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Unclaimed Property ALERT ▪

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Five Unclaimed Property Issues That Resist Easy Answers

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Synopsis: This advisory focuses on five of the more challenging issues that arise in connection with unclaimed property audits and that businesses should carefully consider in their efforts to comply with state unclaimed property/escheat laws. Although in most instances these issues do not lend themselves to easy or clear answers, the authors present a number of practical insights and suggestions to help mitigate some of the problems and place businesses in a position to assert more effective audit defense strategies.

Introduction

States continue to actively enforce their unclaimed property/custodial escheat laws through audit initiatives (typically involving contract audit firms). As a result, many holders of unclaimed property have belatedly found that their unclaimed property compliance policies and procedures are deficient and, in many instances, materially deficient. Many other holders have learned this fact in the course of conducting a compliance self-review, which may be performed in order to take advantage of many states' formal or informal Voluntary Disclosure Agreement programs.

In addition to the "easy" compliance questions that arise in the course of a holder's audit or compliance self-review—such as, for example, what are a state's due diligence requirements—we are finding that certain issues arise frequently but resist easy analysis, and consequently require special consideration by a holder business. The purpose of this article is to present an assortment of these issues so that holders can begin the fact-finding and analysis that will either permit a more effective audit defense strategy or identify opportunities for process improvement and mitigation of prospective liability where an audit is not ongoing.

Issue 1: When Is an Address an Address? It Depends.

The question regarding whether a holder's books and records contain owner address data is critical to the determination of which state has jurisdiction over a specific item of unclaimed property. States claim unclaimed property pursuant to the jurisdictional priority rules articulated by the U.S. Supreme Court in *Texas v. New Jersey*[1] and its progeny, which all states either have incorporated into their unclaimed property laws or recognize administratively. Under the so-called "first-priority rule," the state of the owner's last-known address, as shown on the holder's books and records, has the right to claim the property. If the holder does not have an owner's last-known address, or if the last-known address is in a state that does not provide for the escheat of the property, the state of the holder's domicile has the right to claim the property under the so-called "second-priority rule."[2] Although the Court has entertained additional jurisdictional grounds that various states with ties to the holder, owners or property have proposed to the Court, it has repeatedly affirmed these two priority rules.[3] Thus, the issue of what constitutes an address is of utmost importance since it drives the application of the jurisdictional priority rules.

New Jersey's Stored Value Card law (originally adopted in 2010 and revised in 2012), the litigation that the law generated[4] and New Jersey's recently proposed regulation amendment (which purports to provide that records containing a zip code are sufficient to establish a "last known address" for purposes of applying the jurisdictional priority rules) have put this issue front-and-center. As amended, the regulation would provide:

> "Last known address" means a description of the location of the apparent owner sufficient for the purpose of determining which state has the right to escheat the abandoned property and the zip code of the apparent owner's (creditor's) last known address is sufficient.[5]

Is a zip code an "address" for purposes of establishing first-priority jurisdiction over property? For that matter, what about state coding (e.g., "AL" or "TN") but no street address or city information? What about a partial address that includes either a state code or zip code? When viewed in light of the fact that unclaimed property laws are primarily intended to reunite owners with their property, it is difficult to conceive how a state could do so simply by using an owner's zip code (or state code) and no other address information.

Indeed, the term "address" in common application generally implies more than a zip code—if an owner or purchaser is asked for his or her "address," the owner or purchaser is likely to (1) provide a street number, street address, city,

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1 379 U.S. 674 (1965).

2 *See id.* at 682.

3 The Supreme Court reaffirmed the priority rules again in *Delaware v. New York*, 507 U.S. 490 (1993). The property at issue in that case consisted of securities and dividends thereon that remained unclaimed by their owners for the statutory period of abandonment.

