Unclaimed Property: The Solution To State Budget Woes?

by Ethan D. Millar and Kendall L. Houghton

Introduction

States continue to face severe financial difficulties and struggle to replace the massive revenue losses triggered by the last recession. States suffered large shortfalls in fiscal years 2009 through 2011. In fiscal 2012, 42 states and the District of Columbia have closed, or are working to close, $103 billion in budget gaps.1 Many states have looked to state unclaimed property laws for help in filling these gaps.

Any corporate group that has survived or is still undergoing a multistate unclaimed property audit can recite the factors that contribute to aggressive audits and high assessments. First and foremost, the audits are typically conducted by third-party auditors compensated by the states on a contingent fee basis. Because the third-party auditors have a direct pecuniary interest in an audit’s outcome, they have a strong incentive to resolve any doubts in favor of the state and against the holder (that is, the audited business that issues or “holds” reportable property). Furthermore, many of those audits also are conducted on behalf of multiple states simultaneously (often, as many as 30-40 states). This can create significant problems in appealing adverse determinations of the auditor, which are worsened by the fact that few states offer any sort of formal administrative review process.2

However, these general complaints can pale in comparison with the specific complaints many holders articulate, based on some audit techniques employed by the audit firms. This article highlights some of the most prevalent and potentially objectionable trends in unclaimed property audit techniques. In addition, this article discusses a number of developments over the last year or so that highlight the trend of states’ use of unclaimed property laws to raise revenue, including shortening the dormancy periods for reporting unclaimed property, targeting new types of property (including securities, stored value cards, and promotional incentives), creating new jurisdictional rules to claim property (the place-of-purchase presumption and the third-priority rule), and even retroactively escheating unclaimed property. All of these trends further exacerbate the compliance costs and audit risks faced by holders.

A. Unclaimed Property Audit Techniques

1. Estimation Techniques

When a holder no longer has records for prior periods covered by an audit, the state of domicile of the holder will generally “estimate” the amount of unclaimed property held by the holder for those prior periods. To do so, the state will typically calculate the holder’s actual unclaimed property

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liability for the more recent periods for which the holder does have adequate records; compute an “error rate” equal to the unclaimed property liability as a percentage of the holder’s revenues (or other financial metric, as appropriate) for those periods; and use the “error rate” to extrapolate unclaimed property liability for the prior periods based on the revenues (or other financial metric) of the holder for those periods. Any “estimated” unclaimed property, of course, has no real or identifiable owner, and therefore the holder’s state of domicile will deem that it has the right to claim any extrapolated liabilities under the jurisdictional “priority” rules set forth by the U.S. Supreme Court in Texas v. New Jersey.3

As the state of domicile of the largest percentage of incorporated and unincorporated business entities, Delaware is the state that most often benefits from these estimations. Indeed, unclaimed property is now the third-largest revenue source for Delaware, bringing in almost half a billion dollars annually. However, until recently, Delaware did not actually have statutory authority to perform these types of estimations.4 This changed on July 23, 2010, when Delaware enacted SB 272 into law. SB 272 amended 12 Del. Code section 1155 to expressly authorize Delaware to use “reasonable” estimation techniques to determine the existence and amount of unclaimed property when the holder’s records are “insufficient” to permit the preparation of a report.5 SB 272 thus attempts to deflate holders’ prior arguments that Delaware’s use of estimation was illegal. However, despite this new legislation, holders may still challenge the use of estimation on constitutional grounds or question the manner of estimation used in any particular case.6

2. Look-Back Periods

Estimated unclaimed property liabilities will, of course, be larger the longer the look-back period of the audit. Most states have a look-back period of 10 reporting years, which, as a result of the dormancy period preceding reporting, is generally 13 to 15 years since the potential “liability” was originally incurred. By contrast, most companies keep records for about seven years, virtually ensuring that the state will perform some type of estimation. Delaware typically goes back to 1981 on audit.

However, holders are not defenseless against these tactics. Some of the more common defenses holders may raise to limit a state’s look-back period are:

• that the holder has qualified for a shorter look-back period through prior filings or by entering into a voluntary disclosure agreement with the state;
• the state’s claim is barred by a statute of limitations (many states do not have statutes of limitations in their unclaimed property laws unless the holder was regularly filing reports, but other state and federal statutes of limitations may apply7); and
• the state’s claim is barred by the doctrine of laches or the doctrine of acquiescence due to the failure by the state to assert its rights in a timely manner.

