Professional Perspective

# Managing Unclaimed Property Risks in Bankruptcy

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The extended shuttering of business operations due to the Covid-19 pandemic is expected to contribute to a sharp increase in corporate bankruptcy cases in 2021. As beleaguered companies seek to reorganize or sell themselves through the Chapter 11 bankruptcy process, prospective acquirers of bankrupt entities should understand the impact that a target's bankruptcy history can have on its unclaimed property profile, which may affect its desirability as a target. Many prospective acquirers believe that if a target has filed for bankruptcy in the past, its historical unclaimed property liabilities have been discharged through the bankruptcy process. However, that is not always the case.

Compounding that concern, companies involved in significant merger and acquisition transactions and high-profile bankruptcy cases are frequently in the news and may make attractive unclaimed property audit targets for states facing declining revenues and budget shortfalls as the result of the pandemic. Therefore, it is critical for acquirers to understand how a bankruptcy filing can impact a target's potential unclaimed property reporting responsibilities, and to dispel the myth that once a company files for bankruptcy, no potential unclaimed property liability remains.

This article discusses the bankruptcy discharge process and how prospective acquirors of bankrupt companies can identify and potentially avoid liability for legacy unclaimed property liabilities that may remain following confirmation of a plan of reorganization.

## Unclaimed Property 101

Unclaimed property is generally defined as any tangible or intangible property that is held, issued, or owed by a company, known as the "holder," in the course of its business that has remained unclaimed by the owner of the property for a specific period of time (the dormancy period). All U.S. states, several U.S. territories, and certain Canadian provinces have established unclaimed property reporting requirements that allow the state to take custody of dormant property.

Typical examples include accounts receivable net credit balances, unused gift cards and stored value cards, and uncashed payroll, vendor, and dividend checks. In addition, a company's unclaimed property liability is not limited to amounts reflected on its current books and records, but may include items incorrectly taken into income—e.g., uncashed checks or small dollar credit balances.

Once the dormancy period has passed without the company receiving any contact from the owner, the company may have an obligation to report the property to the appropriate jurisdiction as established by the priority rules laid down in a series of U.S. Supreme Court cases. The first priority rule provides that unclaimed property should be reported to the state of the owner's last known address, as shown on the holder's books and records. If the apparent owner's address is unknown, the last known address is in a foreign country, or if the last known address is in a state that does not provide for escheat of the type of property in question, the second priority rule provides that the property should be reported to the holder's state of domicile—typically the state of incorporation or formation.

## Unclaimed Property Audits on the Rise

Enforcement activity by the states to ensure a holder's compliance with its unclaimed property reporting responsibilities has long been a part of the unclaimed property landscape. Historically, most unclaimed property audits were led by Delaware and its principal third-party contingent fee auditor, with other states joining as participating states. However, as states struggle to fill budgetary shortfalls created by the pandemic, more states have shown a willingness to select and pursue companies formed in their states, enabling them to lay claim to any owner-unknown property the holder may have, as well as companies with significant business operations within their borders.

At the same time, the number of third-party unclaimed property audit firms working for the states has increased, with some audit firms focusing on specific industries—e.g., energy, healthcare and insurance—and/or narrow geographic locations—e.g., oil-producing states. Many of these firms work on contingent fee basis, creating financial incentives for them to maximize the property that they attempt to identify and scope into the audit, resulting in costly and time-consuming audits for companies typically lasting three to five years or longer.

 

## Bankruptcy and Unclaimed Property

The filing of a petition in bankruptcy creates an automatic stay that temporarily prevents creditors, collections agencies, government entities, and individuals from pursuing the debtor for pre-petition obligations. In most cases, the court establishes a claims bar date or deadline by which creditors holding pre-petition claims against the debtors must file a proof of claim stating the nature and amount of their claims against the debtor's estate. Because there may be creditors who are unknown to the debtor at the time the bar date motion is filed, the debtor will often seek court approval to publish a notice of the bar date.

State unclaimed property administrators are subject to the bar date set for governmental agencies and are general unsecured creditors with respect to any unclaimed property liabilities that have reached dormancy as of the petition date. Owners of unclaimed property that has not reached dormancy as of the petition date must comply with the claims' deadline established for all other general unsecured creditors.

