

## Client Alert

July 14, 2016

### Federal District Court Holds Delaware's Unclaimed Property Enforcement Practices "Shock the Conscience"

On June 28, 2016, in *Temple-Inland Inc. v. Cook*, 1:14-cv-00654 (D. Del. filed May 21, 2014), the U.S. District Court for the District of Delaware handed Temple-Inland Inc. ("Temple-Inland"), the plaintiff, a major victory over the Delaware Department of Finance (the "Department"), the defendants, declaring some of the Department's most egregious abandoned and unclaimed property practices to be unconstitutional executive action. As the court succinctly explained:

In summary, defendants: (i) waited 22 years to audit plaintiff; (ii) exploited loopholes in the statute of limitations; (iii) never properly notified holders regarding the need to maintain unclaimed property records longer than is standard; (iv) failed to articulate any legitimate state interest in retroactively applying Section 1155 [the Delaware statute allowing estimated assessments of unclaimed property] except to raise revenue; (v) employed a method of estimation where characteristics that favored liability were replicated across the whole, but characteristics that reduced liability were ignored; and (vi) subjected plaintiff to multiple liability. To put the matter gently, defendants have engaged in a game of "gotcha" that shocks the conscience.

The court's ruling provides many companies allegedly holding unclaimed property (referred to herein as "holders"), especially those incorporated in Delaware, with opportunities to challenge the Department's enforcement practices. Holders currently under audit, and potentially holders that have been previously audited or entered into voluntary disclosure agreements with the state, should consult with counsel to evaluate the proper course of action in light of this favorable development.

Temple-Inland is a Delaware-incorporated company with operations in various states. In 2008, Temple-Inland was notified that it would be subject to an audit administered by the Department's primary contract auditor, Kelmar Associates LLC ("Kelmar"), for the periods January 1986 through December 2007. Consistent with its internal record-retention policies, Temple-Inland was only able to produce complete books and records for its payroll and accounts payable disbursements dating back to 2003 and 2004, respectively. Temple-Inland also produced unclaimed property reports it filed in Delaware for each year from 1998 to 2008, some Delaware reports filed before 1998, and two Texas unclaimed property audit reports, covering years 1985 to 2005.

The Department, through Kelmar, audited Temple-Inland's payroll and accounts payable accounts for the 2004-2007 period ("Audit Period") and used an extrapolation formula to estimate a liability for the 1986 through 2003 period ("Estimation Period"). As explained in detail by the court, the estimate was based

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on all unclaimed property found by Kelmar during the Audit Period, including property owed to other states in addition to property owed to Delaware and regardless of whether the property was previously reported and remitted to the appropriate state. The Department ultimately assessed unclaimed property liability of \$2,128,834.13, notwithstanding that the audit only identified a single outstanding payroll check in the amount of \$147.30 that was escheatable to Delaware.

Temple-Inland protested the audit results through several levels of administrative appeal, resulting in \$1,388,573.97 of the original assessment being upheld. Temple-Inland declined to pursue an appeal to Delaware's Court of Chancery, and instead challenged the constitutionality of the Department's actions in federal court. The court issued its June 28, 2016 opinion on the parties' cross-motions for summary judgment.

(For additional background, please see *Tax News and Developments* article [A Real Game Changer? Temple-Inland v. Cook and the Future of Unclaimed Property in Delaware](#) (Volume XIV, Issue 6, December 2014), located under insights at [www.bakermckenzie.com](http://www.bakermckenzie.com).)

## Abstention

As an initial matter, the Department argued that the Delaware statute allowing for "reasonable estimation" of unclaimed property liability, Del. Code Ann. tit. 12 § 1155 (2010) ("Section 1155"), is ambiguous and requested that the federal court abstain from interpreting Section 1155 until it could first be interpreted by a Delaware state court. The court was not persuaded. Noting that federal common law limits abstention to "exceptional circumstances where construction of an ambiguous state statute by a state court could avoid or modify the federal question," the court found Section 1155 to be unambiguous, obviating any need for federal abstention. Further, the court found it unclear whether Delaware's Court of Chancery even had the authority to consider Temple-Inland's federal constitutional challenges.

## The Court Held the Department's Unclaimed Property Enforcement Practices Violate Substantive Due Process

The Due Process Clause of the U.S. Constitution generally prohibits states from depriving "any person of life, liberty, or property, without due process of law." At its core, due process protects against arbitrary government action. Legislative action violates substantive due process when a statute does not rationally serve a legitimate state interest. Executive action, such as the Department's audit and assessment of unclaimed property liability, violates substantive due process "only when it shocks the conscience."

Citing a lack of clear precedent, the court found no need to determine if any of the Department's actions taken alone violated substantive due process. Rather, the court held that the Department's executive unclaimed property enforcement practices, taken together, shocked the conscience.

