

Eleventh Amendment
In rem
Setoff
Sovereign Immunity
Abrogation of Sovereign Immunity
Waiver of Sovereign Immunity
11 U.S.C. § 106(a)
11 U.S.C. § 106(b)
11 U.S.C. § 106(c)
11 U.S.C. § 502(d)
11 U.S.C. § 547
FRBP 7012
FRCP 12(b)(1)
FRCP 12(b)(6)

Sticka v. Oregon State Lottery Commission
In Re Moore

Adv. # 03-6148-aer
Case # 601-62971-aer7

3/14/05

Radcliffe

Published

The Ch. 7 Trustee brought a preference action against the State of Oregon through its agency the Oregon State Lottery Commission. The State moved to dismiss on sovereign immunity grounds. In the main case, the State had filed a proof of claim for unpaid taxes through the Oregon Department of Revenue (ODR). Trustee objected to the claim based on § 502(d) (which would disallow the claim, so long as an avoidable transfer remained unpaid by the State), and “setoff” (which would reduce the State’s claim up to the amount of any preference judgment). The State argued sovereign immunity shielded it from the Trustee’s claim defenses.

Held:

In the adversary, the State was immune from suit, and the proceeding was dismissed. Section § 106(a) which purported to abrogate immunity was unconstitutional. Further, the State had not waived immunity because the operative facts underlying the preference adversary and the ODR’s claim did not arise from the “same transaction”, with the court declining to extend the “same transaction” test to transactions which had a mere general connection to debtor’s business.

In the claims matter, the sovereign immunity objection was overruled. Although the merits of the preference claim would need to be litigated within the ambit of both § 502(d) and “setoff”, those theories are defenses to a claim, and thus come within the “in rem” exception to Eleventh Amendment immunity. Further, the State waived immunity insofar as adjudication of defenses to the claim were involved, with setoff being limited to reduction of the claim, with no affirmative relief.

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF OREGON

In Re:)	Bankruptcy Case No.
)	601-62971-aer7
JUDY A. MOORE,)	
)	
<u>Debtor.</u>)	
)	
RONALD R. STICKA, Trustee,)	Adversary Proceeding
)	No. 03-6148-aer
Plaintiff,)	
)	
v.)	
)	
OREGON STATE LOTTERY COMMISSION,)	MEMORANDUM OPINION
)	
<u>Defendant.</u>)	

18 This matter comes before the court on Defendant Oregon State
19 Lottery Commission's (Lottery) motion to dismiss this adversary
20 proceeding, and the Chapter 7 Trustee's (Trustee) objection to the
21 Oregon Department of Revenue's (ODR) proof of claim in the main
22 case.

23 Background:

24 Debtor, Judy Moore, filed her Chapter 7 petition on April 20,
25 2001. Trustee filed this adversary proceeding to avoid a
26 preferential transfer to Lottery in the amount of \$10,000.00.

1 Lottery filed a special appearance and moved to dismiss for lack of
2 jurisdiction, based on Eleventh Amendment immunity.¹

3 In the main case, ODR filed proof of claim # 1 (the claim)
4 for \$15,026.26, \$14,988.00 of which is claimed as priority.² The
5 claim is for 1999 personal income taxes, interest and penalties
6 thereon. Trustee objected claiming Lottery is liable in the
7 preference action, asserting 11 U.S.C § 502(d) and setoff (through
8 § 106(c))³ as defenses. ODR asserted immunity as to the defenses,
9 arguing §§ 106(c), and 502(d) are unconstitutional, as applied in
10 this context. The court consolidated both matters, which after
11 briefing and argument, are ripe for decision.⁴

12 Adversary-Motion to Dismiss:

13 Rule 12 Standards:

14 Lottery brings its motion to dismiss under FRCP 12(b)(1) (as
15 incorporated by FRBP 7012(b)), based on lack of subject matter
16 jurisdiction. It has supported its motion with an affidavit. The
17 court has reviewed said affidavit in considering the motion. Savage

18
19 ¹ The Eleventh Amendment provides:
20 The Judicial power of the United States shall not be
21 construed to extend to any suit in law or equity,
22 commenced or prosecuted against one of the United States
23 by Citizens of another State, or by Citizens or Subjects
24 of any Foreign State.
25 U.S. Const. amend XI.

26 ² Lottery has not filed a claim in this case.

