MEMORANDUM

To: **Drafting Committee, Revision of the Uniform Unclaimed Property Act, Uniform Law Commission**

From: **National Association Unclaimed Property Administrators**

Re: **The States' Effective Utilization of Private Auditors for the Identification of Unclaimed Property**

Date: **May 9, 2014**

Introduction

For the last 30 years, state unclaimed property programs have engaged contractors to perform unclaimed property compliance examinations. These contractors, or "contract examiners," generally are compensated on a contingency basis; they are paid by the state only when they successfully identify and remit past-due unclaimed property and do so in a manner that is consistent with the terms of a contractual agreement. Moreover, these contract examiners are not compensated at all for the significant amount of unclaimed property that is identified through the audit process and is returned to the owner through due diligence before being reported to the state. All states utilize contract examiners, and for a number of states contract examiners represent a major component of the state's compliance program. Contract examiners have proven highly effective, collecting billions of dollars in unreported property, which the states have in many cases been able to pay to missing owners.

The states view the utilization of contract examiners as a successful public-private partnership. It is recognized by the states that some holders and holder advocates may have a different view of contract examiners. However, accusations that contract examiners are "unethical" or "overly-aggressive" simply don't bear scrutiny. Rather, the states believe that contract examiners are controversial primarily because of the nature of their work, and the level of success that they have achieved.

The purpose of this white paper is to explain the role of contract examiners, the contribution that contract examiners make to state unclaimed property programs, and the basis of compensating contract examiners on a pay-for-performance basis. In conjunction with a discussion of these points, NAUPA will address and debunk many of the misconceptions that have been promoted concerning contract examiners, and their utilization by the states.

The Importance of Compliance and the Need for Enforcement

State unclaimed property programs are based on the consumer protection goal of ensuring that property is returned to its rightful owners. In order for the unclaimed property programs to operate as intended, holders must self-report unclaimed property in their possession.[1] Even though holders must self-report, states have taken additional steps to help facilitate holder compliance by employing outreach programs, conducting seminars and utilizing collaborative multi-state forums, such as the National Association of Unclaimed Property Administrators, to educate holders about the law and their responsibilities under it. The states have promulgated a uniform electronic reporting format, which is routinely updated to improve the reporting process for both states and holders. Individual states have constructed extensive "holder pages" within their respective websites, describing in detail the reporting process, delineating common reporting errors, posting frequently asked questions (along with answers), and providing on-line access to state laws and administrative rules. Furthermore, states have offered voluntary disclosure and amnesty programs to induce holders to comply. These voluntary disclosure and amnesty programs usually reduce look back periods and waive statutorily authorized penalty and interest provisions for holders who previously have neglected to self-report.

Despite these state efforts, voluntary unclaimed property reporting and participation in voluntary amnesty programs is low,[2] especially when compared to other compliance laws.[3] Consequently, states are forced to utilize other means, such as unclaimed property examinations, to ensure compliance. The goal of an examination is not only to identify past due property in the holder's possession but to ensure that the holder is compliant with the law going forward. Examinations also serve as a deterrent to non-compliance by holders. While the probability of an examination remains small, voluntary compliance by holders is increased in states that utilize audit programs.

Note that in states that have discontinued their audit programs (no matter how robust the program), the states have realized a decrease in reporting that is greater than the value of the property that was collected through examinations. In other words, voluntary compliance decreases when audits decrease. Conversely, states with audit programs have higher per capita collections, even after adjusting for audit collections. If there is a chance (however small that

[1] *See* Comment to 1995 Uniform Unclaimed Property Act § 19. "Since the Unclaimed Property Act is based on a theory of truthful self-reporting, a holder which conceals property, willfully or otherwise, cannot expect the protection of the stated limitations period."

[2] "Wisconsin estimates that less than two percent of companies incorporated in the state actually comply with Wisconsin unclaimed property reporting requirements. The compliance rate is further reduced when considering holders that are not incorporated in the state but still have a Wisconsin filing requirement." Patty Jo Sheets, "Abandoned & Unclaimed Property Alert," November 27, 2012, available at http://www.statetreasury.wisconsin.gov/news_doc_get.asp?onid=5651, last accessed April 25, 2014.

[3] Internal Revenue Service, "IRS Releases New Tax Gap Estimates; Compliance Rates Remain Statistically Unchanged from Previous Study," last updated February 6, 2014, available at http://www.irs.gov/uac/IRS-Releases-New-Tax-Gap-Estimates;-Compliance-Rates-Remain-Statistically-Unchanged-From-Previous-Study, last accessed April 25, 2014.

chance) of a company being audited, there is a greater probability that it will report voluntarily and consistently than if there is no risk of an examination. Until holders voluntarily report and remit property as lawfully required and compliance rates reach significantly improved levels, examinations will remain an essential component of the states' enforcement activities.

The states cannot satisfy their consumer protection goal of reuniting owners with their property unless the property is remitted in compliance with the law. Non-compliance not only denies missing owners the optimal means through which they might recover their funds. Non-compliance creates an uneven playing field that discriminates among holders by rewarding non-reporting holders, effectively and punishes holders that comply with the law by placing them at an unfair competitive advantage.[4] As a result, states have chosen to undertake proactive compliance and enforcement initiatives rather than allow holders to retain property to which, in accord with well-established public policy, they have no right to retain.

Contract Examiners and Public Policy Considerations

Many states lack sufficient resources and cannot conduct audits of large, complex, multi-state companies on their own. These companies have subsidiaries and related entities that are located in many different states. The records necessary to determine if any unreported property exists are often located in states other than the state conducting the examination. Due to budget constraints, many states cannot hire, train and retain auditors for unclaimed property nor can the state afford the associated costs necessary to conduct an effective and efficient unclaimed property examination.