### 1. Ignoring the Statute of Limitations

Delaware's statute of limitations applicable to assessments of unclaimed property generally provides the state three years from the date a report was filed to assess a deficiency. That period extends to six years to bring an action against a holder in the event a holder's liability is greater than 25% of any amount reported. To the extent a holder fails to file a report, the state is permitted to assess at any time.

For purposes of determining liability for the Estimation Period, the Department made an irrebuttable presumption that Temple-Inland failed to file unclaimed property reports, resulting in no applicable statute of limitations. However, this presumption plainly ignored two alternative explanations: (i) Temple-Inland may have had no liability for the Estimation Period, and per the Department's historical guidance, was not required to file "negative reports" indicating no unclaimed property owed; or (ii) Temple-Inland had unclaimed property liability and filed reports for years during the Estimation Period but destroyed those reports in accordance with the company's standard record-retention policies.

With respect to the first alternative, the district court criticized the Department for not informing holders (other than financial institutions) of the need to file negative reports. Without such reports, the statute of limitations would never begin to run against the state.

With respect to the second alternative, the court criticized the Department for placing the burden on holders to maintain records beyond standard record-retention policies, while providing no notice of such an extraordinary requirement. Because Temple-Inland was able to produce three Delaware unclaimed property reports from before 2002, and a report from every year within Temple-Inland's record retention policy period, the court found it likely that Temple-Inland filed reports that were now missing or destroyed.

The court found it particularly troubling that the state placed the entire burden of proving prior filings on Temple-Inland, while never putting the company on notice of the potentially severe consequences for not maintaining reports beyond standard record-retention policies.

## 2. Lack of Notice to Retain Unclaimed Property Records

The court found no reasonable estimation could be made without putting a holder on notice that it would be essentially defenseless "against overreaching in an unclaimed property audit unless it retained all of its records forever." Significantly, the court first determined that the Department, not Temple-Inland, bore the burden of proof with respect to the existence of unclaimed property.

The court followed authority holding that a government agency can meet its burden of proof with regard to an estimation if the presumption of liability created is rebuttable, and that the opportunity to rebut a presumption of liability is most readily provided by notice that relevant records must be retained. In this regard, the court was critical of both Delaware's failure to enact a records retention statute (unlike all but three of its fellow states), and the Department's temerity in arguing that Temple-Inland took a "calculated risk" by not maintaining records in anticipation of a 22-year unclaimed property audit.

## 3. Excessive Retroactivity

Temple-Inland also challenged the length of the Estimation Period as an unconstitutional retroactive application of Section 1155, which was enacted in 2010 and contained no express period of retroactivity. The court found the length of the Estimation Period -- by itself -- did not violate substantive due process. Instead, the court considered whether the length of the retroactive period was appropriate given the reasons why the statute was being applied retroactively. In this case, the Department failed to identify an adequate reason for the retroactive application of Section

1155. The court determined that the Department's action would not further the purpose of Delaware's unclaimed property laws, *i.e.*, returning property to the rightful owners. In this regard, the court stated that unclaimed property laws generally were:

[N]ever intended to be a tax mechanism whereby states can raise revenue as needed for the general welfare. States violate substantive due process if the sole purpose of enacting an unclaimed property law is to raise revenue.

Accordingly, the court found the Department's lengthy retroactive Estimation Period violated Temple-Inland's substantive due process rights in that it only served to raise revenue for the state.

4. Significantly Misleading Estimation

The court held that the Department's use of property owed to all states to estimate liability owed to Delaware "created significantly misleading results" and a violation of due process. The court stated that "estimation is properly performed when it is based on the principle that the unclaimed property in the [Estimation Period] has 'all the same qualities and characteristics' as unclaimed property in the [Audit Period]" and determined that the Department's estimation failed to apply that principle.

Significant to the court's analysis of the Department's estimation methodology, the U.S. Supreme Court has articulated two priority rules with respect to the rights of states to take custody of unclaimed property: (i) the state of the owner's last known address, as reflected in the holder's books and records, has first priority; and (ii) in the event the first priority rule fails for lack of an owner last known address, the second priority rule gives the right to take custody of unclaimed property to the holder's state of incorporation. *Texas v. New Jersey*, 379 U.S. 674 (1965). In making its estimation, the Department refused to account for the fact that property in the Audit Period showed addresses in other states, and instead included such property in the estimation of liability owed to Delaware. The Department's position has been that any estimated liability has no last known address and is owed to Temple-Inland's state of incorporation -- *i.e.*, Delaware. The court flatly rejected this logic, finding that the estimation failed to extrapolate the characteristics of the property back into the Estimation Period. This created "significantly misleading results" and violated substantive due process protections.

