No. 111 ORIGINAL

IN THE

Supreme Court of the United States

OCTOBER TERM, 1992

STATE OF DELAWARE,

Plaintiff,

STATE OF TEXAS,

Plaintiff-Intervenor,

vs.

STATE OF NEW YORK,

Defendant.

EXCEPTIONS OF THE STATE OF NEW YORK TO THE REPORT OF THE SPECIAL MASTER

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QUESTIONS PRESENTED

In *Texas v. New Jersey*, 379 U.S. 674 (1965), the Court announced rules to determine the States' priority in escheating or taking custodial possession of abandoned intangible property such as debts. The right and power to escheat the debt is accorded to the State of the creditor's last known address as shown by the debtor's books and records (the primary rule). 379 U.S. at 681-682. Where there is no last known address, or where the State of last known address does not, at the time in question, provide for escheat of the property, the State of the debtor's domicile shall take the property, subject to the right of the State of last known address to recover it if and when its law makes provision for the escheat (the backup rule). *Id.* at 682. The questions raised in this case concern the application of the Court's escheat rules.

1. Under the *Texas v. New Jersey* backup rule, is New York entitled to custody of the unclaimed dividend and interest overpayments held by the Depository Trust Company and New York custodian banks, entities domiciled in New York whose books and records do not identify a creditor of the property?

2. Under the *Texas v. New Jersey* primary rule, is New York entitled to custody of dividend and interest overpayments abandoned by creditor brokers with New York addresses on the books and records of debtor brokers in New York?

3. Should the changes in the *Texas v. New Jersey* rules proposed by the Report of the Special Master be implemented prospectively if adopted by the Court, or New York's retroactive monetary liability be subject to remedial limitation?

PARTIES

The parties to the action are listed in the caption. The intervention motions of the 47 remaining States and the District of Columbia are pending before the Court.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

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EXCEPTIONS

The defendant State of New York, by Robert Abrams, Attorney General of the State of New York, excepts to the Report of the Special Master dated January 28, 1992, heretofore filed with the Court, insofar as it concluded that New York's escheat of the abandoned property at issue conflicts with *Texas v. New Jersey*, 379 U.S. 674 (1965), and *Pennsylvania v. New York*, 407 U.S. 206 (1972), and recommended the imposition of retroactive monetary relief, and in support of such exceptions respectfully submits the following brief.

JURISDICTION

The original jurisdiction of the Court is invoked under Article III, Section 2 of the Constitution of the United States, and under United States Code, Title 28, Section 1251(a).[1]

STATUTE INVOLVED

New York's current Abandoned Property Law is the product of a general codification in 1943 of then existing law. In adopting it, the Legislature declared that it was "the policy of the state, while protecting the interest of the owners thereof, to utilize escheated lands and unclaimed property for the benefit of all the people of the state." N.Y. Aband. Prop. Law § 102 (2½ McKinney's Cons. Laws of N.Y. 1991). Thus, the policy of the State is custodial protection, not confiscation.[2] The Abandoned Property Law includes provisions specifically applying to unclaimed property held by securities brokers or dealers (N.Y. Aband. Prop. Law §§ 510-514) (article V-A), and by banking organizations organized under or subject to the laws of New York. N.Y. Aband. Prop. Law § 300 (article III). In the case of securities brokers or dealers, the property includes any dividends, profits, or other distributions, paid in stock or cash, and any interest or other payment or principal held by brokers or dealers which remain unclaimed for three years. N.Y. Aband. Prop. Law §§ 510(7), 511. The unclaimed property held by banking organizations includes any amount or security representing a dividend or other payment on any stock, bond or other security of a corporation or governmental issuer which remains unclaimed for three years. N.Y. Aband. Prop. Law § 300(e).[3]

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[1] The Court appointed Thomas H. Jackson, Dean of the University of Virginia Law School, as Special Master, on December 12, 1988. 488 U.S. 990.

[2] The Report of the Special Master noted that these proceedings technically involve "custodial taking," not escheat. Report at 2, n.1. It added, however, that continued reference to "escheat" law was appropriate for resolution of the issues under *Texas v. New Jersey*, 379 U.S. 674 (1965).

[3] If the banking organization holds the property as the issuer's agent, the statute provides coverage only if the property is payable to a New York resident. N.Y. Aband. Prop. Law § 300(h)(i). Since the issuer remains the debtor in this

(Footnote continued)

STATEMENT OF THE CASE

I. INTRODUCTION

The resolution of the competing claims in this action is governed by the Court's precedents in *Texas v. New Jersey*, 379 U.S. 674 (1965), and *Pennsylvania v. New York*, 407 U.S. 206 (1972). Although New York takes issue with the Report of the Special Master over certain facts in the evidentiary record, the application of the Court's escheat precedents to this case devolves upon clear legal principles which the Master misinterpreted.

In *Texas v. New Jersey*, the Court recognized the necessity for a "clear rule" to govern the escheat of abandoned intangible property, to be applied to "all types of intangible obligations" and "to which all States may refer with confidence." *Texas v. New Jersey*, 379 U.S. at 678. The rule announced by the Court is that jurisdiction to escheat abandoned intangible property lies in the State of the creditor's last known address on the debtor's books and records (the primary rule); if the creditor's address does not appear on the debtor's books (is unknown), or is in a State that does not provide for escheat of the property in question, then the State of the debtor's incorporation may take the funds, subject to the right of the State of last known address to recover it upon proof that the creditor's last known address is within its borders, or when its law makes provision for escheat of such property (the backup rule). 379 U.S. at 681-682. Thus, central to the application of the Court's escheat rules in a particular case is the identification of the debtors and creditors of the abandoned intangible property.

The present case was commenced in 1988,[4] approximately twenty-three years after the Court proclaimed the creditor-debtor rule in *Texas v. New Jersey*, and some sixteen years after

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circumstance, its domicile has the right to escheat the property owed to unknown creditors. Section 300(h)(i) originally applied only to the distributions of corporate issuers. A recent amendment added coverage for the distributions of governmental issuers owed to New York residents. L. 1989, c.61, § 262, effective April 19, 1989.

[4] The Court granted the State of Delaware's motion for leave to file a complaint against the State of New York on May 31, 1988. 486 U.S. 1030.

it decided *Pennsylvania v. New York*. In the latter case, the Court rejected a bid to vary the rule when the debtor did not regularly record the addresses of its creditors, notwithstanding the fact that this business practice altered the anticipated operation of the rule by "[making] the debtor's domicile the primary recipient of unclaimed intangibles." 407 U.S. at 214. The Court used this opportunity to reiterate its refusal " 'to decide each escheat case on the basis of its particular facts or to devise new rules of law to apply to ever - developing new categories of facts.' " *Pennsylvania v. New York*, 407 U.S. at 215 (citing *Texas v. New Jersey*, 379 U.S. at 679).

The Court is now being asked, once again, to reconsider the rule in *Texas v. New Jersey* as applied to a different type of intangible obligation. The unclaimed property in this case consists of dividend and interest distributions on underlying equity (stock) and debt (bond) issues, as well as stock dividends. The issuers of the underlying securities declare these distributions and pay them to the stockholders or bondholders of record who are registered on the issuer's books and records as the owners of the securities.

The stockholders or bondholders of record, also called the registered owners or record holders, are typically brokerage firms, custodian banks and securities depositories.[5] They hold the underlying securities in a variety of different ways. In some cases, brokers and banks are themselves the beneficial owners. More often, however, the broker or bank has an arrangement with its customer to own the securities in its nominee or street name on behalf of the customer, who is the beneficial owner. If the broker and bank participate in the depository system, the depository functions as its agent to receive distributions from the issuers or their paying agents.[6] The depository is then the

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[5] The registered owner of a security may also be an individual, in which case the issuer will pay the distribution directly to that person.

[6] In most instances, the issuer hires a paying agent to pay the dividend, interest or other declared distribution. Paying agents, also called disbursing

(Footnote continued)

registered owner in its nominee name. Only property held by New York brokers and banks and The Depository Trust Company (DTC), a New York domiciled securities depository, is at issue in this case. The property held by registered owners in other States escheats to those States according to the same understanding of the *Texas* rules that New York has relied on.

The issuer of the securities is not a party to the arrangement between the registered owner and its customer. In fact, the identity of the customer is often known only to the registered owner, although it may be known to the issuer as well. The customer may not even be the ultimate beneficial owner but may be acting for someone else. There is no standard format for ownership and the attributes of beneficial ownership may be divided among more than one person or entity. The highly variable nature of beneficial ownership is reflected in the complex Federal securities regulations that attempt to define it. *See, e.g.*, Rules 13d-3 ("Determination of Beneficial Owner"), 13d-4 ("Disclaimer of Beneficial Ownership") and 16a-1(a) (definition of "beneficial owner" for purpose of Section 16) under the Securities Exchange Act of 1934. Record ownership, on the other hand, is simple - the person or entity whose name appears on the issuer's books is the registered owner.

When the registered owner is not the beneficial owner of a security, it has an obligation to pay distributions to the entity or person on whose behalf it is acting. At this stage, the issuer is no longer involved because its payment to the registered owner discharges its obligation. Uniform Commercial Code (U.C.C.) § 8-207(1). Banks and brokers employ an automatic payment procedure to pay their customers. Payment is based upon the customer's ownership position in the security regardless of the amount of the distribution which the broker or bank receives from the issuer or depository. Thus, if a broker or bank is

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agents, are usually banking institutions with whom the issuer contracts to perform this service. Issuers also employ transfer agents (or registrars in the case of bond issues) to maintain accurate and up-to-date records of the names and addresses of the registered owners.

underpaid, that entity, not the beneficial owner, sustains the loss. The beneficial owner's right to the distribution is routinely satisfied.

When a registered owner receives an overpayment, that property will be subject to escheat if it remains unclaimed for a period of time, determined by the dormancy period of the escheating jurisdiction. Determining the correct escheating jurisdiction requires the application of the *Texas v. New Jersey* escheat rules. The rules require no more than the identification of the jurisdiction of the creditor's last known address from the debtor's books and records, and in the absence of that information, the domicile of the debtor.

The identification of the debtor and creditor in this case can be accomplished by applying the commercial law principles of the Uniform Commercial Code, § 8-207(1), which all 50 States and the District of Columbia have adopted. These principles have also been incorporated by the States into their own abandoned property statutes.[7] Pursuant to this uniform body of commercial and escheat law, the debtors of the property in question are the registered owners after the issuer has made payment and discharged its debt under state law. Thus, New York escheats the property held by DTC and New York custodian banks under the *Texas* backup rule because these debtor entities are domiciled here and it is undisputed that their books do not identify a creditor of the property.

Under the *Texas* primary rule, the creditor must be determined from the books and records of the debtor, which is the registered owner under state law.[8] New York contends that unlike DTC

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[7] Since the commencement of this lawsuit, a number of States have amended their abandoned property laws to conform to the theory advanced by Texas, *et al.* and Alabama, *et al.*, that the issuer is the debtor even after it has paid the distribution to the shareholder of record. *See* p. 60, *post.*

[8] The Report of the Special Master also specified that the books of the record owners be examined to determine if the creditor's jurisdiction can be identified, notwithstanding the Report's conclusion that the issuer is the debtor. *See* Report at A-3.

and custodian banks, brokers do record the last known addresses of their creditors, which correspond to the brokers and banks that were underpaid the distributions on which the debtor brokers were overpaid. The creditor broker or bank is the apparent owner of the distribution on the debtor broker's books. Again, most States' abandoned property laws are modeled on the uniform abandoned property acts, which interpret the creditor's last known address provision of the *Texas* primary rule as applying to the apparent owner of the property on the debtor's books and records.

The Report of the Special Master[8] concluded that the issuer of the underlying security remains the debtor even after it has discharged its debt by paying the distribution to the registered owner. In order to reach this conclusion, the Special Master stated that the *Texas* rules were really concerned with identifying debtor and creditor "attributes." For the same reason, the Special Master concluded that the creditors of the property in question are the "ultimate intended beneficial owners," not the creditors identified on the debtor's books as the primary rule requires. Thus the Court's clear escheat rules, imbued with the threshold fairness of recognizing the primacy of the creditor through its last known address and the convenience of using the debtor's domicile as a backup, have been changed and rendered uncertain.

In addition, the identification of the creditor as the ultimate intended beneficial owner cuts off escheat rights that would be valid even under the Special Master's formulation of the primary rule. The evidentiary record established that creditor brokers and banks have beneficial ownership interests in the property because they pay their customers all of the distributions to which they are entitled. The loss resulting from the underpayment of a distribution is sustained by the creditor broker or bank unless it asserts a claim against the debtor broker that was overpaid.

The Special Master's reliance upon the ultimate beneficial owner as the creditor under the *Texas* primary rule pretermitted

New York's factual contention that it is the State of last known address of almost all creditor brokers and banks on the books of debtor brokers in New York. Accordingly, New York was not given the opportunity to demonstrate its right to escheat the unclaimed distributions from New York debtor brokers. The Special Master concluded instead that all of the property in question must escheat under the *Texas* backup provision, since no debtor entity has any identifying information concerning ultimate beneficial owners.

It is apparent from the Special Master's Report that its conclusions were propelled by the notion that it would be fairer to distribute the funds which New York presently escheats to more jurisdictions. This is accomplished in part by diverting all of the property to the States under the *Texas* backup rule as parsed by the Special Master, pursuant to which the issuer is viewed as the debtor. Since many issuers are domiciled in Delaware, however, the Special Master also found it necessary to change the locational test under the backup rule from that of the issuer's domicile to its chief executive office.

Even if this case is to be decided on fairness grounds, a more even division of the property is not necessarily more fair. Securities depositories, brokers and banks perform essential and highly complex functions without which there could be no corporate and governmental investment. Since New York gives the benefits of its economy and laws to DTC, New York brokers and New York banks, the abandoned property held by these entities appropriately escheats to New York.

II. THE *TEXAS V. NEW JERSEY* RULE

A. The Court's Concerns For Fairness And Ease Of Administration Are Embodied In The Creditor's Last Known Address Provision Of The *Texas* Primary Rule

In *Texas v. New Jersey*, 379 U.S. 674 (1965), the Court was asked to settle a controversy among States as to which State had

jurisdiction to escheat certain abandoned intangible personal property.[9] The property in question, debts of Sun Oil Company, a New Jersey corporation, resulted primarily from the failure of creditors to claim or cash checks in payment of Sun's various debt obligations. The amounts were owed to creditors some of whom had last known addresses on the books of Sun's two Texas offices or other offices throughout the country, and some of whom had no last known addresses indicated.

In the case of unclaimed cash dividends on Sun's common stock, the funds for payment were deposited in a special dividend account in a Philadelphia bank on which checks were drawn. *See* Report of the Special Master, *Texas v. New Jersey*, No. 13 Original, at 11 (Dec. 2, 1963). After two years, funds to cover unclaimed dividends were transferred from the special dividend account to a general account of the company in Philadelphia. *Id.* In the case of unclaimed stock scrip certificates for fractional shares of Sun resulting from stock dividends, the certificates were issued by Sun's transfer agent, Chase Manhattan Bank of New York, and were held in Philadelphia after being returned to Sun undelivered. *Id.* at 12, 13. It is thus apparent from the record in *Texas v. New Jersey* that Sun's unclaimed stock distributions were held either by Sun or its agents, not by a stockholder of record.[10]

Texas claimed the right to escheat all of the property as the State with the most significant "contacts" with the debt. New Jersey asserted that it had the power to escheat as the domicile

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[9] The Court noted that "[a]s was pointed out in *Western Union Tel. Co. v. Pennsylvania*, 368 U.S. 71, 77-78, none of this Court's cases allowing States to escheat intangible property decided the possible effect of conflicting claims of other States." *Texas v. New Jersey*, 379 U.S. at 682, n.13.

[10] Sun also employed the Fidelity - Philadelphia Trust Company as co-transfer agent for the transfer of the shares of the company's stock, and the Bankers Trust Company of New York and the Girard Trust Corn Exchange Bank of Philadelphia as registrars. Report of the Special Master, *Texas v. New Jersey*, No. 13 Original, at 5 (Dec. 2, 1963).

of the debtor, Sun. Pennsylvania's claim looked to the fact that Sun's principal office and corporate activities were there. Finally, Florida laid claim only to those items that were payable to persons whose last known address was in Florida.

The Court rejected the "contacts" solution proposed by Texas because it concluded that the problem before it, deciding which State's claim to escheat is superior to all others, should not be controlled by a test to determine "whether a defendant has had sufficient contact with a State to make him or his property rights subject to the jurisdiction of its courts, a jurisdiction which need not be exclusive." *Texas v. New Jersey*, 379 U.S. at 678. The Court also concluded that the "contacts" test was unworkable in this situation because it would require the Court to "examine the circumstances surrounding each particular item of escheatable property on its own peculiar facts and then try to make a difficult, often quite subjective, decision as to which State's claim . . . seems stronger than another's." *Id.* at 679.

Turning to New Jersey's bid as Sun's State of incorporation, the Court found that this approach had the "obvious virtues of clarity and ease of application," but declined, on principles of fairness, to confer the primary right of escheat upon the State in which the debtor happened to be incorporated. *Texas v. New Jersey*, 379 U.S. at 680. In this respect, the Court found it more persuasive to look to Pennsylvania, the State in which Sun's principal offices were located, because Sun benefitted more from that State's economy and laws. However, the Court did not adopt Pennsylvania's proposal because "these debts owed by Sun are not property to it, but rather a liability, and it would be strange to convert a liability into an asset when the State decides to escheat." *Id.* The Court also doubted the functionality of Pennsylvania's approach because it "would raise in every case the sometimes difficult question of where a company's 'main office' or 'principal place of business' or whatever it might be designated is located." *Id.*

The Court adopted the rule advanced by Florida, "that since a debt is property of the creditor, not of the debtor, fairness among the States requires that the right and power to escheat

the debt should be accorded to the State of the creditor's last known address as shown on the debtor's books and records." *Texas v. New Jersey*, 379 U.S. at 680-681. The Court noted that this rule was a variation of the common law maxim "*mobilia sequuntur personam*," establishing the situs of personal property at the domicile of its owner.[11] *Id.* at 680, n.10. It found the rule to be consistent with a group of cases dealing with intangible property for other purposes in other areas of the law.[12] The Court further stated that the rule "takes account of the fact that if the creditor instead of perhaps leaving behind an uncashed check had negotiated the check and left behind the cash, this State would have been the sole possible escheat claimant." 379 U.S. at 681. Finally, the Court indicated that the rule "will tend to distribute escheats among the States in the proportion of the commercial activities of their residents." *Id.*

After considering the rule's fairness, the Court assessed its practicality, concluding that it satisfied the concern for ease of administration. *Texas v. New Jersey*, 379 U.S. at 681-682. In this context, the Court said that by looking to the creditor's domicile, and using a standard of last known address on the records of the debtor rather than technical legal concepts of residence and domicile, the rule "involves a factual issue simple and easy to resolve, and leaves no legal issue to be decided." *Id.* at 681. The Court noted its agreement with the Special Master that "the address on the records of the debtor, which in most cases will be the only one available, should be the only relevant last known address." *Texas v. New Jersey*, 379 U.S. at 681, n.11. This, the Court said, was consistent with the fact that its inquiry was not concerned with the technical domicile of the creditor, whereas ease of administration was an important consideration.

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[11] As set forth in the Report of the Special Master in *Texas v. New Jersey*, escheat is a proceeding in rem in which a State seeks to acquire title to and take possession of abandoned property. *Id.* at 21. The exercise of such jurisdiction is valid only if the situs or location of the property or res involved is within the territorial boundaries of the State. *Id.*

[12] The Court cited, as examples, *Baldwin v. Missouri*, 281 U.S. 586 (1930), *Farmers Loan & Trust Co. v. Minnesota*, 280 U.S. 204 (1930), and *Blodgett v. Silberman*, 277 U.S. 1 (1928). 379 U.S. at 681, n.12.

