.

14. Examples include Texas and Florida, although both states only allow a holder to come forward once on a voluntary basis and in the case of Florida, holders are prevented from participating in its Voluntary Disclosure Program ("VDA") if they have a history of past reporting. Virtually all states offering VDA programs prevent holders from participating if they are under audit.

15. See notice mailed to thousands of potential holders at <http://www.michamber.com/files/michamber.com/Treasury%20Unclaimed%20Property%20Notice.pdf>

16. 17,164 filings of forms seeking to participate in the 2012 Michigan VDA program. Of those seeking to participate, 15,253 filed "zero" reports or filed no response. There were 1,863 holders who remitted payments.

The payments remitted under the VDA program totaled approximately \$15.9 million.

17. *CA, Inc. v. Pfeiffer*, See generally, Case Nos. 4111-CC (Del. Ch. Feb 12, 2010)

In a similar unfortunate turn of events, Staples voluntarily entered into Delaware's VDA program in 2000. It initially self-determined its liability to be \$239,000. Five years later Delaware engaged Kelmar, its third party contingent firm, to audit Staples results and based on the use of extrapolation techniques a settlement was reached for \$8.9 million.¹⁸

Delaware's New VDA Program

In order to partially quell the unrest of corporations threatening to reincorporate in jurisdictions outside of the state, in June, 2012 Delaware initiated a new VDA program, professing to be more fair, efficient and collaborative than past initiatives.¹⁹ The new program is administered by the Secretary of State's office versus the Department of Finance that is responsible for enforcement activities. Key components of the new program include:

- limited look-back to 1993 versus 1981 under audit (reduction of 12 years) for companies opting in before June 30, 2014,
- waiver of interest and penalties,
- no risk of audit by state, and
- the ability to self-control the process.

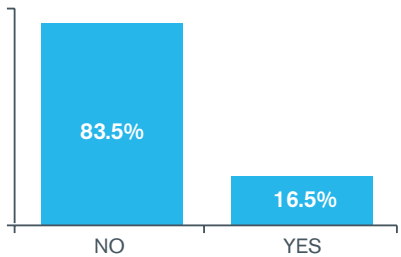
In order to qualify for the liberalized provisions holders are required to:

1. state their intention to participate in the program no later than **June 30, 2014**,
2. not currently be under audit and,
3. complete the final submission and report of past due obligations by **June 30, 2015**.

Initial response to Delaware's new program was tepid. Within six months from the program's introduction, less than 50 companies volunteered to come forward. However, due in part to an aggressive marketing campaign by the Secretary of State's office over 450 companies submitted their intention to participate by June 30, 2013 and it is likely several hundred more will "sign on" before June 30, 2014 (the date the programs sunsets). During the initial months of the program the Department of Finance even agreed to defer initiating any new audits in order to allow time for holders to come forward.

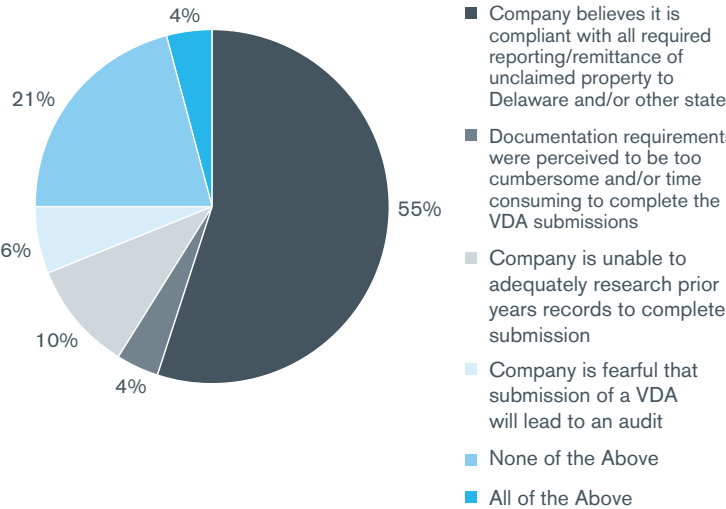
Our survey results confirm the suspicions and also some misperceptions of corporations regarding their unclaimed property obligations. Consistent with the findings of several states, our survey results indicated that less than 17 percent of respondents have participated in a VDA program.

Chart 5: VDA Program Participation Results



The reasons offered for non-participation struck a common theme. The majority of companies not entering into a VDA program stated as the rationale that the Company believed it is compliant with all required reporting/remittance of unclaimed property to Delaware and other States. Refer to the chart below for additional reasons for companies not participating in the VDA programs.

