

I. The Intersection of Sovereign Immunity and Bankruptcy Jurisdiction¹

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It is axiomatic that a State may not be sued without its consent. But what, as a practical matter, does this mean in the context of a bankruptcy proceeding and determining the reach of a bankruptcy court's jurisdiction? Unfortunately, the answer is not that simple. And, here is why:

- Section 8 of Article 1 of the United States Constitution bestows upon Congress the authority to establish "uniform Laws on the subject of Bankruptcies throughout the United States."
- The Eleventh Amendment² to the United States Constitution provides that no person may sue a State without that State's consent – unless the immunity from suit has been abrogated by Congress. Congressional abrogation of the States' sovereign immunity must meet two requirements. First, the intent to abrogate must be "unequivocally expressed"³ (sometimes a tall task for a body known for equivocation). Second, Congress must have "acted pursuant to a valid exercise" of its power.⁴ And we all know that Congress would never act other than pursuant to a valid exercise of its power.⁵

¹ Because there is little question that Congress can, when it deems it appropriate, abrogate the sovereign immunity of the Federal Government, this article focuses on the sovereign immunity of the States.

² The Eleventh Amendment provides as follows: "The Judicial Power of the United States shall not be construed to extend to any suit in law or equity, commenced or prosecuted against one of the United States by citizens of another state, or by citizens or subjects of any foreign state."

³ *See Seminole Tribe v. Florida*, 517 U.S. 44, 56, 116 S. Ct. 1114 (1996).

⁴ *See id.*

⁵ *See e.g. Seminole Tribe*, 517 U.S. at 72; *United States v. Lopez*, 514 U.S. 549, 602 (1995) (determining that Congress had exceeded its power under the Commerce Clause in enacting legislation dealing with the possession of handguns near schools).

- Section 106 of the Bankruptcy Code is intended to abrogate sovereign immunity in specified situations. Unfortunately, the Supreme Court’s decision in *Seminole Tribe*⁶ continues to spur much debate over whether Section 106 constitutes a valid exercise of Congress’s power.⁷ And the Supreme Court’s most recent treatment of sovereign immunity, in *Tennessee Student Assistance Corp. v. Hood*, 124 S. Ct. 1905 (2004), creates as many questions as it answers.

A. Section 106

As an initial note, sovereign immunity generally causes difficulty in bankruptcy cases only when the bankruptcy court is attempting to affect the rights of one of the States. There is little question that Congress can, if it so chooses, abrogate the sovereign immunity of the Federal Government and its agencies. And, Section 106 expresses Congress’s clear intent to do just that. Moreover, the Eleventh Amendment has been determined not to apply to municipalities and local governments, so those entities generally are subject to the abrogation of sovereign immunity set forth in Section 106.⁸

⁶ In *Seminole Tribe*, a nonbankruptcy case, a deeply-divided Court held that Congress lacked the power under the Indian Commerce Clause in Article I of the Constitution to override the Eleventh Amendment. In doing so, the Court stated that the Eleventh Amendment restricted the judiciary’s power under Article III of the Constitution, and Article I of the Constitution could not be used to circumvent that limitation. Since the Bankruptcy Clause also appears in Article I, some commentators (and courts) have hypothesized that Congress is similarly incapable of abrogating the States’ sovereign immunity by means of the Bankruptcy Clause.

⁷ Compare *Schlossberg v. State of Maryland*, 119 F.3d 1140 (4th Cir. 1997), *cert denied*, 523 U.S. 1075 (1998) (Bankruptcy Clause *does not* give Congress the power to abrogate the States’ sovereign immunity), with *Hood v. Tenn. Student Assistance Corp.* (In re Hood), 319 F.3d 755 (6th Cir. 2003), *aff’d*, 124 S.Ct. 1905 (2004) (Bankruptcy Clause *does* give Congress the power to abrogate the States’ sovereign immunity). *But see also* *United States v. Nordic Village, Inc.*, 503 U.S. 30, 38-9, 112 S. Ct. 1011, 1017, 117 L. Ed. 2d 181 (1992) (“We have never applied an *in rem* exception to the sovereign-immunity bar against monetary recovery, and have suggested that no such exception exists.”); *In re Fernandez*, 123 F.3d 241, 243-44 (5th Cir. 1997) (even where federal government has exclusive control over area of law, such as bankruptcy, Eleventh Amendment applies).