The state’s ability to claim some property may also be limited to the extent the property has changed hands over the years.

3 379 U.S. 674 (1965). In Texas, the U.S. Supreme Court held that under the “first-priority rule,” the state with the right to claim unclaimed property is the state in which the last known address is located, if the holder has a record of that address. If the holder has no record of the owner’s address or if the state of last known address does not provide for escheat of the property, under the second-priority rule, the state of domicile of the holder has the right to claim the property. The Court has determined that the state of domicile of a corporation is its state of incorporation.

4 The Delaware legislature had previously rejected — in 2000 — a bill that would have granted the Delaware escheator that authority. By contrast, Delaware has long had statutory authority to use extrapolation to estimate tax liability in some circumstances (Del. Code Ann. sections 521(b), 364) so it is clear the Delaware legislature knew how to write that legislation and recognized it is necessary to authorize that process.

5 SB 272 also attempts to retroactively sanction Delaware’s prior use of statistical estimation by stating:

The General Assembly finds that the employment of estimation techniques is an accepted and routine practice used both by holders of abandoned and unclaimed property and by the State Escheator in determining holders’ liability to report and pay such property to the State with respect to periods for which inadequate holder records exist, and desires to ratify and affirm that the State Escheator has inherent authority to estimate abandoned and unclaimed property liability when adequate records do not exist.

6 For example, in Staples, Inc. v. Cook, C.A. No. 5447-VCS (Del. Ch. Ct. 2010), Staples argues that (1) Delaware cannot use a strict proof standard in determining whether an outstanding check is includible in the error rate that is used to estimate a holder’s unclaimed property liability for prior years; (2) Delaware should only be able to include in the error rate unclaimed property owed to Delaware residents; and (3) Delaware’s error rate is unreliable (and thus an unreasonable method of estimation) if it fluctuates widely from year to year.

7 For example, one argument raised by holders is that the four-year statute of limitations in Delaware’s Uniform Commercial Code (6 Del. Code section 2-725) trumps the five-year abandonment period applicable to uncashed vendor checks and other business-to-business obligations. Although Delaware, like almost all states, has adopted an anti-limitations provision in 6 Del. Code section 1202 (which essentially provides that state statutes of limitations are ignored for escheat purposes), holders have argued that this provision is “repealed” to the extent it conflicts with the UCC. See 6 Del. Code section 10-103.
3. Burden of Proof Placed on Holder

In general, the state has the burden of proving the existence and the amount of any unclaimed property that is due. However, many states take the position that if the holder’s records indicate the existence of a liability, the burden is shifted to the holder to demonstrate that the liability is no longer owed. Some states are even more aggressive in shifting the burden to holders. For example, Delaware has taken the position that if a check remains outstanding for more than 90 days, the underlying obligation constitutes unclaimed property unless the holder can provide “strict proof beyond a reasonable doubt” that the obligation does not exist. In many cases, the obligation is no longer owed and thus the accounting entry is merely an error, but holders often maintain inadequate records to meet the state’s high standard of proof, and thus the states treat the obligation as unclaimed property. This error is compounded significantly once the so-called liability is extrapolated back many years to estimate liability for prior periods.

In any event, the strict proof standard used by Delaware is clearly the wrong standard to apply. One of the basic principles of unclaimed property law is that the state derives its right to claim unclaimed property from the owner of the property. This is commonly referred to as the “derivative rights doctrine.” Thus, the state “stands in the shoes” of the owner in claiming the property, which it then holds on the owner’s behalf. As a result, the state should generally be bound by the same standard of proof that the owner would need to satisfy to claim the property from the holder. A person claiming that he is owed specific property would certainly need to show more than simply an entry in the holder’s books and records to claim the property. In addition, it should also be remembered that the law disfavors true escheats of property and generally permits those escheats only in rare and unusual situations in which there is no doubt about the existence and amount of the liability.

