Supreme Court Ducks Sovereign Immunity Question

A Recap of the Remaining Circuit Conflicts

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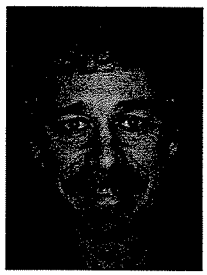
Under the Eleventh Amendment to the U.S. Constitution, no individual may sue a state without its consent. Using its powers granted under the Bankruptcy Clause in Article I of the Constitution, Congress enacted §106 of the Bankruptcy Code, under which sovereign immunity is expressly abrogated. The circuit courts have split on whether or not Congress exceeded its powers in enacting §106 of the Bankruptcy Code. The Supreme Court recently had an opportunity to rule on the issue in connection with the dischargeability of a student loan guaranteed by a state agency. Despite granting *certiorari* on the issue, the Court avoided ruling directly. Instead, the Court held that the Eleventh Amendment was not implicated because the bankruptcy court was exercising its *in rem* jurisdiction and was not attempting to adjudicate claims outside of that jurisdiction.[1]

The Eleventh Amendment



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The Eleventh Amendment provides: "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."[2] The Supreme Court has construed the amendment to contain two parts; first, that each state is a sovereign entity within the federal system, and second, that the nature of sovereignty precludes a suit by an individual without the state's consent.[3] The Court has commented that for more than a century, it has recognized that the Constitution did not contemplate suits against unconsenting states.[4]

Over the years, the Supreme Court has upheld a state's sovereign immunity many times in various contexts. In a landmark case, *Seminole Tribe of Florida v. Florida,*[5] the Court dismissed the petitioner's suit on the basis of the Eleventh Amendment sovereign immunity afforded to states. The case dealt with the Indian Gaming Regulatory Act, which provides that an Indian tribe may conduct certain gaming activities only in conformance with a pact with the state.[6] States are obligated to negotiate in good faith and can be sued in federal court to compel performance of their good-faith duty.[7] The Court focused on whether the Indian Commerce Clause is a grant of authority to the federal government at the states' expense.[8] The Court agreed that Congress clearly intended to abrogate the states' sovereign immunity through the enactment of Title 25, §2710(d)(7).[9] However, the Court determined that the regulation of Indian commerce, even though it is under the exclusive control of the federal government, is protected by the Eleventh Amendment.[10]

Section 106 of the Bankruptcy Code

Article I, §8, clause 4 of the Constitution provides that Congress shall have the power to "establish...uniform laws on the subject of bankruptcies throughout the United States." In 1994, Congress enacted §106 of the Bankruptcy Code.[11] Under §106(a), sovereign immunity is abrogated as to a governmental unit with respect to many actions arising under the Bankruptcy Code, including, for example, §§362, 365, 547, 548 and 1141.[12]

While §106(a) of the Bankruptcy Code expressly abrogates sovereign immunity to the extent necessary to permit bankruptcy courts to deal with issues arising in connection with certain provisions of the Bankruptcy Code, the Supreme Court's *Seminole* opinion has cast doubt on the constitutionality of §106. Subsequent to *Seminole*, several appeals courts have issued decisions regarding sovereign immunity in the bankruptcy context.

No Power to Abrogate, Says the Fourth Circuit

In July 1998, the Fourth Circuit Court of Appeals held that Congress does not have the power to abrogate the state's sovereign immunity.[13] Roger Schlossberg (as chapter 7 trustee) sued the Maryland state comptroller to avoid as a preference the debtor's $4,382 income tax payment.[14] The state prevailed on its defense that the payment was made in the ordinary course.[15] Responding to the trustee's appeal, the state raised the sovereign immunity defense for the first time in the Fourth Circuit.[16] Schlossberg responded that the state had waived its sovereign immunity by filing a proof of claim for sales and withholding taxes.[17]

The bankruptcy court ruled that the payments were ordinary course and not avoidable as preferences, and the district court affirmed.[18] On appeal, the trustee argued that §106 of the Bankruptcy Code abrogates sovereign immunity.[19] He also argued that the state had waived any sovereign immunity by filing a proof of claim.[20]

The Fourth Circuit noted that in light of *Seminole,* any Eleventh Amendment analysis had to take into account an inquiry as to whether Congress had the power to abrogate a state's sovereign immunity.[21] The Fourth Circuit concluded that Congress had no power under the Bankruptcy Clause to abrogate state sovereign immunity.[22] Accordingly, the appeals court held that Congress's effort to abrogate the states' Eleventh Amendment immunity through the enactment of §106 was unconstitutional and ineffective.[23] The Fourth Circuit acknowledged *Seminole*'s analysis of §5 of the Fourteenth Amendment, but concluded that it did not apply in the bankruptcy context.[24]

