taxanalysts UPwords

Unclaimed Property Administration — Taking Advantage of Uncertainty

by Diann L. Smith and Matthew P. Hedstrom

Diann L. Smith Matthew P. Hedstrom

In this installment of UPwords, we suggest that with the increased attention surrounding unclaimed property law and the states' aggressive posture toward unclaimed property as a source of revenue, holders of unclaimed property should prepare as never before to vigorously and confidently challenge the states' administration of unclaimed property laws. We support this suggestion through an exploration of two significant recent cases — one an unclaimed property holder victory and the other an example of a property holder aggressively defending its position on audit. These cases demonstrate the imperative for unclaimed property holders to take an active role in the development of state unclaimed property law to ensure its fair application and administration.

The roots of unclaimed property law are ancient — tracing back at least to the Roman Empire and the concept of *caducam*. Over time these laws developed with the economy, eventually leading to the promulgation of the unclaimed property uniform acts and their variations that have been adopted by the many states. Even so, it was not until 1951 that the U.S. Supreme Court in *Standard Oil v. New Jersey*[1] solidified the broad power of the state to take custody over abandoned property. In *Standard Oil*, the Supreme Court held that New Jersey's unclaimed property laws were constitutional as applied to stock and dividends that had been abandoned for 14 years. The Court echoed existing precedent and established the most fundamental premise of modern unclaimed property law — unclaimed property is better held by the states for use for the general good than held by an individual for a singular enrichment.

Arguably, *Standard Oil* set the stage for what has become one of the most mysterious, misunderstood, and volatile areas in state tax today. Unclaimed property law's mystery is counterintuitive. With deep roots, state unclaimed property law should be well defined and its fundamental concepts well vetted through legislative and judicial processes. In part because of the relative obscurity of unclaimed property law, its development as a body of law has lagged behind its age. The lack of development has left unresolved and subject to debate many fundamental issues involved in the administration of unclaimed property, including the validity of sampling, the definition of property types subject to escheat laws, and the precise application of the priority rules established in *Texas v. New Jersey*.[2]

That uncertainty has been used by revenue hungry administrators (and their bounty-hunting auditors) to put unclaimed property holders in the untenable position of defending against liability asserted with little or no legal authority. The lack of clarity has been used by administrators to put property holders in a vulnerable position.

Let's hope the tide is changing.

American Express v. Hollenbach — The Big Victory

In what is one of the most significant unclaimed property holder victories in some time, on June 15,

[1]341 U.S. 428 (1951).
[2]379 U.S. 674 (1965).

2009, American Express prevailed in the Kentucky District Court with the court's invalidation of a Kentucky legislative amendment to the state's unclaimed property dormancy provisions.[3]

Factual Background

American Express issues traveler's checks to customers as part of its regular business. In providing that service to customers, American Express does not charge a fee for issuing the traveler's checks, but rather derives income from investments on the funds backing the checks during the time the checks remain outstanding.

Traveler's checks have no expiration date. However, every state has legislation that presumes that the checks are abandoned after a certain period as part of its unclaimed property laws. Kentucky imposed a 15-year presumptive abandonment period (dormancy period)[4] until 2006, when the Kentucky General Assembly amended the statute to retroactively shorten the period to seven years.

American Express brought suit challenging the legislation as "an attempt to unconstitutionally misappropriate or interfere with its [American Express's] property and contract interests in traveler's check funds."[5] Kentucky argued that the statute at issue was constitutional as a valid exercise of legislative authority.

Issue

The issue in *American Express* was whether Kentucky's statutory amendment of the presumptive abandonment period for traveler's checks from 15 to 7 years violated the due process, takings, or contract clauses of the U.S. Constitution.[6]

Holding

American Express argued that the statute violated "the Due Process Clause because it arbitrarily extinguish[ed] its property interest in traveler's check funds."[7] In determining the validity of American Express's challenge, the court examined the due process claim under a two-part analysis. First, to sustain the due process challenge the interest must be a protected liberty or property interest. The court said: "Thus, the first prong of the due process analysis requires examination of Kentucky law to determine whether American Express has a legitimate claim of entitlement to the funds obtained from the sale of traveler's checks."[8] Second, if there is a protectable interest, the inquiry is whether the deprivation of that interest violates due process.[9]

