

I

On November 12, 1986, the Commonwealth of Kentucky Natural Resources and Environmental Protection Cabinet (the “Cabinet”), a governmental agency, obtained a default judgment in a Kentucky state court against Jimmy L. Hess for civil penalties arising out of his mining activities in Kentucky. In July 1996, the Cabinet domesticated the judgment in a Virginia state court.

After the Cabinet attempted to garnishee Hess’ wages in Virginia, Hess filed a Chapter 7 bankruptcy petition. In the course of the bankruptcy proceedings, the Cabinet filed a proof of claim on its judgment for \$75,864.24. Hess did not object to the Cabinet’s proof of claim. Hess received his Chapter 7 discharge on June 12, 1998. The Cabinet continued its efforts to collect on the debt.

On November 15, 1999, Hess initiated a Chapter 13 bankruptcy petition and filed an adversary proceeding seeking a determination that the Kentucky judgment either (1) was void because of invalid service of process in the underlying state action, or (2) had been discharged in Hess’ 1998 Chapter 7 bankruptcy proceeding. It is undisputed that Hess did not meet the qualifications for Chapter 13 relief, and the bankruptcy court dismissed the case.¹ The bankruptcy court did, however, reopen Hess’ Chapter 7 proceeding and transferred the adversary proceeding to that case.

¹ See 11 U.S.C.A. § 109(e) (West 1993).

In a decision dated July 31, 2000, the bankruptcy court (Stone, J.) held that sovereign immunity prevented the court from adjudicating the validity of the judgment. In the alternative, Judge Stone found that in light of the availability of a state court forum in Kentucky for Hess to attack the validity of the judgment, it was appropriate for the court to abstain from determining the issue.² In a subsequent decision dated October 6, 2000, Judge Stone held that the Cabinet's claim for civil penalties had not been discharged in the Chapter 7 case because it constituted an exception to discharge pursuant to 11 U.S.C.A. § 523(a)(7) (West 1993 & Supp. 2000). Hess noted an appeal from these decisions.

The issues on appeal, as identified by Hess in his brief, are (1) whether the bankruptcy court erred in abstaining from considering the debtor's challenge to the validity of the judgment, and (2) whether I should follow the holding of Judge Williams of this court in *Kentucky Natural Resources & Environmental Protection Cabinet v. Seals*, 161 B.R. 615, 621 (W.D. Va. 1993), in which he found the Cabinet's civil penalties to be non-dischargeable in Chapter 7 proceedings. In response, the appellee seeks to uphold the bankruptcy court's decision, including its holding that the Cabinet was entitled to sovereign immunity.

The parties have briefed the issues, and the appeal is ripe for decision.

² See 28 U.S.C.A. § 1334(c) (West 2000).

II

In its decision of July 31, 2000, the bankruptcy court held that the Cabinet “has not waived any claim of sovereign immunity as to a determination of the validity of its original judgment.” Sovereign immunity, as provided in the Eleventh Amendment, bars the judiciary branch’s jurisdiction over a “suit in law or equity” against a state. U.S. Const. amend. XI; *see also Hans v. Louisiana*, 134 U.S. 1, 16-17 (1890); *Seminole Tribe v. Florida*, 517 U.S. 44, 54 (1996). A state may waive sovereign immunity, but such waivers must be express and will be narrowly construed. *See Port Auth. Trans-Hudson Corp. v. Feeney*, 495 U.S. 299, 305-06 (1990). Therefore, in finding that the Cabinet had not waived sovereign immunity as to the determination of validity of the original judgment, the bankruptcy court acknowledged that it lacked jurisdiction to decide the issue.³

An adversary proceeding in bankruptcy qualifies as a “suit” under the Eleventh Amendment, thereby entitling a state to a claim of sovereign immunity. *See Schlossberg v. Maryland (In re Creative Goldsmiths of Wash. D.C., Inc.)*, 119 F.3d

³ The plaintiff contends that the bankruptcy court did not sustain the Cabinet’s plea of sovereign immunity, but rather based its decision on abstention under 28 U.S.C.A. § 1334(c). A plain reading of the bankruptcy court’s order of July 31, 2000, however, shows that the court did hold that sovereign immunity barred its consideration of the issue, and that abstention was merely an alternative holding. Regardless of the basis for the court’s holding, however, sovereign immunity is a jurisdictional bar that may be considered for the first time on appeal, even if not raised in the court below. *See Edelman v. Jordan*, 415 U.S. 651, 677-78 (1974).

