UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF TENNESSEE
SOUTHERN DIVISION

In re:

NORTH AMERICAN ROYALTIES, INC., ET. AL.

No. 01-17271

Chapter 7

Debtors

DOUGLAS R. JOHNSON, TRUSTEE

Plaintiff

vs.

Adversary Proceeding No. 03-1279

CHATTANOOGA STATE TECHNICAL COMMUNITY COLLAGE and THE STATE OF TENNESSEE/TENNESSEE BOARD OF REGENTS

Defendants

MEMORANDUM

Appearances: Lex A. Coleman, Johnson, Mulroony & Coleman, P.C., Chattanooga, Tennessee, Attorney for Trustee/Plaintiff

Marvin E. Clements, Jr., Senior Counsel, The University of Tennessee, Knoxville, Tennessee, Attorney for Defendants

HONORABLE R. THOMAS STINNETT
UNITED STATES BANKRUPTCY JUDGE

The bankruptcy trustee for North American Royalties brought this suit against Chattanooga State Technical Community College to recover alleged preferential transfers. 11 U.S.C. § 547. The alleged preferences were tuition payments that North American made to Chattanooga State within the 90 days before North American's bankruptcy. Chattanooga State filed a motion to dismiss on the ground that the state's sovereign immunity deprives the federal courts of jurisdiction. This memorandum deals with Chattanooga State's motion to dismiss.

The parties do not dispute Chattanooga State's right to assert sovereign immunity as an arm of the state. The trustee contends the state's sovereign immunity has been abrogated by Bankruptcy Code § 106(a). Section 106(a) expressly abrogates a state's sovereign immunity for proceedings under numerous bankruptcy statutes, including the statute providing for the recovery of preferential transfers. 11 U.S.C. § 106(a) & § 547. Several circuit courts have held that § 106(a) is unconstitutional, but the Sixth Circuit decided in the *Hood* case that § 106(a) is constitutional. *Hood v. Tennessee Student Assistance Corp. (In re Hood)*, 319 F.3d 755 (6th Cir. 2003), *contra*: *Nelson v. La Crosse County District Attorney (In re Nelson)*, 301 F.3d 820 (7th Cir. 2002); *Mitchell v. Franchise Tax Board (In re Mitchell)*, 209 F.3d 1111 (9th Cir. 2000); *Sacred Heart Hospital v. Pennsylvania (In re Sacred Heart Hospital)*, 133 F.3d 237 (3d Cir. 1998); *Department of Transportation and Development v. PNL Asset Mgmt. Co. (In re Fernandez)*, 123 F.3d 241 (5th Cir. 1997), *amended*, 130 F.3d 1138 (5th Cir. 1997); *Schlossberg v. Maryland (In re Creative Goldsmiths)*, 119 F.3d 1140 (4th Cir. 1997), *cert. den.*, 523 U.S. 1075, 118 S.Ct. 1517, 140 L.Ed.2d 670 (1998); *Georgia Higher Education Assistance Corp. v. Crow (In re Crow)*, No. 04-10369, 2004 WL 2965458 (11th Cir. Jan. 26, 2004).

Chattanooga State raised the defense of sovereign immunity, despite the Sixth Circuit's decision in *Hood*, because *Hood* was on appeal to the Supreme Court and could have been reversed. *Hood v. Tennessee Student Assistance Corp.*, 539 U.S. 986, 124 S.Ct. 45, 156 L.Ed.2d 703 (2003) (granting *certiorari*). The court entered an order staying proceedings on the trustee's complaint until after the Supreme Court decided the *Hood* case.

The Supreme Court affirmed the Sixth Circuit's decision in *Hood* but on different grounds. The majority opinion said nothing to undermine or support the Sixth Circuit's decision that § 106(a) is constitutional. Likewise, the Supreme Court's order did not expressly affect the Sixth Circuit's ruling. *Hood v. Tennessee Student Assistance Corp.*, 541 U.S. 440, 124 S.Ct. 1905, 158 L.Ed.2d 764 (2004). Nevertheless, Chattanooga State argues that the Sixth Circuit's decision in *Hood* is no longer binding precedent within this circuit.

The court rejected the same argument in the trustee's preference suit against the University of Tennessee. The court held that the Sixth Circuit's decision in *Hood* is still binding precedent in this circuit. *Johnson v. University of Tennessee dba The UT Center For Industrial Services (In re North American Royalties, Inc., et al.*), Adv. Proceeding No. 03-1351, Bankr. Case No. 01-17271 (Bankr. E. D. Tenn. Jan. 21, 2005). The same reasoning applies in this lawsuit. Section 106(a) constitutionally abrogates the state's sovereign immunity in this lawsuit. Therefore, the court will deny Chattanooga State's motion to dismiss.

