BNA's

Corporate Counsel Weekly

CORPORATE PRACTICE SERIES

VOL. 24, NO. 49 DECEMBER 30, 2009

 ISSN 0886-0475

Analysis
Unclaimed Property

'McKesson' Part II—State's Response Offers Insight, Guidance To Holders Facing Audit for Inventory and Other Property Types

BY MICHAEL HOUGHTON, ESQ.,
BRENDA R. MAYRACK, ESQ.,
AND
SAMUEL SCHAUNAMAN, ESQ.

In Part I of this two-part series on the *McKesson* case (24 CCW 336, 11/4/09), we noted that a Complaint with potentially far-reaching implications for corporate holders of unclaimed property, particularly those holders incorporated in Delaware, was recently filed in the Delaware Court of Chancery. On Sept. 25, 2009, McKesson Corporation (''McKesson'') filed suit against Thomas Cook, Acting Delaware Secretary of Finance and Delaware State Escheator; Patrick Carter, Director of Division of Revenue; and the Delaware Department of Finance, Division of Revenue (collectively referred to as the ''State''). The Complaint challenges the State's approximately $4.6 million assessment of McKesson's unclaimed property liability relating to certain inventory mismatches under Delaware's unclaimed property law, 12 Del. C. §§ 1101 et seq. (the ''Delaware Escheat Act'').[1]

In Part I, we examined the issues raised in McKesson's Complaint, and explored the background information giving rise to the underlying dispute leading to the lawsuit. In this Part, we examine the implications of the State's Answer and Counterclaim, filed on Oct. 30, 2009, as well as McKesson's Answer and Affirmative Defenses to Defendants' Counterclaim, filed on Nov. 23, 2009.

As we indicated in Part I, our experience in recent unclaimed property matters indicates an increased interest by the State in inventory-related property as a potential source of unclaimed property liability. In particular, the State has focused its attention on inventory mismatches, overages, and unbilled full shipments that are often captured by inventory management and tracking systems. These inventory mismatches may arise for many reasons, e.g., providing free goods as a sample or extra goods to compensate for damage during shipping; convenience, packaging, or custom (either industry-wide or between a holder and vendor) resulting in mismatches between shipments and invoices; shipments lacking invoices for a variety of reasons; and inventory receiving and data processing errors.

Such inventory ''mismatches'' are often referred to as ''good receipt/invoice receipt'' (''GR/IR''), ''goods received, no invoice'' (''GR/NI''), ''unbilled payables,'' ''free goods,'' or ''overages.'' Depending upon each holder's particular inventory procedures, supplier relationships, or industry customs, whether or not such inventory mismatches represent an unclaimed property liability may be an open question.

The *McKesson* lawsuit is the first instance of litigation before a Delaware court—of which we are aware—where a holder has challenged the State's audit and assessment of unclaimed property liability for this property type. As such, the progress and eventual outcome of this litigation will continue to provide some clarity to holders with respect to this property type, as well as other aspects of Delaware's administration of its unclaimed property program, in the near future.

State's Answer, Counterclaim

In its Answer and Counterclaim, the State alleges that McKesson refused to pay or deliver property to the State as required by the Delaware Escheat Act. The State reiterates its understanding of the history of the audit, various information requests to McKesson, as well as the partial settlement, noting that as early as October 2003 they sought information pertinent to how McKesson recorded and handled ''unmatched receivers,'' sometimes referred to as ''excess inventory'' or ''inventory received but not invoiced.''

What may be most interesting for corporate holders in the State's Answer and Counterclaim is a look at the State's administration of its unclaimed property program and the description of the estimation methodology applied to McKesson's inventory. This offers a rare public glimpse into what otherwise seems an opaque process employed by the State and its contract audit firms.

For instance, in its Answer, the State admits that it ''audits holders as far back as 1981, depending on the circumstances of the particular case''—suggesting, perhaps, that Delaware's look-back period may be negotiable.

The State notes that when holders do not file complete reports and fail to preserve records, audit by the State is ''more difficult'' and ''increases the likelihood that the State will need to use estimation techniques to determine liability.'' However, the State also admits that holders ''may offer evidence'' to show that

(continued on page 390)

[1] *See* McKesson Corp. v. Cook, C.A. No. 4920-CC.

Michael Houghton is a partner and Brenda R. Mayrack is an associate with Morris, Nichols, Arsht & Tunnell LLP, in Wilmington, Del. Mr. Houghton is also a co-author of BNA's Corporate Practice Series portfolio on unclaimed property. Samuel Schaunaman is a senior manager at Thomson Reuters. Part I of this article appeared in the Nov. 4, 2009, issue of Corporate Counsel Weekly.

