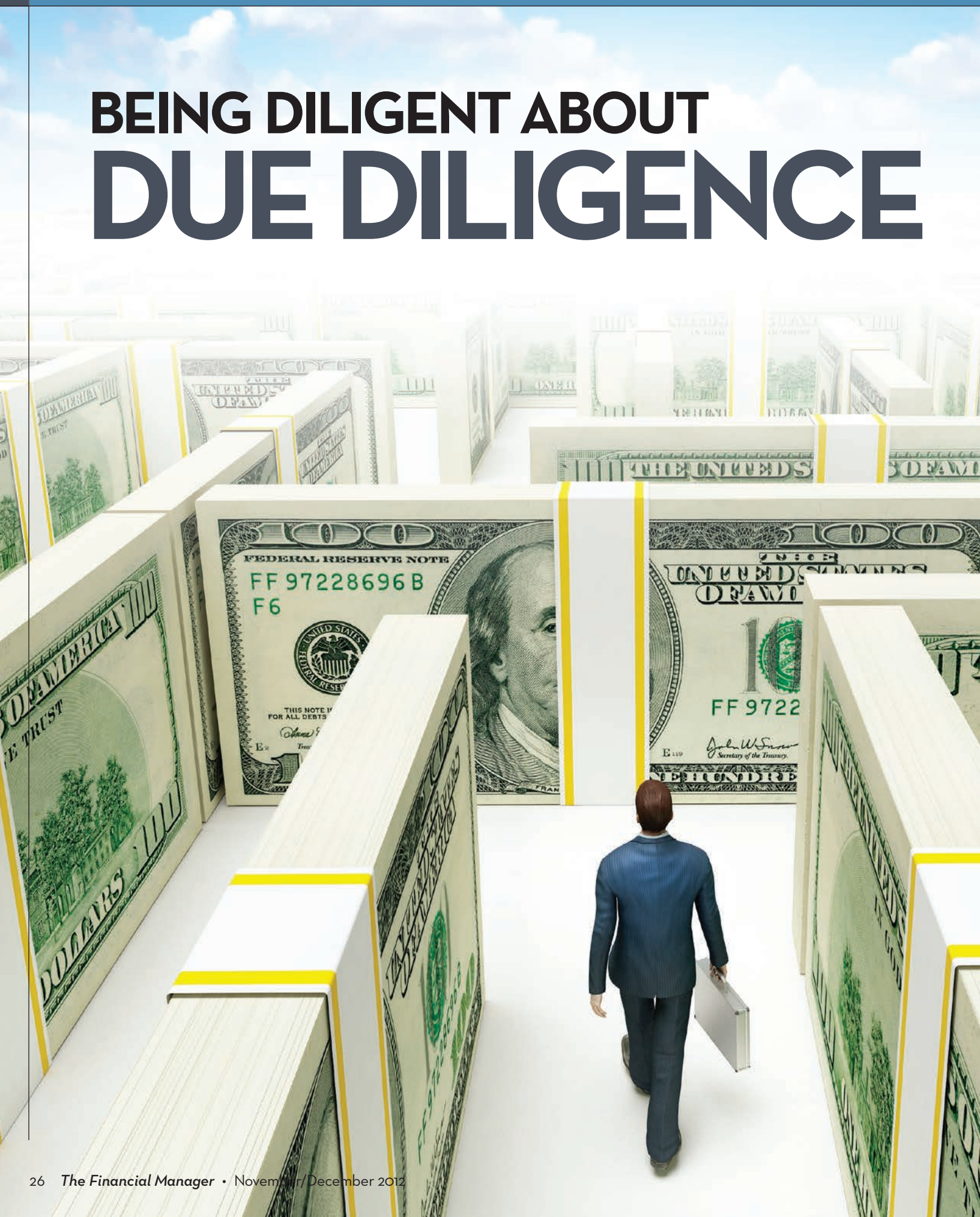
BEING DILIGENT ABOUT DUE DILIGENCE



Finding owners of unclaimed property with monetary value has become more pressing. There are unfortunate consequences for those who fail to do so.