B. The Court Looked To The Debtor's Domicile For A Rule Of Certainty When The Creditor's Last Known Address Provision Could Not Be Applied

After announcing the creditor's last known address rule, the Court turned to the questions of what was to be done with property owed persons (1) as to whom there is no record of any address at all, or (2) whose last known address is in a State which does not provide for escheat of the property owed them. *Texas v. New Jersey*, 379 U.S. at 682. In both instances, the Court held that the property be subject to escheat by the State of corporate domicile, provided that another State could later escheat upon proof of a superior claim under the primary rule (either by demonstrating that the creditor's last known address is within its borders, or by changing its law to obtain coverage for the property). *Id.* Although the Court referred to the State of "corporate domicile," it is clear from the Master's Report, upon which the Court expressly relied, that the Court was concerned only with the domicile of the debtor. *See* Report of the Special Master, *Texas v. New Jersey*, at 34-35.[13] The Court viewed its backup provision as addressing problems that were "likely to arise with comparative infrequency," and which was "conducive to needed certainty." *Texas v. New Jersey*, 379 U.S. at 682.

C. The Court Refused To Carve Out An Exception To The *Texas v. New Jersey* Rule Based Upon The Facts Of A Particular Case

In *Pennsylvania v. New York*, 407 U.S. 206 (1972), the Court had the opportunity to apply the *Texas v. New Jersey* rule to

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[13] It is further apparent from the Report that in selecting the domicile of the debtor in the absence of a known creditor, the Special Master was concerned with the debtor in the sense of the entity obligated to pay the funds. Thus, the Special Master cited authorities such as *Standard Oil Company v. New Jersey*, 341 U.S. 428 (1951), wherein "the court speaks of the power of the state to seize the debt by jurisdiction over the debtor and since it is the obligation to pay that is seized, the jurisdiction of the debtor corporation effects a seizure." Report of the Special Master, *Texas v. New Jersey*, at 35.

another dispute among States over the right to escheat certain abandoned intangible property, this time the unclaimed funds paid to the Western Union Telegraph Company for the purchase of money orders. The Court described Western Union's telegraph money order business by reference to the description in its earlier decision in *Western Union Telegraph Co. v. Pennsylvania*, 368 U.S. 71 (1961), as follows:

> A sender goes to a Western Union office, fills out an application and gives it to the company clerk who waits on him together with the money to be sent and the charges for sending it. A receipt is given to the sender and a telegraph message is transmitted to the company's office nearest to the payee directing that office to pay the money order to the payee. The payee is then notified and upon properly identifying himself is given a negotiable draft, which he can either endorse and cash at once or keep for use in the future. If the payee cannot be located for delivery of the notice, or fails to call for the draft within 72 hours, the office of destination notifies the sending office. This office then notifies the original sender of the failure to deliver and makes a refund, as it makes payments to payees, by way of a negotiable draft which may be either cashed immediately or kept for use in the future.
>
> In the thousands of money order transactions carried on by the company, it sometimes happens that it can neither make payment to the payee nor make a refund to the sender. Similarly, payees and senders who accept drafts as payment or refund sometimes fail to cash them. For this reason, large amounts of money due from Western Union for undelivered money orders and unpaid drafts accumulate over the years in the company's offices and bank accounts throughout the country.

Id. at 72-73.

Pennsylvania instituted the action against New York, Florida, Oregon, Virginia and Western Union.[14] The States of California, Indiana and Arizona were permitted to intervene, and New Jersey filed an *amicus* brief. In fact, most jurisdictions had an interest in the outcome since Western Union did business and had offices in all States except Alaska and Hawaii, as well as in the District of Columbia. *See Pennsylvania v. New York*, 407 U.S. at 208 (citing *Western Union Telegraph Co. v. Pennsylvania*, 368 U.S. 71 (1961)).

Pennsylvania asserted the right to escheat the unclaimed proceeds of money orders purchased from Western Union offices in that State. In support of its place of purchase theory, Pennsylvania contended that because Western Union's money order records did not identify anyone as a "creditor," and in many instances did not list an address for either the sender or payee, strict application of the *Texas v. New Jersey* rule would result in the escheat of almost all the funds to New York, Western Union's domicile.[15] Pennsylvania argued that selecting the State of purchase "as determinative would result in a division of the funds roughly in proportion to the amount of business originating in each State." Report of the Special Master, *Pennsylvania v. New York*, No. 40 Original, at 14 (Jan. 11, 1972). Pennsylvania urged finally that its solution could be harmonized

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[14] Pennsylvania's prior effort to take custody of the funds through proceedings in its courts was overturned by this Court in *Western Union Telegraph Co. v. Pennsylvania*, 368 U.S. 71 (1961). The Court held, based upon its exclusive jurisdiction over the disputes between States, that it was the only forum that could give Western Union due process of law by protecting it against the rival claims of other States.

[15] The Special Master found that Western Union maintained ledger books which showed the amount of the transaction and the location of the office of origin and the office of destination, but did not designate a creditor, or indicate the address of either the sender or the payee. Report of the Special Master, *Pennsylvania v. New York*, No. 40 Original, at 8-9 (Jan. 11, 1972). The Special Master also found, however, that the senders' application forms, including their addresses whenever supplied, were retained in records that went back as far as 1930. *Id.* at 9.

with *Texas v. New Jersey* by treating the State of purchase as presumptively the sender's (creditor's) residence. *Pennsylvania v. New York*, 407 U.S. at 211-212. Florida and Arizona supported Pennsylvania but argued in favor of the State of destination as having the primary right to escheat the property. *Id.* at 212. These States later abandoned this approach for that of the State of purchase. *Id.* at 214.

The Court adopted the Report of the Special Master recommending that the *Texas* rule be strictly applied to all items in the case. *Pennsylvania v. New York*, 407 U.S. at 212-213. The Court specifically referred to the Special Master's finding that the *Texas* rule should apply to these obligations, as they were applied to the obligations in *Texas v. New Jersey*, because the *Texas* rule " 'presents an easily administered standard preventing multiple claims and giving all parties a fixed rule on which they can rely.' " *Id.* at 213 (citing Report at 20). The Court also quoted language from the Report which clearly viewed Western Union's obligation to be that of a common debt owed to a creditor, be that the sender or the payee.

> 'Any sum now held by Western Union unclaimed for the period of time prescribed by the applicable State statutes may be escheated or taken into custody by the State in which the records of Western Union placed the address of the creditor, whether that creditor be the payee of an unpaid draft, the sender of a money order entitled to a refund, or an individual whose claim has been underpaid through error . . . . [I]f no address is contained in the records of Western Union, or if the State in which the address of the creditor falls has no applicable escheat law, then the right to escheat or take custody shall be in the domicilary State of the debtor, in this case, New York.'

407 U.S. at 213 (quoting Report, at 20-21).[16]

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[16] The Report also stated: "In this case the nature of Western Union's obligation appears to the Special Master to be that of a common debt, not dissimilar

(Footnote continued)

In reaching its result, the Court stated that "we do not regard the likelihood of a 'windfall' for New York as a sufficient reason for carving out this exception to the *Texas* rule." *Pennsylvania v. New York*, 407 U.S. at 214. It noted that "*Texas v. New Jersey* was not grounded on the assumption that all creditors' addresses are known" and, therefore, "the only arguable basis for distinguishing money orders is that they involve a higher percentage of unknown addresses." *Id.* However, "we are not told what percentage is high enough to justify an exception to the *Texas* rule, nor is it clear that money orders constitute the only form of transaction where the percentage of unknown addresses may run high." *Id.* at 214-15.[17] Thus, the Court concluded:

> In other words, to vary the application of the *Texas* rule according to the adequacy of the debtor's records would require this Court to do precisely what we said should be avoided - that is, 'to decide each escheat case on the basis of its particular facts or to devise new rules of law to apply to ever - developing new categories of facts.' *Texas v. New Jersey*, 379 U.S. at 679.

Pennsylvania v. New York, 407 U.S. at 215. To the extent that creditor addresses were available from the individual money order applications, as opposed to Western Union's ledger books, the Court placed the burden of establishing the addresses on the claimant State. *Id.*

The dissenters supported a modification of the *Texas* rule. *Pennsylvania v. New York*, 407 U.S. at 216-222 (opinion of

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to the types of obligations considered by this court in *Texas v. New Jersey*." Report of the Special Master, *Pennsylvania v. New York*, at 15 (footnote omitted).

[17] For example, the American Express Company, in its *amicus* brief, informed the Court that it retained the addresses of its travelers check purchasers, if given, for only a short period of time. American Express held $2,224,200 in unclaimed proceeds of travelers checks dating back to 1964. *See* Pennsylvania's Petition for Rehearing, *Pennsylvania v. New York*, at 3.

Powell, J., in which Blackmun and Rehnquist, JJ., joined). They proposed that the State of purchase be presumed to be the State of the creditor's domicile when the payee failed to claim the money, and the State of destination carry that presumption whenever a draft had been issued to either the payee or the sender but it was not negotiated. *Id.* at 220.

III. THE EVIDENTIARY RECORD

Following New York's motion for judgment on the pleadings, the Special Master authorized a limited program of discovery. Report at 6.

> Discovery was permitted to seek identification of the principal entities involved in the securities distribution process, the levels, steps, or stages in the process, the relationships *inter se* of the organizations involved, and the variety of circumstances giving rise to the unclaimed intangible distributions in which the parties assert an interest.

The Special Master attempted to compile the results of this discovery into Appendix B to his Report, titled "Facts Not Reasonably Subject To Dispute" (B-1 to B-22), and "Metafacts: General Propositions Generally Beyond Dispute" (B-22 to B-25). New York, however, has disputed, and continues to dispute, many of the Special Master's characterizations of the evidentiary record set forth in Appendix B. *See, e.g.*, Comments On The Draft Report Of The Special Master By Defendant State of New York (August 12, 1991). The errors contained in Appendix B are set forth in the discussion below of the discovery's salient themes, as well as in the detailed analysis of the record holders' operations that follows.

The abandoned property in this case arises when the issuer or its paying agent overpays a distribution to a registered owner, here DTC, New York custodian banks and New York debtor brokers. The principal reason for the overpayment is that the registered owner no longer owns the underlying security when the distribution is paid. The new owner, being unable to

re-register the security into its own name in time to receive the distribution, is underpaid.[18]

The registered owner owes the distribution to the new owner. The issuer, having discharged its debt by paying the registered owner, has a complete defense to a claim from the new owner. U.C.C. § 8-207(1).[19] The issuer, moreover, does not (and apparently cannot) claim the property back from the registered owner.[20]

There is no dispute among the parties that the books and records of record holders such as DTC and custodian banks do not identify the creditors of their unclaimed distributions. The evidentiary record is instructive in this regard because it explains why these entities are unable to record a last known address for

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[18] Issuers and their agents close their books for a particular distribution on a specified date, called the "record date." The distribution is paid to the registered owner as of that date.

[19] If the issuer (or its paying agent) is unable to effect payment on the registered owner, the issuer remains the debtor. Applying the *Texas v. New Jersey* rules in that situation, the primary right of escheat lies with the State of last known address of the registered owner on the issuer's books. If the address is in a jurisdiction that does not have coverage for this property (or there is no registered owner, as in the case of bearer certificates), the issuer's domicile escheats the property. This is in accord with the escheat practices followed by the Corporate Trust Department of Citibank, N.A., a paying agent. *See* Deposition Transcript of Katherine Wellener, a Vice President of the Corporate Trust Department, at 57-60, 67, 68, 130-131, 143-145, 147, 148. Although the escheat of unclaimed funds in the hands of issuers and their paying agents is not involved in this litigation, the Special Master was under the erroneous belief that such property is retained by the issuer, or escheats only to its domicile rather than to the State of last known address of the registered owner in the first instance. *See* Report, Appendix B, Facts (23), (24), at B-6.

[20] The Special Master recognized that issuers do not reclaim distributions paid to registered owners, adding that even if they were legally entitled to do so, there would be no financial incentive to make the effort because the property would eventually escheat to their home State. Report at 36, n.33. This statement unaccountably ignores the substantial financial incentives to be derived from the interest on the property that accrues in the years preceding escheat. This benefit is enjoyed by the registered owners.

the new owner of the security. In the case of DTC this is due to a phenomenon called Cede float, certificates registered in DTC's nominee name, Cede & Co., and placed in the stream of commerce. DTC cannot track the movements of its Cede certificates. In the case of custodian banks, which deliver out physical certificates registered in their nominee name to settle trades in the underlying securities ("nominee float"), the banks' records do not identify the new owners because the banks are not participants to the trades. New York escheats the property from DTC and New York custodian banks under the *Texas* backup rule as the domicile of these debtor entities.[21]

By contrast, when brokers deliver out physical certificates registered in their nominee name to settle trades for their customers, the certificates are sent directly to the purchasing broker or bank. The address on the delivery ticket, which the selling broker retains, is the last known address of the new owner of the security. In the case of the brokers' nominee float, therefore, the brokers' records do identify the new owners of the securities. Based upon sample audits of the records of New York debtor brokers, New York has determined that in almost all instances, New York debtor brokers deliver their physical certificates to creditor brokers and banks addressed in New York. *See* Affidavit of Robert Griffin, Director of Audits, Office of Unclaimed Funds (May 5, 1988), annexed to New York's Brief in Opposition To Delaware's Motion For Leave To File Complaint. Accordingly, New York claims this property under the *Texas* primary rule.

The Special Master's central misconception concerning the evidentiary record is his belief that unclaimed distributions arise for various reasons, including errors on the part of the record holders. *See* Appendix B. In fact, errors, missed transfers and other discrepancies cause initial overpayments to the record

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[21] The custodian banks involved here, in addition to banks chartered in New York, include national banks whose principal operations are conducted in New York. The Special Master recognized the appropriateness of using principal place of business to locate federally chartered entities. Report at 49, n.45.

holders, but not abandoned property. Their automated accounting procedures and other control mechanisms detect these differences and correct them long before they become a meaningful source of escheatable funds. The principal cause of abandoned securities distributions is the continued presence of securities issues in certificated format, giving rise to Cede float and nominee float. Thus, the witness for DTC testified that:

> "A. As long as there are certificates outstanding, we will have differences with agents. What it will eliminate, once all the outstanding Cede Float certificates are transferred, it will eliminate to a large extent overpayments.
>
> Q. Because most of the overpayments result from Cede Float?
>
> A. We know for a fact, we know just by looking at the overpayment balance drops as a result of claims that come into us."

DeCesare Dep. at 353.

In addition, record holders such as DTC and brokers are taking steps to ameliorate the problems created by certificated issues as well as promote the changeover to certificateless issues, which will eliminate the problem of abandoned property in this area.

> "Q. Just so the record may be clear when you say T plus three, are you referring to the proposed procedure to have all trades settle three days after the trade date?
>
> A. As opposed to five days after.
>
> Q. Which is the current practice?
>
> A. That's correct. Current practice. One of the things that's built into that is that all settlements between financial institutions, including banks, brokers and DVP clients, will be only done through the depository

> situation, and so virtually every security would have to become depository eligible.
>
> A second recommendation is that the certificate ultimately be eliminated and they're trying to focus on a time frame for that so that, as we go forward, only having securities in the depository environment will dramatically if not effectively eliminate over-payments that result from dividend and interest."

Cirrito Dep. (Prudential-Bache Securities, Inc.) at 152-153.

The Special Master's failure to correctly interpret the evidence resulted in various errors in his legal analysis. He concluded, for example, that New York's claim under the *Texas* primary rule could not depend upon the last known addresses of creditor brokers and banks because these entities do not have ownership interests in the property unless they were trading for their own accounts. Report at 63-65. Although the primary rule looks only to the apparent owner on the debtor's records, the creditor brokers and banks do have beneficial ownership interests in the property in question as well. These entities testified that they routinely pay their customers (beneficial owners) all of the income distributions to which they are entitled. Shearer Dep. at 124, 135, 138, 140, 152, 154-155, 171, 190-191; Principe Dep. at 79-80; Cirrito Dep. at 61-62, 125-126; Scott Dep. at 53 (*see* p. 26, n.27, and p. 29, n.30). Accordingly, if the creditor broker or bank is underpaid, the distribution belongs to it. This is further exemplified by the fact that for the years 1985 through 1989, 97.4% of the claims which New York has paid, or is in the process of paying, are to brokers and financial institutions including banks and DTC. *See* Responses of the State of New York to the First Set of Interrogatories Propounded by the States of Alabama, *et al.*, Answers to Interrogatories 5(e) and 25. The Special Master did not appreciate the significance of the automatic payment procedures in giving beneficial ownership interests in the property in question to creditor brokers and banks because he attributed the abandoned property to the *debtor brokers'* inability to pay distributions to their own customers due to bookkeeping and other errors. *See* Report at 62, n.54. The Master cited no evidentiary support for his conclusion.

By attributing abandoned property to record holder error the Special Master also failed to appreciate the merit of permitting escheat by the jurisdictions most closely associated with the record holders. *See* Report at 35-36. Indeed, understanding that the principal cause of abandoned securities distributions is the persistence of securities issues in certificated format focuses responsibility on the issuers, not the record holders. If, as the Special Master believed, a fairness test should be applied in determining which jurisdictions should escheat the property in question, then the role of the record holders in seeking to eliminate the certificated security should have been given dominant consideration.

A. The Depository Trust Company[22]

DTC, a limited purpose trust company incorporated under New York's Banking Law, is the largest of three securities depositories in the United States (the others are The Mid-West Securities Depository Trust Company and The Philadelphia Depository Trust Company). DTC is owned by its "participant" brokers and banks whose ownership interests in the company are revised annually according to a formula that reflects their use of the depository during the preceding year.

The basic concept underlying the securities depository is the funneling of its participants' securities holdings into a centralized location. In the case of certificated issues, brokers and custodian banks can then conduct their transactions without physical movement of the certificates. Income distributions can also be paid to the depository for distribution to its participants. Indeed, DTC was born out of the paperwork crisis in the securities industry in the late 1960's, when the increase in the volume of trades, coupled with the settlement of trades by manual deliveries of certificates against payment, created processing difficulties that became unmanageable.

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[22] The operations of The Depository Trust Company were presented in a Statement prepared in conjunction with the discovery requests of the plaintiff-intervenor States, the deposition testimony of Raymond DeCesare, a company officer, and supplemental documents.

When a participant deposits eligible certificated securities (those satisfying DTC's operational requirements) into DTC's custody, DTC makes a "book entry" into the participant's account to reflect the participant's ownership of the security. DTC makes subsequent changes to the participant's ownership position in that security by electronically recording book entry credits and debits. Thus, if a participant sells a security to another participant, DTC debits the account of the selling broker or bank and makes a corresponding book entry credit into the account of the purchasing broker or bank. The certificates themselves remain "parked" in DTC's vault.

Because of DTC's extensive securities holdings, large number of participants, and interface with the country's two other securities depositories, most securities trades today are handled by book entry. This has gone a long way in eliminating nominee float at the brokerage level and the resultant unclaimed property. The potential for nominee float persists, however, in the case of securities that are not depository eligible, or when one or both of the trading entities are not depository participants.

The physical certificates which DTC holds are registered in its nominee name, "Cede & Co." When DTC initially receives custody of certificates, it immediately forwards them to the issuer's transfer agent for re-registration into Cede certificates. Thereafter, the issuer or its paying agent will pay income and dividend distributions directly to DTC, based upon the securities' Cede registration. DTC pays the distributions to its participants according to their book entry ownership position in the security on the record date.[23]

After DTC credits its participants' accounts on the payable date, by applying the payment rate to their record date ownership positions, DTC may receive more or less than it expected

[23] DTC requires paying agents of corporate equity and debt securities to pay distributions in immediately available funds. DeCesare Dep. at 184-188. Since DTC pays its participants in next-day funds, DTC, not the paying agents, realizes a profit on the float. DTC uses the profit to offset costs and pays any surplus to its participants. DeCesare Dep. at 177.

from the issuer or its paying agent. DTC initially investigates the difference and resolves out-of-balance conditions with issuers and paying agents. DTC also checks its participant account records for erroneous entries. At the close of each business day, for example, DTC's computerized systems produce a trial balance which will detect overages and underages. DeCesare Dep. at 116.[24] DTC also generates a daily settlement report for each participant, including the distributions disbursed to the participant that day. *Id.* at 66. Participants are required to confirm on a daily and monthly basis that they agree with their positions as reported by DTC. *Id.* at 139, 310-311, 388-389. DTC does not believe that initial overpayments due to out-of-balance conditions or errors are a significant source of its unclaimed property. DTC Statement at 15-18.

