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Recent Decisions Could Fuel Escheatment Audits

By **Valerie Hletko and Mark Rooney** (April 26, 2018, 5:05 PM EDT)

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The centuries-old, common-law principles by which sovereign entities take unclaimed or abandoned property are coming under renewed scrutiny in the United States, as states pursue different policies that threaten to trigger legal disputes. Companies whose businesses give rise to these types of property — including issuers of prepaid, gift and stored-value cards — may find themselves caught up in these disputes.

Most recently, two legal decisions by the U.S. Court of Appeals for the Third Circuit left a path open for states to look for unclaimed property on the books of subsidiaries operating in another state. In both cases, Marathon Petroleum Corp. v. Secretary of Finance for Delaware and Office Depot v. Secretary of Finance for Delaware, companies unsuccessfully sought to block Delaware from performing escheatment audits — decisions that could inspire more vigorous and expansive audits where unclaimed property may primarily be out of state.

While the decisions apply broadly to states' authority to conduct escheatment audits, both cases centered on abandoned value on prepaid store gift cards, and suggest that states may see significant untapped revenue relating to gift cards, rebate cards, or other stored-value cards — potentially subjecting a wide variety of financial and retail businesses to escheatment scrutiny. This is particularly true given the reliance by states on outside firms to conduct audits on a contingency basis. As a result of these decisions, companies in possession of abandoned property potentially subject to escheatment should evaluate their escheatment compliance procedures and may reassess where to incorporate their operating subsidiaries in order to minimize escheatment liability.

Marathon Case Background

The Marathon litigation began in 2016 when Marathon and certain subsidiaries sued the Delaware officials responsible for conducting state escheatment audits. The suit sought to bar the state from continuing its audit into Marathon, which had evolved to include requests for voluminous documents and information relating to some of Marathon's Ohio-based subsidiaries.[1] The subsidiaries issued "non-expiring stored-value gift cards"[2] and were "solely liable and obligated for the value of all [c]ards."[3] Marathon's challenge to the audit centered on the federal common law relating to

escheatment priority, developed through a number of Supreme Court cases.[4] As construed by the Third Circuit, those cases collectively establish that the "order of priority gives first place to the state where the property owner was last known to reside. If that residence cannot be identified or if that state has disclaimed its interest in escheating the property, second in line for the opportunity to escheat is the state where the holder of the abandoned property is incorporated. Any other state is preempted by federal common law from escheating the property."[5]

The subsidiaries did not collect address information on the owners or holders of the prepaid cards.[6] As the subsidiaries were Ohio corporations conducting business entirely outside Delaware, Marathon argued that Delaware could not claim abandoned gift card value under the Supreme Court's escheatment-priority test.[7] Accordingly, Marathon sought declaratory and injunctive relief barring enforcement of the auditor's request for documents and information relating to the subsidiaries.[8]

In the district court, Delaware first argued that the dispute was not ripe for adjudication, asserting that the state is "not able to punish Plaintiffs without first allowing Plaintiffs to present a defense," and that "there is no real threat to Plaintiffs" at the investigation stage.[9] The district court found that the claims were ripe for adjudication in light of "the real and detrimental effects of the audit process, the uncertainty regarding Plaintiffs' operating funds, and the harm caused by the ongoing, and possibly unconstitutional, audit process."[10]

Delaware also argued that Supreme Court precedent governing the priority rules for escheatment — relied on by Marathon to bar the escheatment audit — applied only to disputes between states competing for the same abandoned property and did not confer a private right of action for individuals or companies.[11] The district court agreed and dismissed Marathon's suit for failure to state a claim.[12]

The Third Circuit's Marathon Decision

On appeal, the Third Circuit concurred that dismissal of Marathon's claim was warranted but for different reasons. The court explained that there are two ways to examine the question of ripeness. "[T]o the extent the Companies are challenging Delaware's authority to initiate an audit in the first instance, the claim is ripe but wrong."[13] In other words, viewed as a purely facial challenge to the state's audit authority, the case presents no ripeness concern. However, "to the extent the Companies are challenging the scope or means of the examination in this case, the claim is not ripe, since the State has taken no formal steps to compel compliance with the audit."[14]

