

## State and Local Tax ADVISORY

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### Limiting State Anti-Limitations Provisions

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In unclaimed property audits and in voluntary disclosures, states commonly take the position that time-based contractual limitations on an owner's right to claim unclaimed property may be disregarded by the state. That allows states to seize unclaimed property even if the owner no longer has a right to claim the property. States justify that position based on so-called anti-limitations provisions that provide that the expiration of a contractual period of limitation on the owner's right to claim property does not prevent the property from being presumed abandoned. Not all states have adopted those provisions, though, and therefore sometimes a state will seek to ignore these contractual limitations based on a common law doctrine known as private escheat. However, the idea that a state can claim property that the owner himself could not claim flies in the face of basic unclaimed property principles, and is also contrary to common sense and good public policy. As a result, the anti-limitations provisions should, like the private escheat cases on which they are based, be limited to very unusual and abusive circumstances.

This issue arises in various different contexts. Perhaps the most common situation, and the one on which this article will focus, involves contracts between sophisticated businesses operating at arm's length. Those contracts often place explicit time limits on one or both parties' ability to claim any amount that is or may be owed between the parties as a result of ordinary business transactions. For example, a contract may provide that in order for a party to make a claim regarding a transaction covered by the contract (for example, for overpayments or underpayments, overshipments or undershipments of goods, and so on), the claim must be made within two years of the date of the transaction. Alternatively, the contract may provide a limited period of time in which one party may audit the other party's records to determine the other parties' compliance with the contract and thus whether a claim might exist regarding a specific transaction or transactions. Again, if that period of time has passed, no claim may be made under the contract regarding those transactions. However, states (and their auditors) often ignore those provisions and assert that any outstanding obligations that are owed, or that *may* be owed,<sup>1</sup> by one business to another constitute unclaimed property even though

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<sup>1</sup> Often, those questions arise in situations in which there is some uncertainty whether an obligation actually exists. For example, a health care provider may receive a payment from an insurance company that exceeds the amount that it expected to be paid based on its contract with the insurer. The healthcare provider may record that excess as a credit balance on its books even if it has not determined that the amount it expected to be paid is in fact the actual amount due. Credit balances are frequently improperly recorded on a company's books for a variety of other reasons as well, including internal processing errors, pricing adjustments, recovery of bad debt write-offs, errors in recording the original accounts receivable, and so on. Even if it is unclear whether a credit balance is actually owed, however, states often attempt to claim the credit balances as unclaimed property if the alleged holder cannot provide adequate proof that no underlying obligation exists.

the business on which the state is acting could no longer claim the property itself.<sup>2</sup>

Moreover, once the state has succeeded in claiming the property, the business on whose behalf the state acted would then be entitled to reclaim the property from the state, thereby circumventing the express terms of the contract. More often, though, the business does not actually get the property back. That is because most of the property claimed by states on behalf of businesses is based on a statistical estimate of property owed rather than on actual debts owed to a specific business organization.<sup>3</sup> And when the state's claim is by estimation, there is no actual "owner" of the property claimed and therefore no person to whom the state can return the property. In those situations, the application of the anti-limitations provisions is even more questionable because the state is attempting a "true escheat" of the property. The law disfavors true escheats of property and generally permits those escheats only in rare and unusual situations in which there is no doubt whatsoever that the property may be claimed.<sup>4</sup>

### Construing the State Contractual "Anti-Limitations" Provisions

State contractual anti-limitations provisions first arose in connection with the drafting of the Uniform Unclaimed Property Act of 1981 (the 1981 Act).<sup>5</sup> In particular, Section 29(a) of the 1981 Act provides that:

The expiration, before or after the effective date of this Act, of any period of time specified by contract, statute, or court order, during which a claim for money or property can be made or during which an action or proceeding may be commenced or enforced to obtain payment of a claim for money or to recover property, does not prevent the money or property from being presumed abandoned or affect any duty to file a report or to pay or deliver abandoned property to the administrator as required by this Act.

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<sup>2</sup> Not all states require the escheat of obligations owed between businesses. Thirteen states have now adopted in their unclaimed property statutes some type of statutory business-to-business exemption that generally applies to those obligations. See, e.g., 765 Ill. Comp. Stat. section 1025/ 2a(b); Ohio Code section 169.01(B)(2)(b), (c). Also, several additional states, including New York and Texas, have adopted administrative policies that do not require the escheat of those obligations as long as the holder maintains an ongoing business relationship with the owner. Those exemptions recognize that state unclaimed property laws were originally intended to be consumer protection devices, and that businesses dealing at arm's length will generally claim actual amounts owed between them, and therefore if no claim is made regarding a particular item, it is unlikely that the item is actually owed.

<sup>3</sup> All or almost all states take the position that they have the right to use those estimations when the holder has failed to keep adequate records for prior years. Although most states now have statutory authority to use those estimations (see, e.g., Unif. Unclaimed Prop. Act, section 30(e) (1981); Unif. Unclaimed Prop. Act, section 20(f) (1995); 12 Del. Code section 1155), it is not clear that unclaimed property may lawfully be claimed based on an estimate and, if so, under what circumstances. However, a discussion of the constitutional and other challenges that can be made to states' use of estimation in the unclaimed property context is well beyond the scope of this article.