4 In *N.J. Retail Merchants Ass'n v. Sidamon-Eristoff*, 669 F.3d 374 (3d Cir. 2012) *cert. denied*, 133 S. Ct. 528 (2012), the Third Circuit upheld the preliminary injunction related to the "place of presumption" provision, concluding that the plaintiffs demonstrated a reasonable likelihood of success on their claim that it, and the so-called "third-priority rule" were both preempted under the jurisdictional priority rules established in *Texas v. New Jersey*. The Third Circuit, however, found that the plaintiffs did not meet their burden of showing that the ZIP code collection requirement was likely preempted and therefore lifted the injunction with respect to that part of the law. After the Third Circuit's decision in *N.J. Retail Merchants*, the New Jersey legislature passed, and Governor Christie signed into law, Senate Bill No. 1928 (S.B. 1928), which made a number of changes to New Jersey's unclaimed property laws applicable to stored value cards. In particular, the legislation deferred the implementation of the ZIP code collection requirement until at least July 1, 2016.

5 45 N.J.R. 1377. Currently, the regulation's definition of "last known address" is "a description of the location of the apparent owner sufficient for the purpose of the delivery of mail." N.J.A.C. § 17:18-1.2. *See* N.J.S.A. 46:30B-42.1(a) (requiring stored value card issuers to collect ZIP codes on sales to New Jersey customers). In response to business concerns and many of the major gift card issuers ceasing sales of gift cards in the state of New Jersey, the legislature decided to enact "curative" legislation in the form of S.B. 1928 (*see supra* note 4).

state and zip code; or (2) refuse to give any information to the seller/issuer. Moreover, the proposed amendment to the regulation runs counter to the 1981 Uniform Act, which refers to "mailing-sufficient address" for this purpose.[6]

By amending the definition of the last known address in this way, New Jersey would be able to claim gift cards sold in the state on a first-priority basis to the extent an issuer had zip code information, but no other address information. Not surprisingly, Delaware—one of the most aggressive states in terms of enforcement of its unclaimed property laws—insists that there must be a mailing-sufficient address in order to assert first-priority jurisdiction over unclaimed property.[7] Of course, the different interpretations by New Jersey and Delaware serve to illustrate the risk that two states would claim the identical item of property with partial address data. This being the case, a holder MUST seek explicit indemnification from whichever state it reports property to, when the property that it reports and pays over-bears only partial address data.

As Kelmar (one of the best-known contract audit firms) begins to cater to its client states other than Delaware through more accelerated, intensive first-priority property audits, we wonder how *it* will resolve this tension between client New Jersey, which wants to treat a zip code-only item of property as New Jersey-reportable, and client Delaware, which views the same item as Delaware-reportable.

Issue 2: Multiple Owner Addresses – Now What?

It is often the case that a business records more than one address for a single owner of escheatable property. These addresses could be (1) the bill-to address, (2) the residence or mailing address, (3) ship-to address(es), and (4) in the case of individuals with more than one residential address, seasonal mailing addresses. The question that arises where more than one address is recorded for a specific owner, or for a specific category of owners, is which address controls for purposes of reporting the escheatable property, given the relevance of an owner's address to the U.S. Supreme Court's jurisdictional priority rules, as discussed above.

We suggest that a holder should consider developing a protocol for ordering of addresses that is tiered and will be applied by the holder consistently. Such ordering could first be based on whether one address is more "complete" (i.e., mailing sufficient) than another. Thus, under one possible protocol, the holder would escheat property to the state of the "top-tier" address—that is, the address that reflects the most complete information. The question for each holder to consider is how to determine whether one address is more complete than another. If one considers a zip code record and a mailing-sufficient address, the use of the mailing-sufficient address would certainly comport with the laws of those states that have adopted the 1981 Act, as well as with Delaware's position (and would arguably not conflict with New Jersey's position, since such mailing address will necessarily contain a zip code); in addition, the holder's more complete record would tend to invite greater reliance as a source of information about the property owner. Nevertheless, in arriving at the ordering of addresses under the tier system, the purpose for which a partial address was recorded by the holder should be examined, since a partial address collected for tax determination

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[6] The 1995 Uniform Act did not include the term "last known address" in its definitions section. The comment to the definitions section notes the omission of this definition and states that "the [1981] Act indicated some uncertainty over whether this was an accurate interpretation of *Texas v. New Jersey*, since this definition was accompanied by a Commissioners' comment that 'where a holder originally had the address of the owner and it has been subsequently destroyed, a computer code may be one way of establishing an address within the state.'"