1140 (4th Cir. 1997); *Univ. of Va. v. Robertson*, 243 B.R. 657, 661 (W.D. Va. 2000). Therefore, the bankruptcy court had no jurisdiction to hear the adversary proceeding unless the state had waived sovereign immunity as to the issues to be decided. The issue in this case is whether the Cabinet's filing of a proof of claim in Hess' Chapter 7 proceeding constituted a waiver of sovereign immunity, allowing the bankruptcy court to rule on the validity of the original judgment. I agree with the bankruptcy court that the Cabinet's filing of a proof of claim waived sovereign immunity as to the issue of the dischargeability of the debt, but not as to the issue of the underlying validity of the claim.

When a state entity is a creditor in bankruptcy, it “voluntarily . . . invoke[s] federal process in a federal forum, [and] thereby consents to the federal forum’s rules of procedure and may not invoke sovereign immunity to protect itself against the interposition of defenses to its action.” *Schlossberg*, 119 F.3d at 1148. This waiver of sovereign immunity as to its bankruptcy claim, however, is to be construed narrowly. *See id.*

Because the present case arose in an adversary proceeding, Kentucky’s sovereign immunity is implicated. *See Collins*, 173 F.3d at 929 (indicating that adversary proceedings are “suits” under the Eleventh Amendment); *Univ. of Va.*, 243 B.R. at 661 (concluding that adversary proceeding was “suit” under the Eleventh

Amendment). However, I find that by filing a proof of claim, the Cabinet waived its sovereign immunity as to the determination of the dischargeability of that debt.

In *Collins*, the Fourth Circuit held that sovereign immunity did not bar the bankruptcy court from reopening a Chapter 7 case to determine whether a state creditor's claim was dischargeable. *See* 173 F.3d at 929. In that case, however, the court found that because the debtor had not brought an adversary proceeding against the state, sovereign immunity did not apply because no "suit" had been brought against the state within the meaning of the Eleventh Amendment. *See id.* Thus, the bankruptcy court had jurisdiction over the bankruptcy estate, which includes the power to determine which debts are dischargeable and which are not. *See id.* at 930.

By filing a proof of claim against the debtor in the Chapter 7 proceeding, the Cabinet waived its sovereign immunity as to the bankruptcy court's authority to determine the dischargeability of that claim. In such an inquiry, the court looks only to the nature of the statute under which the original judgment was rendered, and does not examine the facts of the particular case, nor the procedures of the state court that decided it. *See Seals*, 161 B.R. at 620. As stated in *Collins*, "[i]f a state could assert Eleventh Amendment immunity to avoid the effect of a discharge order, the bankruptcy system would be seriously undermined." *Collins*, 173 F.3d at 930. Furthermore, this court's decision in *Seals*, which originated as an adversary proceeding against the same

state defendant as in the present case, provides precedent that a court can examine the question of the dischargeability of a state's claim against a debtor. *See generally Seals*, 161 B.R. 615. Therefore, sovereign immunity did not bar the bankruptcy court from determining whether Hess' debt to the Cabinet had been discharged.

The Cabinet's waiver of sovereign immunity as to the issue of dischargeability does not, however, mean that sovereign immunity is waived as to all issues that may arise in the adversary proceeding. As the Fourth Circuit stated in *Schlossberg*, "well-established principles of sovereign immunity dictate that [a] waiver be narrowly construed." 119 F.3d at 1148. The test for determining whether a state-filed proof of claim in a bankruptcy case has waived sovereign immunity as to other issues arising in the bankruptcy case is whether the issue raised would amount to a compulsory counterclaim. *See id.* Thus, the issue raised must have arisen from the "same transaction or occurrence" as the state's claim as a creditor. *Id.* at 1149. In determining whether two issues arise from the same transaction or occurrence to mandate a compulsory counterclaim, the Fourth Circuit generally focuses on the "evidentiary similarity" in proving the issues. *Painter v. Harvey*, 863 F.2d 329, 331-32 (4th Cir. 1988). Thus, if essentially the same evidence could prove both of the issues, then the "same transaction or occurrence" test is met.

