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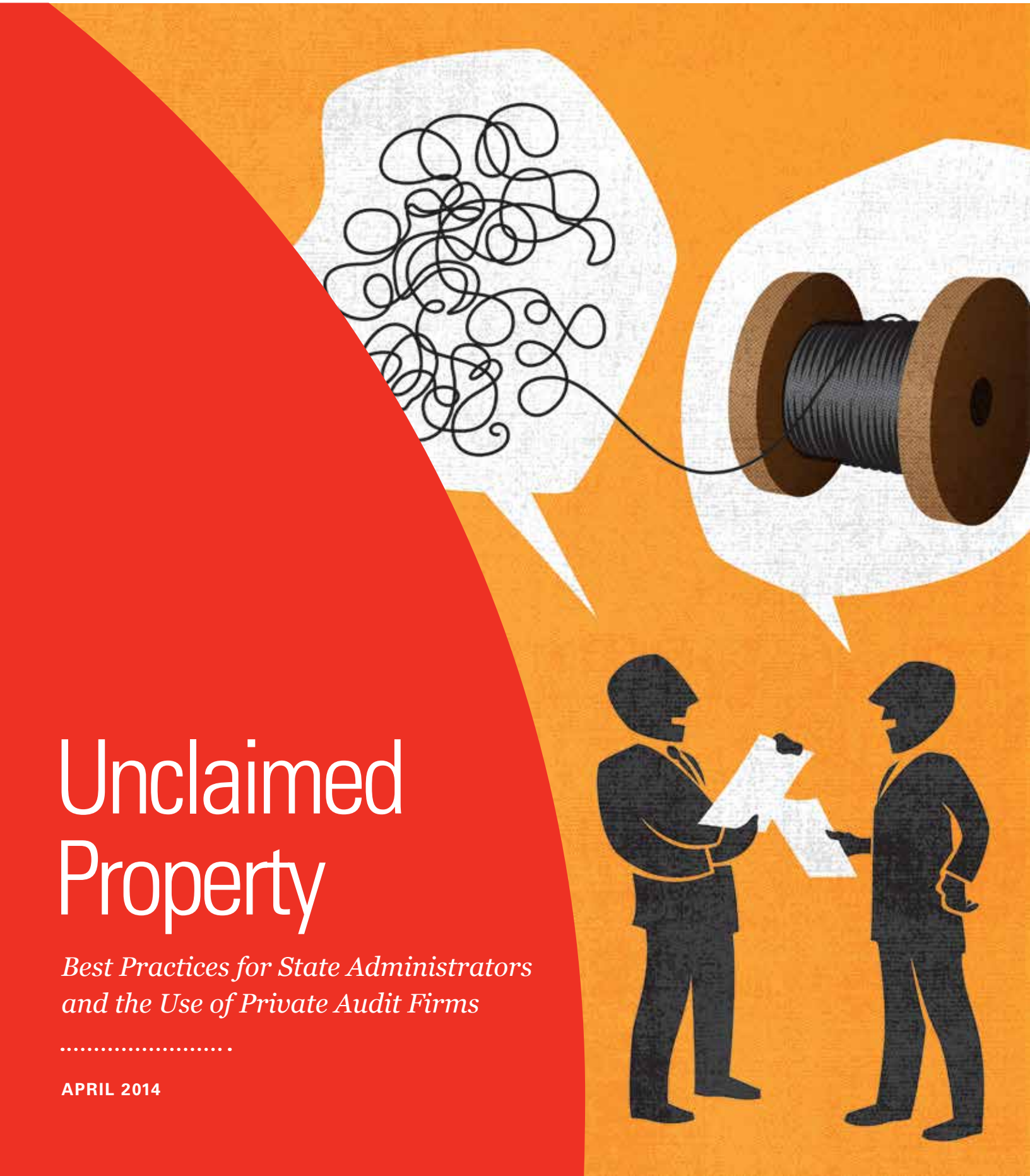

Unclaimed Property

Best Practices for State Administrators and the Use of Private Audit Firms

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Introduction

State unclaimed property laws, when fairly and appropriately enforced, serve several important functions. Among other things, such laws may help reunite rightful owners with their property, may help ensure that companies are incentivized to protect abandoned consumer property, and may generate cash flow for state treasuries.

