



Unclaimed Property ALERT ■

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Select Medical Litigation Draws to a Close: What Settlement Means for Holders

The following is a joint advisory released by Alston & Bird and its strategic Delaware law firm partner Mayrack LLC.

Select Medical Corporation and the state of Delaware, as represented by Secretary of Finance Thomas Cook and current State Escheator David Gregor, have settled their unclaimed property litigation, ***Select Medical Corporation v. Cook, et al.***, No. 1:13-CV-00694-LPS, in the United States District Court for the District of Delaware (Judge Leonard P. Stark presiding). This advisory explains the significance of this settlement, identifies the numerous important legal issues that remain unaddressed as a result and provides background on the procedural history of the case.

CASE SETTLED, BUT CORE ISSUES REMAIN UNSETTLED

The stipulation of dismissal with prejudice filed for the parties on January 21, 2014, indicates only that the parties stipulate to the dismissal of all claims with prejudice and for each party to bear its own costs, expenses and attorneys' fees. Judge Stark approved the settlement on January 23, 2014. No other details regarding the terms of the settlement have been made public by the parties, nor is any additional information expected to be made available.

By settling, both sides have avoided a judicial determination of several issues that may have had far-reaching implications for both holders of unclaimed property and Delaware's unclaimed property program, depending on how the court may have ruled. As a result, holders are again left with little guidance regarding several aspects of Delaware's unclaimed property laws and auditing practices, including:

- whether holders must exhaust the administrative appeal process under 12 Del. C. § 1156 before initiating litigation;
- whether Delaware's use of estimation to establish the existence and amount of liability arising from unknown, unaddressed property assumed to exist in years for which the holder no longer has records violates the U.S. Constitution and the federal common law governing unclaimed property;

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- how Delaware's three-year statute of limitations, provided for in 12 Del. C. § 1158, operates and whether that provision barred the state's claims;
- whether Delaware has statutory authority under 12 Del. C. § 1155 to apply estimation retroactively for periods prior to July 2010 when Senate Bill 272 was enacted;
- whether holders can litigate state law unclaimed property matters in federal courts, rather than state courts, by raising only questions of federal law; and
- what records are sufficient to require the state to determine actual, rather than estimated, liability in an unclaimed property examination, and when/how quickly the holder must provide these records in order to avoid estimation.

The settlement of this litigation, though it does not constitute legal precedent or persuasive authority, may nevertheless offer some limited guidance to holders and holder advocates. Delaware's willingness to concede during the litigation that it would no longer use estimation for the property at issue because Select Medical had eventually provided sufficient records suggests that, on a prospective basis, holders may be able to insist that Delaware calculate an actual liability based on actual records when such records are available. Of course, determining whether existing records are sufficient and/or have been timely provided by the holder remains an open question that must be addressed on a case-specific basis, in the absence of a court ruling. Delaware's concession during the litigation also suggests that holders may initiate or threaten litigation to gain leverage during the audit process in the future.

Even if holders are emboldened by this result to litigate with Delaware in the future, this case also underscores Delaware's continued willingness to aggressively defend its unclaimed property program and current audit and estimation practices. However, the state's willingness to agree not to estimate the property at issue had the effect of mooting Select Medical's fundamental dispute; this suggests that Delaware would prefer the continued ambiguity and lack of judicial guidance regarding both the constitutionality and statutory sufficiency of its practice of estimating unknown, unaddressed property.

PROCEDURAL HISTORY OF THE LITIGATION

Select Medical's Complaint and Motion for a Preliminary Injunction: Select Medical initiated the litigation on April 17, 2013, when it filed suit challenging Delaware's unclaimed property assessment of approximately \$300,000 for accounts payable property for the period of 1997-2001 and seeking a preliminary injunction against the state's collection of the property at issue, the imposition of penalties and interest, and the continued pursuit of the unclaimed property examination until resolution of the litigation are resolved. According to the verified complaint, Select Medical had records for the period at issue (1997-2001), which it provided to Delaware, and previously submitted a payment of \$17,637.04 to Delaware in final settlement of a Department of Finance-managed voluntary disclosure agreement (VDA).

