2016

Whether Sovereign Immunity is a Defense for States in Bankruptcy Cases

Melanie Lee

ST. JOHN'S UNIVERSITY
SCHOOL OF LAW

Whether Sovereign Immunity is a Defense for States in Bankruptcy Cases

2016 Volume VIII No. 17

Whether Sovereign Immunity is a Defense for States in Bankruptcy Cases

Melanie Lee, J.D. Candidate 2017

Cite as: *Whether Sovereign Immunity is a Defense for States in Bankruptcy Cases*, 8 ST. JOHN'S BANKR. RESEARCH LIBR. NO. 17 (2016)

Introduction

Sovereign immunity, generally, prohibits suit against a sovereign without the sovereign's consent.[1] The defense of sovereign immunity may not be asserted by any state, or arm of the state, in any bankruptcy proceeding.[2] The prohibition of asserting sovereign immunity in a bankruptcy case has been common practice, almost continuously, since the states agreed to such a waiver in the Constitutional Convention.[3] Moreover, this waiver of sovereign immunity, has since been codified in Section 106 of title 11 of the United States Code (the "Bankruptcy Code").[4] As a result, a state involved in a bankruptcy case will typically be treated like any other

---

[1] *See* Katherine Florey, *Sovereign Immunity Penumbras: Common Law, "Accident," and Policy in the Development of Sovereign Immunity Doctrine*, 43 Wake Forest L. Rev. 765, 765 (2008) (noting "the doctrine of sovereign immunity itself contains a certain fuzziness around the edges").

[2] *See* Central Va. Cmty. Coll. v. Katz, 126 U.S. 356, 363 (2006) (*citing* Tenn. Student Assistance Corp. v. Hood, 541 U.S. 440, 448 (1905) (noting states "whether or not they choose to participate in the proceeding are bound by a bankruptcy court's discharge order no less than other creditors").

[3] *See* Central Va. Cmty. Coll., 126 U.S. at 377–78 (determining scope of this waiver was limited to *in rem* bankruptcy proceedings).

[4] *See* 11 U.S.C. § 106 (2010) (abrogating sovereign immunity of government units in bankruptcy proceedings).

creditor, that is, unless legislation is passed by Congress which exempts the state from that particular proceeding. [5]

No sovereign immunity for states in bankruptcy cases has been the rule for over two-hundred years following the Constitutional Convention. However, the Supreme Court's 1997 ruling in *Seminole Tribe of Florida v Florida*, reversed this longstanding rule and was thought to insulate "state[s] from bankruptcy court jurisdiction."[6] Almost ten years later, in *Central Va. Cmty. Coll. v Katz*, in yet another pivotal decision, the Supreme Court disregarded the bankruptcy element of the *Seminole* decision as dicta, and made clear that sovereign immunity was not a defense that could be asserted by a state in bankruptcy proceedings.[7] More recently, in *In re Bulk Petroleum* ("*Bulk Petroleum*"), the Seventh Circuit reaffirmed that sovereign immunity was not a defense for the Kentucky Department of Revenue ("Kentucky") in a chapter 11 bankruptcy case. [8]

Part I of this article describes the history of the prohibition of the sovereign immunity defense in bankruptcy proceedings. Part II discusses the *Seminole Tribe* and *Katz* cases and the dichotomous effect that the two had on sovereign immunity in bankruptcy proceedings. Part III explores the Seventh Circuit's *Bulk Petroleum* decision and the prohibition of sovereign immunity by the court in that case. This article concludes with a summation of how sovereign

---

[5] *See State Sovereign Immunity—Bankruptcy*, 120 Harv. L. Rev. 125, 128 (2006) (positing that "Congress has the authority to decide whether to treat states like any other creditor…") (*citing Central Va. Cmty. Coll.*, 126 U.S. at 379 (2006)).
[6] *State Sovereign Immunity in Bankruptcy After Seminole Tribe of Florida v Florida*, 1997 WL 985139 at *2.
[7] *See infra* note 29.
[8] *See* Bulk Petroleum Corp. v. Kentucky Dep't of Rev. (*In re* Bulk Petroleum), 796 F.3d 667, 679 (7th Cir. July 31, 2015) (holding Eleventh Amendment did not apply to the claim in bankruptcy).

immunity in bankruptcy cases will continue to be an invalid defense for states into the foreseeable future.