B. Multistate Unclaimed Property Trends With Revenue Implications

1. State Reductions in Dormancy Periods

A number of states, including New York, Illinois, Texas, Michigan, and Nevada, have recently enacted bills reducing the dormancy periods for various types of unclaimed property. Most of these reductions are from five to three years, though some reductions are more drastic. Holders have claimed that these shortened dormancy periods are intended primarily to increase revenues for states, and that the shorter dormancy periods often have nothing to do with when property is actually “abandoned” by its owner. In American Express Travel Related Services Company v. Hollenbach, American Express Travel Related Services Co. (Amex) claimed that Kentucky’s reduced dormancy period for traveler’s checks (from 15 years to seven years) violated substantive due process for these very reasons.

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The U.S. District Court for the Eastern District of Kentucky agreed with Amex. However, the U.S. Court of Appeals for the Sixth Circuit reversed, holding that the reduced dormancy period did not violate due process. The Sixth Circuit concluded that the lower court applied the incorrect standard of review, and that the traditional rational basis

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9An example may be useful to illustrate the significance of these issues in real audits. In an audit we completed recently, the sample drawn by the auditors for uncashed accounts payable checks was divided into a number of strata, from checks under $75 in the lowest stratum to checks over $75,000 in the highest. A check for $76,471, which the client could not prove to the auditors’ satisfaction was no longer due and owing, extrapolated into total liability of $140,773. However, because of the vagaries of the extrapolation method (which takes into account the number of checks outstanding and remediated in each stratum), another check for just $399 extrapolated into total liability of $147,824 — more than the $75,000 check produced! A check for $75 in the lowest stratum extrapolated into total liability of $111,263; and a check for $2,889 in a middle stratum actually extrapolated into total liability of over $308,000. Regarding this last check, the company found handwritten notes that were made on the cancelled check shortly after it was issued and later voided more than 10 years earlier stating, “This has already been paid. It was on 1 large ck. Do not reissue.” This was deemed by the auditors insufficient to establish that the check had been properly voided and that the amount was no longer due, and the auditors included the check in the extrapolation “error rate” to calculate an extrapolated liability of more than $300,000 for that single check.

10See, e.g., State v. Standard Oil Co., 74 A.2d 565, 573 (1950), aff’d, 341 U.S. 428 (1951). (“The State’s right is purely derivative: it takes only the interest of the unknown or absentee owner.”)

11See, e.g., State v. United States Steel Corp., 95 A.2d 734, 738 (N.J. 1953) (“any doubt as to whether property is subject to escheat is resolved against the state”).

122009 WL 1663441 (E.D.Ky.), rev’d, No. 09-5898 (6th Cir. 2011).
standard of review was appropriate. Under this standard, which is highly deferential to the legislature, legislation will survive a substantive due process challenge as long as the legislation was rationally related to a legitimate state purpose. The Sixth Circuit found that Kentucky had a legitimate interest in taking custody of abandoned property and that the shortened dormancy period was rationally related to that purpose, even if the actual purpose of the legislature may have been to generate revenue. This decision does not bode well for holders, and may encourage some states to reduce the abandonment periods even further.

2. New Jersey Stored Value Card Litigation Raises Important Issues for Holders in All States

On June 30, 2010, New Jersey adopted P.L. 2010, c. 25, which:

- requires the escheat of stored value cards;
- requires issuers of stored value cards to collect the name and address of the purchaser or owner of the card, and to maintain at least the ZIP code of the purchaser or owner; and
- provides that if the card issuer does not collect the address of the purchaser or owner of the card, the address will be presumed to be in New Jersey if the card was sold in New Jersey (this is referred to as the place-of-purchase presumption).13

The legislation generally became effective July 1, 2010, but purported to apply to stored value cards issued before July 1, 2010. The New Jersey treasurer estimated that the legislation would generate about $80 million in revenues in fiscal year 2011 alone, largely because of this retroactivity provision.

After this legislation was adopted, the treasurer released guidance that provided, among other things, that an issuer could satisfy the requirement to collect purchaser/owner address information if the issuer merely collects (and maintains) the ZIP code of the purchaser/owner and not the full address. At the same time, New Jersey contended that a ZIP code is a “last known address” sufficient to trigger the first-priority rule and therefore, if the purchaser or owner of the card has a ZIP code located in New Jersey, then the unredeemed card balance is escheatable to New Jersey. The treasurer also relaxed the place-of-purchase presumption, at least as applied to cards previously issued, but instead asserted that cards sold in New Jersey before the enactment of the 2010 legislation were nevertheless subject to escheat under the “third-priority rule” if the issuer was domiciled in a state that does not provide for the escheat of unredeemed stored value cards. Though 37 states (including the District of Columbia) have statutes authorizing them to claim unclaimed property under the third-priority rule, this was the first time a state had formally asserted its right to claim on this basis.

