

PUBLICATION

Spotlight on Unclaimed Property: How Delaware Turns \$19,377 of Unclaimed Medical Device Property into \$4.5 Million of Possible Revenue

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Distributors, manufacturers and sellers of pharmaceutical products and medical devices (and other Delaware-incorporated businesses having inventories) are alerted to the aggressive Delaware Division of Revenue's (Division) expanded unclaimed property audit focus on accrued, uninvoiced inventory.

According to the National Association of Unclaimed Property Administrators (NAUPA), States are holding \$32.877 billion of unclaimed funds in their treasuries. In reality, few of these unclaimed funds will ever be claimed by their rightful owners, and States are the ones that will benefit.

Despite being a preferred state of incorporation, unclaimed property is the second largest revenue source for Delaware. And, the Division is an aggressive and tough auditor of companies' unclaimed property liabilities, as manifested by penalties and interest that often equal up to 75 percent of the assessment. Because there is no statute of limitations defense for a holder that has not filed Delaware unclaimed property reports, the Division's audits routinely cover all years back to 1981 (the year Delaware enacted its unclaimed property statute), or to the year of incorporation if more recent. Delaware (as well as other States) typically retains the services of third party auditors, namely Kelmar Associates, LLC (Kelmar), to conduct audit examinations of unclaimed property holders. Kelmar and other contract auditors are often compensated on a contingent fee basis. To make matters worse, Delaware provides no predeprivation or postdeprivation process to challenge an unclaimed property assessment or sue for a refund. In many respects, Delaware unclaimed property administration is the "wild, wild East."

Unclaimed property is broadly defined. For example, Delaware defines "property" for purposes of its unclaimed property reporting statute as "personal property...of every kind or description, tangible or intangible, in the possession or under the control of a holder...." 12 Del. Code § 1198(11). Common types of unclaimed property include unclaimed dividend distributions, uncashed vendor accounts payable checks, uncashed payroll checks, uncashed workers' compensation and benefit plan payments, unredeemed gift cards, and unclaimed rebates, refunds and other accounts receivable credit balances. Delaware is now attempting to treat accrued, uninvoiced inventory as unclaimed property. A recent declaratory judgment action challenging this practice has been filed by McKesson Corporation in Delaware Chancery Court. *McKesson Corp. v. Cook*, No. 4920 (filed, Sept. 25, 2009).

McKesson is the largest distributor of pharmaceutical drugs and medical devices in the United States. It obtains title to inventory upon physical delivery of the drugs and devices from its vendors. Its vendors often provide excess quantities of complementary or sample products with no intention of submitting an invoice for the extra products. Upon delivery, McKesson records all of the products in a "goods received/invoice received" (GR/IR) general ledger account. After matching the inventory with an invoice, McKesson debits the GR/IR account and credits the accounts payable account. When the invoice is paid, the accounts payable account is debited and the cash and discounts received account is credited. McKesson, like many sellers and distributors, also obtains volume discounts, rebates and early payment discounts. Thus, the actual amount that McKesson pays its vendors is commonly not the invoiced amount. It is also not possible to determine from a purchase order or an entry in the GR/IR account the value of the excess "inventory" received complements of a vendor.

Because this extra and discounted inventory cannot be matched to an invoice, Delaware views it as unclaimed property.

Like most companies, McKesson had accounting records for only five years of the nine-year audit period: from 1994, the year McKesson was incorporated in Delaware, to 2002. Since complete records did not exist, Kelmar estimated an amount of unclaimed property owed Delaware. Kelmar selected a sample of entries from the GR/IR account for the period of July 1, 2002 to June 30, 2003, and identified \$2.9 million of uninvoiced transactions. McKesson corresponded with the 116 vendors of these transactions. One hundred vendors responded that they were not owed anything. Four vendors stated McKesson owed them a total of \$19,337; an additional four were unable to confirm whether they were owed a total of \$24,590; and eight failed to respond regarding the remaining \$11,931. None of the vendors were located in Delaware.

The Kelmar auditor then proceeded to calculate an "error rate" for purposes of estimation (the amount owed the four vendors, plus the amounts attributable to the other 12 vendors, over McKesson's 2002 revenues). This "error rate" was used to extrapolate an unclaimed property liability to the prior years by multiplying McKesson's revenues for each year by the error rate. Property must be abandoned for a prescribed period of time (the "dormancy period") before it is unclaimed property. Delaware treated the inventory as five-year property and extrapolated back to 1989, since any such property held by McKesson in 1989 would have been reportable if unclaimed property in 1994. As a result, McKesson was assessed more than \$4.5 million, not including penalties and interest. By the way, Kelmar's audit lasted six years.

In its declaratory judgment action, McKesson is challenging the estimation method and the treatment of accrued, uninvoiced inventory as unclaimed property on federal Due Process Clause and Takings Clause grounds, federal preemption under the Federal Food and Drug Act, 21 U.S.C. § 1, et seq., and state constitution grounds.

Although egregious, McKesson's experience is unfortunately common with respect to state unclaimed property audits in general, and Delaware in particular. Similar audits are ongoing with other companies.

Because of financial statement auditor independence issues, certain accounting firms have jettisoned much of their unclaimed property practices since the Sarbanes-Oxley Act was enacted. Thus, third party auditors like Kelmar have been born from this exodus of talented professionals who previously served Fortune 500 companies. In addition to Delaware, other States have become increasingly aggressive with unclaimed property audits and regularly retain the services of third party auditors.

If you are concerned about unclaimed property compliance and would like to discuss options and alternatives, please contact any attorney in our Tax Department.