³ Except as otherwise noted, all subsequent statutory references are to
Title 11 of the United States Code.

⁴ The United States was given an opportunity under 28 U.S.C. § 2403 to
intervene to defend the constitutionality of the applicable statutes. It has not
done so.

1 v. Glendale Union High School, 343 F.3d 1036, 1040, n.2 (2003),
2 cert. den., ___ U.S. ___, 124 S.Ct. 2067, 158 L. Ed.2d 618, (2004).⁵

3 Abrogation:

4 Lottery has raised an Eleventh Amendment immunity defense.
5 Trustee has raised §106(a), which abrogates that immunity with
6 respect to actions under §§ 547, 550 and 551 as pled here⁶. In
7 Mitchell v. Franchise Tax (In Re Mitchell), 209 F.3d 1111 (9th Cir.
8 2000), the court held §106(a) unconstitutional⁷ as applied to the
9 states because in enacting this statute, Congress was not acting

10
11
12
13
14
15 ⁵ [R]ule 12(b)(1) attacks on jurisdiction can be either
16 facial, confining the inquiry to allegations in the
17 complaint, or factual, permitting the court to look
18 beyond the complaint. Once the moving party has
19 converted the motion to dismiss into a factual motion by
20 presenting affidavits or other evidence properly brought
21 before the court, the party opposing the motion must
22 furnish affidavits or other evidence necessary to satisfy
23 its burden of establishing subject matter jurisdiction.

24 Savage, supra. (internal citations omitted)

25 ⁶ Section 106(a) provides in pertinent part:

26 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 ...502... 547... 550... 551...
of this title.

27 ⁷ Mitchell's holding has recently been reaffirmed in dicta. Krystal Energy
28 Co. v. Navajo Nation, 357 F.3d 1055, 1056, n.2 (9th Cir. 2004), cert. den., ___
U.S. ___, 125 S.Ct. 99, 160 L. Ed.2d 118 (2004).

1 pursuant to a valid power to abrogate.⁸ Thus, Plaintiff may not
2 rely on § 106(a).

3 Waiver

4 Trustee also argues Lottery waived any immunity by virtue of
5 ODR's claim. In Schulman v. California (In re Lazar), 237 F.3d 967
6 (2001), the court discussed the extent to which a state waives its
7 immunity by filing a proof of claim in bankruptcy, as established in
8 Gardner v. New Jersey, 329 U.S. 565, 67 S.Ct. 467, 91 L.Ed. 504
9 (1947). The Lazar court held that "when a state or an 'arm of the
10 state' files a proof of claim in a bankruptcy proceeding, the state
11 waives its Eleventh Amendment immunity with regard to the bankruptcy
12 estate's claims that arise from the same transaction or occurrence
13 as the state's claim." Id. at 978.⁹ A "logical relationship" test

14
15 ⁸ The Supreme Court in Tennessee Student Assistance Corp. v. Hood, 541 U.S.
16 440, 124 S.Ct. 1905, 148 L. Ed. 2d 764 (2004) had, but avoided, the issue of
17 § 106(a)'s constitutionality, basing its decision on the "in rem" exclusion to
18 the Eleventh Amendment. Trustee has not raised the "in rem" exclusion as a
19 defense to the immunity defense in the preference adversary. It should be noted
20 that in Hood the court, in dicta, distinguished a § 523(a)(8) student loan
discharge suit from a suit by a bankruptcy trustee to recover a preference, as
here. Id. at ___, 124 S. Ct. at 1914. That dicta notwithstanding, it appears the
only court to consider the issue post-Hood, has held the avoidance portion of a
suit under § 547 is "in rem," although any recovery under § 550 would probably
not be. Official Committee of Unsecured Creditors v. PUC of California (In re
360NETWORKS (USA) INC.), 316 B.R. 797 (Bankr. S.D.N.Y. 2004).

21 ⁹ The Bankruptcy Code section encompassing this type of waiver is § 106(b)
22 which provides:

23 A governmental unit that has filed a proof of claim
24 in the case is deemed to have waived sovereign immunity
25 with respect to a claim against such governmental unit
26 that is property of the estate and that arose out of the
same transaction or occurrence out of which the claim of
such governmental unit arose.

The Ninth Circuit Court of Appeals, although opining that §106(b) is a
(continued...)

