U.S. Supreme Court Rejects Operating Subsidiaries' Presumptive Right to Tax Refunds in Bankruptcy

March 13, 2020

Key Takeaways

The U.S. Supreme Court issued a decision on February 25, 2020, that reduces certainty as to which member of a consolidated tax group is entitled to tax refunds delivered by the Internal Revenue Service (**IRS**). In *Rodriguez v. FDIC*, No. 18-1269, 2020 U.S. Lexis 1364 (U.S. Feb. 25, 2020), the Court ruled unanimously that the issue is a question of corporate property rights governed exclusively by state law. It rejected a line of lower court decisions applying a federal common law presumption in favor of the subsidiary corporation whose operations generated the right to the tax refund. State law rules of contractual interpretation, as well as state law equitable principles, such as the doctrine of unjust enrichment, will now control this question. Since most state laws will respect explicit and clear contractual language, the key bottom line takeaway from the case is that corporate groups should review their tax allocation agreements and confirm that the contractual provisions governing allocations of tax refunds between the parent and any subsidiaries are clear and explicit. Bank holding companies should confirm that they have complied with 2014 regulatory guidance which requires specific contractual language making clear the bank's entitlement to tax refunds.

Basics of Corporate Group Tax Allocation Agreements

When corporate groups file consolidated tax returns, the tax liability of the group is determined on a consolidated basis and each entity is jointly and severally liable for the taxes of the group. The parent corporation generally serves as the sole agent for the group in dealings with the IRS regarding all matters relating to the group's tax liability, including the filing of claims for refund. The IRS issues a refund directly to, and in the name of, the parent corporation, and that payment discharges the government's liability to each member of the group. The tax law does not provide rules for the distribution of that refund among members of a consolidated group. Corporate groups generally enter into tax allocation agreements that specify what share of the group's liability each member is responsible for paying, and what share of the group's tax refunds each member is entitled to receive.

While the issue is not unique to bank groups, in the wake of the 2008 financial crisis many disputes have arisen over rights to tax refunds when a parent bank holding corporation files for bankruptcy protection and the Federal Deposit Insurance Corporation (**FDIC**), acting as receiver for the bank subsidiary, claims entitlement to a tax refund paid to the parent corporation but generated by losses of the subsidiary. The question is often whether the tax allocation agreement should be construed as establishing that the parent corporation receives the tax refund in its own right, with an offsetting contractual obligation to pay some portion of it over to the subsidiary, or, alternatively, whether the parent receives the tax refund as agent for the subsidiary, with no independent claim to it in its own right. In the former case, the subsidiary will be left with an unsecured creditor's claim in bankruptcy, with uncertainties of recovery, while in the latter case the refund will be excluded from the parent's bankruptcy estate and held in trust for the subsidiary. In *Rodriguez*, the Supreme Court vacated a 10th Circuit decision in favor of the subsidiary, holding that the presumption in favor of subsidiaries established in the *Bob Richards* case was not a legitimate exercise of federal common lawmaking and remanding the case for evaluation under state law principles.

The Bob Richards Rule

The Supreme Court took the *Rodriguez* case "to decide *Bob Richards*'s fate."[1] In that case, Western Dealer Management, Inc. was a holding company for Bob Richards Chrysler-Plymouth Corporation, Inc. (**Bob Richards**) and the parent of a consolidated federal tax group that included Bob Richards. While Bob Richards was in bankruptcy proceedings, Western Dealer Management received a federal refund that was attributable to losses incurred by Bob Richards. The bankruptcy trustee claimed that the refund was part of Bob Richards's bankruptcy estate, while Western Dealer Management claimed it was entitled to the entire amount of the refund as a set-off against an unrelated debt of Bob Richards. The parties did not have a written agreement governing the disposition of the refund. The Ninth Circuit ruled in favor of the trustee, reasoning that by consenting to join in the filing of a consolidated return, Bob Richards merely agreed that Western Dealer Management would act as its agent in dealings with the IRS and that "[a]llowing the parent to keep any refunds arising solely from a subsidiary's losses simply because the parent and subsidiary chose a procedural device to facilitate their income tax reporting unjustly enriches the parent."[2] The court held that without an "express or implied agreement that the agent" had the right to keep the refund, a refund received by the parent of a consolidated group belongs to the member responsible for the losses that generated the refund, and Western Dealer Management was merely acting as a trustee with respect to the refund owned by Bob Richards's estate.

