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Federal Court Finds Delaware's Unclaimed Property Enforcement "Shocks the Conscience"

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On June 28, 2016, the much-anticipated memorandum opinion of the US District Court for the District of Delaware in Temple-Inland, Inc. v. Cook et al., No. 14-654-GMS was released on the parties' cross-motions for summary judgment, finding Delaware's extrapolation methodology and audit techniques collectively violate substantive due process. According to Judge Gregory M. Sleet, "[t]o put the matter gently, [Delaware has] engaged in a game of 'gotcha' that shocks the conscience." The opinion also specifically called third-party auditor Kelmar Associates LLC's formula used for estimation into question, noting that the use of a holder's calendar sales as the denominator in the ratio used to estimate liability raises questions given the lack of connection between abandoned property and the economy. In sum, this opinion is a "must read" for any unclaimed property advisor or holder going through a Delaware audit and is likely to have a drastic impact on both on-going and future unclaimed property audits. Holders should contact their unclaimed property advisors immediately to begin discussing how to proceed based on this groundbreaking development.

Background

Temple-Inland originally filed suit against Delaware in May 2014 following an unclaimed property audit of its accounts payable and payroll balances. After requesting records dating back to 1981, Temple-Inland was only able to provide records back to 2003. This is a frequent occurrence in these types of audits because companies typically have a seven-year record retention policy (tied to federal regulations). After reviewing the balances (or lack thereof), Delaware ultimately found Temple-Inland liable for nearly $1.4 million in unclaimed property liability going back to 1986 based on the use of sampling and extrapolation, after identifying one $147.30 payroll check with a Delaware address subject to escheat during the audit (which Temple-Inland remitted in 2013 upon request).

On March 11, 2015, the court denied Delaware's motion to dismiss (*see* prior coverage, available here), permitting Temple-Inland to proceed with their constitutional claims, which include violations of substantive due process, *ex post facto* clause, takings clause, commerce clause and full faith and

credit clause. After conducting discovery and extensively briefing the claims, Temple-Inland filed an amended complaint on December 3, 2015, dropping its claims based on the commerce clause and full faith and credit clause. Oral argument was held on March 16, 2016, addressing the cross-motions for summary judgment on the remaining claims at issue in yesterday's order.

Yesterday's Opinion

Abstention

Prior to addressing the substantive constitutional claims, the opinion first rejected Delaware's argument (not raised until recently) that the court should abstain under *Pullman* until a state court has the opportunity to interpret 12 *Del.* C. § 1155 (the statute authorizing Delaware to examine holder's records), which they claim is an ambiguous statute. The court quickly rejected this argument, not that "[b]ecause § 1155 is unambiguous, there is no need for the court to exercise *Pullman* abstention in this case."

Due Process

In order to violate constitutional substantive due process protections, the executive actions taken by Delaware here must "shock the conscience." While Judge Sleet did not specifically list any of these actions as "shocking the conscience" in isolation, he concluded that "[i]t is sufficient that, in combination, defendants' executive actions shock the conscience." Specifically, Judge Sleet concluded that Delaware:

> "(i) waited 22 years to audit plaintiff; (ii) exploited loopholes in the statute of limitations; (iii) never properly notified holders regarding the need to maintain unclaimed property records longer than is standard; (iv) failed to articulate any legitimate state interest in retroactively applying Section 1155 except to raise revenue; (v) employed a method of estimation where characteristics that favored liability were replicated across the whole, but characteristics that reduced liability were ignored; and (viii) subjected plaintiff to multiple liability. To put the matter gently, defendants have engaged in a game of 'gotcha' that shocks the conscience." Mem. Op. p. 33.

In reaching this decision, Judge Sleet deferred a decision on an appropriate remedy until later.

Takings Clause

In denying Temple-Inland's takings clause claim, the court held that a reasonable estimation of a holders' unclaimed property liability is not an unconstitutional taking, but failed to expressly classify Delaware's approach as reasonable. Judge Sleet noted that the parties did not present evidence or argument to whether or not the estimation was reasonable, and because a dispute of material fact remains, the court could not resolve the claim on summary judgment.

Ex Post Facto Clause

The court also denied Temple-Inland's *ex post facto* clause claim, on the basis that it is limited to criminal punishments and civil measures which are really criminal punishments in disguise. After

evaluating the intent of § 1155 and the *Mendoza-Martinez* factors, the court found that the statute "does not have a criminally punitive purpose or effect."

Note

Yesterday's opinion is a golden ticket for every holder currently under audit (or with an outstanding VDA in process) by Delaware and will have a material impact on negotiations with the state and third-party auditors going forward. There can be no doubt that Delaware will appeal the case and thus any final resolution is likely more than a year in the future. Nevertheless, Holders should carefully consider their options prior to responding to audit document requests, concluding VDAs, and finalizing audits. Holders that have previously settled audits should consider reviewing their closing agreements.

Aside from the significant due process victory for holders, the opinion also sheds light on the estimation techniques used by Kelmar, one of Delaware's third-party contract auditors. In a footnote, Judge Sleet notes that "[t]he court has not been asked to determine if the formula used for estimation is reasonable. But Kelmar's use of 'calendar sales' as the denominator does raise questions, because, as the state acknowledged, 'abandoned property has no pertinent link to the economy.'" Mem. Op. p. 8. Holders and their advocates have long argued that the denominator was not an accurate reflection of the base line against which sampled liability should be extrapolated.

It is also interesting to note that this decision comes in light of Delaware's fight with a number of states over the proper classification of MoneyGram's Official Checks, which Delaware has classified as third-party bank checks and accepted as rightfully theirs under the priority rules. Over 20 other states (and likely more to come) have claimed that the Official Checks are money orders, which would be governed by a federal statute providing for escheat to the state where purchased. *See* prior coverage here. Since our last blog, Wisconsin has requested that the US Supreme Court join the two pending cases due to similarity of facts and issues. As part of the Court's review of these two cases, they may have the appetite to review the priority rules established by *Texas v. New Jersey,* 379 U.S. 674 (1965) and its progeny, as specifically requested by Pennsylvania in its response to Delaware, just a few weeks ago. As noted by Judge Sleet in yesterday's opinion, because so many corporations are formed in Delaware, the state benefits significantly from the second priority rule (which escheats to the holder's state of incorporation when the owner/address is unknown). Practically speaking, this results in unclaimed property being the third largest revenue source for Delaware—with over 90 percent stemming from property with the owner/address unknown. Any such revision or narrowing of the common law priority rules by the court would have an additional detrimental impact on Delaware's ability to fund the state.

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