<sup>4</sup> See, 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").

<sup>5</sup> States had adopted non-contractual anti-limitations provisions before the 1981 Act. Indeed, the first anti-limitation provision, which applied only to limitations imposed by statute or court order, appeared in section 16 of the Uniform Unclaimed Property Act of 1954. That section provided as follows: The expiration of any period of time specified by statute or court order, during which an action or proceeding may be commenced or enforced to obtain payment of a claim for money or recovery of property, shall not prevent the money or property from being presumed abandoned property, nor affect any duty to file a report required by this act or to pay or deliver abandoned property to the [State Treasurer].

Section 19(a) of the Uniform Unclaimed Property Act of 1995 (the 1995 Act) contains an almost identical provision.<sup>6</sup> Thirty-five states (plus the District of Columbia) have adopted that provision or a nearly identical one in their unclaimed property statutes.<sup>7</sup> Delaware has also adopted a contractual anti-limitations provision, but it is worded much differently from those in the Uniform Acts and is therefore discussed separately below.<sup>8</sup> The comment to section 29(a) of the 1981 Act further states that the contractual anti-limitations provision was designed so that “the expiration of time periods set forth in contracts will not prevent the property from becoming reportable.” On its face, therefore, the general anti-limitation provision appears to be very broad.

However, the first thing to note about this provision is that it applies when there is an expiration of an owner’s existing right to claim property. Thus, this provision applies to a *condition subsequent* that seeks to deprive an owner’s right to claim property after a specific period of time. However, it is not as clear that it applies to a *condition precedent* that imposes a restriction on a person’s right to claim property in the first place. That can be an important distinction, as often a condition subsequent and a condition precedent can be worded similarly. For example, a condition subsequent may state that a business’s right to make a claim expires if the claim is not made by the business within two years. However, a condition precedent may state that in order to make a claim, the business must initiate that claim within two years of the date of the transaction. Both conditions are substantively similar, but the anti-limitations provision arguably applies only to the former and not the latter. Thus, as a preliminary matter, it is generally advisable for contractual limitations provisions to be worded as conditions precedent rather than conditions subsequent to reduce the likelihood that the anti-limitations provisions apply at all.<sup>9</sup>

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<sup>6</sup> Section 19(a) states: “The expiration, before or after the effective date of this [Act], of a period of limitation on the owner’s right to receive or recover property, whether specified by contract, statute, or court order, does not preclude the property from being presumed abandoned or affect a duty to file a report or to pay or deliver or transfer property to the administrator as required by this [Act].”

<sup>7</sup> See Alaska Stat. section 34.45.430; Ala. Code section 35-12-88(a); Ariz. Rev. Stat. section 44-321(A); Ark. Code Ann. section 18-28-219(a); Colo. Rev. Stat. section 38-13-122(1); Conn. Gen. Stat. section 3-73b; D.C. Code Ann. section 41-129(a); Fla. Rev. Stat. section 717.129(1); Ga. Code Ann. section 44-12-226; Hawaii Rev. Stat. section 523A-29(a); Idaho Code section 14-529(1); Ind. Code section 32-34-1-41(a); Kan. Stat. Ann. section 58-3962(a); La. Rev. Stat. section 9:171(A); Maine Rev. Stat. Ann. section 1970(1); Mich. Comp. Laws section 567.250(1); Minn. Stat. section 345.46(a); Mont. Code Ann. section 70-9-819(1); N.C. Gen. Stat. section 116B-71(a); N.D. Code section 47-30.1-29; Nev. Rev. Stat. section 120A.150(1); N.H. Rev. Stat. Ann. section 471-C:33(I); N.J. Rev. Stat. section 46:30B-88; N.M. Stat. Ann. section 7-8A-19(a); Ohio Rev. Code section 169.03(H); Okla. Stat. section 666(A); R.I. Gen. Laws section 33-21.1-29(a); S.C. Code section 27-18-300(A); S.D. Cod. Laws section 43-41B-30(a); Texas Prop. Code section 74.308; Utah Code Ann. section 67-4a-103(2); Vt. Stat. Ann. section 1259(a); Wash. Rev. Code section 63.29.290(1); Wis. Stat. section 177.29(1); W.Va. Code section 36-8-19(a); Wyo. Stat. section 34-24-130(a).

<sup>8</sup> 12 Del. Code section 1210. Delaware is specifically discussed here because it is an important state in the unclaimed property field as a result of the rule, created by the U.S. Supreme Court, that the state of incorporation of the holder of unclaimed property has the right to claim the property if the holder has no record of the address of the owner of the property. See *Texas v. New Jersey*, 379 U.S. 674 (1965). Thus, because most publicly traded companies, as well as many privately traded ones, are incorporated in Delaware, Delaware is often the state that is seeking to claim unclaimed property based on statistical estimations. Unclaimed property is now the third largest source of revenue for the state, producing approximately \$500 million in revenue annually.

