TUCKER | HESTER, LLC

STATE SOVEREIGN IMMUNITY AND THE BANKRUPTCY CODE: VIRGINIA COMMONWEALTH

2006
A CLE Presentation

By: William J. Tucker*
Attorney at Law
bill@tucker-hester.com

Tucker | Hester, LLC
www.tucker-hester.com

Pennsylvania Center, Suite 100
429 North Pennsylvania Street
Indianapolis, IN 46204-1816

317.833.3030 | 317.833.3031 [fax]

*Also written by: Robin Tubesing

NOTICE

This is a CLE (continuing legal education) article, and it is not legal advice. This article was prepared for information purposes only for other lawyers only and deals with hypothetical or historical situations. The information is certainly not intended and should not in any way be construed as legal advice. Your receipt of this information does not in any way create an attorney-client relationship and cannot substitute for obtaining legal advice from an attorney. The author makes no claim about the correct interpretation of any law discussed in this article. The author does not make any claim about what the correct course of action might be in a particular matter. The author also does not make any claim that the information contained in this article is complete or correct. Finally, the information in this article may not be up to date. The contents of this article are not updated.

ISSUE

Has the Supreme Court case of *Central Virginia Comm. College v. Katz*[1] resolved the conflicts regarding state sovereign immunity and the Bankruptcy Code?

RULES

U.S. Const. art. 1 § 8, cl. 4
To establish a uniform Rule of Naturalization, and uniform Laws on the subject of Bankruptcies throughout the United States.

U.S. Const. amend. XI
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.

Section 106(a) of Bankruptcy Code
(a) Notwithstanding an assertion of sovereign immunity, sovereign immunity is abrogated as to a governmental unit to the extent set forth in this section with respect to the following:

(1) Sections 105,106, 107, 108, 303, 346,362, 363, 364, 365, 366,502, 503, 505, 506, 510, 522, 523, 524, 525, 542, 543, 544, 545, 546, 547, 548, 549, 550, 551, 552, 553, 722, 724, 726, 728, 744, 749, 764, 901, 922, 926, 928, 929, 944, 1107, 1141, 1142, 1143, 1146, 1201, 1203, 1205, 1206, 1227, 1231, 1301, 1303, 1305, and 1327 of this title.

(2) The court may hear and determine any issue arising with respect to the application of such sections to governmental units.

DISCUSSION

1. Prior to *Central Virginia Comm. College v. Katz*

Prior to *Katz*, there was limited guidance regarding the scope of the sovereign immunity defense in bankruptcy proceedings. The leading cases addressing the issue of sovereign immunity were *Seminole Tribe of Florida v. Florida*[2] and *Tennessee Student Assistance Corp. v Hood*.[3]

A. *Seminole Tribe of Florida v. Florida*

In *Seminole Tribe*, the Seminole Tribe sued Florida alleging the state violated a statute, which allowed for negotiations for a tribal-state compact "governing the conduct of gaming activities" upon the Indian tribes' request. The statute authorized a tribe to bring suit in federal court against a state in order to compel performance of that duty. Florida argued that the lawsuit violated Florida's sovereign immunity under the Eleventh Amendment.

The Supreme Court was called upon to resolve two issues: "(1) Does the Eleventh Amendment prevent Congress from authorizing suits by Indian tribes against States for prospective injunctive relief to enforce legislation enacted pursuant to the Indian Commerce Clause?; and (2) Does the doctrine of *Ex*

[1] *Central Virginia College v. Katz*, 126 S.Ct. 990 (2006).
[2] *Seminole Tribe of Florida v. Florida*, 517 U.S. 44 (1996).
[3] *Tennessee student Assistance Corp. v. Hood,* 541 U.S. 440 (2004).

Parte Young[4] permit suits against a State's Governor for prospective injunctive relief to enforce the good-faith bargaining requirement of the Act?"[5]

The Supreme Court held that Congress lacked the authority under the Indian Commerce Clause to abrogate the states' Eleventh Amendment sovereign immunity and that the doctrine of *Ex Parte Young* was not applicable in this case.

The Court in *Seminole Tribe* set the standards by which courts would adjudicate a sovereign immunity defense and any attempted at congressional abrogation. The Court stated that under the Eleventh Amendment, a state is sovereign and is not susceptible to private suits unless the state consents. If the state does not consent, Congress may abrogate the sovereign immunity defense in certain circumstances. The test to determine whether Congress may abrogate the sovereign immunity is that Congress must express a specific intent to abrogate sovereign immunity. Next, the abrogation of sovereign immunity must be "passed pursuant to a constitutional provision granting Congress the power to abrogate" sovereign immunity.[6]

B. *Tennessee Student Assistance Corp. v. Hood*

In *Hood*, Pamela Hood received a discharge in a no-asset Chapter 7 bankruptcy. Hood had student loans that, according to 11 U.S.C. § 528(a)(8) were not dischargeable, except on a determination by the court of an undue hardship. Hood filed an adversary proceeding for a hardship discharge. The Tennessee Student Assistance Corporation claimed that the complaint should be dismissed on the grounds of sovereign immunity.