For many decades, state unclaimed property administrators enforced laws responsibly and without controversy, working within the boundaries of the law to protect companies and consumers alike. In recent years, however, there has been a heightened reliance on private audit firms to collect purportedly unclaimed property on behalf of the state in exchange for a contingency fee. In an attempt to increase their profit-making potential, these private auditors have taken an increasingly aggressive approach to the interpretation and enforcement of unclaimed property laws. While such arrangements may enable unclaimed property administrators to leverage limited resources, they raise numerous concerns requiring oversight and accountability. The U.S. Chamber Institute for Legal Reform has identified a series of "Best Practices" for unclaimed property administrators to use in the engagement of private audit firms. These Best Practices are intended to facilitate responsible and fair enforcement of state unclaimed property laws while minimizing the potential for abuse that can result from contingency fee arrangements with private auditors.

Background

State unclaimed property laws apply to a great variety of intangible assets and complex financial products, such as uncashed checks, shares of stock, dividends, and life insurance proceeds, to cite a few examples.

Unclaimed property laws require companies to transfer (or "escheat") to state treasuries any money or property deemed abandoned after a certain period of inactivity by the property's last-known owner. Such funds are then held by the state, nominally for the benefit of the absent owner, but as a practical matter as an indefinite, interest-free loan to the state.[1] Therefore, states often incorrectly view unclaimed property as a revenue source, rather than a property rights issue.[2] Some states require unclaimed property administrators to fund their offices with collected unclaimed property instead of funding the offices through general appropriations. Making matters worse, these states often raid the collected unclaimed property principal and generated interest to fund state government projects. Unsurprisingly, in times of budget tightening, aggressive collection of unclaimed property is a natural focus of cash-strapped states. The value of unclaimed property held in state coffers has nearly doubled in the past ten years, reflecting increasingly aggressive interpretation and enforcement of unclaimed property laws.[3] New York, alone, presently holds over $12 billion in unclaimed property collected since 1942.[4]

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The heightened focus on unclaimed property as a cash source has coincided with a marked increase in unclaimed property administrators' use of private audit firms to collect purportedly unclaimed property on behalf of the state in exchange for a contingency fee based on the total amount of funds collected.[5] These arrangements inject a private profit motive into the enforcement of state laws and therefore carry a significant risk of abuse.

Auditors who stand to gain from every additional dollar collected have a built-in incentive to aggressively interpret or exceed the boundaries of the law in order to maximize their return, whereas auditors paid by the hour or on a flat-fee basis have no such improper financial interest in the audits they conduct.[6] The lack of transparency surrounding the selection and contracting process heightens the risks inherent in contingency fee arrangements by opening the door to "pay to play" schemes, in which lucrative contracts are awarded in exchange for campaign contributions or other quid pro quos, and by shielding contract terms, including the transfer of unclaimed funds belonging to state residents to private auditors in the form of contingency fees, from public scrutiny.[7] The vast majority of states do not make their private auditor selection process or contracts publicly available.

Recent events in the life insurance industry demonstrate the perils of such contingency fee arrangements with private unclaimed property auditors. In 2009, a private firm began a series of audits of life insurance companies on behalf of unclaimed property administrators seeking to identify unreported funds.

To increase escheatment, and thus the size of its contingency fee, the audit firm adopted the novel practice of requiring life insurance companies to cross-reference their policy records against the Social Security Administration's (SSA) publicly available Death Master File[8] (DMF)—a partial and unverified database of deaths recorded in the United States—in order to identify policyholder deaths that had not yet been reported to the insurance company and corresponding benefits that had been "abandoned."

The audit firm pushed this practice despite the fact that, when these audits began, there were no laws on the books in any state that affirmatively required life insurance companies to search the DMF for deceased policyholders. Nevertheless, enforcement efforts broadened significantly as unclaimed property regulators, insurance departments, and private auditors recognized the potential of DMF searching to increase escheatment revenue and, for private auditors, contingency fees.