<sup>9</sup> In *Association of Business Advocating Tariff Equity v. Public Service Comm.*, 435 N.W.2d 766 (Mich. App. 1989), the court made a similar distinction between conditions subsequent and conditions precedent, and found that some refunds did not constitute unclaimed property because a condition for the refund (the negotiation of the check) was determined to be a condition precedent rather than a condition subsequent.

Also, in order to properly construe a contractual anti-limitation provision, it must first be placed in context. Specifically, it is important to understand why those provisions were created and what purpose they were intended to serve. Indeed, “the purpose of statutory construction is not merely to declare the plain meaning of the words used; the purpose is to understand the intent of the lawmakers, and the goal of that inquiry, in turn, is to give maximum effect to that intent.”<sup>10</sup> Although legislative intent may vary from state to state, the comments to the 1981 Act and 1995 Act anti-limitations provisions provide the best general evidence of the legislatures’ intent in adopting those provisions. The comment in the 1981 Act cites three cases—that have since become known as the “private escheat” cases—as support for this rule. The comment to the anti-limitations provision in the 1995 Act further states that the provision is “consistent” with those three cases. Those comments, while not explicit, seem to suggest that the drafters of the 1981 Act intended the anti-limitations provision to essentially codify the holdings of those three cases.<sup>11</sup> Therefore, an understanding of those three cases and exactly what they hold is necessary to properly understand the intended scope and effect of the contractual anti-limitations provisions in the 1981 and 1995 Acts.

### The Private Escheat Cases

The first of the so-called private escheat cases is *State v. Jefferson Lake Sulphur Co.*<sup>12</sup> That case involved the potential application of New Jersey’s unclaimed property law to dividends issued by Jefferson Lake Sulphur Co. A few months after New Jersey enacted its unclaimed property law, generally permitting New Jersey to take custody of any dividends that remained unclaimed after five years from the date of payment, the board of directors of Jefferson Lake voted to amend the company’s certificate of incorporation to provide that any dividends that remained unclaimed for a period of *three* years would revert back to Jefferson Lake. The board of directors mailed a notice to each of the stockholders of the company (and its predecessor) to explain the change. In the notice, the Board admitted that the change was being made to circumvent the New Jersey unclaimed property statute. The New Jersey Supreme Court stated that “escheat of unclaimed dividends serves the important public need of providing revenue to be utilized for the common good.”<sup>13</sup> The court also concluded that a company such as Jefferson Lake that incorporates in New Jersey becomes subject to that public policy, and thus the “alteration of a charter for the avowed purpose of defeating a relevant aspect of the sovereign’s declared public policy cannot achieve judicial approval.”<sup>14</sup> In reaching that conclusion, the court relied on several cases holding that a corporation’s charter or bylaws that conflicts with the state’s public policy is void. Thus, because Jefferson Lake’s charter was amended for the express purpose of avoiding the escheat laws, the court held that the amendment was invalid.

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<sup>10</sup> *Rossi v. Brown*, 9 Cal. 4th 688 (1995). See also, e.g., *Title Ins. & Trust Co. v. County of Riverside*, 48 Cal.3d 84, 95 (1989) (“The intent of the Legislature is the end and aim of all statutory construction”); *City of Phoenix v. Superior Court*, 677 P.2d 1283, 1286 (Ariz. 1984) (The basic rule of statutory construction “is to ascertain the meaning of the statute and intent of the legislature”); *Polaroid Corp. v. Offerman*, 507 S.E.2d 284, 290 (N.C. 1998) (“[u]nder the canons of statutory construction, the cardinal principle is to ensure accomplishment of the legislative intent”); *Gholston v. State*, 620 So.2d 719 (Ala. 1993).

<sup>11</sup> See also *Benson v. Simon Prop. Group, Inc.*, 642 S.E.2d 687, 690 (Ga. 2007) (noting that the 1981 Act expanded the anti-limitations provisions to be “consistent with case law forbidding ‘private escheat’”).

<sup>12</sup> 178 A.2d 329 (N.J. 1962).

<sup>13</sup> *Id.* at 336.

<sup>14</sup> *Id.*

A California Court of Appeals reached a similar conclusion regarding unclaimed royalty payments in *Screen Actors Guild, Inc. v. Cory*.<sup>15</sup> In that case, the Screen Actors Guild (SAG) received residuals for its members—actors, stuntmen and other performers—and forwarded the residuals to the persons entitled to them. SAG’s bylaws provided that if a residual is unclaimed for at least six years, it reverts to SAG for the benefit of all its members. However, in practice, SAG did not enforce that provision. The court held that SAG’s bylaw was contrary to public policy because it “would deny to the state the benefit of the use of most of the unclaimed residuals” and was “obviously designed to frustrate operation of the [unclaimed property laws].”<sup>16</sup>

