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Update on Corporate Bankruptcy Tax Refund Litigation

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The bankruptcy trustee of a bank holding company was not entitled to a consolidated corporate tax refund when a bank subsidiary had incurred losses generating the refund, held the U.S. Court of Appeals for the Tenth Circuit on May 26, 2020. *Rodriguez v. FDIC (In re United Western Bancorp, Inc.)*, 2020 WL 2702425(10th Cir May 26, 2020). On remand from the U.S. Supreme Court, the Tenth Circuit, as directed, applied "Colorado law to resolve" the question of "who owns the federal tax refund." *Id.*, at 2. The court had initially held for the FDIC, the bank subsidiary's receiver, but, according to the Supreme Court, mistakenly failed to apply state law and relied instead on a Ninth Circuit decision, *In re Bob Richards Chrysler Plymouth Corp.*, 473 F.2d 262,265 (9th Cir 1973). *Id*. The Supreme Court rejected *Bob Richards* as inappropriate federal "common lawmaking," and remanded the case back to the Tenth Circuit. *Id.*

Relevance

Federal courts regularly resolve consolidated corporate tax refund disputes in bankruptcy cases. By way of background, corporate parents and their subsidiaries often file a single consolidated tax return. That consolidated return enables affiliates to offset their losses against each other and to reduce the group's overall tax liability. *See*, 26 U. S. C §§1501 *et seq*. It also is administratively efficient. But the affiliates must appoint the corporate parent as their agent to file the consolidated return. When the group members are entitled to a refund, the refund must be paid "directly to and in the name of "the corporate parent, not to individual affiliates. 26 C.F.R §1.1502-77(a), (e) (i). To deal with the later distribution of the refund, affiliated groups usually enter into tax sharing or allocation agreements.

Ownership Litigation. Litigation has often ensued over who owns the refund paid to an affiliated group. The corporate parent side claims ownership of the refund and that a subsidiary is simply a creditor. The subsidiary side, however, may claim ownership because it generated the loss leading to the refund, arguing that the parent is merely an agent or trustee of the funds.

Bankruptcy Relevance. The issue is increasingly significant in business bankruptcy cases during the current economic downturn. If a debtor corporate parent owns the refund, it is part of the parent's bankruptcy estate; the subsidiary seeking the refund is an unsecured creditor. Conversely, if the debtor parent is an agent or trustee for its affiliates, the parent cannot use the refund to repay its creditors. The refund can also be substantial. *FDIC v. Amfin Fin. Corp.*, 757 F.3d 530, 532 (6th Cir. 2014) (dispute over ownership of $170 million refund). Deciding ownership of a refund, therefore, may be critically important to creditors of either the parent or subsidiary.

Recent Circuit Split Over Applicable Law. The Circuit Courts of Appeals had been sharply split on how to resolve ownership of a tax refund paid to an affiliated corporate group until the Supreme Court held this year that state law determines a "fight over a tax refund", and rejected the federal default rule of *Bob Richards*, as noted. *Rodriguez v. FDIC (In re United Western Bancorp, Inc.)*, 589 U.S. ___, 140 S. Ct. 713 (Feb 25, 2020). The Circuits had either followed Bob Richards, or found alternative approaches. *See*, *e.g.*, *Indy Mac Bancorp.*, 554 F. App'x 668, 670 (9th Cir. 2012) ("[T]he parent holds the tax refunds in trust for the subsidiary unless the parties have made [an] agreement concerning the ultimate disposition of the tax refund."), *quoting Bob Richards*, 473 F.2d at 265; *In re First Regional Bancorp*, 703 F. App'x 565 (9th Cir. 2017) (no unjust enrichment of parent; "no tax sharing agreement — express or implied — between" the parties) (following *Bob Richards*); *Capital Bancshares, Inc. v. FDIC*, 957 F.2d 203 (5th Cir. 1992) (following *Bob Richards*), *Contra*, *FDIC v. AmFin Financial Corp.*,757 F. 3d 530, 536 (6th Cir. 2014) ("Congress generally allows state law to determine the property interests subject to bankruptcy."; "decline[d] to apply federal common law".); *In re Bank United Financial Corp.*, 727 F.3d 1100, 1108-09 (11th Cir. 2013) (rejected *Bob Richards* and looked to state law; parent held funds "in escrow" for subsidiary); *In re Netbank, Inc.*, 729 F.3d 1344, 1347 n.3 (11th Cir. 2013) [" … we apply … Georgia contract law"); *In re Downey Financial Corp.*, 593 F. App'x 123, 126 (3d Cir. 2015) ("*Bob Richards* default rule … not applicable" when "parties have agreed to " an allocation; no trust relationship imposed on parent; parent owned refund); *In re First central Financial Corp.*, 377 F.3d 209, 211 (2d

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Cir. 2004) (Ignored *Bob Richards*; written agreement governed).

