



BNA's

Corporate Counsel Weekly

CORPORATE PRACTICE SERIES

VOL. 25, NO. 29

JULY 28, 2010

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BNA Insights

Unclaimed Property

Delaware Makes Significant Changes to Its Unclaimed Property Statute

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Unclaimed property consists of a variety of types of tangible or intangible property which states are, by law, entitled to collect from “holders,” often corporations and businesses, after a period of dormancy, or lack of contact from the owners of the property. States hold this property for the benefit of “lost” owners, but each year, billions of dollars are collected by states, never claimed by owners and spent by states as part of their budgets. Delaware has a large stake in the success of unclaimed property collection efforts because, if there is no last known address for the lost owner, the state of formation or incorporation of the entity holding the property takes the property. Delaware, home to thousands of the nation’s largest corporations, now collects nearly \$500 million annually in unclaimed property, making unclaimed property the third largest revenue source for the State.

Pressure has been building for years, from the dozens of Delaware corporations audited annually by the State’s contract auditors, for Delaware to change its statute to promote transparency and predictability in its audit process and to allow holders a right to appeal an unclaimed property administrator’s determination of liability. Holders and holder advocacy groups such as the Council on State Taxation (“COST”) have been increasingly critical of the Delaware program. During early 2009, several *Fortune* 1000 corporations, along with Michael Houghton of MNAT,

met with senior Delaware government officials to discuss their concerns with the Delaware program and urge legislative changes. Litigation involving the State also increased during this period.¹

It is the most comprehensive change to Delaware’s unclaimed property law since Delaware adopted its current statute in 1981.

Delaware Governor Jack A. Markell and his Administration understood holder community concerns and was committed to making statutory changes in 2010. On July 23, 2010, Markell signed Senate Bill 272 (“S.B. 272”), enacting a series of amendments to Delaware’s unclaimed property statutes, 12 Del. C. §§ 1130 *et seq.* S.B. 272 is not a perfect or complete overhaul of Delaware’s unclaimed property statutes. It is, though, the most comprehensive change to Delaware’s unclaimed property law since Delaware adopted its current statute in 1981. The authors of this article provided significant input to State officials during the drafting of this legislation. The holder community will not view every aspect of S.B. 272 favorably—like all legislation, it represents the “sausage mak-

¹ See, e.g., *Cordrey v. CA, Inc.*, C.A. No. 4195-CC; *McKesson Corp. v. Cook*, C.A. No. 4920-CC; *Staples, Inc. v. Cook*, C.A. No. 5447-VCS.

ing” which is the legislative process. But the legislation demonstrates the current Administration’s willingness to listen to and pragmatically respond to holders’ concerns at a time of significant fiscal challenges for Delaware.

S.B. 272 eliminates “uninvoiced payables” from the definition of unclaimed or abandoned property. The legislation also creates an administrative appeals process within the Department of Finance, which offers holders the opportunity to administratively challenge an assessment or liability before the Audit Manager and an Independent Reviewer in lieu of litigation. In doing so, Delaware became one of likely fewer than a dozen states with significant unclaimed property appeals processes, and the new Delaware process is probably the most extensive in the nation. The legislation authorizes the use of estimation to determine liability when holder records do not exist or are insufficient, employing language derived, in part, from that found in the most recent version of the Uniform Unclaimed Property Act promulgated by the Uniform Law Commission. The legislation also implements certain technical changes intended to ease the administrative reporting burdens for holders.

Features and Implications of Bill

Elimination of “uninvoiced payables” as a potential source of unclaimed property liability. For the last several years, Delaware has had a new and intense interest in pursuing, as unclaimed property, inventory mismatches, overages, and unbilled full shipments that are often captured by inventory management and tracking systems. Such inventory “mismatches” are often referred to as “goods receipt/invoice receipt” (“GR/IR”), “goods received, no invoice” (“GR/NI”), “unbilled payables,” “free goods,” or

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“overages.”