DTC pinpoints the cause of its abandoned property as "Cede float."[25] DTC Statement at 15-18. Cede float is caused by DTC's Certificate On Demand ("COD") withdrawal procedure.[26]

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[24] DTC also considers it unlikely that a paying agent will permit an overpayment to DTC to go undetected since the agent will then have a corresponding underpayment to another registered owner. DeCesare Dep. at 120-122.

[25] By contrast, the Report of the Special Master ignored DTC's conclusion that its abandoned property is caused by Cede float. Instead, the Special Master treated all initial overages at DTC as causes of abandoned property. *See* Report at Appendix B, Facts (41) to (45), at B-12 to B-13. While errors (41), out-of-balance conditions (42), and rate changes (45) give rise to such initial overages, they are corrected long before the property is deemed abandoned. Fact (43) discussing "occasional mishandling of bearer bonds," is irrelevant since such "found" bonds are rare and do not escheat as intangible property. *See* DTC Statement at 16 n. Only Facts (38), (39) and (44) relating to Cede float are pertinent.

[26] DTC notes that another withdrawal procedure, called "Withdrawal By Transfer," could give rise to abandoned property. DTC Statement at 12, n.1. Participants use this procedure when they want certificates to be re-registered prior to withdrawal. DTC forwards the participant's transfer instructions to the transfer agent. If the agent subscribes to DTC's Fast Automated Securities Transfer ("FAST") program, the agent will issue the newly registered certificates. Otherwise, DTC must forward the Cede certificates for re-registration to the agent along with the instructions. Since DTC does not retain the instructions, its records will not indicate the new registered owner in the event that the transfer misses the record date and DTC is paid the distribution.

(Footnote continued)

Participants use COD withdrawals when they have an urgent need for physical certificates and cannot arrange for their re-registration prior to withdrawal. This could occur, for example, if the participant requires the certificates to settle a trade outside of the depository. When the certificates are withdrawn from DTC's vault and given to the participant, they enter the stream of commerce still registered in Cede's name. DTC Statement at 17. DTC has no control over these Cede certificates and no way of knowing who owns them on a record date. *Id.*

DTC does not consider the participant who made the COD withdrawal to be entitled to a distribution paid to DTC on Cede float.

> While DTC knows who withdrew Cede float, the withdrawing participant is unlikely still to be the owner of Cede float not promptly re-registered. It is presumed the Participant withdrew the COD to make physical delivery to a party unknown to DTC. Thus, the withdrawing participant's address is not considered to be the "last known address of the creditor" for the unclaimed distribution.

DTC Statement at 17. DTC accepts claims for distributions from participants and non-participants, and from individuals represented by a financial institution who present the underlying Cede certificates. DTC's claim verification procedures are described in its Statement, at 18. Most claims are made between three to six months after a record date. DeCesare Dep. at 242, 272-273. DTC reports the property that is unclaimed after three years to New York, its State of incorporation, since the owners of its Cede float are unknown. DTC Statement at 19. After escheat, DTC will provide a claimant with the necessary documentation to recover the funds from New York.

However, the fact that the certificates are re-registered means that the new registered owner is likely to claim the distribution from DTC long before the property is deemed abandoned. That is not so in the case of Cede float, because Cede certificates continue to change hands. *Compare* Report of the Special Master, Appendix B, Facts (36), (37), (38), at B-10 to B-11, which does not emphasize, as DTC does, the predominance of Cede float in DTC's unclaimed property holdings.

In an effort to eliminate Cede float, DTC has devised a new withdrawal procedure called Rush Withdrawals By Transfer. DTC Statement at 6. The procedure allows for withdrawal and re-registration of Cede certificates within 48 hours. DTC is also advancing certificateless or "Book Entry Only" securities. DTC Statement at 8. Under this form of issuance, a single certificate evidencing all securities outstanding for the issue is registered in the name of Cede & Co. and held in DTC's vault. The certificate may be cancelled and reissued to reflect denomination changes if additional securities are issued or a portion of the issue is redeemed. Because certificates are not available, no withdrawals can occur. As of March 1990, after three years of experience with Book Entry Only securities, DTC has not had a single unresolved overpayment on such issues. DTC Statement at 15.

B. Custodian Banks[27]

The custodial services division of a bank acts as the custodian for customers' investment portfolios. As custodian, the bank does not trade for its customers. Rather, it maintains a computer record of the holdings in each customer's account, which it updates as transactions occur and uses to distribute dividend and interest payments.[28]

When the bank receives a customer's certificated holdings, they may be registered in street name, the customer's name, or

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[27] The operation of custodian banks was exemplified by the Custody Services Division of Citibank, N.A., through its Narrative Statement, the deposition testimony of Hugh Scott, the operation head of the Custody Services Division's corporate reorganization and income collection units, and various documents.

[28] The bank also distributes materials to its customers from issuers regarding the securities it holds as custodian, including exchanges, tenders, conversions, annual reports, proxy materials and voting solicitations. Unless the bank has express authorization from a customer, it will not disclose any information about a customer to an issuer or its agent. The bank only informs the issuer's agent, upon request, of the number of sets of materials that are needed for distribution. Scott Dep. at 120-121, 123-127, 198.

the name of another holder. If the security is depository eligible, the bank arranges for the re-registration of the certificates into the depository's nominee name, such as DTC's nominee, Cede & Co. Otherwise, the bank re-registers the certificate into its nominee name.

The announcement of an upcoming dividend or interest distribution is posted in the bank's computerized files either manually or by a direct computer "feed" from a subscription data service. The bank then generates a pending file of all customer accounts and their positions in the particular security on the record date. These accounts are marked with a "pay" instruction and are automatically credited with the distribution on the pay date. The bank pays its customers on the pay date regardless of whether it has received payment of the distribution. Scott Dep. at 53; *see also* Citibank Narr. St. at 1 of 4. The payment is not reversible unless the bank subsequently determines that the customer was not entitled to it in the first place.

The bank receives distributions from DTC if its holdings are on deposit there, and directly from issuers or their paying agents on securities registered in the bank's nominee name. Based on the evidence provided by Citibank, neither out-of-balance conditions between it and DTC or issuers and their paying agents, nor internal errors in the records of its customer holdings, is responsible for unclaimed property. Scott Dep. at 166-167, 174-175, 215-216. *Compare* Report of the Special Master, Appendix B, Facts (73), (75), (76) at B-20, B-21, which misstate the causes of abandoned property.[29] Citibank relies on its

[29] Indeed, at Fact (75), the Special Master described a typical "missed transfer," which could not give rise to abandoned property. He postulated that a broker or bank will have an overpayment if it deposits certificates in its nominee name with a depository, and the depository's effort to re-register it before the record date misses. The Master concluded that the broker or bank would then have an overpayment because it would be paid by both the depository and the issuer's paying agent. In fact, the depository would not pay because its records would show the certificates to be "in transfer." Even if it did pay, it would be able to quickly locate and correct the error long before the property was deemed abandoned.

computer technology to identify out-of-balance conditions and initiate inquiries. It also relies on its customers, large institutional investors, to initiate inquiries that will reveal initial payment errors.

The abandoned property at custodian banks is the result of nominee float - physical certificates in the bank's nominee name owned by another entity over a record date. Scott Dep. at 163-164, 209; *see also* Report of the Special Master, Appendix B, Fact (74), at B-21 (describing a situation that conforms to the phenomenon of nominee float but is referred to as a "missed transfer"). Nominee float in the context of custodian banks occurs when the bank's customer or representative directs the bank to deliver out physical certificates to the customer, or to its broker or another broker or bank, to settle a trade. Scott Dep. at 98-99, 100, 114. The certificates are forwarded in negotiable form registered in the bank's nominee name. *Id.* The bank will be paid the distribution on the underlying security if the certificates are not timely re-registered by their new owner.

When Citibank receives a claim, it requires some documentation that re-registration of the certificate was not accomplished prior to the record date. Since Citibank was not a participant to the transaction that created the nominee float, it also requires information on the trade to validate the claim. Scott Dep. at 190. Citibank's records reflect only the deliveries of the certificates, which may or may not have been sent to the purchasing entity. In 1990, Citibank was receiving claims for overpayments booked into its payable accounts in 1986 and 1987. Scott Dep. at 168. It attributed the upsurge in claims to the financial decline in the securities industry. *Id.* As a result, brokers and banks were intensifying their efforts to research outstanding receivables and collect them. *Id.* If no claim is received after three years, Citibank, as a national bank whose principal operations are in New York, reports the unclaimed property to New York under the *Texas* backup rule since its records do not identify the creditors of the abandoned property it holds.

C. Brokerage Firms[30]

When a broker is the registered owner of a security on the record date, the issuer or its paying agent will pay the broker a dividend and/or interest distribution based upon the broker's total ownership position on the issuer's books.[31] If the broker receives more or less than it expected, it will research the discrepancy. Shearer Dep. at 191, 194-197. The broker, if necessary, goes back to the issuer or its paying agent to resolve any out-of-balance conditions. *Id.* These procedures eliminate initial overages as a source of unclaimed property.

It is the responsibility of the broker to pay its customers the portion of the distribution to which each is entitled. The broker's work in this regard begins at the close of business on the record date. The broker simply determines, through a "snapshot" of each customer's account, the number of shares owned by the customer on the record date. Any changes in that information are entered into a "dividend pending file" prior to the payment date.[32] The adjusted file becomes the basis for allocating the distribution to the customers' accounts.

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[30] The evidence in the record concerning the operations of brokerage firms was provided by three firms, in response to the discovery requests of the plaintiff-intervenor States. *See* Deposition Transcript of Robert Shearer, Group Manager Operations Division, Merrill Lynch, Pierce Fenner & Smith, dated July 19 and 20, 1990; Deposition Transcript of Joseph S. Principe, Director of Internal Control for the John Hancock Clearing Corporation, the operational entity for the brokerage firm of Tucker Anthony, dated July 25, 1990; and the Deposition Transcript of John Cirrito, a Senior Vice President of Prudential-Bache Securities, Inc., dated July 26, 1990.

[31] Brokers' services are extremely varied. The payment of dividend and interest to their customers, the beneficial owners, is but one aspect. Shearer Dep. at 361; Principe Dep. at 67, 174-175, 187-189, 191-192; Cirrito Dep. at 50-53, and Prudential-Bache Exhibit 7, Example H (Proxy Label Report). Issuers do not have access to, or information about, the brokers' customers unless the customers have designated themselves as "non-objecting beneficial owners" ("NOBOs"). *Id.*; *see* Prudential-Bache Exhibit 7, Example K (Tape Edit Record - NOBO List).

[32] If, for example, the broker forwards a security certificate to a transfer agent to change the registered owner prior to the record date but the transfer "misses,"

(Footnote continued)

As in the case of out-of-balance conditions with a paying agent or securities depository, brokers make certain that their customer account data is correct. Shearer Dep. at 196. In addition, the customers regularly receive account statements which detail their transactions and the distributions credited to their accounts. *See, e.g.*, Prudential-Bache Exhibit 7, Example D (Securities Account Statement). If a customer was underpaid, the customer would normally come in and initiate an inquiry. Shearer Dep. at 226-227. In fact, Merrill Lynch has experienced "very few instances" of this nature. *Id.* at 225. Accordingly, if a broker is left with an overpayment after paying all of its customers, the funds are owed elsewhere.[33]

The brokers attribute their overpayments to securities outstanding in their nominee name which are owned by another broker on the record date ("nominee float"). Cirrito Dep. at 128-129. This occurs when securities are bought and sold, and the trade is settled by the manual delivery of physical certificates. When such transactions are conducted close to a record date, the purchasing broker may be unable to re-register the certificates into its own name before the record date. Therefore, the selling broker remains the registered owner and is paid the distributions to which it is no longer entitled.

In the case of nominee float, the brokers' automatic payment of distributions to their customers satisfies the beneficial owners' interests in the distributions. Although the purchasing brokers may not re-register the certificates into their nominee name in time to receive the distributions from the issuer, they do increase their customers' ownership positions to reflect the purchase. The brokers will then pay the distributions to their customers according to their new ownership positions, thereby ensuring that

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that is, the change is not made until after the record date, the broker uses the dividend pending file to correct its records accordingly.

[33] The brokers also testified that they do not permit their customers to take possession of physical certificates registered in the broker's nominee name. Shearer Dep. at 67, 69, 86-87; Principe Dep. at 61; Cirrito Dep. at 45-47. Since the certificates are re-registered into the customer's name, the customer receives payment of the distribution directly from the issuer in that case.

the beneficial owners are paid everything they are entitled to. The broker, however, will be underpaid the distribution. The broker records the obligation into an account receivable. The beneficial owner's interest in the distribution has been fully satisfied. As set forth in New York's Renewed Motion For Judgment On The Pleadings (October 30, 1990), at 41-42:

> On pay date, the broker credits all of its customers' accounts that have long positions in the particular security, based upon the dividend or interest rate and the number of shares held. Shearer Dep. at 124, 135, 138, 140, 152, 154-155, 171, 190-191; Principe Dep. at 79-80; Cirrito Dep. at 61-62, 125-126. This is standard practice for all account types and all distributions, including stock dividends, on domestic securities. Shearer Dep. at 120-121; Principe Dep. at 83-84; Cirrito Dep. at 62-63. The crediting procedure is automatic, based upon the dividend pending file as adjusted up to the pay date, and occurs *regardless of whether the broker has actually been paid* by the paying agent or other source. Shearer Dep. at 154-155; Cirrito Dep. at 174-175 and Prudential-Bache Exhibit 7, Example I (Cash Distribution Report - Pay Date). The customer is entitled to the money as of the date it is credited to his account (Shearer Dep. at 113, 156), or it is available to be drawn on the next day (Cirrito Dep. at 64-65). As long as the customer was entitled to the credit, it is not reversible even if the broker itself never receives payment of the distribution. Shearer Dep. at 190-191; Cirrito Dep. at 62-63. (Emphasis added; the deposition references in the original use the brokerage name.)

In order for a broker to reverse the payment to its customer, the circumstance would have to be "awfully extreme." Principe Dep. at 80-81. This occurs only when the broker determines that its customer was not entitled to the distribution in the first instance. Shearer Dep. at 164, 165, 170; Principe Dep. at 81; Cirrito Dep. at 63. An example would be payment of the distribution on an invalid certificate.

Whether or not the overpayment to the debtor broker eventuates into abandoned property depends upon the efforts of the creditor broker to claim the property from the debtor broker. The debtor broker itself will not research the overpayment until it receives the claim. According to the practice at Prudential-Bache, which appears to be representative of the industry, "[i]n most cases, in the vast, vast majority of the cases," the debtor broker will wait for a claim to come in. Cirrito Dep. at 73. *Compare with* Report of the Special Master, Appendix B, Fact (61), at B-18, indicating that debtor broker initiative in researching overpayments is not unusual. If the creditor broker decides to write off the receivable or is unsuccessful in pursuing a claim, the property will become escheatable.

When a creditor broker makes a claim, it must specify the security, record date, pay date and precise certificate numbers of the shares it owned on the record date but which were registered in the debtor broker's name.[34] The "inherent uncertainty" in resolving such an ownership interest, recognized by the Special Master (*see* Report, Appendix B, Fact (61), at B-18), militates against the pursuit of all claims. Merrill Lynch focuses on a threshold amount, while Prudential-Bache factors the amount into its decision, which it characterized as being one of "degrees." Shearer Dep. at 239-241; Cirrito Dep. at 77-78. Indeed, the fact that brokers exercise this discretion in pursuing claims contradicts the Special Master's belief that at least in part, the claims are "to recover distributions to which . . . their customers were entitled on a payable date." Report, Appendix B, Fact (60), at B-17. *See also* Fact (65), at B-19.

Claims are generally made within a couple of weeks after the pay date and drop off dramatically after a year. Shearer Dep.

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[34] The Special Master's description of the claiming process is incorrect. *See* Report, Appendix B, Fact (61), at B-18. According to the description there, the claimant (creditor broker) must show that "the certificate was registered in the name of the claiming brokerage at some time prior to the record date for the payment of the distribution." *Id.* Were this so, the claiming brokerage, as the record owner prior to the record date, would have received the distribution.

at 231-232.[35] The residue of the property, arising out of nominee float, becomes the corpus of property that is ultimately deemed abandoned and escheatable.[36]

Since debtor brokers make no effort to research overpayments, if no claim is made, the debtor broker is unaware of the creditor broker's identity at the time of the escheat. However, as the Special Master recognized, there are "numerous verification procedures" available to the debtor broker which, if undertaken, would establish the creditor broker's identity.

> It may have recourse to its "overs" or "overage" account to determine whether it booked an overpayment in the particular security for the record and pay dates involved. The broker may also examine its daily stock record which lists, by account number, all trades in that security on a particular day. This record may indicate whether a delivery was made to the claiming broker around the record date. In addition, the firm may inspect records to match the certificate numbers in the claim against those on its delivery tickets.

Report, Appendix B, Fact (62), at B-18.

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[35] In addition to claims arising out of nominee float, brokers claim against other brokers for distributions owed to them on a "fail to deliver" (or "fail to receive"), and on securities loaned or pledged. *See* Report of the Special Master, Appendix B, Facts (58), (59), at B-17. The critical distinction between these claims and those arising out of nominee float, unacknowledged by the Special Master, is that brokers' transactional records, both those of the creditor broker and the debtor broker, flag "fails," loans and pledges. Shearer Dep. at 294; Principe Dep. at 78, 100-101, 168; Cirrito Dep. at 75-76, 87. Thus, the creditor brokers routinely make, and prevail on, such claims. Even in these situations, however, the debtor brokers wait for claims to come in.

[36] In view of the enormous number of accounts, securities and trades handled by the large brokerage houses, the residue of unclaimed distributions is, indeed, comparatively minute. Merrill Lynch and Prudential-Bache have millions of accounts worldwide. Shearer Dep. at 29; Cirrito Dep. at 18. Prudential-Bache estimated that it has 300,000 different securities on its books, and conducts between 30,000 and 40,000 trades a day. Cirrito Dep. at 18, 167. Merrill Lynch estimated that "far, far less" than 1% of the distributions it receives in a year are unaccounted for. Shearer Dep. at 516.

The delivery ticket in particular, which documents the actual delivery of the physical certificates, identifies the contraparty to the trade and, hence, the creditor broker of the unclaimed distribution. New York escheats the unclaimed property of debtor brokers in New York as the State of last known address of almost all of the creditor brokers and banks on the debtor brokers' books and records.

IV. THE REPORT OF THE SPECIAL MASTER

A. Overview

The States raised three disparate legal theories in asserting their right to escheat the unclaimed distributions reported to New York by New York debtor brokers, DTC and New York custodian banks. In its complaint filed on May 31, 1988 pursuant to leave of the Court (486 U.S. 1030), Delaware asserted a claim to the distributions held by brokers incorporated in Delaware for which there was no known beneficial owner on the brokers' books and records. Delaware advanced its claim under the *Texas v. New Jersey* backup rule as the debtors' domiciliary State.

Texas, as an intervening plaintiff, asserted a claim to a portion of the same property claimed by Delaware. The Texas complaint was accepted for filing on February 21, 1989 (489 U.S. 1005). The complaint alleged that Texas was entitled to escheat the distributions owed to unknown beneficial owners if the underlying securities were issued by corporations and municipalities domiciled in Texas. The Texas theory was predicated on the *Texas v. New Jersey* backup rule, except that Texas asserted that the securities issuers, not the brokers, were the debtors of the property. In October, 1989, Texas amended its complaint to encompass the unclaimed distributions on Texas securities issues paid to DTC and New York's custodian banks. Various States supporting the Texas theory, including the lead State of Alabama, filed motions to intervene on April 21, 1989.

