
The Future of Unclaimed Property: A Glance into the Crystal Ball

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Introduction

While there have been several landmark decisions in the area of unclaimed property over the decades, there has probably never been a period of time riddled with as much uncertainty about the future of unclaimed property, than right now. This uncertainty is caused in large part by the *Temple-Inland*¹ decision issued by the United States District Court (“District Court”) in June 2016, as well as the anticipation of other pending court decisions raising similar statutory and constitutional challenges.² As a result of these cases, many corporate finance, tax and treasury officers have been waiting, with baited breath, for the outcome of these cases, which they hope would provide guidance on the right of Delaware and other states to aggressively audit and demand unclaimed property purely as a source of revenue.

The issues to be decided in these cases have the profound ability to significantly impact, change or alter the course of unclaimed property compliance, audits and VDAs from what we have experienced in the past and what we experienced up until June 2016, with the issuance of the District Court’s decision in *Temple-Inland*. Specifically, these cases have challenged among other issues, Delaware’s ability to (i) audit back up to 30 years; (ii) retroactively estimate an unclaimed property liability; and (iii) demand property with addresses in foreign countries. In addition to these arguments, the cases also allege several constitution violations including but not limited to: Due Process; the Takings Clause; and the Ex Post Facto Laws.

Growing Frustration by Corporate America

The noted increase in unclaimed property litigation within the past five years is clearly symptomatic of companies’ rapidly diminishing tolerance for the over-reaching and aggressive audit tactics of states like Delaware and their 3rd party contingent-fee auditors. States, to a large extent, use unclaimed property as a means of plugging budget gaps and increasing revenues without having to raise taxes. Compounding matters is the fact that unclaimed property audits not only have resulted in multi-million dollar assessments, but require extensive resources to gather financial information that can extend back 10-20

¹ *Temple-Inland, Inc., v. Thomas Cook et al.* Civ. No. 14-654-GMS, (D.Del. June 28, 2016).

² See for example *Office Depot, Inc. et al v. Cook et al.* Filed as 1:2016cv00609 (D. Del. July 18, 2016); *Plains All American Pipeline, L.P. v. Thomas Cook et al.* Filed as 1:15-cv00468 (D. Del. June 5, 2015), *Marathon Petroleum Corporation et al. v. Thomas Cook, et al.* Filed at 1:16cv00080 (D.Del February 121, 2016) and *Osram Sylvania, Inc. v. Thomas Cook et al.* Filed as 1:14cv01475 (D.Del. December 11, 2014).

years and most unclaimed property audits: (i) tend to last between three to five years, (ii) are conducted on behalf of multiple states; and (iii) are highly intrusive, impacting virtually all functional areas within an organization tend to last between three to five years;

1. are conducted on behalf of multiple states; and
2. are highly intrusive, impacting virtually all functional areas within an organization.³

States and these third-party auditors have historically applied estimation techniques that can transform relatively minor amounts of liability into multi-million dollar assessments with limited to no administrative remedies.⁴ Even sophisticated companies with a long pattern of complying with the multi-state unclaimed property provisions have chosen to settle audits, rather than face the time and expense of years of prolonged and protracted litigation.

Much like William Holden's lead character in the movie *Network*, several corporate officers and their representatives have raised their voices, their ire and frustrations at Delaware's aggressive audit practices over the years and are simply 'sick and tired' of the status quo, no longer willing to sit back and accept these practices. Consequently, after years of scratching their heads over the unorthodox unclaimed property collection practices employed by the State and its contingent-fee auditors, a number of corporations have stepped forward challenging in Federal court what they consider to be an unconstitutional "taking" of property. Among the legal claims asserted by the Corporate holders⁵ is that the State, through its auditors, have grossly disregarded the basic tenets of the consumer oriented foundation of the unclaimed property laws, which is to protect the rights of the owner and reunite owners with their lost property rather than serve as a scheme to enrich the coffers of the states.⁶

Temple-Inland: The First of Many

In June 2016, the first of these long awaited decisions was issued in *Temple-Inland*, which pronounced sharp criticisms of both the breadth and scope of Delaware's audit practices as well as its estimation methodology. The District Court found Delaware's audit practices to be in violation of the Due Process Clause of the United States Constitution; however, despite the tone and tenor of the decision, the unclaimed property world remains perplexed as to exactly what options and/or corrections will occur to curb the overreaching of the State and to remedy the constitutional violation for companies currently under audit or participating in a voluntary disclosure agreement (VDA).