I. The History of Sovereign Immunity in Bankruptcy Cases

Each state within the United States is a sovereign, and "[i]t is inherent in the nature of sovereignty not to be amenable to the suit of an individual without its consent."[9] Such a fundamental principle has been a centerpiece of the functioning of the United States government on both a state wide and national level, and is the basis of the Eleventh Amendment to the Constitution of the United States, which reads 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.[10]

Since the infancy of the nation, states have been required to forego this sovereignty in the context of bankruptcy proceedings. Such a sacrifice is justified because of the nation's need for uniform bankruptcy laws which must often span the borders of several states due to the *in rem* nature of bankruptcy proceedings.[11]

The Supreme Court's ruling in *Katz* illustrates the "difficulties posed by [the] patchwork of insolvency and bankruptcy laws… peculiar to the American experience."[12] In its discussion, the Court first examined the 1786 Court of Common Pleas decision of *James v Allen*, where a discharge of a debtor in New Jersey did not release the debtor from claims asserted in

---

[9] Hans v State of Louisiana, 134 U.S. 1, 13 (1890) (*citing* The Federalist No. 81 (Alexander Hamilton)).
[10] U.S. Const. amend. XI.
[11] *See* Central Va. Cmty. Coll., 126 U.S. at 369–70 (2006) (stating that today and at the time of framing bankruptcy jurisdiction has been principally *in rem*).
[12] *Id.* at 366.

Pennsylvania.[13] In *Allen*, the Court recognized that the insolvency laws of all of the states were "probably different from each other…."[14] Then, after examining the difficulties faced in *Allen*, the Court, in *Katz*, discussed the 1788 *Millar v Hall* case, where a debtor who was released from his debt in Maryland was arrested shortly thereafter in Pennsylvania for a debt incurred there.[15] Unlike in *Allen*, the court in *Millar* recognized that one state should honor another state's discharge of a debtor, and so chose to deem the debtor's obligations fulfilled in Pennsylvania, even though he had surrendered all of his effects in Maryland.[16] In both cases, the debtors argued that their earlier discharges should have been given "effect pursuant to the Full Faith and Credit Clause of the Articles of Confederation."[17] And, when news spread of the two cases presenting similar issues with the lack of uniformity in the bankruptcy laws, a proposal for a uniform discharge agreement amongst the states was discussed at the Constitutional Convention.[18] With very little debate, Article I of the Constitution requires uniformity among bankruptcy laws.[19]

Typically, the exercise of bankruptcy jurisdiction does not interfere with state sovereignty "even when States' interests are affected."[20] When a states' interests are involved in a bankruptcy proceeding, the typical practice of bankruptcy courts is to treat the state as any other

---

[13] *See id.* (noting the 1786 court found that the effect of the New Jersey order went no further than discharging the debtor from his imprisonment in New Jersey) (*citing* James v. Allen, 1 U.S. 188, 192 (C.P. Phila.Cty. 1786).
[14] Central Va. Cmty. Coll., 126 U.S. at 366 (2006) (*citing* James v. Allen, 1 U.S. 188, 192 (C.P. Phila.Cty. 1786).
[15] *See id*. at 369–70 (2006) (applying the holding of *James v. Allen* the court adopted a rule allowing debtor's Pennsylvania and Maryland debts to be discharged) (discussing Millar v. Hall, 1 U.S. 229, 231 (Pa. 1788)) (citing *James v. Allen*, 1 U.S. 188, 192 (C.P. Phila.Cty. 1786).
[16] *See* Central Va. Cmty. Coll., 126 U.S. at 368 (2006) (*discussing* Millar v. Hall, 1 U.S. at 231 (Pa. 1788)) (*citing* James v. Allen, 1 U.S. at 192 (C.P. Phila.Cty. 1786)).
[17] Central Va. Cmty. Coll., 126 U.S. at 368 (2006).
[18] *See id.* (highlighting that after only a few days the Committee of Detail at the Constitutional Convention recommended adding uniform bankruptcy laws to Article I of the Constitution).
[19] *See id*.
[20] *Id.* at 370.

creditor would be treated.[21] Though this was, and currently is, the standard practice in such a case, this practice was turned on its head following the opinion of the Supreme Court in *Seminole Tribe of Fla. v Florida*.

