

## ESCHEAT OR ELSE

As consumers and businesses grapple with both a floundering economy and the prognosis for an extended recession, state budgets are proving anything but immune to the global economic crisis. A report in June by the national associations of governors and state budget offices suggests that after several years of relative prosperity, state budgets are now coming under extreme pressure. *The Wall Street Journal* reported in June that state governments, most of which are required by law to balance their budgets, are cutting spending on programs and eliminating jobs to confront widening budget gaps and shortfalls. Moreover, as consumer confidence and spending drops, state tax revenues are plummeting.

With these challenges at hand, many states are in the process of exploring ways to increase revenue. One option that is growing in popularity is the act of collecting lost or dormant accounts held by financial institutions and companies operating within state jurisdictions across a range of industry sectors.

When an account – which could be a security, mutual fund holding or simply a basic savings or checking account – goes dormant for an extended period of time, the holder of that account is required by law to attempt to locate its owners, or a descendant should the owner have passed away. If the account holder cannot find said owner in a prescribed period of time, those funds must be escheated, or forfeited, to the state. When this occurs, the state may use the funds in anyway its government sees fit until the assets are claimed. Escheated funds are a valuable source of revenue for a state because research indicates that owners often fail to claim a large percentage of these funds. Simply said, unclaimed accounts are like interest free loans that may never come due.

To offer some monetary perspective: In 2006, the National Association of Unclaimed Property Administrators (NAUPA) reported that state treasuries and other agencies were collectively holding some \$32.7 billion in unclaimed property. In Delaware, a tax friendly environment and thus the legal home to many of the country's largest corporations, unclaimed property has become that state's third largest source of revenue, generating \$365 million at end of the state's most recent fiscal year. California's unclaimed property collection program has added as much as \$300 million in a single year to that state's general fund.

Each state has its own laws and regulations regarding the management and reporting of lost accounts. Dormancy periods – the amount of time before a holding company is

required to escheat – also varies widely. Faced with yawning budget gaps, many states have begun to reduce dormancy periods and apply more reporting pressure on companies. State governments are becoming more insistent that companies comply with stricter state guidelines for reporting unclaimed accounts, all in an effort to increase escheatment of lost funds and grow state coffers.

Perhaps no state has been more aggressive and controversial in pursuing escheatable property than California. The state Controller's penchant for claiming property has inspired a public relations backlash and lawsuits from property owners claiming they were never appropriately notified.

As a result of one 2007 lawsuit, the state was instructed by the courts to establish a new regulatory framework to alleviate concerns among property holders and ensure that proper steps had been taken to unite these owners with their property before escheatment. Unfortunately for the California business community, the new framework developed by the state essentially places all the burdens for reporting and locating property owners on businesses, requiring the creation and management of multiple reports. New legislation has since been introduced – but not yet passed – in an effort to ease the administrative headache, but as it stands today, California businesses are forced to allocate significant time and resources to managing lost property so as to be in compliance with state law.

While California may be an example, it is no means the exception and companies around the country are struggling to cope with tighter escheatment standards. Corporations and the executives responsible for accounting, reporting and compliance are now handed an additional headache at a time when there are no shortage of challenges. Instead of focusing exclusively on their respective core businesses and generating shareholder value - something of particular importance during these tumultuous times - executives are distracted by new and sometimes arduous state requirements pertaining to lost accounts. In addition to having to account for and report on these assets, the actual process of escheatment when the dormancy period expires is an administrative bear in its own right.

Those who do not yield to the states and comply with tighter standards may face financial punitive action and damage to their corporate reputation. For example, interest charges on past-due unclaimed property liabilities can range from 10- to 25-percent of the value of the asset, with up to an additional 50-percent assessment in penalties for non-compliance. In cases where companies are in violation of state law regarding unclaimed property, some state governments are pursuing prosecution of the individuals charged with the responsibility for ensuring compliance. A handful of states have even

introduced “whistleblower” statutes to not only protect but also reward – with cash – employees who disclose their company’s unclaimed property liability or non-compliance.

