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Unclaimed Property ADVISORY ■

JUNE 29, 2016

Delaware's Estimation Practices Declared Unconstitutional in Recent *Temple-Inland* Decision

On June 28, 2016, the U.S. District Court for the District of Delaware issued a long-awaited decision in *Temple-Inland, Inc. v. Cook*, No. 1:14-cv-00654. In a ruling on the parties' cross motions for summary judgment, the district court granted Temple-Inland's motion for summary judgment on its substantive due process claim and, in so doing, proclaimed Delaware's historical method and practice of estimation unconstitutional.

While this is a significant win for Temple-Inland, the ruling is not a total victory, as it denied Temple-Inland's motion for summary judgment on two other grounds and did not universally outlaw Delaware's use of estimation, apparently leaving the door open for the use of "reasonable" estimation techniques. The court also left a number of questions unanswered, including what the remedy should be for Delaware's violation of Temple-Inland's due process rights. In addition, the relevance of this decision to the audit practices of other states must be considered.

Nevertheless, this decision is an important win for Temple-Inland and the holder community, is likely to result in significant changes to the use of estimation in Delaware, and may impact pending Delaware audits and voluntary disclosure agreements.

Background

In 2014, Temple-Inland filed a complaint in the District of Delaware challenging Delaware's estimation methodology on federal common law and U.S. constitutional grounds.[1] The Delaware Secretary of Finance, State Escheator and Audit Manager filed a motion to dismiss the action. In a ruling that could be seen as foreshadowing the court's most recent decision in the case, the district court granted Delaware's motion on Temple-Inland's federal common law claim, but allowed the case to move forward on the constitutional claims. The parties filed cross motions for summary judgment on Temple-Inland's claims that Delaware's estimation techniques violated substantive due process, the takings clause and the ex post facto clause. The decision at hand is the result.

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1 For additional background and facts, see our prior advisories: "Delaware's First Published Administrative Appeals Decision Addresses Validity of Estimation Techniques" (June 16, 2014) and "Temple-Inland District Court Denies Delaware's Motion to Dismiss – Looks Good for Temple-Inland and Holders" (March 12, 2015).

The District Court's Decision

In its decision, the district court granted Temple-Inland's motion for summary judgment on its substantive due process claim, granted Delaware's motion for summary judgment on Temple-Inland's ex post facto claim, and declined to grant summary judgment in either party's favor on the takings claim.

Substantive due process

The district court used the majority of its summary judgment opinion to explain that Delaware's actions during its audit of Temple-Inland violated the company's substantive due process rights guaranteed by the U.S. Constitution. In particular, five of Delaware's practices during the audit—in combination—"shocked the conscience" sufficiently to violate due process.

1. Ignoring the Statute of Limitations

The district court found that Delaware's six-year statute of limitations on assessments operated to limit the state's ability to audit Temple-Inland for the entire 22-year period. Notably, the court did not address (and it is unclear whether the state raised) the fact that the statute of limitations only applies to report years beginning in 2003, per the enacting legislation. Thus, the court found that the state could only audit Temple-Inland for years outside the six-year limitation period if Temple-Inland had not filed reports for those years.

The court found that Delaware made an impermissible irrebuttable assumption that Temple-Inland had unclaimed property but filed no reports for the 1986–2002 report years. In the court's view, this assumption ignored the possibilities either that Temple-Inland filed no reports, because it had no unclaimed property (which is consistent with the state's historical advice to holders that negative reports need not be filed) or that copies of filed reports were destroyed pursuant to the company's standard record-retention policies. The court found it problematic both that Delaware permits holders to forego filing negative reports in years in which they have no property and that Delaware itself appears to have destroyed its own copies of unclaimed property records—actions that make it more difficult for holders to demonstrate that they filed reports sufficient to preserve the statute of limitations.

2. Failure to Provide Notice to Retain Records

The district court found that Temple-Inland had insufficient notice that it was required to retain "all of its records forever" related to unclaimed property. Unlike many other states, Delaware puts no requirement on holders to maintain their records for a certain period of time. Thus, when Delaware initiated a 22-year audit—a period well beyond the retention requirements of other states—Temple-Inland was left "with few means to defend against overreaching."

