An Evolving Cacophony:
Escheatment Laws and Credit Manager Risk

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The decision whether to extend credit turns on many factors, but an understanding of escheatment laws allows a credit manager to protect against the dangers presented by this constantly evolving area.

"Unclaimed" or "abandoned" property refers to any property held by a business, where the business is not the owner of the property, and there has been no contact with the owner for a set period of time, called a "dormancy period."[1] Usually, unclaimed property is money in the form of uncashed vendor checks, uncashed wage and expense checks, unused customer/client refunds or credits, uncashed dividend checks, idle account proceeds of savings and checking accounts, or even unclaimed gift card balances.

All fifty states, as well as the District of Columbia, have laws addressing how businesses must handle unclaimed property. Such businesses are commonly called "holders," who must report and transfer (or "escheat") to the state any property that has been abandoned as of the end of the prior year.[2] Ownership of the funds does not transfer to the state; instead, the state holds the abandoned property in trust in perpetuity until claimed by the owner or the owner's successor in interest.[3] Importantly, until the owner claims the property, a state can use the funds for the general welfare.[4] Because a state may use these funds, it is important that a credit manager, when deciding whether to extend credit, properly assesses whether the business seeking the trade credit faces exposure under escheatment law, or is otherwise in compliance with applicable state escheatment law.

A Brief History of Escheatment

The term "escheat" derives from the Latin *cadere*, meaning "to fall out." The idea behind ancient escheatment laws is powerful in its simplicity: when a landholder died, went to war, or became imprisoned, his property reverted to the landowner to ensure continued productivity.[5] In the United States, nineteenth century writings indicate that the philosophical basis for escheatment was similar, with individual states taking the place of feudal lords and the monarchy.[6] Over the years, U.S. escheatment law saw several statutory changes, first by the Revised Uniform Disposition of Unclaimed Property Act of 1966 and later by the 1981 Uniform Unclaimed Property Act (UUPA).[7] Revised in 1995, the Uniform Act was broadened to include additional property types, such as gift cards, royalties, and mineral interests.[8] The 1995 Act also shortened dormancy periods and streamlined the process of escheatment for both holders and state regulatory agencies.[9]

The Supreme Court Weighs In

In the seminal opinion *Texas v. New Jersey*,[10] the Court held in what is now known as the "Primary Rule" that "each item of property in question . . . is subject to escheat only by the State of the last

1 See, generally, Temple-Inland, Inc. v. Cook, 192 F.Supp.3d 527, 531 (D. Del. 2016).

2 *Id.*

3 *Id.*

4 *Id*.

5 *Whose Property Is It, Anyway? – A Brief History of Escheatment Law*, UNCLAIMED PROP. PROF'LS ORG. (Jan. 20, 2013), http://www.uppo.org/blogpost/925381/157316/Whose-Property-Is-It-Anyway--A-Brief-History-of-Escheatment-Law.

6 *Id.*

7 *Id.*

8 *Id.*

9 *Id.*

10 379 U.S. 674 (1965).

known address of the creditor, as shown by the debtor's books and records."[11] The "Secondary Rule," applying in situations where the state of the last known address is not known, allows the "State of corporate domicile [to] escheat the property[.]"[12]

Delaware's Outsized Importance

The Secondary Rule presented by *Texas v. New Jersey*, of course, inured to the state of Delaware's benefit because over half of all public corporations in the United States[13] have made Delaware their legal home, citing as justification the flexibility of the Delaware General Corporation Law, Delaware's highly respected corporations court, the Court of Chancery, and the Secretary of State's Office which "thinks and acts more like one of the corporations it administers than a government bureaucracy."[14]

Delaware's aggressive escheatment enforcement has paid off in spades. In 2017, Delaware collected a net $404 million in unclaimed property, about 10 percent of its budget. Contrasted with Pennsylvania, where after refunds, the Treasurer's Unclaimed Property office netted only $195 million, or less than 1 percent of Pennsylvania's gross revenues,[15] it is clear that any discussion of escheatment law must begin in Delaware. But such an aggressive posture may also be described as overreaching, and in *Temple-Inland, Inc. v. Cook*, the United States District Court for the District of Delaware began to push back.

The *Temple-Inland* Decision

Temple-Inland, a Delaware corporation that manufactured corrugated packaging, had its principal place of business in Texas, and its operations primarily in Texas, Indianapolis, and Indiana. The defendants, Delaware state employees authorized to enforce Delaware's escheatment laws, audited Temple-Inland in 2008 for deficiencies in reporting and escheating unclaimed property for the previous 22-year period. Temple-Inland argued that the audit was unconstitutional.

