



## Unclaimed Property ADVISORY ■

**JUNE 16, 2014**

### Delaware's First Published Administrative Appeals Decision Addresses Validity of Estimation Techniques

In the first published decision from an administrative appeal under the Delaware Escheats Law, the independent reviewer rejected the holder's arguments that Delaware's ability to estimate a liability was both unconstitutional and unlawful, and largely disagreed with the position that Delaware's estimation methodologies were flawed (though some potentially viable arguments were raised). Temple-Inland, Inc., has since appealed that decision to federal district court. The case raises important questions concerning Delaware's use of estimation and the methodology that is employed.

#### **Overview**

In 2010, the Delaware General Assembly amended Section 1156 of the Delaware Escheats Law to create an administrative appeals process for holders regarding an audit initiated by the state under the Escheats Law.<sup>1</sup> As amended, Section 1156 provides holders with the right to protest the findings and request for payment by the audit manager following such an audit. If the audit manager renders an adverse determination of the protest, the holder can then appeal to the Secretary of Finance (the "Secretary"). Section 1156 requires the Secretary to appoint an "independent reviewer" to consider the appeal. Such appeal must be conducted *de novo* on the audit and protest record. The independent reviewer must also hold an oral hearing, which involves the preparation and submission of briefs. Following the hearing, the independent reviewer submits his or her findings of fact and conclusions of law to the Secretary, who then is required to adopt or reject the determination in whole or in part.

On April 22, 2014, the first written decision by an independent reviewer regarding a Section 1156 appeal was published on the Delaware Department of Finance's unclaimed property website. That decision involved the appeal of Temple-Inland, Inc. ("Temple-Inland"), a Delaware incorporated entity, regarding the state's audit findings relative to Temple-Inland's accounts payable and payroll liabilities. Essentially, the dispute between Temple-Inland and the state focused on the validity of the state's estimation of Temple-Inland's liabilities.

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<sup>1</sup> The enactment of S.B. 272 in 2010 added Sections 1156(b) through (j) to the Delaware Escheats Law (Del. Code Ann. tit. 12, § 1101 *et seq.*).

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## The Facts of the Appeal

According to the independent reviewer's published decision, the audit was conducted by Kelmar Associates, LLC ("Kelmar"), on behalf of Delaware, commencing in 2008. The issues involved in the appeal pertained to Temple-Inland's accounts payable and payroll accounts for non-records years. With respect to accounts payable, Temple-Inland had researchable records back to 2003, and for payroll, records existed back to 2004. Kelmar's final audit report requested a payment of \$2,128,834.13, which was computed using an estimation of liability for the non-records years. Temple-Inland, acknowledging a liability of only \$147.30, protested the assessment under Section 1156(b). The audit manager upheld the assessment, with a minor adjustment. Temple-Inland subsequently appealed to the Secretary under Section 1156(f) and raised three major issues on appeal, as follows:

1. whether the state exceeded its authority by estimating a liability for Temple-Inland for periods prior to 2003 for accounts payable and prior to 2004 because (a) the estimation provision in the Escheats Law (Section 1155) only permits estimation prospectively after its effective date, July 23, 2010, and (b) federal common law prohibits the state from identifying unclaimed property through estimation and thus preempts Section 1155;
2. whether the state may estimate a liability for non-records years even though the audit showed that Temple-Inland was in material compliance with the Escheats Law with respect to both its accounts payable and payroll for the years it had records; and
3. whether the state's estimation methodology was valid and reasonable, based on both the sample drawn by the auditor and the adjustment of revenues (for purposes of applying the error ratio) to exclude estimated ACH transactions.

## The Independent Reviewer's Decision

The independent reviewer, Ronald S. Gellert, generally disagreed with Temple-Inland's views and arguments regarding estimation. First, the independent reviewer concluded that Delaware's ability to estimate liability was not preempted by federal common law, i.e., the U.S. Supreme Court's *Texas v. New Jersey*,<sup>2</sup> *Pennsylvania v. New York*,<sup>3</sup> and *Delaware v. New York* decisions.<sup>4</sup> Temple-Inland argued that if property cannot be specifically identified, then it cannot be estimated and is not subject to state unclaimed property laws. However, the independent reviewer determined that estimation of liability is not preempted by federal common law based on the plain reading of the case law. The independent reviewer found that those cases do not address the issue of estimating the amount of unclaimed property, but rather establish the unclaimed property "priority rules," and the Court did not hold that a "specific identification of property is required" in order to support a claim to escheat property under the priority rules. The independent reviewer also relied on the 1981 and 1995 Uniform Unclaimed Property Act provisions authorizing estimation—despite the fact that Delaware has not adopted either of those acts. Moreover, the independent reviewer rejected Temple-Inland's position that estimation is inappropriate because it would amount to a windfall for the state, citing the general policy that states only hold the property until recovery is made by the owner and that the state is a more neutral holder of such unclaimed property.

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<sup>2</sup> 379 U.S. 674 (1965).

<sup>3</sup> 407 U.S. 206 (1972).

<sup>4</sup> 507 U.S. 490 (1993).