II. From *Seminole Tribe* to *Katz*: The Supreme Court's Fast Return to Precedent

(i) Seminole Tribe of Fl. v Florida suddenly suggests that sovereign immunity is a defense for states in bankruptcy cases

The inability of states to raise sovereign immunity as a defense in bankruptcy proceedings remained fairly stagnant from the time of the Constitutional Convention until the *Seminole Tribe* decision in 1997. In *Seminole Tribe*, an Indian tribe filed suit against Florida to compel the state to negotiate in good faith with it toward the formation of a compact regarding certain gaming activities under the Indian Gaming Regulatory Act ("Act").[22] Such suit was specifically permitted by the Act and did not require the state to consent, as is typically required by the Eleventh Amendment.[23] The Supreme Court reviewed the Act and then proceeded in a discussion of past cases which limited Congress' ability to abridge state sovereign immunity to certain areas.[24] First, the Court reviewed *Fitzpatrick v Bitzer*, where the Court held that "through the Fourteenth Amendment, federal power extended to intrude upon the province of the Eleventh Amendment and therefore… allowed Congress to abrogate the immunity from suit…."[25] Then,

---

[21] *See State Sovereign Immunity—Bankruptcy*, 120 Harv. L. Rev. 125, 128 (2006) (noting "Congress has the authority to decide whether to treat the states like any other creditor…").
[22] *See* Seminole Tribe of Fl. v. Florida, 517 U.S. 44, 51 (1996) (Seminole Tribe of Florida sued the state of Florida in September 1991).
[23] *See id*. at 54 (enumerating the language of the Eleventh Amendment).
[24] *See id*. at 59.
[25] *See id*. (*citing* Fitzpatrick v. Baker, 427 US 445, 453-55 (1976) (discussing that "the expansion of Congress' powers with the corresponding diminution of state sovereignty found to be intended by the Framers and made part of the Constitution upon the States' ratification of those Amendments, [is] a phenomenon aptly described as a 'carv(ing) out'….").

Pennsylvania v Union Gas Co., in which a plurality of the Court had determined that the Interstate Commerce Clause, Art. 1 §8, cl. 3, would be "'incomplete without [Congress'] authority to render States liable in damages.'"[26] After discussion of these cases, the Court overruled *Union Gas* and held that "the Eleventh Amendment is not so ephemeral as to dissipate when the subject of suit is an area… that is under the exclusive control of the Federal Government."[27]

Despite *Seminole* not involving bankruptcy, the Court stated in a footnote that "although… the bankruptcy laws have existed practically since our nation's inception…, there is no established tradition in the lower federal courts of allowing enforcement of those federal statutes against the States."[28] Several courts interpreted *Seminole* as holding that bankruptcy courts lack jurisdiction over the states because of the sovereign immunity protection of the Eleventh Amendment.[29] Further, *Seminole* seemed to permit that by asserting sovereign immunity as a defense, a state would no longer be faced with being treated as any other creditor would be in a bankruptcy proceeding.[30]

---

[26] *See id.* (*reviewing* Pennsylvania v. Union Gas Co., 491 US 1, 19 (1989)).
[27] *Id*. at 72.
[28] *Id*. at 73; *State Sovereign Immunity in Bankruptcy After Seminole Tribe of Florida v Florida*, 1997 WL 985139 at *1.
[29] *State Sovereign Immunity in Bankruptcy After Seminole Tribe of Florida v Florida*, 1997 WL 985139 at *1.
[30] *Id.* at *10,

> The Bankruptcy Code strikes a delicate balance between the rights of creditors to collect debts and the rights of debtors to restructure or discharge those debts. By exempting states from the jurisdiction of the bankruptcy court, *Seminole* arguably places states and state agencies outside this delicate balance regardless of what role they play in the case. This exclusion is detrimental to both debtors and creditors. Bankruptcy works in large measure because it provides a single forum with a binding determination of all of the competing rights in the debtor's property. Exempting even one party from this process invariably reduces its effectiveness for the remaining parties.

