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Feature

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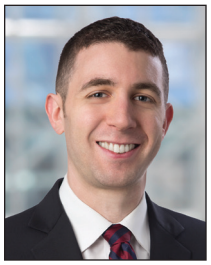
A Swan Song for Federal Common Lawmaking in Bankruptcy Courts



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Bankruptcy disputes are often governed by two distinct sources of legal authority. The Bankruptcy Code is, of course, a federal statute, interpreted by federal courts and enacted pursuant to Congress's power to "establish ... uniform Laws on the subject of Bankruptcies."[1] By contrast, property rights in bankruptcy are generally determined by state law. Whether a debtor has established a valid trust, whether a creditor has an enforceable contractual lien, whether party A is a lessor of party B, these questions (and much more of the daily fare of bankruptcy courts) are usually answered by consulting the law of a particular state, not by recourse to a "uniform" federal rule.

Sometimes, determining whether state or federal law should govern a particular question is more difficult than it appears. This past term, in *Rodriguez v. Federal Deposit Insurance Corp.*,[2] the U.S. Supreme Court made an important statement on the line between federal and state law in bankruptcy cases. The Court unanimously invalidated the "*Bob Richards* rule," a federal common-law rule that bankruptcy judges have used for decades to determine ownership of consolidated tax refunds. The Court described the *Bob Richards* rule as a "cautionary tale," the product of judges "too quickly" attempting to fashion a federal law rule where state law should have governed.[3]

Rodriguez attracted little notice in a term of blockbuster decisions, but it carries the potential to upset far more than just Bob Richards and his namesake. A number of bankruptcy-law doctrines rest on just as dubious a federal law basis as the *Bob Richards* rule. Indeed, two of that rule's close cousins (the so-called "*IndyMac* factors" and the "*Prudential Lines* rule") are all but certain to fall in its wake. More than a few other bankruptcy doctrines might also be destined for the chopping block. Once courts begin to ask, with the skeptical eye that *Rodriguez* instructs, "Should federal law control here?," the cautionary tale that the Supreme Court described might be closer to its beginning than its end.

The Beginning of *Bob Richards*

The story of *Rodriguez* begins in another jurisprudential era. In 1966, a California car dealership, Western Dealer Management Inc., and its subsidiary, Bob Richards Chrysler-Plymouth Corp., filed a consolidated tax return, which permits a parent corporation and its subsidiaries to compute their taxes largely as if they were divisions of a single corporation.[4] The Internal Revenue Service (IRS) issued the companies a consolidated tax refund for roughly $10,000, attributable almost exclusively to the losses of the subsidiary. The parent corporation and the estate of its subsidiary, which had since filed for bankruptcy, both claimed that they were rightful owners of the refund.[5]

The dispute reached the Ninth Circuit in the case of *In re Bob Richards Chrysler-Plymouth Corp*. The panel began by explaining that it saw "nothing" in the pertinent federal statutes or regulations that addressed ownership of consolidated tax refunds.[6] The panel then proceeded to announce its own rule. The Ninth Circuit felt that "a tax refund resulting solely from offsetting the losses of one member of a consolidated filing group against the income of that same member in a prior or subsequent year should

1 U.S. Const. art. I, § 8, cl. 4.
2 140 S. Ct. 713 (2020). The author represented the bankruptcy trustee who prevailed in the Court.
3 *Id.* at 718.
4 *In re Bob Richards Chrysler-Plymouth Corp.*, 473 F.2d 262, 263 (9th Cir. 1973); *see* 26 U.S.C. § 1501; 26 C.F.R. §§ 1:1502-0, *et seq.*
5 *Bob Richards*, 473 F.2d at 263.
6 *Id.* at 264 (citation omitted).

inure to the benefit of that member," unless the parties reach a "differing agreement."[7]

