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UNCLAIMED PROPERTY

Unclaimed Property Year in Review: A Tale of Two Cities

The future of unclaimed property for corporate America looks far brighter in 2018 than in years past.

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The 2017 unclaimed property year in review could very easily be characterized by the words of Charles Dickens from his famous novel *A Tale of Two Cities*, "It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity . . . ." While it is quite doubtful that Dickens had unclaimed property developments on his mind while authoring this novel, his words are jarringly apropos in characterizing the unclaimed property events of last year, especially in relation to events in the state of Delaware.

Developments in Delaware

The year began with a heightened sense of uncertainty over what would happen next in the continuing saga of Delaware and its seemingly battered unclaimed property audit program and use of estimations, after a bruising opinion by the U.S. District Court for the District of Delaware in the now landmark *Temple-Inland, Inc. v. Cook*[1] decision.

By way of background, on June 28, 2016, the District Court found that Delaware's unclaimed property audit practices violated Temple-Inland's right to constitutional due process. In addition, the court found that the state's estimation practices were so egregious that Delaware was found to be engaged "in a game of

'gotcha' that shocks the conscience."[2] However, despite these adverse findings, the judge's decision stopped short of establishing a remedy for the state to correct these constitutional violations and, instead, directed Delaware to propose what, in the state's opinion, would be an adequate remedy.

"It was the best of times" for corporate America, including those companies subject to Delaware audits as well as those participating in Delaware Voluntary Disclosure Agreements ("VDAs"), who for years have questioned and bemoaned the aggressive audit and review practices of the state and its third-party auditors. This decision, at long last, echoed the sentiments of the vast majority of companies and their advocates and delivered the rebuke that was believed to be both long overdue and warranted.

Correspondingly, it was seemingly "the worst of times" for Delaware and its third-party auditors as unclaimed property was (and continues to be) a significant source of revenue, not only to the state's coffers—representing approximately one third of the state's revenues—but was also quite lucrative to its third-party contingent fee auditors. Thus, the *Temple-Inland* decision appeared to have dealt a deadly blow to the existing audit practices and, in particular, the state's use of estimation was thought to be in mortal jeopardy.

However, the exuberance ignited by the *Temple-Inland* decision was short-lived and quickly diminished as Delaware beat a path to Temple-Inland's door agreeing to: (i) settle the audit for zero dollars; and (ii) pay all of the company's legal fees and associated costs. By accepting the terms of the settlement, Temple-Inland agreed to withdraw its complaint, thus putting an end to the litigation and keeping the door open for Delaware to strategically plan its next move.

2017 began with an air of stagnation over Delaware and its audit practices. Third-party audit firms were eerily silent, not scheduling calls or following up on audits matters and issues, thus relegating all audits to an informal holding pattern. Then, on January 12, 2017, in what appears to be have been "the age of wisdom" for the state, Senate Bill 13 ("SB 13") was introduced in the Delaware Legislature.

SB 13 was primarily intended to remedy the constitutional violations identified by the District Court in *Temple-Inland* in order to fortify the state's defense of its audit program in future challenges or lawsuits. To this end, SB 13 nullified the existing unclaimed property law in its entirety and became the state's new Unclaimed Property Act. SB 13 moved with lightning speed through the Legislature and was signed into law less than a month after its introduction, on February 2, 2017.

However, while SB 13 addressed some important issues identified by the court, by including a record retention provision and reducing the audit scope from 30-plus years to 15 years (10 report years plus

Delaware's five-year dormancy period), the bill was silent on the seminal issue for which the state was chastised by the District Court—Delaware's estimation methodology used in extrapolations. For many observers, failing to address this critical issue in SB 13 represented "the age of foolishness," as it is believed that Delaware left the litigation door wide open for additional legal challenges to its audit program.

