

PROCEDURE

Uncharted Waters: Temple-Inland's Big Win Raises as Many Unclaimed Property Questions as It Addresses

The Delaware federal court's opinion represents a major victory for the plaintiff and, in a larger sense, for the corporate holder community.

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On June 28, 2016, an Opinion was issued by the U.S. District Court, District of Delaware (the "Court"), ruling that Delaware's unclaimed property audit and subsequent assessment of Temple-Inland, Inc. ("Plaintiff") violated Plaintiff's substantive due process rights. The Court granted Plaintiff's Motion for Summary Judgment for its substantive due process claim against Thomas Cook, Delaware Secretary of Finance; David Gregor, Delaware State Escheator; and Michelle Whitaker, Delaware State Audit Manager (collectively referred to hereinafter as "Defendants"). Thus, the Opinion represents a major victory for Plaintiff and, in a larger sense, for the corporate holder community.

The Opinion is important for several reasons. First, the Opinion noted that courts have routinely upheld the government's use of estimation as a valid audit tool, provided it was properly performed. However, the Opinion called into question the estimation methodology used by Delaware in this case, and opined that it was not a reasonable estimation methodology.

Second, the Opinion noted that no previous case had ever addressed the question of whether estimation applied by two or more states in different audit scenarios could result in multiple liability. The Opinion concluded that such estimation could result in multiple liability, which was in violation of the federal common law principles delineated in the *Texas v. New Jersey* line of cases.

However, several key issues of interest to the holder community were left unanswered by the Opinion. This article addresses the following areas: (i) analysis of key issues discussed in the Opinion, (ii) discussion of questions left unanswered by the Opinion, (iii) what this may mean to holders under a Delaware audit or enrolled in the Delaware voluntary disclosure agreement (VDA) program, and (iv) concluding comments.

By way of background, Plaintiff, after having undergone a Delaware unclaimed property audit conducted by the contract auditor, Kelmar Associates LLC, filed suit in the U.S. District Court in Delaware seeking equitable, declaratory, injunctive and other relief for alleged violation of Plaintiff's rights associated with Defendants' use of estimation and other techniques arising during the course of the audit. The extrapolated liability was originally in excess of \$2 million calculated back to 1981. Following an administrative appeal, the assessment was reduced to \$1.4 million. When the matter could not be resolved in an amicable fashion, Plaintiff filed its lawsuit.

Analysis of Key Issues Discussed in the Opinion

The following discussion summarizes some of the key issues addressed in the Opinion.

What specific audit actions of Delaware did the court find objectionable?

Plaintiff's Motion for Summary Judgment on its substantive due process claims was granted. Our understanding is that no one factor led the Court to conclude that Defendants' actions were unconstitutional. Rather, the Opinion indicated that the totality of the state's conduct in the audit violated Plaintiff's substantive due process rights.

More specifically, the Opinion noted a number of factors arising from Defendants' actions that, when considered together, were troubling to the Court. It specifically stated that Defendants:

- waited 22 years to conduct the audit,
- avoided the otherwise applicable six-year statute of limitations under dubious circumstances,
- never gave holders notice that they would need to retain unclaimed property records to defend against what it termed "unmeritorious audits,"
- applied the section of the law authorizing estimation for a "prolonged retroactive period for no obvious purpose other than to raise revenue,"

- failed to follow fundamental principles of estimation, thus putting Plaintiff at greater risk for liability, and
- subjected Plaintiff to multiple liability.¹

As stated in the Opinion, "the court finds no need to determine if any of these actions on their own shock the conscience. It is sufficient that, in combination, defendants' executive actions shock the conscience."²

Whose money is it?

Plaintiff had argued that Defendants' actions in taking property allegedly belonging to Plaintiff violated the Takings Clause of the U.S. Constitution. The Court denied both the Plaintiff's and the Defendants' respective Motions for Summary Judgment with respect to the Takings Clause. The Opinion stated that each party argued that all of the funds in question were either unclaimed property or were not unclaimed property. Because the Opinion stated "neither side can be entirely correct,"³ it declined to rule on this issue at this time.