Several plaintiffs brought suit against the New Jersey treasurer in the U.S. District Court for the District of New Jersey challenging various aspects of the 2010 legislation and the treasurer’s guidance, including the place-of-purchase presumption, the third-priority rule, the ZIP code collection requirement, and the retroactive escheat of stored value cards.14 The plaintiffs have argued that the place-of-purchase presumption and the third-priority rule are preempted by the federal common law priority rules adopted by the U.S. Supreme Court in Texas v. New Jersey.15 Indeed, the place-of-purchase presumption directly conflicts with the second-priority rule (which permits the holder’s state of domicile to claim owner-unknown property rather than the state in which the card was sold, if the first-priority rule does not apply) and the third-priority rule is at odds with the Supreme Court’s adoption of a two-part scheme and its specific rejection of a transaction-based custody rule.16 Moreover, the third-priority rule fails a common-sense test: If the state of domicile has the superior right to claim the property (which even New Jersey concedes), how can a third-priority state trump a domiciliary state’s statute that expressly allows the holder to retain the property?

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The federal district court upheld the ZIP code collection requirement, but concluded that the retroactive escheat, the place-of-purchase presumption, and the third-priority rule were unconstitutional. The court held that the retroactive escheat would

13The legislation also shortened the abandonment periods for traveler’s checks and money orders and restricted the use of dormancy fees on stored value cards and other instruments.


15379 U.S. 674 (1965).

violate the contracts clause of the U.S. Constitution because it would substantially impair the existing stored value card contracts (by depriving the card issuers of the unredeemed card balances and expected profits resulting from the sales of the cards) and there was no legitimate or important public purpose that could justify that impairment. Both sides appealed to the Third Circuit. The Third Circuit issued an order preliminarily enjoining the ZIP code collection requirement, pending the court's final resolution on the merits. The parties finished briefing their arguments in May. Oral arguments have been scheduled for September 12, 2011, and a decision is expected from the Third Circuit shortly thereafter.

Though New Jersey is the only state that has adopted a ZIP code collection requirement and is one of only a few states that have a place-of-purchase presumption, holders should pay close attention to this litigation for several reasons. First, it raises the question of the constitutionality of the third-priority rule, which is at issue in all 37 states (including the District of Columbia) that have adopted it. Few holders are complying with this rule, on the basis that it is widely believed to be unenforceable. Second, the New Jersey litigation involves the retroactive escheat of property, which is a potential issue in any state regardless of the type of property at issue. And third, if the ZIP code collection is upheld by the Third Circuit, other states will presumably follow, creating significant technical challenges and unclaimed property issues for holders across the country.

3. States Claim New Property Types

a. Uninvoiced Receivables

Delaware's SB 272, discussed above, also enacted 12 Del. Code section 1211, which expressly excludes "uninvoiced payables" from the definition of property subject to escheat. Before this legislation, Delaware had taken the position that uninvoiced payables — also sometimes referred to as balances in GR/IR (goods received/invoice received) or GR/NI (goods received/no invoice) accounts — were subject to escheat. These account balances are generated when a company received goods but either the company does not receive a corresponding invoice that can be associated with those goods or the company receives an invoice but the amount of goods actually received exceeds the amount stated on the invoice.

