FUNDAMENTALS OF THE ESCHEAT OF ABANDONED PROPERTY

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I. Introduction.

A. States have long claimed the power of escheat over abandoned property, characterizing themselves as taking custody of the property from the holder of the property for the benefit of the property's rightful owner.

While state laws relating to the escheat of abandoned property have existed for many years, until recently there was relatively little awareness of or compliance with these laws.[1] In part, that may be because abandoned property laws are typically administered by the state department of financial institutions or similar agency, not the department of revenue. Such agencies frequently have small budgets, limited audit staffs and, therefore, limited ability to enforce the state's abandoned property laws.

B. All states and the District of Columbia have enacted statutes requiring holders of unclaimed property to report and deliver such property to the appropriate state. In large part, the states laws are derived from the 1954, 1966, 1981, or 1995 Uniform Unclaimed Property Acts.

The National Conference of Commissioners on Uniform State Laws drafted the 1954 Uniform Act as an effort to promote uniformity in state unclaimed property laws, especially with regard to those principles which determine the states' priority to take possession of abandoned property. More than a dozen states still follow the 1954 Uniform Act and its 1966 revision.

C. In general, under state abandoned property statutes intangible personal property is presumed to be abandoned if:

1. The intangible personal property is held or issued in the ordinary course of the holder's business; and

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[1] Industries that have been the traditional audit targets include banks and other financial institutions, public utilities, and insurance companies.

2. The intangible personal property constitutes a debt or obligation running from the holder to its creditor or owner; and

3. The intangible personal property has remained unclaimed by the owner for more than the statutory period of time (typically five years) after the intangible personal property becomes payable or distributable by the holder to the owner.[2]

D. Examples of unclaimed property subject to escheat include uncashed payroll checks, uncashed payments to suppliers, uncashed dividend checks, customer overpayments, unreturned deposits, and uncashed refund checks.

In addition, gift certificates are escheatable under the uniform acts (see below); however, not all states treat gift certificates as escheatable property. See, e.g., Matter of November 8 Determination of the State of New Jersey, Department of Treasury, Unclaimed Property Office, 156 N.J. 599 (1999), affirming the decision of the Appellate Division, 309 N.J. Super. 272 (1998). In Matter of November 8, the New Jersey Supreme Court adopted the Appellate Division's holding that, under the state laws, unclaimed gift certificates redeemable only for services and merchandise, and not for money, are not escheatable to the State of New Jersey. The Appellate Division first noted that the relevant New Jersey statute omits gift certificates from a statutory listing of escheatable intangible property, and then concluded that the omission was intentional. As stated by the Court

> "When any of these claims to the payment of money [expressly identified in New Jersey law] are transferred to the State, the obligors can readily discharge them by the paying the State what they would have paid to the prior owners… The issuers of gift certificates, however, frequently do not bind themselves to pay money. The contractual terms of the Hilton gift certificates which are the subject of this suit provide that they can be redeemed only for services or merchandise. We have denied the State the right to exact cash by escheating obligations which do not bind the obligor to pay money."

E. In certain cases, the amount to be escheated to a state may be less than the face amount of the abandoned property. For example, a holder may be able to deduct service charges. Or the property may be a gift certificate (or other unused customer deposit), such that the profit-element is not escheatable.

1. Service charges. Holders maybe able to deduct service charges from the face amount of the abandoned property if the service charge (i) is

[2] In general, there have been reductions in the length of the required dormancy periods. For example, under the 1995 Uniform Act the statutory dormancy period for gift certificates has been set at three years after the year in which the certificate is issued. Section 2(a)(7) of the 1995 Uniform Act. The 1981 Uniform Act treated gift certificates as being escheatable five years after issuance, under a characterization as miscellaneous intangible property. Section 2(a) of the 1981 Uniform Act.

authorized by a valid and enforceable written contract between the holder and owner, (ii) is regularly imposed by the holder, and (iii) is not regularly reversed, waived or cancelled by the holder. Section 5 of the 1995 Uniform Act follows case law in providing that a service charge may be disregarded unless those conditions are satisfied. In addition, the amount of the service charge may not be unconscionable.