According to Select Medical, on June 10, 2008, Delaware notified the company that it would audit its unclaimed property compliance; incidentally, this notice occurred on the same day the state cashed the check received in settlement of the VDA. Select Medical had also reported approximately \$300,000 in unclaimed property liability on a multistate basis at the same time it had submitted its Delaware VDA during 2007-2008.

Select Medical's lawsuit challenged Delaware's assessment on several grounds. In particular, Select Medical alleged that 1) Delaware's demand is barred by the state's three-year statute of limitations in 12 Del. C. § 1158; 2) Delaware has no statutory authority under 12 Del. C. § 1155 to apply estimation retroactively, for periods prior to July 2010, when Senate Bill 272 was enacted; and 3) Delaware has no authority to use estimation under the federal common law governing unclaimed property, *Texas v. New Jersey*, 379 U.S. 674 (1965), and its progeny, because records are available for the period at issue.

Select Medical charged that the specific application of Delaware's estimation methodology is arbitrary and capricious and thus, unconstitutional. In addition, because Delaware fails to recognize in its estimated assessment business-to-business and other exemptions allowed by other states, Delaware's estimation method violates the Commerce Clause and Full Faith and Credit Clause of the United States Constitution. Finally, Select Medical alleges Delaware's demand violates the Takings and Substantive Due Process Clauses of the U.S. Constitution.

Delaware's Answer: On May 2, 2013, Delaware filed its response in opposition to Select Medical's motion for a preliminary injunction. In its response, Delaware argued that 1) the federal district court lacks subject matter jurisdiction over the case because there is no legitimate federal question and 2) Select Medical failed to meet the requirements for a preliminary injunction.

According to the state, Select Medical had maintained during the audit that complete records for the period at issue were unavailable, which caused the state to employ estimation for this period, until Select Medical "represented that the requested records were indeed available after all" during a conference call with State Escheator Mark Udinski on March 26, 2013.

Upon learning that these records were available, the state "agreed to review the records and adjust any liability accordingly if warranted. Select Medical provided the records in question to the state on April 15, 2013. Two days later, on April 17, 2013, while the state and Kelmar Associates, its contract auditor, were reviewing the records, Select Medical filed its complaint initiating this litigation and its motion for a preliminary injunction.

In its answer, the state argued that a preliminary injunction is inappropriate because Select Medical has failed to let the audit process run its course and has failed to exhaust its administrative remedies provided under the statute, particularly the administrative review process under 12 Del. C. § 1156. The state also argued that Select Medical is "attempt[ing] to move the case from the Court of Chancery, which has jurisdiction over the matter under the [Delaware state] statute, to federal court by raising baseless and speculative claims of federal and Constitutional law."¹

Select Medical's Response: On May 8, 2013, Select Medical filed a response in support of its motion for a preliminary injunction. In this filing, Select Medical largely reiterated previous arguments. Notably, Select Medical appeared to be challenging Delaware's right, under the *Texas v. New Jersey* holdings, to "estimate

¹ In 2012, the Court of Chancery rejected a holder's statutory interpretation arguments in *Staples, Inc. v. Cook*, 35 A.3d 421 (Del. Ch. 2012), in one of the few examples of Delaware case law on unclaimed property. The outcome in the *Staples* litigation likely influenced Select Medical's decision to file in federal court, at least in part.

the existence of unclaimed property” when records do not exist, a practice that underlies the Delaware unclaimed property audit program.

Delaware’s Motion to Dismiss: On the same day, Delaware moved for dismissal of Select Medical’s suit in its entirety, on the grounds that the court has no subject matter jurisdiction because the state’s examination is not complete. The state’s arguments emphasize that Select Medical “cannot establish harm until it can claim an interest in the property being taken that is superior” to the state’s.

The filings of the parties also indicate a robust dispute between Select Medical and Delaware regarding document productions and responsiveness by Select Medical during the almost five-year-long examination.

Select Medical’s opposition to Delaware’s motion to dismiss focused on attacking Delaware’s longstanding estimation practices, arguing that they violate the federal common law established by the United States Supreme Court in *Texas v. New Jersey*, 379 U.S. 674 (1965), and its progeny, because Delaware fails to “identify particular property” and instead “ignore[s] this threshold requirement and simply estimate[s] the existence of unclaimed property by mathematical formula based on amounts that [Select Medical] escheated to all other states from different time periods.” Select Medical also reasserted that it need not exhaust Delaware’s administrative review procedure under 12 Del. C. § 1156 before pursuing other remedies, such as this lawsuit.

