Resistance is not Always Futile: New Decision in Ongoing Delaware Unclaimed Property Audit Litigation

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On August 9, 2017, the US Court of Appeals for the Third Circuit (Third Circuit), overruling the US District Court for the District of Delaware (District Court), allowed a claim by a holder seeking to prevent an unclaimed property audit by Delaware on due process grounds to proceed. See Plains All American Pipeline L.P. v. Cook et al., No. 16-3631 (3d Cir. Aug. 9, 2017). The procedural due process claim challenges Delaware’s use of auditors that have a stake in the assessment. Consistent with the District Court decision, the Third Circuit held that challenges to Delaware’s estimation methodology were ruled not ripe. The case has been remanded to the District Court for further proceedings.

Background

The holder, Plains All American Pipeline L.P. (Plains) brought a lawsuit against Delaware officials including the Secretary of Finance, the State Escheator, the State unclaimed property Audit Manager and third party auditor, Kelmar Associates, LLC (Kelmar). Plains challenged the audit on due process and Fourth Amendment grounds and sought to enjoin the audit from proceeding. The District Court dismissed Kelmar from the lawsuit; a dismissal that was upheld on appeal by the Third Circuit.

Third Circuit Opinion

The Third Circuit upheld the dismissal of the audit methodology claims because they were not ripe (also analyzed under a standing theory). In reaching this conclusion, the Third Circuit applied a three point analysis. First, it found there was no adversity of interest (this is where some holders are openly laughing out loud regarding the existence of “adversity”). The court believed that “estimation merely requires Plains to sit back and wait while Delaware calculates its liability.” See Plains (3d Cir.), p. 13. It seems that the court did not fully understand what an audit relying on estimation requires of a holder. This misunderstanding would not have changed the ultimate result, however, because the court found that even the potential for a burdensome audit was not sufficient to create ripeness in the challenge to the methodology because the burden was purely conjectural until the audit was actually conducted. This seems to be a circular conclusion that does nothing to protect a holder. The court also found that a threatened penalty for non-compliance was not imminent enough. Second, the Third Circuit found that a facial challenge to the audit methodology, even if primarily legal, needed additional factual development. Sadly, it reached this conclusion based on the vagueness of the estimation statute itself. Since the statute did not define estimation, the court was unclear whether some constitutional methods could be found. Finally, the Third Circuit decided that a judgment at this point would not affect Plains’ actions in the future. The Third Circuit reversed the District Court’s dismissal of the procedural due process claim regarding the use of auditors paid based on results. The court found this claim ripe because Plains was required to submit a dispute to a self-interested party. Given this development, the challenge in this litigation moving forward is regarding how an auditor is compensated, not the audit methodology itself.

Practice Note
It is unfortunate that the courts continue to dismiss pre-audit claims to Delaware’s audit methodology. This methodology is not uncertain or speculative, as it is: (a) routinely used in almost every audit; and (b) memorialized in the recent proposed regulations. Holders are left with the choices of complying with an audit that uses potentially unconstitutional methods or declining to comply such an audit, with the resulting risks of a subpoena and noncompliance penalties.

The remand to the District Court regarding the constitutionality of using auditors paid based on results raises some options for holders currently under audit to consider. For example, a holder could follow Plains’ approach and seek an injunction in court. A holder could also refuse to move forward with the audit until the constitutionality of the auditor compensation arrangement is determined, risking a subpoena and penalties. Alternatively, a holder could continue to power through an audit with a potentially unconstitutional auditor compensation arrangement. If the holder proceeds with an audit, it is not clear what the remedy (if any) would be, should the auditor’s compensation ultimately be invalidated at the conclusion of the litigation.

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