For the purpose of providing the parties a complete decision on the issue of sovereign immunity, the court will also rule on the trustee's alternative argument that the

state waived sovereign immunity by filing proof of claim. Section 106(b) of the Bankruptcy Code provides for a waiver of sovereign immunity as the result of filing a proof of claim. 11 U.S.C. § 106(b). The waiver under § 106(b) applies only to compulsory counterclaims –counterclaims that arise out of the same transaction or occurrence as the state's claim. *Ashbrook v. Block*, 917 F.2d 918 (6th Cir. 1990); *Gordon Sel-way, Inc. v. United States (In re Gordon Sel-Way, Inc.)*, 270 F.3d 280 (6th Cir. 2001); Fed. R. Civ. P. 13(a); Fed. R. Bankr. P. 7013. Chattanooga State contends the trustee's suit is not a compulsory counterclaim.

Chattanooga State's claim for tuition arose from North American's agreement to pay tuition for its employees who attended Chattanooga State. Chattanooga State's proof of claim includes tuition for the fall semester of 2000 and the summer of 2001. The trustee's preference suit seeks to recover North American's tuition payments to Chattanooga State for one of the same semesters, fall 2000, and for the spring semester of 2001.

Chattanooga State relies upon the Sixth Circuit's decision in *Rebel Coal* for the argument that the preference complaint is not a compulsory counterclaim. *Brown v. United States (In re Rebel Coal Co.)*, 944 F.2d 320 (6th Cir. 1991). *Rebel Coal* involved the government's collection of fines for violating the mine safety and health laws. The government obtained a judgment against the coal company for some of the fines and collected part of the judgment by garnishment. The bankruptcy trustee brought a preference suit against the government to recover the money collected by garnishment. The Sixth Circuit held that trustee's preference suit was not a compulsory counterclaim because it did not arise from the same transaction or occurrence as the government's claim for the fines.

The Sixth Circuit considered the first, second, and fourth of four factors set out in an earlier decision: (1) whether there is a logical relationship between the claim and the counterclaim; (2) whether the issues of fact and law raised by the claim and counterclaim are largely the same; (3) whether *res judicata* will bar a later suit on the counterclaim if the court refuses to hear it; (4) whether substantially the same evidence supports or refutes both the claim and the counterclaim. *Maddox v. Kentucky Finance Co.*, 736 F.2d 380, 382 (6th Cir. 1984).

According to the Sixth Circuit, the government's claim in *Rebel Coal* raised questions as to liability and amount, such as, whether coal company violated the mine safety and health laws, whether the government followed the correct procedure for imposing the fines, and whether the government correctly calculated the fines. The Sixth Circuit concluded that these issues were not related to the issues that would arise in proving the elements of a preferential transfer. 11 U.S.C. § 547(b).

The Sixth Circuit also relied on its decision in *Ashbrook v. Block*, 917 F.2d 918 (6th Cir. 1990). That case involved loans to the debtors by the Farmers Home Administration. As a result of making the loans, the administration was supposed to provide credit and management counseling to the debtors. The government filed a proof of claim for the loan debts, and the debtors counterclaimed for failure to provide the counseling and failure to make emergency loans. The Sixth Circuit held that the debtors' counterclaim did not arise from the same transaction. The Sixth Circuit compared this result to the facts of *Rebel Coal*: "Similarly, the fact that a preference is a consequence of [payment on] assessed penalties fails to establish the relationship necessary to waive immunity." *Rebel Coal*, 944 F.2d 320, 323.

The Sixth Circuit rejected the trustee's argument that the preference suit arose from the same transaction or occurrence because it required proof of an antecedent debt to the government for the fines collected by garnishment, and the government's claim required proof of a debt to the government for the unpaid fines. 11 U.S.C. § 547(b)(2). The Sixth Circuit said that this overlap of issues was not sufficient to result in a waiver of immunity since the other factors also did not support a waiver..

The Sixth Circuit's reasoning in *Rebel Coal* suggests that a suit against a creditor to recover a preferential transfer can never be a compulsory counterclaim to a claim filed by the creditor. The opinion leaves some doubt on this point, however, as a result of the Sixth Circuit's discussion of the First Circuit's decision in *WJM, Inc. v. Massachusetts Department of Public Welfare*, 840 F.2d 996 (1st Cir. 1988). *WJM* involved Medicaid payments from the government to the debtor. Shortly before the debtor's bankruptcy, the government set off payments it owed to the debtor as a means of collecting a debt from the debtor for earlier overpayments. The government filed a proof of claim for other Medicaid overpayments. The bankruptcy trustee sought to recover the set-off as a preferential transfer. The First Circuit pointed out that the mutual debts involved in the set-off (the alleged preference) arose from the same contract between the government and the debtor. The First Circuit held that the trustee's preference claim was a compulsory counterclaim for which the government had waived sovereign immunity. The Sixth Circuit distinguished *WJM* from *Rebel Coal* on the ground that the government's claim and the alleged preference in *WJM* arose from an established course of business dealings between the government and the debtor, but in *Rebel Coal* the government's assessment of fines and the garnishment to collect the fines did not arise from a course of business dealings between the debtor and the creditor.