In particular, the district court addressed Delaware's practice of estimating a holder's liabilities for past years. Though the court found that Delaware has "the burden of proving that the property is in fact unclaimed," the court did not hold that estimation can never meet that burden. Instead, the court pointed to case law permitting estimation when the party whose liabilities are estimated has "an opportunity to rebut the estimation." This opportunity is most readily available when "parties have notice that they should retain the records that the estimation is designed to represent." Delaware provided no such notice.

3. Retroactivity

Section 1155 of Delaware's Escheats Law was amended in 2010 to provide statutory authority for the State Escheator to estimate a holder's liability. Temple-Inland argued that it was a violation of the company's substantive due process rights for Delaware to apply Section 1155 retroactively to estimate a liability for periods before 2010. The district court agreed.

The court refused to entertain Delaware's argument that it was not relying on Section 1155 to estimate a liability. However, the court also rejected Temple-Inland's argument that the sheer length of the retroactive period violates due process. Instead, the court found that Delaware's reasons for applying Section 1155 retroactively did not withstand scrutiny under a "shocks the conscience" test and that such retroactive application was unconstitutional for three reasons: (1) the audit of Temple-Inland "did not shift the benefits and burdens of economic life between different public constituencies"; (2) the state's actions "do not reinforce the viability of the state's unclaimed property program"; and (3) the use of estimation "will not make it easier for owners to be reunited with their abandoned property, and may, in fact, make it harder."

This conclusion led the district court to state a broader constitutional principle applicable to unclaimed property. The court observed that:

> [U]nclaimed property laws were never intended to be a tax mechanism whereby states can raise revenue as needed for the general welfare. States violate substantive due process if the sole purpose of enacting an unclaimed property law is to raise revenue.

The court specifically rejected Delaware's argument that an increase in the general public good (i.e., through increased state revenue) justifies estimation. To accept that argument would be to treat unclaimed property "like a tax."

4. Misleading Estimation

The district court held that "estimation is properly performed when it is based on the principle that the unclaimed property in the reach-back years has 'all the same qualities and characteristics' as unclaimed property in the base-years." Thus, "due process violations arise where the estimation methodology creates misleading results." The court found that Delaware's estimation of Temple-Inland's liabilities created misleading results by extrapolating Delaware liability based on checks with payees in other states—some of which Temple-Inland had previously escheated to those states. In other words, characteristics of the sample (property owed to Delaware and other states) did not match the characteristics sought by the estimated liability (property owed to Delaware only).

The court rejected Delaware's presumption that all property in periods for which the holder has no records is escheatable to the holder's state of domicile under the second-priority rule, declining to equate the holder's lack of records with the determination that the owner's address is unknown:

> When the [U.S.] Supreme Court created the priority rules, however, it was addressing the escheatment of intangible personal property, such as money orders, where the property clearly existed but the owner's address could not be ascertained from the four corners of that property or related records. . . [Delaware's] logic stretches the definition of address unknown property to troubling heights.

5. Exposure to Multiple Liabilities

The court found a second problem with Delaware's use of property escheated to other states for estimation: the practice exposes holders to multiple liabilities. The court noted that while no courts have addressed the issue,

> it seems logical that if two states use the same property in the base years to infer the existence of unclaimed property in reach back years, then a holder is being compelled to escheat the same estimated property to two states, in violation of the principles articulated [by the U.S. Supreme Court] in the *Texas* cases. This is exactly what happened to [Temple-Inland].

In particular, the court found it to be problematic that no states that permit the use of estimation "have expressly limited the use of estimation to the secondary rule, and Texas' audit of [Temple-Inland] is clear evidence that, in practice, states use estimation when calculating liability under the primary rule." Thus, the court expressly rejected Delaware's argument that there can be no risk of multiple liability with the use of estimation.