Finally, on November 17, 1989, the State of California, with other States jointly moving for leave to intervene, asserted a claim

to a portion of the property in question to the extent it was generated by the commercial activities of unknown beneficial owners in each State. The California theory was advocated as a variant of the *Texas v. New Jersey* primary rule in that these States alleged that the resulting allocation of the property, pursuant to some aggregate formula, would satisfy that rule's concern for fairness and further goal of tending to distribute the funds to the States in proportion to the commercial activities of their residents. The California theory was also adopted by the District of Columbia in a separate motion for leave to intervene.[37]

New York defended its claim to the property in its answers to the complaints,[38] opposing brief,[39] and dispositive motions against the intervenors.[40] New York asserted that it was entitled to the property in accordance with *Texas v. New Jersey* and *Pennsylvania v. New York*, and that the intervenors' theories could not succeed without changing those precedents. New York

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[37] The Special Master has recommended that the Court grant the applications of all jurisdictions that filed motions for leave to intervene, as well as the motion of Texas for leave to file an amended complaint in intervention. Report at 5; A-2.

[38] New York answered the Delaware complaint on July 27, 1988, the Texas complaint in intervention on April 21, 1989, the Texas and Alabama amended complaints in intervention on November 17, 1989, and the California complaint in intervention on July 20, 1990.

[39] New York lodged its Brief in Opposition to Motion [of Delaware] for Leave to File Complaint, on May 9, 1988, and Brief in Opposition to Motions [of Alabama, *et al.*] for Leave to Intervene, on May 18, 1989.

[40] New York moved for judgment on the pleadings against Texas on May 26, 1989. On October 30, 1990, following a limited program of discovery authorized by the Special Master (and described in his Report at 5-7), New York renewed its motion, directed against all of the complaints in intervention. Delaware also moved to dismiss the complaints in intervention. Texas, *et al.* and Alabama, *et al.* responded with motions for judgment on the pleadings and partial summary judgment, respectively, and California, *et al.* requested an "initial ruling" on its legal theory.

also contended that Delaware's claim under the *Texas* backup rule, to the property held by brokers domiciled there, raised an issue of fact regarding the brokers' ability to use their records, including the delivery tickets associated with trades of physical certificates, to identify the creditor brokers of unclaimed distributions. New York urged that this facet of the case could not be explored on the basis of the limited discovery authorized by the Special Master.

In the Report dated January 28, 1992, the Special Master proposed a resolution of the competing claims essentially in line with the Texas theory advocated by Texas, *et al.* and Alabama, *et al.*[41] Pursuant to the recommendation, the primary right to escheat unclaimed distributions lies in the jurisdiction of the last known address of the ultimate intended beneficial owner of the underlying securities. If that address is unknown, or is in a jurisdiction that does not provide for the escheat, then the right falls to the jurisdiction where the issuer of the underlying security has its principal executive offices. If the issuer's identity is unknown, or the jurisdiction of its principal executive offices does not have coverage for the property, then the jurisdiction where the holder has its principal executive offices is the proper recipient. In each instance, the recommendations preserved the right of a jurisdiction to assert a superior claim to the property if and when its laws made provision for the escheat. Report at A-2 to A-4.

With the exception of using a new locational test under the backup rule based upon principal executive offices, the Special Master viewed his recommendations as the product of resolving ambiguities in the Court's precedents. *See, e.g.*, Report at 28-32. He proposed using the chief executive office, rather than domicile, to locate the debtor as a more equitable but equally convenient alternative. *Id.* at 40-50. Finally, the Special Master accorded full retroactive effect to his recommendations. *Id.* at 70-77.

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[41] The Special Master circulated a Draft Report for comment by the parties on June 21, 1991. Report, at 7-8.

B. The Legal Analysis

a. The Dual Debtor Conundrum

The Special Master believed that this case was novel in that it presented the necessity of choosing between two distinctive uses of the term "debtor" in order to apply the *Texas v. New Jersey* backup rule. Report at 34. On the one hand, an issuer is no longer a debtor after it makes a payment to the registered owner, as evidenced by U.C.C. § 8-207(1). *Id.* at 25. The registered owner has the acknowledged debt. On the other hand, the registered owner has no ownership rights to the funds (having received an overpayment), leaving the issuer as the entity with the last claim to the funds as an asset.

Having postulated a split in the debtor's identity, the Special Master proceeded to eliminate the payment obligation of the registered owner as determinative of the jurisdiction entitled to escheat the funds under the *Texas* backup rule. He stated that "[w]hile federal common law rules, such as the Supreme Court's rules governing the resolution of conflicting claims of escheat cannot (and should not) operate in a vacuum, ignoring all state-law rules, it does not follow that federal law must track one particular manifestation of a state law rule." Report at 25-26. The state law rule which the Special Master believed to be expendable for escheat jurisprudence was U.C.C. § 8-207(1).

> But the effect of issuer protection provisions such as U.C.C. § 8-207(1), whether conceived of as substantive rules or affirmative defenses, is not, even under state law, a declaration that *ownership* of the funds in issue shifts from issuer to intermediary to beneficial owner. Issuers are acquitted of a responsibility but the intermediaries do not necessarily acquire the rights of owners at that point; indeed, it is this understanding that sets in motion the very possibility of escheat.

Report at 26.

The Special Master then turned to the decisions in *Texas v. New Jersey* and *Pennsylvania v. New York* and concluded that

there, the Court did not use the term "debtor" (or "creditor") in any specific state law sense.

> All this is by way of saying that the Court's use of the terms "debtor" and "creditor" in *Texas v. New Jersey* and *Pennsylvania v. New York*, seems to be more descriptive - an attempt to identify the relevant parties - than prescriptive legal commands, carrying the kind of definition one might find, for example, in the Uniform Fraudulent Transfer Act. It seems to me that the Court's use of these terms was not intended to send courts (or Special Masters), in subsequent cases, in search of particular state-law definitions of "debtor" and "creditor" (which may, in any case, vary from state to state and context to context).

Report at 29-30 (footnote omitted).

Accordingly, the Special Master characterized his role in this case as "search[ing] for parties with relevant *attributes*, for purposes of escheat jurisprudence." Report at 30. Under this "relevant attributes" scrutiny, the Special Master concluded that the term "debtor" could still refer to the registered owner.

> The term "debtor" could refer to an entity that, at a particular point in time, had a legal obligation to turn the funds over to the "creditor". This would point to the position of Delaware and New York . . . .

Report at 31-32. However, the Special Master went on, the term "debtor" could also refer to the issuer of the underlying security.

> But the Court's use of the term "debtor" could also descriptively refer, under these circumstances, to the last owner of the funds, in the sense of the last person who had a claim to the funds as an asset that would be appropriately reflected in the net worth of the entity in question. This would be . . . the issuer in the instant case.

Report at 32.

Turning once again to the decisions in *Texas v. New Jersey* and *Pennsylvania v. New York*, the Special Master found no precise answer to the question of which of the entities, the issuer or the registered owner, had the more relevant debtor attributes.

> Thus, in neither case was the Court faced with a need to choose between two distinctive uses of either the term "debtor" or the term "creditor." This case, however, presents just such a need.

Report at 34.

In the end, the Special Master called upon the principles of certainty and fairness to resolve the dilemma which he had posed. In terms of certainty, the Special Master found no preference between use of the issuer's domicile or that of the record holder. Report at 34. In terms of fairness, however, he found that using the issuer's domicile won out. *Id.* at 35.

The particular concept of fairness which the Special Master had in mind at this point in his analysis was not a more even distribution of the funds among the States. Report at 35. Rather, he linked fairness to rewarding the jurisdiction that had "a claim to benefitting the 'company whose business activities made the intangible property come into existence.' " *Id.*[42] By contrast, the Special Master saw nothing fair about rewarding the jurisdiction of the registered owner, relying on his misconception that it was that entity's "records (or lack thereof) [that] created the problem that resulted in the escheatable property in the first instance." Report at 36.

Finally, despite the evidence in the record to the contrary, the Special Master concluded that "a focus on the location of the issuer is simple and inexpensive to implement." Report at 39.

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[42] The quoted language is from *Texas v. New Jersey*, 379 U.S. at 680, erroneously attributed by the Special Master to *Pennsylvania v. New York*.

He perceived the different administrative burdens as "differences of a minor degree" which should not control the result. *Id.*

Having identified the issuer as the debtor, the Special Master examined the other component of the *Texas* backup rule, the proxy for locating the debtor. Report at 41. Whereas the Court used the jurisdiction of incorporation, the Special Master recommended a change to the jurisdiction of chief executive office. *Id.* He concluded that in the years following the Court's rejection of a principal place of business test in *Texas v. New Jersey*, 379 U.S. at 680, the concept of chief executive office had attained the requisite certainty to qualify as a locational proxy. *Id.* at 42-44. The Special Master reiterated the Court's view that such a proxy was inherently more persuasive than one which depended upon the happenstance of corporate domicile. *Id.* at 45-46. Finally, the Special Master endorsed the change in the locational test under the *Texas* backup rule because "it also is more likely to distribute the funds, in this and other cases, fairly among the various jurisdictions." *Id.* at 50. In particular, the Master was concerned about the disproportionate share of the funds that would accrue to Delaware if issuers were located by their domicile. *Id.* at 47.

b. The Ultimate Beneficial Owner As Creditor

The Special Master found less difficulty in identifying the relevant attributes of a "creditor."

> One attribute seems to dominate both as a matter of logic and as a matter of the internal structure of the Court's prior cases. A legal right to the funds, as beneficial "owner," under whatever basis, makes one a "creditor."

Report at 31. Having identified the "ultimate intended beneficiary" as the creditor (Report at 64), the Special Master concluded that New York could not prevail on its claim under the *Texas* primary rule as the State of last known address of the creditor brokers.

Central to the Special Master's reasoning was his statement that creditor brokers have no beneficial ownership interests in the funds in question.

> Only if it could be further determined that the identified bank or broker was trading for its own account, or was otherwise the beneficial owner of the distribution (such as might be the case if the identified bank or broker had paid the beneficial owner originally), would it be sensible to launch an effort to locate that bank or broker. The difficulty, however, is that there is no basis to presume this conclusion.

Report at 65-66. According to the Special Master, "it is almost never the case that an intermediary acting other than for its own trading account will have a claim as a creditor." *Id.* at 66, n.57.

The remainder of the Special Master's analysis rejecting New York's position under the primary rule focused on the rule's provision for locating the jurisdiction of the creditor, *i.e.*, the creditor's last known address on the debtor's books and records. The Special Master concluded that even if creditor brokers had beneficial ownership interests in the funds, New York's claim would fail because it was based upon a presumption that the creditor brokers' last known addresses were in New York. Report at 58-59, 62-63, 66-67.

First, the Special Master noted New York's suggestion, originally set forth in the Robert Griffin Affidavit, that "[a] far less time - consuming and costly alternative to attempting reconstruction of every overpayment transaction, and one which would be almost as accurate, would be to use representative samples from each debtor broker." Brief in Opposition to Motion for Leave to File Complaint, A-5. The Special Master viewed this as "essentially asking for the adoption of a legal standard for presuming addresses that are in fact unknown." Report at 59, n.50.

Second, the Special Master opined that the address on the debtor brokers' books, even if known, might not correlate with a creditor broker. Report at 62-63. In other words, if the broker so located traded the underlying security to another broker prior to the record date, it would owe the distribution to that broker.

C. The California, *et al.* Theory[43]

The Special Master rejected the theory raised by the States led by California because it altered precedent in order to achieve greater geographic diversity for escheat of the funds.

> California, *et al.*, in short, would have the Court now do what it refused to do under the circumstances of *Pennsylvania v. New York*. In the view of California, *et al.*, a rough, aggregate concept of fairness could be attained through adoption of a gross formula that would, in some approximate fashion, reflect where the nation's beneficial owners lived or conducted commercial activities.

Report at 51. In addition, the Special Master concluded that an equivalent diversity was attainable through the *Texas v. New Jersey* backup rule as interpreted by him, "without adding a further fiction to the concept of the beneficial owner's location." Report at 52.

In discussing the relevance of *stare decisis*, the Special Master said:

> There is virtue in clear rules, and in discouraging parties from routinely challenging those rules as not quite right for their particular case.

Report at 53. In the Special Master's opinion, a change in the Court's basic rules with respect to a particular type of transaction

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[43] New York does not take issue with the Report's analysis of the California, *et al.* theory, but contends that factors recognized by the Special Master as defeating that theory also apply to the theory of Texas, *et al.* and Alabama, *et al.*

is best left to Congress, citing the statutory solution adopted in response to *Pennsylvania v. New York.*[44]

> Fashioning precise fairness rules to handle a relatively unique, complex, and significant (in terms of dollar) case (as this case is) . . . seems best addressed by Congress.

Report at 54.

Finally, the Special Master found serious administrative difficulties inherent in the California theory. He noted, for example, that "unless all jurisdictions have the same period for escheat, the funds might be partially escheated at any given time, with other funds continued to be held by the intermediary." Report at 54, n.48.

D. Reachback Period[45]

The Special Master concluded that New York must "disgorge" all of the funds in question that it has escheated, other than those for which New York can show that it is the location of the issuer's principal executive offices. Report at 76. Although

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[44] Congress enacted legislation to establish the entitlement to escheat any unclaimed sum payable on a money order, travelers check, or other similar instrument (other than a third party bank check), on which a banking or financial organization or a business association is directly liable. 12 U.S.C. §§ 2501, *et seq.* Under the statute, the primary right of escheat is given to the State of purchase as shown on the debtor entity's books and records. 12 U.S.C. § 2503(1). This reflected Congress' findings that such books and records do not show a last known address for the purchaser, and a substantial majority of purchasers reside where the instruments were purchased. 12 U.S.C. § 2501(1), (2). The backup provision conferred the right of escheat upon the State where the debtor entity's principal place of business was located. 12 U.S.C. § 2503(2),(3).

[45] The issue of retroactivity appears in Part IV of the Report, which includes an analysis of Delaware's minimum contacts concerns (Report at 68-70), and a discussion of implemental considerations (*id.* at 77). New York excepts to these portions of the Report to the extent that they subsume the correctness of the Texas, *et al.* and Alabama, *et al.* theory on the merits.

the Special Master "admit[ted] to being troubled" by the financial impact that a disgorgement of such "magnitude" would have, he took consolation in his belief that there would be practical limitations stemming from the fact that records may "no longer exist that reveal who the issuers were of funds that became 'stuck' in the 1970s or earlier." *Id.* at 76, 77. He also attributed much of New York's anticipated hardship to the fact that it spent the money rather than maintaining a larger reserve fund (citing the New York State Finance Law § 95). *Id.* at 76, n.68.

The Special Master's retroactivity analysis centered on *Chevron Oil v. Huson*, 404 U.S. 97 (1971). Report at 72. Although he expressed some reservation as to whether *Pennsylvania v. New York* precluded application of the *Chevron Oil* doctrine, he concluded that New York could not, in any event, satisfy the first prong of the doctrine - the establishment of a "new principle of law." In the Special Master's opinion, his disposition was "a logical interpretation of prior precedents in this area." Report at 71-73. Turning, then, to the question of remedial limitations, the Special Master found none available to New York under a statute of limitations or laches defense. *Id.* at 74-75.

SUMMARY OF ARGUMENT

In *Texas v. New Jersey*, this Court announced a "clear rule" to govern the escheat of abandoned intangible property, to be applied to "all types of intangible obligations" and "to which all states may refer with confidence." 379 U.S. at 678. The rule requires that intangible property escheat to the State of the creditor's last known address on the debtor's books and records (primary rule). If the creditor's last known address does not appear on the creditor's books, or is in a State that does not provide for escheat of the property in question, then the State of the debtor's domicile may escheat the funds until another State comes forward with proof of a superior claim (backup rule). *Id.* at 682. Thus, the application of the Court's rules to the various types of abandoned intangible property requires only the identification of the debtors and creditors of the property. The property involved in this case consists of unclaimed dividend, interest, and stock dividends on stocks and bonds paid to New York brokers, New

York banks and DTC and owed to unknown creditors or New York addressed creditors.

The application of the *Texas* escheat rules to the property in question is straightforward because the debtors and creditors of this property are fixed by uniform commercial law principles codified in the Uniform Commercial Code (U.C.C. § 8-207), which all States and the District of Columbia have adopted in relevant form. Pursuant to state law, the issuer of the underlying securities is the debtor of the distribution only to the stockholder or bondholder of record. Upon paying the record holder, the issuer's debt is satisfied and its rights in the property cease. *See* U.C.C. § 8-207(1). The record holder is the debtor of any distributions that become abandoned in its possession. The creditor is the owner of the property entered on the record holder's books and records regardless of whether it has beneficial ownership interests in the property that could be established as a matter of fact.

Pursuant to these uniformly established principles of commercial law, New York escheats the unclaimed distributions held by record holders that are domiciled in New York and have no record of a creditor on their books. These entities are New York custodian banks and DTC, a securities depository incorporated under New York's banking law. The unclaimed distributions held by brokerage firms in New York, by contrast, are owed to creditors that are identifiable from the debtor brokers' books and records. The creditors are the brokers and banks that purchased the underlying securities but were not paid the distributions to which they were entitled. New York escheats this property because it can demonstrate that in virtually all instances, the debtor brokers' books identify creditor brokers and banks with New York addresses. The right of a State to demonstrate a superior claim to abandoned property under the *Texas* primary rule is central to the Court's escheat precedents.

The Special Master rejected New York's claims to the property in question because he concluded that the Court did not intend to use the terms debtor and creditor according to their state law meanings, nor, indeed, according to their commonly accepted

usage. Rather, the Master concluded that the Court used these terms as "shorthand" provisions for merely identifying persons or entities with debtor and creditor "attributes." Under this novel approach, he concluded that the debtors of the property were the issuers of the securities because they were the last to have "a claim to the funds as an asset that would appropriately be reflected in the net worth of the entity in question." Report at 32. In identifying the creditors, the Special Master ignored the record holders' recorded debts to creditor brokers and banks in favor of parties with "ultimate intended" beneficial ownership interests in the property. *Id.* at 64.

The Special Master's definitions of the debtors and creditors of the property in question are contrary to the Court's escheat precedents (and the States' escheat laws), which expressly recognize that intangible property is a debt and that the "asset" is the right to enforce the payment obligation, not the underlying property from which it is derived. Accordingly, the Court specifically referred to the debtor as the obligor subject to the payment demand, and the creditor as the obligee or apparent owner on the debtor's records who had the right to the payment obligation. *See, e.g., Standard Oil Co. v. New Jersey*, 341 U.S. 428 (1951). The Court did not alter these understandings of the debtor and creditor when it announced the *Texas* rules of priority. In *Texas v. New Jersey*, the Court used the terms debtor and creditor without defining them. It thereby demonstrated its intent to rely on state law in this context as it had done previously.

It was therefore incumbent on the Special Master to apply the Uniform Commercial Code in defining the debtor-creditor relationships for the property in question unless its definitions proved to be incompatible with the purposes of the *Texas* escheat rules. The Special Master could not find any disharmony, however. State law is uniform in its provision that the issuers' debt is discharged upon paying a distribution to the record holder. Indeed, as the Special Master recognized, without such a release the payment of distributions would not be possible. Moreover, escheat by the record holders' jurisdictions under the

Texas backup rule is demonstrably easier than escheat by 51 jurisdictions according to the issuer's domicile (or chief executive office). Reliance on state law thus accomplishes the Court's goals under the *Texas* backup rule of certainty and ease of administration.

