

Spotlight on Unclaimed Property: Is Unclaimed Property Hidden in Your M&A Deal?

September 7, 2011

During the first half of 2011, U.S. merger and acquisition activity robustly increased over 2010. The accounting firm PricewaterhouseCoopers reported that 2011 M&A activity through May increased 39% over the same period in 2010. As cash on corporate balance sheets continues to grow, this may fuel additional M&A activity during the second half of 2011.

Despite this good news, unclaimed property of the target company is one liability that could be hidden in the deal. According to the National Association of Unclaimed Property Administrators, state treasuries currently hold in custody more than \$33 billion of unclaimed property funds. This makes unclaimed property an important revenue source for states, as evidenced by states' expanded audit programs and the increasing use of often aggressive third party contingent fee audit firms. For example, unclaimed property is regularly the third largest revenue source for the important corporate domicile State of Delaware. And, states are not focusing only on the Fortune 500. States are extending their audit programs to include middle market companies, and there are contingent fee auditors exclusively focused on this market segment.

A review of a company's historical M&A activity, often reaching back 10 years or more, is always close to the top (if not tops) on the list for an unclaimed property auditor. Here are just some of the issues and concerns that an acquirer should be considering before, during, and after the deal:

1. **Is this a stock acquisition, or an asset acquisition?** As a general rule, a stock acquisition will always include an acquisition of the target's unclaimed property liabilities, while an asset acquisition may not depending on the facts. However, this is only a general rule. If the asset acquisition includes bank accounts or accounts receivable, unclaimed property liabilities hidden in those assets become the acquirer's.
2. **Has the target complied with state unclaimed property laws?** Although compliance with state unclaimed property laws has improved over the past 10 years, due in part to increased audit aggressiveness as well as the internal financial controls certifications and disclosures mandated by the Sarbanes-Oxley Act of 2002, a target's compliance should not be taken for granted. One state unclaimed property administrator has advised that up to 50 percent of companies are not in compliance, while other state administrators estimate non-compliance rates of 15 to 35 percent.
3. **What was the target's acquisition history?** If the target has an acquisitive history, the target's previous acquisitions and these businesses' unclaimed property liabilities could carry over to the acquirer when the target is acquired.
4. **Will the target records be obtainable?** After closing, a target's records may not necessarily be obtainable unless addressed by the purchase agreement. In the absence of records, state unclaimed property auditors are usually authorized by statute to estimate and extrapolate an unclaimed property liability 10, 20 or even 30 years into the past resulting in seven or eight figure audit liabilities.
5. **Have all target shareholders exchanged their shares?** For share certificates held directly by a shareholder and not beneficially by a transfer agent, the shareholder may not complete the exchange of shares. The explanation may simply be that the shareholder needs assistance to complete the exchange or possibly the shareholder is "lost," which creates unclaimed property issues.

6. **What will be the effect of SEC Rule 17Ad-17?** Transfer agents have been subject to this SEC Rule and have been required to annually attempt to locate lost security holders (and required to notify a security holder that fails to cash any check payment over \$25 from an issuer). After the Dodd-Frank Wall Street Reform and Consumer Protection Act was enacted in 2010, this Rule is extended to broker-dealers and paying agents. This Rule represents another unclaimed property compliance process, albeit mandated by federal law, which could complicate the deal.
7. **Does the acquirer succeed to the target's immunity?** When a holder of unclaimed property reports the property to the appropriate state, the holder typically is immunized against the claims to the property brought by either the owner or another state. However, if the holder did not follow all of a state's unclaimed property compliance procedures (e.g., failed to mail notice to the owner's last known address), immunity may not attach. After closing, an acquirer may find that it has succeeded to the target's lack of immunity even though the target had an apparently sound compliance record.
8. **What if the acquisition results in a change in the target's or acquirer's state of incorporation?** Auditors representing the new state of incorporation could demand the target's historic unclaimed property liabilities under statutory requirements or audit procedures or both, that differ from those of the "old" state of incorporation. For example, the "old" state's unclaimed property law may have a five-year statute of limitations to audit or may exclude business-to-business transactions as unclaimed property, while the "new" state may apply a 10-year statute and may have no business-to-business exemption. Resolution of these issues typically involves numerous considerations, including the state corporate/partnership law governing the transaction, state unclaimed property laws, and conflict of law principles.
9. **Could the target have unclaimed property arising out of foreign transactions?** Increasingly, state unclaimed property auditors are focusing on foreign transactions. While some states provide explicit exemptions for unclaimed property arising out of foreign transactions, other states, relying on statutory silence, have been laying claim to this form of unclaimed property. As a result, just as export compliance is a subject for due diligence, a target's unclaimed foreign-transaction property should be reviewed.
10. **What can be done?** A range of pre-closing and post-closing initiatives can be pursued to address potential unclaimed property problems. These range from pre-closing reviews of sample financial data from the target as well as the target's practices, including unclaimed property provisions in indemnification provisions, adding record retention requirements to the purchase agreement, initiating voluntary compliance agreements with states under the target's name prior to closing, among other initiatives.

Acquiring a target's unclaimed property liabilities and compliance records (or lack thereof) can be a costly headache for the acquirer. Proactively confronting the risk is the better course of action. Should you like to discuss the issues raised in this Alert or any other unclaimed property issues in general, please contact an attorney in the Firm's Tax Department.