taxnotes® state

Volume 103, Number 5 ■ January 31, 2022

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by Kendall L. Houghton and Ethan D. Millar
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Reprinted from *Tax Notes State*, January 31, 2022, p. 465

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Kendall L. Houghton

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Kendall L. Houghton and Ethan D. Millar are partners with Alston & Bird LLP in Washington and Los Angeles, respectively.

In this installment of UP Ahead, Houghton and Millar talk to *Tax Notes State* senior editor Doug Sheppard about recent unclaimed property developments, including how litigation may be a more effective means for holders to reach a settlement in Delaware than the state's voluntary disclosure agreement program.

Kendall L. Houghton: As we launch into a new year that will present both opportunities and perhaps some new pitfalls for companies that have to contend with multistate unclaimed property compliance regimes, let's discuss litigation as a potential arrow in a holder's quiver. Ethan, you have been directly involved in many litigation matters over the past several years, as have I, and we have discussed the fact that litigation is more relevant and prevalent than ever before in the unclaimed property arena. Let's explore how and why companies are using litigation as a tactic or a strategy to manage escheat compliance and to manage risk.

We know that the states have billions of dollars of unclaimed property in their custody — most of which is being held for the benefit of known owners, but some of which is state-custodied in an owner-unknown capacity. If so, those funds can never be returned to an owner, which appears to render unclaimed property laws — not consumer protection laws, but anti-holder windfall laws. Is there a reason, in your view, why the states continue to rely on unclaimed property as a revenue generator — beyond its obvious success?

Ethan D. Millar: Certainly that's a big part of it. States are constantly looking for sources of revenue, and unclaimed property in the past has been an easy target. We see that in the form of increased aggressiveness by states in audits and voluntary disclosure programs throughout the country. This is particularly true in Delaware — but it is also a big problem in states like California, Michigan, and New Jersey that seem to view unclaimed property as much as a revenue source as a means of returning property to the rightful owner.

Of course, some states emphasize the fact that they are acting on behalf of owners who have lost contact with their property and deemphasize the revenue impact as a mere side benefit. But the revenue focus is encouraged by the unclaimed property audit firms, which generally are still compensated on a contingency fee basis.

Some states' aggressive actions are also fueled by the misperception that many holders are acting in bad faith, when most are simply defending their rights and pointing out where states are overstepping.

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Houghton: Well, clearly every business entity has to understand the multistate laws in order to comply with them. Every state — and the District of Columbia and the U.S. territories — has an Unclaimed Property Act; and as you noted, audits are a principal enforcement mechanism. Of course, many states also deploy programs such as webinars and other forms of holder outreach to educate companies on their filing obligations. But audits have been viewed as a more effective and lucrative means of bringing companies into the fold of annual filers that report and remit unclaimed property.

But you also mentioned voluntary disclosures as a compliance tool. Of course, Delaware has had a formal program in place conducted by the secretary of state's office since 2012, and we're now a full decade into its operation. That program has been viewed as effective and beneficial for numerous holders that had accrued liabilities and were concerned about the potential exposure to an assessment of interest or penalties, based on their prior failure to comply with Delaware's unclaimed property laws. Nevertheless, I believe that based on our interactions with companies in recent years, there are some risks to undertaking a voluntary disclosure process — certainly with Delaware, as well as with other states that offer it. We'll turn to litigation in a moment, but I feel the risks of a voluntary disclosure agreement [VDA] could theoretically outweigh the potential benefits for some companies. Would you agree?

Millar: Yes, absolutely. The benefits of a VDA, in short, are waiver of penalties and interest. There is also a more favorable standard applied in the VDA to the records that are under review — in particular, in a VDA, the state only reviews checks voided after 90 days, whereas in an audit, checks voided after 30 days are reviewed. Both standards are arbitrary and improperly attempt to shift the burden of proof to the holder. But the VDA standard can benefit holders based on the lower number of checks at issue, which often translates into a lower unclaimed property calculated liability in the VDA. Those are the chief benefits.

The chief disadvantage of the Delaware VDA, at least in my view, is that there is no appeal procedure. If a holder disagrees with the position of the VDA administrator or the secretary of state, the holder's only recourse is to exit the VDA program — at which point the holder will likely have to go through a completely separate audit before it can avail itself of the right to appeal to court.