⁸ Of course, every general rule has its exception. In instances where a municipality (or other non-State entity) is determined to be an “arm of the State”, it is possible that the

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Section 106 was included in the Bankruptcy Code in 1978 to establish the extent to which sovereign immunity would be abrogated by bankruptcy law. In response to decisions of the Supreme Court citing a lack of clarity in Congress's intent under Section 106, Congress amended the section as part of the Bankruptcy Reform Act of 1994. As it reads now, Section 106(a)(1) lists sixty sections of the Bankruptcy Code that are to be given effect notwithstanding the otherwise applicable sovereign immunity of governmental units (defined to include States) and the means by which those sections may be implemented. The scope of Section 106 generally is limited to "bankruptcy-specific" remedies and causes of action. For example, Section 106 abrogates sovereign immunity to the extent necessary to prosecute avoidance actions and assert the automatic stay.⁹ But, Section 106 omits Section 541 from the scope of abrogation. As a result, a debtor will be unable to assert its prepetition (i.e. nonbankruptcy) causes of action against the sovereign.

Section 106(b) deems a governmental unit that files a claim against the debtor to have waived its sovereign immunity with respect to a claim against such governmental unit that is property of the debtor's estate and which arose out of the same transaction or occurrence as the claim asserted against the debtor. Because of its "deemed waiver" language, the validity of Section 106(b) has also been questioned.¹⁰ There is also some dispute among the courts as to whether Section 106(b) allows only a setoff against a governmental unit that files a proof of claim or whether the Section permits an affirmative recovery above and beyond the amount sought in the proof of claim. If the debtor's relief is limited to a setoff against the governmental unit, it would seem that Section 106(b) has no purpose since Section 106(c) endows the debtor with the same setoff right (but without the requirement for the governmental unit to have filed a claim).

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Eleventh Amendment will apply to limit the Bankruptcy Court's exercise of jurisdiction. The cases dealing with this issue are as varied as they are many; and the subject is, therefore, beyond the scope of this paper.

⁹ Other examples include the trustee's administrative powers (e.g. Sections 362-66, 922, and 1206), stays against co-debtors (e.g. Sections 1201 and 1301), provisions dealing with creditors and claims against the debtor's estate (e.g. Sections 502-06, 510 and 1305), duties and benefits of the trustee (e.g. Sections 522-25, 1107, 1205, and 1303), means for collecting, increasing and distributing the debtor's estate (e.g. Sections 542-53, 722, 724, 726, 728, 749, 764, 926, and 928), and the effect of plan confirmation (e.g. Sections 944, 1141, 1142, 1143, 1146, 1227, 1231, and 1327)

¹⁰ In *College Savings Bank v. Florida Prepaid Postsecondary Education*, 527 U.S. 666 (1999), the Supreme Court invalidated a similar provision in the Trademark Remedy Clarification Act.

Section 106(c) authorizes setoff against governmental unit claims. Unlike Section 106(b), there is no need to have filed a proof of claim for the debtor to invoke its setoff rights under Section 106(c). And, under the equitable principles of the setoff doctrine, the debtor's claim against the governmental unit need not relate to the claim against which it is offset.

II. Chinks in the States' Armor

While the concept of sovereign immunity adds a layer of difficulty to a debtor's dealings with a State, the problem may not be insurmountable. Over the years, there have developed limited exceptions to the doctrine that, in appropriate circumstances, a debtor may employ to get what it needs from a State.

