STATES PUSHING THE BOUNDARIES IN THE COLLECTION OF UNCLAIMED PROPERTY

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I. INTRODUCTION – THE CURRENT ENVIRONMENT

It is no mystery that states are facing critical budget deficits and have been forced to look for ways to increase their cash flow without raising taxes. Consequently, many states are now turning their attention to the seizure of apparently unclaimed or abandoned intangible property held by a company ("Holder") presumably owed to another party ("Owner"). These items are generally referred to as unclaimed property ("UP") and can include, but are not limited to, uncashed vendor, payroll, or dividend checks, unused customer credits, gift card balances, bank account and brokerage account balances, undistributed royalties, contents from safe deposit boxes, and other intangible assets owed to or belonging to suppliers, customers, employees or other parties having a business relationship with the Holder.[2] Jurisdictions are empowered to take possession of potential UP under the authority of their statutory UP laws (or "escheat laws"). Every U.S. state, as well as Washington, DC, Puerto Rico, Guam, the Virgin Islands, and the most recent addition of the Northern Marianas Islands, ("Jurisdictions") have adopted some form of statutory escheat laws. Most jurisdictions' UP statutes were created through the adoption and subsequent modification of one of the model UP acts drafted to promote some degree of uniformity among the various jurisdictions. These model acts consist of the Uniform Disposition of Unclaimed Property Act of 1954 ("UDUPA"), the 1966 revisions to UDUPA, the 1981 Uniform Unclaimed Property Act

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[2]Common types of UP differ for various industries. For example, the insurance industry may generate unpaid death benefits and uncashed claim checks, oil and gas exploration firms could realize unclaimed property related to royalties, hospitals would generate UP from aged patient credit balances and banks generally have UP related to account balances and safe deposit boxes.

(“UUPA”) and the 1995 revision to UUPA (collectively “the Uniform Acts”).[3] In lieu of adopting and modifying one of the Uniform Acts, a minority of jurisdictions have drafted their own statutes.

Numerous judicial rulings also authorize the states’ right to demand and hold unclaimed or abandoned property on behalf of missing Owners (“right to escheat”). The key judicial ruling on escheat law was the landmark Supreme Court case, Texas v. New Jersey, 379 U.S. 674 (1965), which created what is commonly known as the escheat priority rules (“Priority Rules”) for determining which state has the superior right to escheat a specific item of unclaimed property. For example, the first rule of priority (“1st Priority Rule”) establishes that intangible property is reportable to the jurisdiction of the last known address of the apparent Owner[4]. If the name and address of the apparent Owner are unknown, the analysis of which state has jurisdiction over the UP defaults to the second rule of priority (“2nd Priority Rule”) which provides that “owner unknown” UP is reportable to the Holder’s jurisdiction of domicile, usually the Holder’s state of incorporation. These priority rules govern UP legislation for all the 54 jurisdictions that currently require some form of UP reporting. The provisions of *Texas v. New Jersey* were later re-affirmed in two other Supreme Court cases. Pennsylvania v. New York, 407 U.S. 223 (1972), confirmed *Texas v. New Jersey* and further provided that Holders were not required to look beyond their own records to verify an address. Delaware v. New York, 507 U.S. 490 (1993), resulted in the Supreme Court holding that states may not legislate alternative priority rules under their own state laws.

There are cases where neither the 1st or 2nd Priority Rules will apply. For example, when the item of UP is “owner unknown” and the UP statutes of the Holder’s state of domicile exempt the potential UP, neither Rule is applicable. Some believe that in these cases, there is an implied third rule of priority (“3rd Priority Rule”) that would give the right to escheat to the state where the transaction that gave rise to the UP took place. For example, if neither the 1st or 2nd Priority Rules applied, but the UP arose out of a transaction that took place in Texas, the

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[3] CPA Journal, *Perils of Unclaimed Property*, Lori Furguson-Kenney, 2006. Discussion of specific provisions of the various Acts and details of judicial rulings is beyond the scope of this article.

[4] Pursuant to the 1995 revisions to UUPA, the address must be sufficient for the delivery of mail. Obtaining only the state or zip code is generally not sufficient basis for application of the 1st Priority Rule.

3rd Priority Rule would provide that Texas would have jurisdiction over the property. In practice however, the 3rd Priority Rule is seldom if ever applied, and many challenge the validity of the 3rd Priority Rule on the basis that the Supreme Court's adoption of the 1st and 2nd Priority Rules provided a complete priority scheme that precludes and invalidates the 3rd Priority Rule. Nevertheless, some states have tried unsuccessfully to invoke the 3rd Priority Rule to claim UP that would otherwise not be subject to escheat.

