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Unclaimed Property ADVISORY ■

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Delaware Secretary of State Assesses Impact of *Temple-Inland* on VDA Program

On Friday, August 26, 2016, Delaware Secretary of State Jeffrey Bullock issued a statement to representatives of holders currently registered in the Delaware VDA program,[1] with a direct opening message to recipients:

> In light of the memorandum opinion issued on June 28, 2016 in the case of *Temple-Inland, Inc. v. Cook*, and the subsequent settlement and voluntary dismissal of the case, I thought it was important to address some of the questions current VDA enrollees have asked regarding the impact of the court's opinion on the VDA program.

This advisory discusses the secretary's statement, analyzes the Delaware VDA program in terms of what will, and what will *not*, change—at least in the immediate future—as a consequence of the *Temple-Inland* decision and the case's settlement and dismissal, and contemplates what is on the horizon for holders that are or will in the future be involved in either a Delaware VDA or audit.

VDA Program Distinguished from Audit Program

Secretary Bullock readily acknowledges that the VDA program he oversees was set up in response to holder expressions of concern about the Delaware audit program that is administered by the Department of Finance and the State Escheator, and he concedes that the *Temple-Inland* decision identified an array of "procedurally unfair" practices by the State Escheator. Nevertheless, he distinguishes the state's audit program, as discussed in the *Temple-Inland* decision, from "his" VDA program in no uncertain terms:

> The actions taken by the State Escheator in the Temple-Inland audit bear little, if any, resemblance to the administration of the VDA program. We designed the VDA program with procedural safeguards in place to ensure that Companies who voluntarily step forward and enroll would be treated fairly.

Secretary Bullock also takes the position that we have expected Delaware as a whole (meaning the Secretary of State's office with respect to the voluntary disclosure process and the Department of Finance and the State Escheator with

[1] Statement from Delaware Secretary of State Bullock regarding Delaware VDA Program sent by VDA Administrators head, Geoffrey Sawyer, to individuals identified as representing a holder in the Delaware VDA program. The transmittal e-mail noted that the Statement will be sent to all currently enrolled holders in the VDA program based on the contact information that was provided when the company enrolled.

respect to audits) to assert in response to the *Temple-Inland* decision and settlement, which is that "[t]he Court's ruling in *Temple-Inland* is limited to the specific facts and circumstances of the unclaimed property audit at issue in the case."[2] Nevertheless, Secretary Bullock does officially address how the VDA program will change in light of the court's decision, and the message differs somewhat from a statement given by Secretary of Finance Thomas Cook last week with respect to audits currently being conducted by the Department of Finance and State Escheator's office.[3]

What Changes in the VDA Program?

The principal change announced by Secretary Bullock is that the look-back period for currently pending VDAs[4] is henceforth shortened to 10 years (plus relevant dormancy periods) from a holder's date of entry into the VDA program.

What about holders that already completed VDA submissions with longer look-back periods? The statement does not address this issue, but this question presents the same set of concerns – both over unequal treatment of otherwise similarly situated holders, and whether the liability paid is in accordance with constitutional principles – that using the "traditional" audit estimation methodology presents. Our assumption is that this is not an oversight, but rather a tacit indication that Delaware's position will be that voluntary disclosures that have previously been finalized through the signing of a Form VDA-2 will not be reopened or liability recalculated using the 10-year look-back announced in the new statement.

What Remains the Same: Use of Estimation on an Aggregated Basis

Secretary Bullock's statement indicates that VDA program participants must continue to employ estimation if they are Delaware-domiciled, and "all estimated unclaimed property for the period a holder determines it does not have available records would be reportable to the holder's state of incorporation or formation." In other words, Secretary Bullock is still asserting that, to estimate unclaimed property due to Delaware for periods for which the holder lacks complete and researchable records, the estimation should be based not only on unclaimed property owed to Delaware residents or address-unknown property for the periods for which records are available, *but also unclaimed property owed to residents in other states or countries.*

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[2] For additional background and facts, see our prior advisories: "Delaware's First Published Administrative Appeals Decision Addresses Validity of Estimation Techniques" and "Temple-Inland District Court Denies Delaware's Motion to Dismiss – Looks Good for Temple-Inland and Holders." For complete discussion of the district court's decision, see: "Delaware's Estimation Practices Declared Unconstitutional in Recent *Temple-Inland* Decision."