Implied Tax Sharing Agreements. Courts have not only relied on written tax sharing agreements, but have also implied such agreements based on the actions of a group member. *Capital Bancshares, Inc., v. FDIC*, 957 F, 2d 203, 207 (5th Cir. 1992) ("[C]ourts will not question an allocation which results from an express agreement which is clearly implied"); *Bob Richards*, 473 F.2d at 265 (9th Cir. 1973) (… where an agreement can be fairly implied, as a matter of state corporation law the parties are free to adjust among themselves the ultimate tax liability."); *In re First Financial Corp.*, 269 B.R.481 490 (Bankr. E. D. N.Y. 2001) (same); *In re All Prods. Co.*, 32 B.R. 811, 814 (Bankr E.D. Mich. 1983) (same). *But see*, *In re Coral Petroleum, Inc.*, 60 B.R. 377, 388, 390 (Bankr. S. D. Tex. 1986) (rejected claim by consolidated group member against parent to be compensated for use of its losses to offset group taxable income when no tax sharing agreement existed; held, no implied contract to compensate subsidiary group member; bookkeeping alone is insufficient to establish a duty to compensate for the use of losses; also, "in absence of fraud or overreaching," decision to compensate group member "for tax savings is a matter of business judgment not to be disturbed by the court," even when parent dominates subsidiary).

Banks and sophisticated lenders often require written tax sharing agreements that are favorable to the group member borrowing funds, but trade creditors usually lack that leverage. As a result, a bankruptcy court may misread or imply a tax sharing agreement when confronting the entitlement issue in the case of a group member under the court's protection, as happened in *Rodriguez*. The Supreme Court may have resolved one issue in *Rodriguez* this past February — state, not federal law, applies — but litigation over ownership of tax refunds will continue. Is there a tax sharing agreement? If so, what did the parties intend? If there is no such agreement, can the court imply one?

Facts in *Rodriguez*

The Internal Revenue Service (IRS) in *Rodriguez* paid a tax refund to the bank holding company, although the tax refund had resulted from losses incurred by its bank subsidiary. The bankruptcy trustee of the holding company sued the FDIC, as receiver for the bank, claiming ownership of the refund. The bankruptcy court granted summary judgment for the trustee, finding that the parent owned the refund, but the district court reversed. In its original decision, the Tenth Circuit, applying *Bob Richards* ("Federal common law … provides a framework for resolving the issue"), affirmed the district court's judgment that the tax refund belonged to the FDIC (the subsidiary's receiver), finding that the parties' tax allocation agreement was "ambiguous." Still, the parent holding company had an agency relationship "with respect to federal tax refunds," held the Tenth Circuit, and had agreed to an "equitable allocation of tax liability." *In re United Western Bancorp, Inc.*, 914 F.3d 1262, 1269, 1274 (10th Cir 2019). According to the allocation agreement, reasoned the court, tax benefits would be computed "on a separate entity basis for each" member of the affiliated corporate group. *Id.*, at 1270.

Analysis

Ambiguous Agreement. Despite the Supreme Court's holding, the Tenth Circuit said that it had "not ignore[d] Colorado law in [its] original decision." 2020 WL 270 2425, at 2. Reviewing the affiliates' tax sharing agreement, it first found it to be "at best, ambiguous regarding the nature of the relationship that [the parent holding company] and the Bank intended to create with one another." *Id*. On one hand, certain provisions suggested that the parent was the bank's agent in collecting the refund, but other provisions suggested "something other than an agency relationship." *Id*. The court stressed that the relevant provision of the tax sharing agreement was "poorly drafted and ambiguous." *Id.*, at 6.

Clear Resolution Provision. But the group's tax sharing agreement, held the court, explicitly "provides a method for resolving the ambiguity." *Id*. "Any ambiguity in the interpretation hereof shall be resolved, with a view to effectuating such intent [*i.e.*, to provide an equitable allocation of the tax liability of the Group among [the parent] and the Affiliates], in favor of any insured depository institution." *Id*. (quoting agreement). Thus, instead of a debtor-creditor relationship that would give "ownership of federal tax refunds to" the parent, the court construed the tax sharing agreement in favor of the bank subsidiary — an agency relationship "affording ownership of the tax refund to the Bank." *Id*. In the end, Colorado contract law governed the outcome here.

Comment

This dispute arose in a bankruptcy case. But "the determination of property rights" in a debtor's assets is governed by state law. *Butner v. United States*, 440 U.S. 48, 54 (1979). *See also*, *Wellness International Network Ltd., v. Sharif*, 135 S. Ct. 1932, 1952 (2015) ("Identifying property that constitutes the estate [under state law] has long been a central feature of bankruptcy adjudication.") (dissent on other grounds) (Roberts, Ch. J.), *citing Stern v. Marshall*, 131 S. Ct. 2594, 2619 (2011).

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