The Supreme Court held that, for Eleventh Amendment purposes, a discharge proceeding was not a private civil suit and that the state's sovereign immunity defense was not implicated. Thus, the Eleventh Amendment does not bar courts from exercising *in rem* jurisdiction against a state or an agency of a state. The focus is on the debtor and the bankruptcy estate rather than creditors.

Finally, the Court held that a ruling in a discharge proceeding will bind a state agency and does not infringe upon a state's sovereignty because a debtor does not seek monetary damages or affirmative relief from the state. A state's Eleventh Amendment rights are not implicated and the state cannot claim sovereign immunity from the effect of a discharge order since a discharge proceeding does not constitute a private civil suit.

2. *Central Virginia Comm. College v. Katz*

Prior to *Katz*, the circuit courts were split as to whether the Eleventh Amendment barred preference actions from being prosecuted against states or their instrumentalities. In *Katz*, a chapter 11 trustee brought an adversary proceeding to avoid and recover preferential transfers against Central Virginia Community College, which is considered an arm of the state, and thus entitled to sovereign immunity. The college moved to dismiss on sovereign immunity grounds.

The Supreme Court held that states do not enjoy immunity from preference proceedings. The Court stated that the states had waived their sovereign immunity defense when they ratified Article 1, section 8, clause 4 of the United States Constitution, which provides for uniform laws on the subject of bankruptcies throughout the United States. The Court relied on *Hood* and found that when the Framers included the Bankruptcy Clause, they intended that the Clause was a waiver by the states of the sovereign immunity defense in connection with bankruptcy proceedings that were ancillary to the Court's *in rem* bankruptcy jurisdiction.

The Court concluded that compelling a state to honor another state's discharge orders was the primary motivation behind the Framer's decision to include the Bankruptcy Clause in the Constitution.

---

[4] The *Ex Parte Young* doctrine is where the Court has "found federal jurisdiction over a suit against a state official when that suit seeks only prospective injunctive relief in order to 'end a continuing violation of federal law.'" *Seminole Tribe*, 517 U.S. 44, 73.
[5] *Id.* at 53.
[6] *Id*. at 59.

Thus, the Framers intended to give Congress the power to redress the problem of a state's refusal to respect another state's discharge orders. Further, the Court found that it authorized limited subordination of state sovereign immunity in bankruptcy based on the history of the Bankruptcy Clause, the reasons for including it, and the legislation proposed and enacted under it following its ratification. The express purpose of the Bankruptcy Clause was to make bankruptcy laws uniform, thus, the Bankruptcy Clause must subordinate the states' sovereign immunity rights in bankruptcy. Since the states ratified it, the states acquiesced to it.

As stated previously, the Court relied on *Hood*. However, in that case their holding turned on the distinction between *in rem* and *in personam* jurisdiction. In *Hood*, the focus was on the debtor and the bankruptcy estate. The Court found that the state could claim sovereign immunity if the proceeding constituted *in rem* jurisdiction for a private civil suit. The Court had to reconcile their ruling in *Hood* with the fact that in *Katz* the action sought to avoid and recover money transferred to a state agency. To avoid having to find a private civil suit in *Katz*, which would trigger the sovereign immunity defense, the Court relied on the fact that the plaintiff did not ask for a money judgment. That way, the preference action could not be characterized as a private civil suit against the state for the recovery of money. The Court instead relied on the bankruptcy code's provision regarding trustee duties, in which the trustee is required to managed the debtor's estate, including recovering transferred property. The trustee's Order for Turnover, "although ancillary to and in furtherance of the court's *in rem* jurisdiction, might itself involve *in personam* process."[7]

In order to avoid a conflict with *Hood*, the Court stated that the states waived their sovereign immunity with respect to matters ancillary to the bankruptcy court's *in rem* jurisdiction, which included preference actions. "Insofar as orders ancillary to the bankruptcy courts' *in rem* jurisdiction, like orders directing turnover of preferential transfers, implicate States' sovereign immunity from suit, the States agreed in the plan of the Convention not to assert that immunity."[8]

3. Unresolved Issues in the Wake of *Katz*

While *Katz* helps to resolve the conflicts between state sovereignty and the Bankruptcy Code, the issue is far from being resolved. Also, *Katz* did not overturn *Seminole Tribe* or *Hood* (though *Seminole Tribe* was questioned by the Court), which means all three cases are still good law. The Court in *Katz* did not intend to resolve every issue regarding state sovereign immunity and the Bankruptcy Code. The Court stated that the ratification of the Bankruptcy Clause represented a surrender by the states of their sovereign immunity *in certain federal proceedings*. Thus, it leaves open the question of whether the states have waived their sovereign immunity defense in other bankruptcy proceedings other than those involving preference or an ancillary matter in the Court's *in rem* jurisdiction.

Finally, while there seems to be a trend away from finding for sovereign immunity, this trend will likely be ending. The *Katz* decision found no sovereign immunity by the slightest majority, 5-4. It is significant that Justice O'Connor was included in the majority, as the *Katz* decision was announced on the day of her retirement from the Court. Replacing her was Justice Alito, who is predicted to favor states' rights. Thus, it is now likely the application in *Katz* will be applied narrowly.

[7] *Katz*, 126 S.Ct. 990, 1001.
[8] *Id.* at 1002.