Significantly, the Court held "that a reasonable estimation of a holders' unclaimed property liability is not an unconstitutional taking."⁴ The Opinion concluded, after finding that there were still disputes of material facts as to whether the estimation in this case was reasonable, that "there is a dispute of material fact that cannot be resolved on summary judgment."⁵ However, as discussed hereafter, the Opinion pointed out numerous issues with the way estimation was utilized by Defendants in this case.

Estimation—Can it still be used?

As noted above, the manner in which Defendants utilized estimation was one of the factors the Opinion noted as causing a violation of substantive due process. As a starting point for analysis of the use of estimation, the Opinion stated: "Courts have routinely upheld the government's use of statistical sampling as a valid audit tool, provided it was properly performed."⁶ However, the Opinion noted that for estimation to be properly performed, it must be based on the principle that the unclaimed property in the reach back years has all the same qualities and characteristics as unclaimed property in the base years.⁷ The Opinion noted that "due process violations arise where the estimation methodology creates misleading results."⁸ Defendants acknowledged this essential principle, the Opinion stated, but failed to apply it.

Thus, under the primary rule of the *Texas* line of cases, it stated "Delaware cannot escheat any checks from the base years with payees in other states. But defendants estimated that plaintiff owed unclaimed property

to Delaware by extrapolating those checks into the reach back years."⁹ The Opinion noted the flawed logic on which Delaware's estimation actions were based (i.e., Delaware believed that if records do not exist, then the address must be unknown). Delaware's logic, the Opinion stated, is "contrary to the fundamental principle of estimation. Defendants used the existence of unclaimed property in base years to infer the existence of unclaimed property in the reach back years."¹⁰

The Opinion indicates that Defendants failed to extrapolate the characteristics of the property that would reduce the liability owed to Delaware. Thus, if the property in base years shows an address in another state, then the characteristic of that property has to be extrapolated into the reach back years. However, the Opinion stated "Defendants simply did not do that. Because Defendants employed estimation in a manner where the characteristics and quality of the property within the sample were not replicated across the whole, it created significantly misleading results."¹¹

In summary, the Opinion concluded that reasonable estimation could be applied. In this case, the estimation utilized by Delaware was found to be flawed and produced misleading results, which the Opinion criticized. However, the Opinion did not clearly define what would be considered a reasonable estimation.

Can multiple states estimate based on the same property?

The Opinion noted that the U.S. Supreme Court held in *Texas v. New Jersey* that "the same property cannot constitutionally be escheated by more than one State" but that no case has addressed whether estimation based on the same property results in multiple liability.¹² The Opinion concluded that "[i]t seems logical that if two states use the same property in the base years to infer the existence of unclaimed property in the reach back years, then a holder is being compelled to escheat the same estimated property to two states, in violation of the principles articulated in the *Texas* cases. This is exactly what happened to Plaintiff."¹³

Defendants argued, on the other hand, that there is no risk of multiple liability with the use of estimation because only the state seeking to escheat property under the secondary rule can use estimation. Because Delaware is the state of Plaintiff's incorporation, and it sought to escheat address unknown property, Delaware argued that it is the only state that can use estimation to calculate Plaintiff's unclaimed property liability. Thus, Delaware argued, other states, like Texas, seeking to escheat under the primary rule of *Texas v. New Jersey* cannot use estimation.

Significantly, the Opinion stated that the Delaware arguments are neither the law nor the custom. Indeed, it stated, "none of the states that have adopted statutes permitting the use of estimation, including Delaware,

have expressly limited the use of estimation to the secondary rule, and Texas' audit of Plaintiff is clear evidence that, in practice, states use estimation when calculating liability under the primary rule."¹⁴ In summary, the Opinion concludes that if two states use estimation based on the same property, resulting in the holder being compelled to escheat the same estimated property to two states, then a violation of the basic principles articulated in the *Texas* line of cases has occurred.

Why was the statute of limitations a critical factor?