The audits were premised on two unprecedented positions with respect to unclaimed insurance proceeds: (i) life insurers must use the DMF at regular intervals and across all lines of business to identify potentially deceased policyholders or annuitants; and (ii) life insurers must begin the "countdown" to escheatment beginning on the date of death as reflected on the DMF as opposed to the date on which an insurance company is notified of a death or claim.

Although these positions had never before been asserted, unclaimed property administrators and private auditors pushed insurers to pay examination costs, monitoring costs and interest based on alleged failures to have adhered to these new standards in the past. In particular, unclaimed property administrators and private auditors required insurers to pay interest on "late-escheated" property calculated from the date of death to the date of escheatment, and in some instances threatened additional fines and penalties, even if the insurance company did not learn of the death until the audit-mandated DMF search.

Insurance companies maintained that the private auditors' requirements had no legal basis, but the companies had scant opportunity to challenge them. The auditors failed or refused to issue formal audit findings that an insurance company could challenge in an administrative proceeding, thereby evading review of their legal positions. At the same time, unclaimed property administrators and insurance regulators fueled significant adverse publicity for the life insurance industry premised on the assumption that insurers had been legally obligated to search the DMF for potentially deceased policyholders but had failed to do so, and the number of life insurance companies facing private audits continued to grow.

The audits imposed substantial costs and burdens on companies, often requiring the hiring or redeployment of dozens of employees to meet the private auditors' demands. The DMF is unverified and often contains inaccurate data, ranging from purported death records for people who are actually alive to typographical errors in social security numbers or other identifying information.[9] A Government Accountability Office (GAO) report issued last year found that the "SSA does not independently verify all reports before including them in its death records" and therefore "risks having erroneous death information in the DMF, such as including living individuals in the file or not including deceased individuals."[10] The GAO "identified instances where this approach led to inaccurate data."[11]

In fact, an article by NBC News details the story of Laura Todd, a Tennessee woman who was incorrectly declared dead by the government because of "a typo in government records."[12] The article explains that Laura Todd "is one of tens of thousands of living, breathing Americans whom the federal government has wrongly declared dead—by one measure, more than 35 a day."[13] An investigation by the Social Security Office of the Inspector General, which oversees the SSA, identified 36,657 Americans in the DMF who were falsely classified as dead.[14] In 2012, a Scripps Howard News Service study estimated that each month nearly 1,200 living Americans are falsely reported.[15] Social Security

Commissioner Michael Astrue even admitted to having personal experience with the unreliability of the DMF.[16] During an oversight hearing Commissioner Astrue told the House Ways and Means Subcommittee on Social Security that, "I've actually had, in one week, one of my closest relatives and one of my closest friends and neighbors (who both) were declared dead," even though both were very much alive.[17]

As a result, DMF matching is not an automated process; instead, each "match" between company records and the DMF must be verified by the insurance company through labor-intensive manual research to determine whether the person identified in the DMF was in fact a company policyholder, whether the policy was in force at the time of death, whether a claim had already been paid, whether a death benefit was owed, whether beneficiaries could be identified or whether funds were due to be escheated.

The private auditors exacerbated this problem by insisting upon "fuzzy" matching methodology that defined similar but not identical records as "matches"—for example, records with transposed digits in a date of birth or social security number or differently spelled names. This "fuzzy matching" methodology substantially increased the number of initial hits, the number of false matches, and the amount of manual labor required to verify or refute the private auditors' search results. In many instances, private audit firms took the position that initial hits would be deemed to be actual matches if not refuted within a short and specified time period, intensifying the burden on insurers.

Faced with burdensome audits, numerous companies entered into multi-state settlements, agreeing, despite strong legal defenses, to search the DMF for escheatment purposes, to pay interest calculated from the date of death on all amounts escheated (regardless of when the company actually learned of the death and would have been in a position to process a claim or escheatment absent DMF searching), and to pay to the states millions of dollars to cover their costs of investigation.