Those states that do maintain audit programs often face resource restrictions. State staff auditors may be limited to desk audits rather than field work or limited to travel within the state. Even fewer states have the requisite number of unclaimed property auditors required to conduct more than one examination of a multi-state corporation at a time. While state auditors have experience in unclaimed property, they sometimes do not have the training or expertise to evaluate complicated, new or evolving corporate transactions that exist in the various industries that holders operate in. The records to be reviewed are voluminous and require an extensive commitment to collect, convert and analyze. Large expenditures in capital infrastructure, security and electronic data processing capabilities are necessary to handle this data.

As a result, for the states to conduct meaningful collection programs (as well as administer the reporting requirements which they are charged with to enforce), third party auditors have become a necessary component of this compliance effort. States have successfully utilized outside audit

[4] "Plaintiffs also argue that requiring them to make the report is, in itself, burdensome and unworkable, given the scanty nature of their files…As the evidence showed, other states do not relieve companies of the requirement because their records are scanty. To do so would defeat the purpose of the statute: any company with bad records could legally avoid its statutory obligation—a result which I cannot but conclude unfairly rewards the haphazard and penalizes the meticulous." *Decision and Order at 14, Employers Insurance of Wausau, et al. v. Smith*, No. 86 CV 2283, at 14 (Wis. Dane Cnty. Cir. Ct. June 17, 1986).

firms for thirty years and the states can only meet their goal of protecting consumer rights if this option remains available to them.

States use these outside firms because the contract examiners have assembled personnel with expertise in multiple disciplines, that a single state often will not have available to them. Most contract examiners have the requisite staffing levels to conduct examinations of a number of large companies at one time. Also, contract examiners allow multiple states to examine a single holder's records concurrently so that records do not have to be repeatedly produced for several single state examinations. Multi-state examinations can also remedy priority and custody issues regarding a holder's unclaimed property liabilities.[5] In some instances, holders would not agree to a resolution with only a single state; a "global settlement" is necessary. These firms are experienced, heavily invested in human capital, in training, and information systems. Contract examiners have the ability to hire subject matter experts and other professional disciplines, such as attorneys and statisticians, which are often required to perform an efficient and effective examination.

With unclaimed property, contract examiners are usually paid a percentage of the unclaimed property recovered for the state because of state budget constraints. Hourly fee arrangements involve the appropriation of a state's limited funds on an annual basis. The examinations resulting in limited or zero findings (which even with the best research are unavoidable) would require the states to pay out significantly more funds in hourly charges than they received. Small states, which do not have the funding for internal auditors, could never enforce their statute if they were required to pay on an hourly basis.

The solution to these concerns has been a percentage of recovery fees; the contract examiner is paid for its performance. The audit firm is paid based on the property returned to each state from the audit. It is important to note that the audit firm is not paid any fee whatsoever on property that is identified by the examination but is returned to the rightful owner during the course of the examination or soon thereafter. This solution removes the dependence on state budgets but allows the state to enforce compliance. Regardless of what a state pays as a contingency fee, the state pays 100 percent of the claim to the rightful owner as there is no deduction based on the fee paid to recover the property. Also, while holders may object to a contingency fee paid to private auditors, it should be noted that the holder effectively receives a far more substantial sum when unclaimed funds are retained and taken into income.[6]

[5] Consider the global settlements in the life insurance industry. To maintain consistent application, the holders and many states agreed to parameters on how the unclaimed property liability would be determined and allocated. For example, if the last known address of a beneficiary is unknown, most states have a statutory provision requiring that the last known address of the policy holder be considered the last known address of the beneficiary. Not all states, however, have adopted this provision which could result in conflict between the holder and the states.

[6] In the last year, perhaps realizing that the argument that contingent fee auditors operated under an irreconcilable conflict of interest was not legally valid, critics of contingent fee auditors have shifted focus on the

For both states and private auditors, there are additional issues with an hourly fee arrangement. States could not realistically secure funding to pay private auditors to seek out new areas of non-compliance or for the private auditors to assume the risk/reward balance of investing in human capital, IT and other resources to take on difficult issues. Additionally, holders have previously raised the concern that under hourly arrangements, the third party auditor's emphasis is now on billable hours rather than identifying property as efficiently as possible.

Some holders complain that pay for performance auditing prejudices an auditor and improperly influences the firm to inflate an unclaimed property assessment. There are safeguards that exist that make the complaint meritless.[7] State administrators select the holders to be audited, not the auditing firms. Secondly, the unclaimed property is identified on the books and records of the holder. If the property does not exist on the holder's books and records it cannot be artificially created or "identified." Even in the instances where no records exist and reasonable estimations are required, the estimations are based on mathematic principles applied to the actual books and records of the holder. Finally, the determination of a liability or amount due is not made by the audit firm. The final assessment of a liability is exclusively the province of state administrators.

Throughout the audit process, the state administrators are engaged. If a holder questions the propriety of any decision made by the auditor, the auditor does not make the final ruling on the contested issue. The matter is referred to the administrator and the state determines the outcome. In other words all contested, critical decisions regarding the identification of a liability are made by the state and not the audit firm. An administrator's final decision is usually subject to some level of administrative appeal and always subject to judicial review.