By contrast, in an audit, the holder will certainly be able to appeal to court at the end of the process and may have the right to appeal some issues early in the audit.

The lack of a direct right of appeal in the VDA program has led the secretary of state to take very hardline positions on some issues, such as Delaware's controversial estimation method and its controversial escheatment of foreign address property — with essentially no compromise to holders to account for litigation or other risks in the state's position, even though those risks are widely known.

Houghton: In that regard, Ethan, the issues with Delaware's liability estimation method certainly *are* widely known, and the *Temple-Inland* decision[1] is one that I think would cause some holders to think twice before signing up for a VDA program in which you're agreeing to all the objectionable features of estimation that were challenged in that case. And the foreign address issue is one that you yourself have litigated with Delaware, albeit your clients ultimately settled with the state — hence, we don't have a final decision on the substantive issue that undergirds the question whether a domicile state of a company can claim foreign address property from a U.S.-domiciled company. For companies that issue publicly traded shares and that are Delaware domiciled, this issue is of central relevance, whether in an audit or in the VDA program. But in the VDA program, your point is you don't get to litigate that issue.

Millar: That's right. And if you do dispute it and choose to exit the program and proceed through audit instead, you've then likely already wasted two, maybe three, years or even more going through the VDA program. And it can be an expensive process to go through the VDA program and then a separate audit. But until you've actually gone through the analysis and

[1] *Temple-Inland Inc. v. Cook*, Civ. No. 14-654-SLR (D. Del. Mar. 11, 2015).

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know how much is at issue, a holder may face a difficult decision on the front end trying to decide whether the VDA program or an audit is the better option. As you know, an audit can often take eight years or more to resolve and may involve many states, not just one, as in the VDA program. This can substantially increase the holder's costs.

So without knowing all the facts at the beginning, it's often difficult to make an informed decision about whether to opt into the VDA program or not. And so many holders default to the VDA program hoping that they can work it out and that the liability will be relatively minimal. And sometimes it works out fine. But by the time the holder has completed that process, it may be daunting to start all over, even if the VDA liability is higher than the holder believes is reasonable, and even if the holder may have gotten a better result in an audit — because of the added cost of going through both a VDA and audit. So unfortunately, I think some holders ultimately end up paying more in the VDA program than they ought to.

Houghton: That said, Ethan, holders have — in the most recent five-year period — had significant success in litigating a variety of issues, both procedural and substantive, with states including but not limited to Delaware. Let's discuss recent scenarios in which holders have elected to litigate and why those litigating tactics may be important for a holder currently under audit to keep front-of-mind. I feel your personal experiences litigating procedural and substantive issues for the benefit of clients are instructive. Would you share some thoughts about litigation as a tool to either confirm a company's compliance with state law or to effectuate a fair and reasonable settlement of an audit?

Millar: Sure. As you know, it cuts both ways, right? We have seen more holder-initiated litigation, but we've seen more state-initiated litigation as well. So both sides have been trying to ratchet up the temperature in order to gain leverage — for settlement or other purposes.

On the holder side, there are a number of different tactics that we've used and seen used successfully by holders in the last few years. In the aftermath of the *Temple-Inland* case, in which the court concluded that Delaware's audit practices violated substantive due process, holders have raised the same issues in Delaware audits as leverage with the state to try to reach a settlement — essentially threatening to litigate the same types of claims that *Temple-Inland* raised and challenging the state's use of estimation. Delaware is well aware that it has risk on that issue, so it has reasonably decided to settle those claims rather than litigating them and potentially losing its entire estimated revenue stream going forward. That knowledge gives holders substantial leverage in an audit.

The flip side of that is that we see Delaware pushing holders to the VDA process, where they lack the right to use litigation as leverage to try to extract a lower settlement. So you see dozens and dozens of VDA notices going out, encouraging holders to join the VDA process. And once they're in, assuming the holder completes the VDA process — which 99 percent of them do, as I understand it — then the state continues to avoid having to litigate these risky issues.