By KELLIE A. LANFORD & MARSHAL T. KLINE

Unclaimed property audits are on the rise, thanks in large part to an environment of ever-growing state budget deficits. As states attempt to balance their budgets by generating revenues from unclaimed property audits, property owners have likewise become just as aware of the potential for generating additional cash flow from these "forgotten" monies.

In these difficult economic times, it can be a pleasant surprise to find your name listed in a state or national database as an owner of unclaimed property. So, what does this mean to holders of unclaimed property? People who find themselves in this situation should pay close attention to their due diligence reporting responsibilities.

Failure to comply with the proper due diligence requirements can create additional risk in the form of scrutiny from both states and the rightful property owners. While you may be aware of a state's ability to assess penalties for the performance of improper due diligence (or for lack of performance), you may be surprised to learn that rightful property owners have successfully litigated lawsuits against corporations over these same infractions.

Take, for example, recent litigation in California and Delaware in which rightful property owners sued corporations for delivering property to the state without having conducted proper due diligence.

The Case Against HP

In *Vondjidis v. Hewlett Packard Corp.,* Vondjidis was an engineer employed by Hewlett Packard (HP) in Athens, Greece. Vondjidis provided his home address to HP on an application through which he purchased shares of HP stock pursuant to an employee stock purchase plan. However, HP corporate policy was to list the employee's work address in its shareholder records. After HP closed its Athens, Greece office, all correspondence from HP to Vondjidis with respect to his stock interests was returned as undeliverable, and HP ultimately transferred Vondjidis' shares of stock to the state as unclaimed property.

Vondjidis filed suit against HP, claiming that HP had not exercised proper due diligence before transferring the shares to the state. HP argued that Vondjidis' claim should be rejected due to the immunity provisions provided under Part 3 of Title 10 of California's Code of Civil Procedure, (sections 1321 and/or 1532(d)), which governs the transfer of unclaimed property to the state.

Section 1321 contains a general immunity provision holding harmless those persons delivering money or other property to the state from any or all present or future claims with respect to the delivered property. This provision seemingly provides "absolute" immunity regardless of whether or not the holder complies with the express requirements of Title 10.

However, section 1532(d) contains another immunity provision, which relates specifically to the transfers of stock. This provision relieves the holder of interests under section 1516(b) (i.e., stock interests) from all liability once the holder has delivered duplicate certificates to the state's controller. Stock interests (under section 1516(b)) may only escheat to the state if the hold-

er does not know the location of the owner at the end of a three-year period in which the owner has neither claimed a dividend nor corresponded with the holder with respect to such stock interests.

The California Court of Appeals determined that the general immunity provision (under section 1321) did not grant "absolute" immunity to holders who had not complied with the provisions of the unclaimed property laws. The unclaimed property laws were enacted to protect the interests of property owners by locating them and reuniting them with their property, and, thus, the state Legislature never intended to grant "absolute" immunity to holders "who violated the statutory scheme in derogation of the property owner's interests."

The Court of Appeals further concluded that the immunity provision specific to the transfer of stock interests (under section1532(d)) was also consistent with the intent of the legislature, because it applied only to those transfers that were in fact escheatable to the state (i.e., the location of the owner was unknown).

Harris v. Verizon

The court in *Vondjidis* reached this decision despite the fact that several years earlier the court in *Harris v. Verizon* concluded that "absolute" immunity was the intent of the legislature.

In *Harris*, Gene Harris was an employee of GTE Corp. (later named Verizon when GTE merged with Bell Atlantic). He received shares in the corporation as a fringe benefit. However, Harris claimed that GTE never actually provided him with stock certificates or any other indicia of his stock ownership. He later discovered that GTE transferred his shares to California as unclaimed property. California subsequently sold those shares and held the proceeds on Harris' behalf.

Harris filed suit against GTE seeking damages caused by delivery of his shares to the state since he alleged that GTE was always aware of his whereabouts. The California court concluded that "absolute" immunity was granted under section 1532(d).

In other words, even though GTE failed to comply with the notice provision requirements, that fact did not "diminish the absolute immunity conferred by section 1532, subdivision [(d)]," according to the court.