5. Estimation Practices Result in Multiple Liability

The court also held that the Department's estimation method resulted in unconstitutional multiple liability across states. As described above, the Department included property with last known addresses outside of Delaware in determining the liability owed to Delaware for the Estimation Period. However, Texas also employed estimation using property with last known addresses in Texas in an audit of Temple-Inland for the same years. Texas and Delaware used some of the same property in determining estimated unclaimed property liability due to each state. As a result, the court found the Department required Temple-Inland to escheat the same items of property to two states, violating the principle against multiple liability established by the U.S. Supreme Court in *Texas v. New Jersey*.

## Takings Cause Claim Unresolved

Temple-Inland argued Delaware's method of estimating unclaimed property due during the Estimation Period constituted an unconstitutional taking. The court determined that the Department "used Section 1155 to identify a specific fund of money, which, if not unclaimed property, is a legitimate property interest protected by the takings clause." However, the court, having found "that the proper use of estimation can satisfy [the Department's] burden that property is unclaimed" could not agree with Temple-Inland's "absolutist" argument that the entire estimation was an unconstitutional taking. The court stated that an estimation could be proper "when it balances the competing interests between unlawful taking by the state and improper windfall for the holders." The court found that the Delaware legislature appeared to have intended to strike that balance when it provided that the estimation must be reasonable, and held that a reasonable estimation of a holder's unclaimed property liability is not an unconstitutional taking. The court concluded that whether the Department's estimation was reasonable was not addressed by the parties, and presented a question of material fact that could not be resolved on summary judgment.

## No *Ex Post Facto* Law

The court denied Temple-Inland's *ex post facto* clause claim on the basis that Section 1155 was not intended as criminal punishment by the Delaware legislature and did not operate in practice like criminal punishment. Although the court noted that Section 1155 may be excessive in relation to its purpose -- resulting in an assessment that was "7,541 times greater" than all authorized penalties combined -- this was not enough to transform an otherwise civil penalty into a criminal one in violation of the *ex post facto* clause.

## The Impact of *Temple-Inland*

A few open questions remain, such as the remedy for the substantive due process violation and the disposition of the takings clause claim, and the court has set a status date of September 9, 2016. Regardless of how those issues are resolved, *Temple-Inland* has already proven to be a game changer. Although the Department may well appeal the district court's ruling to the U.S. Court of Appeals for the Third Circuit, that may not be a foregone conclusion. It is understood that there has been significant disagreement within Delaware government concerning the wisdom and fairness of the Department's unclaimed property enforcement measures. While the revenue generated may be a boon to state coffers, the cost to the state's business-friendly reputation has been high. The internal strife concerning the Department's practices is evident in the legislature's frequent changes to the state's unclaimed property statutes in recent years, as well as the decision to entrust the state's current voluntary disclosure program to the Delaware Secretary of State's office rather than the Department. Now that a federal court has found the Department's actions "shock the conscience" there may be significant resistance to an appeal within the state government. There is some hope the state will see the error of its ways and reform its unclaimed property enforcement practices without further litigation.

Assuming an appeal is pursued, holders remain in a strong position to push back against the Department's enforcement practices. The court's ruling may impact holders currently under audit by one of the Department's third-party auditors, holders that are participating in or have completed the state's voluntary disclosure program, and holders that have paid estimations of Delaware unclaimed property liability.

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For holders currently under audit only by Delaware, there is arguably no reason to continue participating in the audit. If the Department does not agree to suspend the audit and instead pursues further enforcement measures, a path forward has potentially been paved by Plains All American Pipeline, L.P. ("Plains"). Shortly after the Department and Kelmar initiated an unclaimed property audit of Plains, the company filed a pre-emptive suit in the U.S. District Court for the District of Delaware, seeking, in part, an injunction against continuation of the audit. *Plains All American Pipeline, L.P. v. Cook*, No. 1:15-cv-00468 (D. Del. filed June 5, 2015). That matter is still pending. Holders that are currently under audit may want to consider a similar approach if the Department continues to pursue its historic audit practices.

Holders currently under a multistate audit including Delaware may have different considerations. Other states may not be persuaded that *Temple-Inland* has any impact on their ability to proceed. Holders may find it advantageous to continue the audit and pursue a closing agreement resolving any potential past liabilities with those states. *Temple-Inland* raises many issues for states other than Delaware, and could potentially increase the use of estimations by other states. However, it will take time for the states to evaluate and act on the decision. Holders may find the period while *Temple-Inland* is (presumably) on appeal to be an opportune time to resolve potential liabilities with other states.

Those holders who have already paid Delaware on an estimation of purported unclaimed property liability, whether under audit or pursuant to a voluntary disclosure agreement, should review their closing agreements with the state. It may be possible to pursue a refund of improperly estimated amounts.

These are but a few of the possible implications of *Temple-Inland*. Each holder's circumstances will differ, and a number of considerations will inform the best course of action. Holders should consult with their unclaimed property advisors to determine the appropriate path forward. More broadly, the court's criticism of the purposes and presumptions underlying the Department's enforcement of Delaware's unclaimed property laws could signal long-overdue examination of other state unclaimed property enforcement practices.

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