For the first prong of the analysis, the court concluded that traveler's checks are protected property interests under Kentucky law because American Express owns those funds as debtor until the purchaser acting as creditor claims those funds. Moreover, because American Express issued checks free of charge, American Express relied on the presumptive abandonment period of 15 years with which it could use those funds to its benefit. The court correctly reasoned that if the abandonment period were significantly shorter, American Express may not have made the same decision to issue those checks free of charge.[10]

> ***The court held that because it is clear that the state's objective was to raise revenue rather than to reunite citizens with lost property, the statute did not satisfy rational basis review.***

In support of the second prong of the analysis, American Express had argued "that changing the presumptive abandonment period from fifteen to seven years has no relationship to when traveler's checks are actually abandoned."[11] The state treasurer responded that the state's authority to hold unclaimed property for the benefit of the owner is accompanied by the authority to determine the presumed abandonment period.[12] The court concluded that the state did not provide sufficient evidence proving that traveler's checks are actually more likely abandoned after seven years. In fact, the state did not produce any evidence to answer the critical question "whether the presumptive abandonment period was reached in accordance with specific standards set out in" past precedent.[13]

The court held that because it is clear that the state's objective was to raise revenue rather than to reunite citizens with lost property, the statute did not satisfy rational basis review. Moreover, the court held that even if raising revenue was a legitimate state objective and therefore subject to rational basis review, shortening the presumptive abandonment period from 15 to 7 years was not rationally

[3] *American Express v. Hollenbach*. 630 F. Supp.2nd 757 (Dist. Ct. Kentucky June 15, 2009).

[4] Ky. Rev. Stat. section 393.060.

[5] *American Express*, *supra* note 3, at 759.

[6] *Id.* The court ultimately did not reach the merits of plaintiff's takings and contract clause claims.

[7] *Id.* at 760.

[8] *Id.* at 761.

[9] *Id.* at 759.

[10] *Id.* at 761.

[11] *Id.*

[12] *Id.*

[13] *Id.*, *citing Anderson Nat'l Bank v. Luckett*, 321 U.S. 233 (1944).

related to that state objective. Therefore, the Kentucky statutory amendment violated the due process clause.

Analysis

Essentially, the court examined whether the state had substantial ground for its belief that property was abandoned or forgotten after seven years, and whether that belief was based on evidence that property that owners never came forward to claim was actually abandoned after seven years. Arguably, if the state could have shown that the property was truly abandoned after seven years, it may have been able to show that shortening the dormancy period was necessary to carry out the purpose of modern unclaimed property law — to provide for a custodial taking. Not only was the state unable to make the necessary showing, but it acknowledged that the purpose for reducing the dormancy period was to raise revenue. With that in mind, the court concluded that raising revenue was not the legitimate objective of abandoned property law since the purpose of the law was to reunite owners with lost property. Accordingly, reducing the dormancy periods to achieve an objective that was outside the scope and intent of the law violated due process.

McKesson v. Cook — The Next Big Victory?

McKesson v. Cook,[14] a recently filed case in the Delaware Chancery Court, represents the most recent example of an unclaimed property holder challenging a state's administration and interpretation of its unclaimed property laws. Coming on the heels of *CA, Inc. v. Cordrey*,[15] *McKesson* continues the recent trend of litigation related challenges to states' unclaimed property laws.

Factual Background

In August 2002 Delaware, using a third-party auditor, commenced an audit of McKesson Corp.'s compliance with the Delaware escheat laws. Over the course of the audit, disagreements surrounding the treatment of "goods received, not invoiced" surfaced. Essentially, that type of property represents inventory received by an unclaimed property holder without a corresponding invoice.

In June 2008 McKesson and the state of Delaware entered into a closing agreement to settle all unclaimed property liability for three property types under audit (accounts payable, payroll, and accounts receivable). Thereafter, over McKesson's objection, Delaware continued to audit the inventory issue.