The court also stated that if the immunity was conditional, then the immunity became meaningless since it was only needed when there was a wrongdoing. The court further recognized that without "absolute" immunity, holders might err on the side of caution and fail to deliver property to the state for fear of potential litigation from owners, thus denying the state the benefit of any use of the property.

Azure's Suit Against I-Flow

In another case with similar facts, *Azure Limited v. I-Flow Corp.*, the California Court of Appeals reached a conclusion consistent with that of the court in *Vondjidis*. The California Supreme Court subsequently agreed to review *Azure* in order to resolve the conflict between the appellate courts' decisions. In *Azure,* I-Flow transferred several thousand shares of its stock, which was owned by Azure, to California as escheated property. Azure filed suit against I-Flow for breach of fiduciary duty, claiming that I-Flow knew of Azure's location and that no proper notice was provided before I-Flow delivered the stock to the state.

When Azure requested that the state return its stock, California informed Azure that it had already sold the stock, but that Azure would receive the proceeds from the stock sale. Azure further sought damages from I-Flow representing the difference between the proceeds received from the sale and the value of the stock on the date that Azure learned the stock had been sold. (The value had increased from $4.62 to $17.72 per share.)

I-Flow argued that the immunity granted under section1532(d) was absolute and applied to any corporation that transferred a duplicate stock certificate to the state, regardless of whether it was in compliance with other unclaimed property requirements. The California Supreme Court determined that immunity only applied to the "holder" of stock that was actually subject to escheat. Ordinarily, since the stockholder was in physical possession of the original stock certificate, the stockholder would be considered the "holder" of this property. However, section 1516(b) deems the corporation to be the "holder" of unclaimed stock interests, and the corporation is instructed, pursuant to section 1532(d), to deliver duplicate stock certificates to the state controller.

Because the section 1516(b) provision also contains the criteria for when stock interests escheat to the state, the state Supreme Court determined that, in order to be the deemed "holder" for which immunity is granted, the "holder" must have transferred stock interests that met those criteria. The court summarized this point by stating that "this interpretation means that only a corporation delivering a duplicate certificate of stock actually subject to escheat under 1516,

TROUBLESHOOTING POTENTIAL LEGAL ACTION

Failure to comply with (or to completely disregard) a state's due diligence procedures can result in significant consequences from the rightful property owners, an outcome that may be unexpected given a corporation's reliance on a state's unclaimed property immunity provisions. In order to avoid costly claims, companies should evaluate their current due diligence procedures as compared to each jurisdiction's statutory requirements.

These areas can include, but are not limited to, identification of dormancy periods for escheatable property; proper notification requirements; the existence of standard policies that may limit the evaluation of property owner information; a timely determination of when property becomes escheatable, and the proper method for surrendering escheatable property.

Too often, companies standardize their due diligence procedures ... without fully considering the nuances of each jurisdiction.

Each state's due diligence requirements differ, and it is therefore important to ensure that your company has implemented the necessary internal controls needed to comply with those requirements. Too often, companies standardize their due diligence procedures in order to streamline the notification process without fully considering the nuances of each jurisdiction.

Although this additional diligence will undoubtedly increase your administrative burden, it may save you costly lawsuits and damages resulting from the claims of property owners as well as potential penalties assessed by the states.

subdivision (b), receives section 1532, subdivision (d)'s immunity."

The court further concluded that the immunity granted under section 1532(d) would not apply to corporations that deliver the duplicate stock certificates to the state without also complying with the notice requirements contained in section 1516(d). "This means the stock is not actually escheatable until the notice requirements are satisfied. Indeed, the notice provision would be meaningless if corporations could ignore it and still receive immunity for their actions."

Delaware Suits

In 2009, Delaware also issued an opinion with respect to its immunity provisions contained in section 1203(a) and (b) of Delaware's escheat statutes. The Delaware Supreme Court, in *A.W. Financial Services v. Empire*, was asked by the U.S. District Court for the Southern District of New York to address several questions regarding Delaware escheat law. In 1994, A.W. Financial's predecessor corporation, Tertiaire Investissement, S.A., purchased 40 shares of Integrated Technology USA stock. Due to a merger between Integrated Technology USA and Empire, Tertiaire became the owner of 30,426 shares of Empire.