Battleground for Unclaimed Property

It is ironic that the State of Delaware ("Delaware" or "State"), the first state to ratify the Declaration of Independence, is also the first state to have its unclaimed property audit practices struck down by the District Court as being unconstitutional. As the legal home to over 800,000 corporations⁷, Delaware has without question become the most aggressive state in its pursuit of unclaimed property collections in large part due to its expansive interpretation of three United States Supreme Court decisions that date back over fifty years.⁸

³ These areas include all disbursement functions e.g. treasury, tax, vendor payments, third party payments and payroll; all revenue functions including accounts receivables, customer credit, gift cards and securities including shareholder services and third party transfer agents.

⁴ In among the more egregious examples, Delaware is asserting over a \$2 million assessment based on one item of unclaimed property for \$147 that both the holder, Temple-Inland and Delaware agree is deemed due to the State.

⁵ The term "holder" is generally understood as the entity deemed to be in possession, custody or control of the unclaimed property.

⁶ Each of the 50 states and the District of Columbia has unclaimed property laws under which the states hold property that is unclaimed by the owners as custodians until the owners claim the property. The state statutes are custodial in nature; the states do not take title to the property, but instead hold the property as custodians and use it for the benefit of the general public, until and only if, the true owner claims it. (1981 and 1995 Uniform Unclaimed Property Provisions of which a number of states that have adopted some or major portions of the law.

⁷ More than half of U.S. publicly-traded companies and fully 64 percent of the Fortune 500 were among that number, according to the state's Division of Corporations. In 2012, more than 90 percent of IPOs were from Delaware legal entities. <http://technical.ly/delaware/2014/09/23/why-delaware-incorporation/>

⁸ *Texas v. New Jersey* 379 U.S. 674 (1965); *Pennsylvania v. New York* 407 U.S. 206 (1972); *Delaware v. New York*, 507 U.S. 490, 500 (1993).

Under this trilogy of cases, the Supreme Court has held and affirmed that when it comes to determining which state has jurisdiction over unclaimed property; the first priority goes to the state of the property owner's last known address (first priority claim). If the property owner's address is unknown, or if the state has no unclaimed property law on its books (as was the case over 35 years ago in 1965), then the state of incorporation of the holder⁹ has a second priority claim over the unclaimed property.¹⁰

Delaware and its auditors have liberally applied these decisions to collect (or as some would argue, "extort") hundreds of millions in assessments from corporations based on the application of this second priority right. Specifically, Delaware and its agents assert that if a corporation fails to maintain explicit records going back 20-30 years, the State is not only entitled to estimate the amount of liability for the years without records, but most importantly, the state has the right to use the amounts deemed to be unclaimed for **all** states, not just Delaware, to quantify, assess and demand payment. Thus, the State has used items with valid addresses to estimate amounts owed to Delaware (as state of incorporation) for periods when no records exist. Since Delaware is the state of incorporation for the overwhelming majority of America's largest corporations, it is entitled to the estimated amounts for the years where records are not available.¹¹ For these and other aggressive audit practices, Delaware has continually received a failing grade of "F" from the Council on State Taxation (COST), a non-profit trade group that evaluates the unclaimed property practices of all 50 states.¹²

