



Unclaimed Property ADVISORY ■

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Third Circuit Continues the Marathon Battle Over Delaware's Escheat Law

On December 4, 2017, the Third Circuit Court of Appeals vacated the Delaware federal district court's dismissal of the plaintiffs' claims in *Marathon Petroleum Corp., et al. v. Cook*. The court held that the plaintiffs did in fact have standing to challenge a state's authority to conduct an audit and escheat unclaimed property under the federal common law jurisdictional escheat rules established by the U.S. Supreme Court in *Texas v. New Jersey*. The court also reaffirmed its prior ruling that the *Texas* rules constitute the only bases under which states may escheat unclaimed intangible property. However, the court also held that the plaintiffs' challenge to the scope of the state's audit was not yet ripe and remanded the case to the district court to clarify that the dismissal was without prejudice so that the plaintiffs could possibly bring their claims at a later date.

Background

[We summarized](#) the district court's ruling last year. Through its third-party auditor, Kelmar Associates, Delaware had initiated an unclaimed property audit of Marathon Petroleum Corporation and Speedway LLC. As part of the audit, Kelmar requested "extensive detailed information" about Marathon and Speedway's affiliated entities, Marathon PrePaid Card LLC (MPC) and Speedway Prepaid Card LLC (SPC), which are Ohio-domiciled LLCs. Under a prepaid card agreement, MPC issued Marathon-branded gift cards that were sold and redeemable at Marathon retail locations. When Marathon sold an MPC-issued card, it transferred the funds to MPC, and when a card was later redeemed by Marathon, MPC transferred the funds to Marathon. SPC had a similar agreement with Speedway to issue Speedway-branded cards.

In response to Kelmar's request, Marathon and Speedway produced documents demonstrating that MPC and SPC were not Delaware-domiciled entities to show "that Delaware lacks standing to claim any unredeemed gift cards, even if any exist." Kelmar responded in a letter stating that failing to comply with the request "will result in the Office [i.e., the State Escheator] referring the matter to the Attorney General's Office for consideration of enforcement action."

Marathon and Speedway, along with their affiliated entities, filed a complaint in federal district court seeking a declaratory judgment and injunctive relief against Delaware's audit requests because Delaware's actions were preempted by and in violation of federal law—i.e., the federal common law rules regarding when a state has the power to escheat unclaimed property established in *Texas v. New Jersey*—and constituted an unreasonable search in violation of the Fourth Amendment.

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The district court granted Delaware's motion to dismiss, holding that although the plaintiffs' claims were ripe, the federal common law rules established in *Texas v. New Jersey* do not apply to disputes between a state and a private party. The plaintiffs appealed this holding, but did not appeal dismissal of their Fourth Amendment claims.

Federal Common Law Rules and Private Right of Action

Citing its earlier opinion in *N.J. Retail Merchants Association v. Sidamon-Eristoff*, 669 F.3d 374 (3d Cir. 2012), the Third Circuit held that the federal common law rules established by the Supreme Court created a private right of action to challenge a state's unclaimed property audit and escheatment of unclaimed property. The court noted that one of the original defendants in *Texas* was a private party, and it would be nonsensical to allow a private party to be sued in a dispute over these rules but not allow the same party to bring suit to enforce the rules when the same interests are at stake. According to the court, these rules "were created not merely to reduce conflicts between states, but also to protect individuals," and "[d]enying a private right of action would leave property holders largely at the mercy of state governments for the vindication of their rights." Furthermore, a private right of action serves the public interest by "aiding states in the maintenance of their sovereignty" (e.g., states like Ohio that have made the decision not to escheat certain property such as gift cards) and supporting "a uniform and consistent approach to escheatment disputes." The court directly overruled the district court's earlier conclusion in *Temple-Inland* that the priority rules applied only to disputes among states, concluding that "without a private cause of action, the *Texas* trilogy's protections of property against escheatment would, in many instances, become a dead letter."

The court also rejected Delaware's argument that a private right of action is inappropriate because holders do not have a lawful interest in the unclaimed property. Because the plaintiffs were entitled to keep the funds under Ohio's unclaimed property law unless and until the cardholder redeemed the card, the court held that the plaintiffs had a "very real entitlement" to the funds.