During 2000, Tertiaire wrote a letter to Empire inquiring about its shares for which it never received the original stock certificates. Tertiaire submitted an "Affidavit of Loss and Indemnity Agreement" and purchased a surety bond (as requested by American Stock, Empire's transfer stock agent) so that American Stock could issue replacement stock certificates.

Approximately four and a half years later, during 2004, Tertiaire's shares of Empire were transferred to Delaware as escheated property. In 2006, Tertiaire learned that its shares of stock had been escheated to Delaware upon writing to Empire requesting that its shares be re-registered under its new name, A.W. Financial. Upon discovering that its Empire stock had been escheated, A.W. Financial claimed that the shares had been transferred to the state in violation of Delaware's escheat law, and sought compensatory damages in the amount of $870,487 (the increased value of the stock from the date that the stock was sold to the date that A.W. Financial first inquired about the stock). A.W. Financial argued that the stock interests had not been dormant for at least five years as required by Delaware escheat law at the time the interests were transferred to the state. They also argued that their address should have been stored in the defendants' records and that defendants failed to check their records.

Empire claimed that it was immune from A.W. Financial's lawsuit pursuant to Delaware's immunity provisions under section1203. Delaware's escheat statutes contain two provisions related to immunity: section 1203(a) provides general immunity over delivery of property to the state, and section 1203(b) provides immunity with respect to the delivery of stock interests to the state.

Azure filed suit against I-Flow for breach of fiduciary duty, claiming that I-Flow knew of Azure's location and that no proper notice was provided before I-Flow delivered the stock to the state.

Section 1203(a) states: The payment or delivery of property to the state escheator by any holder shall terminate any legal relationship between the holder and the owner and shall release and discharge such holder from any and all liability to the owner … by reason of such delivery or payment, regardless of whether such property is in fact and in law abandoned property and such delivery and payment may be pleaded as a bar to recovery and shall be a conclusive defense in any suit or action brought by such owner … against the holder by reason of such delivery or payment.

Section 1203(b) states: "Upon the delivery in good faith of a duplicate registration of an uncertificated security to the state escheator … the holder and any transfer agent, registrar or other person acting for or on behalf of the holder in executing or delivering such duplicate certificate or effectuating such registration, is relieved of all liability of every kind to every person."

Both A.W. Financial and Empire agreed that section 1203(b) was applicable to the escheat issue at hand since subsection (b) was explicit to the escheatment of stock interests. Empire, however, also contended that section 1203(a) was applicable as well. The Delaware Supreme Court explained that, if "read literally, subsection (a) is applicable to the escheat at issue here because: (i) subsection (a) applies to the payment or delivery of 'property' to the state escheator by any 'holder,' (ii) 'property' includes 'intangible ownership interests in corporations;' and (iii) 'holder' includes 'the issuer of any intangible interest in a corporation.'"

As a result, if read literally, and in cases where stock interests are escheated, a conflict existed between subsection (a) and (b). Unlike subsection (b), subsection (a) imposed no requirement that the delivery of property to the state be made in good faith. The Delaware Supreme Court determined that "absurd results" would be created in instances where subsection (a) was also used to cover property escheated under subsection (b).

The court stated that "the only sensible construction is that subsection (b) applies exclusively, because only that interpretation would effectuate the General Assembly's intent where securities are the property being escheated."

The court further explained that subsection (a) pre-dated subsection (b), which most likely was added to create a safeguard against improperly escheating stock interests; therefore, the construction as adopted by the court made more sense from a policy standpoint. As a result of the Delaware Supreme Court's ruling, Empire will now be required to show that it acted in good faith in order to seek protection under the subsection (b) immunity provision. The unconditional immunity granted under subsection (a) will not be available to it as a defense.

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Any excerpts and/or references to Title 10 of the California Code of Civil Procedure in this article are from the statutes in effect prior to the Jan. 1, 2010 California amendments. In 2007, the California legislature amended section 1532, thereby re-designating subdivision (b) as subdivision (d) without change. In order to provide consistency in the terms utilized throughout this article, the court's references to the immunity provisions of section 1532(b) in Harris and this article's discussion of the aforementioned case have been cited as section 1532(d).