The Opinion noted that the statute of limitations is a critical issue, stating that "[i]t explains why Defendants are allowed to assess a liability against Plaintiff for something that happened 22 years ago."¹⁵ It discussed the three rules under the Delaware Abandoned or Unclaimed Property Law, which essentially provides for:

- a three-year statute of limitations for a suit to enforce a deficiency in payment of unclaimed property,
- a six-year statute of limitations for an omission having a value in excess of 25% of the amount of unclaimed property disclosed in a report, and
- no statute of limitations if no report is filed or if a false or fraudulent report is filed with an intent to evade an unclaimed property obligation.¹⁶

In the case at hand, Defendants sought a deficiency payment for each year from 1986 to 2002. The Opinion stated that Defendants did not claim Plaintiff filed false or fraudulent reports. Rather, they assumed that Plaintiff had unclaimed property but failed to report.

The Opinion found it troubling that Plaintiff was able to produce reports for years 1996, 1998, and 1999, yet Defendants assessed a liability for those years. The Opinion stated: "It is not clear why a liability for those years is not barred by the statute of limitations."¹⁷ Given that Plaintiff was able to produce three reports from before 2002, as well as a report from every year within its record retention policy, the Opinion found it likely that Plaintiff filed reports that are now missing.

The Opinion further indicated the Court was troubled by the fact that Defendants did not tell holders they need to retain all of their unclaimed property reports, that Defendants did not retain unclaimed property reports filed with the state, and then attempted on audit to put the burden on Plaintiff to show it had in fact filed reports with the state. Finally, it noted that Defendants did not require negative reports, yet failed to warn holders of the consequences that, when no negative report is filed, the statute of limitations never begins to run in Delaware.

In summary, the Opinion concluded it was reasonable to assume that either (i) Plaintiff had no unclaimed property for the years in question when a report was missing and, per Defendants' own guidance, did not file a report, or (ii) Plaintiff did in fact file reports for such years but the copies were lost or destroyed. In effect, the Opinion found that Defendants ignored the two equally plausible explanations as to why reports could not be found, which effectively barred Defendants from reaching back beyond the six-year statute of limitations in this case.

Can federal courts intervene in state unclaimed property proceedings?

Defendants asked the Court to abstain from rendering a decision, which presumably would have meant the matter would revert back to state court. The Court expressed surprise that Defendants would now ask for abstention after almost two years of active litigation, and noted Defendants could have raised this claim earlier in the case. In any event, the Opinion concluded that abstention was not warranted in this case, and noted that abstention is an "extraordinary and narrow exception" to a court's duty to adjudicate a controversy properly before it.¹⁸

It should be noted that arguments by the states that federal courts abstain from hearing unclaimed property disputes between holders and the states have also been rejected by several other leading federal court cases.¹⁹ This is good news for the holder community, as it indicates a willingness by the federal courts to consider state abandoned and unclaimed property controversies in light of federal legal principles.

Questions Left Unanswered by the Opinion

Several key questions of interest to the holder community remain unanswered. First, the Court did not render any decision as to what was the appropriate remedy for violation by Defendants of Plaintiff's substantive due process rights. The Court stated in its Opinion that "[i]t is Defendants who are best able to know which remedy will be the most palatable in its anticipated efforts to normalize the enforcement of its unclaimed property laws. Thus, this court will defer its decision on the subject of an appropriate remedy until another day."²⁰

Second, the Court did not provide any guidance on what is or might be a permissible type of estimation methodology. Thus, one possible outcome of this Opinion is that states claiming under the first priority rule

of *Texas v. New Jersey* may increasingly seek to invoke claims to funds pursuant to estimation, perhaps pursuant to an allocated estimation methodology.

If this does occur, holders need to be aware of several items.

First, the state seeking to estimate should have authority in its statute authorizing the use of estimation.

Second, some states may currently have authorization to estimate a first-priority rule liability when appropriate records have not been maintained. For example, a section of the Uniform Unclaimed Property Act of 1981 provides, in pertinent part, that if the records of the holder are insufficient to permit the preparation of a report, the state administrator may "require the holder to report and pay such amounts as may reasonably be estimated from any available records."²¹

Third, as noted above, the Takings Clause issue was not decided.