Application of the Priority Rules has ended most of the disputes among the Jurisdictions regarding which one has the right to escheat. However, the Priority Rules only establish which state has the superior right to escheat; they do not address the variation and conflicts among the states' own escheat laws. Therefore, confusion surrounding UP administration did not end with the establishment of the Priority Rules. In fact, the entire body of UP law at both the federal and state level is plagued with ambiguity, limited definitions, obsolescence, and inadequate interpretations. For example, when the Priority Rules were established under *Texas v. New Jersey*, internet mail, IP addresses and electronic payments (electronic checks) did not exist. Therefore, issues may still exist for interpreting what is considered a sufficient address for the delivery of mail.[5]

Another emerging issue has developed as states, having exhausted the revenue stream of conventional sources of UP, such as aged customer credit balances or uncashed checks, have sought to legislate into their escheat laws new types of UP. One of the best known of these "expansions" was the claim that mismatched inventory, overages, and unbilled full shipments, often referred to as "goods received, not invoiced" or "GR/NI", are reportable UP. If any state were successful in adopting and enforcing these laws, it could potentially realize windfall receipts on "new" UP property types. As Holders would have never reported these new types of UP, they could therefore be faced with decades of past due property liability as well as interest and penalties.

Finally, most states, not wanting to try to remedy their budget shortfalls using the difficult, and potentially unenforceable, paths of either invoking the 3rd Priority Rule or adding new property types to their definitions of UP, are simply shortening the length of time required to elapse before an intangible asset is deemed to be abandoned ("abandonment period"

[5] There are many gray areas of interpretation revolving around UP. However, these issues are included within the focus of this article.

or “dormancy period”). For example, Massachusetts has, over time, decreased its dormancy period for bank accounts from thirty years in 1907 to three years by 1992. Delaware’s dormancy period for bank accounts, once at twenty-five years, is now only five years. Uncashed payroll checks, once considered dormant at seven, five or three years depending on the jurisdiction, are now dormant after only one year in virtually every state, barring only a few.[6]

II. STATE EFFORTS TO EXPAND THEIR RIGHT TO ESCHEAT

A. *Challenging The Priority Rules: Case Study – New Jersey*

Legislation introduced and enacted by New Jersey, 2010 N.J. Law Chapter 25 (“NJ Law”), challenged the authority of all three Supreme Court decisions in *Texas v. New Jersey*, *Pennsylvania v. New York,* and *Delaware v. New York* by including a language providing that the address of the owner or purchaser of an unredeemed stored value card (“SVC”) that does not have a name and address is presumed to be in New Jersey if the SVC was sold or issued in the state, an apparent effort by New Jersey to invoke the elusive 3rd Priority Rule. The 3rd District Court initially enjoined this provision, and on January 5, 2012, the 3rd Circuit Court issued its opinion affirming the holding of the 3rd District Court on all issues. The second key provision enjoined by the 3rd District Court and later affirmed by the 3rd Circuit was the requirement that issuers of SVCs must report unclaimed SVCs that were redeemable solely for services or merchandise, even if they were issued prior to the enactment of the NJ Law. The 3rd District Court determined that to do otherwise would impact the already existing contractual obligations. However, the new law does not impact the prospective application of this provision, as now issuers have notice of the NJ Law.

One portion of the NJ Law that was upheld by the 3rd District Court and the 3rd Circuit Court was section 5(c), which provides that an issuer of SVCs is now required to obtain and maintain the name and address or, at a minimum, the zip code of

[6] Honey, I Shrunk the Dormancy Periods, Tax Analyst, Hollis L. Hyans, Amy F. Nogid, Morrison & Foerster, LLP, February 8, 2011.

the purchaser or owner of each SVC issued or sold. Where the full address is unknown, rather than assigning the “owner unknown” property to the state of incorporation of the issuer, the statute provides that UP is to be reported to New Jersey if the SCVs had a New Jersey zip code.[7] Included with this legislation was the automatic elimination of a prior exemption for SVC. Under sections 5(a) and (h), the new statute provides that the abandonment period, when there has been no activity on the SVC, is two years.[8] It is estimated that this new legislation will enable New Jersey to seize an additional $79.5 million of UP per year.[9]