As a result, *Seminole*, a decision which seemed to have no ties to bankruptcy proceedings, seemed to undue centuries of precedent in the bankruptcy field through the addition of a footnote. However, the Supreme Court, apparently in response to the uproar that *Seminole* caused, backtracked on its *Seminole* position in its later *Central Va. Cmty. Coll. v Katz* decision.[31]

(ii) Central Va. Cmty. Coll. v. Katz reaffirmed that sovereign immunity is not a defense for states in bankruptcy cases

In *Katz*, a court appointed liquidating supervisor commenced proceedings to recover transfers made by the debtor, a bookstore, which filed for relief under chapter 11.[32] Though the debtor had done business with Virginia higher education institutions prior to its bankruptcy, the transfers at issue were made after it filed for bankruptcy.[33] The Virginia institutions, relying on the *Seminole* footnote, argued that they could not be sued under the principles of sovereign immunity and moved to dismiss the lawsuit.[34] Despite *Seminole*'s reach into the bankruptcy arena, the Bankruptcy Court for the Eastern District of Kentucky, the District Court, and the United States Court of Appeals for the Sixth Circuit all denied the motion to dismiss on sovereign immunity grounds.[35] But, though the lower courts agreed that sovereign immunity would not bar the Virginia institutions from the bankruptcy case, on appeal, the Supreme Court granted certiorari to determine whether Art. 1, §8, cl. 3 of the Constitution, which provides for uniform bankruptcy laws, "gives Congress the authority to abrogate States' immunity from

---

[31] *See infra* note 33–36.
[32] *See* Central Va. Cmty. Coll., 126 U.S. at 360 (2006) (discussing trustees' action seeking to "set aside preferential transfers by the debtor").
[33] *See* Central Va. Cmty. Coll., 126 U.S. at 360 (2006) (stating debtor did business with the Virginia institutions prior to its insolvency).
[34] *See id*.
[35] *See id*.

private suits."[36] The Court denied that sovereign immunity could be asserted in the bankruptcy proceedings, and then proceeded to discuss the long history of bankruptcy proceedings since the country's inception.[37] Acknowledging the *Seminole* decision, and the effect it had on the Bankruptcy Clause, Justice Stevens, writing for the 5-4 majority, deemed the footnote being relied on to apply sovereign immunity in bankruptcy proceedings "dicta" which was "not fully debated" at the time.[38] Thus, after almost ten years of being in limbo post the *Seminole* decision, sovereign immunity was again denied as a defense for states in bankruptcy proceedings.

(iii) In re Bulk Petroleum and the Current State of the Law

In *In re* Bulk Petroleum, the Seventh Circuit held that the Kentucky Department of Revenue could not assert sovereign immunity as a defense to an excise tax refund request from a debtor, despite the fact that neither party raised the defense as an issue.[39] There, prior to filing for relief under chapter 11, Bulk Petroleum Corp., the debtor, lost its "gasoline and special fuels dealer" license issued by the state of Kentucky.[40] Although the loss of license did not require the debtor to cease conducting business in the state, the debtor was required to continue to satisfy its in-state tax obligations by remitting its tax obligations through its upstream suppliers.[41] However, despite that the debtor paid an excess of fuel taxes, Kentucky refused to issue a refund of the excess because it determined that only a "taxpayer" within the meaning of the statute was

[36] *Id*. at 359.
[37] *See supra* notes 13–17 and accompanying text.
[38] Central Va. Cmty. Coll., 126 U.S. at 363 (2006).
[39] Bulk Petroleum Corp. v. Kentucky Dep't of Rev. (*In re* Bulk Petroleum), 796 F.3d 667, 679 (7th Cir. July 31, 2015).
[40] *Id*. at 668.
[41] *See id.* (finding the change in who paid the tax raised the question of "from whom was that tax collected?").

entitled to a refund.[42] Because the debtor was paying the fuel tax through its upstream suppliers, Kentucky determined that the debtor was not a 'taxpayer' entitled to a refund.[43]

The Seventh Circuit disagreed with Kentucky's position; the Court found that the upstream suppliers operated as collectors of the tax from the debtor, "in trust for the state," and that the tax was remitted to Kentucky by those suppliers on Bulk's behalf.[44] Thus, although unlicensed, the debtor continued to pay the tax due, and as a result, the debtor was found to be entitled to a refund of the excess taxes it paid.[45] The Seventh Circuit also addressed other arguments, some of which were not raised by either party. These other arguments included that Bulk should have pursued its refund through the upstream suppliers which it paid its taxes too[46] and the aforementioned sovereign immunity defense.[47]