Recent legal developments have made clear, however, that the industry was correct: the private audit firms' demand that insurance companies cross-reference their book of business against the DMF, which resulted in substantial contingency fees for the audit firms and substantial revenues to the states, is not supported by law.

- Most recently, a West Virginia court dismissed lawsuits brought by the West Virginia State Treasurer against 69 life insurance companies alleging that they had violated West Virginia's unclaimed property law, which is based on a widely used model, by failing to search the DMF for escheatment purposes. The West Virginia court granted the motion to dismiss on the grounds that West Virginia's unclaimed property law does not require DMF searches.[18]
- A Florida court has likewise found that Florida's unclaimed property law, based on another widely used model, does not require DMF searches. The court dismissed the lawsuit and found that "Florida has not adopted a law requiring Prudential to consult the Death Master File, averred by TARS, in connection

> *"The private audit firms are now expanding their aggressive enforcement tactics to other industries and financial products, including among others the mutual fund industry, property and casualty insurers, and broker-dealers, in furtherance of private gain."*

with payment or escheatment of life insurance benefits. Likewise, Florida has adopted no law imposing an obligation on Prudential to engage in elaborate data mining of external databases…in connection with payment or escheatment of life insurance benefits."[19]

- A recent decision by the United States District Court for the District of Massachusetts held that, in the context of unclaimed property litigation, the insurance laws of Massachusetts and Illinois do not require life insurance companies to affirmatively seek out potentially deceased policyholders.[20]
- In addition, an Ohio court rejected a claim that an insurer was under a duty to search the DMF to determine whether any policyholders had died, holding that the contracts and applicable case law put the burden on the beneficiary to come forward with proof of death and declining to "import additional unspoken duties and obligations onto Nationwide that will conflict with the parties' contracted terms."[21]

There have been no countervailing rulings to date by a federal or state court upholding the position taken by unclaimed property administrators and private auditors with regard to DMF searching.

Notwithstanding these decisions, unclaimed property audits premised on DMF searching continue, with many smaller companies now caught in the crosshairs and facing substantial costs from extra-legal audits. The private audit firms are now expanding their aggressive enforcement tactics to other industries and financial products, including the mutual fund industry, property and casualty insurers, and broker-dealers, in furtherance of private gain.

It is critical that private audit firms purporting to act on behalf of unclaimed property administrators are subject to appropriate oversight and accountability to ensure that they act at all times with the highest ethical standards and within the boundaries of the law. It is likewise critical that the process for selecting private auditors and the terms of contracts with private auditors are publicly disclosed to avoid the conflicts of interest inherent in "pay to play" schemes and to ensure accountability for the use of taxpayer dollars.

Best Practices

With the current landscape of unclaimed property audits in mind, the U.S. Chamber Institute for Legal Reform has identified a series of "Best Practices" for unclaimed property administrators to use in the engagement of private audit firms.

These Best Practices are intended to facilitate responsible and fair enforcement of state unclaimed property laws by enabling unclaimed property administrators to maximize limited resources while minimizing the potential for abuse that can result from contingency fee arrangements with private auditors.

Transparency Reforms

Unclaimed property administrators may retain private audit firms to represent the state when staffing limitations necessitate the employment of such firms to conduct audits that are authorized under state unclaimed property law. Before engaging a private auditor, the unclaimed property administrator should make a written determination that such engagement is both cost-effective and in the public interest and should post such determination on the unclaimed property administrator's website. Any contract for private audit services should be subject to an open, competitive bidding process. In addition, any such contract should be posted on the unclaimed property administrator's website for public inspection and should remain posted throughout the duration of the contract.

These transparency reforms will ensure that unclaimed property administrators retain the highest quality private audit firms that will deliver the best value to state residents. In addition, public posting of the contracts will ensure that unclaimed property administrators and private audit firms are accountable to the public for fee arrangements impacting public funds.[22]

Fee Arrangements

An unclaimed property administrator should not enter into a contract with a private audit firm to collect unclaimed property where the audit firm's compensation is contingent on the amount recovered. All private audit firms should be compensated pursuant to a written contract on an hourly basis or an agreed-upon fixed amount.