2. Gift certificates. The 1995 Uniform Act presumes that 40% of the face value of a gift certificate represents the profit that the issuer would have made if the owner had used the gift certificate to purchase merchandise. Section 2(a)(7) of the 1995 Uniform Act. Therefore, under that Act only 60% of the face value of unclaimed "merchandise-only" gift certificates is required to be reported as abandoned property. (Compare to the 1981 Uniform Act, which requires the holder to report the face value of unclaimed gift certificates. Section 14(b) of the 1981 Uniform Act.)

F. Business to Business Transactions. Some states exempt outstanding balances on certain business to business transactions from their escheat provisions. See e.g., Illinois law Section 765 ILCS 1025/2a(b) ("Notwithstanding the provisions of Subsection (a), any property due or owed by a business association to or for the benefit of another business association resulting from a transaction occurring in the normal and ordinary course of business shall be exempt from the provisions of this Act.")

II. Nexus. Abandoned property nexus rules have become increasingly relaxed since the first Uniform Act. For example, while the 1954 and 1966 Uniform Acts limit states to making claims against only those holders doing business in the state, the 1981 Uniform Act contains no such limitation. Currently, the proper nexus standard to be applied may range anywhere from the strict "doing business" standard to the physical presence standard of Quill Corp. v. North Dakota, 504 U.S. 298 (1992) and National Bellas Hess Inc. v. Illinois Dept. of Rev., 386 U.S. 753 (1967) or even to the lesser "long-arm" jurisdictional standard used for service of process under state civil procedure rules.

Indeed, many states take the view that nexus between the owner and the state is not required, instead asserting that a "mere debt/contract-right" standard applies. Under this theory, the states assert that they are "stepping into the owner's shoes" and therefore that they are entitled to require a holder to report escheatable property that belongs to an owner located in that state. Moreover, the 1995 Uniform Act permits states to require holders to report and deliver unclaimed property to the state even if the holder does not "do business" in that state. The Commissioners claim additional support for this jurisdictional standard under the United States Supreme Court's rationale in Texas v. New Jersey, 379 U.S. 674 (1965) (discussed below) and under the doctrine of mobilia sequuntur personam: The principle that movables follow the law of the person. Thus, under that doctrine the determination of ownership of intangible personal property is governed by the law of the owner's domicile.

Finally, even if a state does not have nexus to sue a business in its own court system, it may be able to bring suit in the state court system where the business is located.

III. Priority Rules. General priority rules of Texas v. New Jersey and the 1981 Uniform Act.

A. The first priority claim to the abandoned property is to the state of last known address of the apparent owner (i.e., the person whose name appears on the business records of the holder), as shown on the business records of the holder.

1. Under the 1981 Uniform Act, the state of last known address is an address sufficient for sending mail to the apparent owner. A holder of escheatable property may rely on the name of the owner and the last known address of the owner in its books and records.

2. The 1995 Uniform Act modifies the rule to require only some indication in the holder's records (e.g., a computer code or E-mail address) that the apparent owner's last known address was located in a particular state.

B. If the apparent owner's address is unknown, or if the apparent owner resides in a state that does not claim the abandoned property (or in a foreign country), the holder's state of corporate domicile (i.e., state of incorporation or place of principal business of a noncorporate holder) has the next claim to the abandoned property.

C. The initial claim of the holder's state of corporate domicile to abandoned property remains subject to a subsequent claim by the state of the owner's last known address, if that state can prove that the address of the owner was within its borders or if it subsequently enacts an unclaimed property law. Section 25(a) of the 1981 Uniform Act.

