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Impact Report, July 2015:

Current Delaware Litigation & Potential Protective Claims

MarketSphere's advisory solutions practice leader, Jon D'Amato, and the company's advisory solutions director, David Poehler, recently sat down with members of the unclaimed property team at McDermott, Will & Emery to discuss current Delaware litigation and its impact on unclaimed property audits. Steve Kranz, a McDermott partner, has worked consistently on unclaimed property policy issues, such as the use of contingent fee-based third-party auditors, through organizations such as the National Conference of State Legislatures (NCSL). McDermott counsel, Diann L. Smith, while general counsel at the Council on State Taxation (COST), led the agency's Unclaimed Property Task Force.

In that discussion, shown below in the Q/A section of this report, Kranz and Smith analyze the cases to date and offer insight and advice to holders for treatment of audits and Voluntary Disclosure Agreements (VDAs) in process.

These cases, in conjunction with recent task force studies and legislative actions in the state of Delaware, specifically the passing of DE SB 141, are creating a new statutory framework unclaimed property holders must learn to navigate.

In particular, two lawsuits being heard in federal court could significantly affect Delaware's audit program. The cases are *Temple Inland vs. Delaware (Finance and State Escheator) & Kelmar Associates* and *Plains All American Pipeline vs. Delaware (Finance, State Escheator, Audit Manager) & Kelmar Associates, LLC*. Once the cases are resolved, the next question will be whether any final judgments can be applied to audits and VDAs currently being conducted by other states.

An immediate pressing question for holders is whether it's possible to file protective claims in Delaware and other states to preserve the right to applicable refunds. Protective claims are used commonly in conjunction with IRS issues. Although the term doesn't appear in the Code or regulations, taxpayers file them when the right to a refund is contingent on future events, such as pending litigation or regulatory changes. The right to a refund is based on events that won't be resolved until after expiration of the statute of limitations. A valid protective claim filed at the right time preserves the right to a refund.

At this point in time it is unclear whether the concept of a protective refund claim can be applied to state unclaimed property. The analysis by McDermott, Will & Emery in this report can assist holders with this and other issues and decisions as they prepare for changes in the audit process.

This is a complex issue and there is potential for disagreement between holders and states in the resolution of audits in progress during litigation of these important cases. We recommend engaging an advocate experienced in these areas, with specialized skills necessary for properly evaluating and using the protective refund claim to a company's best advantage. Each organization must evaluate unique facts surrounding its own circumstances and carefully choose the best option available, whether it is filing a protective claim, settling for an amount less than an audit assessment, or another remedy.

Temple Inland vs. Delaware (Finance and State Escheator) & Kelmar Associates, LLC

Date Entered: 5/21/14
Court: U.S. District Court
Date Resolved: Case Ongoing
Resolution Type: Case Ongoing

Issue/Position	Outcome/UP Guidance Provided
Whether estimation of undocumented liabilities violates priority rules from *Texas v. NJ* (preemption of federal common law)	Dismissed by District Judge: *Texas v. NJ* sets precedent for conflict between states, NOT private parties vs. states.
Substantive Due Process - Escheating identical property to multiple state is a violation of due process. DE using unclaimed property as revenue with no ability or intention of finding original owner does not exceed Temple's property interest.	TBD – Delaware's dismissal request denied
Ex Post Defacto - Retroactive application of Section 1155 as amended by S.B. No. 272 (codified estimation) violates ex post defacto. Plaintiff could not have known to keep records before 2010 because the law was passed in 2010.	TBD – Delaware's dismissal request denied. DE unclaimed property law does not state that estimation is a penaltly. If estimation is not a penalty, then it violates substantive due process. However, if it is a penalty it likely violates ex post defacto by retroactively applying the penalty.
Unlawful Taking - Estimation of liability violates taking clause. Records only show $147.30 unreported payroll due to DE. Nothing in AP. Using Non-DE property in estimation.	TBD – Delaware's dismissal request denied. Plaintiff has legitimate property interest in estimated debt because estimate may not be traceable to bona fide creditors. If Delaware does not have the authority to escheat the property, it violates the taking clause.
Violation of Commerce Clause & Full Faith and Credit Clause - Estimation based on non-DE checks is violation of commerce clause because it interferes with plaintiff's dealings with other states, especially when using properties due to creditors in other states that exempt that property type.	TBD – Delaware's dismissal request denied. Using cashed checks and checks escheated to other states in estimation, if true, means double escheat and violates full faith and credit clause.