This conclusion became known as the *Bob Richards* rule in subsequent cases where courts adopted it. Some courts even expanded the rule to hold that "*Bob Richards* doesn't just supply a stopgap rule for situations when group members lack an allocation agreement," but "represents a general rule always to be followed unless the parties' tax allocation agreement *unambiguously* specifies a different result."[3]

Other courts rejected this approach. In particular, in *FDIC v. AmFin Fin. Corp.*, 757 F.3d 530 (6th Cir. 2014), the Sixth Circuit found that a tax allocation agreement between a bank holding company and its subsidiary bank was ambiguous as to whether the parties were in a debtor-creditor or principal-agent relationship and remanded the case to be decided under state law. The Sixth Circuit rejected the argument advanced by the FDIC, the receiver for the bank, that it was entitled to the refund under the *Bob Richards* rule. The court explained that the rule was a "creature of federal common law" and concluded that courts adopting it had improperly engaged in federal common lawmaking because state law should govern whether property is excluded from a debtor's estate, absent "a significant conflict between some federal policy or interest and the use of state law."[4]

Similar disputes over tax refunds arose in several other cases involving the bankruptcy of a bank holding company and receivership of a bank subsidiary, with mixed results.[5]

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[1] *Rodriguez*, 2020 U.S. Lexis 1364, at *6.

[2] *Bob Richards*, 473 F.2d at, 265.

[3] *Rodriguez*, 2020 U.S. Lexis 1364, at *6.

[4] *AmFin*, 757 F.3d at 535-36.

[5] *Compare AmFin*, 757 F.3d 530 (refusing to apply the *Bob Richards* rule on the grounds that federal law does not govern the allocation of a consolidated tax refund) *and* FDIC v. Siegel (In re IndyMac Bancorp.), 554 Fed. Appx. 668 (9th Cir. Apr. 21, 2014) (*per curiam)* (''The TSA does not create a trust relationship. The absence of language creating a trust relationship is explicitly an indication of a debtor-creditor relationship in California.'') *with* FDIC v. Zucker (In re NetBank), 729 F.3d 1344 (11th Cir. 2013), *cert. denied*, 135 S. Ct. 476 (2014) (holding that the bank holding company held the fund as agent for the bank) *and* Zucker v. FDIC (In re BankUnited Fin. Corp.), 727 F.3d 1100 (11th Cir. 2013), *cert. denied*, 134 S. Ct. 1505 (2014) (''The relationship between the Holding Company and the Bank is not a debtor-creditor relationship. When the Holding Company received the tax refunds it held the funds intact—as if in escrow—for the benefit of the Bank and thus the remaining members of the Consolidated Group.'').

Bank Regulatory Guidance

In response to these cases, in 2014, the FDIC, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Department of the Treasury jointly issued an addendum to prior guidance directing groups with an insured depositary institution (**IDI**) to provide specific language in their tax allocation agreements regarding the nature of the relationship between the group members (the **Addendum**). The Addendum supplemented a 1998 joint policy statement that provided guidance to IDIs and their holding companies regarding consolidated tax returns, one of the principal goals of which was to "protect IDIs' ownership rights in tax refunds" (the **Interagency Policy Statement**).

The Addendum provides that bank holding companies and their IDI subsidiaries should ensure that their tax allocation agreement clearly acknowledge that an agency relationship exists between the bank holding company and the IDI regarding tax refunds. Under the Addendum, all consolidated groups should amend their tax allocation agreements to include the following paragraph or substantially similar language:

> The [holding company] is an agent for the [IDI and its subsidiaries] (the "Institution") with respect to all matters related to consolidated tax returns and refund claims, and nothing in this agreement shall be construed to alter or modify this agency relationship. If the [holding company] receives a tax refund from a taxing authority, these funds are obtained as agent for the Institution. Any tax refund attributable to income earned, taxes paid, and losses incurred by the Institution is the property of and owned by the Institution, and shall be held in trust by the [holding company] for the benefit of the Institution. The [holding company] shall forward promptly the amounts held in trust to the Institution. Nothing in this agreement is intended to be or should be construed to provide the [holding company] with an ownership interest in a tax refund that is attributable to income earned, taxes paid, and losses incurred by the Institution. The [holding company] hereby agrees that this tax sharing agreement does not give it an ownership interest in a tax refund generated by the tax attributes of the Institution.

