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North Carolina Court Rules The State May Retain Interest Accrued On Unclaimed Property In Its Custody

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Several owners of unclaimed property have challenged states' retention of interest earned on the use of their funds as an unconstitutional taking. On February 19, 2008, North Carolina joined a growing list of states permitting interest earned on unclaimed property held in custody by the State to be retained by the State. In *Rowlette*,¹ the Court of Appeals held that "the State's retention of interest earned on unclaimed property while that property is in the State's possession is not a taking and, therefore, does not violate the United States or North Carolina Constitutions."²

Background

Over the course of 2004, North Carolina returned to three individuals (the "Plaintiffs") property that had been transferred to the custody of the State Treasurer pursuant to the North Carolina Unclaimed Property Act, N.C. Gen. Stat. §§ 116B-51 *et seq.* The Treasurer's return of the Plaintiffs' property, however, did not include the interest that had accrued while the property was held in the custody of the State. The Plaintiffs sued alleging that retention of the interest or income effected a taking of private property for public use without just compensation in violation of the Fifth and Fourteenth Amendments of the United States Constitution.³ By Order dated June 8, 2006, the Wake County Superior Court dismissed the plaintiffs' action, and the Plaintiffs filed an appeal in the North Carolina Court of Appeals.

The North Carolina Unclaimed Property Act

The North Carolina Unclaimed Property Act (the "Act") provides that the "holder"⁴ of property presumed abandoned shall pay, deliver, or cause to be paid or delivered to the Treasurer the property."⁵ A "holder" is defined as "a person obligated to hold for the

¹ *Rowlette v. North Carolina*, 656 S.E.2d 619 (N.C. Ct. App. 2008).

² *Rowlette*, 656 S.E.2d at 625-26.

³ *Id.* at 620. The Plaintiffs further alleged that the State's action violated 42 U.S.C. § 1983 and Article I, § 19 of the North Carolina Constitution and they sought a determination that the case could be maintained as a class action. These claims are not addressed in this article.

⁴ N.C. GEN. STAT. § 116B-52(5).

⁵ *Id.* § 116B-61(a).

account of or deliver or pay to the owner property.” Under the Act, property is presumed abandoned or unclaimed after a prescribed period of time “if the apparent owner has not communicated in writing or by other means . . . with the holder concerning the property or the account in which the property is held, and has not otherwise indicated an interest in the property.”⁶ A “apparent owner” is “a person whose name appears on the records of a holder as the person entitled to property held, issued, or owing by the holder.”⁷

Upon “payment or delivery of property to the Treasurer, the State assumes custody and responsibility for the safekeeping of the property.”⁸ If property other than money is delivered to the State under the Act, then

the owner is entitled to receive from the Treasurer any income or gain realized or accruing on the property at or before liquidation or conversion of the property into money. If the property is interest-bearing or pays dividends, the interest or dividends shall be paid until the date on which the amount of the deposits, accounts, or funds, or the shares must be remitted or delivered to the Treasurer . . .
Otherwise, when property is delivered or paid to the Treasurer, the Treasurer shall hold the property without liability for income or gain.⁹

The Treasurer, within three years after the receipt of abandoned property, must sell it to the highest bidder at a public sale in the State.¹⁰ At “any time after unclaimed property is delivered to the Treasurer, a holder or owner may subsequently reclaim the property, or the amount received by the Treasurer from the sale of the property, by filing a claim with the Treasurer.”¹¹ Because interest accrued on the property while it is held custody by the Treasurer is not remitted to the owner, the issue on appeal in *Rowlette* was “whether this directive – that the Treasurer, when returning property to its owner after a claim is made, shall not surrender income the State earned on the property or its proceeds – is unconstitutional.”¹²

The *Rowlette* Decision

The Plaintiffs claimed that the State’s retention of the interest earned on the unclaimed property violated the Fifth and Fourteenth Amendments of the United States Constitution. The Fifth Amendment provides, in relevant part, that private property shall

⁶ *Id.* § 116B-53(a).

⁷ *Id.* § 116B-52(1).

⁸ *Id.* § 116B-63(B).

⁹ *Id.* § 116B-64 (emphasis added).

¹⁰ *Id.* § 116B-65.

¹¹ *Rowlette*, 656 S.E.2d at 621.