While most Chapter 11 reorganization plans provide for the downsizing and restructuring of a debtor's business operations and capital structure, some cases involve "liquidating plans" for the sale of the debtor's operations and assets and an orderly wind down of the debtor's business affairs. In each case, the plan dictates how particular classes of claims against the debtor will be treated and paid from the assets available for distribution to creditors, in exchange for which the debtor is typically, but not always, discharged and/or released from such claims.

Whether and to what extent a debtor's unclaimed property liabilities are discharged in bankruptcy depends upon the terms of the bankruptcy plan itself and whether the debtor has followed proper procedures regarding notice to creditors of the claims bar date. As a rule, both dormant and non-dormant property in existence as of the petition date is subject to the claims bar date and discharge as of the date specified in the reorganization plan.

Both the state (as to dormant property), and the owner (as to property not yet dormant), may file a general unsecured proof of claim to share pro rata with other general unsecured creditors in distributions under the plan. However, a proof of claim's prima facie validity is subject to the debtor's right to object to the merits of the claim, and the bankruptcy court may disallow the claim if the objection is sustained.

The effort to substantiate a state's claim can be substantial and may require an audit of the debtors' books and records, all in order to share pro rata in what is frequently a limited pool of funds. As a result, many state administrators forego participation in the bankruptcy claims process except in cases where the percentage distribution to general unsecured creditors is sufficient to justify the time and expense.

Individual owners of property that has not reached dormancy as of the petition date are often unaware that property is being held on their behalf and may fail to file a proof of claim despite notice of the claims bar date. An owner's failure to file a proof of claim by the claims bar date generally results in a discharge of the claim as of the effective date set forth in the plan, which may occur many months after confirmation. As the state's right to unclaimed property is purely derivative of the rights of the owner, the state will have no right to succeed if owner fails to file a proof of claim as of the effective date of the discharge.

## Exceptions and Pitfalls

While most Chapter 11 debtors establish a claims bar date by which creditors must file a claim and provide for the discharge of claims not timely filed, there are exceptions to the general rule. Bankruptcy plans designed to restructure a debtor's funded debt facilities without affecting the debtor's business operations do not affect the debtor's obligations to general unsecured creditors, and these obligations will automatically survive the bankruptcy process. Therefore, it is critically important to consult the bankruptcy plan to determine whether and to what extent general unsecured liabilities, including potential legacy unclaimed property liabilities, have been affected by the debtor's Chapter 11 plan.

Issues may also arise regarding the adequacy of notice of the claims bar date provided to creditors, which may prevent state unclaimed property liabilities from being discharged in the bankruptcy process. While many debtors send notice to known taxing authorities to which taxes may be owed, state unclaimed property administrators are frequently overlooked in the notice process.

This can create the potential for disputes as to whether unclaimed property liabilities have been discharged due to lack of adequate notice. Although many debtors attempt to sidestep these issues by publishing notice of the claims bar date in national publications, publication notice—particularly as to known creditors—may be subject to attack on due process grounds.

Finally, prospective acquirers of entities with a prior Chapter 11 filing should identify the specific entities included in the underlying bankruptcy case. While a debtor will typically include all of its operating entities in a corporate restructuring, that is not always the case, and only those entities actually included in the filing are eligible to receive a discharge. For this reason, most unclaimed property administrators typically request copies of the underlying bankruptcy petitions for purposes of identifying companies within the debtors' organizational structure that may continue to have historical unclaimed property liability by virtue of their exclusion from the bankruptcy process.

## When Good Targets Go Bad

Historically, most M&A due diligence processes did not specifically address unclaimed property. When it was included, it was typically limited to a cursory review of accounts payable and payroll, resulting in a conclusion that any potential exposure was immaterial. This was especially true if a target had undergone a bankruptcy and it was assumed that all prior unclaimed property liabilities had been discharged.

Unfortunately, in many cases the extent to which any unclaimed property exposure acquired is only discovered years after the transaction has been completed. By that time, any applicable indemnification provisions may have expired, and the lack of "corporate history" through the loss of personnel and records can severely limit a company's ability to defend an unclaimed property audit of the acquired entity.

