Hughes Hubbard & Reed

Tax Sharing Arrangements in Bankruptcy: Who's Refund Is It?

Client Advisories

Hughes Hubbard & Reed LLP • A New York Limited Liability Partnership
One Battery Park Plaza • New York, New York 10004-1482 • +1 (212) 837-6000

November 18, 2013 - When a multi-national conglomerate corporation fails, how the corporation's tax-sharing arrangements ("TSAs") will be interpreted in bankruptcy can be a multi-million dollar question, especially where a holding company is being reorganized separately from a subsidiary. If the TSA is deemed to create debtor-creditor relationships between the affiliates, the affiliate holding the rebate on the date of bankruptcy need only distribute any refund owed to other affiliates at an unsecured creditor rate – resulting in a significant loss to the other companies and a windfall to the affiliate holding the rebate when the music stopped. If, however, the TSA is deemed to create an agency relationship between the affiliates, the rebate should be distributed between them in parity notwithstanding the bankruptcy. For a subsidiary – such as a bank owned by a holding company – the difference can be a matter of millions of dollars and have a substantial impact on its creditors' recovery rates.

Conglomerate corporations use TSAs principally because they offer a mechanism for simplifying and organizing the tax filings of companies in a consolidated group. Under certain conditions, federal law permits a parent company to file a consolidated tax return on behalf of itself and its subsidiaries. Since federal law does not specify how the tax liabilities or refunds should be allocated between the companies, TSAs exist to allocate the liabilities and refunds between the companies in the group.

When a bankruptcy occurs, one affiliate may be holding the rebate for the entire conglomerate. In these cases, the TSA must be interpreted to determine whether the estate of the affiliate holding the rebate effectively gets a windfall, such that a significant portion of the refund will go to that affiliate's creditors, or whether the rebate will be split between the entities in the conglomerate as it would have been outside of the bankruptcy context. Many TSAs are silent on how a refund should be handled in a bankruptcy and so bankruptcy courts must determine, according to the governing state's contract law, how the refund will be treated.

In a pair of recent cases, the Eleventh Circuit interpreted two tax-sharing agreements to create an agency relationship between the parent company and its subsidiary. In both cases, a dispute arose between the holding company in Chapter 11 and the FDIC as receiver for a subsidiary bank over the proper treatment of the tax refund.

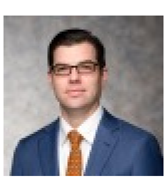
In *In Re Bamkunited Financial Corp.*, 12-11392 (11th Cir. Aug. 15, 2013), U.S. Bankruptcy Judge Laurel Isicoff held that the rebates became the property of the holding company estate on receipt, and that the obligation to transfer the refunds to the FDIC (as receiver for the bank) became a debt of the holding company estate. On appeal, after finding that the contract was silent on the issue of the holding company's "ownership" of the refunds before they were forwarded to the bank under the TSA, the Eleventh Circuit applied Delaware law in determining that the contract should be interpreted to create an agency relationship. The court relied on two key aspects of the contract: first, the absence of any collateral or any other contractual protection for the subsidiary for the obligation owed by the parent company; and second, the absence of any language from which a debtor-creditor relationship was created or implied, and the absence of any method to determine the terms of the indebtedness.

About three weeks later, the Eleventh Circuit decided *In Re Netbank, Inc.*, 12-13965 (11th Cir. Sept. 10, 2013), again holding in similar circumstances that, under Georgia law, a TSA should be interpreted to create an agency relationship. The court based its decision on two specific clauses in the TSA; first, a provision that incorporated the language of the FDIC's Policy Statement on TSAs that notes that the parent receives refunds as an "agent" on behalf of group members; and second, a provision that stated that the TSA should result in "no less favorable" treatment for the subsidiary than if it had filed on its own. The Eleventh Circuit held that reducing the subsidiary's claim to the refund to that of an unsecured creditor would result in giving the subsidiary less favorable treatment than if it had filed alone.

While a going concern is free to write its TSA to specify whether the relationship between the entities should be considered a debtor-creditor relationship or an agency relationship, in most cases the situation will never be considered until the conglomerate is in bankruptcy. Prudence counsels that any corporation considering a new TSA should consider the issue of how the refund should be treated in bankruptcy and explicitly state that the TSA creates an agency relationship (if the corporation desires that the refund distribution not be affected by a bankruptcy), or a debtor-creditor relationship (if the conglomerate seeks to advantage the estate of the company holding the refund in the event of a bankruptcy).

These two Eleventh Circuit decisions provide a blueprint for arguing that existing TSAs that are silent on the status of the refunds should be interpreted to create an agency relationship and remove refunds owed to other companies from the bankruptcy estate. They strongly support the position that the default interpretation of an ambiguous TSA should be an agency relationship, resulting in complete distribution of the refund in the event of bankruptcy. This gives the trustee or receiver of a subsidiary company owed a tax refund a significant advantage in obtaining the refund in full from the parent company's estate, either through a negotiated settlement or litigation.

Related People



Dustin P. Smith

Related Areas of Focus