New Jersey’s effort to expand its statutory authority over SVCs was met with vigorous opposition. Upon enactment of the NJ Laws, lawsuits were immediately filed against Andrew P. Sidamon-Eristoff, New Jersey State Treasurer, by the New Jersey Food Council, the New Jersey Retailers Association, American Express Travel Related Services Co., American Express Prepaid Card Management Corp. and MEMO Money Order Co. The original lawsuit sought a preliminary injunction against enforcement of the law contending that the new law violates the Priority Rules as well as the U.S. Constitutions Contract, Taking, Commerce and Due Process clauses.[10]

Multiple arguments were raised against New Jersey’s zip code collection requirement. For example, the Commerce Clause, referring to Article 1, Section 8, Clause 3 of the US Constitution, gave Congress the power “to regulate commerce with foreign nations, and among the several states, and with the Indian tribes.” Some felt that the zip code collection requirement may violate the Commerce Clause as outlined by the U.S. Supreme Court in Bibb v. Navajo Freight Lines, Inc., 359 U.S. 520 (1959), which held that the Commerce Clause prohibits state regulations that “unduly burden” interstate commerce.

It was also argued that many issuers may be incapable of making changes to their SVC issuing systems that affect only one state, *i.e.*, New Jersey. In order to comply with the New Jersey zip code collection requirement, these issuers would be forced

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[7] Guidance on Implementation and Notice of Exemption from Certain Provisions of L.2010, c.25, State of New Jersey Treasury Announcement FY 2011-03, 09/23/2010.

[8] Guidance on Implementation and Notice of Exemption from Certain Provisions of L.2010, c.25, State of New Jersey Treasury Announcement FY 2011-03, 09/23/2010.

[9] Merchants Sue NJ Over Funds from Unused Gift Cards, Travelers Checks, New Jersey Law Journal, Charles Toutant, October 11, 2010.

[10] *Ibid*.

to modify all their point of sale systems and technology nationwide to enable the systems to collect zip codes and to prompt cashiers to ask purchasers for that information whenever a SVC is being sold in any states. In their *Memorandum Amicus Curiae, a* group of attorneys who specialize in defending Holders against state unclaimed property matters prepared a response to and in support of the lawsuits, providing in their Memorandum that "requiring such expensive and intrusive changes to the way stored value cards are sold throughout the country in order to comply with New Jersey's unique zip code requirement constitutes a significant and, we believe, undue burden on interstate commerce[11]." After the 3rd Circuit upheld the zip code collection provisions of the new law, some New Jersey merchants decided that they would stop issuing SVCs in New Jersey rather than try to follow the laws' requirements. On April 2, 2012, American Express became the first major issuer of SVCs to announce the decision to pull its SVCs from retail locations in New Jersey rather than try to meet the technological burdens of collecting zip code information. On April 5, 2012, InComm and Blackhawk also announced that they, too, plan to cease sales of SVCs in New Jersey[12].

B. *Uninvoiced Inventory: Case Study - Delaware*

The 2nd Priority Rule provides that, where the Owner or the Owner's address is unknown, intangible UP is reportable to the Holder's jurisdiction of incorporation. As Delaware is the preferred state of incorporation for a majority of Fortune 500 and publicly traded companies, it has received a huge windfall of UP collections over the last twenty years.[13]

Delaware's audit look back period generally extends back to 1981. However, since corporate record retention policies usually require that detailed account records be maintained for an

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[11] Memorandum Amicus Curiae of Unclaimed Property Professionals Organization, in Support of Plaintiffs'/Appellants Emergency Motion for Injunctive Relief , Michael Houghton, Esq., John L. Coalson Jr., Esq., Ethan D. Millar, Esq., Kendall L. Houghton, Esq., John Biek, Esq., January 25, 2011.

[12] APNewsBreak: AmEx pulls gift cards from NJ, Associated Press, Angela Delli Santi, Monday, April 2, 1012

[13] Pursuant to the 1995 revisions to UUPA, the address must be sufficient for the delivery of mail. Obtaining only the state or zip code is not sufficient basis for application of the 1st Priority Rule.

average of seven years, Delaware is often able to claim presumed unreported unclaimed property that was generated in years for which detailed records are not available. Accordingly, if a corporation with a seven year retention policy is identified for audit by Delaware, Delaware would be entitled to estimate and claim as owner-unknown unreported UP for a1most all of the years included under the scope of the audit. As a result, the privilege sanctioned by the Supreme Court in *Texas v New Jersey* has turned Delaware into one of the more aggressive, and financially successful, states conducting UP audits. Consequently, Delaware has a long history of litigation in establishing and asserting its right to claim UP under audit.

