Temple-Inland Sheds Light on Delaware's Use of Estimations in Unclaimed Property Audits

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As noted in prior mailings on this topic, all 50 states require companies to comply with broad and often complex unclaimed property laws that mandate annual reporting. Unclaimed property is generally defined as tangible or intangible property that has gone unclaimed by its rightful owner for a specified period of time. Most states focus on recovering intangible property, including general ledger property (such as unused customer credits or refunds, and uncashed vendor checks and wage checks) and unclaimed equity (such as unclaimed dividends).

Unclaimed Property Audits and the Use of Estimation Techniques

For those companies faced with an unclaimed property audit, one of the more frustrating aspects is the use of estimation techniques to assess liability for periods where no actual records exist. This is particularly so because most states allow for liability to extend back for 20 or more years without limitation, and most companies do not maintain records for more than seven to 10 years. As a result, estimation techniques often account for the greatest amount of liability.

Delaware, home to numerous business entities, is well known as one of the more aggressive states when it comes to pursuing unclaimed property audits and using estimation techniques to determine liability. In part, this is the result of Delaware's interpretation of the "priority rules" set forth in a series of U.S. Supreme Court cases. Those cases state that when a company does not maintain records establishing, at a minimum, the state where the rightful owner of the unclaimed property resides, the company as "holder" of such property must remit it to the state of incorporation.

Temple-Inland, Inc. v. Cook

Case law regarding unclaimed property compliance, including the use of estimation techniques, is sparse. However, a recent opinion issued in the U.S. District Court for the District of Delaware sheds light on Delaware's use of estimation techniques and calls into question whether they are permissible. *Temple-Inland, Inc. v. Cook*, Civ. No. 14-654-SLR (Mar. 11, 2015).

The underlying facts of the opinion may sound familiar to those that have dealt with or are currently dealing with an unclaimed property audit, particularly a Delaware audit. Plaintiff Temple-Inland, a Delaware corporation, was the subject of an unclaimed property audit, with the relevant time period of the audit stretching back to 1981. Not surprisingly, Temple-Inland was unable to locate any relevant records between 1981 and 2003. The records it was able to locate post-2003 revealed approximately $1.3 million of unclaimed accounts payable and payroll checks owed to various states including Delaware, which, after remediation, led to a check of $147.30 being paid to Delaware. Delaware pressed on, however, and used estimation techniques to extrapolate about $2 million in liability for the period where Temple-Inland did not have records. Temple-Inland took an administrative appeal, and ultimately, the secretary of Finance accepted a reduced liability amount of $1.3 million and began to enforce collection.

Temple-Inland then filed suit, raising five categories of arguments based on federal and constitutional law for why Delaware's estimation techniques are unlawful. Defendants moved to dismiss, and Temple-Inland moved for summary judgment on certain aspects of its case. The ruling was a mixed bag but left open a number of constitutional arguments that might prevent the state's use of estimations in *Temple-Inland*. Key aspects of the ruling are:

- **Federal Common Law and Pre-Emption — Defendants' Motion to Dismiss Granted.** Plaintiff's argument that the Supreme Court decisions setting forth the "priority rules" (referred to by the Court as the "Texas Cases") "limited the State's authority to collect unclaimed property to situations where a 'precise debtor-creditor relationship' is shown," was rejected. The district court held that "the Texas Cases apply to disputes among States, not to disputes between private parties and States."
- **Substantive Due Process — Defendants' Motion to Dismiss Denied.** Plaintiff alleged "a deprivation of property in the form of the money claimed by the State under the authority of the [Delaware] Escheat Act, arguing that the use of estimates to calculate the debt results in two or more States claiming the same property as expressly prohibited by the Texas Cases. Although as an estimate, the disputed debt itself cannot be attributed to a particular owner, the unclaimed money on which the estimate is based may be traced to identifiable creditors." As a result, the court concluded that "[i]f the allegations as claimed are true, the disputed money may indeed violate the Supreme Court's prohibition against 'more than one State … escheating a given item of property.'"
- **Ex Post Facto Clause — Defendants' Motion to Dismiss Denied; Plaintiff's Motion for Summary Judgment Denied.** Plaintiff alleged that Section 1155 of the Escheat Act "violates the Ex Post Facto Clause by imposing a retroactive penalty for lack of record-keeping." The current version of Section 1155 was adopted in June 2010, to clarify that the state may use estimation techniques in certain circumstances to determine a holder's liability. Defendants argued this practice was not "retroactive" because the use of estimates to evaluate debt is a longstanding practice in Delaware. Plaintiff took issue with Defendants' argument that statistical sampling was generally accepted prior to the June 2010 adoption of Section 1155, "arguing that any use of estimates occurred outside of Delaware and, in those States, estimation was a penalty for inadequate record-keeping. Additionally, plaintiff alleges that the State Escheator admitted that 'standard retention policies' are 7 to 10 years."