The independent reviewer then turned to the issue of whether Section 1155 of the Escheats Law, which authorizes estimation, could be applied retrospectively. Temple-Inland argued that Section 1155, which was effective July 23, 2010, was *intended* to apply prospectively, and therefore, the state could not apply estimation to its audit. The independent reviewer rejected this argument. After concluding that the statute was ambiguous on the question of retroactivity, the independent reviewer found that the amendment was a remedial statutory amendment and that “Delaware was merely codifying its existing practices of reviewing and estimating unclaimed property liabilities.” Therefore, the independent reviewer concluded that retroactive estimation is permissible as a “remedial codification of a permissible practice by the State.” Of note, Temple-Inland argued that retroactive application of Section 1155 “would facilitate the taking of property without due process.” The independent reviewer also rejected this, holding that “unclaimed escheatable property is not property of the holder, it is the property of the owner.”

The second major issue raised by Temple-Inland on appeal was whether Delaware could estimate a liability for non-records years, despite the fact that the audit revealed that Temple-Inland had no liability to Delaware for records years. The independent reviewer agreed with Delaware on this issue, holding that under the second-priority rule, a holder’s state of incorporation may estimate “*all* obligations that would be due to be held in escheat by the state of incorporation.” Thus, according to the independent reviewer, “if a state may hold all of the identifiable property, it should be entitled to estimate all unidentifiable property.”

Finally, the independent reviewer addressed Temple-Inland’s issues regarding the validity of the state’s estimation methodology. Despite acknowledging the flaws and “potential errors inherent to a statistical sample analysis,” the independent reviewer found the estimated liabilities, which applied a margin of error for accounts payable and payrolls accounts, to be “reasonable and appropriate.” Temple-Inland suggested that Kelmar’s estimate was flawed by specifically pointing to certain transactions that should not have been included in the sample. Temple-Inland asserted that the certain transactions should not be included, including business-to-business transactions that would have been exempt under the laws of the first-priority state, checks issued in error, charitable donations, and transactions for which property was already escheated to another state. The independent reviewer found that Delaware had accepted Temple-Inland’s position for “several” of these issues and had reduced its demand accordingly. However, with respect to the other issues, the independent reviewer accepted the state’s analysis as “reasonable and appropriate” given that there was a “margin of error” designed to address inaccuracies “inherent in applying a statistical sample.”

The independent reviewer did, however, accept Temple-Inland’s argument that Kelmar’s error rate was “artificially higher” as a result of ACH adjustments. Specifically, Kelmar reduced the denominator of the error rate (Temple-Inland’s revenue) by adjusting for ACH transactions arising from the accounts payable and payroll accounts. However, Kelmar applied the error rate to Temple-Inland’s “full revenues” over the estimation period rather than its adjusted revenues. In other words, Kelmar was not applying the ACH adjustment consistently. Temple-Inland argued, and the independent reviewer agreed, that there was “no clear demonstrable correlation of the ACH adjustment applied by Kelmar.” The independent reviewer also found that the ACH adjustment did not “adequately adjust” for the gradual increase in Temple-Inland’s ACH transactions over time. In other words, the independent reviewer rejected Kelmar’s “static use” of the same ACH adjustment for all of the estimation years, finding that there was “no margin of error protecting against the inherent inaccuracies involved with this type of estimation.” The independent reviewer did not accept, however, Temple-Inland’s position that the denominator of the error rate should consist of its unadjusted revenues; rather, the independent reviewer “agree[d] with the State that some adjustment for ACH transactions is appropriate.” The independent reviewer found that not adjusting revenues by ACH transactions, Temple-Inland’s analysis “seems to inaccurately skew the estimation too far in the other direction.” Thus, the independent reviewer reduced Temple-Inland’s liability from \$2,128,834.13 to \$1,388,573. The independent reviewer concluded that “this figure, while not a perfect figure, more accurately reflects the analysis with a gradual element of ACH transactions.”

## Temple-Inland Has Filed a Complaint in Federal Court

On May 21, 2014, Temple-Inland filed a complaint in the U.S. District Court for the District of Delaware, seeking a declaratory judgment and injunctive relief against Delaware and Kelmar. In its complaint, Temple-Inland reiterates many of the arguments addressed by the independent reviewer. Specifically, Temple-Inland alleges that the estimation of liability by Delaware violates federal common law (i.e., the *Texas v. New Jersey* priority rules), because Delaware does not first identify the property interest at issue or the precise debtor-creditor relationship. Temple-Inland also alleges that Delaware cannot retroactively apply the records retention requirement and the estimation provision to years prior to 2010 under the due process clause.