Despite SB 13's failure to address the estimation issues for which Delaware was severely chastised in *Temple-Inland*, corporate America, including companies under audit as well as those participating in Delaware VDAs, held its collective breath hoping that, just maybe, the state would address these issue through the regulations mandated by SB 13. Specifically, Section 1176(b) of SB 13 required the Secretary of Finance, in consultation with the Secretary of State, to promulgate regulations intended to promote consistency in the audit standards used for both audits and VDAs. "It was the epoch of belief" and hope by companies that, having failed to address this issue in SB 13, Delaware would provide the relief desired, in keeping with the judge's opinion in *Temple-Inland*, through the regulations.

On October 2, 2017, the state adopted Regulation 104, Department of Finance Abandoned or Unclaimed Property Reporting and Examination Manual (the "Regulations"), and issued it in final form with an effective date of October 11, 2017. Sadly, there were no meaningful changes to the existing estimation methodology severely criticized in *Temple-Inland.* "It was the epoch of incredulity" as continued legal challenges to Delaware's audit methodology are expected to mount in the near and immediate future.

However, while the Regulations did not provide the guidance hoped for with respect to estimations, they did clarify and offer some much-needed uniformity pertaining to other areas of the state's enforcement of its unclaimed property law, including the following:

Stored value cards/gift cards: Guidance is provided on the calculations of the maximum cost deduction for stored value or gift cards using a company's Federal 1120s.

Owner's address (to establish priority): An address is deemed to be sufficient to identify the state, which has the jurisdictional right to the property, if the address on the company's books has two of the following three criteria: (i) a city; (ii) a state; and/or (iii) a postal code.

Examination of holders: The State Escheator has the express authority to resolve an examination via negotiation and settlement with the company under audit or VDA ("Holder").

Auditor solicitation: An auditor of the state shall not inform other states or jurisdictions that Delaware has authorized an examination of a Holder in order to solicit such states or jurisdictions to join the audit or conduct an audit of the Holder.

Historical filings of the holder: If requested by the Holder, the state shall provide the Holder with all records of prior unclaimed property reports filed with the state.

Abatement of interest and penalties for "good cause": In certain circumstances, interest and penalties may be abated for "good cause" at the discretion of the State Escheator. In determining good cause, the State Escheator may consider: (i) whether the Holder has a significant history of filing unclaimed property reports, (ii) the responsiveness of the Holder during the examination, and (iii) whether the Holder used ordinary business care in its compliance efforts.[3]

Adding new entities to an audit: Once an entity scoping has been determined by the state, no additional entities may be included in the examination without the Holder's consent. Also, at the election of the Holder and with the consent of the state, legal entities acquired after the conclusion of the entity scoping may be added to the existing examination.

Record retention: Holders who file reports are required to retain records 10 years after the date the report is filed.

Estimations: Funds returned in the normal course of business will *not* be included in the population of potential unclaimed items. Checks that remain outstanding less than 90 days will be excluded from the population. Checks voided within 30 days shall be excluded from the population (unless the State Escheator, in his/her sole discretion, determines that a redefined outstanding period is warranted). "To the extent permitted by law" names and addresses identified in the base period shall not be used to determine which state has the priority claim to the abandoned property estimated to be due over periods where records of owners' addresses do not exist. All sampling, projection and estimation techniques used by the auditor to determine unclaimed property due to the state shall be in a method approved by the state prior to use. Finally, the state may permit the Holder to comment on or suggest an alternative technique; however, the ultimate decision to employ a particular technique is at the sole discretion of the state. The Holder may challenge this decision at the close of the examination.

In addition to the clarifications listed above, the Regulations also provided companies that were currently under Delaware audits three options to conclude their audits. Companies had until December 11, 2017 (60

days from the effective date of the Regulations) to elect one of the following three options that would significantly impact the conclusion of each audit:

1. convert the current audit to a VDA administered by the Secretary of State and interest and penalties will be waived;
2. enter into an expedited audit and interest and penalties will be waived if the audit is completed within two years; however, if after the expiration of the two-year period the audit is not completed, interest and penalties will be assessed; or, by default,
3. continue the existing audit and be subject to all statutorily mandated interest and penalties.