Although the Ninth Circuit identified no clear legal basis for this rule, it gradually caught on throughout the nation. A growing number of courts cited the "*Bob Richards* rule" as the rule governing any dispute over consolidated tax refunds.[8] As the rule became more popular, it became more potent, too. Courts began to assert that the *Bob Richards* rule governed not merely when an agreement was silent on the question of ownership, but also when an agreement "unambiguously" departed from the *Bob Richards* rule.[9]

*Bob Richard*s also had its critics. Some federal courts adopted a competing framework, dubbed by one court as the "*IndyMac* factors," under which courts used several criteria to determine whether the parties had agreed to make a parent corporation the owner of a tax refund or instead the agent of its subsidiary.[10] Other courts, such as the Sixth and Eleventh Circuits, held that state law governed all disputes over ownership of consolidated tax refunds, thus rejecting the *Bob Richards* rule as a "creature of federal common law."[11]

The End of *Bob Richards*

Bob Richards's reign started to unravel in the wake of the Great Recession. In 2010, a Colorado bank holding company, United Western Bancorp. Inc., and its subsidiary, United Western Bank, both fell on hard times.[12] The Office of Thrift Supervision closed the subsidiary and placed it under the receivership of the Federal Deposit Insurance Corp. (FDIC). The parent quickly went out of business and filed for chapter 11 (later converted to chapter 7). Before both companies collapsed, they filed a consolidated tax return with the IRS, which yielded them a $4.1 million tax refund. Both the parent's estate and the subsidiary's receiver eagerly claimed the refund as their own.[13]

The bankruptcy court initially held that the tax refund belonged to the parent's bankruptcy estate, relying on both the *IndyMac* factors and Colorado state law.[14] However, the Tenth Circuit ruled for the FDIC, holding that the *Bob Richards* rule constituted a rule of "federal common law."[15] Under that rule, it said, parties needed to "unambiguously address" how tax refunds are to be handled in order to "deviate from the general rule outlined in ... *Bob Richards*."[16] Applying that standard, the Tenth Circuit found that the tax refund belonged to the subsidiary, which was responsible for most if not all of the losses underlying the tax refund.[17]

The Supreme Court granted *certiorari* and vacated the Tenth Circuit's decision. Writing for the Court, Justice Neil Gorsuch stated that "[t]he cases in which federal courts may engage in common lawmaking are few and far between."[18] He added that this "is one of the cases that lie between,"[19] noting that "Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law."[20]

Courts may make "exceptions" to this rule only where "necessary to protect ... uniquely federal interests."[21] However, courts had identified no such interest justifying the *Bob Richards* rule. "[S]tate law is well equipped to handle disputes involving corporate property rights" and is "replete with rules readymade" for resolving them.[22] Therefore, state law should govern disputes over tax refunds.[23]

The Supreme Court concluded with a warning: "We took this case only to underscore the care [that] federal courts should exercise before taking up an invitation to try their hand at common lawmaking."[24] In *Bob Richards*, the Ninth Circuit "made the mistake of moving too quickly past important threshold questions at the heart of our separation of powers."[25] The Court urged lower courts to heed this "cautionary tale."[26]

The Beginning of the End of *IndyMac* and *Prudential Lines*

Rodriguez was not heralded as a decision of great significance. One tax scholar wrote, the day after the decision was announced, that as "far as Supreme Court cases go, it's hard to get much narrower than this."[27] True enough, the impact of *Bob Richards*'s burial will be less than seismic for most. But the Court's decision has significance for more than the California car dealership whose namesake it interred and the Colorado bank whom it deprived (at least temporarily) of a tax refund.

Like many doctrines that have endured for decades, the *Bob Richards* rule cast deep roots. During its 47-year lifespan, *Bob Richards* gave rise to several related doctrines that, like the rule itself, can only be understood as creatures of federal common law. Once courts are faced with questions about the validity of those doctrines, they are almost certain to meet the same fate as *Bob Richards* itself.