  The court concluded that "[a]lthough Section 1155 was retroactively applied in accordance with the intent of the General Assembly, questions of fact remain as to whether the legislation merely codified a pre-existing practice and, as a consequence, fails to trigger Ex Post Facto review." The court also held that: "The drafters of the [Uniform Unclaimed Property Act] anticipated a potential conflict with the Texas Cases for dual-liability by authorizing the use of estimates, and they forestalled any such conflict by explaining that [use of estimates] was to be viewed as a penalty. The Delaware General Assembly, on the other hand, eliminated the document retention requirement and avoided characterizing Section 1155 as a penalty. In so doing, defendants are faced with a dilemma: If Section 1155 is not a penalty provision, it likely violates plaintiff's rights to substantive due process. If, on the other hand, Section 1155 is a penalty provision, its retroactive application likely violates the Ex Post Facto Clause. The court is unprepared, at this juncture, to determine which scenario is most likely." The court concluded by remarking that "[a] t a minimum, issues of fact remain regarding whether using estimates to calculate liability was a change of practice, or merely codification of a pre-existing practice."
- **Takings Clause — Defendants' Motion to Dismiss Denied.** Here, "[t]he parties focus their dispute on whether plaintiff has a legitimate property interest in the assets, with defendants arguing that plaintiff is merely holding the property for the legitimate owner and plaintiff arguing that defendants have failed to identify any property legitimately subject to escheat. As previously explained, the court finds that plaintiff has pled sufficient facts to support the position that it has a legitimate property interest in the estimated debt given that the estimate may not be traceable to bona fide creditors. It follows that, if Delaware does not have the authority to escheat the property in question, then the seizure of such property without just compensation would be a violation of the Takings Clause."

- **Commerce Clause and Full Faith and Credit Clause — Defendants' Motion to Dismiss Denied.** Finally, the court held it was "unprepared, at this stage, to determine whether the Supreme Court intended secondary priority to attach if the laws of the creditor's State are silent on the question of escheat or if, as defendants allege, secondary priority attached if the laws of the creditor's State actively exempt certain property from escheat. Whether or not it is appropriate for the State where the debtor is incorporated to base estimates on property that was exempted by the creditor's State, plaintiff also alleges that estimates were based on cashed checks as well as property actually escheated to other States. These latter examples, if true, are in tension with the Supreme Court's prohibition against double escheat as a violation of the Full Faith and Credit Clause. As pled, the Full Faith and Credit Clause violation is inexorably intertwined with the alleged violation of the Commerce Clause. The court is unwilling to dispense with a potentially meritorious Commerce Clause claim at this stage of the litigation, as a more complete factual record would aid the court in making a determination."

Conclusion

Though the case stops short of a definitive ruling on whether Delaware's use of estimation techniques — which are the same or similar to estimation techniques used in many states — is lawful, the fact that a court in Delaware has permitted these types of constitutional challenges to the practice to survive a motion to dismiss cannot be ignored. This case should be carefully monitored by anyone facing an audit where estimation techniques are being utilized, whether in Delaware or any other states.