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Where We've Been and Where We're Going — Taking Stock

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Unclaimed property law has seen significant development over the past few years. These changes have created excitement for practitioners, holders, and states alike. The scope and breadth of the recent developments are quite remarkable considering that the body of law has been in existence since the time of the Roman Empire and is now being pondered by those wondering how to survive a zombie apocalypse.[1] You would think that with such a long history the law would be more settled.

In this installment of UPwords, we review some of the more significant legal developments over the past few years and highlight a few of the interesting developments on the horizon.

What We Didn't Know Then but Know Now

Qualified Immunity in Delaware (at Least for Stock . . .)

Perhaps one of the most important decisions this past year was out of a most appropriate state — Delaware — the center of the unclaimed property universe. On September 15, 2009, in *A.W. Financial, S.A. v. Empire Resources, Inc., American Stock Transfer & ACS*[2] the Delaware Supreme Court *sua sponte* considered and decided novel questions of unclaimed property law.[3]

The underlying cause of action involved the escheat of unclaimed stock. The plaintiff brought suit in the Southern District Court of New York alleging that the stock was improperly turned over to Delaware before the running of the proper abandonment period. Under escheat laws then in effect, stock must be dormant for five years before it can be abandoned. Delaware subsequently amended its law shortening the dormancy period for stock and escheated the stock under the shortened period.[4]

A.W. Financial brought various actions, including negligence, breach of contract, breach of fiduciary duties, and conversion. Delaware moved to dismiss for failure to state a claim and argued that the change in the statute was to apply retroactively and also asserted immunity from suit as provided for under Delaware's escheat laws.

The Southern District of New York certified the case to the Delaware Supreme Court to answer four novel questions of law:

- whether the reduced dormancy period under Delaware's unclaimed property law applies retroactively;
- what is the proper legal theory under which a plaintiff may bring a cause of action for improper escheatment of stock;

[1]*See* http://howtosurviveazombieapocalypse.co.uk/#/e-is-for/4534255883.

[2]Cite 981 A. 2d 1114 (Del. 2009).

[3]Despite a recent trend in which courts are confronted with novel issues of unclaimed property law, decisions of this kind are still rare. In this case, the court clarified or established fundamental aspects of Delaware's escheat laws. In addition to serving as a foundational case in application of Delaware's escheat laws, this case is also instructive to other state's unclaimed property laws that contain similar provisions.

[4]In 2008, Delaware, by law, reduced its dormancy period to three years.

- whether general/absolute immunity or qualified/"good faith" immunity applies to escheatment of securities under Delaware unclaimed property law; and
- what is the standard of pleading for allegations that a party did not act in good faith and is therefore not entitled to immunity?

The court answered all the issues in favor of A.W. Financial. The court concluded that:

- the amended dormancy period does not apply retroactively;
- common law or statutory causes of action may be brought against third parties (other than the state);
- the good faith requirement for protection under the statutory immunity provision applies to the escheatment of stock; and
- good faith is an affirmative defense that must be pleaded and proved by the party claiming immunity under the statute.

Of particular interest are the Delaware Supreme Court's conclusions regarding the availability of statutory immunity and the good faith requirement. In determining the immunity issue, the court compared the two relevant Delaware immunity provisions. Under Delaware Code section 1203(a), a holder who delivers *property* to the state is immunized from liability, regardless of the holder's good faith. Conversely, under section 1203(b) that same holder is immunized from liability only if the delivery of *duplicate certificated and uncertificated securities* is made in good faith. The Delaware Supreme Court determined that regarding stock, the "good faith delivery" immunity standard of Delaware Code section 1203(b) applied, rather than the general immunity provision of section 1203(a). In so holding, the Delaware Supreme Court emphasized that section 1203(a) applied broadly to all property, whereas section 1203(b) applied only to the delivery of securities.

The *A.W. Financial* decision provides further guidance on the issue of the proper standard regarding statutory immunity. In *Azure Ltd. v. I-Flow Corp.*,[5] a relatively recent California case, the California Supreme Court addressed statutory immunity and also sided with the owner rather than the holder regarding whether a holder is entitled to statutory immunity when property is turned over to the state. However, unlike in *Azure*, the Delaware Supreme Court expressly established a good faith delivery standard for a particular property type. Also, the Delaware Supreme Court suggested that the escheatment of other property types may be entitled to absolute immunity under Delaware's unclaimed property laws.