In order to reject state law, the Special Master reached beyond the Court's precedents by adopting a "fairness" standard under the backup rule. It was also necessary for him to give content to the standard since the Court never articulated one in this context. The fairness test which the Special Master adopted rewarded the jurisdiction that benefitted the company whose business activities gave rise to the distributions. Report at 35. Even if a fairness test were appropriate in applying the backup rule, the jurisdictions of the record holders have an equal or better claim to the property. These entities - securities depositories, brokers and custodian banks - not only make corporate and governmental investment possible, they are foremost in seeking to eliminate the single operative cause of the unclaimed distributions involved here, the certificated security.

Equally untenable is the Special Master's rejection of the apparent owner of the property on the debtor's books as the creditor under the *Texas* primary rule, in favor of a party with "ultimate beneficial ownership" interests in the property as an asset. Under the primary rule, the Court required that the creditor be identified from the debtor's books and records. The Court never looked beyond the debtor's books to identify the creditor because it always identified the creditor's asset as the right to the payment obligation, not to the underlying property from which it derived. Moreover, defining the creditor by actual beneficial ownership rights in the underlying property results in a fact-oriented approach which is contrary to the Court's stated concern for a uniform rule.

The Special Master's definition of the creditor is fundamentally at odds with the *Texas* rules because it relates to parties that *cannot* be identified from the debtors' books. "Ultimate intended beneficial owners" are never discernible from the debtor

brokers' records and, in any event, have been paid the distributions to which they were entitled in virtually all instances by their own brokers (the creditor brokers and banks). By ignoring the creditor brokers and banks on the debtor's books in favor of entities or persons that cannot be identified from the debtor's records, the Special Master has made it impossible to apply the *Texas* primary rule. The Master has thus reversed the priorities established by the Court in *Texas v. New Jersey*.

Even under the Master's "ultimate" creditor attributes test, the creditor brokers and banks qualify as creditors because they have beneficial ownership interests in the property. These entities routinely pay their customers, the beneficial owners, all of the distributions to which they are entitled. If the creditor brokers or banks are underpaid the distributions that they have already paid to the beneficial owners, they are entitled to keep the funds they subsequently collect. The Special Master's refusal to recognize the beneficial ownership rights of creditor brokers and banks warrants the conclusion that his designation of the creditors as the "ultimate intended beneficial owners" was a mere formalism that has no relation to the Court's escheat rules. The Special Master's "ultimate" goal was the dispersal of the property escheated by New York to the various States, a usage of the *Texas* rules which the Court rejected in *Pennsylvania v. New York*, 407 U.S. 206 (1972).

Finally, if the Court were to adopt the Special Master's Report, it should do so prospectively since the Report proposes revisions in rules announced by the Court in the exercise of its original rule-making jurisdiction. If the Court were to apply the standard retroactivity analysis of *Chevron Oil v. Huson*, 404 U.S. 97 (1971), this case satisfies its various prongs. The recommendations of the Special Master constitute fundamental changes of law that could not have been reasonably anticipated. The Special Master's definitions of the debtors and creditors of the property in question are inconsistent with the Court's escheat decisions, the States' own escheat laws incorporating those decisions, and uniform state commercial law principles that adopt the usual meanings of the terms debtor and creditor. The

Master's usage of the *Texas* rules, moreover, ignores the priority which the Court gave to the creditor's jurisdiction, and imposes an unprecedented (and invalid) fairness test under the backup rule to allocate property to the various States.

Under the second *Chevron Oil* prong, the disruption of New York's genuine reliance interests is amply demonstrated by the fact that the Special Master's recommendations are contrary to the understanding of the *Texas* rules embodied in the uniform abandoned property acts and the States' abandoned property laws. The States have applied the *Texas* rules in the same way that New York has. The imposition of unlimited retroactive liability on New York, moreover, will result in fiscal and administrative burdens of devastating proportion. The "confidence" which the Court hoped to instill in the States through its escheat rules will be eroded by retroactive liability imposed after the rules are changed. *Texas v. New Jersey*, 379 U.S. at 678.

ARGUMENT

POINT I

THE RECORD HOLDER IS THE DEBTOR OF THE PROPERTY IN QUESTION UNDER THE *TEXAS V. NEW JERSEY* BACKUP RULE

The Special Master concluded that the issuer of the securities distributions, rather than the obligor or holder of the property, was the debtor under the *Texas* backup rule based upon his (1) interpretation of the Court's precedents; (2) refusal to apply the uniform commercial law principle that the issuer's debt is discharged upon payment of the distribution to the record holder; and (3) predilection for using the *Texas* backup rule to allocate the property to the States. None of these rationales is consistent with *Texas v. New Jersey* or *Pennsylvania v. New York*. In addition, the Special Master's analysis is inconsistent with the Court's earlier escheat decisions, which clearly identify the debtor of abandoned intangible property as the obligor or holder. *Standard Oil Co. v. New Jersey*, 341 U.S. 428 (1951); *Anderson*

Nat. Bank v. Luckett, 321 U.S. 233 (1944); *Security Savings Bank v. California*, 263 U.S. 282 (1923).

A. The Court's Precedents Consistently Apply The Term Debtor To The Obligor Or Holder Of Abandoned Intangible Property

The Special Master incorrectly interpreted *Texas v. New Jersey* and *Pennsylvania v. New York* as raising an ambiguity in the Court's use of the term "debtor." It is evident from these decisions that the debtor refers to the obligor, the entity that owes the property to someone else.

In *Texas v. New Jersey* the property in question consisted of

> various small debts totalling $26,461.65 which the Sun Oil Company for periods of approximately seven to 40 years prior to the bringing of this action owed to approximately 1,730 small creditors who have never appeared to collect them. The amounts owed, most of them resulting from failure of creditors to claim or cash checks, are either evidenced on the books of Sun's two Texas offices or are owing to persons whose last known address was in Texas, or both.

379 U.S. at 675 (footnote reference omitted).

It is apparent from the Court's description of the property that Sun Oil was considered the debtor because of its outstanding payment obligations, represented by the uncashed checks and various other indicia of indebtedness. There is simply nothing, express or implied, in the Court's discussion that would warrant the conclusion that the term debtor could ever be applied to an entity that had satisfied its payment obligation. Indeed, the Special Master characterized the Court's opinion as follows:

> . . . the opinion treated the unclaimed funds as if they were funds held by Sun Oil that simply had never been claimed by the appropriate creditor - in other words,

> treating this case as if it involved a rather simple "debtor-creditor" relationship. . . .

Report at 18.

Nevertheless, the Special Master concluded that the Court did not intend to limit the application of the *Texas* backup rule to the jurisdictions of the obligors. He relied on two factors in this regard, neither of which is credible. First, he noted the fact that when the Court announced the backup rule, it referred to "escheat by the State of corporate domicile," not "debtor's" domicile. Report at 18 (citing 379 U.S. at 682). *See also* Report at 28. Second, the Special Master stated that the underlying Report of the Special Master in *Texas v. New Jersey* indicated that "several categories of distributions . . . were held by intermediary banks and paying agents rather than Sun Oil, but the Court did not on that account launch into an inquiry as to whether Sun Oil remained a debtor or not." Report at 28; *see also id.* at 18, 32-34, 37. The Special Master speculated, therefore, that the Court was concerned with debtors in the sense of the originators of the debt, not the obligors.

Concerning the Court's reference to "corporate domicile" in the context of the backup rule, it can only be read to refer to Sun Oil, not to corporate issuers or debt originators generally, and to subsume the Court's prior discussion of Sun Oil as the obligor. In fact, the Court, in its Final Decree, makes clear that its reference to "corporate domicile" was a specific reference to Sun Oil.

Equally spurious is the Special Master's belief that the Court's disregard of the intermediaries holding Sun Oil's funds could be construed as a lack of concern for the obligor in delineating the debtor under the backup rule. The concise response to the Master is that Sun Oil's status as the obligor of the funds was never in dispute.

> In its answer, the Sun Oil Company admits that it owes the obligations in question and its willingness to pay them to the State found entitled thereto by the

> judgment of this Court. It asserts no claim to any of the funds in controversy.

Report of the Special Master, *Texas v. New Jersey*, at 4.

Moreover, the intermediaries in possession of Sun Oil's funds were Sun's agents. Although the Special Master here suggested that there was some doubt as to the capacity in which the intermediaries held the funds, that is not evident from the Special Master's Report in *Texas v. New Jersey*. To the contrary, that Report demonstrated that the entities involved were banks that functioned as Sun's paying agents and transfer agents. Report of the Special Master, *Texas v. New Jersey*, at 5, 11, 12-13. Since Sun's debt obligations were unaffected by the location of its assets, the existence of the intermediaries was irrelevant to the Court's discussion of the backup rule. Clearly, under all of these circumstances, *Texas v. New Jersey* does not permit the conclusion that the Court used the term "debtor" as "shorthand" to identify parties with "debtor attributes" rather than the obligor of the debt. *See* Report at 28-30.

Precisely the same conclusion must be drawn from the Court's decision in *Pennsylvania v. New York*. In that case, the Court adopted the Special Master's reasoning that the nature of Western Union's obligation was that of a "common debt." Report of the Special Master, *Pennsylvania v. New York*, at 15. Accordingly, there was no dispute that Western Union was the debtor for the purpose of applying the *Texas* backup rule, based upon its obligation to pay the funds to the payee or return them to the sender. The Court's sole concern was whether the backup rule should be utilized when the debtor-obligor (Western Union) did not routinely record the addresses of the parties to whom it owed the funds.

The Special Master's tendency to confound the Court's decisions is nowhere more evident than in his analysis of *Pennsylvania v. New York*. He contended that the Court did not use strict debtor-creditor terminology in that case because "it would be possible to view Western Union as a bailee for hire - an

agent of the sender - and not as a debtor in a transaction where the sender was the creditor." Report at 28. Further, stated the Master, if there was an underlying debt, "the sender remained the payee's debtor until the obligation that was the subject of the money order was satisfied." *Id.* at 28-29. Based on this, the Master concluded that the Court's references to Western Union as the debtor, and to the sender and payee as creditors, were merely "descriptive." *Id.* at 29.

The Special Master's strenuous effort to demonstrate that the Court was not concerned with "technical" state law definitions of debtors and creditors goes too far. It misses the point that Western Union was the debtor because it had an outstanding payment obligation, and the sender and payee were creditors because either could claim the funds back from Western Union. Indeed, the Court considered Western Union's payment obligation to be a common debt because Western Union was a debtor-obligor in accordance with usual commercial law understandings. It was, therefore, contrary to the Court's specific references to Western Union as the debtor for the Special Master to have concluded that its domicile was permitted to escheat "simply because Western Union was in possession of the funds." Report at 36-37.

All of this was but a preamble to the Master's attempt to reconcile *Pennsylvania v. New York* with his ultimate conclusion that the debtor of the property involved here is the issuer - "the last owner of the funds, in the sense of the last person who had a claim to the funds as an asset that would appropriately be reflected in the net worth of the entity in question." Report at 32. Even if this unorthodox definition of a debtor were tenable, it is inconsistent with the Master's own conclusion that Western Union was a debtor. Clearly, Western Union could not satisfy the test of having a claim to the funds as an asset that could be reflected in its net worth. The sender, however, could have satisfied this test, but as the Master recognized, the Court identified the sender as a creditor, not a debtor. These contradictions in the Master's analysis of *Pennsylvania v. New York* stem from the fact that the Master defined the terms debtor and creditor in novel ways never contemplated by the Court.

Thus, as interesting as the Master's analysis may be, it is contrary to the Court's decision and incompatible with the Court's concern for certainty in its escheat rules. The intellectual gymnastics that were required to construe *Pennsylvania v. New York* as supporting the proposition that issuers are debtors after paying their debts destroys any semblance of predictability in the Court's escheat jurisprudence. The only consistent and logical reading of *Pennsylvania v. New York* is that the Court applied the backup rule to Western Union because it was the obligor. In so doing, and by treating the sender and payee as Western Union's creditors, the Court further demonstrated its unwillingness to plumb the origins of the payment obligation as a predicate for identifying the debtor. In short, an issuer, shorn of its obligation to pay, is irrelevant to the operation of the *Texas* backup rule.

Finally, the Court's uniform application of the term "debtor" in its earlier escheat decisions to the obligor, regardless of the diverse origins of the debt, clearly informs the Court's intended meaning of that term in *Texas v. New Jersey* and *Pennsylvania v. New York*. In this regard, the Special Master was in error when he concluded that the Court's earlier decisions "support a *right* to escheat by the jurisdiction where the issuing corporation is located." Report at 32 (citing *Standard Oil v. New Jersey*, 341 U.S. 428 (1951) ("*Standard Oil*"); *Anderson Nat. Bank v. Luckett*, 321 U.S. 233 (1944) ("*Anderson Nat. Bank*"); *Security Savings Bank v. California*, 263 U.S. 282 (1923) ("*Security Savings Bank*")).

In each of these cases, the Court was concerned only with the right of a State to escheat or take custodial possession of abandoned intangible property when no other State had asserted a claim to the same property. In that circumstance, the Court recognized the right to escheat if the State acted pursuant to a valid exercise of its own jurisdiction. The State thereby satisfied the requirements of due process by affording notice to the absent owners of the transfer of the property to it while protecting the debtor from the possibility of having to pay the debt twice.

The Court concluded that a State's escheat procedures satisfied due process if they provided for personal service on the debtor and adequate notice by publication to the absent owners. Personal jurisdiction over the debtor was the means by which the State seized the abandoned property, since the Court equated intangible property with the obligation to pay the debt. The State thereby obtained the power to compel the debtor to pay the property to it, either for purposes of taking title (escheat), or conservation (custodial appropriation), until the rightful claimant appeared. The seizure also supplemented the notice to absent owners. *See Standard Oil*, 341 U.S. at 439.

Because the Court was concerned with the obligation to pay, not with a prior beneficial ownership interest, its decisions applied the term debtor to banks as well as to securities issuers.

> The contract of deposit does not give the bank a tontine right to retain the money in the event that it is not called for by the depositor. It gives the bank merely the right to use the depositor's money until called for by him or some other person duly authorized.

Security Savings Bank, 263 U.S. at 286; *see also Anderson Nat. Bank*, 321 U.S. at 241-242.

> The rights of the owners of the stock and dividends come within the reach of the court by the notice, *i.e.*, service by publication; the rights of the appellant [issuing corporation] by personal service. That power enables the escheating state to compel the issue of the certificates or payment of the dividends.

Standard Oil, 341 U.S. at 440; *see also id.* at 436, where the Court expressly referred to the debtor as the "obligor or holder."

Accordingly, the Court's earlier escheat decisions refute the Special Master's conclusion that "it is more consistent with the precedent to support escheat (or custodial taking) by the jurisdiction that was connected with the entity that was the originator of the transaction (or the original owner of the funds)" over the

jurisdiction of the obligor. Report at 38. Since the obligation to pay the debt was viewed as the crux of the State's exercise of its dominion over the intangible property, it was the essence of the term "debtor."

The *Texas v. New Jersey* rule, which the Court subsequently adopted to resolve competing State claims to abandoned intangible property, preserved the concept of the debtor as the obligor. Although the primary right of escheat was accorded to the jurisdiction most closely associated with the creditor, rather than the debtor, the underlying intangible property was still defined as a "liability" in the hands of the debtor. *Texas v. New Jersey*, 379 U.S. at 680. The Court's conclusion that fairness required it to treat the debt as property of the creditor simply construed the debtor's obligation to pay as the creditor's asset. The debtor remained the obligor or holder because it was required to satisfy a demand for payment. *See* Report of the Special Master, *Texas v. New Jersey*, at 35.

The fact that the holder of the payment obligation is quintessential to the operation of the *Texas* backup rule is further evident from the Court's reliance on that obligation, as recorded on the debtor's books and records, to determine the creditor's jurisdiction under the primary rule. It is thus apparent that the Special Master's perception of an ambiguity in the Court's precedents concerning the meaning of the term "debtor" is unfounded. The Court has consistently applied that term to the holder of the payment obligation, not to the individual or entity that had a prior claim to the funds as an asset.

B. The Special Master's Novel Definitions Of The Debtors And Creditors Is Also Contrary To The Uniform Abandoned Property Acts And The States' Abandoned Property Laws

The conclusion that the Special Master has erroneously applied the *Texas* rules to the issuer and ultimate intended beneficial owners of the property in question is further demonstrated by the fact that this result conflicts with the

uniform abandoned property acts and the States' own abandoned property laws. This universal body of state law accords with the Court's escheat precedents which define the debtor as the obligor or holder of the debt, and the creditor as the obligee or apparent owner of the right to payment reflected on the holder's books.[46]

The Uniform Abandoned Property Act of 1981, upon which many States modeled their abandoned property laws, incorporated the *Texas v. New Jersey* rule for determining the States' priority in escheating abandoned intangible property. *See* Uniform Act, § 3 (General Rules for Taking Custody of Intangible Unclaimed Property).[47] The Act provides that the holder of unclaimed property is the debtor for purposes of escheat.

> § 2 Property Presumed Abandoned; General Rule
>
> (a) Except as otherwise provided by this Act, all intangible property, including any income or increment derived therefrom, less any lawful charges, that is

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[46] Because the States have applied the *Texas* rules to the property at issue in the same way that New York has, the changes in the rules proposed by the Special Master, if adopted by the Court, would necessarily invalidate their escheat activities as well. To preserve its claim to property escheated by these States to which New York would be entitled under the proposed changes, New York will seek leave to set up a counterclaim by amendment pursuant to Fed. R. Civ. P. Rule 13(f).

[47] The following States adopted completely, or in relevant part, the cited provisions of the 1981 Uniform Act: Alaska (Alas. St. §§ 34.45.010 *et seq.*); Arizona (Az. Rev. St. §§44-301 *et seq.*); California (Cal. Code §§ 1500 *et seq.*); Colorado (Col. Rev. St. §§ 38-13-102 *et seq.*); Florida (Fla. St. Anno. §§ 717.001 *et seq.*); Georgia (Off Code of Ga. Anno. §§ 44-12-190 *et seq.*); Hawaii (Haw. Rev. St. Anno. §§ 523A-1 *et seq.*); Idaho (Id. Code §§ 14-501 *et seq.*); Louisiana(La. Rev. St. §§9:151 *et seq.*); Maine (33 Me. Rev. St. Anno. §§ 1801 *et seq.*); Montana (Mont. Code Anno. §§70-9-101 *et seq.*); New Hampshire (NH Rev. St. Anno. §§ 471-C:1 *et seq.*); New Jersey (NJ St. Anno. §§46:30B-1 *et seq.*); New Mexico (NM St. Anno. 1978 §§ 7-8-1 *et seq.*); North Carolina (NC Gen. St. §§ 116B-10 *et seq.*); North Dakota (ND Cent. Code Anno. §§ 47-30.1-01 *et seq.*); Rhode Island (Gen. Laws of RI 1956 §§ 33-21-1 *et seq.*); South Carolina (SC Code 1976 §§ 27-18-10 *et seq.*); Texas (Texas Code Anno., §§ 72.101 *et seq.*); Utah(Utah Code Anno. §§ 78-44-1 *et seq.*); Washington (Rev. Code of Wash. Anno. §§ 63-29-010 *et seq.*); Wisconsin (Wisc. St. Anno. §§ 177.01 *et seq.*).

held, issued, or owing in the ordinary course of a holder's business and has remained unclaimed by the owner for more than 5 years after it became payable or distributable is presumed abandoned.

(b) Property is payable or distributable for the purpose of this Act notwithstanding the owner's failure to make demand or to present any instrument or document required to receive payment.

The term "holder" is defined in § 1(8) of the Act as follows:

(8) 'Holder' means a person, wherever organized or domiciled, who is:

(i) in possession of property belonging to another

(ii) a trustee, or

(iii) indebted to another on an obligation.

Where, however, the holder is acting in an agency or fiduciary capacity for a business association alone (*e.g.*, a paying agent) the business association is deemed the holder (or debtor) under § 12 of the Act, as follows:

(12) Property held by Agents and Fiduciaries

* * *

(c) For the purpose of this section, a person who holds property as an agent for a business association is deemed to hold the property in a fiduciary capacity for that business association alone, unless the agreement between him and the business association provides otherwise.