IV. Abandoned Property Audits.

A. Limitations Periods. Holders are required to retain records of owner names and last known addresses (if they obtain this information in the first instance) for ten years. Under the 1981 Uniform Act, that information must be retained for 10 years after the property is reportable; under the 1995 Uniform Act, that information must be retained for 10 years after the report is actually filed.

Compare the 1981 Uniform Act, Section 29[3] with the 1995 Uniform Act, Section 19[4].

B. Contract Auditors. Third-party audit firms have brought increased attention to state abandoned property laws by performing contingency fee audits.

1. The third-party audit firms have contracted with states to conduct abandoned property audits on their behalf. Through these audits, states have tapped into new revenue sources.

2. The third-party audit firms have extended abandoned property audits beyond the traditional spheres of financial institutions, insurance companies and public utilities.

3. Embedded issues:

a. Legality/propriety of contract auditing, particularly with regard to holder privacy issues and the states' ability to assign their authority/delegate their responsibilities.

b. Legality/propriety of contingent fee contracts.

(A) Sears, Roebuck and Co. v. Parsons, 260 Ga. 824 (1991). Contingent fee arrangements violate public policy.

(B) Appeal of Philip Morris U.S.A., 335 N.C. 227 (1993). Contingent fee arrangements do not violate public policy.

C. Audit Techniques. It is common practice for unclaimed property auditors to use some type of estimation or extrapolation technique to calculate the amount of unclaimed property due for the audit period.

The 1981 Uniform Act specifically provides that when a holder fails to maintain/keep adequate records of its unclaimed property for the audit period, the state is allowed to "estimate" the amount of unclaimed property due from any available records of the holder. The 1995 Uniform Act specifically allows unclaimed property administrators to use reasonable estimation techniques. Section 20(f) of the 1995 Uniform Act and Section 30(e) of the 1981 Uniform Act.

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[3] "No action or proceeding may be commenced by the administrator with respect to any duty of a holder under this Act more than 10 years after the duty arose." 1981 Uniform Act 1981, Section 29.

[4] "An action or proceeding may not be maintained by the administrator to enforce this Act in regard to the reporting, delivery, or payment of property more than 10 years after the holder specifically identified the property in a report filed with the administrator or gave express notice to the administrator of a dispute regarding the property. In the absence of such a report or other expressed notice, the period of limitation is tolled. The period of limitation is also tolled by the filing of a report that is fraudulent." 1995 Uniform Act, Section 19.

Some states may be limited in their estimation techniques by the wording of the state's statute. For instance, Illinois requires that any estimation technique must "conform to either generally accepted auditing standards or generally accepted accounting principles." 765 ILCS 1025/11.5(a).

V. Other Issues.

A. "Private Escheat" or Anti-Limitations Statutes.

1. Holders should not be required to report and turn over to the state unclaimed property that no longer constitutes a legal obligation of the holder to the owner, as a state's claim to take custody of abandoned property is derivative of the owner's right to claim that property from the holder.

2. A gift certificate might not be deemed to be abandoned if it expires under its own terms before the end of the state escheat period. For that treatment to be available, (i) the terms of the expiration provision should be part of a written contract entered into between the holder and the purchaser at the time the gift certificate was purchased, and (ii) the holder should regularly enforce the expiration provision.

Even if those two requirements are met, a court may treat the expiration provision as violating public policy. See People v. Marshall Field & Co., 404 N.E.2d 368 (1980) (gift certificate remained escheatable property despite retailer's efforts to shorten expiration period of gift certificate to comply with statutory dormancy period under Illinois escheat laws).

B. Penalties and Interest Levied in Audits. Depending upon the state, penalties, interest and administrative fees may be levied against a holder who fails to pay or report unclaimed property to the state within the time prescribed by law. All four Uniform Acts (1954, 1966, 1981 and 1995), have some provision for fines, penalties or interest to be levied against holders who fail to pay unclaimed property to the state. The 1954 and 1966 Acts are very limited, providing for the possibility of fines in certain circumstances, while not providing for interest or penalties. The 1981 and 1995 Acts are more expansive and require interest and penalties from holders who fail to pay or deliver property to the state.