  CCW ISSN 0886-0475

(continued from back page)

the State's estimate ''should be adjusted.'' Does this mean that the State is open to alternative estimation methodologies being offered by holders and their advocates? This would be at least consistent with a leading case in this area, *New Jersey v. Chubb Corp.*,[2] which notes that a state's estimation methodology must be proven ''reliable and trustworthy,'' but does not specify what comprises an acceptable estimation calculation.[3] Presumably, more than one technique could be reliable.

If the *McKesson* litigation progresses, it is possible that the Delaware courts may provide guidance regarding what constitutes a ''reliable'' estimation methodology in the context of an unclaimed property audit. If so, holders may be more successful in the future in offering alternative unclaimed property estimations to the State and its auditors.

Delaware's unclaimed property statutes and regulations do not address what comprises an acceptable estimation methodology, nor does Delaware case law address what makes one estimation method more ''reliable'' than another. In other contexts, however, Delaware courts have relied upon extrapolation to estimate financial information under the appropriate circumstances.[4] As McKesson continues to challenge aspects of the State's estimation methodology during this litigation, the court's consideration of McKesson's alternative calculations should provide relief and will help clarify what holders can offer in the future as credible substitutes for the State's estimations of liability.

The State's Counterclaim outlines—in detail—the process applied by its contract auditor to estimate McKesson's unclaimed property liability for inventory. Based on this account, holders should know what to expect and what to challenge if they face an audit of this property type by Delaware in the near future.

The State admits that it narrowed the ''scope of the inventory/uninvoiced payables audit to uninvoiced payables, i.e., GR/IR entries of inventory received from the vendor for which McKesson had no partial or full invoice from the vendor ('GR/IR abandoned property'), rather than the broader category of unmatched receivers, i.e., instances in which either more or fewer inventory items than set forth on an invoice were received ('overages' or 'shortages').'' After identifying an overall population of ''9,773 potential abandoned property transactions,'' the State and McKesson agreed to a smaller statistical sample of a few hundred items to determine an estimate of liability.

It appears that McKesson provided internal documentation to remediate a significant portion of the sample. For the remaining items, McKesson conducted external ''due diligence,'' a process whereby the holder contacts a purported owner and seeks a signed statement from the owner that the credit at issue is not owed.

If the 'McKesson' litigation progresses, it is possible that the Delaware courts may provide guidance regarding what constitutes a ''reliable'' estimation methodology in the context of an unclaimed property audit.

It seems that McKesson was able to remediate many of the sample items. For those sample items which remained outstanding, the State used these to calculate an ''escheat percentage,'' which was multiplied by annual sales to estimate McKesson's inventory-related liability.

Without conceding that the State has any right—as a matter of law, as McKesson argues—to seek unclaimed property arising from inventory, the State's process offers valuable insight for any holder under audit for this property type. Any holder facing an audit of inventory should obtain experienced assistance to challenge and limit the scope and methods of the State's examination to ensure that a holder's final assessment of liability for inventory or any other property type is limited, reasonable, and fair.

First, holders should always seek to have the State limit any inventory-related audits to ''uninvoiced payables'' only, so that the State at least remains consistent with the position it took during the audit of McKesson. Based on the State's agreement to limit the scope of McKesson's inventory audit to ''uninvoiced payables'' only, holders should not agree to allow a broader audit of inventory-related property.

Second, the process employed by the State in the McKesson audit suggests that sampling is an appropriate approach for auditing inventory-related property, similar to other property types. In our experience representing holders during unclaimed property audits and voluntary disclosure agreements, holders and the State's contract auditors can negotiate an agreement on the use of statistical sampling for other property types, such as accounts payable or accounts receivable. In many cases, sampling can be more efficient for holders under audit because it requires fewer internal resources to research and remediate a few hundred, as opposed to several thousand, items.

Third, the State's acceptance of ''due diligence'' letters to remediate inventory transaction items suggests that such external documentation is sufficient to convince the State that those sample items are not unclaimed property in the context of an inventory-related audit. Thus, where holders cannot produce internal records to show that an inventory ''credit'' is not unclaimed property, holders may remediate such items by contacting the purported owners and obtaining a statement from the owner that the property is not owed. In our experience in other audits, ''due diligence'' is an accepted form of remediation for other property types. The *McKesson* litigation indicates that such documentation is equally appropriate for inventory as well.

Finally, the State's Counterclaim indicates that holders may continue to submit remediation documentation to reduce their liability—even after the State has issued a ''Report of Examination'' with a ''final'' assessment of liability. The State notes that its first Report of Examination for inventory, issued July 13, 2009, contained a liability assessment of approximately $16.5 million. McKesson, however, continued to submit remediation documentation, which the State accepted. As a result, the State issued new Reports, each with subsequent reductions in McKesson's liability.