Among publicly traded companies, there are even greater implications for non-compliance. Section 404 of the Sarbanes-Oxley Act of 2002 requires that specific internal controls and compliance with various laws and regulations be met. Failure to comply with unclaimed property statutes could subject a listed company to additional penalties for failure to perform the duties required under the Act.

In an effort to curb non-compliance and increase revenue, state governments have begun targeting and auditing businesses within their jurisdictions. Penalties for noncompliance can be particularly significant if the government audits a business and finds that unclaimed property laws have been ignored. While the penalties are usually relatively light for first-time offenders, the length of the audit look-back period can be very long – as many as fifteen years or more. The further back an audit goes, the greater the likelihood that records will be incomplete, unsupported or missing altogether. In such a circumstance, an auditor may approximate what the unclaimed property liability could have been and assess an amount owed on that basis. In particularly egregious situations, interest and penalties have been extraordinarily large.

A number of companies have learned hard lessons from past mistakes. In 2005, a subsidiary of Old Republic Title Company failed to let \$9.5 million of unclaimed escrow funds escheat to California, as required under state law. The failure to escheat was one of a number of charges against the subsidiary in a case that resulted in paying over \$33 million to the city and county of San Francisco in January after lengthy civil and private class-action legal battles.

Traditionally, financial institutions such as banks, transfer agents and mutual fund companies have needed to be most concerned with unclaimed property laws and compliance. After all, it’s these organizations that typically hold the types of accounts that are either forgotten about by the owner or not known about by family members when the account owner dies. As part of their clamp down, states are now looking outside the financial services sector in an attempt to collect anything and everything not rightfully owned by the asset holder. This could include unclaimed insurance payouts, overpayments to hospitals, utilities, car rental companies or even unused funds from expired gift cards. As a result, unclaimed property compliance is no longer solely the problem of the banks. Indeed, companies that never thought twice about their unclaimed assets and may not even know what the term ‘escheatment’ means are scrambling to achieve compliance.

So what is a company with unclaimed assets to do? The first step is recognizing that you do have unclaimed assets that could someday become escheatable and ensuring that there is an understanding within your organization of the relevant laws and regulations – a task made difficult by the fact that such regulations are changing as states become wise to the revenue opportunities associated with unclaimed property. Ignorance of these laws will not spare you from audits or potential punitive action.

The second prudent step would be to conduct an internal audit of all accounts to determine which ones could be classified as dormant and therefore may be targets for escheatment. Though the task of sifting through records and accounts can be daunting and arduous, it's certainly favorable to do it on your own as opposed to under the watchful eye of a government auditor.

Thirdly, make the appropriate efforts to find the people whose accounts have become dormant. Depending upon the size of your organization and the number of lost accounts, this too can be an administrative chore. Finding the owners of or heirs to lost accounts, however, poses significant challenges. Be mindful that, in addition to being an ethical obligation, it's a legal requirement as well. It's easier to return lost funds to their rightful owner than to continue having to report the accounts and ultimately enter the escheatment process.

Finally, institute a process of ongoing reviews of lost accounts. Make it a part of your standard business operating procedure to ensure that once you are in compliance, you remain in compliance.

And if all of this sounds too time consuming and challenging, perhaps your best option is to outsource the entire process to a company like Equisearch who has the resources, expertise, local regulatory knowledge and systems to help you manage your dormant accounts, locate holders of said accounts and help you stay in the good graces of your state compliance officers.

Economic indicators and experts suggest that we are in for a lengthy and painful recession. Despite the recession, one can always rely on the fact that the government will find a way to get its money. As such, we can expect more and more state governments to follow the lead of California and Delaware and aggressively increase their pursuit of unclaimed property. Awareness and preparation can help you avoid the wrath of a state with a hunger for revenue and an appetite for escheated funds.