Delaware, in its reply brief filed on June 3, 2013, defended its estimation practices. Citing *Daubert v. Merrell Dow Pharms., Inc.*, 509 U.S. 579 (1993), the Sarbanes-Oxley Act of 2002 and Statement Number 5 of the Financial Accounting Standards Board (FASB), the state noted that estimation and statistical sampling are “widely accepted” in accounting and as admissible evidence in courts, as a form of expert testimony, particularly where records do not exist or are otherwise too voluminous to permit a detailed review. If a party has not maintained records, the state countered that it has “no choice but to prove liability through ‘reasonable estimation.’ To find otherwise would reward the holder for inadequate record keeping, or for outright refusal to produce the records necessary to determine its liability.”

Additional Filings: In early November, Delaware requested the leave of the court to file additional affidavits from Delaware State Escheator David Gregor and Kelmar Associates personnel with knowledge of the audit, in support of its motion to dismiss. Gregor’s statement notes that Delaware will no longer attempt to estimate Select Medical’s liability because the records provided by the company—two days before the litigation was initiated—have been reviewed and deemed sufficient to permit a determination of the company’s actual liability without the use of estimation. Kelmar’s affidavit confirms this, but further notes that the company has not provided any additional requested information while the litigation has been ongoing and that additional information might be required to avoid estimation of some liability.

Delaware also provided the court a letter to Select Medical dated November 6, 2013, in which Delaware indicated that it was withdrawing its request for payment that initially caused this litigation and also provided a covenant not to sue for such liability. Delaware argued that the court should grant the state’s motion to dismiss because Select Medical’s arguments would be mooted if the court accepts and relies upon the new information provided by Delaware: “There is no longer a justiciable controversy between the parties that would invoke the Court’s subject matter jurisdiction.”

Select Medical responded by opposing the state's request to supplement its motion and, in turn, requesting leave to supplement its own filings with additional information. Select Medical noted that the state delayed several months—while pursuing its motion to dismiss based on a subject matter jurisdiction argument—in deciding not to pursue its demands. The company insisted that even if the state's concessions have mooted the instant case, the court must still determine—on a fundamental level—whether Delaware's estimation practices are constitutional and allowed under the federal unclaimed property common law—unless Delaware could prove that the practice will not continue after the litigation ends.

December 19 Hearing Canceled by Parties: On Thursday, December 19, 2013, Judge Stark had scheduled oral arguments regarding the parties' pending motions—i.e., Select Medical's motion for a preliminary injunction and Delaware's motion to dismiss. Related, but secondary, issues included attempts by both parties to supplement earlier filings with additional factual information and to oppose such attempts by the other party, as discussed above.

However, the day before this scheduled hearing, the parties asked the court to cancel the hearing. In a letter to the court, Select Medical's attorneys noted that the parties were "discussing the possibility of a resolution for this action, and ... are close to finalizing and documenting a resolution." The court requested a joint update from the parties by January 8, 2014.

On January 8, 2014, the parties provided a status update to the court and again requested additional time until January 22, 2014, to finalize and document their settlement agreement, which they were still negotiating.

Stipulation of Dismissal: As noted above, on January 21, 2014, the parties filed a stipulation of dismissal with prejudice asking the court to dismiss all claims with prejudice and for each party to bear its own costs, expenses and attorneys' fees. Judge Stark approved the settlement on January 23, 2014, thus ending the litigation.

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Please contact either **Alston & Bird LLP** or **Mayrack Law LLC** for more information about this settlement and how it may impact unclaimed property compliance, reporting or audit defense.

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Alston & Bird offers clients unparalleled experience dealing with issues involving state unclaimed property/escheat laws. Our five senior attorneys with unclaimed property expertise together have more than 85 years of experience advising major corporations on unclaimed property matters. We assist our clients in analyzing complex legal issues, obtaining legal opinions, conducting multistate/multi-entity internal compliance reviews, designing corporate compliance policies, advising clients on planning and related restructurings, negotiating voluntary disclosure agreements, defending single-state and multistate audits, litigating unclaimed property issues and influencing unclaimed property policy and administration.

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