According to the State's Counterclaim, McKesson's current liability

[2] 570 A.2d 1313 (N.J. Super. 1989).

[3] *Id.* at 1317.

[4] *See, e.g.,* Oliver B. Cannon & Son, Inc. v. Dorr-Oliver, Inc., 1979 Del. Super. LEXIS 102, at *10–13 (Del. Super. Ct. Aug. 23, 1979).

for inventory stands at just over $1.7 million, a significant reduction even from the $4.6 million assessment on Aug. 25, 2009, which precipitated this litigation. The *McKesson* litigation suggests that holders should not stop submitting remediation documentation, even after a ''final'' assessment. The State's actions in this matter suggest that the State will continue to accept and accordingly reduce a holder's liability upon the receipt of additional remediation.

Answer, Affirmative Defenses

McKesson's Answer is largely concerned with clarifying the timing of key factual events in the audit, and is not as critical to this discussion as the insights offered by the State's response, as discussed above. McKesson, however, did offer several Affirmative Defenses, all of which reiterated arguments raised in the initial Complaint, as follows:

UCC Arguments. McKesson alleges that the Delaware Uniform Commercial Code (''UCC'') preempts the Delaware Escheat Act with respect to the category of property at issue, i.e., inventory, and asks that the court enter an order ''declaring that because of the 4-year statute of limitations in the Uniform Commercial Code, neither inventory nor the value of inventory escheats to the State of Delaware under the Delaware Escheats Law.'' However, it may be an open question under Delaware law whether provisions of the Delaware Escheat Act, such as 12 Del. C. § 1198(11), trump the UCC's default statute of limitation provisions.

In our experience, there are other provisions of the UCC that might augment the position that GR/IR does not constitute unclaimed property. For example, it could be argued that the inventory credits at issue do not represent an enforceable property interest by the owner, due to long-term contractual relationships, courses of dealing, and courses of performance between McKesson and any purported owners. As such, these inventory credits would not constitute unclaimed property subject to escheat by the State.

Inventory and Extrapolation Arguments. In its Complaint, McKesson has raised several challenges related specifically to unclaimed property liability derived from inventory and inventory mismatches. McKesson reiterates these arguments in its Answer and asks that the court declare ''that inventory is not unclaimed property.''

McKesson has also challenged several aspects of the State's extrapolation methodologies, the outcome of which may affect the State's handling of property types other than inventory. Thus, McKesson notes here as an Affirmative Defense that the State's methodology for calculating its assessment against McKesson is arbitrary and capricious and against the manifest weight of the evidence.

Constitutional and Federal Preemption Arguments. McKesson raises, as Affirmative Defenses, that Delaware's conduct is a violation of its procedural and substantive due process rights, as well as unlawful taking, under both the U.S. and Delaware Constitutions. Specifically, McKesson claims that the Delaware Escheat Act violates procedural due process under the due process clause of the U.S. Constitution and the Delaware Constitution because it does not provide a procedure whereby a holder can challenge an assessment made by the State or obtain a refund from the State.

Finally, McKesson argues as an Affirmative Defense that the Delaware Escheat Act—at least with respect to the pharmaceutical and medical device inventory purchased by McKesson—is preempted by the Federal Food and Drug Act.

Conclusion

Developments in the *McKesson* litigation will continue to have a significant impact on the holder community with respect to the treatment of inventory mismatches, whether in the context of an unclaimed property audit, voluntary disclosure agreement, or prospective compliance activity. Several key issues may be resolved by this litigation in the near future. Is inventory unclaimed property under Delaware law? Does the Uniform Commercial Code trump conflicting provisions of the Delaware Escheat Act? What does the Delaware Court of Chancery consider a ''reliable'' or credible estimation methodology? Finally, will the court see merit in the various constitutional and preemption challenges alleged by McKesson? Resolution of these and other issues raised will shape the State's treatment of inventory and other property types and, as such, will affect and be of importance to corporate holders of unclaimed property.

It is clear, as the State's Answer and Counterclaim indicate here, that subsequent filings in this litigation may offer important insight for holders, whether currently under audit or facing the prospect of an audit in the near future. The State's filings to date suggest that holders can attempt to limit their exposure for inventory-related unclaimed property by narrowing the scope of any audit to ''uninvoiced payables,'' agreeing to a limited sample, conducting external ''due diligence,'' and continuing remediation efforts after an initial assessment of liability by the State. Holders may also challenge the scope of the look-back period as well as offer alternatives to the State's estimation methods, although both of these remain open legal questions for now, which may be clarified by this litigation. Holders should seek the advice of experienced unclaimed property advocates to ensure that their interests are adequately recognized by the State during an audit of inventory or other property types.

CCW ISSN 0886-0475