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If You Think You Have Immunity From Claims Regarding Property Escheated To The State – Think Again!

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In a recent shareholder action seeking damages for breach of fiduciary duty, the California Court of Appeals (4th Dist.) held that California's Unclaimed Property Law ("UPL")¹ does not provide immunity from a shareholder's claim of wrongful transfer of stock to the state.² This case rejected the analysis of the Second District of California Court of Appeals in a similar case.³ This latest California decision could raise exposure concerns for businesses that wrongfully report unclaimed property, particularly when reporting unclaimed stock.

Background on Unclaimed Stock

In 1990, Azure Limited acquired approximately 95,000 shares of I-Flow Corporation's stock. In 1993, Azure exchanged its shares for approximately 19,000 new shares of I-Flow pursuant to a reverse stock split. In 2003, Azure learned that I-Flow had transferred its shares to California as unclaimed property.

When Azure filed a claim with the California Controller to return its shares, the Controller advised that Azure would receive the proceeds from the Controller's sale of the I-Flow shares. In November 2004, when I-Flow's common stock traded at \$17.72 per share, Azure learned that the Controller had sold Azure's I-Flow shares in June 2003 for a mere \$4.62 per share.

Azure sued I-Flow for breach of fiduciary duty, alleging that I-Flow wrongly transferred the 19,000 shares to the State of California as unclaimed property. Azure alleged that I-Flow (i) knew its location at all times, (ii) wrongly treated the shares as abandoned, and (iii) transferred the shares to California without giving Azure any notice. Azure sought to recover the difference between the sales proceeds and the shares' fair

¹ Calif. Code Civ. Pro. § 1500 *et seq.*

² *Azure Ltd. v. I-Flow Corp.*, 77 Cal.Rptr.3d at 463 (Cal.App. [4 Dist.] 2008).

³ *Harris v. Verizon Communications*, 141 Cal.App.4th 573 (Cal.App. [2 Dist.] 2006).

market value in November 2004. The District Court found that the UPL law granted absolute immunity to I-Flow and denied Azure's claim for damages.

California Court of Appeals Rules Corporations Alleged To Have Wrongfully Transferred Shares Without Notice Are Not Immunized from Suit under the UPL

The Court of Appeals in *Azure*, which reversed the District Court's decision and declined to follow the determination of the Court of Appeals (2nd Dist.) in *Verizon*, ruled that the UPL provides immunity to companies only if the stock is transferred to the Controller in full compliance with the UPL. The *Verizon* court had concluded such limited interpretation of immunity "would render the immunity meaningless because immunity comes into play when, and *only* when, the defendant is charged with wrongdoing."⁴

Contrary to *Verizon*, the *Azure* court focused on compliance with the unclaimed property notice requirements prior to submitting property to the state to justify immunity. In both decisions, the courts considered the policy and objectives of the UPL.

Policy and Objectives of the UPL. The California UPL has been interpreted as having "two objectives: (1) protect unknown property owners by locating them and restoring their property to them, and (2) give the state, rather than the owners of the unclaimed property, the benefits of holding the property, since experience shows most abandoned property will never be claimed."⁵ Only when property is remitted to the state can both objectives be obtained. Business holders may question whether these objectives may be jeopardized by the potential liability for defending shareholder lawsuits upon the remittance of stock.

Inherently, the UPL burdens business holders of unclaimed property by compliance requirements for the primary benefit of owners and the secondary benefit of the states. This burden placed upon businesses justifies immunity for remitting property to the state. The question at issue is whether that immunity is waived if the business fails to follow proper procedure for remitting the property.

Business holders may argue that the problem in the *Azure* case is not that the corporation turned over the stock to the state, but that the stock was sold so it cannot be restored to the owner. In hindsight, in this case, the owner's property may have been safeguarded better if either (i) the corporation had not remitted the stock, *or* (ii) the state had not sold the stock. Of course, discouraging the remittance of unclaimed property (or even property believed to be unclaimed) cuts against the basic objectives of the UPL.

⁴ *Azure*, 77 Cal.Rptr. 3d at 466, citing *Verizon*, 141 Cal.App.4th at 578 (emphasis in original, citations omitted).

⁵ *Azure*, 77 Cal.Rptr. 3d at 465, citing *Fong v. Westly*, 117 Cal.App.4th 841, 844 (2004).