Finally, in *People v. Marshall Field & Co.*,<sup>17</sup> an Illinois Appellate Court was faced with the question of whether Illinois had the right under its unclaimed property laws to take custody of unredeemed, expired gift certificates issued by Marshall Field & Co. Until 1975, the period of presumed abandonment in Illinois was 15 years; however, the gift certificates issued by Marshall Field expired after 10 years. In 1975 Illinois changed its abandonment period to seven years; a year later, Marshall Field modified its gift certificates to expire after only five years. The court, relying on *Jefferson Lake* and *Screen Actors Guild*, stated that “where a private agreement between the parties is in fundamental conflict with public policy as established by the legislature, the private agreement must fall.”<sup>18</sup> Because of the expiration dates on the gift certificates, Marshall Field—rather than the state—would receive the benefit of the unredeemed gift certificates. Thus, the court held that the expiration dates violated the public policy of the unclaimed property laws. The court also noted that if it were to reach a different result, Marshall Field and the state might enter into an “unseemly” race as to which could come up with the shortest period.<sup>19</sup>

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<sup>15</sup> 154 Cal. Rptr. 77 (Cal. App. 1979).

<sup>16</sup> 154 Cal. Rptr. at 80. However, the court acknowledged that because of SAG’s relationship with its members and its extensive process for distributing residuals, SAG may be better able than the state to actually serve the goal of the unclaimed property laws to locate missing owners of abandoned property. The court thus suggested that the “Legislature may wish to make this circumstance the basis for a special exemption of the unclaimed residuals at issue.” *Id.* See also *Blue Cross of Northern California v. Cory*, 120 Cal. App. 3d 723 (1981) (holding that a “claims withdrawal provision” that provided that a claim was deemed to be automatically withdrawn if the claimant failed to negotiate a check issued in settlement of the claim within six months of the date of the check, was invalid as a private escheat).

<sup>17</sup> 404 N.E.2d 368 (Ill. App. 1980).

<sup>18</sup> 404 N.E.2d at 373.

<sup>19</sup> Arguably, the *Marshall Field* court went too far in relying on *Jefferson Lake* and *Screen Actors Guild* as the basis for its holding. Those earlier cases involved amendments to the holder’s charter or bylaws that, as the courts noted, raise special public policy concerns. In the gift certificate context, however, it is not as clear that public policy supports the same conclusion. After all, when *Marshall Field* was decided, most states, including Illinois, permitted the use of expiration dates on gift certificates. Thus, it was apparently not the use of an expiration date per se that the court found objectionable, but rather the motive of the holder in expressly using an expiration date to circumvent the state’s unclaimed property laws. Accordingly, when that motive is lacking (which would typically be the case, because many issuers find expiration dates helpful for financial accounting or other reasons), it would seem that an expiration date on a gift certificate should be upheld, consistent with state legislative intent, even if the expiration date is shorter than the applicable abandonment period. The escheat of gift certificates also raises other public policy concerns that were not addressed by the Illinois court including, most significantly, the issue why a state should be entitled to escheat the cash value of a gift certificate if the owner of the gift certificate could have redeemed the certificate only for merchandise and not cash. As discussed below, under the derivative rights doctrine, the state’s rights to take custody of unclaimed property are derived from the owner; thus, if an owner cannot claim cash for an unredeemed gift certificate, it is difficult to understand why the state should be entitled to do so. On the other hand, if Marshall Field permitted the redemption of the gift certificates for cash (which was not uncommon in 1980), the escheat of the gift certificates would not violate this doctrine.

Accordingly, the private escheat cases involved unusual factual situations in which the courts found that the holders of unclaimed property had unilaterally taken actions designed specifically to circumvent state unclaimed property laws by cutting off the rights of owners after a specified period of time. That is in stark contrast to most time-based contractual limitations provisions entered into between sophisticated business entities. Those provisions are not normally intended to circumvent state unclaimed property laws; rather, they are designed to provide certainty to each of the parties regarding the amounts that are potentially owed under the terms of the contract. That legitimate goal would be undermined by a broad application of the anti-limitations provisions. Contractual limitations provisions between businesses are also rarely “unilaterally” imposed on the other party; instead, they are normally the product of arm’s length negotiation. Indeed, that is clearly the case in those agreements that include reciprocal limitations provisions.<sup>20</sup> I have found no case that has applied the private escheat doctrine to a time-based limitation provision negotiated at arm’s length.

Hence, since the anti-limitations provisions in the 1981 and 1995 Acts were based on the private escheat cases, it seems that the provisions should be construed consistently with those cases to apply only when holders of unclaimed property have unilaterally taken actions designed specifically to circumvent state unclaimed property laws by cutting off the rights of owners after a specified period of time.