KEYS TO THE CASE AND CLIENT IMPACT:

- Case is the first filed in federal court (vs. DE Chancery Court) which challenges Delaware's unclaimed property practices
- Suit filed after unclaimed property liabilities were quantified by Kelmar and Report of Examination was issued by Delaware
- Some holders who are currently under audit are waiting for the outcome of the case prior to providing more records to Kelmar/Delaware

Plains All American Pipeline vs. Delaware (Finance, State Escheator, Audit Manager) & Kelmar Associates, LLC

Date Entered: 6/5/15
Court: U.S. District Court
Date Resolved: Case Ongoing
Resolution Type: Case Ongoing

Issue/Position	Outcome/UP Guidance Provided
Substantive Due Process - Plains being penalized (by use of estimation) for failure to maintain records for a time period when state law did not require the records to be kept. Plains has a protectable property interest in the estimated debt that could be found through the audit and also the resources that will be used to comply with the audit. The taking of that property would violate due process.	**TBD**
Unlawful Taking - Unclaimed property debts resulting from estimation have no tie to identifiable unclaimed property, which forces holders to fund from its own funds. These funds are then placed in DE's General Fund and are used for public use. It is an unconstitutional taking of private property for public use without just compensation.	
Unreasonable Search and Seizure - DE's audit is an unreasonable, warrantless search and seizure of non-public premises and documents. No warrant to require document request. No court oversight. Violates 4th Amendment.	
Equal Protection - DE unclaimed property law has no set criteria for selecting audit targets. DE looks for large/famous companies that will produce more money to fund the state's General Fund. The purpose of unclaimed property law is to facilitate the state to reunite owners with their property. Selecting companies that will produce the most for the General Fund has no relationship to the purpose of unclaimed property laws. Plains was selected for audit using non-neutral criteria.	

KEYS TO THE CASE AND CLIENT IMPACT:

» Case was filed in federal court; there are now two open cases challenging Delaware and their unclaimed property practices

Insight on Delaware Unclaimed Property Audit Litigation and Impact for Holders: McDermott, Will & Emery

Q1 **David Poehler—MarketSphere:** ***Given the potentially significant impacts current cases could have on Delaware unclaimed property law, should holders await a resolution to these cases before finalizing an ongoing audit or voluntary disclosure?***

A1 **Steve Kranz—McDermott, Will & Emery:** Four separate buckets of lawsuits are pending in Delaware right now. Each bucket has different implications for holders to consider.

1. Challenges to Delaware's general assessment methodology, including audit estimation and look-back period (*Temple Inland* and *Plains All American Pipeline*)

2. Challenges to the audit process itself, including audit selection, document request authority and scope, and deference to private auditors (*Plains All American Pipeline*)

3. Qui tam gift card cases

4. Escheatment of foreign owned stock and immediate liquidation (*JLI Invest*)

In many cases, the timing of finalizing an ongoing audit or voluntary disclosure is not going to be up to the holder. A holder that deliberately delays an audit puts itself at risk of incurring penalties for being uncooperative and becomes a less sympathetic party if the case ever goes to court. Holders should use the administrative review and/or judicial process to protect their issues, rather than engaging in unsupportable delay tactics during the audit. That said, holders that receive an audit notice should at least ask Delaware to postpone those elements of the audit that are being challenged in the pending cases.

Q2 **David Poehler—MarketSphere:** ***Which of the cases will have the most impact? Why?***

A2 **Steve Kranz—McDermott, Will & Emery:** *Temple-Inland* and *Plains All American* potentially will have the biggest impact on holders, because the claims in these cases go to the very heart of how Delaware conducts its unclaimed property audit program.

Every holder must examine its own timing issues, compliance history and potential liability, and stomach for litigation before making a decision regarding document/information production, finalizing an audit or entering into a voluntary disclosure.

Q3 **David Poehler—MarketSphere:** ***When do you expect final resolution of these cases?***

A3 **Steve Kranz—McDermott, Will & Emery:** Past cases raising similar issues have settled without a final resolution. Thus, knowing whether and when a definitive resolution will be reached is difficult. *Temple-Inland* currently is scheduled to go to trial in January 2016. Any opinion from the district court will almost certainly be appealed to the circuit court, so a final resolution is likely more than a year away. The complaint in *Plains All American* was just recently filed and Delaware's response is not due until August 13th.

Q4 **Jon D'Amato—MarketSphere:** ***How will the court cases affect holders at different stages of the audit process as the Delaware litigation is being resolved? What developments are possible or likely during this process? What advice can you offer?***

A4 **Diann L. Smith—McDermott, Will & Emery:** For a holder just beginning an audit or starting a new phase of the document request process, the issues raised in *Plains All American* are pivotal. A holder may want to take the position that for some or all of the reasons set forward in *Plains All American*, Delaware's auditors do not have the legal authority to demand certain documents or information. Any legal objection of a holder to the document/information request, such as it is an unreasonable search and seizure, should be made at the time the document or information is demanded. At such point, Delaware may be forced into either abandoning its request or issuing a warrant, summons, or subpoena for the documents or information.