As Delaware continues to exhaust its list of viable audit targets, and as corporations step up their efforts to strengthen their record retention policies and internal accounting procedures, the possibility that Delaware's revenue stream may eventually dry up presents a serious threat to the state's ongoing economic security.

In its most recent effort to ensure its UP revenue stream, Delaware attempted to escheat presumed UP resulting from GR/NI, even though this property type was not specifically designated as UP in their statutes. GR/NI balances can arise when, for example, goods are shipped to make up a shortage on an earlier order or extra goods are provided to replace damaged merchandise. Many industries have attempted to address this problem by standardizing the practice of shipping additional units to their customers with no expectation of payment. However, inventory tracking software often tracks these make-up shipments as a liability, pending the receipt of future invoices to off-set the liability. Without documentation to support the basis of these credit balances, under an audit these amounts could appear to be UP and, over time, the recorded liability could be significant.

The recent case *of* McKesson Corp. v Thomas Cook, Delaware State Escheator, C.A. No.4920-CC (Del. Ch. Sept. 25, 2010), addressed the issue of GR/NI property. Delaware, after entering into a settlement agreement with McKesson after an exhaustive five-year UP audit relating to accounts payable, payroll and accounts receivable, (the standard transaction types that typically result in UP), subsequently assessed McKesson $4.6 million dollars for presumed UP related to inventory mismatches, overages and unbilled shipments.[14] The $4.6 million assessment came just one year after Delaware had completed its prior audit.

[14] McKesson Corp. v. Cook, C.A. No.4920-CC (Del. Ch. Sept. 25, 2010).

McKesson objected to the assessment and filed a complaint, raising a number of issues, including its primary argument that GR/NI property does not constitute UP because it is not specifically identified as such under Delaware's Abandoned and Unclaimed Property Law ("Delaware Law"). McKesson also asserted that inventory overages were the result of standard industry practices to include free goods to compensate for items damaged during shipping. Therefore, since no obligation exists to pay vendors for the free goods, there can be no liability.[15] Moreover, McKesson argued that is has never reported or been required to report GR/NI related items to any other jurisdiction.[16] In addition, McKesson also argued that general principles of commercial and federal law preempted the State's ability to seize inventory overages. Finally, McKesson also contended that the Delaware Law was in direct violation of the due process clause of the U.S. Constitution in that it does not provide a provision whereby a Holder can appeal and challenge an assessment.[17] However, before any of the issues could be decided at the court level, Delaware conceded on the matter and on May 12, 2010 enacted Delaware Senate Bill 272 ("DE SB 272"), which included GR/NI as a type of UP, but also exempted GR/NI from escheatment.[18] Moreover, DE SB 272 also provides that a review process may be invoked at the option of a Holder at the conclusion of an examination, allowing the Holder to file a written protest, submit additional information in support of the protest, and request that the Audit Manager reconsider the Department's findings following an examination.[19]

C. *Shortening Dormancy Periods*

The practice of expanding the definition of UP or invoking the 3rd Priority rule is clearly an intensive and costly effort for jurisdictions seeking to increase their collection of UP. A

[15] McKesson Lawsuit Challenges Delaware's Assessment of Unclaimed Property Liability for Inventory Mismatches, BNA Corporate Council Weekly, Michael Houghton, Brenda Mayrack, Sam Schaunaman, November 4, 2009.

[16] McKesson Corp. v. Cook, C.A. No.4920-CC (Del. Ch. Sept. 25, 2009), p10.

[17] *Ibid.*, p35-38.

[18] Delaware State Senate 145th General Assembly Senate Bill No. 272, May 12, 2010.

[19] Delaware State Senate 145th General Assembly Senate Bill No. 272, May 12, 2010.

much easier and more economical route is to simply shorten the dormancy period of certain types of UP to speed up the States collection of the property. This approach is not new, as the practice of shortening the dormancy periods of UP has been prolific over the last decade. For example, in 2008, Delaware S.B. 334, 12 Del. C. § 1198 reduced the dormancy period for investment type properties from five to three years and South Carolina 2007 S.B. 741, 27-18-110 reduced the dormancy period for securities from five to three years. In 2007, Oregon H.B. 2104 reduced dormancy period for unclaimed property held by financial institutions, insurance companies, and intangible equity ownership interests from five to three years. In addition, the Oregon bill also provided that any dividend, profit distribution, interest, payment on principal, and other sum held or owed by a business association were presumed abandoned after three years, not five years. In 2006, New York S.B. 6460 shortened dormancy periods for customer credit balances from five to three years and finally, in 2005, Wisconsin S.B. 424 changed the dormancy period from five to three years for stocks or other intangible interest in a business association.