### **The Derivative Rights Doctrine and Good Public Policy**

Such a narrow construction of the anti-limitations provisions is also supported by the derivative rights doctrine and sound public policy. The derivative rights doctrine is a fundamental principle underlying state unclaimed property laws that provides that the state derives its right to take custody of unclaimed property from the owner of the property, and therefore should—at least as a general proposition—have no greater rights to the property than the owner. This common-sense principle has been recognized by numerous federal and state

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<sup>20</sup> Even in consumer contracts, there are often significant benefits to a consumer to agreeing to an expiration date. For example, a product or service may be sold at a lower price to consumers if an expiration date is involved. Indeed, that is the business model used for the popular daily deal discount voucher programs, and similar marketing tactics are also common in other contexts, from theme park tickets to package discounts on spa treatments and similar services. Promotional incentives (such as rebates, customer loyalty rewards, and employee incentives) also commonly bear expiration dates, and many businesses that sponsor promotions would be unable to offer those incentives (or would only be able to offer fewer of them) if expiration dates were prohibited, as the cost and uncertain liability to the business would be too great. Thus, there are legitimate reasons (apart from escheat avoidance) for the use of expiration dates in a variety of different contexts.

courts.<sup>21</sup> (“The State’s right is purely derivative: it takes only the interest of the unknown or absentee owner.”<sup>22</sup>)

Accordingly, under the derivative rights doctrine, a contractual provision that limits the owner’s rights as against the holder (and that is otherwise enforceable under state law) should also limit the state’s power to escheat that same property. The anti-limitations provision conflicts with this principle by allowing the state to claim property that the owner is no longer entitled to claim. Compounding that problem, the owner of the property could then claim the property back from the state, thereby accomplishing indirectly through the state’s escheat laws what it could not do directly (that is, through its contract with the holder). Thus, the anti-limitations provision actually increases the substantive rights of the owner vis-à-vis the holder regarding the property. That is contrary to the primary purpose of unclaimed property laws, which is to act as a procedural mechanism to return missing property to its rightful owner. Again, the state’s claim is wholly derivative of the owner’s, not the other way around. This expansion of rights created by the anti-limitations provisions was almost certainly not intended by the state legislatures when they adopted those provisions.

State contractual anti-limitations provisions also directly interfere with basic principles of freedom of contract. Although courts nowadays rarely invalidate state economic regulations under the due process clause based on freedom of contract principles, there are exceptions, and the overbroad language of the anti-limitations provisions is arguably difficult to justify under any standard.<sup>23</sup> However, one need not find a violation of due process to conclude that the anti-limitations provisions raise significant public policy concerns by restricting the basic freedom of businesses to include time-based limitations provisions in their contracts, and there is no public welfare/safety reason to prevent sophisticated businesses from entering into those arrangements. Although those restrictions may be justifiable in the rare situation in which the sole or primary motive is to avoid unclaimed property laws, those restrictions would be poor public policy in most cases. Indeed, that seems to be the conclusion recently

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<sup>21</sup> See, e.g., *State v. Standard Oil Co.* 74 A.2d 565, 573 (1950), aff’d, 341 U.S. 428 (1951).

<sup>22</sup> See also, e.g., *Allstate Ins. Co. v. Eagerton*, 403 So. 2d 172 (Ala. 1981); *Bank of Am. v. Cory*, 164 Cal. App. 3d 66 (1985); *Blue Cross of N. Cal. v. Cory*, 120 Cal. App. 3d 723 (1981); *Bank of Am. Nat’l Trust & Sav. Ass’n v. Cranston*, 252 Cal. App. 2d 208 (1967); *Bank of Am. Nat’l Trust & Sav. Ass’n v. Cory*, No. 257509 (Cal. Super. Ct. (Sacramento Cty.) July 17, 1980), aff’d, 164 Cal. App. 3d 66 (1985); *Riggs Nat’l Bank v. District of Columbia*, 581 A.2d 1229 (D.C. 1990); *Insurance Co. of N. Am. v. Knight*, 291 N.E.2d 40 (Ill. App. 1972), appeal dismissed, 414 U.S. 804 (1973); *Massachusetts v. FDIC*, 916 F. Supp. 54 (D. Mass. 1996); *Barker v. Leggett*, 102 F. Supp. 642 (W.D. Mo. 1951), appeal dismissed, 342 U.S. 900, reh’g denied, 342 U.S. 931 (1952); *Cole v. National Life Ins. Co.*, 549 So.2d 1301 (Miss. 1989); *State ex rel. Marsh v. Nebraska State Bd. of Agric.*, 350 N.W.2d 535 (Neb. 1984); *State v. Elizabethtown Water Co.*, 191 A.2d 457 (N.J. 1963); *State v. United States Steel Corp.*, 126 A.2d 168 (N.J. 1956); *State v. Sperry & Hutchinson Co.*, 153 A.2d 691 (N.J. Super. App. Div. 1959), aff’d per curiam, 157 A.2d 505 (N.J. 1960); *State v. American- Hawaiian S.S. Co.*, 101 A.2d 598 (N.J. Super. Ch. Div. 1953); *In re Steins Old Harlem Casino Co.*, 138 F. Supp. 661, 666 (S.D.N.Y. 1956); *Petition of Abrams*, 512 N.Y.S.2d 962 (Sup. Ct. 1986); *In re Pepsico, Inc.*, N.Y. Admin. Proc. Act, decision of hearing officer (Nov. 7, 1985); *Kane v. Insurance Co. of N. Am.*, 392 A.2d 325 (Pa. Commw. 1978); *South Carolina Tax Comm’n v. Metropolitan Life Ins. Co.*, 221 S.E.2d 522 (S.C. 1975); *Presley v. Memphis*, 769 S.W.2d 221 (Tenn. Ct. App. 188); *Melton v. Texas*, 993 S.W.2d 95 (Texas 1999), aff’g 970 S.W.2d 146 (Texas App.-Austin 1998); *State v. Texas Elec. Serv. Co.*, 488 S.W.2d 878 (Texas Civ. App. 1972); *State v. Texas Osage Royalty Pool, Inc.*, 394 S.W.2d 241 (Texas Civ. App. 1965); *Southern Pac. Transp. Co. v. State*, 380 S.W.2d 123 (Texas Civ. App. 1964); *Travelers Express Co. v. Utah*, 732 P.2d 121 (Utah 1987); *State Dep’t of Revenue v. Puget Sound Power & Light Co.*, 694 P.2d 7 (Wash. 1985); *Pacific N.W. Bell Tel. Co. v. Department of Revenue*, 481 P.2d 556 (Wash. 1971); *Heritage Mut. Ins. v. Smith*, No. 86-CV-2484 (Wis. Cir. Ct. (Dane Cty.) Jan. 15, 1987).