If Delaware does issue such a document compelling production, the holder will have an opportunity to challenge in state court the legality of the document production demand. The holder could challenge the underlying authority of Delaware to issue the document compelling production and the scope of the production request. Alternatively, holders could file complaints similar to *Plains All American* in federal district court and ask that the action be stayed until a final resolution in *Plains All American*.

Finally, the pending threat to Delaware and its auditors of the *Plains All American* claims may allow holders to negotiate more favorable audit terms with Delaware. At the very least, holders should always express in writing the problems with the document and information requests and offer an alternative document production scope or methodology.

Holders need to consider the risks of penalties if they push back on Delaware's document and information requests. However, holders have an absolute right to assert their statutory and constitutional rights and, if Delaware were to impose penalties merely because a holder in good faith evoked its legal rights, the imposition of penalties could itself be a violation of due process.

For holders reaching the end of an audit for a specific property type, the issues regarding Delaware's use of estimation raised in both *Temple-Inland* and *Plains All American* become important. Such a holder has two clear options: (1) settling the audit for less than the amount in the State's Request for Payment or (2) protesting and appealing the findings.

A settlement likely precludes a holder from subsequently requesting a refund if *Temple-Inland* or similar claims by holders ultimately are successful in court. However, there is no reason a holder should not ask that any settlement be contingent on Delaware succeeding in the pending cases. A holder may want to settle if it (a) can receive a significant discount on the estimated liability as a result of the current uncertainty resulting from the on-going litigation and (b) does not want to incur the costs and publicity of litigation.

Alternatively, if a holder appeals the audit findings, the cleanest route procedurally is to use the internal administrative appeals process and then appeal to the Delaware Chancery Court, if necessary. Some have suggested that this route, dependent entirely on Delaware state decision makers and with a limited standard of review, is an unattractive forum for holders. Holders could challenge an audit directly in state or federal court without using the informal procedure process, but there is a risk that this would be deemed a fatal failure to exhaust administrative remedies.

Whichever route a holder takes, the holder should consider whether to ask the forum to hold stay its case pending the outcome of the lead case.

Finally, for voluntary disclosures, it may be difficult for holders to both agree to voluntarily comply, essentially on Delaware's terms, and at the same time hold out for a final resolution of the pending cases. Delaware can kick a holder out of the program at any time if the holder is not forthcoming with its liability assessment and supporting documentation. Holders should seriously consider whether the assurances of the VDA program outweigh the potential significant decreases in liability if *Temple-Inland* is successful regarding its claims that the estimation and look-back methodology are not supported by law.

Q5 **David Poehler—MarketSphere:** ***Would the resolution of these cases only affect Delaware incorporated entities?***

A5 **Diann L. Smith—McDermott, Will & Emery:** *Temple-Inland* and *Plains All American* are in federal district court. To the extent these cases are appealed up to the Third Circuit, the cases could be controlling for all states within that circuit (Pennsylvania, New Jersey, and Delaware). Furthermore, because these cases address federal common law and federal constitutional principles, any decision will be influential in other jurisdictions.

Q6 **Jon D'Amato—MarketSphere:** ***The new legislation requires payment to the State by 3/1/16. If payment is made thereafter, the State can assess interest. How does this new provision affect the answer to question one above for holders currently under audit by Delaware or enrolled in the Delaware VDA program?***

A6 **Steve Kranz—McDermott, Will & Emery:** If a holder is under audit and expects to have a significant liability, but the audit will not be completed by 3/1/16, the holder should consider asking Delaware to allow a payment on account that can be used as a deposit against such liability to avoid the imposition of interest. Obvious risks to this approach include alerting Delaware to the amount the holder thinks it may be liable for and reducing lavage in settlement discussions. A similar approach was taken in the tax context in California during one of its amnesties in which there were significant affirmative penalties for not participating in the amnesty program.

There is a possibility, given the timing of the *Temple-Inland* trial, that a decision will be available before the March 1st payment deadline. Thus, no early payments should be made until shortly before the deadline. Of course, *Temple-Inland* will almost certainly be appealed by the losing party, so even a pre-3/1/16 decision will not be the final word.

The new penalty provision does provide that no interest is due if the failure to pay was due to "reasonable cause and not willful neglect." Thus, holders may be able to avoid interest payments based on this provision. Once again, tax law provides a plethora of case law interpreting reasonable cause.

Q7 **Jon D'Amato—MarketSphere:** ***How does this new payment provision affect the answer to question one above for holders contemplating entering the new Delaware VDA program?***

A7 **Steve Kranz—McDermott, Will & Emery:** This is a very difficult balancing act that holders must assess based on their total liability risk and risk profile.