This position had been highly controversial because holders asserted that these balances did not actually represent fixed and certain liabilities owed to their vendors. 12 Del. Code section 1211 defines uninvoiced payables to mean "amounts due between merchants as defined in the Delaware Uniform Commercial Code, 6 Del. C sections 1-101, et seq., from a holder who is a buyer to a creditor who is the seller of goods ordered by a holder in the ordinary course of business when the goods were received and accepted by the holder, but which for any reason were never invoiced by the seller." Uninvoiced payables include both (a) the value of goods received by a holder from a seller from out of balance transactions where the holder's purchase order for goods and the amount of goods received by the holder do not match; and (b) unsolicited goods received by a holder from a seller that fall within 6 Del. C. section 2505. However, uninvoiced payables do not include "accounts payable, accounts receivable, or any other type of credit or amount due to the creditor, including uncashed checks of any kind whatsoever whether relating to inventory, goods, or services, and all of these types of property are still reportable as abandoned or unclaimed property."17

Although uninvoiced payables are no longer an issue in Delaware, other states have now begun to assert that uninvoiced payables must be reported as unclaimed property. Holders have a variety of defenses to potential claims by states of this type of property. Most of these defenses, however, require a detailed understanding of the company's business, the circumstances under which the account balances are created (and eliminated), the contractual arrangements among the parties, the general practices in the industry, and the specific course of dealing between the purchaser and seller.

b. Promotional Incentives

States and their third-party contingent fee audit firms have also recently begun to claim that various types of promotional incentives constitute unclaimed property that must be reported and remitted to the states. The most common of these is the traditional cash rebate, which states have now been claiming for several years. There are estimated to be hundreds of millions of dollars of uncashed rebate checks industrywide. However, states have now started to target other types of incentives as well, including incentives issued in the form of prepaid cards (both closed-loop and open-loop cards). Given the increased popularity of rebate cards and other promotional cards in recent years, the potential claims by states in this area are enormous.

If a state seeks to claim promotional incentives, there are a number of defenses holders can raise. First and foremost is the question of consideration — if there is no consideration provided for the promotional incentive, then there can be no unclaimed property (because without consideration, there can be no legal obligation to escheat). A second

17The legislation also makes clear that this exemption is not intended to create a business-to-business exemption of any kind regardless of whether a current business relationship exists between the holder and the creditor.
defense is that promotional incentives often come with strings attached. If the holder has provided for a “condition precedent” that the participant must satisfy to receive the incentive, then the participant’s failure to satisfy the condition should preclude both the participant’s and the state’s claim to the property because the property interest is not fixed and certain. A similar defense may be asserted if a “condition subsequent” occurs that deprives the participant of the right to claim the property. The most common condition subsequent is a deadline by which the participant must claim the property. However, about two-thirds of the states have adopted anti-limitations provisions providing that the expiration of any period of time specified by contract, during which a claim must be made to recover money or property, does not prevent the money or property from being deemed unclaimed property. On the other hand, these provisions were not originally intended to be applied to promotional incentives, and thus there are good reasons why a court may choose to construe these provisions more narrowly.

A third defense that may be asserted depends on the type of promotional incentive at issue. For example, if the promotional incentive is a specific product or service rather than an obligation to pay money, then the escheat laws should not apply. This result follows from the derivative rights doctrine — that is, because the owner has only the right to receive the specific product or service and no right to receive cash, the state should be similarly restricted from claiming cash. What if the promotional item is an open-loop or closed-loop prepaid card?18 Again, under the derivative rights doctrine, both open-loop and closed-loop cards should technically not be escheatable unless they are redeemable for cash (which few are). However, most states require the escheat of open-loop cards, perhaps on the basis that they are sufficiently similar to cash to make the escheat of cash justifiable. A significant number of states also require the escheat of closed-loop gift cards and gift certificates (even if not redeemable for cash), particularly if the cards have expiration dates (which is common for cards distributed in connection with a promotional program). The escheat of these cards is clearly contrary to the derivative rights doctrine, and thus is arguably precluded by U.S. Supreme Court case law recognizing that doctrine.19

In addition, holders should be careful to review the statutes and case law in each state, because some states’ definitions of gift card and gift certificate are narrower than others. For example, some states, like Louisiana and Massachusetts, define a gift card to be an instrument identified as a gift card, which thus would not apply to promotional cards.20 Finally, a few states also have adopted express exemptions for specific types of promotional incentives.21