One month after the *Schlossberg* decision, the Fourth Circuit again addressed sovereign immunity in *Antonelli.*[25] The state

1 *Tennessee Student Assistance Corp. v. Hood,* 124 S.Ct. 1905 (decided May 17, 2004).
2 U.S. Constitution, Eleventh Amendment.
3 *Seminole Tribe of Florida v. Florida,* 517 U.S. 44, 54 (1996) (citations omitted). The Supreme Court noted that previously authority to abrogate had been found only in two provisions of the Constitution. *Id.* at 59. *See Fitzpatrick v. Bitzer,* 427 U.S. 445, 452-56 (1976) (finding that §5 of the Fourteenth Amendment allowed Congress to abrogate sovereign immunity). *See, also, Pennsylvania v. Union Gas Co.,* 491 U.S. 1 (1989) (concluding that the Interstate Commerce Clause granted Congress power to abrogate state sovereign immunity).
4 *Seminole Tribe of Florida v. Florida,* 517 U.S. at 54.
5 517 U.S. at 75.
6 25 U.S.C. §2710(d)(1)(C).
7 25 U.S.C. §§2710(d)(3)(A) and 2710(d)(7).
8 *Seminole Tribe of Florida v. Florida,* 517 U.S. at 62.
9 *Id.* at 56.
10 *Id.* at 72.
11 11 U.S.C. §106.
12 11 U.S.C. §106(a). Under subsection (b), a governmental unit that has filed a proof of claim is deemed to have waived sovereign immunity with respect to a claim against such governmental unit that is property of the estate and arose out of the same transaction. 11 U.S.C. §106(b).
13 *Schlossberg v. State of Maryland,* 119 F.3d 1140 (4th Cir. 1997), *cert. denied,* 523 U.S. 1075 (1998). The Fourth Circuit noted that sovereign immunity raises a jurisdictional issue that cannot be waived and therefore could be considered for the first time on appeal.
14 *Id.* at 1142.
15 *Id.*
16 *Id.* at 1143.
17 *Id.*
18 *Id.*
19 *Id.*
20 *Id.* The state of Maryland filed a proof of claim for sales and withholding taxes, but did not file a claim for the taxes at issue in the case.
21 *Id.* at 1145.
22 *Id.*
23 *Id.* at 1147. *See, also, Nelson v. LeCrosse County District Attorney,* 301 F.3d 820, 838 (7th Cir.) (Congress lacked authority to abrogate sovereign immunity by exacting §106(a) of the Bankruptcy Code); *Gosselin v. Massachusetts Dept. of Revenue,* 276 F.3d 70, 72 (1st Cir. 2002) (limited holding that debtor's action against state on dischargeability of taxes barred by sovereign immunity); *In re Sacred Heart Hosp.,* 133 F.3d 237, 245 (3d Cir. 1998) (§106(a) unconstitutionally abrogates states' sovereign immunity).
24 *Id.* The Fourth Circuit noted: "Furthermore, reliance on §5 of the Fourteenth Amendment as a *post hoc* justification for Congress's attempted abrogation in 11 U.S.C. §106 would require us to ignore the result in *Seminole.*" *Id.*
25 *State of Maryland v. Antonelli Creditors' Liquidating Trust,* 123 F.3d 777 (4th Cir. 1997).

and two counties sued a liquidating trust and the purchasers of the debtors' real estate interests to recover state and county transfer taxes.[26] The district court entered judgment for the trust and the purchasers.[27] The Fourth Circuit held, *inter alia,* that the Eleventh Amendment did not bar enforcement against the state and counties of the order confirming the debtors' plan.[28]

Antonelli and his wife converted involuntary chapter 7 petitions to voluntary chapter 11 petitions and filed a reorganization plan.[29] Under the confirmed plan, a liquidating trust was formed to dispose of assets, including real property, and §1146(c) was invoked to exempt plan transfers.[30] The state of Maryland and the plaintiff counties were served with copies of the plan, but they did not appear at the confirmation hearing or appeal the confirmation order.[31] At the time the transfers were recorded, there was no attempt to impose a transfer or recordation tax.[32] Almost a year later, the state and counties filed suit, seeking to recover more than $95,000 in recordation and transfer taxes.[33] On summary judgment, the district court ruled in favor of the trust and the counties, noting that the state and Montgomery County had sufficient notice of the plan and failed to take action.[34] As to the other counties, the district court held that both the language of §1146(c) and public policy support the application of that section under the debtors' plan.[35]

