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The Mouse That Roared: U.S. Supreme Court's Unanimous Ruling May Limit Application of Federal Common Law

By Sarah R. Borders, Mark M. Maloney, Jonathan W. Jordan, and Sarah L. Primrose*

The authors explore the implications of a recent decision by the U.S. Supreme Court that has significant implications for the business community and tax professionals alike.

The U.S. Supreme Court has issued a unanimous opinion vacating a decision by the U.S. Court of Appeals for the Tenth Circuit applying federal common law to determine the allocation of a corporate tax refund among group members.[1]

In *Rodriguez v. FDIC,* the Court, disfavoring an expansive use of federal common law, rejected the nearly half-century old "Bob Richards Rule,"[2] which had been crafted by prior court decisions, in the absence of a specific statute, to compel allocation of a tax refund for a corporate group to the group member responsible for the losses that led to the refund—unless a tax allocation agreement unambiguously specified a different result. The decision has significant implications for the business community and tax professionals alike. Further, the decision has broader ramifications for litigators in that the nation's highest court has signaled a strong reluctance to apply federal common law—a legal term that is used to describe common law that is developed by the federal courts as opposed to the courts of the various states.

BACKGROUND AND PRIOR DECISIONS

United Western Bancorp (the "Parent"), owned United Western Bank, a bank placed in receivership (the "Bank") during the Great Recession.

Parent filed a consolidated tax return on behalf of itself and the Bank. Parent, who found itself in bankruptcy, claimed a $4.1 million refund, which stemmed from losses the Bank incurred. Parent argued that it should have received the refund under the parties' tax allocation agreement, while the Federal Deposit Insurance Corporation ("FDIC"), as receiver for the Bank, claimed it was

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1 *Rodriguez v. Fed. Deposit Ins. Corp.*, 589 U.S. ___, 140 S. Ct. 713, 206 L. Ed. 2d 62 (2020).

2 *In re Bob Richards Chrysler-Plymouth Corporation,* 473 F.2d 262 (9th Cir. 1973).

entitled to the refund under the Bob Richards Rule.

As originally adopted by the Ninth Circuit, the Bob Richards Rule provided that, in the absence of a tax allocation agreement, a refund belongs to the group member responsible for the losses that led to it. But over time, certain courts expanded the rule into a general rule applied in all cases unless the parties had entered into an allocation agreement that unambiguously addressed the refund issue.

Embracing this expansion of the Bob Richards Rule, the Tenth Circuit affirmed a district court decision awarding the tax refund to the FDIC receiver of the subsidiary—rather than the bankruptcy estate of its corporate parent. In doing so, the Tenth Circuit joined the Fifth and Ninth Circuits. Four other circuits—the Second, Third, Sixth, and Eleventh—had rejected the Bob Richards Rule, at least in the presence of a tax allocation agreement.

THE SUPREME COURT'S DECISION

In an opinion authored by Justice Neil Gorsuch, the Court reiterated the longstanding aphorism that there is "no federal general common law."[3] Specifically, he stated that judicial lawmaking in the form of federal common law "plays a necessarily modest role under a Constitution that vests the federal government's 'legislative Powers' in Congress and reserves most other regulatory authority to the States."[4] While the Court acknowledged that there are areas of law in which federal judges "may appropriately craft the rule of decision"—such as admiralty disputes and controversies between states—none of those interests arise in the question of distribution of a tax refund. The federal government has an interest in regulating how it receives taxes from corporate groups, and in extinguishing its liability to a group when it pays refunds to a group member, which it does through tax regulations applicable to corporate consolidated income tax returns.[5] The federal government, however, has no corresponding interest in determining how a consolidated corporate tax refund is distributed among group members. Further, corporations are "creatures of state law," and even though the dispute arose in the context of a federal bankruptcy, and involved a federal tax dispute, the Court did not find an overarching federal interest that would require imposition of a judicial rule.

In overruling the Tenth Circuit, the Court emphasized that federal courts should pause before applying federal common law. "[W]e did not take this case

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[3] *Rodriguez,* 140 S. Ct. at 717 (quoting *Erie R. Co. v. Tompkins*, 304 U.S. 64, 78 (1938)).

[4] *Rodriguez,* 140 S. Ct. at 717.

[5] *See* Treas. Reg. §§ 1.1502-6,-12,-13, and -77(d)(5).

to decide how this case should be resolved under state law or to determine how IRS regulations might interact with state law. We took this case only to underscore the care federal courts should exercise before taking up an invitation to try their hand at common lawmaking," Justice Gorsuch wrote.[6]

NARROW HOLDING, WIDE IMPLICATIONS

As a matter of tax law, the *Rodriguez* decision is an important reminder that affiliates should take care in drafting agreements regarding the sharing of corporate tax refunds, as the Bob Richards Rule can no longer be relied on as a default rule in the face of an ambiguous agreement allocating tax refunds. Instead, agreements should be as specific as possible. Allocation of future assets, such as tax refunds, should be included in the checklist of deal points, for in situations where disputing parties lack a clear agreement, courts will be forced to look to applicable state law, which may, as in *Rodriguez,* generate results that are difficult to predict and cultivate uncertainty for the parties.

Viewed strictly on its holding, the *Rodriguez* decision may have limited application in future cases. The Tax Cuts and Jobs Act of 2017 eliminated the ability of corporations to carry back net operating losses that may generate tax refunds (though in reaction to the Covid-19 quarantine crisis, the Coronavirus Aid, Relief, and Economic Security Act restored certain carrybacks for losses incurred from 2018–2020). The decision's larger significance lies in its admonition that judges to scrub the law books, including federal statutes, regulations, and state law, before crafting a judicial solution. In the philosophical battle between strict constructionists and judicial activists, the fact that all wings of the current Supreme Court adopted Justice Gorsuch's opinion makes *Rodriguez* another tip of the scales toward paring back activism. At the least, it will become rhetorical fodder for future litigants arguing against imposition of judicially-created "gap fillers."

Rodriguez therefore may have wider implications that spill beyond bankruptcy and tax issues into many other contexts. Litigators should be mindful of the highest court's latest tip of its hat—in a unanimous decision nonetheless—as it could be used to support future limitations on federal court powers. This, in turn, could have ramifications for bankruptcy litigators.

Nevertheless, the application of federal common law by the courts will continue, as the practice is too entrenched, and, in many cases, eminently justified by the absence of a legislative mandate. But *Rodriguez* may require litigants to support arguments with applicable state law, where once a simple

[6] *Rodriguez,* 140 S. Ct. at 718.

citation to a Restatement and nod to federal common law sufficed. For example, the D.C. Circuit has stated that the "federal common law of contracts largely 'dovetails' with 'general principles of contract law.' "[7] In a Bob Richards/*Rodriguez* scenario, a federal court may be hesitant to gloss over the nuances of state contract law and rely on federal court-made contract principles. Litigators, in and outside the bankruptcy context, should be prepared to support their position with state law to guard against reversal following the clarion call in *Rodriguez*.[8] Moreover, transactional attorneys should take care in crafting their documents with precision. Applicable law provisions may be more important than ever before.

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[7] *NRM Corp. v. Hercules, Inc.,* 758 F.2d 676, 681 (D.C. Cir. 1985).

[8] *See Bowden v. United States,* 106 F.3d 433, 439 (D.C. Cir. 1997) (explaining that the Restatement principles are those "from which we would be inclined to fashion a federal common-law rule since those principles represent the 'prevailing view' among the states").