The first doctrine to fall is likely *Bob Richards*'s principal competitor in the lower courts: the *IndyMac* factors. Bankruptcy courts devised these factors as a methodology for determining whether a tax-allocation agreement makes a parent corporation the owner of a consolidated tax refund or the agent of its subsidiary.[28] However, no court has claimed that these factors are grounded in a federal statute or regulation, nor do those factors find any footing in state law. On the contrary, courts apply the *IndyMac* factors irrespective of which state's law governs, and those factors employ a considerably different method than most states to determine whether an agency relationship exists.[29]

7 *Id.* at 265.
8 *See, e.g., Capital Bancshares Inc. v. FDIC*, 957 F.2d 203, 207-208 (5th Cir. 1992); *Barnes v. Harris*, 783 F.3d 1185, 1195 (10th Cir. 2015); *In re First Reg'l Bancorp*, 703 Fed. App'x 565 (9th Cir. 2017).
9 *Rodriguez*, 140 S. Ct. at 716-17.
10 *In re IndyMac Bancorp. Inc.*, No. 2:09-ap-01698, 2012 WL 1037481, at *13-17 (Bankr. C.D. Cal. March 29, 2012), *aff'd*, No. CV 12-02967, 2012 WL 1951474 (C.D. Cal. May 30, 2012), *aff'd*, 554 Fed. App'x 668 (9th Cir. 2014); *see also In re United W. Bancorp Inc.*, 574 B.R. 876, 886-90 (D. Colo. 2017) (discussing "*IndyMac* factors" and noting that "[m]any bankruptcy courts since *IndyMac* have adopted its analysis"), *aff'd*, 914 F.3d 1262 (10th Cir. 2019), *vacated*, 140 S. Ct. 713 (2020).
11 *FDIC v. AmFin Fin. Corp.*, 757 F.3d 530, 535-36 (6th Cir. 2014); *see also In re NetBank Inc.*, 729 F.3d 1344, 1347, n.3 (11th Cir. 2013).
12 *United Western Bancorp*, 914 F.3d at 1266.
13 *Id.* at 1266-67.
14 *In re United Western Bancorp Inc.*, 558 B.R. 409, 424-32 (Bankr. D. Colo. 2016).
15 *United Western Bancorp*, 914 F.3d at 1269 & n.3.
16 *Id.* at 1270.
17 *Id.* at 1274.
18 *Id.*
19 *Rodriguez*, 140 S. Ct. at 716.
20 *Id.* at 718 (citation omitted).
21 *Id.* at 717 (citations omitted).
22 *Id.* at 716, 718.
23 *Id.* at 718.
24 *Id.*
25 *Id.*
26 *Id.* at 718.
27 Daniel Hemel, "Opinion Analysis: In Tax Refund Case, Justices Decide a Narrow Question but Leave Much Unresolved," *SCOTUSblog* (Feb. 26, 2020), *available at* scotusblog.com/2020/02/opinion-analysis-in-tax-refund-case-justices-decide-a-narrow-question-but-leave-much-unresolved (last visited July 23, 2020).
28 *See IndyMac*, 2012 WL 1037481, at *13-17.

Consequently, as the district court in *Rodriguez* observed, the only way to understand the *IndyMac* factors is as an exercise of "federal common law."[30] If there was no justification for *Bob Richards* to engage in federal common lawmaking to determine "the distribution of ... consolidated corporate tax refund[s]," then there is just as surely no valid basis for *IndyMac* to create federal common law for that same purpose.[31]

Next to go after *IndyMac* will, in all probability, be the *Prudential Lines* rule. This rule, named after a Second Circuit decision, is a close cousin of *Bob Richards*: It holds that a corporation filing a consolidated tax return has a right to offset its own income using any "net operating loss" attributable to its losses.[32] Although a mouthful to describe, this rule is used frequently by bankruptcy courts to allocate tax losses.[33] Given the frequency with which such losses are up for grabs at the time of bankruptcy, the *Prudential Lines* rule is arguably of greater economic significance than the *Bob Richards* rule itself.

