Increased attention to equity-related property continues in state audits and enforcement efforts

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During the last few years, holders and holder advocates have experienced a significant increase in state audit activity concerning securities and equity-related property, which includes stocks, bonds, any other equity interest in a business or financial institution, as well as dividends and other payments related to the underlying ownership interest. Much of this increased audit activity has stemmed from contract audit firms working on behalf of Delaware as the lead audit state. As states continue to rely increasingly on unclaimed property as a source of revenue, state audit activity in this area is likely to continue. Holders should take steps to improve their compliance for this type of property to avoid, be prepared to respond to, and minimize any liability arising from an equity audit.

Legal background

State unclaimed property laws have always addressed this equity-related property, even if dormancy triggers and other aspects of the law have changed over time. For example, the 1981 Uniform Unclaimed Property Act, which has been adopted in some form by over two dozen states,[1] provides for the reporting of "stock or other intangible ownership interest in a business association" if a "dividend or other sum payable … has remained unclaimed by the owner for 7

[1] The Uniform Unclaimed Property Acts provide a useful reference for general principles of unclaimed property law but carry no legal authority unless enacted by a particular jurisdiction.

years" and during that seven year period, the owner has not communicated in writing or otherwise regarding the property.[2]

With the 1995 revision of the Uniform Unclaimed Property Act, the dormancy period and trigger applicable to this type of property changed significantly. Under the 1995 Uniform Act, "stock or other equity interest in a business association or financial organization" is presumed abandoned five years after the owner's failure to claim a dividend or other distribution or five years after the date of the second mailing returned as undeliverable.[3] Thus, instead of applying only an owner "inactivity" trigger (*i.e.*, the failure of an owner to communicate regarding or claim the property for a period of time), the 1995 Uniform Act also considers a "lost owner," as evidenced by two occurrences of undeliverable mail, a sufficient dormancy trigger.

State law, however, varies greatly – even for states that have adopted one of the Uniform Acts in some form. Holders should be careful not to generalize regarding the dormancy periods and triggers applied by states. Some states can be fairly characterized as applying an "inactivity" trigger; others a "lost owner," "returned mail," or "RPO" trigger; but some states apply both standards or some other variation.

A few states have begun to recognize and incorporate into their laws that a "lost owner" or "returned mail" dormancy trigger is more appropriate for certain types of equity-related property, particularly those that do not contemplate frequent owner activity, such as investment plans that provide for the automatic reinvestment of dividends, distributions, or other sums payable as the result of the underlying interest. New York, for instance, applies a "returned mail" standard to such automatic reinvestment plans and a "no contact" or "inactivity" standard to other types of securities property.[4]

Because holders or their transfer agents typically retain detailed records, including address information, for owners of equity-related property, states generally claim such property under the United States Supreme Court's "first priority rule," as established by *Texas v. New Jersey*, 379 U.S. 674 (1965) and its progeny. This allows a state to claim only such property addressable to owners in that state. To the extent equity property lacks a sufficient address per the holder's records, the state of the holder's legal domicile (i.e. incorporation) may claim under the "second priority rule."[5] In recent audits of equity-related property, Delaware has also claimed property with addresses outside the United States from holders incorporated in the state.

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2 1981 Uniform Unclaimed Property Act § 10.

3 1995 Uniform Unclaimed Property Act § 2(3).

4 N.Y. ABAND. PROP. LAW § 501(2).

5 *Texas v. New Jersey*, 379 U.S. 674 (1965).

Trends in State Audit Activity

Historically, states have always audited holder compliance for equity-related property. These audits, however, tend to be narrower in scope, with a focus only on uncashed dividend checks, untendered shares, and "lost" shareholders (*i.e.*, those shareholders without a valid mailing address on file, as evidenced by returned mail ("RPO")). Until recently, even audits conducted by contract audit firms, working on behalf of Delaware as the lead jurisdiction, were typically limited to a perfunctory review of the contractual relationship between the issuer and the transfer agent. After confirming the transfer agent's scope of responsibility, the auditors' focus returned to general ledger property.

More recent audits of equity-related property, particularly those conducted by contract audit firms working on behalf of Delaware during the last two years, have been characterized by broad requests for data, close scrutiny of the policies and procedures applied by holders' transfer agents, and strict due diligence standards. Auditors have requested information and records – going back to 1981 – regarding every funding, merger or acquisition, reconciliation, employee stock purchase plan, shareholder, and unclaimed property report filed. Record retention policies and consolidations of transfer agents have made efforts to locate such historical records difficult, if not impossible, for many holders under audit.

Although the data requests have been broad, liability assessments have focused on addressable "first priority" property due to states involved in the audit and non-U.S. property due to the state of incorporation, which is, in many cases, Delaware. During the audits, holders have also had the opportunity to conduct "due diligence," which in this context is an attempt to contact shareholders to reset the dormancy period and avoid escheat of the property. Particularly for foreign shareholders, thorough due diligence efforts can be time-consuming and expensive, but these may be worth the cost to decrease the liability and exposure to the assessment of penalties and interest.

Delaware's recent focus on equity-related property stems at least in part from a 2008 amendment to its unclaimed property statute, which 1) reduced the dormancy period for securities and equity-related property from five years to three years; and 2) eliminated the applicability of a "lost owner" standard to trigger dormancy and applied instead an "inactivity standard."[6] The contract auditors employed by Delaware have focused a significant part of their inquiry on whether holders and transfer agents have updated their procedures to comply with these changes in Delaware law.

[6] 76 Del. Laws 276; 12 *Del. C.* § 1198(9).

How holders can respond

Whether already under audit for equity-related property or anticipating one in the near future, holders can take precautionary steps now to minimize costs and possible exposure.

First, holders should review their transfer agent relationships, including document retention policies as well as the policies and procedures employed by transfer agents to ensure compliance with recent amendments. This includes implementing systems, such as online portals or telephone interfaces, to facilitate shareholder activity within each state's applicable dormancy period.

Second, if the review reveals past due liability, holders might consider taking advantage of various state amnesty or voluntary disclosure agreement ("VDA") programs to achieve compliance with no or reduced interest and penalty assessments. Delaware, for instance, is offering a VDA program with more favorable terms for holders – if holders enter the program by June 30, 2013, for the most favorable terms, or at the latest, by June 30, 2014.[7]

Finally, holders under audit should employ sufficient and appropriate resources to respond and minimize their liability. This includes ensuring that data requests are reasonable and not overly broad, that all factual and legal arguments are raised to reduce liability, and that appropriate due diligence is conducted to contact owners and avoid escheat of the property. After an audit, holders should review and implement compliance procedures that minimize future audit risk.

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State audits of equity-related property have increased in scope and tactics during the last two years, and they are likely to continue in this manner. Holders, however, can and should take steps to minimize their exposure and improve compliance for securities and equity-related property.

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[7] *See* 12 *Del. C.* § 1177.