1 (the same as FRCP 13(a)'s test for compulsory counterclaims) was
2 adopted to see if the "same transaction" requirement was met. Id. at
3 979.

4 A logical relationship exists when the counterclaim
5 arises from the same aggregate set of operative facts
6 as the initial claim, in that the same operative facts
7 serve as the basis of both claims or the aggregate
8 core of facts upon which the claim rests activates
9 additional legal rights otherwise dormant in the
10 defendant.

11 Id. (quoting Pinkstaff v. U.S. (*In Re Pinkstaff*), 974 F.2d 113, 115
12 (9th Cir. 1992)); Montana v. Goldin (*In Re Pegasus Gold Corp.*), 394
13 F.3d 1189 (9th Cir. 2005).

14 Trustee, citing Wyoming Dept. of Transportation v. Straight
15 (*In Re Straight*), 143 F.3d 1387 (10th Cir. 1998),¹⁰ contends the
16 "same transaction" test is met because ODR's claim for 1999 personal
17 income taxes and the antecedent debt paid by debtor which forms the
18 basis of Trustee's preference suit,¹¹ both arise from the operation
19 of debtor's business in 1999. Assuming, for argument's sake, that

20 ⁹(...continued)
21 codification of the Gardner waiver rule, has nevertheless refrained from passing
22 on its constitutionality, instead relying on Gardner. California Franchise Tax
23 Board v. Jackson, (*In Re Jackson*), 184 F.3d 1046 (9th Cir. 1999).

24 ¹⁰ In Straight, the court held the state's claims for unemployment taxes and
25 worker's compensation premiums and debtor's violation of stay claim for
26 decertifying debtor as a disadvantaged business enterprise, arose out of the same
transaction because they were directly related to the operation of debtor's
business.

¹¹ Gerold Floyd's affidavit submitted in support of Lottery's motion
indicates the debtor was president of a corporation named Ulan Enterprises, Inc.,
which had contracted with Lottery to sell lottery games, retain a percentage of
the proceeds as a commission, and remit the balance to Lottery. In November,
1999, Lottery terminated this contract. At that time Ulan owed Lottery
approximately \$14,661.00. In March, 2001, Ulan, Debtor and Lottery settled this
debt. Pursuant to the settlement agreement, Debtor paid Lottery \$10,000, which
Trustee now seeks to recover as a preference.

1 debtor's personal income taxes arose from the operation of her
2 business,¹² a "same transaction" rule based on mere connection to
3 the debtor's business, would pierce the immunity defense for
4 basically any non-consumer claim. This court does not believe the
5 "same transaction" test can stretch that far.

6 Here, it has not been shown that debtor's payment of
7 \$10,000.00 to settle Lottery's claim based on the sales of lottery
8 games, and debtor's liability for personal income tax, share the
9 same "operative facts" so as to have a logical relationship. This
10 conclusion is supported by the Lazar court's ruling that the state's
11 claims there (which were not based on underground storage tank fees
12 for which the trustee in his suit sought reimbursements, yet were
13 still related to the debtor's business including claims attributable
14 to use, fuel, sales, and local taxes), were not logically related to
15 the trustee's claims. Id. at 979. This court concludes that there
16 has been no waiver under the "same transaction" test by virtue of
17 ODR's claim.¹³

18
19 ¹² Trustee has adduced no evidence to make this connection.

20 ¹³ Lottery, at least in its written submissions, has also asked for
21 dismissal based on failure to state a claim under FRCP 12(b)(6), arguing it was a
22 not a "creditor" of debtor, but rather of debtor's corporation, there was no
23 payment on an "antecedent debt, and alternatively, the funds paid were not
24 debtor's, but rather held in trust for Lottery. As support, it has adduced the
25 above- noted affidavit of Gerold Floyd.

26 Lottery's FRCP 12(b)(6) motion will be denied. The complaint adequately
states a preference claim under § 547. Unlike the jurisdictional issues
discussed above, for purposes of a motion to dismiss under Rule 12(b)(6), the
court does not look outside the pleadings, Hal Roach Studios, Inc. v. Richard
Feiner and Co. Inc., 896 F.2d 1542, 1555, n.19 (9th Cir. 1990), and assumes the
truth of all well-pled facts. North Slope Borough v Rogstad (In Re Rogstad), 126

(continued...)