Another holder complaint alleges that states treat unclaimed property as a revenue raising tax. Unclaimed property is not a tax; however, property that remains in the state's custody until it is returned can be used for various public purposes. In addition to general fund uses, some public purposes include funding important socio-economic programs such as college scholarships[8] and schools.[9] Public policy dictates that these abandoned funds be used for the betterment of all rather than the unjust enrichment of the debtor.

A tax, unlike unclaimed property, belongs to the government. It is taken from the owner whose property it was originally in exchange for government provided services. In contrast, unclaimed

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amounts paid by states for the services of contract examiners. State unclaimed property programs have historically considered most significant what contract examiners collect, not what they are paid. And because contract examiners are paid for their performance, higher contract examiner compensation directly reflects the fact that more funds were collected by the State. It is the height of irony to suggest that contract examiners are a drain on public expenditures without giving consideration to the outcome of their efforts, or to take into account the financial costs and risks that they incur in performing their services.

[7] NAUPA has communicated its willingness to include in a new Uniform Unclaimed Property Act provisions relating to audit appeals. NAUPA is open to additional ideas to ensure the proper administration of contract examiners, provided that such ideas are not merely a subterfuge for curtailing their effectiveness.

[8] N.R.S. 120A.610.8 (2011).

[9] W.S.A. 177.23(1) (2006).

property may be used by the government but belongs to the owner. The holder has no ownership interest in any unclaimed property in its possession. Also, taxes can be calculated differently based on subjective measures such as current value, depreciation, deductions, credits, etc. Unclaimed property examinations are not a subjective exercise, as property is identified from the holder's books and records

based on the pre-existing rights of the lost owner. With taxes, parties can often have a reasonable disagreement over a tax amount based on various methods of performing a calculation compared to unclaimed property which identifies specific property interests payable to owners.

Legal Considerations and the Legitimacy of Contingency Fee Audits

It should be emphasized at the outset of this section that no court has found a contract to pay an outside auditor a percentage of the unclaimed property identified or collected as unconstitutional, illegal, invalid, or against public policy. Indeed, in the recent spate of cases that holders have filed and the auditor was compensated in such a fashion, the question was never even raised by the holders even though the holders raised other affirmative defenses.[10] If objecting to contingent fees was a colorable claim, it would have been plead and ultimately ruled upon. Courts also have consistently shown deference to state legislatures as states have the ability to determine how their ventures and initiatives are financed.

Two judicial decisions addressing the use of these arrangements in the tax area demonstrate these principles. In *Sears, Roebuck and Co. v. Parsons et al.*,[11] the county contracted with a private firm to conduct personal property tax return audits. The tax auditor was granted unrestricted discretion over the tax return review and authority to increase the valuation of the property without first obtaining the Board's approval.[12] The Court stated that the contract for auditing was void as to public policy. The Georgia legislature quickly overruled the Court and authorized the use of third party audits and compensation on a contingent fee basis.[13]

Even though the Georgia legislature overruled the Court and specifically authorized the contingent fee, there are significant differences from the application of tax as to an unclaimed property assessment. This case involved the *valuation* of property which is very subjective. For unclaimed property, the process is not a subjective valuation but rather the identification of property on the holder's books and records belonging to a lost owner. The only level of

[10] See, e.g. *Young America Corp., v. Affiliated Computer Services, Inc.*, 424 F.3d 840 (8th Cir. 2005).; *Costco Wholesale Corp. v. Costco*, Wash. Super. Ct., No. 11-2-08830-8 SEA, Aug. 1, 2012.

[11] 260 Ga. 824 (1991). The *Sears* decision is frequently referred to in the holder community as authority for the proposition that a state's compensation of private unclaimed property auditors on a contingency basis constitutes an impermissible conflict of interest. However, this analysis relies exclusively on the holding of the case without a consideration of the underlying facts and circumstances.

[12] *Id*.

[13] Ga. Code Ann. § 48-2-6(e) (2012).

discretion that comes into play is when a holder fails to maintain the necessary records and an estimate, performed in accordance with specific statutory provisions, is required. In these cases, the state of incorporation is significantly involved in the process.

In *re Appeal of Phillip Morris U.S.A.,*[14] the court upheld a similar pay for performance arrangement. The county tax assessor contracted with a third party firm to determine if taxable property was not identified or was identified but substantially undervalued. The terms of the contract were similar to the *Sears* case in that the contingent fee was 35% of discovered property including penalties. The Court believed that the legislature had authorized counties to employ third party auditors and incidental to that authority was the power to decide the basis upon which the auditors would be compensated.[15] The Court said that the legislature was familiar with contingent fee arrangements and could have banned them if it chose.

In a departure from other states, North Carolina recently instituted a partial limitation on contingent fee auditing. It is important to note that North Carolina did not entirely ban contingent fee auditing but focused primarily on private contractors making tax assessments on behalf of municipal and county governments. The legislature clearly agreed that there is nothing inherently illicit or illegal in contingent fee auditing as it expressly exempted contingent fee auditing of life insurance companies.

Note that in the tax cases discussed above, the third party auditor had the unilateral ability to select audit targets, the government did not maintain oversight of the work product or control the process and the auditor compensation was connected to the preliminary amount identified, including amounts determined by subjective valuations, by the auditor, not the final amount remitted to the state. This last scenario often incentivized the auditor to focus solely on the amount due and the state on collecting the highest amount possible in order to compensate the auditor.