A. The *Hood* Case and the *In Rem* Doctrine

While the *Hood* decision does not resolve the dispute engendered by the Supreme Court in *Seminole Tribe*, the case does provide some guidance on the scope of the bankruptcy courts' jurisdiction with respect to the States. The case, therefore, merits some discussion.

In *Hood*, the Supreme Court was faced with the case of a chapter 7 no-asset debtor who had received a discharge in her case. Hood then reopened her case, and sought a determination that she was eligible for a hardship discharge of certain student loan indebtedness. In accordance with Federal Rule of Bankruptcy Procedure 7001(6), Hood filed an adversary proceeding against the Tennessee Student Assistance Corporation ("TSAC"), an agency of the State of Tennessee. TSAC moved for dismissal on the grounds that the Eleventh Amendment divested the bankruptcy court of jurisdiction over the matter. The bankruptcy court disagreed, and, in ruling in favor of Hood, held that Section 106 was a constitutionally-valid abrogation of TSAC's sovereign immunity. The Bankruptcy Appellate Panel for the Sixth Circuit and the Sixth Circuit Court of Appeals each affirmed on appeal.

Because of the split in the Circuits over whether Section 106 permissibly abrogated the States' sovereign immunity, the Supreme Court granted *certiorari*. After considering the parties' arguments, however, the Supreme Court declined to rule explicitly on the constitutionality of Section 106. Instead, the Court focused its decision on whether the action taken by the bankruptcy court was a valid exercise of its *in rem* jurisdiction over the debtor and her estate. In ruling in Hood's favor on this alternative ground, the Supreme Court held that, notwithstanding the need to institute an adversary proceeding and serve the defendant with a summons and complaint, the plaintiff's initiation of an adversary proceeding against TSAC was not a suit against a State within the meaning of the Eleventh

Amendment. Rather, the process resulted only in the bankruptcy court exercising its *in rem* jurisdiction over the debtor and her estate to discharge the State-held student loan obligation. Accordingly, TSAC’s sovereign immunity remained unscathed by the bankruptcy court’s actions.

More specifically, the Court noted the well-recognized rule that States, whether or not they choose to participate in the bankruptcy proceeding, are bound by a bankruptcy court’s discharge order no less than other creditors.¹¹ The discharge order releases the debtor from personal liability with respect to any discharged debt by voiding any past or future judgments on the debt and by operating as an injunction to prohibit creditors from attempting to collect or recover from the debtor on the debt.¹² In summation, the Court found “no authority . . . that suggests a bankruptcy court’s exercise of its *in rem* jurisdiction to discharge a student loan would infringe state sovereignty”¹³

In explaining away the seemingly important fact that the debt in question could be discharged by the bankruptcy court only after the debtor filed suit against the State through an adversary proceeding, the Supreme Court noted:

[T]he bankruptcy court’s jurisdiction is premised on the *res*, not the *persona*; that the States were granted the presumptive benefit of nondischargeability does not alter the court’s underlying authority. A debtor does not seek monetary damages or any affirmative relief from a State by seeking to discharge a debt; nor does he subject an unwilling State to a coercive judicial process. He seeks only a discharge of his debts.¹⁴

It is not yet clear whether *Hood*, an opinion joined by seven justices (Justices Scalia and Thomas filed a dissenting opinion) will be interpreted by lower courts as providing a significant inroad against the States’ sovereign immunity. In a footnote to the majority opinion, the Court was careful to note that:

This is not to say, ‘a bankruptcy court’s *in rem* jurisdiction overrides sovereign immunity’ [internal citation omitted], but rather that the court’s exercise of its *in rem* jurisdiction to discharge a student loan debt is not an

¹¹ *Hood*, 124 S.Ct. at 1911.

¹² *Id* at 1910.

¹³ *Id* at 1912.