As discussed above, the use of contingency fee arrangements with private audit firms purportedly acting on behalf of the state to enforce unclaimed property laws carries significant potential for abuse, as the recent experience of the life insurance industry amply demonstrates. Several states have

already enacted statutes barring the use of contingency fee auditors in recognition of the problematic incentive structure of such arrangements.[23] Requiring unclaimed property administrators to compensate private audit firms on an hourly basis will eliminate the risk of overly aggressive enforcement that exceeds the boundaries of the law and will help ensure that private audit firms prioritize accuracy and operate under the highest ethical standards, befitting their role as representatives of the state. Any resource challenges associated with hourly fee arrangements can be mitigated by implementing a robust voluntary disclosure program, as discussed below.[24]

Contract Reforms

Any contract with a private audit firm should contain provisions:

- *requiring private auditors acting on behalf of the state to act with the highest ethical standards befitting representatives of the state, to conduct all audits within the boundaries of applicable unclaimed property law, and to refrain from pursuing abusive, unreasonable or cumbersome audit procedures;*
- *providing that the unclaimed property administrator shall at all times retain complete control over the course and manner of any audit conducted by a private auditor and shall not delegate to private auditors substantive decision-making authority regarding the types of property to be pursued, the legal theories underlying audit practices, or the initiation, resolution, or termination of an audit;*
- *requiring private auditors acting on behalf of the state to issue formal audit findings at the conclusion of an audit when requested by the holder of unclaimed property; and*
- *providing that any holder of unclaimed property subject to audit by a private audit firm may contact the unclaimed property administrator's staff directly on any matter pertaining to the scope of, legal justification for, or resolution of the audit.*

These proposed reforms will ensure an appropriate degree of transparency, oversight, and accountability for private audit firms purporting to act on behalf of unclaimed property administrators and will help ensure that all audits are conducted within the boundaries of the law. Requiring private audit firms to issue formal findings, which should be standard in any audit, will help ensure that companies subject to audit may, in appropriate circumstances, exercise their legal right to contest the legal basis for audit findings in an administrative proceeding. In addition, providing a direct line of communication to the unclaimed property administrator's staff will help ensure appropriate oversight and protection of the legal rights of companies subject to audit.

Voluntary Disclosure Program

Unclaimed property administrators should implement voluntary disclosure programs (VDP) that provide an incentive for companies to come forward voluntarily, including a route to amnesty for companies that may be out of compliance with unclaimed property laws. To maximize its effectiveness at promoting voluntary compliance, the VDP should:

- *Confer protection against unclaimed property audits to businesses that complete the program and subsequently fulfill their future annual reporting requirements by waiving the state's right to audit compliant businesses for all prior years up to the date of completing the VDP, subject to exceptions (i) in cases of fraud or willful misrepresentation during the process of completing the VDP; (ii) in the event of the business's non-compliance with the state's unclaimed property law during the three years after completing the VDP; or (iii) if the company limited the scope of its settlement under the VDP to certain property types, entities, or years.*
- *Provide a truncated look-back period under which the number of years subject to voluntary reporting is materially shorter than the number of years that would be subject to examination in an audit.*
- *Rely on hourly payments or internal staffing as needed for any audit staff involved in overseeing the VDP.*

While many states have some form of VDP in place, these programs do not always generate a sufficient incentive for companies to come forward and as a result are not as effective as possible at promoting voluntary compliance with unclaimed property laws. In particular, many unclaimed property administrators retain the right to conduct an audit despite the VDP process, potentially through a private audit firm operating on a contingency fee basis. This removes much of the incentive to enroll in the VDP. Rather than providing certainty for a business, coming forward to enter the VDP may be viewed by many businesses as increasing the risk of an audit. In addition, many VDPs fail to offer a materially shorter look-back period than would apply in an audit. These issues undercut the effectiveness of a VDP. We believe that the elements outlined above would provide a powerful incentive for companies to come forward, resulting in efficient and low-cost collection of unclaimed property without the risks associated with the use of private audit firms.[25]

Conclusion

The recent experience of the life insurance industry is a cautionary tale of the risks of delegating enforcement of state unclaimed property laws to private auditors motivated by private gain. While private auditors, if appropriately incentivized and supervised, can serve a useful role, the existing model of private auditor arrangements based on contingency fees, undisclosed contracts, opaque selection processes, and inadequate oversight creates an intolerable risk of abuse.

