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## Whose Refund Is It? Round Three Goes to Bank Holding Company Bankruptcy Estate

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**Summary:** In the first decision on the issue since the Eleventh Circuit decisions in *BankUnited* and *NetBank* holding that tax refunds belonged to the FDIC as receiver for the insolvent bank rather than to the bankruptcy estate of the bank's holding company, the Bankruptcy Court for the District of Delaware reached the opposite conclusion. In the Downey Financial Corporation case, it held that tax refunds arising from the bank's losses belonged to *Downey Financial Corporation's* bankruptcy estate, and not to the FDIC as receiver for the failed Downey Savings and Loan. The Delaware bankruptcy court concluded that the Eleventh Circuit decisions were factually distinguishable, and relied on earlier, lower court precedent to find that the tax sharing agreement among the Downey entities created only a creditor-debtor relationship between the holding company and the bank and thus that the refunds payable to the holding company were the property of the holding company's estate.

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In prior Client Alerts, we reported on two recent Eleventh Circuit decisions (*BankUnited* and *NetBank*) that, in a seeming break with the established precedent in lower courts, held that tax refunds attributable to losses incurred by an insolvent bank belonged to the FDIC, as receiver for the bank, rather than to the bankruptcy estate of the bank's holding company that received those refunds. In those Alerts, we suggested that because of unique facts in those cases, other courts might limit those decisions to their facts and reach a different result in future cases. That is exactly what the Bankruptcy Court for the District of Delaware did in its recent decision in the bankruptcy case of Downey Financial Corp. ("DFC"), the holding company of Downey Savings and Loan, F.A. ("Downey Bank" or the "Bank"). See *Giuliano v. FDIC (In re Downy Fin. Corp.)*, \_\_ B.R. \_\_, No. 10-53731, 2013 WL 5531392 (Bankr. D. Del. Oct. 8, 2013).

As in the Eleventh Circuit cases, the Delaware bankruptcy court's decision in *Downey Financial* arises in a bankruptcy case filed by a bank holding company after its subsidiary bank, its primary asset, was placed into receivership by the Office of Thrift Supervision. In *Downey Financial*, the Director of Thrift Supervision appointed the FDIC as receiver for Downey Bank, which immediately thereafter sold substantially all of the Bank's assets. DFC filed its voluntary Chapter 7 bankruptcy

case four days later. *Id.* at \*2-3.

After the DFC bankruptcy case began, the trustee, on behalf of the bankruptcy estate, filed amended tax returns seeking a tax refund arising from the carryback of Downey Bank's net operating losses in 2008, totaling more than \$373 million. *Id.* at \*5-6. The FDIC filed a claim in the DFC bankruptcy case for, among other things, the tax refund; it also filed with the IRS various statements asserting the FDIC's right to the tax refund. *Id.* at \*3, 6-7. The bankruptcy trustee commenced an adversary proceeding seeking a declaration as to the ownership of the tax refund, and subsequently, joined by the indenture trustee for the holders of DFC's bonds, sought summary judgment that the tax refund belonged to the bankruptcy estate. *Id.* at \*3.

Prior to the DFC bankruptcy case, DFC and its affiliates, including Downey Bank, had executed a tax sharing agreement ("TSA"). Pursuant to the TSA, estimated taxes for each member of the group were calculated on a standalone basis, reflecting each member's tax liability had it filed separately. Each member then paid its estimated taxes to DFC, which DFC deposited into its operating account. The TSA gave DFC broad authority regarding the preparation, filing, and prosecution of the group's joint tax returns. *Id.* at \*4. If a member of the group made an overpayment of taxes, the TSA required DFC to refund the overpayment to the group member within seven days of the earlier of the "receipt of such overpayment from the taxing authorities" or when the overpayment was reflected in reduced tax payments by the consolidated group to the taxing authority. *Id.* at \*5.

Faced on summary judgment with the issue of whether the anticipated tax refund was property of DFC's bankruptcy estate or whether it belonged instead to the FDIC as receiver for the Bank, the bankruptcy court, consistent with both the Eleventh Circuit decisions and earlier precedent, held that the agreement of the parties as set forth in the TSA controlled whether the TSA created an agency or merely debtor-creditor relationship between DFC and Downey Bank. *Id.* at \*10. Relying on earlier, lower court precedent, the court focused on three factors to make this determination: (1) whether the TSA created fungible payment obligations between the parties; (2) whether the TSA required DFC to hold any tax refund it received in escrow for the Bank; and (3) whether the TSA delegated the tax filer (DFC) with sole discretion regarding tax matters. *Id.* at \*11. The court held that each of these factors favored a finding that the TSA established no more than a debtor-creditor relationship between DFC and the Bank. It reasoned that the TSA created a system of intercompany payments and reimbursements that could materially differ from the amount of any tax refund received, that the TSA contained no escrow provisions, segregation provisions or other restrictions on DFC's use of any refund, and that nothing in the agreement imposed any duty on DFC to hold any refund in trust for the other members of the group. *Id.* at \*11-12. Rather, it found that DFC "has complete dominion and control" over refunds received for over a week, and Downey Bank's rights were limited to the "expectancy of payment of a sum at a future date." *Id.* at \*14.

The bankruptcy court acknowledged the Eleventh Circuit's decisions in *BankUnited* and *NetBank*, but noted that the tax sharing agreements in those cases contained provisions not present in the Downey TSA: the provisions in the *BankUnited* tax sharing agreement requiring the bank rather than the holding company to pay the group's tax liability and distribute refunds, and the incorporation of the Interagency Policy Statement in the *NetBank* tax sharing agreement. *Id.* at \*12-13. Citing to

these differences, the court concluded that "[a]lthough the *BankUnited* and *NetBank* cases seem to offer contrary decisions . . . , they are factually distinguishable and do not persuade this Court that DFC and Downey Bank had anything other than a debtor-creditor relationship." *Id.* at \*14.

The FDIC has appealed the bankruptcy court's order to the Delaware district court, and presumably will continue the appeal to the Third Circuit if the district court affirms the bankruptcy court decision. Thus, although the bankruptcy court limited the Eleventh Circuit cases to their facts and reached a contrary result, it remains to be seen if that view will survive appeal or whether the Third Circuit will be more inclined to follow the Eleventh Circuit's approach on this issue.

While which judicial approach will prevail still remains to be seen, the cases are in agreement that the issue of which entity owns a tax refund is a matter of contract interpretation and that clear language in a tax sharing agreement will control. Given that approach, interested parties on all sides have every incentive to try to ensure, going forward, that any applicable tax sharing agreement between a bank and its holding company states clearly the intentions of the parties as to which entity owns any tax refunds and contains terms, such as those focused on by the *Downey* court, consistent with those intentions. Making the agreement clear as to ownership would take only a few words, but could have a substantial impact on the recoveries of the respective parties in the case of the insolvency of the bank and the holding company.

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