In sum, the court observed that during the course of Temple-Inland's audit, Delaware "engaged in a game of 'gotcha' that shocks the conscience" sufficient to violate Temple-Inland's substantive due process rights by:

> (i) wait[ing] 22 years to audit [Temple-Inland]; (ii) exploit[ing] loopholes in the statute of limitations; (iii) never properly notify[ng] holders regarding the need to maintain unclaimed property records longer than is standard; (iv) fail[ing] to articulate any legitimate state interest in retroactively applying Section 1155 except to raise revenue; (v) employ[ing] a method of estimation where characteristics that favored liability were replicated across the whole, but characteristics that reduced liability were ignored; and (vi) subject[ing] [Temple-Inland] to multiple liability.

Nevertheless, the court declined to provide a remedy for this violation in its summary judgment opinion; presumably the court will ask for briefing on the issue at a future date.

Takings clause

The district court declined to grant summary judgment in either party's favor on the takings clause claim, noting that "the parties have taken an absolutist approach to their argument, with each side claiming that all of the funds are, or are not, unclaimed property. Neither party, however, can be entirely correct."

However, the court did express that "a reasonable estimation of a holder's unclaimed property liability is not an unconstitutional taking" and that "the proper use of estimation can satisfy [Delaware's] burden that property is unclaimed."

Ex post facto clause

The district court granted Delaware's motion for summary judgment on Temple-Inland's ex post facto claim, concluding that the Delaware General Assembly did not intend Section 1155 to act as a criminal punishment and the statute does not operate like a criminal punishment. While Temple-Inland argued that "estimation has resulted in an assessment that is 7,541 times greater than all authorized penalties under the UPL combined," the district court did not find this fact to be enough to "transform what has been denominated a civil penalty into a criminal penalty."

Alston & Bird Observations

The district court's declaration that Delaware's current estimation methodology violates substantive due process is a significant win for the holder community. While the decision is appealable to the Third Circuit, it has far-reaching implications both in Delaware and other states. As an initial matter, any company that is under audit by Delaware or participating in the Secretary of State's Voluntary Disclosure Agreement program should take this decision into consideration as it moves forward and discuss the decision with its advisors.

However, the court's decision leaves a number of unanswered questions (for Delaware and other states), and companies will need to carefully consider various strategic options. For example, the court's analysis of the statute of limitations issue raises the question whether, and under what circumstances, a holder that has never filed unclaimed property reports with Delaware can still argue that the statute has started to run. In addition, while Delaware's estimation methodology has been deemed unconstitutional on substantive due process grounds, the court has left open the question of what is the appropriate remedy for Delaware's due process violation.

Further, the court's statement that reasonable estimation techniques can be employed in determining unclaimed property invites the question of what is a permissible estimation methodology and in what contexts. In that regard, the court's strong criticism of Delaware's methodology under which the state extrapolates liability based on unclaimed property owed to persons in other states clearly indicates that the court believes such a methodology is not reasonable. It is very possible that the decision will have the effect of moving estimation from a state of domicile "winner-take-all" approach to an "apportioned" state-by-state estimation methodology.

At this point this is merely conjecture, but it is unlikely that the decision is the death knell for estimation. While currently not a typical approach, states possess the authority to estimate a first-priority rule liability under certain circumstances. The Uniform Unclaimed Property Act of 1981 provides that if the holder of unclaimed property fails to maintain records required to be maintained by the Act "and the records of the holder available for the periods subject to this Act are insufficient to permit the preparation of a report, the administrator may require the holder to report and pay such amounts as may reasonably be estimated from any available records." It seems clear from the court's decision that, for an estimation methodology to be reasonable, the holder must have had reasonable notice that the methodology could be applied for failure to maintain records.

Similarly, unclaimed property subject to claim by the holder's state of domicile would be limited to the percentage of the sum of unclaimed property in the sample period with (1) an owner name and address in the state; and (2) no associated owner address (true no-address property), for example.

It is also important to consider the impact in states other than Delaware. A number of states, including New Jersey, New York and Texas, apply estimation in the administration of their unclaimed property laws to entities that are domiciliaries, under the similar theory that an estimated liability represents "no address" property. The decision in *Temple-Inland* could impact those practices as well, although each holder fact pattern undoubtedly would need to be considered.

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