In addition, Temple-Inland alleges that Delaware's estimation methodology violates federal common law and Temple-Inland's constitutional rights and is arbitrary and capricious, given that Kelmar identified only \$147.30 in property that should have actually been escheatable to Delaware during the audit period (and given Temple-Inland's unclaimed property compliance history, which involved relatively low amounts being escheated to all states annually). Temple-Inland specifically enumerates certain checks that Kelmar used in computing the numerator of its error ratio in violation of the priority rules, including:

- A vendor check to a vendor with a Tennessee address. Temple-Inland alleges that such check was exempt under Tennessee's business-to-business exemption, since Temple-Inland conducted business with that vendor in 2012.
- A check issued to a payee with a Texas address that was uncashed and ultimately reported to Texas as unclaimed property. Similarly, a check issued to a payee with an Arizona address reported to Arizona as unclaimed property.
- Several checks issued to non-Delaware payees that were voided by Temple-Inland after it determined that they were issued erroneously.
- Several checks issued to non-Delaware payees that were voided, reissued and subsequently cleared the bank prior to the expiration of the dormancy period.

Temple-Inland also asserted that the use of the error ratio multiplied by revenues was arbitrary and operated like a tax. Temple-Inland provided evidence that its unclaimed property liability had no correlation to the amount of its revenues in a given year, arguing that there is "no factual or legal basis for using revenues as a benchmark for unclaimed property in a disbursements account." Further, Temple-Inland disputed Kelmar's adjustment of its revenues to reflect ACH payments for purposes of the denominator of the error ratio (but the failure to similarly adjust revenues for purposes of multiplying the error ratio by such revenues). Finally, Temple-Inland takes issue with the independent reviewer's failure to make clear how he arrived at the revised liability calculations.

Temple-Inland filed a motion for preliminary injunction (along with a supporting brief) in conjunction with the complaint. Delaware is currently in the process of securing representation by outside counsel through an RFP process.<sup>5</sup>

## Alston & Bird Observations

On the surface, it appeared that Delaware's unclaimed property laws were made more holder-friendly by the enactment of Section 1156's appeal procedures. However, many have criticized the effectiveness of the appeal process. For example, even if the independent reviewer agrees with a holder regarding a substantive issue, the Secretary of

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<sup>5</sup> Details of the RFP are available here: [http://bidcondocs.delaware.gov/FIN/FIN\\_14002Counsel\\_RFP.pdf](http://bidcondocs.delaware.gov/FIN/FIN_14002Counsel_RFP.pdf).

Finance may simply reject the decision of the reviewer for any or no reason. Furthermore, although a holder has the right to appeal the Secretary's determination to Delaware Chancery Court, the court's review is limited to whether the Secretary's determination was supported by substantial evidence on the record. We believe that these rules significantly limit the effectiveness of the process and render the advantages of this appeal mechanism much less attractive to holders who want an alternative to potentially costly litigation, which is why many holders have opted not to pursue an independent appeal. Indeed, Temple-Inland's own experience with the appeal process suggests that the process is, in fact, skewed in favor of Delaware and provides limited benefit to holders.

The independent reviewer's decision in the Temple-Inland case also demonstrates numerous issues with this appeals process. It is clear that the independent reviewer may have lacked necessary unclaimed property expertise, and much of the reasoning was not apparent in the decision. The independent reviewer did not appear to seriously consider Temple-Inland's constitutional arguments, which further suggests that the Section 1156 appeal process has limited the ability of holders—who now must generally use this administrative appeal process in the first instance—to raise constitutional arguments in an appropriate forum. The independent reviewer also did not directly confront the issues associated with Kelmar's calculation of the error ratio numerator (i.e., including checks that represented amounts not owed, amounts exempt under state business-to-business exemptions, and checks that had been escheated to other states). Although the independent reviewer acknowledged that Temple-Inland made "compelling arguments" regarding the error ratio computation, he simply relied on Kelmar's "margin of error" in resolving the issue. It is unclear whether the independent reviewer felt that those issues were beyond the scope of his charge—to determine the validity of the assessment—or whether he felt that he needed more legal support to render a more compelling decision. Nonetheless, Temple-Inland's complaint recognizes this frustrating lack of clarity.

Interestingly, by filing in federal court, Temple-Inland appears to be attempting to circumvent the remainder of the administrative appeal process established by Section 1156, which requires any appeals of the Secretary of Finance's determination to be appealed to the Delaware Court of Chancery within 30 days, with that court's review limited to "whether the Secretary's determination was supported by substantial evidence on the record."<sup>6</sup> Delaware will likely argue that Temple-Inland's federal lawsuit is inappropriate under theories of exhaustion and jurisdiction.

It would appear that Temple-Inland's complaint presents compelling constitutional and legal arguments, especially given the very low actual unclaimed property amounts that Kelmar was able to identify. However, the legal issues associated with estimation are varied and complex, requiring careful consideration by holders and ultimately, the courts charged with interpreting the law. Moreover, even if estimation may legally be used to create an unclaimed property liability for a holder, it is unclear what a holder must show to successfully challenge an estimation methodology in any particular case. This issue has been complicated by the recently enacted legislation in dispute in *Temple-Inland*, pursuant to which Delaware need only show that its estimation methodology is "reasonable." Thus, for years to which this legislation applies, holders must argue against an unclear standard. Holders have not successfully challenged Delaware's unclaimed property audit practices and methodologies in a judicial setting, and thus it remains to be seen whether Temple-Inland will achieve a different result than the holders that have come before it.

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<sup>6</sup> 12 Del. C. § 1156(j).

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