These circumstances are factually distinct from unclaimed property examinations.[16] As discussed above, third party auditors cannot unilaterally conduct an unclaimed property examination. It is the state or states who mandate the examination of a particular holder. There is significantly less discretion in an unclaimed property examination then there is in a tax examination. Property tax involves issues of valuation and judgment unlike unclaimed property exams where the analysis is based on specific property interests and the holder's records. Also, unlike the tax cases cited above, if the auditor and holder cannot reach a resolution on an issue, the state is responsible for making the final determination. This prevents an auditor from making a determination solely for its own financial gain.

[14] 335 N.C. 227 (1993).
[15] *Id*. at 230-231.
[16] Note, however, that given the far greater discretion possessed by contract tax examiners, courts upholding these arrangements would in all certainty uphold a state unclaimed property program's compensation of contract auditors on a contingency fee basis.

The U.S. Chamber Institute for Legal Reform Position

The U.S. Chamber Institute for Legal Reform (hereafter, "CILR"), an affiliate of the U.S. Chamber of Commerce, recently issued a 13 page white paper entitled "Unclaimed Property Best Practices for State Administrators and the Use of Private Audit Firms."[17] While the states have become accustomed to holder advocate speaking presentations and blog posts decrying the injustices of state engagement of contract examiners, the CILR document takes the debate to a whole new level. Given the source of the publication and the associated distribution channels, NAUPA is concerned that the white paper will quickly become viewed as authoritarian and credible, notwithstanding the lack of fact checking, legal citation, and balanced perspective that went into its production. For this reason, the states believe that it is useful and important here to analyze CILR's claims and arguments (none of which are new, but are now being echoed by "the world's largest business organization representing the interests of more than 3 million businesses of all sizes, sectors, and regions"[18]).

CILR makes it clear from the get-go that contract examiners represent a serious threat to corporate America, stating in the introduction of the white paper that

> [f]or 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 contingent 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 arrangement may enable unclaimed property administrators to leverage limited resources, they raise numerous concerns requiring oversight and accountability.[19]

The states, for their part, have a different view of historical compliance. For many decades, compliance was largely an *in-state* issue. Forty years ago, interstate banking was virtually non-existent, utilities operated within state borders, and the term "multi-national corporation" had yet to be coined. Commercial activity, and the resultant unclaimed property, was less significant,

[17] The white paper, dated April 2014, was prepared by the U.S. Chamber Institute for Legal Reform by Maeve L. O'Connor, Debevoise & Plimpton LLP. Downloaded May 5, 2014 from www.instituteforlegalreform.com/resource/unclaimed-property---best-practices-for-state-administrators-and-the-use-of-private-audit-firm/. Referenced hereafter as "CILR White Paper."

[18] *See* www.uschamber.com/about-us-chamber-commerce.

[19] CILR White Paper, p.1 (emphasis added). It is unclear if the CILR wants the reader to draw an inference that contract auditors operate *outside* the boundaries of the law, but this is certainly one possible interpretation. If in fact this is the message intended by CILR, the organization should make this statement more definitively, and articulate its basis for alleging such illegality.

and it was principally local. It was also far less complex, with a handful of property types that were both readily definable and understandable. Admittedly, there were major life insurance companies for instance, with policyholders in every state. But financial industry behemoths were the exception, not the rule.

The first contract auditor engaged by multiple states was the Unclaimed Property Clearinghouse ("UPCH"), organized in 1983. UPCH was formed to address one specific compliance blind spot: large public corporations, which had shareholders in all or virtually all states, were not reporting and delivering unclaimed securities. Corporations frequently failed to report even to the states where they were headquartered or incorporated, arguing that their New York-based transfer agents should be managing such matters. However, aside from reporting to New York State (whose very able and numerous auditors virtually took up residence in their operations), transfer agents did not report to the states either, on the basis that the issuer, and not the transfer agent was the holder of any unclaimed property. The fact of the matter was that transfer agent systems (circa 1985) were not configured in a manner that enabled compliance, and there were a large number of compliance issues that had never been considered or openly discussed. But through the "Clearinghouse model," the states were successful in obtaining compliance from large segments of the securities industry. And in the process, the states realized that it was possible to achieve collectively what they had been unable to do individually.

In subsequent years, both American business and consumers changed. Holders became bigger and more centralized, acquiring smaller financial and other "local" institutions. Financial products and payment methodologies evolved. Outsourcing models became popular. "Banking," and the manner in which money changed hands, completely changed. Consumers became greater stakeholders in the economy and as it expanded, the average person held more and different kinds of financial assets. But in fact, individuals didn't necessarily do a better job of actually keeping track of what they were owed. At a time when the world was getting smaller and in theory it became easier to find people, unclaimed property mushroomed.

Along with everything else, unclaimed property became more complicated. Diversification, emerging products, and elaborate features made unclaimed property compliance more difficult for holders, who were more focused on growth than filing escheat reports. Through a combination of nonfeasance and malfeasance, non-compliance increased. In many instances, state unclaimed property programs were unaware of the non-compliance, because of the simple reason that they (and the vast majority of the American public) were unaware of the transactions giving rise to the unclaimed property. This situation resulted in the creation of new firms (many with personnel who had worked in the evolving financial sector) who made the states aware of the failure of certain industries to comply with the unclaimed property law, and in sharing their expertise allowed the state to identify specific non-complying holders. After careful consideration, the states agreed that there was in fact a compliance gap, and that there was a need

for specialized audit expertise. Additional contract examiners or "Clearinghouses" were authorized.

