

## **Liability Exposure for Delaware Incorporated Companies**

### **The Risk of an Escheat Audit and Delaware's New Voluntary Disclosure Program to Avoid Penalties <sup>1</sup>**

*by Jeffrey R. Wolters and Michael Houghton*

*Summary: Companies that are incorporated in Delaware are subject to audit and potential liability under U.S. abandoned property laws. Often referred to as "escheat" laws, these rules generally provide that if a company holds intangible property (such as dividends owed to stockholders, or rebates owed to customers) that cannot be delivered because the address of the rightful owner is unknown (or, in some cases, is in a foreign country), then such property is owed to Delaware as the company's state of incorporation. Delaware has instituted a system of auditing companies to determine such liabilities. However, Delaware also recently announced a "limited amnesty" initiative that will allow companies that enter into a voluntary disclosure agreement with the State to avoid potential fines and penalties for not having previously reported and remitted such unclaimed property.*

Under U.S. abandoned property law, securities and other intangible property will escheat to the state (that is, be owed to the state) if not claimed by the rightful owner for a specified number of years (typically 1-5 years). The types of property subject to escheat are quite broad, including not only traditional investment-related property such as stock, dividends, and interest, but also business-specific items such as unredeemed gift cards, unused rebates and unused credits.

Under rules established by the U.S. Supreme Court in a series of decisions, if the holder of the property (such as the company that declared the dividend, issued the rebate, etc.) cannot determine the last known address of the owner entitled to the property, then the property is owed to the state of incorporation of the holder. Some states, such as Delaware, also take the position that the property is owed to the state of incorporation if the owner's last known address is in a foreign country. Given the number of companies incorporated in Delaware, including over half the Fortune 500, Delaware has a strong economic interest in enforcing its escheat laws. A key enforcement mechanism resorted to by Delaware

has been to audit Delaware-incorporated entities, regardless of where they do business, for potential escheat liability. Recently, however, Delaware adopted rules that allow companies with potential escheat liability to avoid an audit, and potential interest and penalties, by using the State's new voluntary disclosure program. The program is essentially a limited amnesty for companies that take advantage of the program in the next two years.

Below is a summary of the new program and the ways in which it may benefit entities that are legally formed in Delaware and that may have potential escheat liability or exposure to an escheat audit and related fines and penalties.

#### **Background: U.S. Unclaimed Property Law**

The law of unclaimed property is arcane, but clear in certain key respects.

As determined through a series of U.S. Supreme Court opinions, companies which are "holders" of unclaimed property have a legal obligation to report and remit such property to the states.

Unclaimed property can be tangible (cash, for instance) or intangible (stock, uncashed checks, unredeemed gift cards, unused rebates, credits, etc.) and must be paid to the various states for the states to hold, for the benefit of the unknown "owner" of the property or – as the law has evolved and recognized – for use by states for the public benefit. Under what are known as "priority rules," property is to be remitted, under the first priority rule, to the state of the last known address of the "owner" who has not claimed their property, based on the holder's books and records. In the absence of such detailed records, under the second priority rule the property is remitted to the state of formation of the holder.

Each state sets its own unclaimed property rules. For most, the dormancy period, i.e., how long property must go unclaimed before it is owed to a state, is usually between 1 and 5 years. The look back period, i.e., how far back in time states can seek to recover unreported property, also varies. Delaware "looks back" to 1981; California looks back even further.

While most companies only retain records for 7 years, the absence of records does not absolve a holder from liability. States often

have a statutory or claimed common law right to “estimate” the liability of holders for those years for which records do not exist. Delaware is one such state, and as a result, unclaimed property is its third largest revenue source.

#### Enforcement Against Delaware-Incorporated Entities

Since at least 2005, Delaware’s Division of Revenue has offered unclaimed property holders the opportunity to enter into what is commonly known as a voluntary disclosure agreement (a “VDA”) to come into compliance for past-due unclaimed property obligations under the Delaware Abandoned Property Law, 12 *Del. C.* §§ 1101 *et seq.* (the “Abandoned Property Law”). The Division of Revenue approach has been controversial due to, among other things, the length of its look-back period as well as the possibility of being targeted for an expensive and time consuming audit potentially involving interest and penalties if initial settlement agreement negotiations failed.

In response, Delaware enacted legislation in June 2012 creating a new voluntary disclosure program (the “New VDA Program” or the “new Program”) managed by the Delaware Department of State that is independent of the Division of Revenue and is intended to be more business-friendly. This new Program, which in effect operates as a limited amnesty, sunsets on July 1, 2015.

#### Advantages of Delaware’s “Limited Amnesty”

The new Delaware VDA program offers several advantages:

- Shortened look-back period
- Enrollees by June 30, 2013 must only report property arising from transaction year 1996 to present (a 15-year advantage over audits)
- Enrollees between June 30, 2013 and June 30, 2014 must only report property arising from transaction year 1993 to present
- Early participants are allowed an extra 12 months to complete their VDA
- Available to all holders except those that are currently under audit or that have already begun or completed a VDA with the State Escheator
- Permits companies that previously entered into a VDA prior to June 30, 2012 to enter into a new VDA for entities, property types and periods not covered by the earlier VDA
- New VDA Program enrollees will not be charged interest or penalties
- Enrollees will receive a complete release from liability for all prior periods

- Enrollees will be protected against unclaimed property audits for all years up to the date of execution of the VDA
- Administered by an independent entity compensated on an hourly basis rather than by the third-party contingency-fee based audit firms retained by the Division of Revenue
- Accounting consultants assist to ensure the program is administered competently, fairly and consistently
- A holder, in exchange for presenting a substantive submission, gets a clean slate for past-due liability owed, improved compliance procedures, and the framework for more accurate and complete reporting going forward.

#### Current Actions in Delaware

Out of 900,000 business entities organized in Delaware, the Delaware Secretary of State has sent letters to 700 companies encouraging participation in the new Program. If Delaware proceeds like other states that have offered “amnesty” programs, a final notice and invitation to participate will be forthcoming.

Concurrently, the Delaware Division of Revenue is sending out audit notices, with more to follow this spring. Companies under audit become ineligible to participate in the New VDA Program and run the risk of a multi-year investigation and the possible assessment of interest and penalties which can potentially double their liability. In short, the Delaware unclaimed property audit program is once again gearing up.

Although every company’s situation is different, in general, holders who have already received letters from the Delaware Secretary of State should seriously consider entering into the New VDA Program – and even companies who have not yet received a letter are strongly encouraged to enroll. Such action will avoid receipt of an audit notice from Delaware’s Division of Revenue and gain the many benefits of the New VDA Program that are being offered for a limited time.

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