By distinguishing *WJM*, the Sixth Circuit necessarily refrained from establishing an absolute rule that a preferential transfer suit can never be a compulsory counterclaim to a creditor's claim. The court left the door open for the lower courts to reach the opposite result on different facts. The distinction between *WJM* and *Rebel Coal* suggests a set of different facts that will justify the opposite result –when the claim filed by the creditor and the alleged preferential transfer arose in an established course of business dealings between the debtor and the creditor, especially a course of business dealings pursuant to a contract between the debtor and the creditor.

The facts of this case fit that pattern even though the course of dealing between North American and Chattanooga State was not as complex as the course of dealing in *WJM*. The transactions between North American and Chattanooga State did not require as many steps in the accounting. But the court does not see the difficulty of the accounting as a critical distinction between this case and *WJM*. Anytime the alleged preferential transfer occurs during a series of transactions, the court is likely to be concerned with more than one of the transactions – especially for the purpose of determining whether the creditor is protected by some of the defenses in § 547(c). 11 U.S.C. § 547(c)(1), (2), (4). Some or all of those defenses are likely to be relevant in this proceeding, but they were not likely to be relevant in *Rebel Coal*.

The court also doubts that the Sixth Circuit's reasoning in *Rebel Coal* was intended to reject established rules as to compulsory counterclaims. A series of transactions can give rise to a compulsory counterclaim based on some of the transactions that were not the subject of the claim. *Moore v. New York Cotton Exchange*, 270 U.S. 593, 46 S.Ct. 367, 70 L.Ed. 750 (1926); *Warshawsky & Co. v. Arcata National Corp.*, 552 F.2d

1257 (7th Cir. 1977). Likewise, a counterclaim can be compulsory even though it is based on different legal rules and requires proof of facts beyond the scope of the other side's claim. *See Southern Union Co. v. Southwest Gas Corp.*, 165 F.Supp.2d 1010 (D. Ariz. 2001); *Painter v. Harvey*, 673 F.Supp. 777 (W. D. Va. 1987), *aff'd* 863 F.2d 329 (4th Cir. 1988); *Eon Laboratories, Inc. v. Smithkline Beecham Corp.*, 298 F.Supp.2d 175 (D. Mass. 2003); *Blue Cross and Blue Shield of Alabama v. Hobbs*, 209 F.R.D. 218 (M. D. Ala. 2002).

Some courts have held that a preference action for the recovery of tax payments is not a compulsory counterclaim when the government's claim involves a different kind of tax. *Schlossberg v. Maryland (In re Creative Goldsmiths)*, 119 F.3d 1140 (4th Cir. 1997), *cert. den.*, 523 U.S. 1075, 118 S.Ct. 1517, 140 L.Ed.2d 670 (1998); *Hoffman v. Connecticut (In re Zera)*, 72 B.R. 997 (D. Conn. 1987), *aff'd on different grounds*, *Hoffman v. Connecticut Department of Income Maintenance*, 492 U.S. 96, 109 S.Ct. 2818, 106 L.Ed.2d 76 (1989).

Other courts have held that the waiver of sovereign immunity for compulsory counterclaims is constitutionally limited to set-off against the government's claim and does not allow any additional recovery from the government. *Grabscheid v. Michigan Employment Security Commission (In re C. J. Rogers, Inc.)*, 212 B.R. 265 (E. D. Mich. 1997).

On the other hand, several courts have held a preferential transfer suit to be a compulsory counterclaim to the government's claim and have allowed recovery from the government, not just set-off. *United States v. Pullman Constr. Ind., Inc.*, 153 B.R. 539 (N. D. Ill. 1993); *Ellenberg v. Dekalb County (In re Maytag Sales and Service, Inc.)*, 23 B.R.

384 (Bankr. N. D. Ga. 1982); *Graham v. United States (In re Malmart Mortg. Co.)*, 109 B.R. 1 (Bankr. D. Mass. 1989). The facts of this case support the same result. Events in the series of transactions between North American and Chattanooga State are related to the trustee's preference claim even if he does not contest North American's liability or Chattanooga State's calculation of the amount due. In light of the course of dealing between North American and Chattanooga State, the court concludes that the trustee's preference suit is a compulsory counterclaim to Chattanooga State's claim. Furthermore, the waiver of sovereign immunity for the compulsory counterclaim is not limited to allowing set-off against Chattanooga State's claim; the trustee can recover from Chattanooga State.