When the CILR comments that "[f]or 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," this suggests CILR's desire to turn back the hands of time to a period when the states were not as well networked, compliance was a purely a "local issue," and there were no contract examiners with a national reach. But the world has changed. Unclaimed property is no longer about states collecting insignificant amounts reported voluntarily by domestic banks and utilities only, with the state then making token efforts to find the owners. Levels of unclaimed property keep growing, and for many holders the amounts have become material. Some holders would like to find a pathway to keeping this property, and if the unclaimed property laws cannot be repealed or otherwise limited in scope, then the focus is shifted to avoiding detection and enforcement. States are both aware of non-compliance, and the need to address it. Having found a highly effective compliance tool in the leveraging of contract examiners, states are not about to change this formula (or otherwise return to the purportedly uncontroversial days of yesteryear), particularly given the very substantial amounts that are collected by contract examiners and returned to rightful owners.

If the CILR's view of the past is questionable, its description of the current state of unclaimed property affairs is likewise debatable. The CILR white paper makes a number of claims that are unsubstantiated. CILR alleges that the "use of private audit firms to collected purportedly unclaimed property on behalf of the state in exchange for a contingency fee…inject a private profit motive into the enforcement of state laws and thus carry a significant risk of abuse."[20] The CILR goes on to explain that one such risk is "opening the door to 'pay to play' schemes, in which lucrative [private audit firm] contracts are awarded in exchange for campaign contributions and other quid pro quos…."[21] CILR's authority for this proposition is contained in a footnote, which explains how six years ago a state governor accepted a substantial campaign contribution from a "contingency fee law firm" whose contract was being renegotiated with the state. However, CILR does not cite any examples of unclaimed property contract examiners having been found involved in influence peddling schemes. CILR does not even provide any actual figures concerning campaign contributions made by unclaimed property contract examiners in state elections.[22]

[20] *Id.*, p.3
[21] *Id*.
[22] According to *The Huffington Post,* the U.S. Chamber of Commerce in 2012 spent $136.6 million on lobbying and $35.6 million on campaign advertising. Paul Blumenthal, "These 24 Corporations Disclosed Their Contributions to the U.S. Chamber of Commerce," *The Huffington Post,* October 28, 2013, downloaded May 5, 2014 from www.huffpost.com/us/entry/4171000.

CILR further alleges that "there is a lack of transparency surrounding the [private audit firm] selection and contracting process" and that the states engage in a "shielding of contract terms." [23] The white paper goes as far as to say that "[t]he vast majority of states do not make their private auditor selection process or contracts publicly available."[24] However, these statements are incorrect. Virtually all states currently post Requests for Proposals ("RFPs") for contract examination services on-line, and a large percentage of states undertake such procurements through their centralized purchasing agencies. The contract solicitations are available to anyone with an Internet connection. Most states have a written review and scoring process for the review of bids, and these documents are available to anyone through a public records request. And while only a few states currently post the actual contracts entered into with contract examiners on-line, with very few (if any) exceptions these contracts can likewise be obtained through a public records request. State unclaimed property programs routinely receive, process, and fulfill in their entirety public record requests for contract auditor agreements.[25]

(It should be additionally noted that state procurements for contract examiners, the bid responses of prospective auditors, and the associated contracts are extensive and detailed. They specify, among many other things, under what circumstances auditors will be paid, and what they will be paid. The contract document also details how holders will be selected for audit by the contract examiner. Contrary to the suggestion of some holder advocates, state unclaimed property programs do not merely issue vague or simplistic "hunting licenses" to contract examiners. To best illustrate the comprehensive nature of the contract auditor procurement and management process, included with this position paper is a complete set of contract documents currently utilized by the State of Florida.)

The CILR analysis lacks specificity in terms of detailing the alleged abuses of contingent fee examiners and their use by state unclaimed property programs. Approximately a quarter of the report is devoted to criticism of the states, through contract examiners, performing audits of life insurance companies and utilizing the Social Security Administration Death Master File (DMF) to determine whether there are deceased insureds of which the life insurer was unaware. This is the only purported "abuse" by contract examiners that is actually discussed and, in doing so, disregards the fact that these audits have resulted in significant amounts of unclaimed property being identified and returned to its rightful owners, either directly from the insurance companies or by the states after being reported. In any event, the significant attention devoted to this one issue leads the reader to conclude that the purpose of the white paper is less about unclaimed

[23] CLR White Paper, p.3.
[24] *Id.*
[25] CILR does not provide in its white paper examples of specific States that have declined to provide contract examiner agreements for public inspection. While there may have been situations where a State has failed to act on such a request, it is misleading to suggest that the "vast majority of states" are not transparent in their procurement of private sector entities to perform unclaimed property examinations.

property contingent fee auditor then it is about states requiring the use of the DMF by life insurers to identify deceased policyholders.

According to the CILR, the DMF is "unverified and often contains inaccurate data." The Social Security Administration has testified before Congress that information contained within the DMF is 99.5 percent accurate. [26] This representation was made several years ago and enhancements have subsequently been made to the DMF, increasing its accuracy.[27] The CILR also is critical of the states (and their contract auditors) for "insisting upon 'fuzzy' matching methodology that defined similar but not identical records as 'matches'…"[28] in the examination of life insurance companies. However, CILR does not acknowledge that the fuzzy matching methodology is based on logarithms that were developed after extensive research and testing, to account for missing and transposed information in life insurer records, which is common.[29] The CILR further fails to acknowledge that the fuzzy matching methodology referred to has utilized in connection with negotiated agreements voluntarily entered into by insurance companies subject to detailed review procedures designed to ensure that any identified insureds were in fact deceased and there was an unclaimed benefit that remained unpaid. However, the most significant oversight in CILR's analysis is the failure to mention that the states' utilization of the DMF in the audit of life insurers has resulted in the identification of more than $2 billion in death benefits that would otherwise have remained unclaimed, half of which has already been paid beneficiaries.[30]

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[26] Statement of Bill Gray, Deputy Commissioner of Systems, Social Security Administration, testimony before the Permanent Subcommittee on Homeland Security and Government Affairs on Medicare Payments for Claims with Identification Numbers of Dead Doctors, July 9, 2008, downloaded May 5, 2014 from www.socialsecurity.gov/legislaton/testimony_070908.html.