Holders and their legal counsel have presented detailed legal arguments regarding why such credits do not constitute unclaimed property as a matter of law to Delaware’s Attorney General. The stakes are high, with the most aggressive calculation by Delaware’s contract auditors resulting in claims for millions of dollars in inventory-related liability by Delaware corporations. In September 2009, one holder initiated litigation to challenge Delaware’s attempt to escheat inventory-related credits.²

In response, S.B. 272 represents Delaware’s pragmatic decision to forego pursuing purported unclaimed property arising from inventory mismatches. S.B. 272 clarifies that Delaware’s definition of “property” in 12 Del. C. § 1198(11) and thus, “abandoned property” in 12 Del. C. § 1198(1) subject to escheatment, excludes “uninvoiced payables.” The bill specifically defines “uninvoiced payables” as (1) “amounts due between merchants . . . in the ordinary course of business when the goods were received and accepted by the holder, but which for any reason were never invoiced by the seller”; (2) “the value of goods received by a holder from a seller from out of balance transactions where the holder’s purchase order for goods and the amount of goods received by the holder do not match”; and 3) “unsolicited goods received by a holder from a seller that fall within 6 Del. C. § 2505.”³

The legislation, however, makes clear that such “uninvoiced payables” “specifically do not include accounts payable, accounts receivable, or any other type of credit or amount due to the creditor, including uncashed checks of any kind whatsoever whether relating to inventory . . .” Furthermore, the legislation expressly notes that the exclusion of “uninvoiced payables” from the definition of “property” shall not be construed to create a business-to-business (“B2B”) exemption of any kind.

The legislation’s definition of “uninvoiced payables” appears broad enough to cover the various inventory procedures and tracking sys-

tems, supplier relationships, and industry customs of holders, and will allow holders to avoid reporting future liability for such credits. S.B. 272’s exemption of “uninvoiced payables” became effective upon enactment and “shall apply with respect to all *uncompleted* examinations being conducted by the State Escheator as of the date of enactment and to all litigation pertaining to the subject matter thereof that is pending as of the date of enactment” (emphasis added). The new exemption would appear to apply to holders who may have received, but not paid, an assessment for such credits; it seems highly unlikely that Delaware would seek payment from these holders.⁴

One of the immediate effects of S.B. 272 will be to moot the main substantive issue in the ongoing *McKesson* litigation. While some of *McKesson*’s arguments may remain unresolved by the legislation, it would seem likely that the parties will resolve their dispute, which has been proceeding through discovery and has had no docket activity since April 2010.

Creation of formal review and appeals process within the Department of Finance. S.B. 272 creates, for the first time, a multistage administrative appeal process for holders within the Department of Finance—a process designed to be streamlined and consistent with the established tenets of administrative law. Unlike traditional litigation, which may involve protracted discovery, the process established by S.B. 272 has limited timeframes for response and no discovery mechanism. As such, the record is essentially fixed during the audit process, making creation of a solid record, and representation by experienced consultants and legal counsel during the audit, critical for holders.

The new procedure has its limitations, but it is a vast improvement over the status quo—which consists of no process whatsoever and requires holders to participate in unreviewed negotiation with the State Escheator. Any procedural issues concerning the process should be addressed through departmental regulations to be promulgated within the next 12 to 18 months.

How the new review process works: After a holder has received a

Statement of Findings and Request for Payment from the Abandoned Property Audit Manager,⁵ either at the conclusion of an audit or after the filing of a report, the holder may file a written protest with additional documentation with the Audit Manager within 60 days. After a holder initiates the internal review process, the holder must exhaust all administrative remedies before proceeding in court. Within 60 to 90 days after receipt of the holder’s protest, the Audit Manager shall provide a written determination on any finding that is adverse, in whole or in part, to the holder. The Audit Manager may extend the time period for response—up to 18 months—for good cause.⁶

Within 30 days, the holder may appeal the determination of the Audit Manager with the Secretary of Finance, who shall appoint an Independent Reviewer within 90 days. The Independent Reviewer must be an individual not currently employed by the Department of Finance and shall be a former member of the Delaware judiciary, an individual who has been previously appointed and served as a master of any Delaware court, or an attorney licensed in Delaware who is qualified by experience or training to serve.⁷ The appeal to the Independent Reviewer is *de novo* but on the record created in the protest before the Audit Manager and may include non-privileged materials prepared by or for the Audit Manager during the examination and experts’ reports prepared by or for the Audit Manager during consideration of a protest. This stage of the appeal includes pre- and post-hearing briefings, a hearing, and a written decision of the Independent Reviewer setting forth findings of fact and conclusions of law. The

⁵ We anticipate that Mark Udinski, the current State Escheator, will function as both the Audit Manager and the State Escheator.

⁶ The State should have little incentive to delay unnecessarily at this stage, particularly where holders have withheld payment of the disputed liability during the pendency of the protest.

⁷ Given the size—and reputation—of the Delaware bench and bar, concerns expressed that Independent Reviewers will undoubtedly favor the State in order to obtain reappointment seem misplaced. In addition, the opportunity for review by the Court of Chancery at the end of the internal appeal process should address any procedural due process issues that may exist due to a biased Independent Reviewer.