In *Temple-Inland*, the corporate holder's Prayer for Relief from the alleged statutory and constitutional violations was partially granted in the District Court's decision rendered by Judge Sleet. In his decision, Judge Sleet opined that the State's audit practices were so egregious that the State was "**engaged in a game of 'gotcha' that shocks the conscience**". *Id.* at 33. That said, the court granted Temple-Inland's motion for summary judgement on its claim that the State, together with its auditors, denied the Company of its fundamental liberties to "substantive due process" that are granted under the US Constitution. Specifically, the court cited the following reasons for ruling in favor of Temple-Inland on the issue of due process:

- (i) The State waited 22 years to audit the company;
- (ii) The State avoided its otherwise applicable six-year statute of limitations;
- (iii) The State failed to give guidance to the holder of what records were required to be retained to defend against "*unmeritorious*" audits;
- (iv) The State improperly applied legislation enacted in 2010 retroactively for no obvious reason other than to raise revenue;
- (v) The State failed to follow fundamental principles of estimation in arriving at the amount of unclaimed property deemed owed to Delaware; and
- (vi) The State applied an estimation methodology that placed Temple-Inland at risk of paying multiple liabilities to Delaware and other states.

Despite these findings, Judge Sleet failed to issue a final order setting forth the remedy to be provided by Delaware for violating Temple-Inland's constitutional right to due process.

⁹ The "holder" is generally defined as the entity in possession of the unclaimed property.

¹⁰ *Texas v. New Jersey, New York v. Delaware and Pennsylvania v. New York.*

¹¹ Delaware's aggressive unclaimed property provisions has created quite a conundrum given that it promotes itself as being among the most business friendly states in the country, yet consistently over 1/3 rd of its budget is derived from unclaimed property collections with a history of returning little if any property to the rightful owners. Delaware has asserted that despite a statute of limitations provision having been enacted in 2010 that it is entitled to estimate a holder's liability going back 15-20 years because the statutory provision was merely codification of the State's long standing existing practice.

¹² COST is a nonprofit trade association consisting of over 600 multistate corporations engaged in interstate and international business. Over years, in its survey, "Best and Worst Unclaimed Property Laws – Scorecard on State Unclaimed Property Laws: The Holder Perspective" Jana S. Leslie, Jan., 2009, Delaware has consistently been issued the grade of "F". The survey notes that, "while some states receive top grades in the COST study, . . . states like Delaware that have lost sight of the purpose for unclaimed property laws receive low—or failing—grades".

In an unprecedented conclusion, the judge deferred its decision of a remedy and stated that Delaware is "... best able to know which remedy will be the most palatable in its anticipated efforts to normalize the enforcement of its unclaimed property laws." *Id.* at 33. As a result, there is a heightened state of uncertainty as legal scholars and unclaimed property practitioners theorize on what happens next.

Delaware's Legal Options

Given the nature of this opinion, which is devoid of a final order on the issue of the State's constitutional violation of due process, there is widespread speculation regarding Delaware's next move in the absence of an appealable order. What will Delaware do next? Would any of the State's options affect unclaimed property audits and VDA processes in the immediate future and prospectively? Given this uncharted space, it is believed that Delaware's options are as follows:

1. Provide an acceptable remedy to Judge Sleet, which cures the constitutional defects identified in its audit practices. The remedy would then likely serve as the audit "standard" for current and prospective audits and VDAs.
2. Seek a re-determination of Judge Sleet's decision arguing that the Judge's decision was faulty (believed to be unlikely)
3. File an interlocutory appeal of the court's current findings; (restrictive conditions may not be met in this case) or
4. Appeal an ultimate final order, which finds that the State has either failed to provide a remedy as required by the District Court; or failed to provide a remedy that cures the constitutional defects of its audit practices.¹³