[27] In most instances, a "death" that is incorrectly included within the DMF is rectified quickly when the "decedent" learns of the error through a credit bureau similar entity. Such self-correction typically occurs well in advance of the running of an abandonment period for unclaimed life insurance proceeds. The DMF is regularly updated and, as necessary, corrected. The Federal Trade Commission's NTIS currently issues a revised DMF weekly.

[28] *Id.,* p.5.

[29] The objective of the fuzzy matching is to facilitate the identification of an insured that is deceased, notwithstanding missing or inaccurate owner information contained in a life insurer's records. The overriding goal of the states' death matching rules is to confirm that an individual named in a life insurer's books and records is the same unique biological individual reflected in the DMF. The CILR alleges that the use of fuzzy matching "substantially increase[s]…the number of false matches." However, CILR provides no quantification of what constitutes "substantial" nor does it cite the facts of any particular audit or audits. The states do not agree with CILR that the death matching rules (including fuzzy matching rules) distort findings in the audits of life insurers.

[30] Undercutting the argument of holder advocates that unclaimed property compliance audits are a mere "money-grab" by "cash-strapped states," a component of the multi-state settlements entered into between life insurers and state unclaimed property programs is a requirement that the life insurers first attempt to locate beneficiaries of deceased insureds, prior to making payment of the audit findings to the states. It is estimated that through this process, life insurers have successfully found, and made payment to beneficiaries due half of the unclaimed death benefits identified as owing. It is worth nothing that where an individual owed unclaimed property is identified in the course of an audit performed by a contract examiner that is compensated by the state on a contingent fee basis, the contract examiner receives no compensation if as part of the remediation of findings process the holder successfully locates and pays the owner.

The "ah-ha" moment in the CILR's white paper comes in its discussion of recent legal developments, which CILR believes validates the proposition that state contract examiners act in a manner that is aggressive and overreaching. According to the CILR, "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."[31] CILR disregards the fact that it is the auditors that performed the DMF comparisons and provided matches to the companies for review pursuant to an agreed upon process set forth in a resolution agreement. CILR then discusses four cases (the only judicial decisions noted in the entirety of the white paper) to support its conclusion. However, none of these cases addressed, nor did they invalidate, the state or an agent of the state performing a compliance examination of a life insurer and utilizing the DMF as an audit tool to identify deceased insureds. Rather, each of the four cases dealt with the issue of whether a life insurer possesses, as a matter of common law, a duty *itself* to undertake on its own accord a review of its policies against the DMF.[32]

There is, however, one case *directly* on point, which is not mentioned in CILR's analysis. In *Chiang v. Am. Nat'l Ins. Co.*,[33] the court held that a life insurer is required to make *all* requested records available in the course of an unclaimed property examination (in this instance, an examination that was being performed by a California contract auditor). The court found that "there were no limitations" on the documents of a holder that could be duly audited by the state (or its agent), provided that there was a possibility that the information would lead to the discovery of reportable property. Additionally, the court expressly rejected the insurer's arguments that use of the DMF by the state in the examination was improper.

The proposition that the state's utilization of the DMF in examinations performed by contract auditors is legally unsupportable, as well as the CILR's other "arguments" against states compensating unclaimed property examiners on the basis of their performance, are simply further examples of holders and their advocates jumping on the contingent fee auditor pig-pile. The states fully understand that no holder desires to be audited for unclaimed property compliance. And the states additionally appreciate the fact that holders are less than fond of

[31] CILR White Paper, p.5. The states' view is that the "private audit firms" were acting as extensions of the states. These contractors were not "freelancing"; each state participating in the audit fully understood the import of DMF matching, and had both authorized and directed that it be undertaken.

[32] Of the four cases, two were brought by insureds alleging a duty on the part of the life insurer to consult the DMF. One cases was brought as a *qui tam* action and asserted the same duty. The fourth case was brought by the Treasurer of West Virginia alleging that the failure of life insurers to consult the DMF had resulted in underreporting of unclaimed death proceeds and thus constituted a failure to comply with the state's unclaimed property law. Not all states agree on the duty of a life insurer to unilaterally review the DMF, but all states do agree, and no court has ruled to the contrary, that the states and their contract examiners may identify matured policy proceeds through use of the DMF.

[33] No. 34-2013-00144517, *Minute Order* (Cal. Super. Ct. Sacramento County) Oct. 9, 2013. As with at least one of the cases cited as authority by the CILR, the ruling in this case is currently being appealed.

private-sector contract examiners, which are compensated as a function of what they collect. However, what states cannot agree with are reckless statements that pay-for-performance contracts represent an inherent conflict of interest, are contrary to public policy, and are not a legitimate means of the state seeking enforcement of the unclaimed property laws. When holders assert that contract examiners are "aggressive and overreaching," such accusations should instead be directed at the states.[34] It is the states, after all, who decide whether and when to engage contract examiners, which theories forming the basis for the states' claim to property have legitimacy, and whether new approaches to compliance should be pursued. The states "own" the decision of which holders and what property is reviewed by contract examiners. This is not to minimize the role of contract examiners; the states do indeed depend upon them to secure compliance, and the states would be placed at an absolute disadvantage of contract examiners were eliminated. Prohibiting the compensation of contract examiners on a contingency basis would be the most effective way to undercut the state's utilization of contract examiners. Thus, the states believe that the push by some in the holder community to outlaw contingency compensation is simply an effort to eliminate contract auditors altogether. And without contract auditors, compliance with state unclaimed property laws would become largely free-will and voluntary on the part of many holders.[35]

