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'McKesson' Lawsuit Challenges Delaware's Assessment Of Unclaimed Property Liability for Inventory Mismatches

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A complaint with potentially far-reaching implications for corporate holders of unclaimed property, particularly those holders incorporated in Delaware, has recently been 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").[1] 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 (the "Delaware Escheat Act").[2]

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Our experience in recent unclaimed property matters involving the State indicates a new and 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," "goods received, no invoice," "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 may 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.

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

[2] 12 Del. C. §§ 1101 *et seq*.

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Background

According to the complaint, McKesson, with its principal place of business in San Francisco, incorporated in Delaware in 1994. McKesson has filed unclaimed property reports with Delaware and other states on a regular basis. In August 2002, Kelmar Associates (''Kelmar''), a contract audit firm working for the State, began an audit of McKesson's 2002 accounting records, focusing on unclaimed accounts payable, uncashed payroll checks, and accounts receivable credit balances.

It was not until 2007—five years after the audit commenced—that Kelmar requested information regarding so-called inventory mismatches. In or approximately June 2008, McKesson and Delaware entered into a ''Closing Agreement Regarding Certain Property Types,'' to settle and release McKesson from any and all unclaimed property liability for three property types under audit (accounts payable, payroll, and accounts receivable) covering all reporting years prior to and including 2002.

After the settlement, Kelmar continued to audit inventory, subject to McKesson's express objection. Kelmar conducted its audit of inventory by selecting a sample of entries for the period July 1, 2002 to June 30, 2003. McKesson and the State had substantial differences over Kelmar's findings with respect to inventory which could not be resolved, leading to the current litigation.

Although McKesson initially sought a temporary restraining order (''TRO'') or preliminary injunction against any enforcement, including the assessment of interest and penalties by the State, McKesson and the State have since agreed to a ''Standstill Agreement.'' Under the agreement, there will be no TRO or preliminary injunction application by McKesson, while the State agreed to not press at this point for payment of the assessed liability and interest and penalties. Instead, the State will seek these in the form of a counterclaim, which will be part of the answer it will file in this matter. McKesson, in turn, has agreed to subsequently file a reply to the State's counterclaim. Furthermore, the parties have agreed that the matter will not be expedited but will be processed in accordance with the court's normal rules and procedures. Chancellor William Chandler, the chief judge of the Delaware Chancery Court and the judge handling another important ongoing unclaimed property litigation matter, *Cordrey v. CA, Inc.*,[3] will preside over the litigation.

Arguments/Issues in Case

In its complaint, McKesson raised several arguments related specifically to unclaimed property liability derived from inventory and inventory mismatches. Additionally, McKesson offered other arguments challenging the appropriateness of the State's extrapolation methodology and general constitutionality of the State's conduct and administration of its unclaimed property program.

McKesson argues that the State's extrapolation methodologies violate the well-settled ''priority rules'' established by the U.S. Supreme Court.

These latter arguments may have implications for holders in other categories of unclaimed property, beyond inventory. As this litigation progresses, the holder community may well gain additional understanding of how the State and the Delaware Court of Chancery will respond to the following issues of concern regarding the State's administration of its unclaimed property program.

Inventory-Related Arguments. In its complaint, McKesson raised several challenges to unclaimed property liability derived from inventory and inventory mismatches.

First, McKesson argues that inventory does not constitute property subject to escheat because inventory is not specifically identified as property subject to remittance in the Delaware Escheat Act or Delaware's Escheat Handbook. McKesson notes that it has historically reported unclaimed property to many states, including Delaware, and has never reported inventory. Moreover, McKesson alleges that it is not being required to remit inventory to any other states in which it has entered into Voluntary Disclosure Agreements.

With respect to so-called ''free goods,'' McKesson claims that it is customary in the industry for vendors to intentionally ship excess quantities and other ''free goods'' without any intention of submitting an invoice or receiving payment for these items. As such, no obligation of McKesson to pay such vendors is created and, as a result, no unclaimed property liability exists.

Finally, McKesson asserts that purported balances created by inventory tracking systems are not proper indicators of ''value'' that should be remitted to the State as unclaimed property because such amounts are often due to delays in invoice or inventory processing, volume discount programs, or incorrect data entries and, thus, do not represent an amount that is owed to the respective vendor.

McKesson also argues that the Uniform Commercial Code's statute of limitations bars escheat of inventory. Under the Delaware Uniform Commercial Code (''UCC''), a vendor must bring a claim for payment on inventory within four years. This statute of limitations extinguishes a vendor's claim against McKesson for the purchase of inventory prior to the five-year dormancy period in the Delaware Escheat Act.

As a result, McKesson argues ''the UCC statute of limitations trumps the Delaware [Escheat Act] with respect to inventory; any other interpretation would produce the absurd result of enabling a vendor to wait five years and claim property from Delaware (as unclaimed property) that the vendor could not have lawfully claimed directly from McKesson because of the four-year statute of limitations.''

Challenges to Extrapolation Methods. 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.

McKesson has asserted that extrapolation of a few sample years over the entire look-back period, which in Delaware goes back to 1981, is improper because a holder's business changes over time by, for example, size, complexity, products and services offered, course of dealing, and accounting systems. As such, the sample years may be materially unrepresentative of a company holder's business during the years covered by the audit.

Further, McKesson argues that to the extent it does not maintain records for certain years, it is ''virtually impossible'' for the holder to refute an assessment constructed for

[3] C.A. No. 4195-CC (Del. Ch.).

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those years by the State because such holder does not have records and because employees with relevant knowledge may be gone.

In addition, McKesson has noted that the State's extrapolation methodologies violate the well-settled ''priority rules'' established by the U.S. Supreme Court. Under the ''first priority rule'' of *Texas v. New Jersey*,[4] if the holder has the name and address of the owner, property escheats to the state of the owner's address.

According to McKesson's complaint, Delaware incorrectly calculated its assessment—in violation of this ''priority rule''—against McKesson by treating inventory receipts from vendors located outside of Delaware as property escheatable to Delaware. Because McKesson has the vendors' names and addresses and most all of them are vendors from states other than Delaware, if such items are escheatable, which McKesson argues they are not, they would be required to be escheated to other states, not to Delaware.

[4] 379 U.S. 674 (1965).

Constitutional and Federal Preemption Arguments. McKesson also alleges Delaware's conduct is a violation of its procedural and substantive due process rights, as well as unlawful taking, under both the United States 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.

Although, as McKesson correctly notes, a bill has been proposed in the Delaware Legislature that would create a process for a holder to challenge an assessment made by the State before the Tax Appeal Board, this bill has not yet passed, leaving holders without any such process—short of litigation—at this time.

Finally, McKesson argues 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 (''FFDA''). The FFDA and regulations promulgated thereunder provide a comprehensive set of laws governing, among other things, the sale, storage, and expiration dating of the pharmaceutical drugs and medical devices.

McKesson argues that the FFDA and related regulations preempt the Delaware Escheat Act ''to the extent that the Delaware Escheats Law seeks escheat of pharmaceutical drugs and medical devices that cannot be escheated without violating federal law.''

Conclusion

Developments in the McKesson litigation may well have a significant impact on the holder community as to inventory mismatches, whether in the context of an unclaimed property audit, voluntary disclosure agreement, or prospective compliance activity as well as issues of extrapolation and due process which cut across the State's administration of its unclaimed property program as it applies to all property categories.

McKesson's complaint offers a preview of the substantive arguments that the State's response and the ensuing litigation will continue to shape with respect to inventory mismatches as potential unclaimed property, legal and factual challenges available to holders regarding this property type, and the possible impact of federal law on state unclaimed property policies.