In this situation, turning the property over to the state failed to safeguard the “full value” of the owner’s property, even though the owner was able to obtain the proceeds. The owner’s property was safeguarded at the value obtained by the state. If the price of the stock had subsequently declined, more value would have been safeguarded. The question sure to be posed to the California Supreme Court is whether the objectives of the UPL justify requiring businesses to guarantee the full value of unclaimed property that is lost as a result of improperly turning property over to the state.

In light of other recent concerns with the California unclaimed property system, the *Azure* case is likely to raise additional questions. Should additional statutory changes be implemented to protect owners? For example, because stock is often purchased as a long-term investment, should the period that the state must hold stock before a sale be extended to safeguard the investment longer in its original form? Should the state be required to provide additional notice and publication before the sale? Alternatively, should the dormancy period be extended, whereby the corporation retains the stock and dividends for a longer period of time on behalf of the owner?

I-Flow Claimed the UPL Provided Complete Immunity. I-Flow claimed that it had complete immunity from liability for its transfer of Azure’s shares. I-Flow asserted that this immunity applied even if I-Flow violated the UPL by transferring shares not properly escheatable with knowledge of Azure’s location. I-Flow relied upon the *Verizon* case. In that case, the court held that:

[T]he immunity conferred by the UPL is absolute and the fact that Verizon allegedly failed to comply with the UPL’s notice requirements thus cannot diminish the absolute immunity conferred by the UPL.⁶

The *Azure* Court Refused to Follow *Verizon*. The *Azure* court noted that § 1516 UPL requires corporate stock to be remitted to the Controller if:

- The person owning the stock has not, for more than three years, claimed a dividend, communicated in writing with the holder, or otherwise indicated an interest in the stock as evidenced by a memo or other record of the corporation; and
- The corporation does not know the location of the owner at the end of the three-year period.⁷

The court also noted that the UPL requires corporations to notify shareholders of stock subject to escheat. The UPL requires the company to make reasonable efforts to

⁶ *Azure*, 77 Cal.Rptr. 3d at 466, citing *Verizon*, 141 Cal.App.4th at 578.

⁷ Cal. Code Civ. Pro. § 1516(b).

notify the owner by mail that the stock will be escheated to the state.⁸ The notice must be given not less than six months nor more than twelve months before the time the stock is reportable to the Controller.

Finally, the UPL requires corporations to transfer duplicate shares of abandoned stock to the Controller and immunizes them from civil liability for doing so. Cal. Code Civ. Pro. § 1532 during the applicable period stated:

Upon delivering a duplicate certificate . . . the holder . . . shall be relieved from all liability of every kind to any person . . . for any losses or damages resulting to that person by the issuance and delivery to the Controller of the duplicate certificate. . . .

The *Azure* court declined to follow *Verizon* for three reasons. First, the notice requirement in Cal. Code Civ. Pro. § 1516 was not adopted until 1993, three years after *Verizon* remitted Harris' stock to California. Therefore, the *Verizon* court had no reason to decide whether the UPL immunized a company that violated the notice requirement. Because of this, the *Verizon* court's discussion regarding *Verizon*'s failure to provide notice to Harris was not binding on the *Azure* Court.

Secondly, the *Azure* court concluded that the *Verizon* court misconstrued the UPL. The UPL immunity applies only to a holder that is defined as "any person in possession of property subject to the [UPL] belonging to another . . ." ⁹ The *Azure* court reasoned that in order to be a holder, a company must be in possession of property that is already escheatable under the UPL. Under this rationale, I-Flow may not be a holder if it knew *Azure*'s location at the time it escheated the stock to the Controller.

Thirdly, the *Azure* court reasoned that the UPL provides immunity only for damages resulting from "the issuance and delivery to the Controller of the duplicate [stock] certificate."¹⁰ The court found that *Azure*'s damages resulted from I-Flow's erroneous determination that *Azure*'s stock was escheatable property and failure to give *Azure* notice. Since *Azure*'s damages resulted from I-Flow's wrongful actions prior to the delivery of the stock to the Controller, the court ruled that the UPL's immunity did not apply.

Conclusion

Holders may not be able to rely on immunity for reporting and remitting intangible property to a state as unclaimed property. Businesses need to be aware of the relevant notice and other requirements under the state's unclaimed property law. Failure to do so

⁸ Cal. Code Civ. Pro. § 1516(d).

⁹ Cal. Code Civ. Pro. § 1501(e).

¹⁰ Cal. Code Civ. Pro. § 1532(b).

may subject the corporation to liability if the owner of the intangible property incurs damages as a result of the wrongful remittance. This case is expected to be appealed. We will update you on further developments.



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