¹⁴ *Id*.

affront to the sovereignty of the State. Nor do we hold that every exercise of *in rem* jurisdiction will not offend the sovereignty of the State.¹⁵

So, it remains to be seen whether *Hood* will be viewed as being limited to student loan discharge cases, or whether debtors will be able to expand upon the *in rem* doctrine to achieve other results arguably affecting States.

On November 10, 2004, the Bankruptcy Court for the Southern District of New York issued an opinion interpreting *Hood* that sets the stage for broader use of the *in rem* doctrine relied upon by the Supreme Court.¹⁶ The *360Networks* court relied on *Hood* to arrive at the conclusion that a preference action against an agency of the State of California did not offend the notions of sovereign immunity.

In doing so, the court first described the boundaries of a bankruptcy court's *in rem* jurisdiction: "A court's *in rem* jurisdiction allows it to 'determine all claims that anyone has to the property or thing in question. The proceeding is one against the world.'"¹⁷ Then, in a somewhat tenuous leap of logic, the court hypothesized that bankruptcy courts have *in rem* jurisdiction over preference actions because they have *in rem* jurisdiction over property of the debtor's estate. In reaching that conclusion, the court reasoned that property transferred preferentially becomes property of the estate upon its recovery, and that such property is within Congress's grant of exclusive *in rem* jurisdiction to the Federal Courts.¹⁸

The *360Networks* decision should be read in context, and heed should be given to the limitations the *360Networks* court placed on the ruling. The decision dealt with a motion by the State to dismiss a preference action on the basis of sovereign immunity. Notwithstanding the somewhat questionable leap the court made to establish *in rem* jurisdiction over preference actions, the *360Networks* court was careful to note that it was not, at that point, providing for an affirmative recovery from the State of the allegedly preferential transfers. Rather, the court was just allowing the preference action to proceed as a valid exercise of the court's *in rem* jurisdiction over the matter. The court noted that, aside from an affirmative recovery from the State, a successful preference action might allow the debtor to obtain relief under Section 502(d) from claims asserted by the State or,

¹⁵ *Id* at 1913 n.5.

¹⁶ *See In re 360Networks (USA) Inc.*, 2004 Bankr. LEXIS 1796 (Bankr. S.D.N.Y. 2004).

¹⁷ *Id* at *12-*13 (internal citations and ellipses omitted).

¹⁸ *Id* at *14-*15.

under proper circumstances, recovery from a third party under Section 550. Thus, the court did not allow the preference action to proceed with the expectation that it would ultimately result in an affirmative recovery from the State (but the court did not expressly foreclose such a result either).

- Time will tell how far the courts will be willing to stretch *Hood*. Although the *Hood* case is still relatively new, the use of *in rem* jurisdiction against States is not. *Hood* may be a signal to the lower courts that the Supremes look favorably on the use of *in rem* remedies to resolve issues with States as opposed to straight abrogation of those States' sovereign immunity.

B. Use of *Ex Parte Young* and its Progeny

As a general rule, parties acting in the capacity of State officials likewise share the protection of sovereign immunity. In *Ex Parte Young*, the Supreme Court ruled that suits against State officials, seeking prospective equitable relief for ongoing violations of federal law, are not barred by the Eleventh Amendment.¹⁹ The doctrine is based on the theory (or legal fiction) that when a State officer acts in contravention of Federal law in the course of discharging his or her duties to the State, he or she is acting *ultra vires* and therefore not as the State or its agent. To elaborate, the *Ex Parte Young* exception to sovereign immunity: 1) may allow suits against a State official (but not against the State itself; 2) is limited to requests for prospective injunctive relief; and 3) only applies to the extent necessary to end the continuing violation of Federal law.