Issue

McKesson filed suit challenging Delaware's assessment related to its unclaimed property liability as applied to the items of unmatched inventory. McKesson argued that either the inventory at issue was not unclaimed property[16] or it was not unclaimed property escheatable to Delaware under the priority rules established in *Delaware v. New York*[17] and *Texas* v. *New Jersey*.[18]

McKesson's Contentions

McKesson contends that such inventory property is not subject to escheat, as defined under Delaware law, and that even if the property were subject to escheat, Delaware's estimate of McKesson's unclaimed property liability regarding that property is arbitrary and capricious because McKesson has the names and addresses of virtually all the vendors from which McKesson received the inventory items.[19]

According to the complaint, of the nearly $3 million in entries in the GR/IR account for which no invoice could be found, vendors confirmed that 98.06 percent were not owed to them; 0.67 percent were confirmed as owed to vendors located outside Delaware (none within Delaware); 0.85 percent were unable to be confirmed by four companies, three of which were located outside Delaware; and 0.41 percent went unanswered by eight companies, only four of which were located in Delaware.

Of particular significance in this case is the relative newness of the property that Delaware now

---

[14]*McKesson Corp. v. Cook*, No. 4920 (Del. Ch. filed Sept. 25, 2009).

[15]*C.A., Inc. v. Cordrey, et al.*, Ch. Ct. of Del. Civil Action No. 4111-CC (Nov. 25, 2008); *Cordrey, et al. v. CA, Inc.*, Ch. Ct. of Del. Civil Action No. 4195-CC (Apr. 18, 2008). In a dispute between CA Inc. (formerly Computer Associates Inc.) and Delaware, CA filed suit to compel Delaware to abide by a voluntary disclosure agreement (VDA). CA in part alleged that Delaware had disregarded the VDA by imposing interest and penalties and auditing CA. In turn, Delaware brought action against CA to recover unclaimed and abandoned property, as well as interest and penalties on amounts CA allegedly owed to Delaware under the Delaware abandoned property law. Delaware alleges in its complaint that CA has unreasonably delayed the VDA process for four years and has refused to turn over records to Delaware. The case was recently settled, but while it was pending it was watched by the unclaimed property community as a case of significant interest for all stakeholders. Arguably, *McKesson* follows in *CA, Inc.'s* footsteps in significance and importance.

[16]McKesson also alleges various constitutional violations including procedural and substantive due process violations that would result from the escheat of the unmatched inventory items.

[17]507 U.S. 490 (1993).

[18]379 U.S. 674 (1965).

[19]In part, McKesson argues that under the priority rules, even if McKesson were required to escheat inventory, it would be required to escheat those items to other states, not Delaware. McKesson alleges that, nevertheless, the error rate that Delaware calculated as consisting of unclaimed property owing to Delaware included all of the amounts confirmed as owing to vendors located outside Delaware, as well as amounts not confirmed by vendors located outside Delaware.

claims is subject to escheat. McKesson contends that no state has required McKesson to escheat inventory. In particular, McKesson claims that it has not reported, as unclaimed property, inventory delivered to McKesson by a vendor that was of a larger quantity or of a different type than McKesson ordered, and McKesson has not reported as unclaimed property inventory delivered by a vendor for which the vendor did not issue an invoice. Also, McKesson contends that before 2003 Delaware did not audit businesses for unclaimed property liability regarding inventory, and did not require companies to escheat inventory in connection with any audits, irrespective of whether inventory was characterized as "unmatched receivers" or "uninvoiced" payables, or any other similar term.

Delaware's Answer

Delaware's answer consists of various denials without significant elaboration. However, Delaware does provide a few insights into its position regarding the inventory at issue. Delaware maintains that inventory is property subject to escheat and that Delaware has audited and required businesses to report and remit inventory property as unclaimed property before 2003. In response to McKesson's contention that the inventory was not in fact unclaimed, Delaware simply says that McKesson was "unable to provide a paid invoice or other evidence that it did not owe its vendors for the inventory received into the GR/IR account with respect to transactions representing inventory with a value of $2,910,132.85."

Analysis

Holders of unclaimed property watching this case closely are likely focused on two issues before the court: whether inventory is property subject to escheat and whether Delaware's use of sampling regarding this "new" property type (or its use of sampling more generally) is valid. Importantly, Delaware's use of sampling to estimate the amount of property at issue but not the estimated location of the owner has been a significant issue in recent discussions among unclaimed property professionals.

