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SALT Alert!

SALT Alert! 2016-13: Combination of Several Aspects of Delaware's Unclaimed Property Audit Process, Including the Estimation Methodology, Violates a Holder's Substantive Due Process

On June 28, 2016, in *Temple-Inland, Inc. v. Cook et al*., the Delaware federal district court held that Delaware's enforcement of its unclaimed property laws against a holder (Temple-Inland) violated the holder's substantive due process. Briefly stated, the court concluded that actions by Delaware, while not singularly leading to the due process violation, in combination led to the violation. Specifically, Delaware waited 22 years to audit the holder, exploited loopholes in the statute of limitations, failed to notify holders of the need to maintain unclaimed property records, failed to articulate a purpose for the unclaimed property law other than raising revenue, employed a flawed estimation method that negatively affected the holder, and subjected the holder to multiple liability. In the court's view, Delaware "engaged in a game of 'gotcha' that shocks the conscience." The court's ruling did not include any remedy for the violation that would have an immediate impact on Delaware's estimation techniques. However, the case remains one to watch because the ultimate decisions made by the court and/or Delaware may have a meaningful effect on the State's reach in terms of audit assessments of other companies in the future.

Background

Delaware is the state of incorporation or formation for many business entities. While that designation does not usually have sweeping tax consequences, it is significant for purposes of compliance with unclaimed property laws. Under rules established by the U.S. Supreme Court, unclaimed property escheats first to the state of the owner's last known address in the holder's books and records. If that address is unknown, the property escheats to the holder's state of incorporation.[1] That state is quite often Delaware. Thus, not surprisingly, Delaware is one of the more aggressive states with respect to unclaimed property compliance. Because Delaware interprets its statutes to allow for an unclaimed property look-back period of 20 years or more when no reports are filed, and most companies do not maintain records for more than seven to ten years, estimation techniques are used to determine unclaimed property liabilities for periods when holder records are not available. Estimations often account for the greatest proportion of unclaimed property liabilities identified by auditors, who are often not state employees, but are third-party contractors compensated on a contingent fee basis.

[1] Texas v. New Jersey (U.S. 1965).

Temple-Inland Decision

In December 2008, Temple-Inland was notified of an unclaimed property audit to be conducted by Kelmar Associates LLC (a contract auditor). Under its records retention policy, Temple-Inland kept copies of old unclaimed property reports (primarily to states other than Delaware) going back ten years, and had complete records for its accounts payable and payroll bank accounts (the accounts being audited) going back to 2003 and 2004 respectively. In situations where no unclaimed property reports were filed, a Delaware audit will typically look back 22 years. At the conclusion of the audit, Temple-Inland was assessed over $2 million, which was reduced to approximately $1.4 million after its administrative appeals were exhausted. At that point, Temple-Inland filed suit in the U.S. District Court for the District of Delaware challenging the constitutionality of several aspects of Delaware's enforcement of its unclaimed property laws, including that its substantive due process rights were violated. After surviving an attempt by the state to dismiss Temple-Inland's constitutional claims, the litigation proceeded.[2] In its June 28, 2016 opinion, the court agreed with Temple-Inland's assertions and granted the company's motion for summary judgment as to the substantive due process claim.

In a lengthy opinion, the court walked through several aspects of the Delaware unclaimed property audit process and the techniques used during such audits and concluded that in combination, these aspects of the audit process "shocked the conscience" and therefore violated Temple-Inland's substantive due process. The aspects of the enforcement process which troubled the court are discussed in more detail below.

- **Statute of Limitations**: Because Temple-Inland had retained only ten years of unclaimed property filings, Delaware essentially assumed the company had not filed reports in the earlier years. The court found several aspects of the audit process "troubling" with regards to the statute of limitations. Specifically, that Delaware placed the burden on Temple-Inland to establish that it filed past reports, yet did not warn holders that they needed to retain reports for all years; that Delaware did not take responsibility for maintaining records of all filings submitted to the state by holders; and that Delaware told holders (other than banks) that they need not file negative reports (i.e., reports with no unclaimed property to remit). In addition, the court held that the state was relying on the wrong statute (Sec. 1202—a statute intended to prevent a holder from limiting an owner's rights in its property) in imposing a look-back period of up to 22 years. The court noted that the statute of limitations provided for action by the state (Sec. 1158(a)) specified a maximum of six years in instances where property was omitted from a filing in excess of 25 percent of the amount of property included in the filing and, otherwise, three years from the date of the filing. Only in cases where no report is filed or where a false or fraudulent report is filed with the intent to evade the obligation to pay over abandoned property does the statute authorize Delaware to bring an action after the specified periods of time.
- **Notice**: Unlike most other states, Delaware does not have a record retention statute for unclaimed property, and a holder is therefore not on notice that it should have retained is unclaimed property records and reports forever.
- **Retroactivity**: In 2010, the law was amended to allow Delaware to use estimation in determining unclaimed property liability. Temple-Inland argued that the state's application of the estimation law retroactive 22 years violated the company's substantive due process. The court agreed that the retroactive application of the estimation statute did not withstand scrutiny because it did not reinforce the viability or purpose behind the state's unclaimed property program (reuniting property with its owner) and appeared to be a means for the state to raise revenues.
- **Estimation Techniques**: The court found fault with Delaware not extrapolating the characteristics of property used to calculate an error ratio in the base years to the years where records were not available. Specifically, certain property used in the base years showed an address in another state. Under the U.S. Supreme Court's rules, that property

[2] On March 11, 2015, the court denied Delaware's motion to dismiss for failure to state a claim upon which relief can be granted.

would not be escheatable to Delaware. However, when extrapolating to the years when records were unavailable (the look-back years), the auditors treated all the property in the estimation period as not having a known address. The underlying theory of Delaware's approach was that, because holder records were unavailable for the estimation period, all unclaimed property in the estimation period was "address unknown" property. However, estimated amounts must have the same qualities and characteristics of the records in the base periods; if no regard is given for property in the base periods that would be sourced to states other than Delaware, the estimation methodology is misleading, according to the court.

- **Multiple Liability:** The court found that Delaware's estimation technique was inappropriate because the same property was being used by Delaware to estimate liabilities that had already been used by Texas to estimate Temple-Inland's unclaimed property liability in Texas for the same audit period.

Based on the combination of these factors, the court concluded that Temple-Inland's due process had been violated. However, the court did not issue a ruling that all estimation techniques are offensive and declined to decide on an appropriate remedy. "It 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."

The court further denied summary judgment on Temple-Inland's claim of Delaware's constitutional violation of the Takings Clause, indicating "a reasonable estimation of a holder's unclaimed property liability is not an unconstitutional" taking. The court also granted Delaware's request for dismissal of Temple-Inland's Ex Post Facto claim against the state, concluding that Delaware's Section 1155 (which allows estimation in audits) does not function as a criminal penalty.

Next steps

While Delaware is fully expected to appeal, any company currently under audit or participating in the Delaware Voluntary Disclosure Agreement program should take note of this ruling and consider the effects it may have on Delaware's estimation methodologies going forward. For more information, please contact:

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