In reversing the lower court on the issue of standing, the court held that the Supreme Court's escheatment-priority rules do confer a private right of action even in state-on-state disputes. The court reasoned that "the Supreme Court's desire for a uniform and consistent approach to escheatment disputes indicates that a private right of action is fully appropriate."[15] In addition, some states may choose not to pursue escheated property as a deliberate public-policy choice to incentivize companies to incorporate there. The court noted that to deny individuals a right to sue to enforce escheatment-priority rules would force states like Ohio to either pursue escheated funds (contrary to their own public policy) or to sit by while other states pursue those funds, thus undermining the incentive to incorporate in Ohio. In short, "[a]llowing private parties to sue thus provides a check against one state undercutting another's decision not to escheat."[16]

The court's rulings on the preliminary issues of ripeness and standing left just one issue for merits adjudication — whether Delaware could conduct an audit at all into property that would not be

escheatable to Delaware under Supreme Court precedent (namely, the abandoned value on gift cards issued by the Ohio subsidiaries). The court held that Delaware does have the authority to conduct such an audit. The court understood Marathon to argue "that Delaware must take them at their word and cannot inquire into their books and records to see if the property belongs to them or the Ohio subsidiaries."[17] But "the Supreme Court has noted that the first step in determining the right to escheat property involves a 'determin[ation] [of] the precise debtor-creditor relationship as defined by the law that creates the property at issue.'"[18] Therefore, at a minimum, states are entitled to conduct an "appropriately targeted audit" to ascertain in the first instance whether property is subject to escheatment in that state.[19]

The Third Circuit's Office Depot Decision

Approximately seven weeks after its Marathon decision, the Third Circuit affirmed its approach in a substantially similar case, Office Depot v. Secretary of Finance for Delaware.[20] In Office Depot, the Third Circuit particularly emphasized, as it noted in Marathon, that while federal common law relating to escheatment does not generally bar state audits, it is conceivable that such an audit could "become so obviously pretextual or insatiable" that it does not constitute a legitimate inquiry into whether subsidiary companies are separate entities.[21] Accordingly, an escheatment audit "that extends beyond a legitimate inquiry into whether a subsidiary company is bona fide may well trigger the priority rules."[22]

Conclusion

The Third Circuit made clear in Office Depot that companies may not argue that an audit "extends beyond a legitimate inquiry" into corporate formalities until after initiation of an enforcement proceeding.[23] Thus, while the impact of Marathon and Office Depot on the viable scope of an audit awaits a post-enforcement challenge, the decisions may encourage states to push the envelope to that point, using escheatment audits to examine whether out-of-state entities are genuine subsidiaries of their corporate parents and whether the assets potentially at issue are assets of the parent or subsidiary company. In the meantime, holders of potentially abandoned property, including financial or retail companies offering gift cards or other stored-value cards, should review their escheatment policies and procedures for compliance with applicable state laws, and may consider reevaluating where to incorporate their consumer-facing subsidiaries.

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[1] See 876 F.3d at 487.

[2] Id. at 485.

[3] Id.

[4] Id. at 484.

[5] Id.

[6] See id. at 485.

[7] See id.

[8] See id. at 487; Marathon Petro. Corp. v. Cook, 208 F. Supp. 3d 576, 579-80 (D. Del. 2016) (lower court description of facts).

[9] 208 F. Supp. 3d at 583.

[10] Id.

[11] See id. at 585.

[12] Id.

[13] 876 F.3d at 484-85.

[14] Id. at 485.

[15] Id. at 495.

[16] Id.

[17] Id. at 499.

[18] Id. (quoting Delaware, 507 U.S. at 499).

[19] Id. at 499-500.

[20] 710 Fed. Appx. 59 (3d Cir. 2018) ("In all material respects, this case is identical to [Marathon].")

[21] Id. at 60 (quoting Marathon, 876 F.3d at 501).

[22] Id.

[23] Id.