In many cases, however, interest or penalties may be waivable by the administrator of the state's unclaimed property law. For example, Section 24 of the 1995 Uniform Act specifically provides that "the administrator for good cause may waive, in whole or in part, interest under Subsection (a) and penalties under Subsections (b) and (c), and shall waive penalties if the holder acted in good faith and without negligence."

C. Voluntary Disclosure. Given the recent aggressiveness of states with respect to unclaimed property, holders of abandoned or unclaimed property who have not reported and delivered such property to the appropriate state may find that the most prudent course is to approach the state and attempt to negotiate a voluntary disclosure agreement. In return for the holder voluntarily coming forward, beginning to deliver unclaimed property on a timely basis, and delivering prior unclaimed property, many states will agree to limit the taxpayer's retroactive liability and to waive any applicable penalties and interest.

D. Amnesty Programs. Many states periodically offer amnesty programs. For example, California's 2002 amnesty program provided for the waiver of interest (otherwise imposed at a 12% rate) for holders escheating to the state property which should have been reported to the state on or before November 1, 1999. California Code of Civil Procedure Section 1577.5.

VI. United States Supreme Court Cases.

A. Connecticut Mutual Life Insurance Co. v. Moore, 333 U.S. 541 (1948). Applying a Due Process analysis, the Supreme Court upheld New York's right to custody of proceeds of unclaimed insurance policies issued on the lives of New York residents by insurance companies incorporated in other states. The Supreme Court held that a creditor's (i.e., the insured's) state of residence has "sufficient contacts" with the proceeds to claim those proceeds.

B. Standard Oil Co. v. New Jersey, 341 U.S. 428 (1951). New Jersey, the state of corporate domicile of the holder of the unclaimed property, asserted custody of property of missing owners, even though the holder's business records indicated that the missing owners did not reside in the state. The Supreme Court sustained New Jersey's right to claim the property of the missing owners.

C. Note that Connecticut Mutual Life and Standard Oil are inconsistent, as Connecticut Mutual Life indicated that the state of the owner's residence had the best claim to abandoned property, while Standard Oil suggested that the holder's state of corporate domicile had the best claim. The result was that many states shortened the dormancy periods in their abandoned property laws in an effort to be the first state to claim abandoned property. Prior to the Standard Oil decision, dormancy periods of 14 to 20 years were used by a number of states; by 1954, some states had shortened their dormancy periods to seven years.

D. Texas v. New Jersey, 379 U.S. 674 (1965). The Supreme Court held that unclaimed benefit payments on insurance policies escheated to state of last known address of the beneficiaries; if none, then to the state of corporate domicile of the holder. The priority rules set forth in Texas v. New Jersey were then adopted in the 1981 Uniform Act, which has been adopted by 19 states and the Virgin Islands.

E. Delaware v. New York, 507 U.S. 490 (1993). The Supreme Court reviewed and reaffirmed the priority rules of Texas v. New Jersey, and made clear that the states may not legislatively supersede those priority rules. The 1995 Uniform Act retains the Texas v. New Jersey priority rules.

In Delaware v. New York, the Supreme Court also held that a "holder" is the person "legally obligated [under applicable state law] to deliver unclaimed [property] to [its] owner." For example, if the original debtor, a dividend-paying corporation, has satisfied its debt under its share agreement and under state law by transmitting payment to an intermediary securities dealer who holds unclaimed securities distributions in its own name and has undertaken to make payment, the intermediary becomes the holder. The 1995 Uniform Act incorporates the Supreme Court's holding by defining a "holder" as the person "obligated to hold for the account of, or deliver or pay to, the owner property that is subject to this Act." Section 1(6) of the 1995 Uniform Act.