The court agreed with Temple-Inland, and found that a combination of actions by the defendants "shock[ed] the conscience."[16] In particular, the court explained the unconstitutional behaviors engaged in by the defendants:

- waiting 22 years to audit Temple-Inland;
- exploiting loopholes in the statute of limitations;
- failing to properly notify holders of the need to retain records longer than normal;
- failing to show any reason other than the raising of revenue for its statute allowing the state to examine holders' records;
- using records characteristics for estimation that favor liability, while ignoring characteristics that reduce liability; and
- subjecting the holder to multiple liabilities.[17]

Considered by some commentators to be a "win" for unclaimed property holders,[18] the net effect of *Temple-Inland* was to illustrate precisely how Delaware's unclaimed property laws could lead to unconstitutional behavior by state enforcement employees. It quickly became clear that the methods used by Delaware and other states to coax, perhaps unconstitutionally, funds from unclaimed property into the state's coffers must be less aggressive. A calibration of sorts was required, and Delaware set about to modify its laws to effect exactly that change.

Delaware's Reaction to *Temple-Inland*

A. Senate Bill 13

Senate Bill 13 ("SB 13") in the Delaware State Senate for the 149th General Assembly, attempted to tackle the issues raised by *Temple-*

11 *Id*. at 681.

12 *Id*. at 682.

13 Leslie Wayne, *How Delaware Thrives as a Corporate Tax Haven*, N.Y. TIMES, June 30, 2012, https://www.nytimes.com/2012/07/01/business/how-delaware-thrives-as-a-corporate-tax-haven.html.

14 Lewis S. Black, Jr., *Why Corporations Choose Delaware*, DEL. DEPT. OF STATE DIV. OF CORPS., 2007, https://corp.delaware.gov/whycorporations_web.pdf.

15 Joseph N. DiStefano, *Delaware's Long Fight to Collect the World's Orphan Cash*, THE INQUIRER, Jan. 15, 2018, http://www.philly.com/philly/blogs/inq-phillydeals/delawares-long-fight-to-collect-the-worlds-orphan-cash-20180115.html.

16 *Temple-Inland*, 192 F.Supp.3d at 541.

17 *Id.*

18 *See generally*, Clive Cohen, *Has Temple-Inland Secured A Big Win for All Unclaimed Property Holders?*, KEEPUP BLOG, July 1, 2016, http://www.unclaimedpropertyspecialists.com/blog/has-temple-inland-secured-a-big-win-for-all-unclaimed-property-holders.

Inland in a holistic way. SB 13, introduced on January 12, 2017 and signed into law on February 2, 2017 by Governor John Carney, Jr., made several revisions to the previous law, including the removal of provisions related to virtual currency and net card value, clarification of the time for escheat related to individual retirement accounts, and changes to the deadline to convert an unclaimed property audit into either a voluntary disclosure program or expedited audit from July 1, 2017, to within 60 days of the adoption of certain regulations.[19]

Advocates for the businesses—the holders of unclaimed property—cautioned that SB 13 introduced no changes to the estimation methodology that shocked the conscience in *Temple-Inland*. Nor, they argued, did SB 13 address the use of contingent fee audits—wherein auditors are paid a fee contingent on the amount of the unclaimed property found in their audits[20] — leading many to wonder if the law would prove as successful as hoped.

B. Senate Substitute 1 for Senate Bill 79

Revised almost immediately, on June 29, 2017, Governor Carney signed into law Senate Substitute 1 for Senate Bill 79 ("SS1/SB 79"), which revised parts of SB 13. As with SB 13, the revisions were broadly pro-holder, such as a provision allowing the State Escheator, as the Director of the Office of Unclaimed Property is called, to waive up to 100 percent of calculable interest for any property remitted to Delaware as part of a holder's annual filing, as opposed to the prior limit of 50 percent.[21] SS1/SB 79 also clarified that Delaware would indemnify and defend a holder against a foreign jurisdiction's claims for property paid or delivered in good faith to Delaware.

Section 1176(b) of the Delaware Escheats Law requires the Department of Finance, "in consultation with the Secretary of State," to adopt regulations "regarding the method of estimation to create consistency in any examination or voluntary disclosure."[22] Perhaps unsurprisingly, this has led to the Finance and State departments appearing at odds with one another regarding the best path forward for estimation methodologies, narrowly, and Delaware escheatment law, more broadly.

To that end, SS1/ SB 79 granted the Secretary of Finance a five-month extension to December 1, 2017 to publish the required estimation methodology regulations for audits and voluntary disclosure agreements ("VDAs"). The Department of State, however, issued its own regulations effective July 11, 2017.

C. The Department of State Regulations

The Department of State's regulations evinced a pro-holder bias:

- The regulations did not mandate a specific estimation methodology; instead, the Department of State and the holder were to agree on the sampling, projection, and estimation techniques used by the holder;

- As a result of SB 13, Delaware required holders to retain records for 10 years (note the significantly shorter time period than the 22-year lookback period used by auditors in *Temple-Inland*) plus the dormancy period. If the holder did not have sufficient records for these years, the Department of State and the holder were to agree on the records to be used for the base period;

- The regulations specifically excluded some property from the estimation population, such as items payable to a U.S. department or agency and checks that are outstanding or voided less than 90 days after issuance; and

- The regulations permitted a holder to determine the scope of entities and property types included in the VDA, but after the holder established the entity scope, the holder would need the Department of State's consent to add additional entities.[23]

19 *See*, Catherine Del Re & Yudit Freda, *Major Overhaul to Delaware Unclaimed Property Laws Enacted*, RSM TAX ALERT, February 6, 2017, https://rsmus.com/what-we-do/services/tax/state-and-local-tax/unclaimed-property/proposed-bill-plans-major-overhaul-of-delaware-unclaimed-propert.html.