The Addendum states that tax allocation agreements with this language will be deemed to acknowledge that an agency relationship exists for purposes of compliance with the Interagency Policy Statement and Addendum as well as Sections 23A and 23B of the Federal Reserve Act.[6]

The Rodriguez Case

Against the backdrop of multiple litigations and regulatory guidance discussed above, the *Rodriguez* case presented yet another opportunity for a court to address entitlement to a consolidated tax refund received by a bank holding company. The facts are as follows: United Western Bancorp Inc. was a bank holding company for a consolidated group that included United Western Bank (the **Bank**). In 2008, United Western Bancorp and its subsidiaries entered into a tax sharing agreement (**TSA**) that obligated United Western Bancorp to pay the Bank a refund equal to or greater than the amount it would have received had it not joined in the filing of a consolidated return. The TSA did not explicitly set forth a principal-agent relationship between the group members and the parent or otherwise expressly define the nature of the

[6] Addendum to the Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure, 79 Fed. Reg. 118 (Jun. 19, 2014), **https://www.govinfo.gov/content/pkg/FR-2014-06-19/pdf/2014- 14325.pdf.** The Addendum notes that tax allocation agreements are subject to the requirements of Section 23B of the Federal Reserve Act, and tax allocation agreements that do not clearly acknowledge that an agency relationship exists may be subject to additional requirements under Section 23A of the Federal Reserve Act. These sections, and the regulations thereunder known as Reg W, address transactions between IDIs and their affiliates, with a focus on protecting the IDI.

intended relationship. In 2011, while a refund request for the group was pending, the Bank entered FDIC receivership and in 2012, United Western Bancorp filed for commencement of a Chapter 11 bankruptcy proceeding.

The FDIC filed a claim in United Western Bancorp's bankruptcy case, arguing that it was entitled to the refund because the refund stemmed exclusively from Bank's net operating losses. United Western Bancorp's trustee disagreed, and in 2016 the bankruptcy court ruled in favor of United Western Bancorp. The bankruptcy court held that the TSA created a debtor-creditor relationship with respect to the tax refund, under which United Western Bancorp was the beneficial owner of the refund and the Bank was a general unsecured creditor of United Western Bancorp's bankruptcy estate, with the result that the Bank would have to share *pari passu* with other general unsecured creditors in that property.[7] The FDIC appealed, and the district court reversed, holding that the TSA was ambiguous and should be construed in favor of the Bank, which it found to have an equitable interest in the refund.[8]

United Western Bancorp's trustee appealed and the Tenth Circuit affirmed, applying the more expansive version of *Bob Richards*. The court asked whether the TSA "unambiguously deviated" from the *Bob Richards* default rule (in other words, whether it unambiguously provided that the tax refund was the property of United Western Bancorp, establishing a debtor-creditor relationship between United Western Bancorp and the Bank), holding that in the absence of such unambiguous language, the TSA must be construed in favor of the Bank.[9] Concluding that the TSA was ambiguous with respect to the type of relationship it intended to create between United Western Bancorp and the Bank as to the ownership of refunds, the Tenth Circuit found that United Western Bancorp was acting as the Bank's agent, and consequently the refund belonged to the Bank (through the FDIC, as receiver).

On appeal, the Supreme Court ruled that the *Bob Richards* rule was invalid because of its improper creation of federal common law. As a general rule, federal judges cannot engage in judicial lawmaking in the form of federal common law, unless strict conditions are satisfied. One of the most basic conditions is that in the absence of congressional authorization, federal common lawmaking must be "necessary to protect uniquely federal interests."[10] The Court found that no such federal interest exists in these circumstances because the federal government does not have an interest in determining how a consolidated tax refund, once paid to a designated agent, is to be distributed among group members. The Court reasoned that "state law is well equipped to handle disputes involving corporate property rights," even in the context of federal bankruptcy and a federal tax dispute, and that *Bob Richards* simply bypassed the threshold question of whether the application of federal common law was justified. Consequently, the Supreme Court remanded the case to be considered under applicable state law. The Court acknowledged that cases may ultimately come out the same way under applicable state law, but it took the case to underscore the care federal courts must exercise before crafting federal common law.

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[7] United W. Bancorp, Inc. v. FDIC (In re United W. Bancorp, Inc.), 558 B.R. 409 (Bankr. D. Colo. 2016).

[8] In re United W. Bancorp, Inc., 574 B.R. 876 (D. Colo. 2017).

[9] In re United W. Bancorp, Inc., 914 F.3d 1262 (10th Cir. 2019).

[10] *Rodriguez*, 2020 U.S. Lexis 1364, at *7.

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