Applying these principles to the present case, the “compulsory counterclaim” test is not met. Whereas the determination of the dischargeability of the debt requires only an examination of the statute by which the judgment was brought, the determination of the validity of the judgment would require an inquiry into state court procedures. Hess claims that when the Cabinet’s action was brought against him in Kentucky in 1986, the sheriff’s deputy improperly served process on Hess’ bookkeeper rather than on Hess himself. (*See* Br. of Appellant at 6.) The evidence that would be presented to prove and refute Hess’ claim is far different from that required to determine the dischargeability question. While the dischargeability issue only requires an examination of Kentucky’s statutes, the validity issue would likely require the testimony of Hess, the sheriff’s deputy, and the bookkeeper, at the least. Such an inquiry would be far off the mark of the issue that the Cabinet consented to by filing its proof of claim.

Two federal appellate decisions provide guidance on the issue of a sovereign immunity waiver in bankruptcy adversary appeals. In *Schlossberg*, a Fourth Circuit case, the court held that a state’s proof of claim as to the debtor’s sales and withholding taxes did not waive sovereign immunity as to the validity of the debtor’s corporate income taxes, for which no proof of claim was filed. *See Schlossberg*, 119 F.3d at

1149. The court expressly reserved a holding as to the debtor's defenses regarding the sales and withholding taxes, for which the state had filed a proof of claim. *See id.*

A case from the Sixth Circuit, however, proves a closer factual analogy to the present case. In *French v. Ga. Dep't of Revenue (In re Abepp Acquisition Corp.)*, 215 B.R. 513 (B.A.P. 6th Cir. 1997), the state had filed a proof of claim for sales tax penalties against the debtor. The Chapter 7 trustee brought an adversary proceeding against the state seeking to recover monies paid to the state under the allegation that one of the state's sales tax statutes was unconstitutional. *See id.* at 514. After quoting heavily from the *Schlossberg* opinion, the court held that the trustee had "failed to carry his burden of establishing that the issues of law and fact raised by his claim to recover the tax paid . . . are largely the same and would involve substantially the same evidence as the . . . proof of claim." *Id.* at 518. Thus, the court held that sovereign immunity prevented the court from deciding the issue in the adversary proceeding.

Schlossberg and *French* confirm that the evidence necessary to prove an issue is key to determining whether sovereign immunity for that issue has been waived by the state's filing of a proof of claim. Because the evidence necessary to prove Hess' claim that he was not properly served in Kentucky in 1986 would be different from that needed to determine whether the state's claim had been discharged in the Chapter 7 bankruptcy proceeding in 1998, I find that the Cabinet's sovereign immunity as to the

issue of the validity of the judgment was not waived by its proof of claim filing. Therefore, the bankruptcy court did not err in refusing to decide that issue on the ground of sovereign immunity.⁴

III

I also affirm the bankruptcy court's grant of summary judgment to the Cabinet on the ground that its claim was non-dischargeable under § 523(a)(7) of the Bankruptcy Code.⁵ In *Seals*, this court held that civil penalties imposed by the Cabinet are penal in nature, and therefore are excepted from discharge under § 523(a)(7). *See* 161 B.R. at 621. The appellant has never suggested that the penalties imposed upon the *Seals* debtor were different in any significant way from those imposed on Hess.⁶ Moreover, he has articulated no persuasive reason for me to reject this precedent, and I decline to do so. Thus, the bankruptcy court did not err in finding that the debt had not been discharged.

⁴ In view of my holding, I need not decide whether the bankruptcy court was correct in its alternative decision based on abstention.

⁵ A debtor is not discharged under § 523(a)(7) from any debt to the extent that it is “for a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit, and is not compensation for actual pecuniary loss” 11 U.S.C.A. § 523(a)(7).

⁶ For example, he does not contend that the penalties imposed upon him represented compensation for actual pecuniary loss, a crucial issue under § 523(a)(7) and *Seals*.

IV

For the foregoing reasons, the decision of the bankruptcy court will be affirmed.

DATED: March 21, 2001

United States District Judge