<sup>23</sup> See, e.g., *Craigmiles v. Giles*, 312 F.3d 220 (6th Cir. 2002) (invalidating a Tennessee state law that forbids any person from selling caskets unless the person is a licensed funeral director). See also the U.S. Supreme Court’s recent decision in *AT&T Mobility, LLC v. Concepcion*, 131 S. Ct. 1740 (2011), which may evidence a shift by the Court back in the direction of stronger protections for freedom of contract.

reached by the Texas Court of Appeals in *State v. Highland Homes, Ltd.*<sup>24</sup> In analyzing the potential application of Texas's anti-limitations provisions to a class action settlement, the court opined: "It is true that this type of public policy exception [that is, the anti-limitations provisions] should apply only where it is clearly established that the motive of the holder was avoidance of unclaimed property laws and in most class action settlements, this would not be the case."<sup>25</sup> In other words, because the state's justification for the contractual anti-limitations provisions is based on public policy, any competing public policy considerations—including loss of contractual freedoms—should also be taken into account in determining the scope of those provisions.

### Federal Law May Preempt a Broader Construction of the Anti-Limitations Provisions

In addition to the rule of statutory interpretation that requires us to ascertain legislative intent, there is also a rule of construction that holds that a statute should not be interpreted in a manner that would or could render it unconstitutional.<sup>26</sup> That principle further supports a narrow reading of the contractual anti-limitations provisions on the basis that a broader interpretation of those provisions may well be preempted by federal law. The preemption of state law by federal law is based on the Supremacy Clause (Article VI, Section 2) of the U.S. Constitution, which provides:

This Constitution, and the Laws of the United States which shall be made in Pursuance thereof...shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.

The U.S. Supreme Court has held that preemption applies when there is a conflict between federal and state law.<sup>27</sup> Federal common law, as created by a federal judicial opinion, preempts state law to the same extent as a federal statute.<sup>28</sup> The U.S. Supreme Court's decision in *Delaware v. New York*<sup>29</sup> is an example of federal common law that has set forth rules regarding state escheat of unclaimed property. Thus, to the extent that the Court's opinion is inconsistent with any state unclaimed property law, the opinion should preempt that state law.

<sup>24</sup> 2012 Texas App. LEXIS 4673 (June 13, 2012).

<sup>25</sup> *State v. Highland Homes, Ltd.*, 2012 Texas App. LEXIS 4673, at \*19. Notably, Texas has adopted two anti-limitations provisions. The first, set forth in Texas Prop. Code section 74.308, is very similar to that in the 1981 Act. The second, codified in Texas Prop. Code section 74.309, states: "An individual, corporation, business association, or other organization may not act through . . . private agreement, or any other means to take or divert funds or personal property into income, divide funds or personal property among locatable patrons or stockholders, or divert funds or personal property by any other method for the purpose of circumventing the unclaimed property process." Although the court focused on the latter in rendering its decision (and that statute does clearly include a bad purpose requirement), the court's statement regarding the need to establish an improper motive appeared to apply to both provisions. The court concluded that this was one of the unusual cases in which there was clear evidence of a motive to circumvent the unclaimed property laws.

<sup>26</sup> See, e.g., *TXO Production Corporation v. Oklahoma Corporation Commission*, 829 P.2d 964 (Okla. 1992); *Forrester v. Culpepper*, 194 Ga. 744, 749 (1942) (holding that the applicable law "must be so construed, if fairly possible, as to avoid not only the conclusion that it is unconstitutional, but also grave doubts upon that score").

<sup>27</sup> See, e.g., *La. Pub. Serv. Comm'n v. F.C.C.*, 476 U.S. 355, 368-69 (1986). Preemption also applies if a federal law expressly overrides state law or if Congress has legislated so comprehensively in a field as to "occupy" that field to the exclusion of state law.