(d) For the purpose of this Act, a person who is deemed to hold property in a fiduciary capacity for a business association alone is the holder of the property only insofar as the interest of the business association in the property is concerned, and the business association is the holder of the property insofar as the interest of any other person in the property is concerned.

With regard to the creditor, the 1981 Act looks to the last known address of the apparent owner, as shown on the books and records of the holder. The term "apparent owner" is defined in §1(2) as follows:

> (2) "Apparent Owner" means that person whose name appears on the records of the holder as the person entitled to property held, issued, or owing by the holder.

Other States (as well as the District of Columbia) adopted versions of the 1954 Uniform Disposition of Unclaimed Property Act, or the 1966 revision of that Act.[48] The Act, both originally and as revised, also provides that the holder is the debtor of the property. The term "holder" is defined in § 1(d) of the 1966 revision as follows:

> (d) 'Holder' means any person in possession of property subject to this Act belonging to another, or who is trustee in case of a trust, or is indebted to another on an obligation subject to this Act.

An examination of the Texas abandoned property statute, which is based upon the 1981 Uniform Act, is illustrative of the States' longstanding practices governing their escheat of unclaimed securities distributions. Under Texas law, the debtor is the holder, and the creditor is the apparent owner (not beneficial

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[48] The following States have adopted completely, or in relevant part, the provisions of the 1954 Act or the 1966 Revised Act. The *1954 Act*: Maryland (Md. Code Commercial Law §§ 17-101 *et seq.*); Vermont (27 Vt. St. Anno. §§ 1208 *et seq.*); West Virginia (W. Va. Code §§ 36-8-1 *et seq.*). The *1966 Revised Act*: Alabama (Code of Ala. 1975 §§ 35-12-1 *et seq.*); Arkansas (Ark. Code of 1987 Anno. §§ 18-28-201 *et seq.*); District of Columbia (DC Code §§ 42-201 *et seq.*); Illinois (Ill. Anno. St. §§ 101 *et seq.*); Indiana (Ind. St. Anno. §§ 32-9-11 *et seq.*); Iowa (Iowa Code Anno. §§ 5561 *et seq.*); Kansas (Kan. St. Anno. §§ 58-3901 *et seq.*); Minnesota (Minn. St. Anno. §§ 345.31 *et seq.*); Mississippi (Miss. Code Anno. 1972 §§ 89-12-1 *et seq.*); Missouri (Anno. Mo. Stat. §§ 447.500 *et seq.*); Nebraska (Rev. Stat. of Neb. 1943 §§ 69-1301 *et seq.*); Nevada (Nev. Rev. Stat. Anno. §§ 120A.010 *et seq.*); Oklahoma (60 Okl. St. Anno. §§ 651 *et seq.*); Oregon (Or. Rev. Stat. §§ 98.302 *et seq.*); South Dakota (S. Dak. Cod. Laws §§ 43-41-A-1 *et seq.*); Tennessee (Tenn. Code Anno. §§ 69-29-101 *et seq.*).

owner) as shown on the records of the holder. Texas escheats the property if it is the State of last known address of the apparent owner.

> (a) Tangible or intangible personal property is subject to this chapter if it is covered by Section 72.101 and:
>
> (1) the last known address of the apparent owner, as shown on the records of the holder, is in this state;

Texas Code Anno., Property, § 72.001.[49]

Accordingly, the prototypic Texas statute conflicts with Texas' own theory in this case and the one adopted by the Special Master. Since Texas intervened in this lawsuit, a number of States - Florida, Iowa, Kansas and Utah - have deemed it necessary to amend their statutes in order to conform them to the Texas theory. It does not appear, however, that any State currently has coverage for this property as the State of the issuer's chief executive office (the Special Master's proposed location in lieu of domicile for the debtor under the *Texas v. New Jersey* backup rule).

C. The Uniform Commercial Code's Definition Of The Debtors And Creditors Of The Property In Question Conforms With The Court's Escheat Precedents And State Escheat Laws

The Special Master's conclusion that the issuer is the debtor under the *Texas* backup rule after it has paid the distribution to the record owner is a radical and unprecedented departure from fundamental principles of corporate and securities

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[49] *See also* Texas letter dated October 16, 1986, annexed as an exhibit to New York's Reply Supplemental Submission dated November 20, 1991, in which Texas claimed abandoned property from a New York debtor broker, E.F. Hutton & Company, Inc. Texas claimed the property as the State of last known address of the owner, and referred to E.F. Hutton & Co., the record holder, as the debtor.

law.[50] The issuer is a debtor only to the record owner, and only between the record date and the pay date. It is a basic principle of corporate law that "[d]eclaration of a dividend sets up a debtor-creditor relationship between the corporation and its shareholders. It creates a debt for which, if unpaid, the shareholder may sue in an action at law." G. Hornstein, 1 *Corporation Law and Practice* ¶ 472 at 594 (1959) ("*Corporation Law and Practice*") (footnotes omitted). *See also McLaren v. Crescent Planing Mill Co.*, 117 Mo. App. 40, 46, 93 S.W. 819, 821 (1906) (and cases cited); *Searles v. Gebbie*, 115 A.D. 778, 780, 101 N.Y.S. 199, 201 (4th Dep't 1906). Thus, a corporation is liable for the payment of dividends and interest only to the shareholder of record until it receives notification of a transfer. *Homestake Oil Co. v. Rigler*, 39 F.2d 40, 41 (9th Cir. 1930) ("the corporation is protected in paying dividends to the record owner until notified of assignment and right to collect the dividends."); *Munro v. Mullen*, 100 N.H. 128, 121 A.2d 312 (1956) (holder of stock on record date entitled to the dividend); *Davis v. Fraser*, 307 N.Y. 433, 121 N.E.2d 406 (1954) (a corporation cannot be held liable at the instance of the beneficial owner if, in good faith, it paid the dividends to the record owner); *Barbato v. Breeze Corp.*, 128 N.J.L. 309, 26 A.2d 53 (1942) (same); *Greasy Brush Coal Co. v. Hays*, 292 Ky. 517, 166 S.W.2d 983 (1942) (same); 11 *Fletcher Cyclopedia of the Law of Private Corporations* § 5377 at 915 (Rev. ed. L. Zajdel ed. 1986) ("*Fletcher*") (footnote omitted); 1 *Corporation Law and Practice* ¶ 472 at 593-94.

The principle has been codified in the 1977 Revision of the Uniform Commercial Code as follows:

> Prior to due presentment for registration of transfer of a certificated security in registered form, the issuer or indenture trustee may treat the registered owner as the person exclusively entitled to vote, to receive

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[50] *See also* DTC's previously filed Motion for Leave to File a Brief as Amicus Curiae in Support of Defendant's Motion for Judgment on the Pleadings, and Brief, dated August 7, 1989, at 3-4.

> notifications, and to otherwise exercise all the rights and powers of an owner.

U.C.C. § 8-207(1).[51]

Accordingly, when a beneficial owner is not a shareholder of record, it has no right to dividends against the corporate issuer; this is a right only belonging to the shareholder since "stock dividends are an incident of ownership of stock," 11 *Fletcher* § 5083 at 24-25 (footnote omitted). A share of stock is "the interest or right which the owner, who is called the 'shareholder,' has in the management of the corporation, and in its surplus profits." *Id.* § 5083 at 24 (footnote omitted). Whatever right a beneficial owner may have to dividends, therefore, lies solely against the record owner.

The Special Master recognized that U.C.C. § 8-207(1) releases the issuer of its obligation to pay the distribution upon paying the record holder, and that without this provision the payment of distributions would be impossible.

> As noted in the 1990 commentaries by the Permanent Editorial Board (PEB) to the Uniform Commercial Code, "[s]uch protection is clearly necessary, since, in the vast majority of cases, the issuer would have no knowledge that a transfer had been made or know the identity of the purchaser. *Inherent in this scheme is that a distribution to the registered owner will relieve the issuer from any liability* to the [subsequent] purchaser for the same distribution. Without that protection, no issuer could safely make any distribution without requiring the surrender, or exhibition, of the security by the distributee - a patently impractical requirement."

Report at 25 (citing PEB Commentary No. 4 discussing U.C.C. § 8-207) (emphasis added).

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[51] This provision of the 1977 Official Code, or the 1977 revision quoted here (adding the word "certificated" to the 1977 Official Code), has been adopted by all 50 States, the District of Columbia and the Virgin Islands.

The Special Master recommended nevertheless that in applying the *Texas* backup rule in this case, the Court should ignore the debtor-creditor relationships established by the Uniform Commercial Code. He reached this conclusion because he believed that adherence to state law in this context was inconsistent with fairness under the *Texas* backup rule. Report at 34-35. The Special Master's analysis in this regard is erroneous.

In *Texas v. New Jersey*, the Court's purpose was to provide a means whereby the States could resolve their controversies over the escheat of intangible property.

> Since the states separately are without constitutional power to provide a rule to settle this interstate controversy and since there is no applicable federal statute, it becomes our responsibility in the exercise of our original jurisdiction to adopt a rule which will settle the question of which state will be allowed to escheat this intangible property.

Texas v. New Jersey, 379 U.S. at 677. Thus, the Court's goal was a clear and uniform rule of escheat.

In giving content to such a rule, the Court was concerned with questions of fairness and ease of administration, not with creating federal common law definitions of "debtor" and "creditor." Fairness was simply a question of viewing the property as the creditor's asset rather than the debtor's, and ease of administration was satisfied by use of the creditor's last known address on the debtor's books. *Texas v. New Jersey*, 379 U.S. at 680-681 (footnote references omitted). In the context of the backup rule, the Court's concern was only for certainty and ease of administration. It concluded that resort to the debtor's domicile was "conducive to needed certainty and we therefore adopt it." *Id.* at 682.

Accordingly, the Court provided the procedural mechanisms whereby the States could resolve their disputes over the escheat of intangible property. The Court did not define the terms "debtor" and "creditor" in its rules because it had already defined

them in its prior cases according to the obligor and obligee of the debt under state law. Indeed, had the Court intended to use the terms debtor and creditor in a way other than according to commonly accepted usage (as the Special Master has done), it would have done so explicitly. In cases before the Court involving statutory construction, it has applied the rule that unless otherwise defined, words are to be given their common meaning. *See* 2A Sutherland Statutory Construction (6th ed. 1992), § 47.28, at 249, n.1 (citing *Woolford Realty Co. v. Rose*, 286 U.S. 319 (1931); *Old Colony R. Co. v. Commissioner of Internal Revenue*, 284 U.S. 552 (1931); *Columbia Water Power Co. v. Columbia Elec. St. Ry. Co.*, 172 U.S. 475 (1898); *Martin v. Hunter*, 1 Wheat (14 U.S.) 304 (1816)); *see also Mallard v. United States District Court*, 490 U.S. 296, 301 (1989).

Since the Court in *Texas v. New Jersey* and *Pennsylvania v. New York* evidenced its intent to rely upon state law understandings of the debtor and creditor, it was incumbent upon the Special Master to apply state law in defining the debtors and creditors of the property in question unless doing so would be demonstrably opposed to the purposes of the *Texas* rules. Not only did the Master decline to apply U.C.C. § 8-207(1) even though he could not find a conflict between its provisions and the *Texas* rules, he made a concerted effort to avert the application of state law.[52]

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[52] The Special Master relied upon a number of decisions of this Court for the proposition that federal interests, as expressed in federal common law and statutes, may be resolved by reference to state law only when state law is consistent with federal purposes. Report at 26 (citing *Connecticut v. Massachusetts*, 282 U.S. 660, 670 (1931); *Mississippi Band of Choctaw Indians v. Holyfield*, 490 U.S. 30, 43 (1989). *See also* discussion of *United States v. Kimbell Foods, Inc.*, 440 U.S. 715, 718 (1979), in Report at 30, n. 28. These decisions do not, however, support the Special Master's conclusion that uniform state debtor - creditor definitions should not be used in this case. In fact, the Court's escheat rules are no more than procedural devices for resolving interstate disputes over abandoned intangible property. The Court did not, thereby, create a separate body of substantive debtor-creditor law. Therefore, there is no conflict between the federal interest in uniform rules of priority and reliance upon uniform state debtor-creditor law. *See Burks v. Lasker*, 441 U.S. 471, 478 (1979), where the Court stated that in areas in which federal interests are largely regulatory, such as corporate law, legislation is generally enacted in reliance upon existing state law.

The state law definitions of the debtor and creditor established by U.C.C. § 8-207(1) advance all of the Court's concerns in formulating the *Texas* rules and should, therefore, have been followed by the Special Master. The Court's predominant concern for clear and certain rules is satisfied because all of the States have adopted U.C.C. § 8-207(1), which is essential to the payment of securities distributions. Indeed, the Special Master recognized that distributions would be impossible without U.C.C. § 8-207(1) because the issuer must be able to discharge its debt upon payment of the distribution to the record holder. Report at 25. Unlike specialized state law enactments such as the Uniform Stock Transfer Act for example (*see Standard Oil v. New Jersey*, 341 U.S. at 441, n.15), the Uniform Commercial Code provisions are fundamental.

Similarly, following state law affords the best means for administering the *Texas* rules. By virtue of recognizing the record holder as the debtor in accordance with state law, the holders of the unclaimed distributions currently report the property they hold, regardless of the underlying issue on which it was paid, to their domiciles. Contrary to the Special Master's comments, this does not reduce "to the feckless view that it is easier to escheat all funds to a single state." Report at 40, n.36. The centralization of funds in the holder's jurisdiction not only simplifies the reporting process, it also maximizes the effectiveness of State audits and other enforcement mechanisms, since all of the record holder's abandoned property is under the jurisdiction of a single authority.

In terms of the claiming process, it is more convenient for record holders, acting on their own behalf or for individuals, to present all of their claims to the jurisdiction where the reporting holder is domiciled, rather than to any of 51 jurisdictions where the issuer is domiciled. Since issuers change domiciles, and claims may be brought on many different issues, the claiming process can become very complex under the issuer - debtor theory. Moreover, the Special Master could not identify the jurisdictions which would be entitled to escheat the unclaimed distributions on foreign issues, a matter that poses no difficulty if the escheating jurisdiction is the record holder's domicile.

Although the Special Master never disputed the fact that state law implements completely the need for ease of administration under the Court's escheat rules, he nevertheless proceeded to consider the practicalities of escheat by the jurisdiction of the issuer. Report at 39. It is initially New York's position that the Master should not have explored this question, state law being fully congruent with the Court's concern for ease of administration. Even if the inquiry were appropriate, it is flawed for two reasons. First, it fails to acknowledge that escheat by the issuer's jurisdiction must be a more burdensome means of implementing the Court's escheat rules because it requires record holders to comply with the different abandoned property laws and reporting requirements of 51 jurisdictions. Second, the Master had no evidentiary basis for concluding that the issuer-debtor theory was practical. During the course of the discovery, the brokers, DTC and Citibank testified only that when they record overpayments into unclaimed distribution accounts, they generally identify the underlying security by its CUSIP, a nine-digit figure obtained by issuers from the Committee on Uniform Securities Identification when they bring an issue to market. The CUSIP does not identify the domiciles of corporate issuers, although it does identify the municipal issuers of governmental debt obligations. No testimony was elicited as to whether it was practical, or even possible to use the CUSIP to report the property to issuers' domiciles.

Well after the close of discovery, during the third round of briefing on the merits before the Special Master, the States advocating the issuer-debtor theory introduced the Affidavit of John Happersett, January 3, 1991,[53] to address the question of whether their theory was practical. The Happersett Affidavit was annexed to the reply brief of Alabama, *et al.* in support of their motion for partial summary judgment, dated January 7, 1991. Mr. Happersett purported to speak for the securities industry by virtue of his position as Unclaimed Property Coordinator at Dean Witter Reynolds, Inc., and his experience with

[53] The Report of the Special Master, at 40, n.36, mistakenly refers to the Happersett Affidavit as dated January 28, 1991.

that brokerage firm's current reporting practices. According to Mr. Happersett, it would be "practicable" to use the issue CUSIP to report unclaimed property to the issuers' domiciles by entering the domiciles into the firm's software database. Happersett Aff. at ¶ 6.

A response to the Happersett Affidavit was provided by the Securities Industry Association ("SIA"), through the head of its Dividend Division, Louis LaRocca. The SIA LaRocca Affidavit, dated February 12, 1991, addressed both the propriety of the Happersett submission and its probative value.

> The purpose of the Happersett Affidavit is purportedly to prove that the Alabama/Texas theory could be readily implemented. We understand that during the discovery phase in this action, lengthy depositions were taken of four witnesses who have personal knowledge of the procedures that would be necessary if the Alabama/Texas theory were adopted, and that counsel for the 38 intervenor states chose not to question these witnesses regarding the ease or difficulty of administration, instead they submitted an affidavit from a person whose experience and motivation have not been subject to scrutiny. The Division believes that under these circumstances, the Happersett Affidavit should be rejected. However, since the Special Master will have had the opportunity to review his affidavit, the Division, a broad - based industry group, is submitting this affidavit to set the record straight.

SIA LaRocca Affidavit at pp. 1-2.

The SIA then demonstrated the extent to which Mr. Happersett's reliance upon a computer match between an issue CUSIP and the issuer's domicile did not begin to explore the realities of attempting to implement the Texas issuer-debtor theory. A few of the problems perceived by the industry as creating questions of enormous administrative complexity were summarized as follows:

1. Each firm would have to become familiar with fifty different sets of laws and adopt procedures reflecting those laws.

2. Many states have different dormancy periods for unclaimed property and different deadlines throughout the calendar year when reports must be filed. It is conceivable that each firm would be continuously reporting unclaimed property to different states throughout the year.

3. Different states require reports in different forms. For example, three years ago, New York State began mandating the submission [of] machine readable tape files of unclaimed distributions rather than hard copy reports. Having converted a machine readable interface with New York, many firms would now have to revert to hard copy reports for other states.

4. The format of unclaimed property reports and the types of information required by each format could vary from state to state creating enormous complexity within each firm's computer system.

5. Each firm would be subject to audit by fifty states rather than one state.

6. When claims arise after unclaimed property has been escheated, each firm would have to deal with fifty states and have the procedures in place to comply with fifty different sets of claim requirements regarding affidavits, forms, etc.

SIA LaRocca Affidavit at pp. 2-3.

No further evidence was adduced concerning the impact of the Texas issuer-debtor theory on the securities industry. The Special Master resolved the ease of administration issue on this record by simply, but unaccountably, giving deference to the

statements of Mr. Happersett over those on behalf of the SIA.[54] *See* Report at 39, n.36. Thus, although the Special Master should not have reached the issue of whether the issuer-debtor theory was practical, he erroneously decided that it was on the evidentiary record before him.

D. The Special Master Rejected State Law For Reasons That Are Contrary To The Court's Precedents And The Evidentiary Record

The Special Master defined the debtor as the issuer rather than the record holder on grounds of fairness. Report at 35-36. Here, however, the Master conceded that the Court's formulation of the *Texas* backup rule was not predicated on concepts of fairness. *See* Report at 17. Rather, the Court was interested solely in a rule of certainty and convenience to accommodate those situations that proved the exception to the primary rule. *Texas v. New Jersey*, 379 U.S. at 682; *see* Report at 17. In *Pennsylvania v. New York*, the Court expressly rejected the argument that the backup rule should not be applied because the result would be unfair. 407 U.S. at 212-213.

Since fairness is not a concern under the *Texas* backup rule, the Special Master's adoption of a fairness test to define the debtor under the rule was erroneous. In addition, since the Court never addressed the question of fairness in that context, it never articulated a standard of fairness. Accordingly, the Special Master was relegated to creating a standard of his own.