1 Main Case-Objection to Claim:

2 § 502(d):

3 Trustee in the main case has raised § 502(d) as a defense to
4 ODR's claim. That section provides in pertinent part as follows:

5 Notwithstanding subsections (a) and (b) of this
6 section, the court shall disallow any claim of any
7 entity from which property is recoverable under
8 section ... 550 ... of this title or that is a
9 transferee of a transfer avoidable under section ...
547 ... of this title, unless such entity or
transferee has paid the amount, or turned over any
such property, for which such entity or transferee is
liable under section ... 550... of this title.

10 ODR has asserted sovereign immunity as a defense to Trustee's
11 objection. In turn, Trustee argues immunity has been abrogated,
12 waived and/or the "in rem" exclusion applies.

13 As to abrogation, § 106(a) (although incorporating § 502(d)
14 in its scope), as discussed above, is unconstitutional as applied to
15 ODR. As such, immunity has not been abrogated.

16 As to the "in rem" exclusion, ODR argues that applying
17 § 502(d) is simply a back-door way of litigating a positive claim
18 against Lottery after dismissal of the preference adversary. The
19 court disagrees. Section 502(d) does not purport to give Trustee an
20 affirmative claim. It merely provides for disallowance of ODR's
21 claim if the State of Oregon [through Lottery] received an

22 _____
23 ¹³(...continued)
24 F.3d 1224, 1228 (9th Cir. 1997)(citations omitted). Mr. Floyd's affidavit, for
25 purposes of the Rule 12(b)(6) motion, has not been considered or relied upon,
26 thus, Lottery's motion has not been converted into one for summary judgment
under FRCP 12(b). Anderson v. Angelone, 86 F.3d 932, 934 (9th Cir. 1996); see,
also, Safe Air For Everyone v. Meyer, 373 F.3d 1035 (9th Cir. 2004) (court may
review evidence beyond the complaint involving an attack on jurisdiction without
turning the motion into one for summary judgment).

1 avoidable transfer. The State can extricate itself from
2 disallowance by paying the bankruptcy estate the value of the
3 avoided transfer.

4 Section 502(d) is, in essence, an affirmative defense to a
5 claim, El Paso City of Texas v. America West Airlines, Inc., (*In Re*
6 *America West Airlines Inc.*), 217 F.3d 1161 (9th Cir. 2000); Parker
7 North American Corp. v. Resolution Trust Corp. (*In Re Parker North*
8 *American Corp.*), 24 F.3d 1145 (9th Cir. 1994), and can be maintained
9 even when the statute of limitations on the underlying avoidance
10 action has run. America West, supra. It is part of the claims
11 process, which is an "in rem" proceeding that does not offend a
12 state's sovereignty. PUC of California, supra.¹⁴

13 Even if the "in rem" exception does not apply to § 502(d),
14 waiver does. It is well settled that a state waives immunity when
15 it files a proof of claim, with respect to adjudication of the proof
16 of claim. State Board of Equalization v. Harleston, (*In Re*
17 *Harleston*), 331 F.3d 699 (9th Cir. 2003). "Adjudication of the
18 claim" necessarily includes adjudication of defense/objections to
19 the claim, including a § 502(d) affirmative defense.

20 The Gardner court, in deciding that bankruptcy jurisdiction
21 existed to determine the amount of a state's claim and the priority
22 of its lien, stated:

23
24 ¹⁴ The Supreme Court, in Hood, cited Gardner (which dealt with the
25 consequences of a state filing a proof of claim), with approval as an example of
26 an "in rem" type matter. Hood, 541 U.S. at ___, 124 S.Ct. at 1912, 158 L. Ed. 2d
at ___(2004). Although technically a "waiver" case, Gardner noted that claims
adjudication is "an adjudication of interests claimed in a res." Id. 329 U.S. at
574, 67 S.Ct. at 472 (emphasis added).

1 When a State files a proof of claim in the
2 reorganization court, it is using a traditional method
of collecting a debt....

3 It is traditional bankruptcy law that he who
4 invokes the aid of the bankruptcy court by offering a
5 proof of claim and demanding its allowance must abide
6 the consequences of that procedure. If the claimant
7 is a State, the procedure of proof and allowance is
8 not transmuted into a suit against the State because
9 the court entertains objections to the claim. The
10 State is seeking something from the debtor. No
11 judgment is sought against the State. The whole
12 process of proof, allowance, and distribution is,
shortly speaking, an adjudication of interests claimed
in a res. It is none the less such because the claim
is rejected in toto, reduced in part, given a priority
inferior to that claimed, or satisfied in some way
other than payment in cash. When the State becomes
the actor and files a claim against the fund, it
waives any immunity which it otherwise might have had
respecting the adjudication of the claim.