Finally, the court should deal with the effect of the Supreme Court's decision in *Gardner*. It established a rule of constitutional law that the state's filing of a proof of claim waives the state's sovereign immunity, but the opinion is not clear as to whether this waiver allows the recovery of money from the state; it may allow only a set-off. *Gardner v. New Jersey*, 329 U.S. 565, 67 S.Ct. 467, 91 L.Ed. 504 (1947); 11 U.S.C. §§ 106(c); *Ossen v. Department of Social Services (In re Charter Oak Associates)*, 361 F.3d 760 (2d Cir. 2004); *Grabscheid v. Michigan Employment Security Commission (In re C. J. Rogers, Inc.)*, 212 B.R. 265 (E. D. Mich. 1997). The trustee has not relied on *Gardner*, apparently because he is not yet interested in remedies other than recovering the amount of the alleged preferences. Set-off is not, however, the only other possible remedy or method by which the trustee can attempt to be fair to all creditors.

In this regard, a rule of constitutional law under which the government's filing of a claim waives sovereign immunity only for set-off and compulsory counterclaims brings up the basic problem with sovereign immunity in bankruptcy cases. Sovereign immunity

appears to favor government creditors by protecting them from rules of bankruptcy law that were intended to create a system of collecting and distributing the debtor's assets that would be fair to all creditors. Another rule of bankruptcy law makes it difficult to determine the existence of the extent of this problem. The other rule appears in § 502(d) of the Bankruptcy Code. It provides that the court shall disallow any claim of a creditor that has received an avoidable transfer and has not turned over the property or the amount for which it is liable. 11 U.S.C. § 502(d). The Supreme Court's decisions in *Gardner* and *Hood* appear to mean that sovereign immunity would not protect a government from disallowance of its claim under § 502(d). *See also New York v. Irving Trust Co.*, 288 U.S. 329, 53 S.Ct. 389, 77 L.Ed. 815 (1933). The court assumes for the purpose of argument that § 502(d) can constitutionally be applied to a claim filed by a government creditor.

Thus, the bankruptcy trustee can use § 502(d) to have the government's claim or all its claims disallowed if it has received an avoidable preferential transfer and has not paid the trustee the amount for which it would be liable under § 550. 11 U.S.C. § 550. The trustee may argue that all claims by any arm of the state government should be disallowed because one particular arm of the government received a relatively small preferential transfer and has not paid it over to the trustee. Whether all the government's claims can be disallowed depends on whether the government should be treated as a unitary creditor. *Official Committee of Unsecured Creditors v. Public Utilities Commission (In re 360networks (USA), Inc.)*, 316 B.R. 797 (Bankr. S. D. N. Y. 2004); *see also Ossen v. Department of Social Services (In re Charter Oak Associates)*, 361 F.3d 760 (2d Cir. 2004).

The limited waiver of sovereign immunity for compulsory counterclaims or set-off may be a small annoyance that convinces the trustee to use a stronger weapon, §

502(d), to attempt to be fair to all creditors. The government creditor can be put to an economic choice between waiving sovereign immunity and having some or all of its claims disallowed.

The government might attempt to avoid this problem by not filing a particular claim, but the wording of § 502(d) may render that tactic ineffective. Its success would also depend on the government's ability to coordinate action among its various departments and to review claims carefully within the time allowed for filing. The court's point, however, is a comparison of the results under § 502(d) and under § 106(b).

A constitutional rule that allows complete disallowance of the government's claim or all its claims under § 502(d) because the government has received an avoidable transfer might be viewed as inconsistent with another constitutional rule that filing a claim waives sovereign immunity only for compulsory counterclaims or set-off. Perhaps there is no constitutional inconsistency, but the different outcomes suggest the Sixth Circuit was on the right track when it decided *Hood*. The power of Congress to establish rules for dealing with creditors' claims in bankruptcy cases may give it more power to affect the states' sovereign immunity than the power of the federal courts to infer or construct a waiver of sovereign immunity by a state government when it asserts a claim in federal court and the opposing party, who is not in bankruptcy, asserts a counterclaim. In any event, since the court has already reached a decision under § 106(b) as to Chattanooga State's motion to dismiss, the court need not decide this larger and more difficult question. The court will enter an order denying the motion to dismiss.

This Memorandum constitutes findings of fact and conclusions of law as required by Fed. R. Bankr. P. 7052.

ENTER:

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R. THOMAS STINNETT
UNITED STATES BANKRUPTCY JUDGE

Entered 2/2/05