20 *See*, e.g., Michael Jacobs et al., *Massachusetts Joint Committee Hears Testimony Yesterday on Bill to Ban Use of Contingent Fee Auditors*, Ma. SALT, November 10, 2015, https://www.massachusettssalt.com/2015/11/massachusetts-joint-committee-hears-testimony-yesterday-on-bill-to-ban-use-of-contingent-fee-auditors/?utm_source=Mondaq&utm_medium=syndication&utm_campaign=View-Original.

21 *Delaware Reworks Its Recent Unclaimed Property Overhaul Legislation*, Alston & Bird, July 18, 2018, https://www.alston.com/en/insights/publications/2017/07/de-reworks-unclaimed-property-overhaul-legislation.

22 See DEL. CODE ANN. tit. 12, § 1176(b) ([2017].

23 *Delaware Reworks Its Recent Unclaimed Property Overhaul Legislation, supra* note 21.

D. The Department of Finance Regulations

On October 1, 2017, the Department of Finance adopted its final set of unclaimed property audit regulations. Far from the pro-holder bent of the Department of State's regulations, the Department of Finance's regulations continued the anti-holder nature of pre-SB 13 Delaware escheatment law:

- The regulations set a standard check avoidance "grace period" at 30 days, rather than the 90 days set in the Department of State regulations (leaving one to wonder how these wild pendulum swings "create consistency in any examination or voluntary disclosure");

- The regulations also included items with addresses in states other than Delaware in the Department's estimate of unaggregated, unapportioned liability, a decision certain to draw constitutionality challenges under the Takings Clause similar in timbre to *Temple-Inland*; and

- The regulations did not provide details about the "expedited audit" procedure adopted by SB 13 as an alternative to the VDA option.[24]

The interplay between the Finance and State departments illustrates the tension behind every escheatment decision. As the Department of State worked to modernize the law, granting holders greater rights and privileges, such as allowing holders the ability to choose the scope of the VDA, the Department of Finance immediately imposed onerous regulations, placing the actual status of holders' rights in limbo. It is difficult to predict the future in the best of times, but under these circumstances, it may prove especially unwise to confidently declare a winner in this high stakes arena.

The Future of Escheatment Law

As *Temple-Inland* and the saga of SB 13 illustrate, escheatment law in Delaware and other states is far from settled and predictable. Certain decisions made by the Department of Finance regarding its recent regulations may well expose such regulations to challenges as against substantive due process, the Takings Clause, and other constitutional provisions.

It is difficult to draw a straight line from escheatment's ancient roots as a means to put unowned property back to productive use to Delaware's recent regulations, but the immense value escheatment laws provides to states' budgets suggest that change for holders will not occur without a protracted fight.

Applicability to Credit Managers

This legal uncertainty makes the role of a credit manager more difficult than in prior years, because as a credit manager weighs whether to extend credit, he or she must anticipate that (i) the business may have significant liabilities owed to the Delaware Office of Unclaimed Property; or (ii) the credit manager itself may also have significant liabilities.

A. Risk of Business Facing Significant Liabilities

The aggressive posture of states in their quest to capture unclaimed property requires that credit managers consciously investigates businesses for potential liability. A credit manager should, when determining whether to extend credit:

1. Calculate the quantity of unclaimed property for which the credit seeker may potentially be liable, as that could impact the finances of the credit seeker;

2. Determine whether the credit seeker has kept adequate records for the 10-year or applicable lookback period;

3. Determine whether any of the credit seeker's assets are subject to exemptions from the unclaimed property calculation; and

4. Stay current on the events happening in Delaware, and other states more broadly, as escheatment law is in a period of massive flux right now, and may not be settled for years.

B. Risk of A Credit Manager's Own Business Facing Significant Liabilities

Credit managers, throughout common daily activities, may generate instances that can cause their own business to face potential escheatment reporting obligations and liability. If a credit manager, for example, offers a refund or credit to its customers or carries a credit memo on its books or records and the credit manager ultimately is unable to locate or identify the recipient of the refund, credit, or credit memo, then there is likely a reporting

24 *Delaware Finalizes Much-Anticipated Audit Regulations*, Alston & Bird, Oct. 4, 2017, https://www.alston.com/en/insights/publications/2017/10/delaware-finalizes-audit-regulations.

obligation under escheatment laws. If the last known address is not known or the credit manager fails to establish contact with the intended recipient or beneficiary, the credit manager's employer likely then has unclaimed property on its books. This property rightfully belongs to the state of incorporation of the recipient or beneficiary per the Secondary Rule. As such, the credit manager must be aware of recent state regulations emphasizing both pro- and anti-holder biases. Further, the credit manager will have to work with others within his or her organization, if it is other than the credit manager herself, in connection with escheatment law reporting and compliance with respect to any such credits, refunds or credit memos that may be "unclaimed."

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