Kentucky did not raise the defense of sovereign immunity, but, the Seventh Circuit addressed the merit of such a defense nonetheless. Simply put, the Court stated that the Eleventh Amendment did not bar the suit because it was a claim in bankruptcy.[48] The Court then went on to discuss how the origin of states not being able to assert sovereign immunity in bankruptcy

---

[42] *Id*.
[43] *See id.* at 675 (Kentucky arguing "[t]he fact that some of the money went to the state as a tax did not… make [the debtor] the taxpayer").
[44] Bulk Petroleum Corp. v. Kentucky Dep't of Rev. (*In re* Bulk Petroleum), 796 F.3d 667, 676 (7th Cir. July 31, 2015).
[45] *See id.* at 678 (holding regardless of where the tax appeared on the debtor's invoices the debtor was entitled to a refund for the excess taxes it paid).
[46] *See id*. at 678 (finding "[t]he notion that relief for [the debtor was] a matter of private ordering between [the debtor] and the suppliers [was]… inconsistent with [the court's] understanding of the suppliers' role as mere collectors of the tax from [the debtor]…").
[47] *See id*. at 679; *see also supra* notes 1–3.
[48] *See In re* Bulk Petroleum, 796 F.3d at 679.

proceedings came about; namely, that the states agreed at the Constitutional Convention not to assert such a defense in bankruptcy proceedings.[49]

Since this ruling, Kentucky has filed a petition for a writ of certiorari to the Supreme Court.[50] In addition to challenging the Seventh Circuit's ruling that Kentucky owed the debtor a refund of the excess tax paid in the amount of $774,961.30, Kentucky also brings up in its petition the fact that the Seventh Circuit addressed in its decision arguments that neither party raised.[51] Although it did not name the Eleventh Amendment issue as one which it seeks the Supreme Court's review, the Court, if it chooses to grant certiorari, will have an opportunity to take up the issue of whether Kentucky should have been able to assert sovereign immunity.

Conclusion

For over 200 years states have not been able to exercise their sovereign immunity in bankruptcy proceedings.[52] However, in a non-bankruptcy related Supreme Court decision, *Seminole Tribe of Fl. v Florida*, it was thought by many that this longstanding precedent was disposed of in favor of allowing states to assert such a defense, even in cases of bankruptcy.[53] To return to the longstanding precedent, the Court, in *Katz*, called this part of the *Seminole* decision dicta and reiterated that states are not permitted to assert sovereign immunity in bankruptcy proceedings.[54] The Seventh Circuit, following this precedent, affirmed in *In re Bulk Petroleum*,

---

[49] *See id*. at 679–80 (determining that "[s]tate sovereign immunity" did not bar the debtor's claim against Kentucky).
[50] *See Petition for Writ of Certiorari*, Kentucky Dep't of Rev v. Bulk Petroleum Co., 796 F.3d 667 (2015) (No. 15-569) 2015 WL 6690395 at *i.
[51] *See* Petition for Writ of Certiorari, *In re* Bulk Petroleum, 796 F.3d 667 (No. 15-569) at *1.
[52] *See State Sovereign Immunity—Bankruptcy*, 120 Harv. L. Rev. 125, 128 (2006) (noting "the states must have agreed during the Convention not to assert sovereign immunity defenses against laws enacted under the Bankruptcy Clause").
[53] *State Sovereign Immunity in Bankruptcy After Seminole Tribe of Florida v Florida*, 1997 WL 985139 at *1.
[54] *See supra* note 29.

that the Kentucky Department of Revenue could not have asserted sovereign immunity as a defense against the debtor's assertions that it was owed a refund on excess taxes paid.[55] Since this decision, Kentucky has filed a petition for a writ of certiorari in hopes that the Supreme Court will reverse the Seventh Circuit's decision.[56] If the Supreme Court grants certiorari, it may again revisit whether sovereign immunity is available to states in bankruptcy cases.

[55] *See Bulk Petroleum Corp. v. Kentucky Dep't of Rev. (In re* Bulk Petroleum), 796 F.3d 667, 679–80 (7th Cir. July 31, 2015).
[56] *See Petition for Writ of Certiorari*, Kentucky Dep't of Rev v. Bulk Petroleum Co., 796 F.3d 667 (2015) (No. 15-569) 2015 WL 6690395 at *1.