



Unclaimed Property ADVISORY ■

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Delaware Finalizes Much-Anticipated Audit Regulations

On October 1, the Delaware Department of Finance adopted its [final set of unclaimed property audit regulations](#), as mandated by Section 1176(b) of Delaware's [newly revised Escheats Law](#). The regulations are effective on October 11, ten days after publication. As a result, the deadline for holders under audit to convert their audits into Department of State-administered voluntary disclosure agreements (VDAs) or to opt into the new expedited audit program is now approaching, though there is some question about when the conversion window actually closes.

Background

As adopted by Delaware [Senate Bill 13](#) (and subsequently revised by [Senate Bill 79](#)), Section 1176(b) of the Delaware Escheats Law requires the Department of Finance, "in consultation with the Secretary of State," to adopt regulations "regarding the method of estimation to create consistency in any examination or voluntary disclosure," including "permissible base periods, items to be excluded from the estimation calculation, aging criteria for outstanding and voided checks, and the definition of what constitutes complete and researchable records." This requirement to adopt estimation regulations was prompted by the [federal district court's 2016 decision](#) in *Temple-Inland*, which held that Delaware's historical audit practices and estimation methodologies were unconstitutional.

The Department of Finance published its original proposed regulations on April 1, and subsequently republished a revised set of proposed regulations on August 1. The final regulations are substantively unchanged from the August 1 version despite significant public commentary regarding the proposal.

Same Old, Same Old

Unfortunately, as was the case with the initial proposed regulations, the final adopted regulations reflect traditional Department of Finance audit practice. One example of this is the use of a standard check voidance "grace period" of only 30 days, rather than the 90-day voidance grace period applied to voided checks in a Delaware VDA. Indeed, the Department of State's separate VDA regulations, which were adopted on July 11, 2017, expressly recognize a 90-day voidance grace period. In this aspect alone, the Department of Finance's regulations have failed to "create consistency in any examination or voluntary disclosure" as required by Section 1176(b).

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The regulations also fail to address issues that drew the critical attention of the district court in its *Temple-Inland* ruling, such as that Delaware has historically considered items of property exempt under one state's laws to be includible in a holder's "error rate" for Delaware estimation purposes. It appears this practice will be continued under the regulations. A more obvious source of heartburn for holders is the inclusion of items with addresses in states other than Delaware, which leads to an aggregated, unapportioned estimate of liability. These implicate the holder's due process rights and, the ruling in *Temple-Inland* suggested, may also violate the Takings Clause. Thus, we anticipate that at some point in the future there is likely to be another challenge by a holder to the constitutionality of the estimation methodology.

The final regulations also do not provide any details about the new "expedited audit" conversion option, which was adopted by SB 13 as an alternative to the VDA conversion option. Despite the lack of details, the deadline to opt into the expedited audit program is also 60 days from the effective date of the regulations. In the absence of any guidance whatsoever, it seems highly unlikely that holders will choose this option.

One major difference in the regulations, in contrast with historical audit and VDA practice, relates to the determination of the "maximum cost" to an issuer of a stored-value card or gift card. Section 1133(14) of the Escheats Law requires a holder to report its "maximum cost ... of the merchandise, goods, or services represented" by a stored-value card or gift card. Historically, the state has required remittance of the issuer's total outstanding gift cards multiplied by a cost-of-goods-sold percentage. However, the final regulations purport to require remittance of the issuer's total expense percentage, as computed by utilizing information from the holder's federal income tax return. For example, the state is instructed to consider the holder's cost of goods sold (Form 1120, line 2) plus total deductions (line 27), minus charitable contributions (line 19), depreciation (line 20), and depletion (line 21). This maximum cost is then divided by gross receipts (line 1) to determine maximum cost as a percentage of gross receipts, which would then be multiplied by the total amount of stored-value cards/gift cards subject to escheatment. The State Escheator may consider alternative calculations, however.

Tuning Out the Public Commentary

Even though the Department of Finance received a significant volume of public commentary from holders and practitioners after republishing the proposed regulations on August 1, no substantive changes were made to the final adopted regulations—the public's comments were largely ignored. This has been received in many circles as the Department of Finance's unwillingness to consider practitioner and holder comments, which were designed to clarify rules and to make improvements in the examination process.

The Conversion Window Is Now Open (Or Soon Will Be)

Section 1172(b) of the Escheats Law provides holders that are currently under audit by the Department of Finance with the ability to convert the audit into a VDA. The conversion must be made "within 60 days of the adoption" of the audit regulations. However, it is unclear whether the 60-day period begins running from October 1 (the date the regulations were finalized), October 2 (the date they were published), or October 11 (their effective date). The order in the Register of Regulations adopting the regulations states that they are "adopted and shall be final effective October 11, 2017." Based on this reference to the regulations being "adopted" on October 11, and given the statutory requirement that a holder convert within 60 days of "adoption," we believe that October 11 is the operative date. Nonetheless, given the uncertainty, holders would be well advised to have their conversion paperwork prepared, finalized, and submitted by December 1 in the absence of official guidance from the state. Of course, holders have been free to convert since SB 13 became effective and may now convert even if the clock does not technically begin running until October 11.

It is important to note that by participating in and completing the VDA program, a holder will be subject to Delaware's estimation methodology in accordance with the VDA regulations (which are substantively identical to the audit regulations for estimation). A holder that refuses to apply this estimation methodology in the VDA will likely be referred back to audit. Once the audit is completed (or perhaps sooner), the holder may challenge the validity of any estimated liability through administrative and/or judicial means.

Audits Are Ready to Ramp Up Again

Finally, the Delaware Secretary of State has recently notified practitioners by email that his office will begin mailing notices to holders that have been identified as "likely being out of compliance" with the Escheats Law, and will request that such holders enroll in the VDA program. Holders that do not opt to enroll in a VDA within 60 days of the notice "will be" referred to the Department of Finance for audit. At that point, there will be no option to convert the audit to a VDA.

Conclusion

Now that Delaware's audit regulations have been finalized and published, holders that have been in the process of determining their next move must now begin making final decisions and preparing for VDA conversion, if that is their selected option. Holders that are not currently under audit should carefully monitor correspondence from the Secretary of State's office requesting enrollment in the VDA program in order to avoid losing the ability to opt into a VDA and having to deal with an audit.

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