[5]210 P.3d 1110 (Cal. 2009).

The case will now be remanded to the Southern District of New York for a final decision in accordance with the conclusions made by the Delaware Supreme Court. However, pending a final decision, practically, this case further emphasizes the importance of carefully complying with a state's dormancy statutes and the importance of performing thorough due diligence — especially considering how quickly states act to liquidate intangible property.

The Revenue Grab Grabs Back — Dormancy Period Reductions Are Not Without Limits

In what could be a trend of holder victories in challenging states' unclaimed property administration, American Express successfully challenged Kentucky's amendment to the state's unclaimed property dormancy provisions regarding travelers' checks in *American Express v. Hollenbach*.[6]

In a well-reasoned opinion from a policy perspective, the Kentucky District Court ultimately held that because it is clear that the state's objective was to raise revenue rather than to fulfill the purpose of the unclaimed property laws — to reunite citizens with lost property — the statute did not satisfy rational basis review. Therefore, the Kentucky statutory amendment violated the U.S. Constitution's due process clause.

> ***The Delaware Supreme Court expressly established a good faith delivery standard for a particular property type. Also, the Delaware Supreme Court suggested that the escheatment of other property types may be entitled to absolute immunity.***

Perhaps an even more interesting question for purposes of predicting whether the *American Express* decision will have broader ramifications is whether a court will be willing to "read" revenue-raising intent into a state's unclaimed property legislation — absent express statutory intent. In other words, how aggressive will a court be in invalidating laws that have an unstated primary purpose of raising revenue, or a secondary purpose raising revenue? There are certainly instances when there will be some tangential relation to reuniting owners with unclaimed property, but the ultimate effect will be to increase state coffers. This is a

[6]630 F. Supp. 2d. 757 (Dist. Ct. Kentucky June 15, 2009). For further background, see "Unclaimed Property Administration — Taking Advantage of Uncertainty," *State Tax Notes*, Dec. 21, 2009, p. 887, *Doc 2009-26883*, or *2009 STT 242-4*.

particularly important considering the rash of legislation reducing various dormancy periods in many states.

What We May Never Know

Can Delaware Disregard a Holder's Books and Records?

CA, Inc. v. Cordrey[7] was one of the most intensely watched cases this past year. To some surprise, its resolution was without significant fanfare — a settlement. Nonetheless, even the settlement has generated great speculation and discussion as to what it all means.

CA Inc. brought suit against Delaware for abuse of discretion regarding its administration of its escheat laws. The case began with CA filing a notice of intent to participate in Delaware's voluntary disclosure program. CA proposed to report $2.3 million in unclaimed property, and Delaware disagreed, proposing a liability of $7.6 million. CA counteroffered, and Delaware responded by threatening to audit. The disagreement between CA and Delaware on the amount of the liability stemmed from Delaware's use of a sampling method to calculate CA's unclaimed property liability.

Ultimately, according to the recent settlement documentation, the parties settled for a little over $17 million. although this may seem like a significant victory for Delaware, there is some uncertainty surrounding the precise facts that brought about the settlement and it may not be that clear cut. In determining whether to enter into a voluntary disclosure agreement (VDA) in Delaware, holders should carefully review their specific facts and not base too much of their decision on the outcome of this case. In any event, the holder community at large must continue to wait for guidence regarding Delaware's administration of its VDA program.

> ***How aggressive will courts be in invalidating laws that have an unstated primary purpose of raising revenue, or a secondary purpose of raising revenue?***

The case focused on the correct use of sampling. Typically, a sampling method is used when a holder's records are insufficient to determine the amount of unclaimed property that is reportable to the state. Based on the records available, states will estimate the likely amount of unclaimed property. However, sampling is inappropriate when the holder produces complete books and records. Per the court filings, CA produced records that showed the actual liability. Even though these records were readily available, Delaware disregarded the records and used its sampling method to determine CA's liability.

The two issues involved in the case were:

- whether Delaware could use a sampling method to determine a holder's unclaimed property liability when the holder's records showing the actual liability are available; and
- under what circumstances could Delaware refuse to agree to a holder's offer of liability under a voluntary disclosure agreement.

As a result of the settlement, the issues will remain unresolved by the courts for the time being. However, the Delaware Chancery Court may rule on the sampling method issue sooner rather than later in the pending case *McKesson Corp. v. Cook*.[8]

Who Is the Holder?

