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Viewpoint: Who Owns a Distressed Bank's Tax Refunds?

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Over the next few years, a significant number of distressed bank-holding companies will face the end of interest-deferral periods and the prospect of payment defaults on certain debt instruments and trust-preferred securities. The looming obligations to repay deferred interest may escalate the need for financial restructuring at these holding companies and may create attractive opportunities for investors to recapitalize or acquire their subsidiary banks, including in a bankruptcy scenario.

Investors considering distressed bank targets must weigh many factors, including the amount and quality of assets a bank holds. A potentially important tax asset is the right to receive refunds for carrybacks of current-period losses to prior tax years. Investors, however, should be aware of a potential pitfall of these sometimes significant assets. In a bankruptcy scenario, bank-holding company creditors may seek to capture the value of these refunds from the bank, thereby undercutting-sometimes fatally-the investment case for buying the bank.

Whether a bankruptcy court will hold that a tax refund asset reflected on the books of a troubled bank is owned by the bank or its parent-holding company is often a function of seemingly small variations in language in tax-sharing agreements between the bank and its parent. Understanding these agreements and their likely effect can help would-be distressed bank investors avoid expensive mistakes.

For federal tax purposes, the parent of an affiliated group filing a consolidated return is generally treated as an agent for its subsidiaries, as well as the responsible party for all tax filings and returns. The parent is the sole entity authorized to file tax returns, file for refunds and receive refunds on behalf of the entire group. Accordingly, tax refunds generally pass through parent companies before being paid to subsidiaries.

In the bankruptcy context, absent an agreement to the contrary, courts have treated the parent as an agent for its subsidiaries, holding any refunds in trust for them. The seminal case is the Ninth Circuit's decision in Bob Richards, which held that **Internal Revenue Service** (IRS) requirements do not alter the fact that the loss-generating entity owns any accompanying tax refund and the parent corporation receives the refund "only in its capacity as agent for the consolidated group." In re Bob Richards Chrysler-Plymouth Corp., 473 F.2d 262, 265 (9th Cir. 1973), cert. denied sub nom. Western Dealer Mgmt. Inc. v. England, 412 U.S. 919 (1973). Other courts have followed this rule, including the Fifth and Eighth Circuits and various lower courts. Capital Bancshares Inc. v. FDIC, 957 F.2d 203 (5th Cir. 1992); Jump v. Manchester Life & Cas. Mgmt. Corp., 579 F.2d 449 (8th Cir. 1978); In re Florida Park Banks Inc., 110 B.R. 986 (Bankr. M.D. Fla. 1990).

However, bankruptcy courts have held that tax-sharing agreements between a parent debtor and a loss-generating subsidiary can alter this relationship, making the parent the owner of any refund and its subsidiary merely a creditor of the parent. See, e.g., In re **IndyMac Bancorp Inc** ., 2012 WL 1037481 (Bankr. C.D. Cal. March 29, 2012) (citing various cases). In the banking space, regulators encourage bank-holding companies and their subsidiary banks to enter into tax-sharing agreements, and in recent years, some of these agreements have provided holding company creditors with golden opportunities to seek additional value by recharacterizing banks' refund claims as assets of their parents.

The recent IndyMac case is a prime example. In that case, the holding company and the bank entered into a tax-sharing agreement that required "payment" or "reimbursement" by the holding company if the subsidiary bank suffered losses that created a tax asset. The court held that this language in the tax-sharing agreement meant that "what the Bank held was a contractual claim against [the parent]." Id. at *15. The parent holding company creditors were successful in recharacterizing the bank's refund claims as assets of the holding company.

As illustrated by IndyMac, the key question in these tax refund disputes is whether the tax-sharing agreement creates an agency relationship or a debtor/creditor relationship between the holding company and its loss-generating bank. In the former case, bankruptcy will not alter the state of nature: The bank owns the refund generated by its losses, and the parent merely receives it from the IRS in trust for the bank. In the latter case, however, bankruptcy courts have declared the holding company the owner, with the bank having nothing more than a pre-petition claim against its parent for the lost refund.
In these kinds of disputes, words matter. When a tax-sharing agreement obligates a parent to "reimburse," "credit" or

"pay" a subsidiary, courts are more likely to find a debtor/creditor relationship. Delegation to the bank-holding company of direction and control over tax matters can provide further support for such a holding. On the other hand, agreements that expressly designate the parent as an "agent" for its subsidiaries and include requirements that the holding company segregate or escrow proceeds for its subsidiaries are less likely to alter the status quo.

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In the aftermath of the financial crisis, many banks have incurred losses and booked significant tax-refund assets as a result. When an expected tax refund is a significant asset of a distressed bank, prudent investors and their professionals will carefully parse the words of any tax-sharing agreement before deciding to invest.

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