[3] In contrast, Secretary of Finance Cook has not issued a statement concerning specific changes that the Department of Finance is making to the audit program that was indicted in the *Temple-Inland* decision, although he did issue the following general statement: "In response to the District Court's decision regarding the state's program, the Department of Finance and the Office of Unclaimed Property are conducting a thorough review of the state's escheat statutes, regulations, policies, and procedures, with the intention of improving the program going forward. Pending the outcome of that process, *the Department will continue to conduct audits and resolve pending examinations on a case by case basis and in accordance with the advice of legal counsel.*" "Delaware Settles Controversial Unclaimed Property Case, Will Review Audit Practices," *State Tax Notes*, Aug. 12, 2016 (emphasis added).

[4] Secretary Bullock's statement notes that more than 400 such agreements have been concluded in addition to the more than 400 still pending (to which this new shortened look-back period will apply).

Secretary Bullock states in this regard:

> When entering into a VDA settlement agreement, a holder is provided a release and the state agrees to indemnify the holder for all future claims by another state on the estimated unclaimed property that was reported. As a result, there is no risk of paying twice based on how the VDA analysis is conducted in combination with the settlement and release agreement entered into by the holder.

This clearly is an attempt to respond to the statement in the district court's decision in *Temple-Inland* that the state's estimation of liability on an "aggregated" basis (i.e., estimating Delaware liability based on unclaimed property owed to any person, worldwide), when the same holder had already been subjected to an estimation of liability by a non-domicile state for overlapping years for the identical type of property, evidenced a clear risk of multiple liability.[5] However, Judge Gregory Sleet specifically considered and rejected this indemnification argument in *Temple-Inland*, holding that "[i]ndemnification is not, however, adequate protection. There is no identifiable property in an estimation to which another state could prove it had a priority claim under the primary rule, especially if the other state estimates a liability too."[6] *Temple-Inland, Inc. v. Cook*, No. 14-654-GMS, 2016 WL 3536710, at *33 (D. Del. June 28, 2016).

Secretary Bullock also claims that "[m]ost if not all states estimate past due unclaimed property liability for holders domiciled in their state the same way as Delaware. Unclaimed property paid to another state during the estimated period will not be assessed twice." Although Secretary Bullock is correct that at least some states have historically applied estimation in the same general manner as Delaware in certain circumstances, we question whether this is likely to continue to be the case after *Temple-Inland*. Judge Sleet's opinion is likely to lead other states to reevaluate their own positions regarding the use of estimation. First, Judge Sleet exposed several constitutional and other concerns with the Delaware approach. Second, other states may argue that an estimation methodology that permits each state to escheat an approximation of what otherwise would have been required to be escheated to that state if records had been maintained comports with common sense. After all, they may argue, if a Delaware-domiciled company holds unclaimed property owed to residents of States X, Y and Z, and fails to maintain records for such property, the holder is violating the record retention requirements of States X, Y and Z, not the State of Delaware. Thus, it should be States X, Y and Z that are permitted to estimate the amount of the unclaimed property that was due. Moreover, as a practical matter, few if any states will be incentivized to use the Delaware historical method of estimation, as they will receive far more escheated property if they estimate based on where the owners are located

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[5] The district 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.

[6] Secretary Bullock's reference to indemnification as adequate protection of holders against multiple liability as a result of claims that may be asserted by other states does not address very real potential problems with indemnification under Delaware law. First, as Judge Sleet notes in the *Temple-Inland* decision, where both Delaware and another state assert liability for prior years for which records are not available, neither state is claiming specific items of property – rather, both states are asserting liability based on an estimation of unidentified property that *may* have been held by the holder in such years. It is not clear that Delaware would agree in the case of an actual indemnification request based on another state's estimation of liability that the other state's claim would be for the same "property" remitted to Delaware as contemplated by 12 Del. Code Ann. § 1203(c). Moreover, it does not appear that any indemnification Delaware may provide would extend to penalties or interest that another state may assert. This could make indemnification by Delaware especially uncertain if the claim by the other state is characterized as a penalty for the holder's failure to maintain records rather than a claim for the unclaimed property itself. *See* Official Comment accompanying 1981 Uniform Unclaimed Property Act §30(e); Official Comment accompanying 1995 Uniform Unclaimed Property Act Section 20(f).

rather than where the holder is domiciled. This method also avoids a windfall for the state of domicile, which has created adverse incentives for such states, particularly Delaware.[7]

Most importantly, though, in taking his position, Secretary Bullock ignores the central ruling in Judge Sleet's decision in *Temple-Inland* that such an "aggregated" estimation methodology "is contrary to the fundamental principle of estimation." Judge Sleet explained:

> [Delaware is] using the existence of unclaimed property in base years to infer the existence of unclaimed property in the reach back years. But [Delaware is] not extrapolating the characteristics of the property that would reduce the liability owed to Delaware. *If the property in base years shows an address in another state, then the characteristic of that property has to be extrapolated into the reach back years*…. Because [Delaware] employed estimation in a manner where the characteristics and qualities of the property within the sample were not replicated across the whole, it created significantly misleading results. (emphasis added)

Judge Sleet also rejected Delaware's argument that such methodology is required by the federal common law jurisdictional escheat rules set forth in *Texas v. New Jersey*, 379 U.S. 674 (1965). *Temple-Inland*, 2016 WL 3536710, at *30-31 (Delaware's estimation methodology "stretches the definition of address unknown property to troubling lengths").