Yet the only legal basis that *Prudential Lines* identified for its rule was — *Bob Richards*. The Second Circuit cited that decision pervasively in its opinion.[34] It echoed the policy logic that the Ninth Circuit gave for the *Bob Richards* rule without identifying any positive legal basis for that intuition.[35] Similar to *Bob Richards* and *IndyMac*, *Prudential Lines* must stand or fall as a rule of federal common law, but it is difficult to conceive of what "uniquely federal interest" would justify federal common lawmaking to allocate net operating losses when such an interest was wholly absent when allocating tax refunds.[36]

The Next Doctrines to Fall

IndyMac and *Prudential Lines* are likely just the beginning. Bankruptcy courts have devised federal common law doctrines to address all manner of property-rights questions without engaging in the rigorous scrutiny that *Rodriguez* dictates. Some courts have crafted a federal common law rule governing ownership of "interline freight charges,"[37] while others have created a federal common law for identifying "business trusts."[38] These doctrines — and many others like them — are unlikely to survive if placed under the harsh light of *Rodriguez*. Indeed, just one month after that decision, the Bankruptcy Appellate Panel of the Eighth Circuit rejected a presumption that several courts adopted for determining the interest rate payable to secured creditors, deeming it the sort of "judicial lawmaking" of which *Rodriguez* disapproved.[39]

Rodriguez will not spell a wholesale revision of how bankruptcy courts go about sorting federal law questions from ones of state law. But *Bob Richards* was far from the only decision that leapt to create federal law to allocate property rights in bankruptcy when state law was fully suited — and uniquely appropriate — for the task. If the Supreme Court's admonition in *Rodriguez* is taken seriously, a number of other bankruptcy doctrines will need to be retired from service along with the *Bob Richards* rule. Practitioners and bankruptcy judges alike should dust off their state law books to find, except in cases "few and far between,"[40] the rules that govern property rights in bankruptcy. abi

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29 *Compare id.* (determining whether parent is agent by asking whether contract uses terms such as "reimbursement" or "payment" requires parent to "segregate or escrow any tax refunds," or gives parent "sole discretion to prepare and file consolidated tax returns"), *with Restatement (Third) of Agency* §§ 1.01-1.02 (Am. Law Inst. 2006) (explaining that "[a]n agency relationship arises *only* when" entity is "subject to the principal's control" and agrees to "act on the principal's behalf") (emphasis added).

30 *United W. Bancorp*, 574 B.R. at 890.

31 *Rodriguez*, 140 S. Ct. at 718.

32 *In re Prudential Lines Inc.*, 928 F.2d 565, 569-71 (2d Cir. 1991).

33 *See, e.g., In re Conex Holdings LLC*, 518 B.R. 792, 802, n.52 (Bankr. D. Del. 2014); *In re Cumberland Farms Inc.*, 162 B.R. 62, 67 (Bankr. D. Mass. 1993); *see generally* Michael J. Holleran, *et al.*, *Bankruptcy Code Manual* § 541:10 (May 2020 Update) (describing this rule as "settled").

34 *Prudential Lines*, 928 F.2d at 570-71.

35 *Id.* at 570 (quoting *Bob Richards*, 473 F.2d at 264).

36 *Rodriguez*, 140 S. Ct. at 717 (citation omitted).

37 *In re Bangor & Aroostook R.R.*, 320 B.R. 226, 234-40 (Bankr. D. Me. 2005) (discussing sharp split over rule's validity).

38 *In re Dille Family Tr.*, 598 B.R. 179, 191-94 (Bankr. W.D. Pa. 2019) (surveying cases).

39 *In re Family Pharmacy Inc.*, 614 B.R. 58, 66 (B.A.P. 8th Cir. 2020) (citing *Rodriguez*, 140 S. Ct. at 718).

40 *Rodriguez*, 140 S. Ct. at 716.