Other Court Cases

As in *Temple-Inland*, it is important to note that while the majority of the court cases have been brought by Corporate America, the states are certainly not to be outdone. Specifically, Delaware initiated a Qui Tam whistleblower action, against several retailers in the area of gift cards; and other states have filed legal action against life insurance companies over who has an obligation to search the Death Master Index as well as rebate processors over uncashed rebate checks. However, even as the states and companies are flexing their legal muscles, we also see litigation among states. Specifically, in 2016 Pennsylvania sued Delaware and as a result, over 23 other states have filed similar suits against Delaware on the issue of which state has jurisdiction over "official checks".¹⁴

Whistle Blowers Law Suit: Challenging Gift Card Activities

In this closely watched case that was originally brought by a whistleblower in 2014, Delaware moved to intervene and is asserting that 20+ major retailers "schemed" to deprive the State of hundreds of millions in revenues and "conspired" with third parties to hide the revenue from Delaware. If successful, the State stands to gain hundreds of millions in unclaimed property from unredeemed gift cards in addition to the ability to impose treble damages, plus interest and penalties, from the retailers.¹⁵

In this case, the State alleged that the Delaware-incorporated retailers "transferred" the obligations owed to the owners of gift cards (the unredeemed balances) to a third party provider ("Card Compliant") that is incorporated in a state which does not provide for the escheat of unredeemed gift cards. The issue asserted by Delaware is that while these major retailers purportedly transferred hundreds of millions of gift card obligations to the third party, no actual cash exchanged hands except for a net fee paid for the "services" provided by Card Compliant. Moreover, the State alleged that despite the appearance of the transfer of the liability to Card Compliant, all of the issued cards remained on the books

¹³ For more information on both Delaware and Holder options to *Temple-Inland* see Duff & Phelps website and blog at <http://www.duffandphelps.com/insights/publications/unclaimed-property/>.

¹⁴ The number of states that have joined in the suit as of the date of this publication, more are expected to sign on.

¹⁵ See *The State of Delaware, William Sean French, relator v. Card Compliant LLC, et al.* 20+ named retailers in a whistleblower, "Qui Tam" Motion Filed as: Case No. N13C-06-289 FSS (March 26, 2014). It should be noted that when it comes to "reuniting unredeemed gift cards with card owners, Delaware has a particularly poor record of having not one documented occasion of reuniting unclaimed property gift card collections with its rightful owner.

and records of the retailers thus giving Delaware, the state of incorporation of the retailers, not the state of incorporation of the third party, jurisdiction over these unredeemed balances. The State further alleged that the structure created to purportedly transfer the unredeemed balances to the third party, lacked economic substance.

Life Insurance: Death Master Index (States vs. Companies and Companies vs. States)

The life insurance industry was tarred and feathered in ugly, highly publicized audits, which resulted in significant findings and ultimately large settlements, pitting the states against the insurance companies. The insurers were challenged for following the long standing statutory provisions directing insurance carriers to be presented with proof of death in order to trigger the dormancy period for life insurance proceeds. In these audits, states have asserted that the insurers have a duty to proactively search the Death Master Index to determine whether or not an insured is deceased, which clearly contradicts the unclaimed property provisions that proof of death is required to commence the running of the dormancy period.¹⁶ Suits were filed by West Virginia against 69 life insurance companies. Insurers have likewise filed suits against the states.¹⁷

Which State has Jurisdiction: Official Checks?

The Commonwealth of Pennsylvania filed suit against Delaware and the MoneyGram Payment Systems, Inc (“MoneyGram”) over the issue of whether Delaware, MoneyGram’s state of incorporation or Pennsylvania, the state where the official checks were purchased from MoneyGram, is entitled to the funds associated with the uncashed official checks. During an audit of MoneyGram by Delaware, the State demanded the funds under the second priority rule and MoneyGram paid. During an audit by Pennsylvania, MoneyGram was told that Pennsylvania is entitled to these funds based on an exception of the priority rules which requires money orders to be remitted to the state of purchase. Pennsylvania has argued that these official checks fall within the money order section of its statute and as a result Pennsylvania, not Delaware is entitled to these funds. Since Pennsylvania’s lawsuit, several other states (such as Texas and Colorado) have also sued Delaware alleging that they too are entitled to the checks that were purchased in their respective states. Delaware has challenged Pennsylvania’s suit, which was brought in federal district court for lack of subject matter jurisdiction. It is Delaware’s position that given the issues in this case, it can only be brought to the United States Supreme Court.