Recently, we've also seen more pushback by holders on state information requests. For example, there's the *AT&T* case[2] from last year, in which the holder challenged the state's subpoena and the Delaware Court of Chancery quashed the subpoena as overbroad. The court's decision included some very favorable language for holders that, even though the state has broad subpoena powers generally, it overstepped its authority by requesting huge volumes of records in the audit. But the amount of records requested in that case is actually very typical of what's requested in unclaimed property audits, so virtually any holder under audit could make similar arguments.

The endgame here is that holders are trying to narrow the scope of review — both to reduce costs in responding to overbroad requests in the short term, and ultimately to back Delaware into a corner so that it has less ability to pursue estimation on a full 50-state basis, which is its general approach in audits. So much of this litigation is intended to best position the holder for favorable settlement with the state on that issue.

Houghton: Ethan, you mentioned contingency fees paid to contract audit firms, which has been a

[2] *Delaware Department of Finance v. AT&T Inc.*, C.A. No. 2019-0985 (Del. June 1, 2021).

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concern for as long as the audit function's been outsourced to private third parties by Delaware and other states. I anticipate that this will continue to be part of holders' litigation focus, and Marathon Petroleum had some interesting success contesting the propriety of this arrangement based on its potential to violate a holder's due process rights.[3]

Millar: Absolutely. There has been some helpful acknowledgment of the issue by the *Marathon* court and other courts as well. For example, in the *AT&T* case, the Delaware Court of Chancery similarly expressed concern regarding the use of private contract audit firms — particularly those compensated on a contingency basis — especially where the firm is making important decisions regarding what information the holder must provide. The court pointed out that the auditors may be doing that for their own reasons to impose pressure on the holder, rather than because those are legitimate requests.

Houghton: Can you tell us a little bit about your recent experience litigating the "underground regulation" issue with California on behalf of your client ClubCorp?

Millar: Sure. Under California law — and the same is true in many states — regulations must be adopted through the Administrative Procedures Act [APA]. If they are not, the regulation is considered invalid and has no force or effect. In the *ClubCorp* case, the issue was whether California had the right to use a private audit firm to conduct the audit.[4] But before the state can use a private audit firm, it is required to promulgate guidance regarding the use of those auditors.

The California State Controller's Office did create a document regarding the use of private audit firms. However, that document includes rules of general application, and thus we argued that it constituted a regulation under the APA. And because it constituted a regulation, California should have gone through the formal rulemaking process, which it didn't do. As a result, the regulation was invalid, and therefore California had failed to satisfy its statutory requirement of promulgating guidance to use third-party auditors. Hence the state had no right to use those auditors.

The state filed a motion to dismiss; the court denied the motion and agreed with us that the document appeared to be a regulation subject to the APA. After that, the state quickly conceded and agreed not to use an audit firm in the audit of ClubCorp.

Houghton: Well, it's a nice exemplar of strategically deploying litigation to position a holder to more effectively address its substantive audit issues, vis-à-vis the examination by California. Congratulations on that result.

Doug Sheppard: The corporate income tax has been steadily decreasing as a share of state revenue for decades. Do you think that perhaps the more aggressive pursuit of unclaimed property is connected to that? And then by the same token, we keep talking about Delaware, which has no sales tax. Do you think this maybe affects its efforts to go after unclaimed property liabilities?

Houghton: Well, there is no doubt that Delaware is relying on the collection of estimated unclaimed property liabilities — which are owner-unknown and which will never be returned to owners — as a disguised or de facto tax. That is to say, estimated "liabilities" constitute revenue that the state will be able to use freely to fund general operations, and unclaimed property is the third-largest source of operating funds for the state — at least as of the most recent report that I've seen.

Millar: I agree — it's an interesting question. It makes sense that, to the extent that we're seeing decreases in corporate income tax revenue in some states, those states will presumably look to other ways to resolve those shortfalls. And unclaimed property does seem to be a convenient substitute.

Houghton: And in an interesting postscript to your question, Doug — California's state controller recently declined to implement an amnesty or VDA program, and California automatically assesses 12 percent per annum interest on unclaimed property liabilities. So there are a few angles there for California to continue to generate revenue while enforcing a purported "consumer protection" regulatory regime. ■

[3] *Marathon Petroleum Corp. v. Secretary of Finance for Delaware*, 876 F.3d 481 (3d Cir. 2017).

[4] *ClubCorp Holdings Inc. et al. v. Yee*, Case No. CGC-19-576314.

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