Finally, Secretary Bullock also expresses that his approach is more efficient for holders that truly wish to come into multistate compliance:

> We continue to believe that our VDA program's approach to estimation is the best business practice for all involved. In our discussions with holders, this bright line rule benefits holders as compared to the alternative of performing potentially 50 separate estimations based off of 50 different state standards and then entering into 50 different VDAs or audits to come into legal compliance.

While in theory this makes sense, it is unclear to what extent this will be a significant problem in practice. As a practical matter, many audits of holders are now conducted on a multistate basis by a single contract audit firm. Accordingly, it is possible that the audit firms will be able to utilize a uniform estimation methodology across all participating states (except perhaps for the look-back period, which varies somewhat among states). As a result, the process may not be much more complicated than the current audit estimation process. Similarly, other states may adopt reasonable and consistent practices in VDAs, so that while it may be a little more work for holders, estimation by multiple states may not pose a significant additional burden. On the other hand, if states other than a holder's state of domicile do *not* adopt and implement reasonable and consistent estimation methodologies, a holder facing multiple claims based on estimation may well face an unconstitutional risk of multiple liability under this approach as well.

Although Secretary Bullock does not say so explicitly, presumably the new 10-year look-back period plus dormancy periods means that the use (and impact) of estimation would be significantly more limited for holders that have retained records for transactions undertaken in all or many of the 15 years before the VDA entry date. This change, together with other potential legislative changes anticipated by the notice, appear designed to give Delaware an

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[7] At the same time, there are also important statutory, common law and constitutional concerns that will need to be addressed should non-domiciliary states attempt to use estimation for failure of the holder to maintain records.

ability to argue that the continued use of its historical estimation methodology is constitutionally acceptable. It appears that the Department of State is hoping most holders will not find this more limited VDA utilization of the estimation methodology that was successfully challenged in *Temple-Inland* to be worth challenging.[8]

On the Horizon in Delaware?

Secretary Bullock predicts several "common sense" legislative changes will be effectuated in 2017, with input of both the Department of State and Department of Finance, including:

- A statutory reduction in the VDA look-back period that is in accord with most states' look-back periods (and which his administrative decision to shorten the VDA look-back period to 10 years is intended to foreshadow), and
- Changes addressing two other issues specifically raised by the district court in the *Temple-Inland* opinion, namely: (1) an express record retention provision for unclaimed property reports tied to the current statute of limitations; and (2) possibly a negative reporting requirement that could clarify how the statute of limitations would be applied to holders that have no property required to be reported to Delaware for any particular year.

Secretary Bullock reminds his audience that under recently enacted law, holders will have a chance to participate in the VDA program before they can be subjected to audit, and he expresses a sentiment certain holders enrolled in the VDA program may agree with on balance – namely, that "the VDA program continues to be the same procedurally fair and business-friendly program that we set out to create together in 2012 – offering enrollees the opportunity to voluntarily 'catch-up' on past due unclaimed property obligations, get into a regular cycle of compliance, and significantly reduce their liability, all at the same time." This effort to timely respond to the developments in Temple-Inland's litigation certainly demonstrates the Department of State's more open process, and will place further pressure on the Department of Finance to follow suit.

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[8] We note that a holder currently enrolled in the Secretary of State VDA program that is unwilling to accept the revised administrative practices announced by Secretary Bullock would likely have to withdraw from the VDA program, subjecting itself to potential audit by the Department of Finance State Escheator's office. In general, audits involved greater uncertainty, greater administrative expense (including the need to deal with a contract audit firm) and potential application of penalties and interest. On the other hand, the statement issued by Secretary of Finance Cook seems to indicate that the State Escheator's office may well have greater ability and/or willingness to compromise on estimation issues on a case-by-case basis, particularly given that (1) the only published authority on these issues is very favorable to holders; and (2) the precedent established by the *Temple-Inland* settlement suggests that, when push comes to shove, Delaware may bend rather than risk another adverse decision that could dismantle its estimation program entirely. Nonetheless, each holder will need to carefully consider the potential cost-benefit analysis of potentially withdrawing from the VDA program and addressing these issues in audit or litigation.

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