The Third Circuit also emphasized that the federal common law rules set forth in *Texas* constitute the only bases under which states can escheat unclaimed intangible property. The court expressly stated that "[a]ny other state is preempted by federal common law from escheating the property." Citing *N.J. Retail Merchants Association*, the court reiterated that "the Supreme Court's 'primary concern' in the *Texas* cases 'was to clearly and definitively resolve disputes among states regarding the right to escheat abandoned property,' and that 'allowing states to implement additional priority rules' was incompatible with that precedent and would create uncertainty. Therefore, the two states allowed to escheat under the priority rules of the *Texas* cases are the *only* states that can do so." This definitive language will be very helpful to holders (and owners) of property that seek to challenge state escheatment claims that are not specifically sanctioned by the *Texas* rules, including: (1) escheatment of foreign-address property; (2) escheatment based on where the transaction giving rise to the property occurred; and (3) escheatment based on the address records of a person other than the holder of the property.

Ripeness of the Challenge to Delaware's Audit

Despite reversing the district court on the issue of the plaintiffs' standing to challenge the state under the federal common law rules, the Third Circuit concluded that the plaintiffs' challenge was not yet ripe.

The court characterized the plaintiffs' lawsuit as either challenging Delaware's authority to audit the plaintiffs in the first place or challenging the scope and intensity of the audit. While the first challenge is ripe for adjudication, the court held that Delaware "plainly" had the authority to conduct an audit and "dig for information about who, a parent

or a subsidiary, is the true holder of escheatable funds.” The court found that this authority was consistent with the first step in determining the right to escheat property as established by *Texas*, which is to make a determination of the “precise debtor-credit relationship as defined by the law that creates the property at issue.” The court also found that the *Texas* trilogy does not restrict the state from looking within the four corners of the contracts in question in making this determination. Rather, exploring an alter ego theory “involves consideration of a variety of factual questions.” Thus, the court concluded that the *Texas* cases do not “foreclos[e] a state’s right to conduct an appropriate examination to determine if there is fraud or another basis for determining that property may be escheated, even if a contract viewed in isolation might suggest otherwise.”

However, the court made clear that its decision does not “foreclose the possibility that a state’s demands for information may become so obviously pretextual or insatiable” as to lead to conflict preemption. In such circumstances, the court stated that “it would defy logic to hold that the process itself [i.e., the audit] cannot be preempted.” The court then held:

When an audit process drags beyond a legitimate inquiry into whether subsidiary companies are in fact bona fide, separate entities, the priority rules may be triggered and the State’s audit process preempted. Determining the difference between a state’s legitimate inquiry into a parent-subsidiary relationship, on the one hand, and, on the other, an abusive process designed to force a monetary settlement, may not always be a simple matter. Hard or not, though, it will have to be done and, in the event, the effort will likely be guided in part by asking whether the state has gone past what is needed to address familiar standards used to distinguish bona fide subsidiaries from mere alter egos.

However, although the scope of an audit may exceed Delaware’s examination authority under federal and state law and lead to conflict preemption if the state pursues inquiries beyond confirming that the gift card entity is a “bona fide, separate entity,” the court held such a challenge was not yet ripe in this case. When the plaintiffs filed suit, Delaware had not even formally demanded they comply with the audit or else risk facing penalties. Moreover, quoting its recent decision in *Plains All American Pipeline LLC v. Cook*, 866 F.3d 534 (3d Cir. 2017), the court stated that “even if Delaware makes a formal demand for documents, the costs of administrative investigations are usually not sufficient, however substantial, to justify review in a case that would otherwise be unripe.” And, given the limited factual record, a decision on the merits would be inconclusive because “the validity of Delaware’s audit may turn largely on how it is enforced, and also on the question of who in fact is the holder of the property.”

Furthermore, in light of Delaware’s [recent overhaul of its unclaimed property statute](#), the court stated that it may be appropriate to allow Delaware courts to address state law issues regarding the scope of Delaware’s audit authority and state law remedies before federal courts weigh in.

Still, the court appeared to take a dim view of Delaware’s aggressive auditing practices and the use of contingency fee auditors. After quoting the district court’s decision in *Temple-Inland Inc. v. Cook*, 82 F. Supp. 3d 539 (D. Del. 2015), [which described Delaware’s audit process](#) in that case as a “game of ‘gotcha’ that shocks the conscience,” the Third Circuit stated that “Kelmar’s financial incentive to claim as much escheatable property as possible taints the entire process with an appearance of self-interested overreaching.” According to the court, the plaintiffs have “good reason to be concerned that Delaware may claim property that it is not entitled to escheat.”

The Third Circuit’s opinion in *Marathon* could prove to be a significant boon for unclaimed property holders in future challenges to overbroad audits conducted by Delaware, or any other state. The court also provides insightful language regarding the contours of a state’s authority to conduct an alter ego inquiry into parent-subsidiary relationships, including language that would support a preemption claim if the process turns from investigative to abusive.

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