A number of factors that can make a target's failure to comply with state unclaimed property laws very costly to a buyer. First, most states' unclaimed property laws' long statute of limitations and look-back provisions can result in lengthy look-back periods for unclaimed property in both voluntary compliance arrangements and audits.

If complete records are not available for the look-back period, the state in which a company is formed or incorporated may have the authority to estimate a potential unclaimed property liability for the periods where supporting documentation is incomplete or missing. Another risk is that the target may have made its own acquisitions before being acquired itself. If the target failed to perform sufficient unclaimed property due diligence in connection with those acquisitions, the resulting undisclosed obligations from those earlier acquisitions may significantly reduce the value of an otherwise attractive target.

## Transaction Terms

The manner in which an acquisition is structured can also impact how much potential unclaimed property exposure a purchaser may inherit as the result of the acquisition. Unless otherwise provided in the acquisition agreement, the acquirer in a stock acquisition generally acquires all of the target's liabilities as well. In some cases this can be a benefit, such as when it acquires desirable tax attributes of the target.

However, when it comes to unclaimed property liabilities there is no potential upside, especially if the acquirer assumes that the target has no unclaimed property liabilities solely because it went through a bankruptcy without reviewing the relevant documents. At best, if no unforeseen unclaimed property liabilities are acquired, or if the acquired liability is factored into the purchase price, the acquiring company receives exactly what it paid for. At worst, the acquiring company unknowingly inherits a significant unclaimed property liability that can materially undercut the value of the transaction.

In some cases, a company will decide to acquire all or part of the assets of a target rather than the target's stock. Generally, in an asset purchase, the acquirer acquires only those assets and liabilities set forth in the asset purchase agreement. While those agreements do not typically include an express assumption of unclaimed property liabilities, a buyer may nonetheless unknowingly acquire at least some of the seller's existing unclaimed property liability.

For example, the seller's accounts receivable or suspense liabilities may include aged credit balances or suspense liabilities that are reportable pursuant state unclaimed property laws. Asset purchases are most commonly done when acquiring smaller entities, but buyers may consider using an asset purchase on larger transactions to minimize acquiring potential unclaimed property liabilities of target, such as when due diligence reveals large, unreserved unclaimed property liabilities in an acquisition target.

One way for an acquiring company to potentially limit the unclaimed property it may inherit, whether on a stock or asset acquisition, is for the acquiring company to specifically carve out the acquired versus excluded assets and/or liabilities in the acquisition agreements. For example, specifically stating in the agreement that the seller retains all unclaimed property liabilities for the pre-acquisition periods can offer the purchaser some protections should it be selected for an unclaimed property examination in the future.

## Representations and Indemnifications

Because unclaimed property is not a tax, unclaimed property is typically not covered by the general tax representations and indemnifications in most acquisition agreements. Even if unclaimed property is included in the tax indemnifications—by virtue of its inclusion in the definition of "taxes" in the agreement—most indemnification provisions are typically of limited duration, while unclaimed property lookbacks may extend for 10 years or more and audits can happen years after the acquisition.

Accordingly, in addition to conducting a thorough due diligence process, the acquiring company should request specific warranties from the seller regarding target entity's unclaimed property liabilities with appropriate indemnification guarantees, including excluding these indemnification obligations from any basket and cap limitations.

## Conclusion

Now more than ever, companies need to be aware of the risks that unclaimed property liabilities can present. State unclaimed property audits and holder outreach efforts to enforce and "encourage" compliance are increasing as states look to ways to make up revenue shortfalls due to diminished tax revenues. As more companies begin looking to restructure or eliminate debt through the bankruptcy process, it is critical to ensure that unclaimed property liabilities are considered in any restructuring plan.

Properly accounting for unclaimed property through the bankruptcy process can allow a company to be on a more solid financial footing post-bankruptcy, as well as make a company more attractive to potential investors or buyers. While some businesses undergo bankruptcy or liquidation, others will be acquiring these companies or their assets. In doing so, it is important for acquiring entities to understand that not all of a target's liabilities may have been discharged through the bankruptcy process.

A careful review of a target's potential unclaimed property liabilities through the due diligence process allows an acquiring company identify issues that may impact the value of the target, and make adjustments to account for these concerns, before the transaction closes. Together, all of this will better ensure your company is not left holding the bag as it relates to unclaimed property liabilities.