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It's Not A Party Unless You Are Invited: Texas Court Rules Due Process Must Be Followed In Unclaimed Property Cases

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In *Metromedia Restaurant Services, Inc. v. Strayhorn*, No. 03-05-00006CV, 2006 Tex. App. LEXIS 1126 (Tex. App. – Austin, Feb. 10, 2006), the Third District Court of Appeals (the “Court”) ruled that due process requirements must still be met even in the arena of unclaimed property. Steak & Ale of Texas, Inc. (“S&A Texas”) and Metromedia Restaurant Services, Inc. (“Metromedia”) were subsidiaries of S&A Corporation (“S&A”), a holding corporation that operates a variety of restaurants in a number of different states. S&A Texas operates Steak & Ale restaurants in Texas while Metromedia provides home office administrative services to both S&A and S&A Texas. The Court found that due process requirements must be met as to each individual entity.

Proceedings Below

During the course of an unclaimed property audit, the Comptroller of the State of Texas (the “Comptroller”) discovered that S&A had improperly deducted a \$15 processing fee from amounts of wages deemed unclaimed under the Texas Property Code. In seeking to recover the improperly retained amounts, the Comptroller did not assess S&A, the party that had delivered the funds to the Comptroller and reported itself as the holder of the unclaimed wage amounts. Nor did the Comptroller assess S&A Texas, the employer. Instead, the Comptroller assessed Metromedia, the company that performs administrative services for these companies. Metromedia filed a district court action to challenge the Comptroller’s assessments. The Comptroller never filed a claim against either S&A or S&A Texas. Neither was joined as a party in the district court action, nor did either entity ever enter an appearance in the district court action.

At trial, the Comptroller took the position that Metromedia was liable for the unclaimed amounts because it operated as a single business enterprise with both S&A and S&A Texas. The Comptroller argued that if the jury found all three entities were part of a single business enterprise, judgment could be granted against any one of them regardless of whether they had been joined as parties to the suit. The jury found that all three entities were holders of the unclaimed property. The jury also found that Metromedia operated as a single business enterprise with both S&A and S&A Texas. Based upon these jury findings, the district court entered judgment against all three of the entities, jointly and severally, for the entire amount of the improperly retained processing fees as well as statutory penalties and interest.

The Court of Appeals' Decision

The parties appealed to the Third District court of Appeals, raising both jurisdictional and substantive claims. S&A and S&A Texas challenged the judgment because they had not been properly served or joined as party to the lawsuit. Metromedia challenged the decision below on substantive grounds.

Jurisdictional Issues

In analyzing whether S&A and S&A Texas could be held liable for the improperly retained funds, the Court began by noting basic tenets of due process under Texas law. One fundamental tenet prohibits judgment against any defendant unless there has been service of process, acceptance or waiver of process, or an appearance by the defendant. A second tenet of Texas due process law mandates that it is essential that judgment may not be granted in favor or against any party not named in the lawsuit. The Comptroller had not named either S&A or S&A Texas as a party, and neither entity had ever accepted or waived process nor entered an appearance in the lawsuit. Based on these facts, the Court ruled that judgment against S&A and S&A Texas was improper and void.

The Comptroller argued that there was no need to name each entity in the lawsuit because the jury found Metromedia operated as a single business enterprise with both S&A and S&A Texas. According to the Comptroller, this finding essentially makes all of the entities one and the same such that naming one party to the lawsuit had the legal effect of naming all of the entities. The Court refused to accept this theory stating that corporate-veil-piercing theories such as alter ego or single business enterprise do not abrogate the requirements of due process in Texas. All parties must still be afforded notice and an opportunity to appear and defend themselves before being subjected to civil liability. The Court noted that even if parties have identical interests and identical defenses, which most parties surely would not, each entity as a matter of due process must be afforded an opportunity to evaluate claims made by adverse parties and decide for itself how to defend such claims. Parties with seemingly identical interests, the Court continued, can have significant differences in how to protect their interests and how to litigate disputes issues.

Unclaimed Property Issues

Metromedia challenged the district court's actions by claiming that it was not the "holder" of the disputed funds as defined under the Texas Property Code. The statute defines a holder of unclaimed funds as a person who is: (1) in possession of property that belongs to another; (2) a trustee; or (3) indebted to another on an obligation. The Comptroller did not assert that Metromedia was a trustee for the unclaimed funds. Therefore, the Comptroller bore the burden of establishing that Metromedia was either in possession of the funds or indebted to the employees of S&A Texas.

In analyzing Metromedia's substantive claim, the Court found that the Comptroller failed to meet its burden of establishing that Metromedia was the holder of the unclaimed funds. Evidence that Metromedia handled payroll responsibilities for S&A and S&A

Texas and that Metromedia provided administrative services with respect to the reporting of the unclaimed wages was insufficient. The Court specifically noted that this evidence did not establish that Metromedia was in possession of the wages in question or that Metromedia was indebted to the employees of S&A Texas.

The Comptroller introduced evidence that the S&A affiliated group participated in a daily cash sweep function. As part of this sweep, all funds received by S&A Texas and Metromedia were transferred from each subsidiaries' respective bank account into a "concentration account" maintained by S&A. As each subsidiary incurred payment obligations, funds equal to those obligations would be transferred from the concentration account into each subsidiaries' respective bank account. As a result, each subsidiaries' bank account was a zero balance account which showed a zero balance at the close of each business day.

The Comptroller also introduced evidence that at least some of the payroll checks that went unclaimed by S&A Texas employees were written on the Metromedia bank account and that, should a S&A Texas employee lose his or her payroll check, the lost check would be reported to Metromedia who would then issue another check. The Court found this evidence did not indicate that Metromedia held the unclaimed wages. Evidence that the funds for claimed wages passed through Metromedia's accounts was not evidence that Metromedia currently had or ever had in its possession funds representing the unclaimed wages of the S&A Texas employees.

In contrast, the Court noted that there was ample evidence that S&A was a holder and in possession of the funds in question. There was no dispute that S&A reported the unclaimed wages to the Comptroller, paid the unclaimed wages (minus the improper processing fee) to the Comptroller and admitted that the monies for the unclaimed employee checks was to come out of its concentration account. However, because S&A was not properly before the Court, the Comptroller could not pursue S&A for the illegal processing fees without violating due process concerns.

Practical Implications

Taxpayers who are members of an affiliated group of corporations that face a Comptroller challenge for unclaimed funds should closely examine each entity being pursued by the Comptroller to ensure that such entity or entities are the proper parties for collection purposes. This is particularly true should the affiliated group utilize a cash sweep function or a common paymaster policy. The Court's decision points out that each party with potentially liable must be enumerated by the Comptroller and have an opportunity to evaluate the merits and potential defenses to the Comptroller's claim. Should the Comptroller not pursue the correct party or parties, taxpayers may have an opportunity to forestall Comptroller action and eliminate potential assessments related to unclaimed property.■



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