It is ironic then that NAUPA actually *concurs* with a number of "best practices" that the CILR recommends (aside from those that regulate the manner in which contract auditors are compensated, which the State view as a smokescreen for the dismantling a highly effective compliance model).
CILR calls for "transparency reforms with respect to unclaimed property contract auditors."[36] Specifically, CILR recommends that the State undertake a determination that the services of contract auditors are required , and that the State publicly communicate this determination; that procurement of contract auditors be subject to an open, competitive process; and that contracts entered into with contract examiners be available for public inspection.[37] NAUPA has no disagreement with these proposals and, as explained above, many states already follow some or all of these procedures.

[34] Although it has been noted elsewhere, it bears repeating that no court has rejected the state's utilization of private contractors that are paid a contingency basis for the collection of unclaimed property. Similarly, no court has concluded that the state's utilization of contract examiners to identify unclaimed property represents an abuse of discretion or impermissible delegation of authority. In the course of unclaimed property litigation challenging finding that were made by a contract examiners, such allegations are never plead by holders. The states believe these meritless claims are not raised because holders understand that a court would in all probability validate the states' use of contingent fee examiners.
[35] Some states, including California, Virginia, Nevada, New Jersey, and New York have very robust "in-house" audit programs, and are highly effective in performing unclaimed property examinations within their own borders. However, in engaging contract examiners, these States recognize that there holders effectively beyond their reach, or holding unreported amounts not sufficiently material for the State to initiate an audit on the other side of the country, that justify the utilization of contract examiners.
[36] *See* CILR White Paper, p.7.
[37] *Id.*

On the matter of "contract reform," CILR seeks requirements that "private auditors acting on behalf of the state to act with the highest ethical standards," "conduct all audits with the boundaries or applicable unclaimed property law," and "refrain from pursuing abusive, unreasonable or cumbersome audit procedures"; that States "at all times retain complete control" over contract audits, "not delegate to private auditors substantive decision making authority," require "private auditors….issue formal audit findings at the conclusion of an audit," and allow "any holder of unclaimed property subject to audit…[to] contact the unclaimed property administrator's staff directly on any matter."[38] As with CILR's proposed transparency reforms, NAUPA does not believe that any State would disagree with these concepts, which are largely already in place in many state unclaimed property programs.[39]

There is one "reform" called for by CILR however that States are not prepared to accept. CILR's bottom line is that "[a]ll private audit firms should be compensated pursuant to a written contract on an hourly basis or an agreed-upon fixed amount."[40] CILR believes this change 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…."[41] CILR has not, however, demonstrated that there is anything broken, nor that anything needs fixing. As such, the states should be permitted to compensate unclaimed property contract auditors in the manner that the states determine to be most efficacious. This is a decision to be made at the discretion of the agency overseeing the program, and the determination should not be challenged, in the absence of a violation of state law.

The Contribution of Contract Examiners to State Unclaimed Property Programs

Contract auditors, which are paid by the states on a performance, or contingency fee basis,[42] contribute materially to the collections of state unclaimed property programs. However, the amount of property received by the states through the collected findings of contract examiners is only one measure of benefit states and citizens realized from contract examiners.

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[38] *Id.,* p.8.

[39] Although the CILR apparently believes that abuses have been committed by contract examiners that warrant the enumerated reforms, the body of the white paper does not provide specifics as to any audit where such abuses occurred. States are in fact very concerned about allegations of improper actions of contract examiners and are quick to address them. Here, however, the suggestions of continuous and significant are merely hyperbole to help build a case for the complete and overhaul of state utilization of contract examiners, the lynchpin of which is to eliminate contractor performance as a basis for compensation.

[40] CILR White Paper, p.7.

[41] *Id.,* p.8.

[42] States that do not employ auditors have, on occasion, also engaged local CPAs on an hourly basis to audit in-state holders. The holders examined under these engagements do not typically operate in multiple states. Although "coverage" of these smaller, localized holders within a compliance program is important, states taking this approach have concluded the payment of auditing fees on an hourly basis is not cost effective.

NAUPA performed a survey of the major contract examiners engaged by the states. The results of the survey disclosed that from January 1, 2011 to current, the contract examiners collected and delivered to the states $2.8 billion in cash and securities. A review of the reports accompanying these remittances by contract examiners disclosed that for the vast bulk of the property— 80.25 percent, or more than $2.2 billion—was reported with an owner name and some form of address.

Contract examiners are required by their agreements with the states to ensure that prior to the remittance of audit findings, holders attempt to notify missing owners of property identified as unclaimed. The contract examiners estimate that during the 40 month period covered by the survey, holders performed due diligence and were able to pay owners included in preliminary audit findings a total of $1.75 billion in property. This is property that was identified by the contract examiner but was returned directly by the holder to the owner, before the audit was closed and the balance of the findings were delivered to the states. Although the contract examiners made these findings, they did not receive any compensation from the states because the property was not remitted to the States.