Q8 **David Poehler—MarketSphere:** ***Can a protective refund claim be filed with respect to unclaimed property audits and VDAs?***

A8 **Diann L. Smith—McDermott, Will & Emery:** Absent a specific provision, a protective refund claim could probably not be filed for an agreed settlement of an unclaimed property audit or for the VDA, since both of these are "voluntarily" agreed to. A holder should at least ask Delaware in both instances to include a provision that the relevant property will be refunded should Delaware lose the estimation or statute of limitations/record retention arguments in the pending cases.

If a holder pays the full amount of the calculated liability finding from an audit, it may be possible to file a refund claim. Delaware §1144(d) provides the basis for a holder requesting a refund for "any moneys or other property not required by this subchapter to be so paid or delivered" to the state. A holder is entitled to a refund if it paid the property to the state based on "some mistake of fact, error in calculation or erroneous interpretation of statute." The claim for refund must

be made within six years of the erroneous payment. There is some risk that the state would assert that the only method to protest an audit assessment is through the internal protest and appeal process and then appeal through the courts. However, the U.S. Supreme Court has been clear in the tax context, if a state offers both a pre-assessment and post-assessment option, it may not preclude a post-assessment review.

Q9 **David Poehler—MarketSphere:** ***Other than a protective claim, are there other legal routes a holder might take to protect itself until these cases are resolved?***

A9 **Diann L. Smith—McDermott, Will & Emery:** A holder might be able to self-assess a historic liability and then, when the cases are resolved, file a refund claim. This self-assessment would be outside of the standard VDA program. The risks would be (a) Delaware would assert penalty and interest; (b) the hypothetical self-assessment period would be longer than the VDA period if the holder wanted to be thorough; and (c) *Temple-Inland* might lose its claims and then the holder would have "voluntarily" paid money for which it might never have been audited. The benefit of this approach is that it clearly keeps the option open for a refund, where the VDA program does not. Of course, the refunds need to be filed within six years of the payment, but *Temple-Inland* should (hopefully) be finalized by then.

Q10 **Jon D'Amato—MarketSphere:** ***If a protective claim is able to be filed, can it be filed while an audit/voluntary disclosure is ongoing or must it be filed prior to the commencement of an audit/voluntary disclosure?***

A10 **Steve Kranz—McDermott, Will & Emery:** It may be difficult to file a protective claim both before and during a VDA, because Delaware may decide to remove the holder from the program. For an audit, the obvious time to file the claim would be after payment was made.

Q11 **David Poehler—MarketSphere:** ***If a protective claim can be filed during a current audit, Delaware audits have specific language around the eleventh amendment: "Plaintiff will have no remedy because it is barred by the Eleventh Amendment to the U.S. Constitution from suing a state for damages." How might this impact a holder's ability to seek reimbursement?***

A11 **Diann L. Smith—McDermott, Will & Emery:** First, the Eleventh Amendment only applies to suits in federal court. Thus, it does not apply to suits for damages in state court. Second, the Eleventh Amendment does not apply when the state has consented to suit – which, arguably, Delaware has in its refund statute in §1144(d).

NEXT STEPS FOR UNCLAIMED PROPERTY HOLDERS UNDER AUDIT OR VOLUNTARY DISCLOSURE

As the court cases develop, the situations and considerations projected here may change. If your organization is currently under audit or VDA—or finds itself under examination at any time before the cases are resolved—it is advisable to work with a professional audit consultant and legal experts with specific experience in these issues to determine the current status and impact of court cases and what steps to take. For more information about this and other unclaimed property matters, contact your MarketSphere representative.

Thank you to our colleagues at McDermott, Will & Emery for sharing their knowledge and insight on this important topic:

Steve Kranz, Partner
McDermott, Will & Emery

Through organizations such as the National Conference of State Legislatures (NCSL), Steve has worked on numerous unclaimed property policy issues. One example is the use of contingent fee-based third-party auditors. At McDermott, Steve engages in all forms of taxpayer advocacy, including audit defense and litigation, legislative monitoring, and the formation and leadership of taxpayer coalitions. He is at the forefront of state and local tax issues, including developments arising in the world of cloud computing and digital goods and services. He assists clients in understanding planning opportunities and compliance obligations for all states and all tax types, including unclaimed property. His approach to taxpayer advocacy brings strategic thinking together with skills for the courtroom and the statehouse.

Diann L. Smith
Counsel

For several years before joining McDermott, Diann led the Unclaimed Property Task Force of the Council on State Taxation (COST). At McDermott, she focuses her practice on state and local taxation with an emphasis on tax challenges relating to compliance, controversy, planning and legislative activity. Diann has experience representing clients in nexus, tax base, business and non-business income classification, apportionment and FIN 48 compliance issues. She has also counseled clients on multi-state unclaimed property compliance and voluntary disclosure opportunities. Diann has represented clients from a broad range of industries, including retail, insurance and communications services. She serves as outside counsel on state tax and unclaimed property matters for the Entertainment Software Association, the National Retail Federation and the Retail Industry Leaders Association.