13 Gardner, 329 U.S. at 573-74, 67 S.Ct. at 471-72 (internal citations
14 omitted).

15 Setoff:

16 Trustee has also raised "setoff" as a defense to ODR's
17 claim. Again, ODR has defended on sovereign immunity grounds, and
18 Trustee has raised the "in rem" exclusion and "waiver".

19 "Setoff" has been likened in some contexts to an affirmative
20 action, and not a defense. Gibson v. U.S. (*In Re Gibson*), 176 B.R.
21 910 (Bankr. D. Or. 1994)(statute of limitations applies to claim
22 asserted by "setoff"). On the other hand, a "setoff" which simply
23 goes to reduce a claim, has been held to be a "defense" to payment,
24 see, e.g., In Re Silver Eagle Co., 262 B.R. 534 (Bankr. D. Or.
25 2001); see also, Jobin v. Arnot (*In re M & L Business Machine Co.*),
26 178 B.R. 270 (Bankr. D. Co. 1995) (setoff is an affirmative defense,

1 so long as no affirmative recovery is sought), and as such would
2 appear to be part of the "in rem" claims adjudication process.

3 "Waiver" of immunity has also been raised by Trustee in the
4 "setoff" context. The waiver involves claims that don't arise from
5 the "same transaction" as the state's. The argument is that by
6 filing a proof of claim, a state waives immunity as to any claim a
7 trustee has (regardless of whether it arises from the same
8 transaction) but such claim may only be used to setoff against the
9 state's claim¹⁵ up to the amount of that claim,¹⁶ (i.e. no positive
10 recovery is permitted).¹⁷ The majority rule appears to uphold this
11 limited waiver. Ossen, supra;¹⁸ Zayler v. Dept. of Agriculture (*In*
12 *Re Supreme Beef Processors, Inc.*), 391 F.3d 629 (5th Cir. 2004); In
13 Re Microage Corp., 288 B.R. 842 (Bankr. D. Az. 2003). This court

14
15 ¹⁵ Lottery and ODR do not defend on the basis that they are different
16 creditors/governmental units, as the Ninth Circuit follows the "unitary creditor"
17 theory. Doe v. U.S., 58 F.3d 494 (9th Cir. 1995).

18 ¹⁶ Here, ODR's claim exceeds Trustee's preference claim.

19 ¹⁷ At least one court, Ossen v. Dept. of Social Services (*In Re Charter Oak*
20 *Associates*), 361 F.3d 760 (2nd Cir. 2004) has opined that this form of limited
21 waiver has been codified in § 106(c), and that section is constitutional.

22 Section 106(c) provides:

23 Notwithstanding any assertion of sovereign immunity
24 by a governmental unit, there shall be offset against a
25 claim or interest of a governmental unit any claim
26 against such governmental unit that is property of the
estate.

27 ¹⁸ The court in Ossen stated that the Fourth Circuit, in Schlossberg v.
28 Maryland (*In Re Creative Goldsmiths of Washington, D.C., Inc.*), 119 F.3d 1140 (4th
29 Cir. 1997) only allowed waiver as to compulsory counterclaims. However, in fact,
30 the Schlossberg court expressly left open the issue of waiver as to setoffs. Id.
at 1149-50. In the Ninth Circuit, the court in Goldin, supra, was not presented
with any "setoff" or §106(c) issues.

1 will follow the majority rule because the rule does not expose the
2 state to positive recovery by Trustee, but merely allows the state's
3 claim to be reduced.

4 Conclusion:

5 Based upon the foregoing, the State of Oregon, State Lottery
6 Commission's Motion to Dismiss this adversary proceeding should be
7 granted, further proceedings should be had with respect to the
8 trustee's objection to the Oregon Department of Revenue's proof of
9 claim. An order consistent herewith shall be entered.

10 The above constitute the court's findings of fact and
11 conclusions of law pursuant to FRBP 7052. They shall not be
12 separately stated.

13

14

15

16

17

ALBERT E. RADCLIFFE
Chief Bankruptcy Judge

18

19

20

21

22

23

24

25

26