Property received through contract examiners is handled in the same manner as other unclaimed property collections for purposes of owner outreach. Accordingly, states have, or ultimately will, successfully locate and pay owners included in contract examiner reports of findings. Much of the property identified by contract examiners is substantially past due, and States may not necessarily experience typical return rates. However, assuming *conservatively* that states will return to owners 25 percent of the property taken in through contract examiners, $550 million of that property will be recovered by owners. Thus, between due diligence performed by holders and outreach performed by states, it is anticipated that rightful owners have recovered (or will recover) more than $2.3 billion as a result of the states' utilization of contract examiners since 2011.

Admittedly, this amount represents only a portion of the funds returned to missing owners through state unclaimed property programs. The other source of property that is ultimately returned to rightful owners by states is received through voluntary holder compliance. What are the drivers of voluntary compliance? Among the many the factors is a holder desire to avoid a state audit. As noted above, the level of concern that a holder actually has over being audited is generally directly proportional to the probability of being audited. The existence of examiners on a national basis, auditing a variety of different industries for different property types (including new and emerging payment instruments and financial transactions), increases the odds that a non-reporting holder will be identified and examined. When surveyed, the states' principal contract auditors estimate that for every three holder audits that are initiated on behalf of the

states, one holder voluntarily complies.[43] This reality is highlighted by the practice of holder advocates, who routinely obtain through public record requests schedules of holders currently under audit by state contract examiners (in some states, this information is confidential; in others it is not). Holder advocates look for an industry focus for the audits, or other patterns. The holder advocates then contact other holders in the same or similar sectors, communicating to the holders that their peers have been placed under audit by state unclaimed property programs, and that they may be next in line for an examination. This "threat" of audit[44] in turn results in many holders filing for the first time, through Voluntary Disclosure Agreements ("VDAs"") or other means.

Once a holder is audited by a contract examiner, the expectation of the states is that the holder will file reports of all unclaimed property directly with the States in the future. As previously noted, the goal of any state audit is not only to identify and collect any unreported property, but to also ensure that going forward, the holder will fully comply with the law. Contract examiners have, since 1984, audited tens of thousands of holders on behalf of the states; many of these holders had not reported unclaimed property prior to being audited. State contract examiners estimate that the value of property received by the states from holders that were previously audited by the contract examiners has reached $1 billion *annually*. This figure represents property for both holders that had not reported prior to being examined, as well as property types that were overlooked by holders prior to being examined.

Thus, in assessing the contribution that contract examiners make to state unclaimed property programs, both direct and indirect impacts must be considered. Contract examiners currently collect and deliver to the States nearly $1 billion in property each year. Their "presence" additionally results in holders electing to report directly to states (with no compensation paid to contract examiners) hundreds of millions of dollars more annually. Both holders previously audited by contract examiners and holders who came into compliance voluntarily so as to preempt an audit have been added to the reporting roles of the States and as a result, States now receive an estimated *further* $1 billion in recurring collections annually (with no additional

[43] While this calculation is somewhat anecdotal, States believe that it is a reasonable estimation. Taken at face value, and assuming that holders who self-report file as complete and as accurate reports as those compiled by state contract auditors, this would mean that the States have collectively realized an additional $900 million+ in property from voluntary holder reporting as a result of contract examiners since 2011. Obviously, contract examiners are not compensated for such State collections, but the value and importance of this indirect effect of contract examiner activity should not be overlooked.

[44] *See, e.g.,* marketing materials for KPMG's National Unclaimed Property Services, downloaded from https://www.kpmg.com/us/en/services/tax/indirect-taxes/unclaimed-property-services/ documents/ unclaimed-property-services.pdf ("State unclaimed property audits are increasing in scope and intensity. Some states and their contract auditors are using estimation techniques to develop extrapolated liabilities where "sufficient" detailed records are not available. The result is that unclaimed property assessments can have a significant financial impact on a company due to insufficient record keeping. In addition, interest and penalties are also being assessed more frequently and these amounts can be significant"). The states support all such efforts that result in increased compliance.

compensation paid to contract examiners). Within these numbers are tens of millions of dollars in property paid to hundreds of thousands of claimants, not only by states but by holders as well. The utilization of contract examiners by the states is a very powerful dynamic, and contract examiners clearly make a significant contribution to state programs.[45]

Conclusion

Unclaimed property examinations are an essential aspect of unclaimed property compliance. Any regulatory body of law expects and depends on the cooperation and voluntary compliance of those that are subject to that law; therefore, states must rely on holders to self-identify property for escheat. If a holder is reporting correctly, there is no examination finding as auditors can only identify property in the holder's records. However, examinations of holders have found this is not the case as significant property has been identified historically. If contingent fee examinations are eliminated,[46] it would be detrimental to many state unclaimed property programs and their ability to most effectively enforce the very laws that they are charged with administering. States that have discontinued their audit programs have seen a drop in holder reporting and in the value of property being reported which is harmful to the rightful owners and allows holders to retain funds which do not belong to them. Contingent fee auditors are effective at finding and rectifying non-compliance and assist states in reaching a broader base of non-complying companies, especially when state auditors do not have the resources to examine some companies due to budget or travel restrictions. As a result, private auditors are an important component in achieving the states' ultimate goal, because more property is identified and collected, and more owners are reunited with their property.

[45] The States' utilization of contract examiners also makes a significant workforce contribution. In addition to contract examiners employing hundreds of auditors and support staff, a cottage industry of "holder advocates" has emerged, consisting of legions of accountants, attorneys and consultants who now base their livelihoods as counterparties in state-initiated contract examinations.

[46] For the reasons explained *supra,* eliminating contingent fee examinations is synonymous with eliminating contract examiners.