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[54] The Special Master's error in relying on the Happersett Affidavit is evidenced, for example, in his conclusion that because record holders presently report unclaimed distributions to the various states according to an available last known address of a beneficial owner, they could just as easily report it to the issuers' jurisdictions. Report at 40, n.36. This conclusion assumes that the property owed to known creditors is comparable in volume and frequency of escheat to property owed to unknowns. There is, of course, nothing in the record to support such a conclusion. To the contrary, the instances in which a known recipient cannot be paid are usually limited to situations in which the recipient has moved without leaving a forwarding address or has died without leaving instructions concerning the checks. *See, e.g.*, Wellener Dep. at 119, 123.

> A more durable consideration is the notion of rewarding the jurisdiction that has a claim to benefitting the "company whose business activities made the intangible property come into existence," *Pennsylvania v. New York*, 379 U.S., at 680.[55]

Report at 35.

Even assuming that it were permissible to use fairness to determine a specific application of the *Texas* backup rule, the Special Master's analysis in this regard is unpersuasive. It is more reasonable to conclude that fairness is served by permitting the record holders' jurisdictions to escheat the property in question.

The Special Master selected the issuer-debtor theory because it would give the property to the jurisdictions that gave the benefits of their laws and economy to the companies whose business activities generated the property. Report at 35. With regard to the record holders' jurisdictions, the Special Master concluded that permitting them to take the funds would "reward the state of incorporation of an intermediary whose records (or lack thereof) created the problem that resulted in the escheatable property in the first instance." *Id.* at 36.

The essential error in the Special Master's reasoning lies in his perception of the causes of abandoned property. The Master would treat "the myriad details of securities transactions" as "one paradigmatic factual pattern" in which payments become abandoned whenever they "get stuck" in the hands of record holders. Report at 9-11; *see also id.* at Appendix B. As the discussion of the evidentiary record demonstrates (*see* pp. 17-22, *ante*), this attempt at simplification results in a critical distortion of the dynamics involved in the creation of escheatable property in this

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[55] The quotation is from *Texas v. New Jersey*, to which the citation refers. It is ironic that the Special Master hinged his fairness standard under the *Texas* backup rule to the Court's discussion in *Texas v. New Jersey* of the relative merits of locating a debtor by its domicile or place of principal office. When the Court announced the backup rule, it selected domicile over principal place of business, thereby rejecting the concept of fairness proposed by the Special Master for identifying debtors under the backup rule.

case. In fact, the problem of abandoned securities distributions results from the persistence of securities issues in certificated format, which results in Cede float and nominee float. *Issuers*, not record holders, are responsible for the format of a security's issuance. The securities industry, operating through the depository system that was born out of the crisis generated by certificated issues, has made significant strides in reducing unclaimed distributions to a tiny fraction of total distributions. *See* Report at 10, n.9, referring to estimates of 0.02% of total distributions. This is remarkable, indeed, considering the fact that hundreds of millions of securities are traded every day. Record holders are also in the vanguard of efforts to eliminate the abandoned property in question by providing the technology and services needed for the complete conversion to certificateless issues.

In addition, contrary to the Special Master's persistent references to the record holders as "intermediaries" in the "securities distribution system" and "transparencies" (*see, e.g.*, Report at 36), their record ownership has a legal and practical significance that is at the very heart of the securities industry. Brokers, banks and depositories perform a multitude of functions all of which are essential to the continued viability of corporate investment. Their role cannot be ignored in any consideration of fairness. Issuers, by contrast, cease to have any connection with securities payments after they pay the record holders. Indeed, they have no contact with, or knowledge of, the beneficial owners of the securities unless the owners request such contact as non-objecting beneficial owners ("NOBOs"). On equitable grounds, therefore, the escheat claims of jurisdictions that provide the benefits of their economy and laws to the entities that make the payment of distributions possible, the record holders, cannot be sublimated to the claims of the issuers' jurisdictions.

E. The Special Master's Ultimate Rejection Of State Law Is Based Upon The Impermissible Ground That It Does Not Result In A Dispersal Of The Funds To All The States

The Special Master's only other objection to resolving the claims in this case according to established state law debtor-creditor relationships is that state law relieves the issuer of its

payment obligation by paying the record holder, but the record holder does not, thereby, obtain the property as an asset. Report at 26. Rather, the record holder, unless it is also a beneficial owner, is obligated to pay the distribution to another person or entity. *Id.*[56] The Master concluded that state law thus "results in incongruous identification as debtors and creditors of entities who may have no ownership claims in the property at issue." *Id.* at 38.

The Special Master could not, however, assert that this state law effect interfered with the operation of the *Texas* rules. He could only conclude that the debtor-creditor relationships delineated by state law were of "no consequence" to the Court's escheat rules. Report at 30, n.28. This conclusion is not only incorrect, since identifying the obligor and obligee are the essence of the Court's escheat jurisprudence, it is not a justifiable rationale for rejecting state law. It therefore suggests that the Special Master was searching for alternative debtor-creditor definitions to facilitate the flow of unclaimed distributions from New York's record holders to other jurisdictions.

The Special Master's first reference to this goal occurred during his imposition of a fairness standard under the *Texas* backup rule. Report at 35. He indicated there that his adoption of the issuer-debtor theory on fairness grounds was "not principally" because it "would necessarily distribute the funds more 'evenly' among the states". *Id.*, and n.32. In fact, because the issuer-debtor theory proffered by Texas, *et al.* and Alabama, *et al.* looked to the issuer's domicile, its adoption in that form would not have resulted in a full dispersal of the funds because of the large number of issuers domiciled in Delaware. It was, therefore, necessary for the Special Master to recommend a change in the locator under the *Texas* backup rule, from domicile to chief executive office, in order for the issuer-debtor theory to produce the sought after allocation.

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[56] It is also apparent, however, that if the record holder is unable to pay the distribution, the issuer is not entitled to a return of the underlying asset. The right to retain the property and derive income from it is appurtenant to the record holder's right to the property under state law after the issuer's debt is discharged.

> However, the Texas, Alabama, et al., position also addresses distributional concerns without adding a further fiction to the concept of the beneficial owner's location. Particularly if the backup rule is construed to define the issuer's location for escheat purposes to be where its principal executive offices are, rather than where it is incorporated, that backup rule may have as much underlying fairness as the approach proposed by California, et al.

Report at 52.

New York does not take exception to the Special Master's analysis supporting a change in the locator under the *Texas* backup rule from domicile to chief executive office. *See* Report at 40-50. Rather, the salient point is that the Master has proposed this change, in conjunction with a new federal common law definition of the issuer as the debtor of the property in question, to redistribute the property among the States.[57] This usage is contrary to the Court's precedents. *See Pennsylvania v. New York*, 407 U.S. at 214-215.

The result sought by the Special Master also raises the very concerns which he deemed relevant in rejecting the commercial activities test advocated by California, *et al.* Report at 53-55. Both the revised issuer-debtor theory and the commercial activities test change the *Texas v. New Jersey* escheat rules, thereby implicating the doctrine of *stare decisis*. *See* Report at 53. In addition, whereas the commercial activities test lacks an allocation formula, the revised issuer-debtor theory also depends upon untested allocation mechanisms that will require record holders to report the property to 51 jurisdictions. There is no credible

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[57] As the Special Master recognized, however, in the case of federal issuers, "use of either a jurisdiction of incorporation test or a principal executive office test seems strained." Report at 49, n.45. Accordingly, he presumed that the District of Columbia would take the funds as the locational surrogate for the federal government. *Id.* This would, of course, produce a windfall for that jurisdiction since a high percentage of the unclaimed distributions in question is attributable to federal issues.

basis for the Court to determine whether the allocation is workable or the extent of the disruption that it will entail for the securities industry. At least one of the problems isolated by the Master in allocating the funds under the commercial activities test - maintaining compliance with diverse state escheat laws - applies as well to the allocation under the issuer-debtor theory. *Compare* Report at 54-55 with the Securities Industry Association LaRocca Affidavit discussed at pp. 67-68, *ante*. As the Special Master appropriately noted:

> Congress has the ability, should it be unsatisfied with the application of the Supreme Court's basic rules in this area to a particular type of transaction to change the rule with respect to that kind of transaction.

Report at 54. Although expressed in the context of the California, *et al.* theory, this statement is equally pertinent to the Special Master's adoption of the Texas, *et al.* and Alabama, *et al.* issuer-debtor theory.

POINT II

THE CREDITOR OF THE PROPERTY IN QUESTION UNDER THE *TEXAS V. NEW JERSEY* PRIMARY RULE IS THE OWNER IDENTIFIED BY THE DEBTOR'S BOOKS

The Special Master incorrectly concluded that the Court's precedents require treating the "ultimate intended beneficiary" as the creditor of abandoned intangible property. *See* Report at 64. To the contrary, the Court's focus under the *Texas* primary rule is on the person or entity identified *by the debtor's books and records* with apparent ownership rights in the property. Accordingly, New York's claim under the primary rule predicated upon the rights of creditor brokers and banks should not have been rejected. In any event, the evidentiary record established that the creditor brokers and banks routinely pay the distributions to their customers, the beneficial owners, and thereby obtain beneficial ownership interests in the property. Finally, New York should have been given the opportunity to demonstrate that

the addresses of the creditor brokers and banks can be ascertained from the debtor brokers' books and records.

A. The Court Did Not Make Escheat Under The *Texas v. New Jersey* Primary Rule Contingent Upon Identifying The Ultimate Intended Beneficial Owners Of The Property

In *Texas v. New Jersey* the Court did not alter the understanding evident from its prior escheat decisions that intangible property, such as a debt, constitutes the payment obligation between the debtor and creditor.

> With respect to tangible property, real or personal, it has always been the unquestioned rule in all jurisdictions that only the State in which the property is located may escheat. But intangible property, *such as a debt which a person is entitled to collect*, is not physical matter which can be located on a map.

Texas v. New Jersey, 379 U.S. at 677 (emphasis added). The Court was concerned only with the fairness of treating the payment obligation as the creditor's property for purposes of a rule that would give a jurisdiction the preeminent right of escheat.

> On the other hand, these debts owed by Sun are not property to it, but rather a liability, and it would be strange to convert a liability into an asset when the State decides to escheat.

Texas v. New Jersey, 379 U.S. at 680.

Accordingly, in announcing the primary rule, the Court simply adopted the position that because the payment obligation is the creditor's property, its jurisdiction, as determined from the debtor's records, should escheat in the first instance. *Id.* at 680-681. This reflected the conclusion of the Special Master in that case.

> The obligation to pay is the creditor's property in the intangible. Seizing that obligation by the state is the equivalent of vesting title of the property in the state.

Report of the Special Master, *Texas v. New Jersey*, at 35.

The Court, therefore, did not look beyond the debtor-creditor relationship established by the debtor's records in determining the jurisdiction with the right to escheat intangible property under the *Texas* primary rule. Indeed, to require, as the Special Master has, that a claiming jurisdiction demonstrate that it stands in the shoes of an "ultimate" owner would hobble the primary rule to the point of inefficacy by making its application dependent upon the facts of each case. As previously pointed out, the broker's customer may not even be the ultimate beneficial owner but may be acting for someone else. *See* p. 5, *ante*. There is no standard format for ownership and the attributes of beneficial ownership may be divided among more than one person or entity. *Id.* The factual approach inherent in an ultimate intended beneficial owner test is one which the Court intended to avoid under its escheat rules. *Texas v. New Jersey*, 379 U.S. at 679; *Pennsylvania v. New York*, 407 U.S. at 215.

Thus, in *Pennsylvania v. New York*, the Court addressed both the sender and the payee of a Western Union money order as creditors. It did so because it agreed with the Special Master in that case that Western Union owed the money, as a "common debt" obligation, either to the payee or back to the sender. 407 U.S. at 213; Report of the Special Master at 15. Therefore, the Court recognized these parties as creditors under the *Texas* primary rule because either had the right to claim the funds from Western Union.

Had the Court been concerned with ultimate ownership interests, as the Special Master here has concluded, the Court could not have designated *two* creditors of the same property. And if the payee was the most logical candidate for creditor, the Court would still have had to determine whether the sender intended the payee to keep the money or pay it to someone else. These concerns were clearly irrelevant and must be interpreted to mean that the Court did not intend "ultimate" ownership interests to determine the application of the *Texas* primary rule.

Similarly, in *Texas v. New Jersey*, the Court identified Sun's creditors as the unpaid distributees of its stock because they alone

had the ostensible right to enforce the payment obligation under the debt. The Court was not concerned with parties outside of the debtor-creditor relationship. Although the Special Master cited the Court's inattention to Sun's "banks, transfer agents and payment intermediaries" as support for his "ultimate owner" theory (*see* Report at 64), this is untenable. As agents of Sun, these entities simply had no ownership interests in the property whatsoever.

The conclusion, therefore, that the creditor of abandoned intangible property under the *Texas* primary rule is the obligee under the debt is the logical interpretation of the Court's precedents. It reflects the fact that the Court's definition of intangible property as an "asset" refers to the right to the payment obligation, not the security or other property from which it is derived. Moreover, the Court's reliance on the debtor's books and records to identify the creditor's jurisdiction encapsulates the debtor-creditor relationship established there for purposes of applying the primary rule. Finally, any attempt to look beyond that relationship would necessarily generate the very type of factual inquiry that the Court strenuously sought to avoid.

B. Creditor Brokers And Banks On the Debtor Brokers' Records Are The Creditors Under The *Texas v. New Jersey* Primary Rule

Under the *Texas* primary rule, the right to escheat must be accorded to the jurisdiction "of the creditor's last known address as shown by the debtor's books and records." 379 U.S. at 680-681. The evidence taken from three brokerage firms established that their unclaimed distributions are owed to other brokers and banks. This corresponds to the fact that the cause of their abandoned property is nominee float, which arises when brokers and banks buy and sell securities in certificated format and are unable to timely re-register the certificates. *See* pp. 29-34, *ante*. The debtors (or selling brokers) owe the funds to the creditors (or purchasing brokers and banks). *Id.* Only these creditors are entitled to enforce the payment obligation under the debt by claiming the distributions from the debtor brokers. *Id.* The focal

point of the primary rule is the debtor-creditor relationship *established by the debtor's books.*

The Special Master's refusal to apply the primary rule to the creditor broker or bank on the debtor broker's records also generates fundamental inconsistencies that cannot be reconciled with the Court's precedents. First, by defining the creditor as the "ultimate intended beneficial owner," the Special Master *precluded* application of the primary rule to virtually all of the unclaimed distributions held by debtor brokers. These entities have no way of knowing the identity of parties that are not recorded as creditors on their books. In particular, "ultimate intended beneficial owners" refers to the customers of the creditor brokers, parties which the debtor brokers do not have knowledge of. Nor could a debtor broker distinguish between brokers and banks that were trading for their own accounts and those that were not. Therefore, the Master's rejection of identifiable creditors in favor of ultimate intended owners simply interprets the primary rule in such a way that it cannot be utilized. This clearly conflicts with the Court's intention of giving the right of escheat to the creditor's jurisdiction. In *Pennsylvania v. New York*, by contrast, the Court permitted the funds to flow under the *Texas* backup rule as a matter of last resort because of Western Union's business practice of not recording the senders and payees of its money orders. The Court viewed its adherence to the last known address provision of the primary rule as a reaffirmation of the rule. In this case, the Special Master's invitation to reconstruct the debtor brokers' records to identify an "ultimate intended beneficial owner" simply obscures the fact that his definition of the creditor prevents the application of the primary rule to the property in question in the first place.

Second, if the Special Master were correct in his conclusion that the primary rule looks to beneficial ownership rights in the property, then he was unjustified in ignoring the rights of

creditor brokers and banks.[58] *See* Report at 65. The property in this case is not the underlying security. Rather, it is the distribution generated by the security. Where, as here, the creditor broker has paid the owner of the security, the creditor broker *owns* the right to the distribution and is, therefore, the creditor. It thus becomes apparent that the Special Master's definition of the creditor as the "ultimate intended beneficial owner" is merely a formalism. *See, e.g.*, Report at 64-65. It simply assigns a creditor counterpart to the issuer under the issuer-debtor theory without regard to the wording and intent of the *Texas* primary rule. For these reasons, the Special Master's result should be rejected.

C. New York Has Raised A Question Of Fact Concerning The Identification Of The Creditors

The Special Master interpreted New York's position "as essentially asking for the adoption of a legal standard for presuming addresses that are in fact unknown." Report at 59, n.50. He concluded that such a position was inconsistent with *Pennsylvania v. New York*, where the Court refused to presume "that the state in which the money orders were purchased was the state of the sender's domicile." *Id.* The Special Master has, thereby, demonstrated a misunderstanding of New York's claim under the *Texas* primary rule.

In this case, unlike *Pennsylvania v. New York*, the creditors' addresses are actually present on the debtors' records. Accordingly, New York is not relying on a legal presumption to locate

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[58] The Special Master's belief that the payments made by creditor brokers and banks to their customers do not correspond to the abandoned property held by debtor brokers is simply the result of a misapprehension over the cause of the abandoned property. *Compare* Report at 62, n.54 and 66, n.57, with discussion at pp. 17-22, *ante*. Indeed, as to the abandoned property received by New York for the years 1985 through 1989, 97.4% of the claims paid by New York were to brokers and financial institutions including banks and DTC. *See* Responses of the State of New York to the First Set of Interrogatories Propounded by the States of Alabama, *et al.*, Answers to Interrogatories 5(e) and 25. Since these entities testified that they routinely pay their customers the distributions to which the customers are entitled, it necessarily follows that the funds are owed to these brokers and banks as their assets.

creditors whose addresses have not been recorded.[59] New York has demonstrated that the debtor brokers' transactions can be reconstructed, and that the trades that resulted in unclaimed distributions can be traced to the creditor brokers that purchased the underlying securities and were underpaid the distributions. *See* Robert Griffin Affidavit (May 5, 1988). However, the amount of time and resources that would be required to reconstruct the overpayment transactions would be very considerable. *Id.* Therefore, New York has suggested the use of statistical sampling to prove that virtually all of the creditor brokers and banks recorded on the books of debtor brokers in New York have New York addresses. *Id.*

The Special Master erroneously stated in this regard that "[t]here is nothing in the Court's jurisprudence to suggest that New York can prevail by making a statistical showing that 'most' such addresses are in New York." Report at 67. To the contrary, the Court's escheat rules are founded upon an express preference for escheat of intangible property by the State of the creditor's jurisdiction. Only when the debtor's books do not record any creditor (or the creditor's jurisdiction does not provide for the escheat of the property), has the Court permitted the property to escheat to the debtor's jurisdiction. Since the purpose for using a statistical sampling here is to implement the priorities established by the Court in its escheat rules, it is both consistent with precedent and logical to do so.

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[59] The Special Master also suggested that the merit of New York's position was doubtful because New York was relying upon the creditor brokers' "trading addresses," a concept which the Special Master questioned. Report at 67, n.59. To the contrary, the trading address is neither a term devised by New York for purposes of this litigation nor one of imprecise meaning. The creditor broker's trading address is the place where it receives delivery of physical certificates and maintains its accounts of those transactions. It is the same address that the debtor broker relies upon to arrange for the delivery of the certificates and which it enters into its records. The trading address, in turn, is the official address used by the National Securities Clearing Corporation ("NSCC"), which is the service that delivers physical certificates between brokers and banks in New York. Most of the creditor brokers who remit property to New York are NSCC participants and most, if not all, of them have New York trading addresses.

Moreover, the fact that the Court has not previously considered the use of statistical proof in this context is not grounds for rejecting it. *See* Report at 67. The Special Master has, for example, proposed that the Court adopt a chief executive office locational test under the *Texas* backup rule even though the Court rejected it when it decided *Texas v. New Jersey* as being too uncertain. The Special Master asserted that, "I do not believe that this concern is warranted today . . . however justified it was in 1965." Report at 42. Similarly, although the Court has not had occasion to pass upon the use of statistical evidence in its prior escheat decisions, it has repeatedly approved the use of statistical proof in various types of cases, most notably to establish racial discrimination in employment discrimination suits, *see, e.g., Hazelwood School District v. United States*, 433 U.S. 299 (1977); *International Brotherhood of Teamsters v. United States*, 431 U.S. 324 (1977), and jury selection cases, *see, e.g., Turner v. Fouche*, 396 U.S. 346 (1970); *Hernandez v. Texas*, 347 U.S. 475 (1954).