The Fourth Circuit noted initially that to the extent the plan incorporated §1146(c), the state and counties were bound by the plan provisions.[36] Under the Bankruptcy Clause of the Constitution, Congress had the power to enact §1146(c), and by virtue of the Supremacy Clause, such enactment takes precedence over any conflicting state provisions.[37]

The taxing authorities also asserted the Eleventh Amendment for the first time on appeal and argued they had not waived immunity.[38] The Fourth Circuit allowed that the state could raise the Eleventh Amendment for the first time on appeal because of jurisdictional aspects.[39] However, the counties could not because case law holds that the Eleventh Amendment does not bar federal lawsuits against political subdivisions of the state.[40]

The appeals court reviewed the Eleventh Amendment language, which denies courts authority to entertain a suit brought by a private party against a state without its consent.[41] However, the court held that the confirmation order was not entered in a suit against a state filed by a private party.[42] The state was not named as a defendant or served with process requiring its attendance in federal court.[43]

According to the Fourth Circuit, this is different from an individual commencing an adversary proceeding against a state in bankruptcy court.[44] A court's jurisdiction to confirm a plan derives from its jurisdiction over the debtor and its estate—not jurisdiction over particular creditors.[45] The Fourth Circuit acknowledged that if the state had challenged the plan, it would have had to submit to federal jurisdiction.[46]

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26 *Id.* at 778.
27 *Id.*
28 *Id.* at 787.
29 *Id.* at 779-80.
30 *Id.* at 780. Section 1146(c) exempts certain transfers from taxes under a confirmed plan. 11 U.S.C. §1146(c).
31 *Id.* at 781.
32 *Id.*
33 *Id.*
34 *Id.*
35 *Id.*
36 *Id.*
37 *Id.*
38 *Id.* at 786.
39 *Id.*
40 *Id. See, also, In re Urban,* 1998 U.S. Dist. LEXIS 229 (S.D.N.Y. 1998) (Eleventh Amendment does not bar suits against counties); *Carlin v. Rogers District Court,* 274 B.R. 821, 823 (Bankr. W.D. Ark. 2002) (counties and cities are not entitled to assert sovereign immunity).
41 *Id.*
42 *Id.*
43 *Id.*
44 *Id.* at 786-87.
45 *Id.* at 787.
46 *Id.*

Alternatively, the state could choose not to appear in federal court.[47] The court admitted this wasn't an ideal choice, but concluded this did not amount to exercise of federal power to hale a state into federal court against its will in violation of the Eleventh Amendment.[48]

Congress Has the Power, Says the Sixth Circuit

The Sixth Circuit weighed in on the sovereign immunity and Bankruptcy Code debate in *In re Hood*.[49] The Tennessee Student Association Corp. (TSAC) appealed from the Sixth Circuit BAP's denial of a motion to dismiss for lack of jurisdiction.[50] After receiving a discharge in her chapter 7 case, the debtor filed a complaint against TSAC, seeking a hardship discharge.[51] The bankruptcy court denied TSAC's motion to dismiss on grounds of sovereign immunity, and the BAP affirmed.[52]

In the 1976 Education Amendments to the Bankruptcy Code, Congress prohibited the discharge of student loans in ordinary non-adversary proceedings unless the loan had been in repayment for more than five years.[53] For other loans, Congress required that the debtor institute an adversary proceeding and demonstrate undue hardship to obtain a discharge.[54] TSAC argued that sovereign immunity protected it from being sued as a defendant in a hardship dischargeability suit.[55]

The Sixth Circuit disagreed, concluding that TSAC could not have its cake and eat it too.[56] The court reviewed the conclusions of the various circuit courts that had ruled against Congress's power to abrogate sovereign immunity under the Bankruptcy Code after the Supreme Court's ruling in *Seminole*.[57] However, the Sixth Circuit concluded that under the Bankruptcy Clause, Congress does have the power to abrogate sovereign immunity.[58]