Each of the three options provided had varied consequences for each company under audit, as the facts, circumstances and audit experiences differed by company. Specifically, for companies that faced aggressive audit scrutiny from third-party auditors, the notion of entering the Secretary of State's VDA program, where the company gets to perform a self-review and present its facts and circumstances before the Secretary of State, was appealing. For other companies that were close to a final resolution with the auditors over one or all of the property types under audit, the expedited audit proved to be the more efficient and cost-effective option to conclude those audits. For others, the means of protecting their right to litigate issues such as the state's estimation practices was deemed to be best preserved through the expedited audit option.

"The Tale of Two Cities" in Delaware has existed over the years and continued to be evident through the December 11, 2017, deadline for companies under audit to select one of the three options to conclude their audits. The dynamic, which existed between the Department of Finance and the Secretary of State, began with the passage of SB 258 on July 11, 2012, when the state, in response to a Holder outcry, provided Holders with the option of participating in VDAs that were administered by the Secretary of State.

Historically, the Department of Finance was responsible for both audits and VDAs. However, due to the increasingly aggressive nature of the Department of Finance, its increasing practice of converting VDAs to audit, its failure to close VDAs on a timely basis, as well as verbal complaints from the Holder community, the state provided the option for VDAs to also be administered by the Secretary of State. As a result, the majority of companies, if not all, participating in Delaware VDA programs have chosen the Secretary of State's VDAs since the inception of the program.

A competing interest then appeared to develop between the two Delaware departments to, in essence, prove that their respective path—audits for the Department of Finance and VDAs for the Secretary of State—was the more effective, timely and lucrative means to enforce the state's unclaimed property law

and gain compliance from the Holder community. This dynamic continued to be manifested up through the December 11, 2017, election date as companies wrestled with choosing between the Department of Finance or the Secretary of State to administer the closing and resolution of their audits.

SB 13 now mandates that all Delaware VDAs be administered by the Secretary of State and also allows for companies to transfer VDAs which originated with the Department of Finance to the Secretary of State. In addition, SB 13 also affirmed the state's 2015 decision that no company can be audited by the state unless the company is first given the opportunity to participate in the Secretary of State's VDA program. These legislative changes now provide clearer guidance on the role of both arms of the state's enforcers of its unclaimed property law. The Department of Finance: (i) governs the reporting process (annual compliance filings), and (ii) initiates and manages audits. The Secretary of State administers the VDA program.

Illinois' Legislative Changes

On July 7, 2017, the Illinois General Assembly overrode the governor's veto of SB 9, the Omnibus Budget Bill, which not only provided for the adoption of an Illinois budget for the first time in two years, but also approved the simultaneous adoption of Illinois' Revised Uniform Unclaimed Property Act ("Act"), which was tethered to SB 9. The Act, which became effective on January 1, 2018, includes the following:

- changes the dormancy period[4] from five years to three years, for most property types;
- maintains an exemption for gift cards, but deems stored value cards to be reportable as unclaimed property;
- creates a statute of limitation and record retention provision for 10-year periods respectively; and
- provides for other clarifying changes, including but not limited to, due diligence and guidelines for the performance of an unclaimed property examination, including the right of the state to contract with third-party contingent fee auditors.

In addition to the changes set forth above, the Act also repeals Illinois' business-to-business exemption. This exemption excluded from reporting property (such as checks, credits or refunds) owed by one business entity to another business entity. The repeal of this exemption will likely be the most significant change for companies and will require amounts that were previously exempt from reporting be reportable beginning on the effective date of the Act.

Further, Illinois' application of the Act mandates a retroactive claw-back of the repeal of the business-to-business exemption for any previously exempt property issued on or after January 1, 2010.[5] In

other words, instead of applying the repeal of the exemption prospectively, Illinois is requiring that any previously exempt business-to-business property on a company's books dating back to January 1, 2010, is reportable under the new Act. However, even prior to the passage of SB 9, HB 4078 was introduced to repeal the new Act in its entirety on July 3, 2017, if and only if SB 9 became law. There was no legislative movement on HB 4078 as of the end of the 2017 Illinois legislative session.