Fitzgerald v. Young America Corp. et al.[9] has received perhaps the most significant attention from the holder community and the states. Recently, Sprint settled with Iowa and the other states involved in the lawsuit for $22 million.[10] The issue of utmost importance in the underlying action was who was responsible for remitting uncashed rebates to the states — who is the holder for unclaimed property purposes. The Iowa lawsuit alleged that either the retailers *or* Young America (the fulfillment center) was responsible to report and remit uncashed rebate checks to the state. Ultimately, the settlement leaves holders with little guidance. Holders must still struggle with the extent to which various arrangements with third-party fulfillment centers will leave them open to unclaimed property liability.[11] Again, the settlement resolution has left us wanting more. Like in *CA, Inc.*, interested parties are left to glean as much as they can from the settlement.

[7] *CA, Inc. v. Cordrey et al.*, Ch. Ct. of Del. Civil Action No. 4111-CC (Nov. 25, 2008); *Cordrey et al v. CA, Inc.*, Ch. Ct. of Del. Civil Action No. 4195-CC (Apr. 18, 2008).

[8] No. 4920 (Del. Ch. Filed Sept. 25, 2009).

[9] Iowa District Court, CV 6030 (Jan. 5, 2009).

[10] *See* Treasurer of the State of Iowa and Iowa Department of Justice Press Release (Feb. 12, 2010).

[11] A similar action was recently commenced in the Arkansas court system. *Wood v. Sprint Spectrum et al.*, C109-5502, (Aug. 7, 2009, Arkansas Circuit Court of Pulaski County).

What We Might Know Soon

Is Everything Unclaimed Property? (and a Bit About Sampling . . . Hopefully)

McKesson v. Cook[12] represents the most recent example of a holder challenging a state's administration and interpretation of its unclaimed property laws and was the subject of the last edition of UPwords.[13]

McKesson filed suit challenging Delaware's assessment related to its unclaimed property liability, as determined by a third-party auditor and as applied to the items of unmatched inventory. McKesson argued that either the inventory at issue was not unclaimed property or it was not unclaimed property escheatable to Delaware under the priority rules established in *Delaware v. New York*[14] and *Texas v. New Jersey*.[15]

As we have previously argued, the particular significance in this case is twofold. First, the case is important because of the potential that the Delaware courts may finally rule on the limitations of Delaware's use of sampling in determining a holder's unclaimed property liability, and second, because the case represents a potential opportunity for the Delaware courts to address the application of a Delaware's escheat laws to a "new" property type. Per the complaints, McKesson contends that before 2003, Delaware did not audit businesses for unclaimed property liability regarding inventory, and did not require companies to escheat inventory in connection with any audits, irrespective of whether inventory was characterized as "unmatched receivers," "un-invoiced" payables, or any other similar term.

> ***The Delaware courts may finally rule on the limitations of Delaware's use of sampling in determining a holder's unclaimed property liability.***

Considering the various technology advancements and the creation of new property types, a decision on the limits of what is considered "new unclaimed property" and the extent to which states are permitted to escheat new property types could have a significant impact beyond whether the "unmatched inventory" is escheatable. We contend that not all property should necessarily be subject to state unclaimed property laws. For example, not all values listed on a holder's books are property in the unclaimed property sense but rather reflect various accounting methods and business practices that do not fit into the traditional application of unclaimed property laws.

States or Charities — Can States Claim Class Action Settlement Funds?

In 2005 book authors and publishers filed a class action lawsuit challenging Google's attempt to create a digital library of copyrighted material. In late 2008 the Authors Guild, the Association of American Publishers, and Google announced a settlement agreement that would allow Google to digitize the copyrighted works but would require Google to make payments totaling $125 million. Settlement proceeds that go unclaimed may ultimately be distributed to charities. During the period in which the court was in the process of approval, five states objected to the settlement agreement[16] on the grounds that any unclaimed proceeds must be governed by the state unclaimed property laws and not distributed to charities as provided for in the amended settlement agreement. This raises a truly controversial issue as to whether and in what circumstances states should be entitled to claim unclaimed class action settlement proceeds.[17]

Will the Uniform Acts Get a Tuneup?

Recently, there has been some discussion amongst legislators and the business community in pursuing a rewrite of the uniform acts that have become outflanked by the developing economy. The issues on the table are varied and nuanced, but could include: the inclusion of an independent appeals provision; the codification and clarification of the business-to-business exemption; inclusion of provisions related to tax deferred assets; removing the transactional/"third priority" rule; limited lookback periods for unclaimed property audits; and the inclusion of further exemptions.