Finally, the Special Master also erred when he concluded that the discovery taken from industry entities and personnel established that the creditors of unclaimed distributions are always unknown. Report at 61. This conclusion is warranted only for the property held by DTC and custodian banks. With regard to debtor brokers, the evidentiary record revealed that they do not make any effort to locate the owners of their unclaimed property. Rather, they wait for the creditor broker to come forward with a claim, and only then will they research the claim to authenticate it. In the case of brokers, therefore, the fact that they do not know the identity of their creditors at the time they report the property as abandoned proves no more than that. It does not dispute that the creditors' identities are ascertainable from the debtor brokers' records if the proper inquiry is undertaken. *See* pp. 32-34, *ante*.

New York should, therefore, be permitted to pursue discovery, beyond that allowed by the Special Master, to demonstrate that it is the State of last known address of virtually all of the creditor brokers on the books and records of New York debtor brokers.

POINT III

THE REPORT OF THE SPECIAL MASTER, IF ADOPTED, SHOULD BE PROSPECTIVELY IMPLEMENTED

When the Court, in *Pennsylvania v. New York*, applied *Texas v. New Jersey* to Western Union money orders purchased seven years before the *Texas* decision (407 U.S. at 212), it did not thereby address the question of retroactivity. Rather, it applied the core principle of its escheat jurisprudence, that a State lacks the jurisdiction to unilaterally cut off the rights of other States asserting superior claims to the property. *Texas v. New Jersey*, 379 U.S. at 682. Accordingly, New York's escheats of Western Union's abandoned money order proceeds as the debtor's domicile were voidable, subject to the rights of States claiming the property as the creditor's jurisdiction. The Court did not apply *Chevron Oil v. Huson*, 404 U.S. 97 (1971), which it decided a year before *Pennsylvania v. New York*, because retroactivity was not the issue there. The Special Master thus missed the point when he asserted that

> The retroactivity of the Court's decision interpreting and applying escheat rules was at issue in *Pennsylvania v. New York*, where the Court adopted, over the express contention of New York that *Texas v. New Jersey* should not be applied retroactively, the Special Master's recommendation that "the *Texas* rule be applied to all items involved in this case regardless of the date of the transactions out of which they arose."

Report at 71 (citing 407 U.S. at 212-213). In the present case, by contrast, retroactivity is involved because the Special Master has recommended changes in the escheat rules themselves, thereby unsettling the expectations of New York (as well as all other jurisdictions) in escheating this property in reliance upon the existing rules.

A. The Retroactivity Issue Should Be Determined With Regard To The Court's Original Rule-Making Jurisdiction

The Special Master has clearly recommended changes in the Court's escheat rules regardless of how significant he perceived those changes to be. The Court's use of the term "debtor" under the *Texas* backup rule would become a reference to debtor attributes, and the attribute that would be controlling is the last "claim to the funds as an asset that would appropriately be reflected in the net worth of the entity in question." Report at 32. Similarly, the term "creditor" under the *Texas* primary rule would be defined according to the attributes test, and the meaning ascribed to that term would be the right to the property as the ultimate intended beneficiary. *Id.* at 31. Finally, under the Special Master's formulation, a new entitlement provision would permit the jurisdictions of record owners to escheat the property in question whenever the beneficial owners and issuers are unknown. Report at A-3 to A-4.

Since the Special Master has recommended that the Court revise the rules it has created, it follows that the changes be announced prospectively. The Court is not revisiting statutory or constitutional precedents thereby invoking seminal questions of retroactivity under its judicial decision-making authority. This case, as viewed by the Special Master, simply requires the Court to elaborate on its own escheat rules. Fairness and logic would dictate that this be done prospectively. *Compare with James B. Beam Distilling Co. v. Georgia*, ____ U.S. ____, 111 S. Ct. 2439 (1991), and *American Trucking Associations, Inc. v. Smith*, 496 U.S. 167 (1990) (discussing the Court's concerns over prospective application of its decisions interpreting constitutional and statutory provisions).

B. The *Chevron Oil* Test

If the Court were to apply a retroactivity analysis, the Special Master correctly recognized that *Chevron Oil* sets forth the generally applicable standard. Report at 72; *see Beam* at 111 S. Ct. at 2447 ("our decision here does not limit the possible

applications of the *Chevron Oil* analysis"); *American Trucking* at 496 U.S. at 178 ("retroactivity of decisions in the civil context 'continues to be governed by the standard announced in [*Chevron Oil*]' " (citing *Griffith v. Kentucky*, 479 U.S. at 322, n.8.). The three steps of the *Chevron Oil* analysis are the following:

> First, the decision to be applied nonretroactively must establish a new principle of law, either by overruling clear past precedent on which litigants may have relied, or by deciding an issue of first impression whose resolution was not clearly foreshadowed. Second, it has been stressed that "we must . . . weigh the merits and demerits in each case by looking to the prior history of the rule in question, its purpose and effect, and whether retrospective operation will further or retard its operation." Finally, we have weighed the inequity imposed by retroactive application, for "[w]here a decision of this Court could produce substantial inequitable results if applied retroactively, there is ample basis in our cases for avoiding the injustice or hardship by a holding of nonretroactivity."

404 U.S. at 106-107 (citations omitted). Applied here, these factors support New York's request for prospectivity.

1. **New Principles Of Law**

The recommendations of the Special Master are contrary to the Court's escheat precedents. The Court has consistently defined the debtor as the obligor, not as a party that has discharged its debt but had the last claim to the underlying property as an asset. The Court has also required that the creditor of unclaimed property be determined from the debtor's books and records. It has thus identified the creditor by its right to demand payment of the debt. The Court has never imposed an "ultimate beneficial ownership interest" test for identifying the creditor.

These clear understandings of the meaning of debtor and creditor in the Court's decisions were incorporated into the

uniform abandoned property acts and the States' own abandoned property statutes, which were modeled on the uniform acts. Accordingly the States, applying the uniform commercial law principle that the issuer's debt is discharged upon payment of a distribution to the record holder (U.C.C. § 8-207(1)), have uniformly treated the record holder as the debtor. The States have also looked to the record holder's books for an apparent owner when identifying the creditor, not for a beneficial owner. The Special Master's Report changes the Court's precedents, established commercial law principles and state escheat law. Therefore, the Report can only be viewed as establishing new legal principles which were not clearly foreshadowed.

Although the Special Master asserted that he was merely interpreting and applying *Texas v. New Jersey*, that is not so. He has dramatically altered the Court's escheat rules based upon his novel debtor-creditor definitions. In the application of the backup rule the Report concluded that "the State of domicile of the originator may take custody of the unclaimed distributions, whether or not the originator would have been entitled to receive the funds back in its own right." It is the novelty of this concept, *i.e.*, applying the term "debtor" to an entity that has discharged its debt, that demonstrates the emergence of new legal principles. The result is no less novel in the context of the *Texas* primary rule, which focuses on the debtor-creditor relationship on the debtor's books and records. The Special Master's requirement that the primary rule search beyond the debtor's records for a party "intended" to have "ultimate" ownership rights in the property is facially inconsistent with the rule and therefore unforeseeable.

Not only have the concepts of the debtor and creditor changed fundamentally, the dynamics of the Court's escheat rules have also been transformed. In the context of the *Texas* backup rule, the Report defines the debtor not by the underlying payment obligation that the Court has consistently relied upon in its escheat decisions, but rather by notions of fairness. The Court, however, never considered fairness when formulating the backup rule, nor did it ever use "fairness" in the same sense that the Special Master has, *i.e.*, rewarding jurisdictions of companies

whose business activities made the intangible property come into existence. Finally, the Report suggests that the Special Master was concerned with using the Court's escheat rules to allocate the property more equitably among the States. In *Pennsylvania v. New York*, the Court rejected such a rationale as a basis for departing from the literal application of its escheat precedents.

With regard to the *Texas* primary rule, the Special Master negated its relevance to the property in question simply by identifying "creditors" that *cannot* be identified from the record holders' books. This stands in direct conflict with the Court's intention that abandoned intangible property escheat to the creditor's jurisdiction whenever possible. Moreover, even if beneficial ownership interests in the underlying asset were required to identify a creditor under the Court's precedents, it would be impossible to predict that the identical ownership interests in the hands of creditor brokers would be disregarded because they were not the "ultimate intended" owners.

Accordingly, the Court's precedents do not foreshadow the Report's conclusions. The idea that the debtor-creditor rules were laid down as shorthand for an originator and ultimate intended beneficiary of the escheatable property is directly contrary to the Court's escheat jurisprudence. This conclusion is all the more compelling since these entities do not possess the attributes of debtors and creditors as those terms are commonly understood. Finally, even if the Special Master's reliance on "fairness" was appropriate, his conclusion that the property should not escheat to the jurisdictions most closely associated with the record holders is untenable. The conclusion is thus warranted that New York has satisfied the first prong of the *Chevron Oil* analysis in favor of nonretroactivity.

2. The Merits Of Prospective Operation

The conclusion that a new principle of law has been announced does not end the inquiry. *American Trucking*, 496 U.S. at 180 (citing *Florida v. Long*, 487 U.S. 223, 230 (1988)); *American Governing Committee for Tax Deferred Annuity and Deferred Compensation Plans v. Norris*, 463 U.S. 1073, 1109-1110 (1983)

(concurring opinion). In conformity with the second prong of the *Chevron Oil* test, the Court seeks to determine whether the purpose of the law at issue dictates retroactive, rather than prospective, operation. The Court has favored nonretroactivity when the purpose of the law is fully served by preventing the proscribed activity as of the date of the decision, and retroactivity would serve no deterrent effect. *American Trucking*, 496 U.S. at 180-181.

Turning to the purpose of the Court's rule-making in this area, *Texas v. New Jersey* clearly expresses the goal of fashioning a rule of priority whereby the States can resolve their disputes over the escheat of intangible property fairly and expeditiously. The Court's quest for uniform rules is compelling support for the nonretroactive application of new principles that affect substantially the rules' impact. This is particularly relevant where, as here, the various States' abandoned property laws provide coverage for the property at issue based upon the same understanding of *Texas v. New Jersey* as that held by New York. *See* pp. 56-60, *ante*.

Debtor brokers throughout the country report their unclaimed distributions to the State in which they conduct their securities trades. This is in recognition of that State's priority under the *Texas v. New Jersey* primary rule as the State of last known address of the creditor broker (or apparent owner). The three securities depositories, holding funds owed to unknown creditors, report their abandoned property to their respective domiciles under the *Texas* backup rule. Custodian banks track the reporting practices of the depositories. These practices must change if the Court adopts the Special Master's recommendation that unclaimed distributions be reported to the issuer's domicile (or chief executive office) whenever the ultimate beneficial owner is unknown. No State, moreover, presently has coverage for the property in question based on the issuer's chief executive office. Both fairness and the concern for ease of administration dictate that new rules of priority altering the escheat activities of all the States commence at the same time.

Other concerns as well are obviated by doing so in this case. For example, since the States have, pursuant to the authority

of their own abandoned property laws, also taken custody of the type of property at issue from record holders incompatibly with the Report's recommendations, applying the new principles of law prospectively leaves their acquisitions in repose. *See Beam*, 111 S. Ct. at 2448 ("[W]hen the Court has applied a rule of law to the litigants in the case it must do so with respect to all others not barred by procedural requirements or res judicata."). If the Special Master's recommendations are given retroactive effect, then New York will pursue its right to collect the funds escheated by the States under existing escheat principles. In addition, in the absence of a solution to the problem of designating a domicile or chief executive office for foreign issuers, remitting the funds previously collected on their issues becomes impractical.

Second, the proposed new debtor-creditor rules will apply as well to unclaimed property in the hands of issuers and their paying agents, which these entities have been reporting to the issuer's domicile (as debts of the issuer) if the creditors are unknown or are in States without coverage for the property. This property includes abandoned securities distributions as well as other types of debts such as unpaid wages and vendor payments. If the Court were to adopt the proposed changes in the *Texas* rules, all of this property must be reported to the State of the issuer's chief executive office. Retroactive application of the new rules, moreover, will also unsettle the prior escheat of these funds and subject the domicilary States to claims by the States of the issuers' chief executive offices.[60] The proposed changes in the escheat rules should, therefore, be chartered prospectively, leaving past actions undisturbed.

The remaining concern for deterrence, subsumed under the second prong of the *Chevron Oil* analysis, is of no moment here. New York's application of uniform state law debtor-creditor

[60] The Special Master concluded that his proposed change in the locator under the *Texas* backup rule from domicile to chief executive office did not implicate reliance interests protected by *Chevron Oil*. Report at 73.

definitions to the property in question is consistent with the Court's precedents, the uniform unclaimed property acts and prevailing escheat laws throughout the country. Consequently, the Court's reason for rejecting a deterrence argument applies here as well (the imposition of liability in hindsight against a state that, acting reasonably would do the same thing again, will serve no deterrent effect). *See Beam*, 111 S. Ct. at 2544 (dissenting opinion of O'Connor, J., citing *American Trucking*, 110 S. Ct. 2323).

For these reasons, the second prong of the *Chevron Oil* analysis also favors nonretroactivity.

3. Weighing The Equities

Finally, in determining whether a decision should be applied retroactively, the *Chevron Oil* test requires consideration of the reliance interests of all parties affected by changes in the law. "Where a State can easily foresee the invalidation of its [actions], its reliance interests may merit little concern." *American Trucking*, 496 U.S. at 182 (citing *McKesson Corp. v. Florida Alcohol & Tobacco Div.*, 496 U.S. at 44-46, 50). "By contrast, because the State cannot be expected to foresee that a decision of this Court would overturn established precedents, the inequity of unsettling actions taken in reliance on those precedents is apparent." *American Trucking*, at 182. *See also Beam*, 111 S. Ct. at 2444. Thus, the equitable analysis of *Chevron Oil* places limitations on the liability that may be imposed upon a party after the Court changes the law.

As New York has demonstrated, its escheat of the property in question was done in conformity with the *Texas v. New Jersey* escheat rules. The genuineness of New York's reliance upon precedent in its application of the primary and backup rules is fully corroborated by the equivalent reliance of the other States expressed in their own escheat practices. In addition, prior to this action, no State questioned these practices either administratively or judicially. Other cases in which the Court has considered the reliance factor establish that a party is entitled

to rely on existing law unless it is plainly invalid or there has been bad faith. None of these circumstances is present here. *See American Trucking*, 496 U.S. at 180 (it is proper to rely upon precedent of the Court even though it appears to rest on decisions rejected in some other line of decisions); *Lemon v. Kurtzman*, 411 U.S. 192, 207 (1973) (*Lemon II*) (although it was clear that there would be a constitutional challenge to a state statute, it could not be said that appellees acted in bad faith or that they relied on a plainly unlawful statute). *See also Goodman v. Lukens Steel Co.*, 482 U.S. 656, 662-663 (1987) (reliance is absent where the precedent that was overruled was not in effect at the time that the petitioner's actions were taken).

It is precisely because the States interpreted the Court's precedents in the same way, and relied upon that understanding in determining the funds to which they were entitled under the *Texas* escheat rules, that they are not harmed by the nonretroactive application of the proposed new escheat principles. The States did not anticipate receiving more of the funds and made their budgetary decisions accordingly. *See Beam*, 111 S. Ct. at 2455 (dissent of O'Connor, J.) ("there is little hardship to these companies from not receiving a tax refund they had no reason to anticipate."). Moreover, all escheated funds may be viewed as a windfall when compared to tax revenues.

By contrast, retroactivity will subject New York to devastating financial liability since the bulk of the money must be paid out of the State Treasury. Pursuant to New York State Finance Law § 95 (55 McKinney's Cons. Laws of N.Y. 1989), monies in the abandoned property fund in excess of $750,000 are paid into the State Treasury to the credit of the general fund. The Court recently concluded that repayment of a $30 million tax refund, a far smaller sum than the hundreds of million of dollars potentially involved here, would result in extreme and undue hardship to a State and its citizens in the form of higher taxes and reduced benefits. *American Trucking*, 496 U.S. at 182.

Although the Special Master admitted to "being troubled" by the enormous fiscal implications of retroactivity in this case,

he speculated that there may be practical limitations on New York's exposure for funds allocated in the 1970s or earlier. Report at 76-77. Even if this proved to be true, it is of little consequence. New York's liability for items collected between 1985 and 1991 alone amounts to approximately $631 million. The Special Master's assertion that New York took a "calculated risk" when it collected the funds and should, therefore, incur the consequences of disgorgement is spurious. Report at 76, n.68. New York has always maintained sufficient reserves to pay claimants, whether creditors or jurisdictions asserting a superior claim under the primary rule. In effect, the Special Master would also require States to anticipate retroactive changes in the underlying escheat rules and budget for the repayment of most of the funds they had escheated. It is unlikely that any jurisdiction would undertake the responsibilities of escheat in the first instance if they were exposed to the possibility of such a huge aggregate liability. It is also ironic that the Special Master would penalize New York for using the escheated funds and yet take the position that escheat is a means of rewarding jurisdictions under the backup rule. *See* Report at 35.

Finally, when considering the equities, the Court has also taken account of "the attendant potentially significant administrative costs" that retroactivity would entail. *American Trucking*, 496 U.S. at 183. In this case, New York will be required to determine the domicile (or chief executive office) of each issuer on whose securities New York received abandoned property and remit the proceeds accordingly. Since issuers change their locations, the process would have to be repeated for every distribution period. This, coupled with the great many issuers involved, would require an extraordinary expenditure of resources and personnel at a time when the State is already undergoing extreme financial difficulties. The Court has repeatedly expressed its great reluctance to engage in retroactive decision-making which threatens to disrupt governmental operations.

> To the extent that retrospective application of a decision burdens a government's ability to plan or carry out its programs, the application injures all of the

> government's constituents. These concerns have long informed the Court's retroactivity decisions.

American Trucking, 496 U.S. at 185 (citations omitted).

In the event that the Court were to give full retroactive effect to the Report of the Special Master, New York requests that consideration be given to remedial limitations based upon a statute of limitations or the equitable doctrine of laches. New York sought such relief in its pleadings. *See, e.g.*, New York's Answer to the Amended Complaint of the State of Texas, dated November 17, 1989, at 22. Contrary to the Special Master's analysis of these defenses, the Court has not previously rejected them in the context of its escheat rulings. *See* Report at 74-75.

The essential difference between this case and the Court's prior decisions is that the States here do not assert a superior claim to the property escheated by New York under the *Texas* primary rule. Rather, they are claiming a right to the property pursuant to changes in the backup rule. The Court's previous refusals to place any limitation on the advancement of claims by the creditors' jurisdictions is simply not involved here. In addition, the States maintain that their claims are merely logical applications of the Court's rules. If that is the case, then the conclusion is warranted that the States slept on their rights until it was financially worthwhile for them to come forward. This is precisely the conduct that invokes the bar of laches.

This case, therefore, raises critical concerns over the administration of the Court's escheat rules. Unless States are insulated from the type of "disgorgement" contemplated by the Special Master, they will be subject to financial consequences of potentially devastating proportion simply because they applied the rules according to their best understanding of them to date.

CONCLUSION

For all of the foregoing reasons, New York respectfully urges that the Court reject the Report of the Special Master adopting the legal theory of Texas, *et al.* and Alabama, *et al.* The complaints of the plaintiff-intervenor States should be dismissed as setting forth legal theories inconsistent with *Texas v. New Jersey* and *Pennsylvania v. New York*. The matter should be remanded to the Special Master for further proceedings concerning the issues raised by New York in response to Delaware's claims under the *Texas* primary rule. Alternatively, if the Court adopts the Special Master's Report, the new escheat principles should be prospectively applied or their retroactive application be subject to remedial constraints.

Dated: New York, New York
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