In a separate and unrelated bill, the governor vetoed changes to the Act pertaining to certain life insurance provisions and, through his veto, proposed language to repeal Illinois' authority to contract with contingent-fee auditors to perform Illinois' unclaimed property audits. There was no legislative change on Illinois' ability to use third-party contingent-fee auditors as of the end of the 2017 legislative session.

Key Legal Decision

On December 4, 2017, the U.S. Court of Appeals for the Third Circuit vacated and remanded the district court's opinion dismissing the plaintiffs' claims in *Marathon Petroleum Corp., et al. v. Cook et al.*[6] In February 2016, Marathon Petroleum Corporation, Speedway LLC, Marathon Prepaid Card LLC and Speedway Prepaid Card LLC (collectively "Marathon") filed suit against the Delaware Secretary of Finance, the State Escheator and the Audit Manager of Delaware and its third-party audit firm, Kelmar Associates ("Kelmar") (collectively "Delaware").

During a state-initiated audit of Marathon, Kelmar requested information pertaining to gift cards issued by two Marathon subsidiaries. Marathon provided Kelmar with documentation showing that both subsidiaries were Ohio LLCs and challenged Kelmar's authority to review gift cards issued by Ohio companies during an audit on behalf of Delaware. Kelmar responded with a letter threatening to refer the matter to Delaware's Attorney General for enforcement if Marathon did not turn over the requested information.

Marathon filed suit in federal district court seeking a declaratory judgment and injunctive relief based on the priority rules established in *Texas v. New Jersey,*[7] which established the jurisdictional rights of states to unclaimed property. Marathon's complaint also stated that Delaware's audit requests constituted an unreasonable search in violation of the Fourth Amendment to the U.S. Constitution. Delaware filed a motion to dismiss Marathon's complaint, stating that the court lacked subject matter jurisdiction and that none of the claims made by Marathon were ripe for the court to hear. In other words, it was Delaware's position that the issues presented by Marathon were premature, as the state had not yet issued a summons, demanded any gift cards as unclaimed property or done any act adverse to Marathon's interest.

The federal district court, while agreeing with Marathon that the issues were ripe for review by the court, granted Delaware's motion to dismiss based on its findings that the priority rules established in *Texas v. New Jersey* only applied to conflicting claims between states and were not applicable to disputes between private parties and a state. The court also found that Delaware's audit did not constitute a search and therefore was not in violation of the Fourth Amendment.

On December 4, 2017, the U.S. Court of Appeals for the Third Circuit reversed and vacated the Delaware federal district court's dismissal of Marathon's complaint and held that private parties can invoke the federal common law set forth in the priority rules established in *Texas v. New Jersey.* The court also found that Marathon's claims were *not* ripe since the company was not subject to any enforcement action by Delaware. The circuit court ordered that the case be remanded to the federal district court so that the dismissal can be noted to be "without prejudice," paving the way for Marathon to initiate suit at a later date upon specific enforcement action by Delaware.

Conclusion

While many can quote from Dickens opening words in *A Tale of Two Cities*, few can quote from the balance of his opening paragraph, "(I)t was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us." How prophetic these words are when applied to the issues that lie ahead in 2018 in the realm of unclaimed property developments.

Companies across the U.S. that are in the midst of unclaimed property audits or in negotiations with one or more states should feel fortunate that the drumbeat of challenges to Delaware's historic audit practices are yielding positive results. The decisions in *Temple-Inland*, *Marathon Petroleum Corp.* and *Plains All American Pipeline LLC*[8] reveal that corporations no longer will accept unfair audit settlements that result from unconstitutional estimation practices used by third-party auditors. With each challenge, Delaware (and other states that deploy unreasonable estimation strategies) will face mounting pressure and lawsuits over when and how to apply these procedures. In 2018, also look for other aggressive legislative actions to be challenged, including Illinois' retroactive claw-back provision regarding the repeal of its business-to-business exemption.

That said, all is not roses for companies. Currently, hundreds of companies remain under audit or have agreed to enter into Delaware's VDA program, which means that for these companies the pressure on resources to manage and negotiate settlements will continue, for at least two years for most and, for many,

far longer. It is also very likely that it may require a constitutional challenge to Illinois' retroactive repeal of otherwise exempt business transactions from its current unclaimed property guidelines.