Rebates

In another highly publicized recent case, several major retailers agreed to enter into multi-million dollar settlements with a series of states over uncashed consumer rebates issued through third party providers.¹⁸

Based on the above case summaries, litigation is alive and well in the area of unclaimed property with an additional case filed against Delaware since the Temple-Inland decision. Holders continue to demand that their voices be heard against the perceived injustices of the states and their third party auditors.¹⁹

¹⁶ See <http://www.duffandphelps.com/insights/publications/unclaimed-property/unclaimed-property-and-the-death-index-scrutiny-shifts-from-life-insurance-to-financial-services>

¹⁷ See *Thrivent Financial for Lutheran v. Florida Dep’t of Financial Services*, No. 1D13-5299 (Fla. Ct. App).

¹⁸ See *Fitzgerald v. Young America Corp.*, Civil Action No. CV 6030, Iowa District Court, Polk County initiated in 2009. Subsequent settlement agreements were reached against T-Mobile USA and Walgreen for an undisclosed amount and a multi-state 22 million settlement against Sprint in 2010. In March, 2016 II brought suit against Sprint in a similar action alleging \$2.6 million. See. <http://www.chicagotribune.com/business/ct-sprint-rebate-lawsuit-0309-biz-20160308-story.html>

¹⁹ See *Office Depot, Inc; and North American Card and Coupon Services, LLC v. Thomas Cook*.

What Does the Future Hold?

For Corporations Under Audits or Under VDAs

As of the date of this publication, there are over 800 companies that are under audit and/or have entered into voluntary disclosure agreements (VDAs) with the State, which remain open. In addition, there are an equal number of multi- and single-state audits and VDAs being pursued in other jurisdictions.

What should these companies do in light of *Temple-Inland*? There is no holy grail or universal path to follow as to what the next step is or should be for companies that are: (1) currently under audit; (2) in the midst of a VDA; (3) may have settled in the past with one or more states; and (4) still may not be entirely compliant with the 50 states' (plus US territories) rules for the reporting unclaimed property. However, as a result of the recent *Temple-Inland* decision, and several more legal challenges in the pipeline, the pendulum definitely seems to have shifted in Corporate America's favor.

In large part, a businesses' reaction to the recent decision depends to a large degree on their specific facts and circumstances. While favorable, it is important to note that *Temple-Inland* has excellent facts as evidenced by a long history of reporting various types of unclaimed property not only to Delaware, but to multiple states throughout the years. *Temple-Inland* was also able to demonstrate that it had existing books and records supporting past practices and was able to evidence (but for a few periods) its compliance with state reporting guidelines. The Company was also able to show that it was previously audited by a competing state (Texas) that also used estimation techniques for some of the years under audit by Delaware. The District Court found that Delaware's use of estimation for the same years previously assessed and demanded by Texas resulted in "multiple liability" requiring *Temple-Inland* to pay the same property to two different states in violation of *Texas v. New Jersey*. It is fair to note that most companies that are currently under audit or are in the midst of one or more voluntary disclosure agreements, do not have fact patterns, quite as favorable as those revealed in *Temple-Inland*.

To the hundreds of businesses that are in the midst of either audits or VDAs the following suggestions are provided:

1. Take stock of your facts and circumstance. Does your organization have a long history of reporting all types of potentially reportable unclaimed property beyond sporadic reports of uncashed payroll checks? Areas of particular concern include un-used customer credits or deposits, unredeemed gift cards, unused customer rebates; self-insured plans; and or third party administered payments.