A final defense that may be raised is that the company under audit may not even be the holder for unclaimed property purposes. In general, the holder is the entity legally obligated to pay or deliver the property to the owner. For example, in the discount voucher programs that have recently skyrocketed in popularity, it is the merchant issuing the voucher that would generally be the holder rather than the company that sells and markets the voucher, because the merchant, rather than the marketer/distributor, has agreed to be directly liable to the purchaser for the unredeemed vouchers. In other promotional programs, there may be several different entities involved and the identity of the holder may shift from one entity to another. For example, in an open-loop rebate card program, the rebate sponsor will often contract with a fulfillment company, which will then contract with a bank that will issue the cards for the program. In these cases, the sponsor would generally be the holder until the time the rebate card is delivered to the customer. At that point, however, the bank, as the issuer of the card, would apparently become the holder because it is the bank, not the rebate sponsor, which is directly liable on the card to the cardholder. Despite these generalizations, however, the determination of which entity is the holder is always a fact-specific inquiry, and requires a close review of the contractual agreements among all of the parties involved.

c. Equity Audits

Delaware recently started conducting audits for equity property (that is, securities and dividends). Previously, Delaware conducted only general ledger audits, though some states, like New York, have been conducting equity audits for years. Delaware apparently believes that securities have not been properly reported in many instances, and for that reason it has now made equity a part of the review in all audits conducted by Kelmar Associates LLC, the state’s primary contract audit firm. Interestingly, several major stock transfer agents had previously retained ACS Unclaimed Property Clearinghouse (another one of the main contract audit firms used

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18 An open-loop card refers to a card, typically issued by a financial institution, that runs on any of the MasterCard, Visa, American Express, or Discover networks and thus can be redeemable wherever those network-branded cards are accepted. A closed-loop card is a card that is issued by a single merchant and that can be redeemed only by that merchant or its affiliates.


21 See, e.g., Va. Code Ann. section 55-210.8:1(B) (exempting promotional incentives from escheat); S.D. Cod. Laws section 43-41B-41 (exempting rewards cards from escheat).
by states, including Delaware) to handle the unclaimed property reporting that the transfer agents were required to perform under their contracts with issuers (which is now under review by Delaware). Complicating matters further, Kelmar recently hired the former ACS CEO to conduct the securities-related audits.

Because this is a relatively new development, it will be interesting to see how these equity audits play out over the next couple of years and, in particular, whether Delaware seeks to expand its use of statistical estimation to equity property.

4. Life Insurance Company Audits

States have also recently begun targeting life insurance companies for unclaimed property audits. As many as 37 states have retained Verus Financial LLC to conduct investigations of dozens of life insurance companies. These audits, often performed in connection with market conduct examinations, are focusing on the insurance companies’ policies and procedures for determining whether an insured is deceased and for locating beneficiaries. For example, insurance regulators have asserted that life insurers should check their records against the Social Security Death Master File to determine if an insured may be deceased. Because the period of presumed abandonment for life insurance proceeds typically starts running when the insurance company becomes “aware” that the insured is deceased, that action could also potentially affect the insurers’ escheat obligations.22

The audits have already begun to affect the way life insurance companies do business, as well as their unclaimed property responsibilities. Earlier this year, John Hancock Life Insurance Co. entered into settlement agreements with California and Florida as well as a global settlement agreement with Verus regarding the remaining states in the audit. As part of the settlement agreements, John Hancock agreed to pay out millions of dollars in damages, restore account balances to thousands of policyholders, and dramatically alter its policies and procedures for determining death benefits and locating beneficiaries.

Conclusion

There seems in the current economic climate to be no hesitation on the part of the states to employ the long-touted “anti-[holder]-windfall” public policy underlying their unclaimed property laws to redirect revenues into their own treasuries. Careful holders would be well advised to review the state of their compliance policies and procedures, and to assess the risks associated with the aggressive audit techniques, litigation postures, and legislative trends discussed above.

22Incidentally, Verus has apparently claimed that the date of death of the insured is the event that triggers the start of the abandonment period even in states that have a clear knowledge requirement. Holders should resist those attempts to improperly accelerate the abandonment period.

Ethan Millar and Kendall Houghton are attorneys with Alston & Bird LLP’s State Tax Practice Group, where their practices focus heavily on multistate unclaimed property legal issues, including compliance, audit, litigation, and planning questions. Millar is based in the firm’s Los Angeles office, where he can be reached at ethan.millar@alston.com or (213) 576-1025; Houghton is based in the firm’s Washington office, where she can be reached at kendall.houghton@alston.com or (202) 239-3673.