¹² *Id.* at 622.

not “be taken for public use, without just compensation.”¹³ To address the Plaintiffs’ claims, the North Carolina Court of Appeals distinguished two recent United States Supreme Court cases addressing the taking of interest earned on principal – *Phillips v. Washington Legal Foundation*, 524 U.S. 156 (1998) and *Brown v. Legal Foundation of Washington*, 538 U.S. 216 (2003). Distinguishing both *Brown* and *Phillips*, the North Carolina court relied instead on the reasoning in the United States Supreme Court’s decision in *Texaco, Inc. v. Short*, 454 U.S. 516 (1982), which addressed the State’s authority to transfer abandoned property to another owner.

1. *Phillips* and *Brown*

In *Phillips v. Washington Legal Foundation*, the United States Supreme Court took up the question of whether interest earned on principal deposited in attorney trust accounts (called “IOLTA”¹⁴ accounts) was the property of the owner of the principal. IOLTA accounts are used to aggregate small deposits of money or money held for short periods of time so that the accrued interest, which would otherwise be too nominal for remittance to an owner because of the administrative costs, can be aggregated and used to finance legal services for the indigent. The Court held that the “interest income generated by funds held in IOLTA accounts is the ‘private property’ of the owner of the principal.”¹⁵ However, the Court was careful to “express no view as to whether these funds have been ‘taken’ by the State; nor . . . express an opinion as to the amount of ‘just compensation,’ if any, [that is] due.”¹⁶ Several years later in *Brown v. Legal Foundation*, the Supreme Court confronted the questions it left unresolved in *Phillips*.¹⁷

The *Brown* court confirmed its holding in *Phillips* that “the interest earned in the IOLTA accounts is the private property of the owner of the principal.”¹⁸ The Court then concluded that the owners of the principal “retained the beneficial ownership of at least a portion of their escrow deposits until the funds were disbursed at the closings, that those funds generated some interest in the IOLTA accounts, and that their interest was taken for a public use when it was ultimately turned over to the Foundation [*i.e.*, the Legal Foundation of Washington].”¹⁹ The issue, therefore, was the amount of “just compensation” due the owners of the principal. The court concluded that *no compensation* was due the owners because “by operation of the Washington IOLTA Rules, no net interest can be earned by the money that is placed in IOLTA accounts in Washington . . . The Rules adopted and administered by the Washington Supreme Court unambiguously require lawyers and LPOs [limited practice officers] to deposit

¹³ The “Fifth Amendment prohibition against the taking of private property for public use without just compensation applies against the States through the Fourteenth Amendment.” *Texaco, Inc. v. Pond*, 454 U.S. 516, 523 (1982).

¹⁴ The term “IOLTA” is the abbreviation for “Interest on Lawyers’ Trust Accounts.”

¹⁵ *Phillips*, 524 U.S. at 172.

¹⁶ *Id.*

¹⁷ *Brown v. Legal Foundation of Washington*, 538 U.S. 216, 220 (2003).

¹⁸ *Id.* at 235 (quoting *Phillips*, 524 U.S. at 172) (internal quotation marks omitted).

¹⁹ *Id.*

client funds in non-IOLTA accounts whenever those funds could generate net earnings for the client.”²⁰ The Court indicated that *if the principal could have generated interest* and was wrongfully deposited into an IOLTA account, then the owner might have a claim against the depositor.²¹

The *Rowlette* court brushed away the lessons of *Phillips* and *Brown* in three sentences:

We again emphasize the unique nature of the property at issue in this case as compared to the property at issue in *Phillips* and *Brown*. Both of those cases dealt with property that unquestionably belonged to identified owners. Here, we are dealing with property that is presumed abandoned until a holder or owner makes a claim to the Treasurer. The holdings of *Phillips* and *Brown* are, thus, distinguishable.²²

The Court essentially concluded that because the invested principal is “abandoned,” which did not occur in either *Phillips* or *Brown*, the interest accruing on the use of the principal during this period of abandonment does not belong to the owner. Indeed, the Court noted that the property is abandoned “until a holder or owner makes a claim.”

The Plaintiffs addressed this line of reasoning in their appellate brief by arguing that the term “abandoned,” as used in the Unclaimed Property Act, did not incorporate the common law concept of relinquishment of title:

[T]he Prefatory Note to the 1995 Uniform Unclaimed Property Act, which forms the basis of the North Carolina Act, states:

This Act retains the custodial features of the 1954 Act and the 1981 Act. Thus, *the State does not take title to unclaimed property, but takes custody only, and holds the property in perpetuity for the owner.*

Thus, defendants’ argument that the Act is an exercise of the State’s inherent power to “redefine” interests in “abandoned” property is completely wrong.²³

²⁰ *Id.* at 238-39.