The Best Practices outlined above are designed to maximize appropriate collection of unclaimed property while protecting and balancing the legitimate interests of consumers, companies, and the state. The combination of appropriately structured and supervised private audits plus a robust VDP designed to incentivize voluntary compliance will facilitate efficient and low-cost collection of unclaimed property within the boundaries of the law.

Endnotes

1 *See* David Pitt, *Cash-Strapped States Go After Unclaimed Benefits*, USA Today, May 2, 2011 ("Technically states hold unclaimed property for the benefit of the owner, but in many cases the owner doesn't come forward. That means the state has use of the money interest-free. It's an easy source of revenue and an important one considering California faces a $15.4 billion budget deficit for the coming fiscal year.").

2 For example, the Oklahoma Senate recently passed S.B. 1651, which would allocate $40 million from Oklahoma's Unclaimed Property Fund to build Oklahoma City's American Indian Cultural Center and Museum. During the Senate Appropriations Committee vote, one state senator even noted that he "appreciate[d] the idea that [the State is] not borrowing money to do this." Randy Ellis, *Committee Approves Bill to Use Unclaimed Property Fund Money for Oklahoma City's American Indian Cultural Center and Museum*, The Oklahoman, Feb. 20, 2014, http://newsok.com/committee-approves-bill-to-use-unclaimed-property-fund-money-for-oklahoma-citys-american-indian-cultural-center-and-museum/article/3935203.

3 *The Best and Worst of State Unclaimed Property Laws*, Council on State Taxation (2013).

4 *See* Office of the State Comptroller, Office of Unclaimed Funds, http://www.osc.state.ny.us/ouf/index.htm?utm_source=www.domtail.com ("New York State has $12 billion in lost money.").

5 For example, under a contract between the Treasurer of the State of Illinois and private auditing firm Verus Financial, LLC, Verus receives 12 percent of the value of the "net abandoned property" collected.

6 In recognition of this problematic incentive structure, Illinois, North Carolina, and Virginia have enacted statutes that limit or bar the state's unclaimed property administrator from relying on contingency fee auditors to collect unclaimed property. *See* 765 ILCS 1025/24.5 (banning use of contingency-fee auditors for in-state companies but allowing such arrangements for audits of out-of-state companies); Va. Code Ann. 55-210.24(D) (banning use of contingency-fee auditors for companies domiciled or having a principal place of business in Virginia); N.C.G.S. § 116B-8 (banning use of contingency fee auditors except with regard to life insurance industry).

7 *See, e.g,. Pay to Sue on the Docket*, The Wall Street Journal, July 28, 2009 (describing Pennsylvania Governor Ed Rendell's engagement on the state's behalf of a contingency fee law firm that made $90,000 in political contributions to Governor Rendell's re-election campaign while the engagement was being negotiated). Such "pay to play" schemes exacerbate the risks inherent in contingency fee arrangements by injecting a conflict of interest into the selection process and making questionable ethical practices—namely, the making of donations in exchange for state contracts—a prerequisite for engagement.

8 The DMF is a database maintained by the SSA containing over 86 million records of deaths and including information such as an individual's social security number, name, date of birth, date of death, state or country of residence, and ZIP code of last residence. The DMF does not purport to contain records for every deceased individual, and the SSA does not guarantee the database's veracity. U.S. Department of Commerce, Social Security Administration's Death Master File, *available at* www.ntis.gov/products/ssa-dmf.aspx.

9 GAO, *Social Security Death Data: Additional Action Needed to Address Data Errors and Federal Agency Access*, GAO-14-46 (Washington, D.C.: Nov. 27, 2013).