In recent years, the Supreme Court has been whittling back on this exception to sovereign immunity. First, in *Seminole Tribe*, the Court stated that “where Congress has prescribed a detailed remedial scheme for the enforcement against a State of a statutorily created right, a court should hesitate before casting aside those limitations and permitting an action against a State officer based upon *Ex Parte Young*.”²⁰ Arguably, the Bankruptcy Code constitutes just such a “detailed remedial scheme” and courts should be reluctant to allow *Ex Parte Young* challenges in bankruptcy proceedings.²¹ Further, in *Idaho v. Coeur d’Alene Tribe*, the Supreme Court provided a further exception to the *Ex Parte Young*

¹⁹ 209 U.S. 123, 28 S.Ct. 441 (1908).

²⁰ 517 U.S. 74.

²¹ See e.g. *Nelson v. La Crosse County Dist. Atty. (In re Nelson)*, 301 F.3d 820, 836 n. 21 (7th Cir. 2002).

doctrine where the suit in question implicates a special sovereignty interest of the State.²² Examples of circumstances in which this exception has been applied include: 1) a suit that “would divest the State of its sovereign control over submerged lands, lands with a unique status in the law and infused with a public trust the State itself is bound to respect”;²³ 2) when quasi-judicial state officers are sued in Federal court to answer to assertions that they made the wrong decision in deciding a matter within their jurisdiction;²⁴ and 3) interference with the allocation of State funds.²⁵ But, the “special sovereignty interest” exception has not been embraced by all courts,²⁶ and the *Ex Parte Young* doctrine appears to remain viable in bankruptcy actions.

²² 521 U.S. 261, 287, 138 L. Ed. 2d 438, 117 S. Ct. 2028 (1997).

²³ *Id.*

²⁴ *Bell Atlantic Md., Inc. v. MCI WorldCom, Inc.*, 240 F.3d 279, 294 (4th Cir. 2001).

²⁵ *Barton v. Summers*, 293 F.3d 944, 951 (6th Cir. 2002). *See also* *MacDonald v. Village of Northport Michigan*, 164 F.3d 964, 972 (6th Cir. 1999) (holding that a state’s “great interest in maintaining access to the Great Lakes” was a “special sovereignty interest” that precluded an *Ex Parte Young* suit); *ANR Pipeline v. LaFaver*, 150 F.3d 1178, 1193 (10th Cir. 1998) (holding that a “state’s interest in the integrity of its property tax system lie[s] at the core of the state’s sovereignty. . . . It is impossible to imagine that a state government could continue to exist without the power to tax.”).

²⁶ *See e.g.*, *Nelson v. Geringer*, 295 F.3d 1082 (10th Cir. 2002) (holding a State’s regulation of Wyoming National Guard was insufficient to implicate a “special sovereignty interest” because of the dual Federal and State nature of national guard service); *Arnett v. Myers*, 281 F.3d 552 (6th Cir. 2002) (holding an action to determine whether State regulations prohibiting duck blinds on areas to which the plaintiffs asserted riparian fishing rights did not implicate the “special sovereignty interests” of the State); *Duke Energy Trading and Marketing L.L.C. v. Davis*, 267 F.3d 1042 (9th Cir. 2001) (holding the governor’s emergency powers to take private property for the public benefit was a “special sovereignty interest,” but the relief requested was not so much of a divestiture of the State’s sovereignty to render the suit as one against the State itself); *In re Ellett*, 254 F.3d 1135 (9th Cir. 2001) (holding an injunction to bar collection of State tax in a bankruptcy proceeding was not a sufficient “special sovereignty interest” because it prohibited the States from seeking to collect specific income tax obligations duly discharged in a Federal bankruptcy proceeding); *TFWS, Inc. v. Schaefer*, 242 F.3d 198 (4th Cir. 2001) (holding a State’s regulation of liquor was not a “special sovereignty interest” in part because of the pervasive Federal interest in the regulation of liquor).