² See Complaint, *McKesson Corp. v. Cook*, C.A. No. 4920-CC.

³ This provision of the Uniform Commercial Code addresses “unsolicited merchandise.” 6 DEL. C. § 2505.

⁴ Since S.B. 272 is clearly not retroactive, holders who have previously settled audits and remitted inventory-related liability to Delaware will encounter challenges in seeking to recover funds paid.

Independent Reviewer shall assess costs, including the Independent Reviewer's fee, against or between the parties.

The Secretary of Finance may adopt or reject the Independent Reviewer's determination, in whole or in part, and must provide a written decision regarding any rejection or modification of the Independent Reviewer's decision. Within 30 days, the holder may appeal the Secretary's final decision to the Court of Chancery, where the court's review shall be limited to whether the Secretary's determination was supported by "substantial evidence on the record." If the administrative record is insufficient for the court's review, the court shall remand the case back to the Department for further proceedings on the record.

The legislation makes clear that holders who have received an audit notice prior to the date of enactment have the option either to (1) use S.B. 272's administrative appeal process; or (2) "independently pursue all legal and equitable remedies available in any court of competent jurisdiction." This should preserve the option of holders under audit now to pursue litigation, though the State may argue that holders' access to the Court of Chancery is limited by 12 Del. C. § 1156 to challenging an abuse of discretion in the imposition of interest and penalties, as it has previously.

Holders receiving an audit notice after enactment of S.B. 272 may have to bring any challenges through the administrative review process, though these holders may seek other remedies—particularly if evoking the traditional equitable jurisdiction of the Court of Chancery or disposition of legal or constitutional issues is outside the capacity of the Audit Manager.

Implications of the new review process: The impact and value of the new appeals process may not be ap-

parent for some time. From the day a holder files a protest with the Audit Manager to initiate the departmental review process, worst case, the entire administrative appeal could take between 13 and 31 months to complete—with review by the Court of Chancery to follow the Department's process.

In the short term, the procedural due process arguments criticizing Delaware's complete lack of a process, such as those raised in the *Staples* and *McKesson* litigations, may become moot. In the long term, the full impact may remain unclear for some time, as both the Department and holders begin to use the process.

Express statutory authorization of the use of estimation where holder records are insufficient to determine holder's liability. Delaware's lack of express statutory authority to estimate liability where records do not exist or are insufficient has been a regular holder criticism and a potential avenue for holders to challenge Delaware's unclaimed property enforcement regime. In S.B. 272, the State has attempted to resolve the issue.

The legislation states that "the employment of estimation techniques is an accepted and routine practice used both by holders of abandoned and unclaimed property and by the State Escheator in determining holders' liability to report and pay such property to the State with respect to periods for which inadequate holder records exist" and that "the State Escheator has inherent authority to estimate abandoned and unclaimed property liability when adequate records do not exist." Like most of the legislation's other provisions, this change took effect upon enactment.

S.B. 272 requires such liability to be "reasonably estimate[d] to be due and owing on the basis of any available records of the holder or by any

other *reasonable* method of estimation" (emphasis added). Requiring any estimate to be "reasonable" is consistent with Delaware case law in other contexts where courts have recognized a "reasonable" or "reliable" estimation in the absence of other information.

This change in Delaware's unclaimed property statutes should shift future holder disputes away from *whether* Delaware has the authority to estimate to *how* Delaware estimates liability—and whether such estimates are "reasonable." What constitutes a "reasonable" unclaimed property estimation is an open, and very contentious, issue and will likely be addressed by the new review process—and, ultimately, resolved by a court.

Conclusion

With the elimination of "uninvoiced payables" as a source of potential liability, holders' exposure to liability should decrease dramatically. And the creation of a departmental review process will change the settlement dynamic between holders and Delaware. In perhaps partial recognition of this fact, Delaware has projected at least a \$35 million decrease in its unclaimed property revenues for the current fiscal year.⁸

Despite the changes, several areas of concern remain. Holders will continue to press for a new statute of limitations, limiting the audit look-back to ten years rather than back to 1981, and for clarification of the estimation methodology employed by the State. S.B. 272 does not purport to completely address complaints the national business community have with Delaware's program, but it is a step in the direction of change and hopefully the start of a process of ongoing review and improvement of Delaware law in this area.

⁸ See Ginger Gibson, *Revenue Pipeline Could Run Dry*, NEWS-J., June 27, 2010.