2. Take stock of how close or far away your organization may be to closing an audit or VDA. Do not follow or agree unadvisably on the traditional methodologies and practices for closing audits and VDAs as it is more likely than not that, either based on *Temple-Inland* or some future decision, that Delaware's (and other states) ability to estimate prior years liabilities back 30 years will be a thing of the past. However, it is possible and likely probably that estimation will still be utilized as a means of quantifying a company's exposure for years where records are no longer available, but instead of 30 years for audits and 20 years for VDAs, we anticipate much shorter reach back periods especially for companies with a history of filing in the State.²⁰

3. Take stock of your internal and external resources. While it is tempting to do a "happy dance" that Delaware's unfair practices have finally been admonished by the Court, it is still quite possible that the end may not yet be in sight. As set forth above, an appeal process, or

²⁰Based on Delaware's five year dormancy period, it is likely that the actual "look back" will likely be a maximum of 11 years, 6 years under the state's statute of limitations that was enacted for reports filed in 2003 or later, plus the 5 year dormancy period. It should be noted that this conclusion is based on the premise that a corporation has a history of reporting in the state, but based on the *Temple-Inland* District court the judge implied in his decision that even corporations that did not file with the state in the past because it may not have had any amounts to report could not be held open to audit indefinitely since Delaware's own statutes do not require the filing of a negative report and prior to 2003 there were no statute of limitation provisions on the books.

negotiation of a remedy could take several months or even years to resolve depending of the course of action chosen by Delaware and should the ultimate outcome be unfavorable or even different than anticipated, businesses will need to consider the following:

- Will systems still be in place to recover the required information?
- Will personnel familiar with the process and past history still be in place?
- Will personnel and financial resources still be available to pick up the pieces at a later point in time; and equally important?
- Will the Company be able to negotiate a more favorable settlement once a final resolution is reached in *Temple-Inland* including the very distinct possibility of the imposition of interest?

At the present time, given the perceived set back to Delaware based on the Judge's determination in *Temple-Inland*, together with several other pending cases raising similar challenges to Delaware's audit practices, the tide may have turned in favor of reaching more favorable settlements in both audits and VDAs. Thus, while it may seem that the more prudent course of action may be to simply adopt a "wait and see" attitude, deferring all future actions, even refusing to provide requested information to complete audits or VDAs, until a clear and definitive order has been issued by the District Court. This course of action, however, could very well prove to be detrimental to companies. We advise companies to continue the review and the remediation phases of both audits and VDAs, but defer the State's use of the findings until the end of the audit or VDA and hopefully a final order in *Temple-Inland* or one of the other pending complaints that have been filed against Delaware's egregious audit practices.

4. Take Note of Developments and Remain Flexible. Unlike the landscape for the past 10-15 years developments are happening in rapid succession. Much like the game of "whack-a-mole", it is highly unlikely that Delaware or other states will waive the white flag in surrender. They and other states will be on the hunt to replace lost revenues. Expect increased audit efforts in a multitude of directions, including specialized industries such as royalty payments for those in the energy and media industries, increased focus on the proliferation of gift card, royalty and loyalty programs and increased pressure on multi-state audits excluding Delaware, which in years past were not a high priority.

Conclusion

While it is clear that after years of frustrating, cantankerous disputes between corporate America and unclaimed property auditors, the pendulum for the first time in a long time seems to be swinging towards a more equitable system of checks and balances. However, the last act has not been written as to how these corporate challenges will play out in the courts. As such, companies still need to be vigilant and ensure that not only past practices (and/or deficiencies) are addressed, but also have solid policies and practices in place to minimize any future exposure to unforeseen unclaimed property obligations.

For more information and assistance on how to address your organization's unclaimed property matters, please visit <http://www.duffandphelps.com/services/tax/unclaimed-property-and-tax-use-advisory> or contact **Robert Peters, Managing Director, at robert.peters@duffandphelps.com** or **Sonia Walwyn, Director, at sonia.walwyn@duffandphelps.com**

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