Worse, other states may similarly seek to apply retroactive changes to their unclaimed property laws, particularly states with relatively high individual income taxes. These states are under pressure to reduce those collections in light of the federal tax law changes coming into effect in 2018 that limit the federal deductibility of state individual income taxes. If state income tax collections go down, the revenue shortfall will need to be addressed elsewhere and unclaimed property is one way to close a state's budget gap without raising taxes.

Furthermore, multistate unclaimed property audits are definitely on the rise; no longer is Delaware the sole state of concern. Aggressive audit practices are now being applied by third-party audit firms in multistate audits to stem the tide of reduced contingent fee payments from Delaware. Several companies have already voiced concern that analogize these firms' audit practices to the game of "Wack-a-Mole," as any reductions in contingent fees earned from Delaware now will be offset by increases in fees earned from other states, as well as increased interest and penalty provisions in Delaware.

So what are companies to do? Here is some advice:

1. Be diligent. Know your rights, document unfair audit practices and push back as appropriate when a state or third-party auditor exceeds its bounds.
2. Be pro-active. Just because Delaware has been handed a set of recent setbacks, do not be lulled into a sense of false security. Most companies still lack comprehensive policies and practices, including uniform retention policies that conform with current state requirements.
3. Be prudent. Not all states or their auditors are unfair or apply unreasonable audit practices. Pick your battles wisely. Also, in considering litigation, companies have incurred considerable costs challenging state audit findings or statutes only to subsequently discover that such efforts proved unsuccessful due to bad facts and corporate practices that did not support a favorable outcome. In some instances, negotiated settlements can lead to as good, if not better, results for a company facing potential unclaimed property liabilities, depending on the company's facts and circumstances. Therefore, exercising reasonable due diligence (on the advice of legal counsel) in deciding the mode to challenge a state's audit findings is advisable.

In conclusion, the future of unclaimed property for corporate America looks far brighter in 2018 than in years past, but with a few clouds on the horizon for at least the next couple of years.

[1] *Temple-Inland v. Cook,* No. 14-654-GMS (D. Del. June 28, 2016).

[2] *Id.* slip op. at 33.

[3] SB 13 made the assessment of interest mandatory by the state for all property filed late on or after July 1, 2017 and: (i) increased the interest from 0.5% per month, limited to 25% of the value of the property, to 0.5% per month, limited to 50% of the value of the property; (ii) imposed a new civil penalty for evasion or willful non-performance in the amount of $1,000 for each day the obligation is evaded or the duty not performed up to $25,000, plus 25% of the amount of the property that should have been reported, paid or delivered. SB 13 also granted the state the ability to waive up to 50% of the interest for good cause. These SB 13 provisions were subsequently modified in SB 79, which became effective on June 29, 2017. Specifically, SB 79: (i) eliminated the 50% mandatory assessment of interest set forth in SB 13 and allows for the full waiver of interest for property reported prior to January 1, 2019; (ii) waives 50% of interest for property reported after January 1, 2019, for non-VDA filers; and (iii) waives penalties, in whole or in part, for good cause if the Holder is assessed penalties as a result of a late filed report. (Del. Code Ann. tit. 12, §§1183 and 1185).

[4] This is the number of years a company can legitimately keep an obligation on its books before it is required to be turned over to the state, if there has been no communication with the owner and the obligation is owed.

[5] IL SB 9, §§15-1503 (transitional provision).

[6] No. 16-4011.

[7] 379 U.S. 674 (1965).

[8] In *Plains All American Pipeline LLC v. Cook*, 866 F.3d 534 (3d Cir. 2017) the Third Circuit affirmed a decision by the District Court of Delaware which held that a company's right to challenge Delaware and its third-party auditor's estimation methodology as unconstitutional was not yet "ripe" since no audit had been conducted. However, the Third Circuit did acknowledge the lower court erred in failing to rule on the use of auditors who are paid based on results (contingent fees). The circuit court found this portion of the company's challenge to be ripe for consideration.