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As a practical matter, even without the Supreme Court's recent steps to limit the scope of the *Ex Parte Young* exception to sovereign immunity, the doctrine is of somewhat limited use in a bankruptcy proceeding. Its primary utility is in possibly allowing actions against State actors who are taking actions in contravention of the Bankruptcy Code or the bankruptcy court's orders. Some circumstances in which the doctrine still appears to have vitality include: 1) a suit to enjoin a government official from canceling a license agreement or right of way;²⁷ 2) a suit to enjoin a government official from taking action with respect to a previously-discharged obligation;²⁸ 3) a suit to enjoin a probation revocation hearing based upon the failure to pay restitution on terms other than those set forth in confirmed plan of reorganization;²⁹ 4) a suit to enjoin a debtor's removal from a State benefit program where notice of termination was transmitted in violation of the automatic stay;³⁰ 5) a suit to remove tax liens attached in violation of the automatic stay;³¹ and 6) a suit to enjoin suspension of a professional license.³² On the other hand, instances where the *Ex Parte Young* exception may not be available include: 1) a suit to challenge tax valuations;³³ and 2) a suit to force turnover of tax refund held on account of unpaid child support obligations.³⁴ Further confusing the issue, the willingness to apply *Ex Parte Young* appears to vary from Circuit to Circuit.

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²⁷ See *In re Metromedia Fiber Network*, 281 B.R. 524 (Bankr. S.D.N.Y. 2002).

²⁸ See *Davie v. Rudgers (In re Davie)*, 302 B.R. 432 (Bankr. S.D.N.Y. 2003).

²⁹ See *Coulter v. Aplin (In re Coulter)*, 305 B.R. 748 (Bankr. D.S.C. 2003).

³⁰ See *Berkelhammer v. Novella (In re Berkelhammer)*, 279 B.R. 660 (Bankr. S.D.N.Y. 2002)

³¹ See *In re LTV Steel Co.*, 264 B.R. 455 (Bankr. N.D. Ohio 2001)

³² See *Alston v. State Bd. of Med. Exam'rs (In re Alston)*, 236 B.R. 214 (Bankr. D.S.C. 1999).

³³ See *Metromedia Fiber Network, Inc. v. Various State & Local Taxing Auth. (In re Metromedia Fiber Network, Inc.)*, 299 B.R. 251 (Bankr. S.D.N.Y. 2003).

³⁴ See *Peterson v. Florida, Dep't of Revenue (In re Peterson)*, 254 B.R. 740 (Bankr. N.D. Ill. 2000).

III. Additional “Limitations” on a Bankruptcy Court’s Jurisdiction

In addition to the foregoing State sovereign immunity issues, there may also exist additional limitations on the jurisdiction a bankruptcy court can or will exercise. For example, while the term “governmental unit” includes foreign states and governments³⁵ (and, therefore, such entities’ sovereign immunity would be abrogated pursuant to Section 106), it may not be possible for the bankruptcy court to affect the rights of foreign states or governments unless there are domestic assets against which the bankruptcy court can take action. And, of course, the foreign government must have had the requisite minimum contacts with the United States. Moreover, even in cases where a bankruptcy court has both the authority and ability to act, the court may (of its own volition or by requirement) remand or abstain from hearing a particular matter. While a full discussion of these concepts is beyond the scope of this paper, reasons for remanding or abstaining could include: 1) the bankruptcy court’s belief that the matter is better suited for some alternative forum (e.g. pending parallel action or administrative proceeding; 2) comity with or respect for State courts or State law; or 3) equitable considerations. Finally, a party may argue that the Bankruptcy Code is preempted by some other body of law.³⁶

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³⁵ *Accord* Tuli v. Republic of Iraq (*In re* Tuli), 172 F.3d 707 (9th Cir. 1999).

³⁶ *See e.g.* Mirant Corp. v. Potomac Electric Power Co., (*In re* Mirant Corp.), 299 B.R. 152 (Bankr. N.D. Tex. 2003); *overruled*, 303 B.R. 304; *rev’d in part*, 378 F.3d 511 (5th Cir. 2004) (addressing whether the bankruptcy court’s jurisdiction was preempted by proceedings under the Federal Power Act).