<sup>28</sup> See *Wilburn Boat Co. v. Fireman's Find Ins. Co.*, 348 U.S. 310, 314 (1955). ("States can no more override . . . [federal] judicial rules validly fashioned than they can override Acts of Congress.")

<sup>29</sup> 507 U.S. 490 (1993).

In *Delaware v. New York*, the Supreme Court essentially adopted the derivative rights doctrine as federal common law. The Court stated that “In framing a State’s power of escheat, we must first look to the law that creates property and binds persons to honor property rights. ‘Property interests, of course, are not created by the Constitution,’ but rather ‘by existing rules or understandings that stem from an independent source such as state law.’”<sup>30</sup> Thus, “funds held by a debtor become subject to escheat because the debtor has no interest in the funds.”<sup>31</sup> To the contrary, if the business that holds the property *does* have an interest in or claim to the property, then the property may not be escheated. In other words, “the holder’s legal obligations... define[] the escheatable property at issue.”<sup>32</sup> Accordingly, a state may escheat property only when there is an outstanding, liquidated and enforceable debt owed by the holder to the owner. However, no such debt exists if the debt has been extinguished by a contractual limitation provision. Thus, a state’s anti-limitation provision that seeks to revive an extinguished debt in favor of the state (and ultimately the owner) is contrary to *Delaware v. New York* and thus should be preempted.

Despite that strong language in *Delaware v. New York*, some states have argued that the U.S. Supreme Court’s earlier decision in *Connecticut Mutual Life Ins. Co. v. Moore*<sup>33</sup> supports the proposition that a state’s escheat powers are not restricted by contractual conditions that may exist between the parties. However, that is a misreading (or at least an overstatement) of that case. In *Connecticut Mutual*, the Court upheld a state unclaimed property statute allowing a state to claim unclaimed insurance proceeds even though the state did not satisfy an insurance policy condition requiring proof of death and surrender of the policy in order to escheat the proceeds. However, in reaching that holding, the Court addressed only the insurance company’s claim that the unclaimed property statute violated the Contracts Clause of the U.S. Constitution. Thus, the Court did not address the more basic question whether, under applicable state law, the condition precedent had to be satisfied before the state could claim the amounts as unclaimed property. Moreover, even in the narrow context of the contracts clause, the Court did not create a broad license for states to ignore contractual conditions when escheating property. Rather, the Court explained that the state statute was not unconstitutional because the condition at issue was essentially a formality and, if the condition is enforced against the state, the insurance companies would retain funds that “normally” they would have been required to pay.<sup>34</sup> Thus, this decision has been construed to excuse compliance with contract conditions “which only go to formalism of interest, such as proof of death... but [the state] is nevertheless held to compliance with matters that deal with substantive determination of ownership.”<sup>35</sup> That result is consistent with the later adoption by states of unclaimed property statutes that excuse the state from having to comply with the formal requirement of presentment (which is a condition precedent to negotiating a check) in order to escheat the funds represented

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<sup>30</sup> *Id.* at 501-502 (internal citations omitted).

<sup>31</sup> *Id.* at 502.

<sup>32</sup> *Id.* at 503.

<sup>33</sup> 333 U.S. 541 (1948).

<sup>34</sup> *Id.* at 546.

<sup>35</sup> *Kane v. Insurance Co. of North America*, Ct. of Common Pleas, Opinion at 21, Jan. 20, 1976.

by an uncashed check.<sup>36</sup>

### Special Considerations for Delaware's Anti-Limitations Provision

As noted above, Delaware has also adopted a contractual anti-limitations provision, but it is worded very differently than the anti-limitations provision in the Uniform Acts. Given Delaware's significance in the unclaimed property world, it is important to address that provision specifically. It provides as follows:

**Section 1210. No private escheats.** Any provision in a certificate of incorporation, bylaw, trust agreement, contract or any other writing regulating the relationships between an owner and a holder, relating to property with the exception of non-escheat capital credits as defined in section 909 of Title 26, which is or may be subject to the provisions of this chapter, which provides that upon the owner's failure to act or make a claim regarding property in possession of the holder, that such property reverts to or becomes the property of the holder, in contravention of this chapter, shall be void and unenforceable.<sup>37</sup>

There are at least three key differences between the Delaware statute and the anti-limitations provisions in the Uniform Acts discussed above. First, the Delaware statute applies by its terms only to a contract "regulating the relationships between an owner and a holder." Under Delaware law, a holder is a "person having possession, custody or control of the property of another person," and the "owner" is the person "having the legal or equitable title to property" held by the holder.<sup>38</sup> Thus, the Delaware statute apparently contemplates a contract wherein one party takes possession, custody or control of the property of another, and thereby becomes the holder of that property. That is not the case for standard purchase or service contracts between businesses, because there is no contemplated holder or owner of any property when those agreements are entered into.<sup>39</sup> Moreover, depending on the situation, either party to the contract could later become the holder in some cases and the owner in other cases. For example, in a purchase contract, the seller would be the holder of the amount of any overpayment, but would be the owner of the amount of any underpayment. If the Delaware statute is applied to that contract, any limitation in the contract on either party's right to claim an alleged overpayment or underpayment after a specified time would be void and unenforceable. That would be completely contrary to the parties' intent in inserting that provision in the agreements, which is generally to the benefit of both parties.

