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More Confusion About Who Owns the Tax Refund Attributable to a Distressed Bank

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In connection with the bankruptcy of a bank holding company (the “Bank Holdco”) and its operating bank subsidiary (the “Bank”), there are often different classes of creditors competing for one tax refund. If the Bank Holdco is the parent corporation of a consolidated group of corporations (the “Consolidated Group”), the Bank Holdco usually is treated as the agent of the group for federal income tax purposes. In such a situation, the Bank Holdco files income tax returns on behalf of the Consolidated Group, carries back and forward net operating losses of the Consolidated Group and receives from the **IRS** any refund of taxes paid by the Consolidated Group as the group’s agent. The federal income tax rules do not address the allocation of tax refunds received by the Bank Holdco with respect to the members of the Consolidated Group. Thus, the members of the Consolidated Group typically execute a tax sharing agreement (a “TSA”) that provides that each group member will pay the Bank Holdco its share of the federal income taxes owed by the Consolidated Group and will receive its portion of any tax refunds received by Bank Holdco attributable to the losses generated by such member.

The **FDIC** has enacted a policy statement pursuant to which tax refunds received by the Bank Holdco that are generated from the losses incurred by the Bank should be paid to the Bank. Consistent with such policy, if the Bank is in receivership, the FDIC is authorized as receiver directly to claim from the IRS a tax refund attributable to the losses generated by the Bank. The IRS can use its discretion to determine whether to pay such refund to Bank Holdco or the FDIC, as receiver for the Bank, and the competing claims for such tax refund by a Bank Holdco and the FDIC has caused extensive litigation.

Pursuant to federal common law, if a TSA does not exist and the Bank would have been entitled to a tax refund had it filed its federal income tax return as a separate company, the refund received by the Bank Holdco is held for the benefit of the Bank and Bank Holdco holds such refund in trust for the Bank. In re Bob Richards Chrysler-Plymouth Corp., 473 F.2d 262 (9th Cir. 1973). However, the courts in In re Franklin Savings Corp., 31 F.3d 1020 (10th Cir. 2004), In re First Central Fin. Corp., 377 F.3d 209 (2nd Cir. 2004) and In re IndyMac Bancorp., Inc., 2012 WL 1037481 (Bank’r. C.D. Cal. March 29, 2012) each stated that if a TSA exists, the federal common law rule does not apply and the TSA will control the arrangement between the parties. The language contained in the TSA in those decisions generally provided that the parent of the Consolidated Group was obligated to “pay” or “reimburse” a subsidiary for, any tax refund attributable to the losses of such subsidiary. The courts held that a debtor-creditor relationship exists if under the terms of the TSA, the tax refunds

attributable to the subsidiary were not expressly held for the subsidiary's benefit or in "trust" for such subsidiary. Thus, depending on the terms of the TSA, the estate of the Bank could be left with only an unsecured contractual claim in bankruptcy against the Bank Holdco for the tax refund.

However, in two recent Eleventh Circuit decisions, In re NetBank, Inc., No. 12-13965 (11th Cir. September 10, 2013) and In re BankUnited Financial Corp., No. 12-11392 (11th Cir. August 15, 2013), the court held that despite the existence of a TSA, the tax refund generated from the losses of a Bank were an asset of the Bank's estate even though the TSAs in both cases provided that the Bank Holdco would "pay" to the Bank the tax refund that was based on the utilization of the losses of such Bank.

The NetBank and BankUnited bankruptcy courts had held the TSAs established debtor-creditor relationships and the Banks were only entitled to an unsecured claim against the estate of the Bank Holdco. On appeal, the Eleventh Circuit did not distinguish the arrangements from the Franklin Savings and In re First Central Fin. Corp. decisions. The Eleventh Circuit instead stated that the TSAs in NetBank and BankUnited were ambiguous, did not contain language that would clearly establish a debtor-creditor relationship and were intended to comply with the FDIC policy statement regarding TSAs. The Eleventh Circuit in NetBank and BankUnited held that based on such intent, the Bank Holdco acted as agent for the Bank and any tax refund attributable to the losses generated by the Bank was the property of the Bank's estate and not the estate of the Bank Holdco.

The court in In re Downey Financial Corp. et al. v. FDIC, No. 08-13041 (Bank'r Ct. D. Del. Oct. 8, 2013) attempted to reconcile the inconsistent decisions regarding the ownership of a tax refund associated with a Bank's losses. In In re Downey Financial, the Bank Holdco and Bank had executed a TSA permitting the Bank Holdco to comingle the proceeds of a tax refund with its other funds and the Bank Holdco had the sole discretion to determine the amount of the tax refund payable or credited to the Bank. The court stated unlike in NetBank and BankUnited, theIn re Downey Financial TSA was not ambiguous because the TSA: (i) created fungible payment obligations among the members of the Consolidated Group, (ii) did not contain language regarding the segregation of, or restrictions on, the proceeds associated with a tax refund and (iii) provided the Bank Holdco with the sole discretion regarding the tax matters of the Consolidated Group.

The court in In re Downey Financial held that the TSA established a debtor-creditor relationship between the parties, the Bank Holdco was not the Bank's agent or trustee, and the Bank merely had an unsecured claim against the estate of Bank Holdco for the amount of the tax refund that was attributable to the Bank's losses.

It is unclear at this time whether the FDIC will appeal the bankruptcy court's decision in In re Downey Financial. Despite similar language being contained in all the TSAs that were subject to a dispute in bankruptcy about the ownership of a tax refund based on the losses of a Bank, the courts have interpreted the words contained in such TSAs in distinctly different manners. Thus, consolidated financial institutions must clearly establish the intended arrangements between the members of the Consolidated Group regarding which party is the owner of a tax refund attributable to the losses of a subsidy member of the group. The words contained in or absent from any TSA could affect the ultimate ownership of any tax refund payable to the Consolidated Group. Creditors of the Bank Holdco and the Bank must also carefully review the terms of any TSA that exists between the parties to determine the owner of the tax refund.

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