10 *Id.*

11 *Id.*

12 Alex Johnson & Nancy Amons, *'Resurrected,' But Still Wallowing in Red Tape*, NBC News, Feb. 29, 2008, http://www.nbcnews.com/id/23378093/ns/us_news-life/t/resurrected-still-wallowing-red-tape/#.UzGtSNzeHKR; *See also* Mari Payton, *Man Fights to Get Name Off Gov't "Dead List,"* NBC 7 San Diego, Feb. 27, 2013, http://www.nbcsandiego.com/investigations/San-Diego-Death-List-Social-Security-Mistake-Death-Master-File-Error-193387321.html; Susan Demar Lafferty, *False Government Death Reports Leave People in the Lurch*, The Chicago Sun-Times, Aug. 7, 2011, http://www.suntimes.com/news/6934785-418/false-government-death-reports-leave-people-in-the-lurch.html.

13 *Id.*

14 Blake Ellis, *Social Security Wrongly Declares 14,000 People Dead Each Year*, CNN Money, Aug. 22, 2011, http://money.cnn.com/2011/08/17/pf/social_security_deaths_mistakes/.

15 Thomas Hargrove, Grave Mistakes: Social Security Clerically Kills Thousands of Americans Each Year (Peter Copeland, et al. eds., 2011).

16 Thomas Hargrove & Waqas Naeem, *Social Security Death Master File Mistakes Hit Home for Chief of the Agency*, San Angelo Standard-Times, Feb. 3, 2012, http://www.gosanangelo.com/news/2012/feb/03/social-security-death-file-mistakes-hit-home-for/.

17 *Id.*

18 *See State of West Virginia ex rel. John Purdue v. Nationwide* (Dec. 27, 2013).

19 *See Total Asset Recovery Servs. v. MetLife, Inc.,* Case No. 2010-CA-3719 (Fl. Cir. Ct. Aug. 20, 2013).

20 *See Feingold v. John Hancock Life in Co. (USA),* Civ. Action No. 13-10185-JLT, 2013 WL 4495126, at *2 (D. Mass. Aug. 19, 2013).

21 *See Andrews v. Nationwide Mut. Ins. Co.,* No. 97891, 2012 WL 5289946, at *5 (Ohio Ct. App. Oct. 25, 2012).

22 *Cf.* American Tort Reform Association "Transparency Pledge"; American Legislative Exchange Council, Private Attorney Retention Sunshine Act (requiring that contracts with private lawyers be reviewed by the legislature); National Association of Regulatory Utility Commissioners, Policy Governing Funding By Governmental and Private Organizations (requiring competitive bidding of contracts exceeding $25,000). Several states have adopted procurement requirements and other restrictions applicable to the hiring of private contingency fee counsel. See Alabama (Ala. Code § 41-16-72), Arizona (Ariz. Rev. Stat. § 41-4801), Florida (Fla. Stat. § 16.0155), Indiana (Ind. Code Ann. § 4-6-3-2.5), Iowa (Iowa Code § 23B.3), Mississippi (Miss. Code § 7-5-8), and Wisconsin (Wisc. Stat. § 20.9305).

23 *See supra* note 6.

24 *Cf.* National District Attorneys Association, National Prosecution Standards § 8.2(f) (specifying that compensation for special assistants employed for particular expertise shall come from state general funds provided to the prosecutor's operating budget and shall be at a rate commensurate with the individual's expertise and prevailing rates in the community).

25 We note that Delaware, in response to criticism that its unclaimed property collection efforts were overly aggressive, enacted a VDP under the auspices of Delaware's Secretary of State that contains many of the recommended provisions above and appears to be a commendable step in the right direction. *See* Delaware Voluntary Disclosure Program, http://sos.delaware.gov/vda.shtml (announcing new VDP program operated by Delaware Secretary of State independently of the State Escheator); *see also* http://delawarevda.com ("After listening to the concerns of many of Delaware's corporate constituents, Delaware Governor Jack Markell and the legislature created a new, more business friendly program where companies can 'catch up' on their past due unclaimed property obligations, avoid an audit, avoid interest and penalties, and significantly reduce their liability, all at the same time.").

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