Commentary on *America Express* and *McKesson*

In *American Express*, the company's commitment to challenge Kentucky's administration and interpretation of its unclaimed property laws has proved invaluable, providing a published opinion that acknowledges that raising revenue is not a legitimate state interest concerning the administration of the state's unclaimed property laws. The holding will undoubtedly have ramifications as applied to other states and other property types. The case also stands for the broader notion that a state's administration of its unclaimed property laws is not without limits.

Will *McKesson* be the next important unclaimed property holder victory? The issues raised have many taxpayers concerned. Contrary to recent trends, not all property should be subject to state unclaimed property laws, and not all values listed on a business's books are "property" in the unclaimed property sense. The broader the interpretation of the term "property" subject to escheat, the further sound unclaimed property policy is stretched. Even before *McKesson*, commentators and property holders alike expressed concern that unclaimed property laws have been applied to subsets of property for which they were never intended to apply.

> ***Not all values listed on a business's books are 'property' in the unclaimed property sense.***

Further, permitting the escheat of inventory violates the fundamental purposes of unclaimed property law as first established in *Standard Oil*. If the stated primary purpose of unclaimed property law is to reunite owners with property that has become abandoned, how is the state justified in laying claim to property over which the "owner" (the vendor) itself makes no claim? If the owner expressly disclaims the property, the primary purpose of the unclaimed property laws is rendered obsolete. Moreover, Delaware would not have the means to maintain and store a large amount of "inventory" property — thereby shedding doubt on whether Delaware would be able to fulfill the primary purpose and reunite the owners with their lost property. It is clear that Delaware would like the value of the inventory but would never have any intention of holding the inventory itself.

We recognize that a secondary purpose of state unclaimed property laws is to ensure that the public, rather than the property holder, benefits from unclaimed property. In other words, unclaimed property law is concerned with preventing a "windfall" to private individuals and private businesses and would prefer that the spoils of that a windfall go to the public benefit. When the property at issue is inventory overages generally known by the vendor and delivered as part of a normal business practice between businesses, the states should not be concerned that such a business-to-business transaction might generate a true windfall. The legitimate reasons for inventory differences and the fact that businesses are involved on both sides of the transaction support the conclusion that those transactions should be outside the scope of state unclaimed

property laws. By arguably "creating" a new abandoned property type — all for the apparent purpose of generating revenue for the empty state coffers — one must question whether Delaware, like Kentucky, seeks simply to use unclaimed property law to raise revenue rather than raising taxes.

Conclusion: A Call to Action?

Both *American Express* and *McKesson* represent a dramatic shift in the approach unclaimed property holders historically have taken in the judicial arena regarding unclaimed property challenges.[20] Property holders are finally "counterpunching" the states regarding the administration and interpretation of unclaimed property law. These two cases not only anecdotally represent the changing unclaimed property landscape, but suggest the viability of using litigation to challenge questionable administration and interpretation. With increased state enforcement, it is particularly important that courts consider what is a fair or equitable result. In an already expensive and burdensome game of compliance, it is imperative that courts adopt a balanced approach — an approach that recognizes the overwhelming obligations placed on property holders, while respecting the important policies underlying state unclaimed property laws. Property holders have a similar responsibility in ensuring a fair and balanced administration and can fulfill that obligation in part by bringing issues such as those in *McKesson* and *American Express* before the legislature and the courts. Now, more than ever, holders of unclaimed property are in a position to affect the rules of engagement and push for limits on a state's administration and interpretation of its laws. ☆

[20]Historically, unclaimed property holders have been more active in the legislative process.

UPwords is a column about unclaimed property from Sutherland Asbill & Brennan LLP's State and Local Tax Practice. This installment is by Diann L. Smith, who is counsel, and Matthew P. Hedstrom, who is an associate, with Sutherland's State and Local Tax Practice.

TAX.COM

At Tax Analysts, we've never been shy about voicing our opinions on tax policy. Now, we'd really like to hear yours. We've launched Tax.com to bring you no-holds-barred blogs from tax experts like Marty Sullivan, David Brunori, and Chris Bergin. To join the conversation, please visit Tax.com today.

The Tax Daily for the Citizen Taxpayer.

Sponsored by Tax Analysts