How Big Is the Unclaimed Property Net? — New Property Types, New Liabilities

States are seeking to expand their control over a vast pool of property by expanding the definition of such property through legislation and audit activity. The increasing prevalence of digital transactions

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[12]*Id.*

[13]*See* "Unclaimed Property Administration — Taking Advantage of Uncertainty," *supra* note 6.

[14]507 U.S. 490 (1993).

[15]379 U.S. 674 (1965).

[16]*The Authors Guild, Inc. et al. v. Google Inc.*, Case No. CV 8136-DC (S.D.N.Y.).

[17]For the various considerations surrounding unclaimed class action settlement funds, see "States Attempt to Seize Unclaimed Property Class Action Settlements as Unclaimed Property," *State Tax Notes,* Sept. 21, 2009, p. 829, *Doc 2009-20202*, or *2009 STT 180-6*; *see also*, *In re San Juan Dupont Plaza Hotel Fire Litigation*, 2010 WL 60955 (D.P.R. Jan. 7, 2010) (applying the *cy pres* doctrine to dispose of unclaimed class action settlement funds).

and new property types that result from these digital transactions have yet to receive significant focus from state unclaimed property administrators. However, as *McKesson* suggests, states are looking for new ways to expand the unclaimed property net. This undoubtedly raises the fundamental derivative rights doctrine — the doctrine recognized by the Supreme Court — which says that states should have no greater property rights than the owners of unclaimed property.

Reform in Delaware?

A significant bill (HB 285) is pending in the Delaware General Assembly that could have a significant impact on Delaware's administration of its unclaimed property laws. The bill would establish an independent appeals process for disputed unclaimed property assessments and establish a statute of limitations for unclaimed property audits. Passage of this bill will have a broad impact on other states' administration as they often look to Delaware as a guide.

Third-Party Auditors — Here to Stay?

Holders often express much frustration at audits conducted by third-party audit firms. It is one thing to be audited by a state that is focused on reuniting owners of lost property, but it is fundamentally another thing to be subject to an audit conducted for multiple states by a third party, whose goal is to find as much liability as possible to maximize profits because of a contingent-fee arrangement. There are unsettled issues as to whether a contingent-fee arrangement violates public policy or due process. Holders are also often faced with confidentiality concerns arising from permitting "agents" of the state to review sensitive information.

Legislation — More Reductions in Dormancy Periods?

The most recent legislative trend is to reduce dormancy periods. For example, Arizona recently enacted sweeping legislation that reduced the dormancy period for nearly all of its abandoned property types.[18] Other states are likely to consider similar legislation, especially considering their unprecedented budget deficits. As *American Express* proves, such legislation is not without limitation and holders should be vigilant in considering whether to challenge the laws.

The States Versus the Feds — Billions of Bonds

In a recent decision by the U.S. District Court for the District of New Jersey, *Rousseau v. United States Department of the Treasury*,[19] a trial court judge ruled that no jurisdiction exists for the states to sue the federal government to require that the $15 billion of unredeemed savings bonds be turned over to the states under state unclaimed property laws. The recent order is the first shot fired in a case that has been ongoing for six years, and stemming from unredeemed war bonds as far back as World War II. The states contend that they are better suited to return the bonds to their rightful owners — carrying out the purpose of the unclaimed property laws. However, the court concluded that the states involvement would "impermissibly interfere" with contracts between the United States and the owners of the bonds. The judge also noted that to the extent the states assert that this case is about mere custody of the bonds, they gloss over the effect of other aspects, such as an attempt to grab revenue.

Conclusion

Holders of unclaimed property are forced to address the ever-changing landscape of unclaimed property law. While some of the developments will resolve long-standing questions, others are more likely to add to the confusion and uncertainty facing the holder community. Only by staying abreast of current developments can holders comply with the law and defend against unfair and burdensome administrative practices. ☆

UPwords is a column about unclaimed property from Sutherland Asbill & Brennan LLP's State and Local Tax Practice. This installment is by Diann L. Smith, counsel, and Matthew P. Hedstrom, an associate, with Sutherland's State and Local Tax Practice.

[18]Arizona SB 1003. *See*, *e.g.*, Pennsylvania HB 1407 (reducing the dormancy period for property types held by insurance companies and financial institutions, as well as for all property types falling within the "catchall" provision).

[19]2010 WL 457702.