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<sup>36</sup> See Unif. Unclaimed Prop. Act, 2(b) (1981) and Unif. Unclaimed Prop. Act, 2(e) (1995), which generally provide that, for purposes of the unclaimed property acts, property is deemed to be payable or distributable notwithstanding the owner's failure to make demand or to present any instrument or document required to receive payment. According to the comments to the 1981 and 1995 acts, these provisions were intended to obviate the results reached in some earlier cases that had held that such a failure barred the state's escheat claim. See, e.g., *Oregon Racing Comm'n v. Multnomah Kennel Club*, 242 Or. 572 (1966). These provisions thus do not excuse the state from compliance with most conditions precedent, but merely the formal requirements of demand and presentment. Indeed, if states were required to comply with such formal requirements, the unclaimed property laws would be rendered essentially meaningless.

<sup>37</sup> Del. Code Ann. tit. 12, § 1210.

<sup>38</sup> Del. Code Ann. tit. 12, §§ 1198(7), (8).

<sup>39</sup> By contrast, in a gift card contract, the issuer of the gift card becomes the holder at the inception of the contract (that is, when the gift card is issued).

Second, the Delaware statute applies only to a contractual provision that provides that on the owner's failure to make a claim regarding the property, the property reverts to or becomes the property of the holder. However, the limitation provisions in many contracts often do not include a reversion provision. Rather, they may simply state that after the limitation period has expired, the amount paid by the purchaser will conclusively be deemed to be correct. Such a provision recognizes that there may be some uncertainty regarding whether an amount is actually owed, particularly when the other party has not sought to claim it in a timely manner. Similarly, business contracts often include a time limit on the right of one party to audit the other party's books and records for purposes of determining whether a claim exists. Again, in those cases, there is still no reversion because there was never a determination that an amount was owed in the first place.

Third, the Delaware statute also applies only to contracts that were deliberately intended to contravene the unclaimed property laws. That conclusion is suggested by the title of the Delaware statute itself: *No private escheats*. As discussed above, the term "private escheat" has been used by several courts to refer to a situation in which a holder of unclaimed property has unilaterally taken actions designed specifically to circumvent state unclaimed property laws by cutting off the rights of the owner of the property after a specified period of time. Thus, the title of the Delaware statute strongly suggests that the statute, like the Uniform Acts, is an effort to codify the decisions of those courts. The legislative history of the Delaware statute arguably supports that view when it states that the statute "is intended to make it clear that provisions having the effect of *avoiding the escheat law* contained in such writings as certificates of incorporation, contracts, liquidation agreements and the like are unenforceable."<sup>40</sup> Finally, the Delaware statute is similar to, and was apparently modeled at least to some extent on, the anti-limitations provision in the 1981 Act. Thus, since that provision was itself based on the private escheat cases, as discussed above, it follows that the Delaware statute was likely also based on these cases. Thus, the Delaware anti-limitations provision should be construed in a manner that is consistent with those cases.

## Conclusion

Despite the seemingly broad language of state contractual anti-limitations provisions, those provisions were never intended to apply to limitations provisions that are commonly found in contracts between sophisticated businesses acting at arm's length. In those contracts, the inclusion of those contractual limitations is typically driven by legitimate business considerations that in no way violate public policy, rather than by escheat avoidance, which was the characteristic focused on by the courts in the private escheat cases out of which the anti-limitations provisions arose. Those legitimate business considerations would be defeated if the limitations provisions were overridden by a state anti-limitations provision. Moreover, the anti-limitations provisions would also violate the derivative rights doctrine and good public policy, by allowing the state (and, indirectly, the business on whose behalf the state is acting) to claim property that could not be claimed under the negotiated terms of the contract. Surely state legislatures, in adopting the anti-limitations provisions, did not intend to wholly deprive businesses of the freedom to include time-based limitations provisions in their contracts with other businesses; nor, presumably, would state legislatures have intended to enlarge the substantive rights of some businesses over others by voiding those provisions. Finally, if the anti-limitations provisions are construed broadly to apply to contracts negotiated at arm's length, those provisions may well

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<sup>40</sup> 1991 Delaware Laws 122 (HB 346) (emphasis added). Similarly, the Delaware statute applies only to limitations provisions in which property reverts to or becomes the property of the holder "in contravention of" the Delaware unclaimed property law.

be preempted by the U.S. Supreme Court's decision in *Delaware v. New York*. For all of those reasons, the contractual anti-limitations provisions in the 1981 Act and 1995 Act (and even more clearly the Delaware anti-limitations provision) should be construed narrowly to apply only when the holder has engaged in unilateral action designed specifically to circumvent state unclaimed property laws.

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