²¹ *Id.* at 239.

²² *Id.* at 623.

²³ Plaintiffs-Appellants’ Brief at 11-12, 2006 WL 2838468, at *11-*12 (citation omitted) (emphasis in original).

This argument, however, did not persuade the Court of Appeals, which determined that the United States Supreme Court decision most analogous to the circumstances in *Rowlette* was the decision in *Texaco, Inc. v. Short*, which addressed the State's authority to transfer "abandoned" property to another owner.

2. *Texaco*

In *Texaco, Inc. v. Short*, the Supreme Court addressed whether the provisions of Indiana's Dormant Mineral Interests Act (the "Mineral Lapse Act") violated the Fifth Amendment as applied to the States by the Fourteenth Amendment. The Act provided that mineral interests were extinguished and transferred to the surface owner after a prescribed period of time if the interests went unused by the owner. The "use" of a mineral interest broadly included the actual or attempted production of minerals, the payment of rents or royalties, and any payment of taxes. In addition, a mineral interest owner could protect its interest by filing a statement of claim with the local recorder of deeds.

Several former mineral interest owners whose interests had transferred to the surface owners under the Mineral Lapse Act filed suit alleging that the Statute effected a taking of private property for public use without just compensation. The Court disagreed:

In ruling that private property may be deemed to be abandoned and to lapse upon the failure of its owner to take reasonable actions imposed by law, this Court has never required the State to compensate the owner for the consequences of his own neglect ... [A]fter abandonment, the former owner retains no interest for which he may claim compensation. It is the owner's failure to make any use of the property – and not the action of the State – that causes the lapse of the property right; there is no "taking" that requires compensation.²⁴

The *Rowlette* court adopted this line of reasoning and held that the State's retention of interest accruing on "abandoned" property was not a taking:

[W]e are persuaded by the United States Supreme Court's reasoning in *Texaco* to conclude that the State's retention of interest earned on unclaimed property while that property is in the State's possession is not a taking . . . Here, the State does not take possession of private property through any overt action on its part. Rather, the State comes into possession of the property as a result of the owner's neglect which causes the property to be unclaimed for the prescribed period of time, and thus deemed abandoned. Due to this unique nature of the property, and since it is the

²⁴ *Texaco, Inc.*, 454 U.S. at 530.

owner's neglect that results in the State's possession of the property, the capture of interest accruing on that property by the State is not a taking, and the State is not required to pay the owner "just compensation."²⁵

The Court was careful to note that it was "cognizant that the statute at issue in [*Texaco*] had the effect of transferring private property rights not to a state, but to another private party."²⁶ Thus, the Court did "not conclude that *Texaco*, as a matter of law, bars Plaintiffs' claim."²⁷ Nonetheless, the result was the same since the court relied on the "underlying reasoning" of *Texaco* to deny the Plaintiffs' Fifth and Fourteenth Amendment claim.

Conclusion

Short of U.S. Supreme Court intervention, the *Rowlette* decision forecloses the possibility of interest being returned to owners of unclaimed property held in custody by the State of North Carolina. What *Rowlette* does not address, however, is the real purpose of the Unclaimed Property Act. In *Texaco*, an owner's mineral interest did not lapse and transfer until 20 years of continuous neglect.²⁸ Under the North Carolina Unclaimed Property Act, many items of property are presumed abandoned after a single year,²⁹ and many more are presumed abandoned after only three years or less.³⁰

The short periods preceding presumed abandonment coupled with the State's deposit of the money into the State's Escheat Fund raises funds for the State. The income from the State's Escheat Fund "is distributed annually to the State Education Assistance Authority for grants and loans to aid worthy and needy students."³¹ This raises the question of whether the Act is really just a tool for generating revenue and whether it should be. If so, the retention of interest accrued on unclaimed property is certainly within the spirit of the Act. But historically, unclaimed property laws were passed to protect property rights of true owners, not as a revenue raiser.■



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²⁵ *Rowlette*, 656 S.E.2d at 625-26.

²⁶ *Id.* at 626.

²⁷ *Id.*

²⁸ See *Texaco*, 454 U.S. at 518.

²⁹ See, e.g., N.C. GEN. STAT. § 116B-53(c)(10)-(12), (14).

³⁰ *Id.* § 116B-53(c)(4)-(5a), (7), (9), (13) & (15).

³¹ *Rowlette*, 656 S.E.2d at 621.