Finally, there is the possibility that any decision rendered in the case may be appealed at the appropriate time to the Third Circuit U.S. Court of Appeals.

What This May Mean to Holders Under a Delaware Audit or Enrolled in a Delaware VDA Program

Holders under a Delaware audit or enrolled in a Delaware VDA program should consider several factors.

First, until further guidance is issued from the state, it is not clear if the state intends to be bound by the recent *Temple-Inland* decision. In other words, the state may seek to appeal the decision at the appropriate time, or may take the informal position on a case-by-case basis that the decision should be interpreted narrowly, such that, in the state's view, the *Temple-Inland* decision does not apply to other audits or VDAs that have a different set of facts and circumstances.

Second, as a decision of the Delaware federal judiciary, the *Temple-Inland* decision should have a significant impact on other Delaware audits and VDAs. For example, estimation methodologies set forth by Kelmar/Delaware now may be challenged on the basis of reasonableness.

Third, while the case is likely to have a short- and long-term impact on both Delaware's audit program and VDA program, until such time as additional guidance is issued by Delaware, holders will need to work through issues in their Delaware audits and VDAs on a case-by-case basis with their advisors.

Conclusion

Several concluding comments are in order. First, the *Temple-Inland* case illustrates, when considered with other recent important unclaimed property cases, that holders are making increased use of litigation as a method to resolve unclaimed property controversies with the states.

Second, the case indicates, when considered with other important federal court rulings, that actions of the states and their contract auditors are expressly subject to review by the courts.

Third, the comments in the Opinion regarding the fact that estimation is not limited to a state of incorporation or domicile are likely to be noticed by other states, thus perhaps leading to an increase in the use of estimation by other states seeking to boost their unclaimed property programs.

Finally, as the title of this article suggests, it should be recalled that the *Temple-Inland* decision, while most helpful to the corporate holder community, does leave many important questions unanswered.²²

¹ See *Temple-Inland, Inc. v. Cook*, Civ. No. 14-654-GMS, slip op. at pp. 17-18 (D. Del. June 28, 2016).

² *Id.* at 18.

³ *Id.* at 34.

⁴ *Id.* at 35.

⁵ *Id.* at 36.

⁶ *Id.* at 29.

⁷ *Id.* at 30.

⁸ *Id.* at 30.

⁹ *Id.* at 30.

¹⁰ *Id.* at 31.

¹¹ *Id.* at 31.

¹² *Id.* at 31.

¹³ *Id.* at 31.

¹⁴ *Id.* at 32.

¹⁵ *Id.* at 18.

¹⁶ See Del. Code Ann. tit. 12, § 1158.

¹⁷ *Id.* at 20. Note: The Opinion did not discuss the fact that the enabling legislation for the current version of § 1158 indicated that the statute of limitations only applied to report years beginning in 2003 (i.e., it was not enacted retroactively). See Del. Laws Ch. 417, § 6. However, there is no mention in § 1158 of this fact, which may have led the Court to believe that holders had no reasonable notice that § 1158 as revised did not apply to certain prior years.

¹⁸ *Id.* at 14.

¹⁹ See *American Petrofina Co. of Texas v. Nance*, 859 F.2d 840 (10th Cir. 1988), and *New Jersey Retail Merchants Ass'n v. Sidamon-Eristoff*, 669 F.3d 374 (3d Cir. 2012), cert. den. sub nom. *Sidamon-Eristoff v. New Jersey Food Council*, Dkt. 12-108 (U.S. Oct. 29, 2012).

²⁰ See *Temple-Inland*, slip op. at 33.

²¹ See Uniform Unclaimed Property Act of 1981, § 30(e), and Comment thereto.

²² Ed. Note: As this article was going to press, the parties to the suit entered into a voluntary settlement agreement whereby the matters in dispute in the case have been resolved.