

## Former Employee Blows the Whistle on Delaware Unclaimed Property Exposure

22 May 2012

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In a recent unpublished decision, the Superior Court of Delaware, New Castle County, decided to allow a business entity's former tax manager, joining with the attorney general for the state of Delaware, to proceed with a False Claims Act ("FCA") case against the entity.<sup>1</sup> The claim alleges that SourceGas Distribution, LLC<sup>2</sup> ("SourceGas") failed to remit unclaimed property, which the tax manager had identified, to the state. The property came into SourceGas' possession through an acquisition of a retail gas distribution business from Kinder Morgan. The record was unclear regarding whether Kinder Morgan's state of incorporation was Delaware or Kansas.

The court permitted a single allegation to proceed past the defendants' motion to dismiss—the allegation that the company had changed the name of an acquired liability account from "Unclaimed Property Liability" to "Converted Balance from Dec. 2004." The court found this to be a sufficient allegation of an attempt to conceal unclaimed property from the state. The complaint also alleges that the company "refused to act" when Higgins, the tax manager, brought the issue to management's attention.

As companies continue to evaluate their unclaimed property reporting obligations—especially with regard to acquired liabilities—this decision is particularly troubling. Delaware's FCA is modeled on the federal law, and so allows for treble damages.<sup>3</sup> Thus, this case adds a potentially material factor to conversations surrounding whether to pursue a Delaware voluntary disclosure agreement. But the heightened risk from FCA lawsuits is hardly the most interesting take-away from this case. The decision establishes that this will be a case to watch in Delaware—both for developments in the False Claims Act arena and in Delaware's Unclaimed Property law.

**Unclaimed Property Issues** The *SourceGas* case raises key issues with respect to ambiguities in the unclaimed property priority rules. The U.S. Supreme Court case has established a hierarchy of sourcing rules for unclaimed property.<sup>4</sup> In particular, intangible unclaimed property

is reportable to the state of the owner's last known address. If the owner's address is unknown by the holder, the property is reported to the holder's state of incorporation.<sup>5</sup>

But which "state of incorporation" is the second priority state in the context of an acquisition? Should the successor company report dormant unreported property to the predecessor's state of incorporation or to its own? In addition, does the acquisition restart the dormancy period? The court noted but has not yet answered these questions, which will clearly have broad implications for holders, and it has requested additional briefing on these issues.

The court refused to pierce the corporate veil and has required specific allegations of FCA violations to be about the entity that is the legal holder for purposes of Delaware's unclaimed property law.

**False Claims Act Issues** Adding a heightened risk of FCA suits to the uncertain standards being applied in state unclaimed property audits may suggest a need for heightened internal controls. Given the uncertainty in the unclaimed property area, companies should consider treating all unclaimed property compliance reviews as involving a realistic risk of future litigation. Thus, once an unclaimed property exposure is suspected, companies would now be well advised to engage attorneys as soon as possible so as to proceed with a review that is fully protected under attorney-work product protection.

The work-product privilege cannot prevent a whistleblower from making allegations to the state. However, the process by which unclaimed property was identified and by which a determination was made as to its status and associated obligations under unclaimed property laws can be conducted under privilege. This would limit the documentation available for a whistleblower to turn over to the state.

In addition, in many cases, proceeding under privilege may help negate a claim of scienter, which is a knowledge or disregard for the truth and the concealment of the truth where a bona fide attempt to determine the applicable law can be demonstrated to have preceded the reporting decision. This is because an attempt to follow the law negates the scienter required for FCA violations.<sup>6</sup> Given the lack of guidance regarding unclaimed property, it would seem difficult to prove the requisite scienter with respect to the alleged violation. For example, if there was doubt about the law as to whether an item is "property" subject to escheatment, the holder's

failure to report and turn over the property may not be associated with the requisite scienter for FCA liability.<sup>7</sup>

Finally, there is the issue as to whether an FCA violation can exist for a violation of a custodial unclaimed property statute. To the extent a state unclaimed property statute is custodial in nature—as many states have clarified their unclaimed property laws to be—it is unclear whether there is any obligation owed to the state by a property holder may give rise to a False Claims Act lawsuit. The property-holder's obligation is, as a matter of law, to the owner of the property, with the state merely acting as a fiduciary or custodian for that owner.

In *SourceGas*, the court recognized that the Delaware False Claims Act law is intended to “provide restitution to the government of money taken from it by fraud.”<sup>8</sup> It seems incongruous that such an action may lie in states where the government has acknowledged—and in some cases argued—that it is not itself entitled to the property.<sup>9</sup> The *SourceGas* decision does not reconcile the purposes behind the FCA with those of the Delaware escheat law. Thus, perhaps this case will bring to the forefront the question of whether the purpose of a given state's unclaimed property law is truly to protect against unjust enrichment and to reunite property with its true owner, or instead, to serve as a pseudo-tax to raise revenue for the state.

With more than \$500 million a year in unclaimed property revenue in Delaware, including at least \$300 million of that being built into Delaware's budget—and treble damages now possible—one thing is certain: all eyes should now turn to the *SourceGas* case.

## **About This Reed Smith State Tax Alert**

For more information on the *SourceGas* case, or to discuss the potential implications of the *SourceGas* case on your company's existing unclaimed property exposures, please contact the authors of this *Alert* or another member of the Reed Smith State Tax Group. For more information on Reed Smith's State Tax practice, visit [www.reedsmith.com/statetax](http://www.reedsmith.com/statetax).

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<sup>1</sup> *State of Delaware ex rel. Anthony Higgins v. SourceGas LLC, et al.*, C.A. No. N11C-07-193 MMJ CCLD, 2002 WL 1721783 (Del. Super. 2012).

<sup>2</sup> The Complaint had also named limited liability holding companies in the action, but the Superior Court dismissed those parties from the suit.

<sup>3</sup> 6 Del. C. § 1201(a). The Complaint alleges a violation of 6 Del. C. § 1201(a)(7).

<sup>4</sup> *Texas v. New Jersey*, 379 U.S. 674 (1965).

<sup>5</sup> *Id.*

<sup>6</sup> *See, e.g., United States ex rel. Perales v. St. Margaret's Hosp.*, 243 F. Supp. 2d 843, 866-68 (C.C. Ill. 2003).

<sup>7</sup> *See, e.g., State ex rel. Beller Chad & Diamond, P.C. v. Ritz Camera Ctr., Inc.*, 878 N.E.2d 1152, 1158 (Ill. App. Ct. 2007) (liability cannot attach when the violation is premised on an unclear area of law because the defendant cannot be said to have “knowingly” made a false claim.)

<sup>8</sup> 2012 WL 1721783 at \*4.

<sup>9</sup> *See e.g., New Jersey Retail Merchants Assoc. v. Sidamon-Eristoff*, Nos. 10-4551, 10-4552, 10-4553, 10-4714, 10-4715, 10-4716, 11-1141, 11-1164 & 11-1170 (3d Cir., Jan. 5, 2012); *Am. Express Travel Related Servs. Co. v. Sidamon-Eristoff*, No. 10-4328 (3d Cir., Jan. 5, 2012).

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