Two more states have joined the trend to reduce dormancy periods on UP. On October 6, 2010, Michigan H.B. 6421 was signed into law with "immediate effect" by the Governor. The new law changed the dormancy periods for banking and insurance properties, as well as the state's "catch all" provision for property not otherwise specified under the state's escheat law, from five to three years. The new bill also reduced the dormancy period for certain money orders from seven to three years, and reduced the dormancy period for travelers' checks from fifteen to three years. On March 18, 2010, under Indiana H.B. 1083, legislation was signed into law by the Indiana Governor, effective July 1, 2010, which reduced the dormancy periods for demand, savings, or matured deposits from five years dormancy period to three years. In addition, the bill also reduced the dormancy period from five to three years for property payable or distributable in the course of a demutualization, rehabilitation, or related reorganization of a mutual insurance company. Finally, the bill provided that any other property with a five-year dormancy period not specifically identified would be reduced to a three-year dormancy period.[20]

These ever decreasing dormancy periods have raised concerns regarding the abandoned status of property subject to escheat,

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[20]HEA 1083, Second Regular Session 116th General Assembly (2010).

which in turn raises issues as to whether the seizure of such property would be consistent with constitutional protection under the “due process” clause. The “due process” clause of the U.S. Constitution provides that a person shall not be “deprived of ... property, without the due process of law.” In a recent case, American Express Travel Related Services v. Hollenbach, 630 F. Supp. 2d 757, the court held that Kentucky’s effort to shorten the dormancy period of travelers checks from fifteen to seven years violated “due process.”[21] However, on appeal, the district court's judgment was subsequently vacated, and the matter was remanded for further proceedings. In addition, in the 2010 lawsuit, American Express Travel Related Services Co. v. Andrew P. Sidamon-Eristoff, Civil Action No. 10-4890, regarding New Jersey’s effort to lower the dormancy period of travelers checks from fifteen to three years, the court held that there was little merit to the Holder’s claim that due process was violated by lowering the dormancy period.[22]

III. PROACTIVE UP REPORTING EFFORTS – TOO LITTLE TOO LATE

Delaware and New Jersey’s efforts to raise revenue through more aggressive enforcement of their UP statutes are indicative of a trend that is being carried out by many jurisdictions. In addition, many states contract with contingent fee third-party audit firms that receive their compensation based on the outcomes of their audits. These audit firms often calculate UP assessments from transactions that many companies overlook as likely to potentially generate UP. Some of the more extensive audits, often resulting in the highest assessments, usually include transactions related to employee welfare benefits administration, unreported UP resulting from acquisitions and mergers, rebates, and many industry specific property types. While UP assessments in these and other more obscure areas can often be challenged by Holders, most companies lack the resources and technical expertise to effectively address these matters themselves. Therefore, the best course of action for holders in these situations may be to consult outside legal or professional assistance from experts proficient in the

[21] Honey, I Shrunk the Dormancy Periods, Tax Analyst, Hollis L. Hyans, Amy F. Nogid, Morrison & Foerster, LLP, February 8, 2011.

[22] *Ibid.*

identification of transactions that may generate UP, knowledgeable about liability estimation methodologies, and able to assist in the implementation of effective internal UP policies and procedures as well as proactive and effective planning.

The important thing for Holders to remember is that it is never too late to proactively address and plan for effective management and mitigation of potential UP exposure. It is widely understood that a significant amount of UP assessments relate to items that are most likely not UP. However, due to the lack of complete documentation, corporations cannot prove that the items in question are either not owed or have since been resolved. Ultimately, the Holder bears the burden of proof to refute assessments determined under a UP examination.[23] Therefore, the optimal time to seek help is before an audit begins, in order to provide ample time for record review, mitigation efforts or to take advantage of a state offered amnesty or voluntary disclosure agreements.

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[23] McKesson Lawsuit Challenges Delaware’s Assessment of Unclaimed Property Liability for Inventory Mismatches, Part II, BNA Corporate Council Weekly, Michael Houghton, Brenda Mayrack, Sam Schaunaman, December 30, 2009.