First, the Sixth Circuit concluded that the language of §106 of the Bankruptcy

47 *Id.*
48 *Id. See, also, In re Collins,* 173 F.3d 924 (4th Cir. 1999) (sovereign immunity was not implicated because motion to reopen case was not a suit against one of the states).
49 319 F.3d 755. (6th Cir. 2003).
50 *Id.* at 758.
51 *Id.*
52 *Id.*
53 *Id.* at 759.
54 *Id.*
55 *Id.*
56 *Id.*
57 *Id.* at 761. *See, e.g., In re Nelson,* 301 F. 3d 820, 832 (7th Cir. 2002); *In re Mitchell,* 209 F. 3d 1111, 1121 (9th Cir. 2000); *In re Fernandez,* 123 F. 3d 241, 243, *amended by* 130 F. 3d 138, 1139 (5th Cir. 1997).
58 *Id.* at 762. *See, also, In re Roberts,* 2003 WL 22439869 * 2 (Bankr. M.D. Ga., Sept. 15, 2003) (states surrendered sovereign immunity with respect to bankruptcy, so the state of Georgia had no immunity).

determination of whether Congress abrogated the immunity of Indian tribes in enacting §106 of the Code.[73] The court concluded that Indian nations are governmental units, as defined in §101(27) of the Code.[74] Accordingly, Congress expressly abrogated the immunity of Indian tribes.[75]

The U.S. Supreme Court

The U.S. Supreme Court had a chance to clarify the sovereign immunity issue under the Code when it granted *certiorari* in *Tennessee Student Assistance Corp. v. Hood.*[76] As mentioned previously in this article, the Sixth Circuit affirmed the Sixth Circuit BAP's holding that §106 of the Code was a valid abrogation of sovereign immunity. TSAC had asserted sovereign immunity in response to Hood's attempt to discharge a student loan.[77]

Hood received a discharge and then reopened her bankruptcy case, seeking a determination that she was entitled to a hardship discharge for her $4,169.31 student loan.[78] As required by the Bankruptcy Rules, Hood filed an adversary proceeding and served TSAC with a summons and a complaint.[79] On May 17, 2004, the Supreme Court affirmed, but did not reach the abrogation issue, holding that the discharge of a student loan debt does not implicate the Eleventh Amendment immunity.[80]

The basis for the Supreme Court's holding was the conclusion that the bankruptcy court was exercising its *in rem* jurisdiction, rather than ruling against a particular creditor.[81] The Supreme Court discussed and analogized to *in rem* admiralty proceedings, which are not barred by the Eleventh Amendment.[82] According to the Court, the discharge of a debt in bankruptcy is also an *in rem* proceeding.[83] Bankruptcy courts have exclusive jurisdiction over a debtor's property and over the estate.[84] Whether or not states choose to participate in a bankruptcy proceeding, they are bound by a debtor's discharge no less than other creditors.[85] The Supreme Court reiterated its position that the exercise of the bankruptcy court's *in rem* jurisdiction does not infringe state sovereignty.[86] The Court found no authority that the bankruptcy court's exercise of *in rem* jurisdiction to discharge a student loan debt would infringe state sovereignty.[87] Accordingly, the Supreme Court concluded that the suit to discharge a student loan debt was not a suit against a state for Eleventh Amendment purposes.[88]

Conclusion

Congress enacted §106 expressly abrogating the states' sovereign immunity. Some circuit courts have held that in doing so, Congress exceeded its powers, and therefore consider §106 unconstitutional. Other circuits have deemed §106 a valid exercise of the power granted to Congress under the Constitution. The Supreme Court recently had an opportunity to settle the debate, but chose not to address the issue. Instead, the Supreme Court held that bankruptcy courts have exclusive *in rem* jurisdiction over debtors and their estates. ■

73 *Id.*
74 *Id.* at 1057. The Ninth Circuit noted that as a governmental unit, Indian tribes are afforded special protection under the Bankruptcy Code.
75 *Id.* at 1058.
76 124 S. Ct. 1905 (2004). In his dissent, Justice Thomas notes that the Supreme Court granted *certiorari* "to decide whether Congress has the authority to abrogate state sovereign immunity under the Bankruptcy Clause." *Id.* at 1915.
77 *Id.* at 1908.
78 *Id.* at 1908-09.
79 *Id.* at 1909.
80 *Id.*
81 *Id.* at 1910.
82 *Id.*
83 *Id.*
84 *Id.*
85 *Id.* at 1911.
86 *Id.* The Supreme Court also dismissed TSAC's procedural argument that an adversary proceeding was an impermissible suit against the state. *Id.* at 1914. The Supreme Court concluded that the complaint and summons could easily have been a motion but for Bankruptcy Rule 7001(b), and therefore there was no reason to give dispositive effect to the service of a summons. *Id.* at 1915.
87 *Id.* at 1912.
88 *Id.* at 1913.