Chart 6: Rationale for No Prior Participation in VDA Programs



18. "Staples Pays \$8.9 M to Settle Dispute with Delaware" Associated Press, September 14, 2012

19. See generally, C.A. No. 5447-VCS (Del. Ch. April 30, 2010)

20. For more information on Delaware's new VDA program see www.delawarevda.com

We specifically surveyed companies about both their awareness of and intent to participate in Delaware's new VDA program. At the time the survey was first introduced less than two-thirds of the respondents were even aware of the new program. And among those that were familiar, an alarming 75 percent indicated they were not likely to participate in the new initiative. The reasons offered were both understandable given the history of others such as Staples and CA, Inc. that voluntarily came forward; and on the other hand a bit problematic reflecting that there may not be a clear understanding of both how the unclaimed property laws are administered and changes under the new program.

The rationale offered for non-participation included:

1. Company is currently under audit or was audited by the state
2. Believed they were compliant with the rules
3. Already completed a VDA
4. Needed to learn more about the program, as many were unfamiliar with the unclaimed property provisions
5. They had no nexus activities in the State of Delaware

This last response has drawn considerable attention by the State of Delaware which as previously indicated under its interpretation of the Supreme Court decisions, believes that virtually all of the 800,000 companies incorporated in Delaware have a reporting obligation. Moreover, that obligation if audited would be applied back 30+ years to 1981, or date of incorporation in the state if later.

The Secretary of State's office in recent months has increased outreach to corporations that are incorporated in the state encouraging them to come forward voluntarily and participate in the new VDA program. They have gone so far as to send a series of letters to over 1,000 public and private corporations organized in the state indicating "reason to believe the Company would benefit from entering the VDA program" and further provides a veiled threat that if the Company does not come forward the Department of Finance is free to initiate an audit that goes back to 1981.

The state through its VDA administrator has also held a series of webcasts sharing the benefits of the program and encouraging companies of all sizes and situations to come forward, even if they believe they were compliant in their past unclaimed property filings with Delaware.

The message appears to be getting through. As of June 30, 2013, over 450 companies have entered into the VDA program.

Recommendations

Perform a full internal assessment of your books and records:

- Consider all legal entities (subsidiaries, merged or acquired entities);
- Determine what property types (other than payroll and accounts payable) have the potential to generate unclaimed property;
- Determine the accuracy of previously submitted unclaimed property reports, if any, including those years in which no or nominal amounts were remitted as unclaimed property;
- Review business practices to determine if liabilities have and/or are written-off or taken back to income (stale date checks; accounts receivable credits; suspense items);
- Perform due diligence to re-unite the owner with the lost property;
- Understand the specific voluntary compliance program rules of the applicable states to which liabilities are owed, and;
- Seek the advice of an outside advocate who is well versed in the unclaimed property practices and has extensive experience in unclaimed property audits and VDA submissions.²¹

21. The following advice was communicated from Delaware Secretary of State's VDA Program administrator to all participants in Delaware's VDA program that did not formally designate an outside consultant, "Finally, and most importantly, third party advocate firms are likely to make the VDA process much more efficient – which is very important in order to meet the statutory deadline contained in the VDA Program's enabling statute. Although a majority of the enrollees have retained third-party advocates to assist them, we have been urging every company that enrolls in the VDA Program without an advocate to at least speak to a third-party advocate firm(s) to see if it makes sense to retain one."

Conclusion

In the current environment states continue to aggressively pursue unclaimed property collections to offset budget shortfalls. Delaware, among the most aggressive of the states, has implemented a program for companies to voluntarily come forward and report their unclaimed property. While there are many benefits of participation, the survey Duff & Phelps conducted in conjunction with the Financial Executive Research Foundation indicated that among those that were familiar with the program 75 percent indicated that they were not likely to participate. While there may be many factors at play driving this result, there are many reasons for companies to reconsider participation. These include a reduced look-back period to 1993, the waiver of interest and penalties, no risk of audit by the state and the ability to self-control the process.

The initial response to Delaware's VDA program was extremely favorable, with over 450 companies initiating their intent to participate before the initial June 30, 2013 date. For those that may still be on the fence, one last opportunity exists to participate by indicating their consent on or before June 30, 2014, and completing the submission on or before June 30, 2015.

Do not let the **June 30, 2014 Sunset Provisions** of the Delaware VDA period expire without careful consideration being given to the benefits of participating vs. costs of inaction.

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