[7] These opposite state positions make sense considering that insistence on having a mailing-sufficient address to support a first-priority claim tends to push property to the holder's state of domicile under the second-priority rule, while utilizing a zip code standard would make it more likely that property is payable to the first-priority state.

purposes might be deemed more probative/reliable than, for example, an address collected in connection with a promotional program (especially if the holder notices a high degree of false addresses associated with promotional accounts—for example, a plethora of address records such as "One Mickey Mouse Way, Disney, CA 02810"). Any tiered system should also be constructed to resolve equally complete addresses (e.g., permanent address prevails over seasonal addresses).

Also, is a zip code (with no other address information) to be considered an "address" for purposes of this analysis (see *infra*)? This is an open question that each holder should discuss with its advisors.

Issue 3: Promotional Programs with Contract Terms – Can Unclaimed Property Result?

Many businesses may assume that when they offer "promotional" or loyalty programs and instruments—for example, a special "pay-$50/get-$75" voucher, or a "free" $25 gift card after spending $250 on goods or services—that there is no potential unclaimed property liability. Not so fast . . .

Among the questions that arise when determining the unclaimed property implications associated with promotional instruments and programs are the following: (1) whether terms and conditions exist for the program, clarifying the customer's entitlement to the particular promotion (e.g., no cash refund, redeemable only for goods/services; any conditions that must be satisfied by the customer before he or she uses the instrument); (2) whether a state treats intangible property as escheatable only if rights are vested in such property (i.e., no unsatisfied conditions) and only to the extent consideration was received for it; (3) whether the various exemptions contained in state laws pertain to the property under review; and (4) whether other doctrines or legal principles support a position that the instrument is not subject to escheatment.

Holders can assert various arguments that their "promotional" rewards/instruments do not constitute escheatable property. One such argument is based upon the "derivative rights doctrine," which stands for the proposition that a state has no greater right to the property than that of the owner. According to a derivative rights doctrine argument, since promotional rewards/instruments are generally not redeemable for cash, a state therefore cannot require the escheat of cash. However, holders face the risk of states taking the position that promotional items are not truly promotional and (1) are akin to credits, (2) should be treated as gift cards and therefore escheatable unless otherwise exempt, or (3) constitute "other" miscellaneous intangible property subject to the state catch-all provision. In this regard, almost all states have adopted a "catch-all" provision in their unclaimed property statutes. The strength of a holder's position with respect to promotional rewards/incentives will depend on the program's terms and conditions, the holder's particular facts (e.g., are some rewards/instruments purchased, is there any established *quid pro quo*, etc.), and the state unclaimed property law in question.

As we see additional inquiries from auditors regarding promotional programs, each of these arguments should be considered for programs in existence, and may be taken into account when designing and implementing such programs going forward.

Issue 4: Where Records Do Not Exist, What Exactly Is a "Reasonable" Estimate of Liability?

Many states have adopted some type of provision to allow their auditors to estimate or extrapolate an unclaimed property liability for a period where inadequate records were kept by the holder. The 1981 Uniform Act specifically provides that when a holder fails to maintain/keep adequate records of its unclaimed property for any part of the audit period, the state is allowed to "estimate" the amount of unclaimed property due for such audit period from any available records of the holder.[8] A similar requirement is contained in the 1995 Uniform Act. Because there are obviously no owner names and addresses associated with a liability based on an estimation (i.e., because there are no records), the state of domicile of the holder will typically deem that it can claim the entire amount under the second-priority rule discussed above.[9]

Estimation techniques vary somewhat by state and audit firm; however, estimation methodology typically entails the following steps:

- Review of the holder's records for years with respect to which such records are complete/researchable (i.e., records can prove that a recorded obligation has been satisfied or otherwise "remediated");
- Establishment of an "error rate" using the dollar value of unclaimed property divided by the holder's annual revenue; and
- Application of the error rate to the holder's annual revenue for years in which records are not available to be audited, resulting in an estimation of liability for such years.

These steps are conducted on both an entity-specific and property-specific basis. In 2010, Delaware enacted legislation providing a reasonableness standard for purposes of estimating an unclaimed property liability.[10] However, the meaning of "reasonable" is not defined by that statute (or regulation) and has not been defined by the courts in a similar context. While there is no general body of law stating what are proper and improper estimation techniques for unclaimed property audits, there is no doubt that any estimation technique used must at least be a "reasonable" and valid method for determining the amount of unclaimed property not reported for an audit period. Estimation techniques that are arbitrary or *not* calculated to provide a reasonable picture of the amount of unclaimed property not reported should be rejected by a court.

Any holder that is subject to an estimation of liability would do well to discuss with its advisors any of the following potential challenges to the validity of such estimation:

- the presumptions are improper and/or violate federal law;
- the population from which the sample was drawn was erroneous;
- the sample was drawn improperly;
- the remediation standard is wrong (e.g., the holder was not given credit for accounting errors);
- the error rate was built using incorrect inputs (denominator); and/or
- the historical revenues by which the error rate is multiplied are inflated or require adjustments.

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8 1981 Uniform Disposition of Unclaimed Property Act, § 30.

9 1995 Uniform Disposition of Unclaimed Property Act, § 20(f).

10 12 Del. Code § 1155; Ch. 417 (S.B. 272), Laws 2010, effective July 23, 2010.

Issue 5: B2B Invoicing and Settlement Practices – Worth the Paper (Napkin) They Are Written On?

When businesses interact with each other, there is often a *de minimis* threshold below, which they will disregard or write off credits and debits on their respective accounts. Such thresholds are often referred to as tolerance thresholds and are implemented to facilitate efficient business transactions. However, most state unclaimed property laws do not recognize a *de minimis* exception, and states take the position that disregarded or written-off credits and debits are reportable as unclaimed property notwithstanding the fact that they originate from an arrangement between sophisticated business parties.[11]

In addition, many businesses utilize "negative confirmation" practices to clear accounts at regular intervals. Typically under such practices, a business with an accounts receivable credit on its books may rely on industry practice to assume that, if the customer does not apply such credit or otherwise communicate about it, the customer does not view itself as entitled to any credit—that is, the customer relies on its own books and records to establish the existence and amount of its obligations, irrespective of whether the holder's books reflect a credit balance. And, for many businesses, the use of estimated payables that are trued up against invoices received from a vendor may create an apparent imbalance, but in reality each party may consider the other to be in good standing, vis-à-vis the transactions and payments that have occurred.

To the extent a company employs any of the above B2B invoicing practices in its business relationships, it is essential to understand both the scope of such practices as well as the potential unclaimed property implications that may arise. Most importantly, the company should discuss with its advisors what to do before an audit, how to protect against claims of liability on audit, and how to structure its unclaimed property policies and procedures to mitigate exposure in light of what is often a necessary business practice.

Conclusion

As with so many legal issues, the answer to many of the unclaimed property issues companies now face under audit or in the course of performing a compliance self-review is: "It depends." It is essential that holders consider these issues carefully and resist the temptation to assume that an easy answer exists. Most often, these issues require special consideration by a holder business and should be actively considered in order to present a more effective audit defense strategy.

This advisory was written by Kendall Houghton, Matthew Hedstrom and Michael Giovannini.

[11] Note, however, that a handful of states have enacted explicit business-to-business (or "B2B") exemptions that may be applicable, depending on the particular facts.

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