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In Re Soledad: The Bankruptcy Court's Jurisdiction over Funds Earned by Bankrupt When Multiple Government Claimants Assert Sovereign Immunity and a Right to Set-Off

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IN RE SOLEDAD: THE BANKRUPTCY COURT'S JURISDICTION OVER FUNDS EARNED BY BANKRUPT WHEN MULTIPLE GOVERNMENT CLAIMANTS ASSERT SOVEREIGN IMMUNITY AND A RIGHT TO SET-OFF

In In re Soledad *the United States Government asserted a "monolith theory" of sovereign immunity whereby one agency of the government has the power and right to withhold and set-off a bankrupt's earned but unpaid funds for the benefit of another agency. This Comment analyzes the Government's claim beyond the factual limitations of* Soledad *and introduces two series of cases that respectively allow and deny the Government's claim. The Comment concludes by examining the 1978 Bankruptcy Act, discussing its effect upon the doctrine of sovereign immunity and calling for the abrogation of the doctrine whenever the Government holds property that belongs to the bankrupt estate.*

During the years 1973, 1974, and 1975, Soledad Enterprises, Inc., entered into a series of eight contracts with the United States Navy to perform various custodial maintenance and yard-care functions at Navy bases in California. Soledad's performance of each of the eight contracts was deficient. As a result of Soledad's inability to perform adequately, the Navy took various remedial actions, including self-help and reference to Soledad's surety.[1]

In late May and early June, 1975, the Navy terminated five of the contracts for alleged defaults in performance. The three remaining contracts, completed by Soledad, became the subject of various disputes. The principal issues concerned the inadequacy of the work and Soledad's right to compensation under the contracts. Soledad submitted its claim for funds earned but retained

1. In Financial Indemnity Co. v. Usery, No. 76-2439 (N.D. Cal., filed Nov. 2, 1976) (transferred to S.D. Cal., Feb. 23, 1978), Soledad's surety, Financial Indemnity Co., filed a separate lawsuit against the Secretary of Labor and the Secretary of the Navy to cover its losses. The resolution of that case and the presence of Financial Indemnity in *In re* Soledad are inconsequential to the issues this Comment will examine. Therefore, all references and subissues relating to Financial Indemnity have been omitted.

by the Navy to a contracting officer pursuant to the disputes clauses of the respective contracts. On August 4, 1977, the contracting officer rendered his final decision.[2] The contracting officer deducted from the amounts earned both alleged administrative costs incurred by the Navy and assessments for unpaid wages by the Department of Labor.[3]

The Navy, as a branch of the executive department, declared that it had the power to determine assessments and set-off claims of other agencies within the executive department. However, on May 13, 1975, more than two years *prior* to the contracting officer's final decision and subsequent affirmation by the Armed Services Board of Contract Appeals, Soledad had filed for bankruptcy.[4] Soledad's trustee later filed a complaint[5] with the bankruptcy court seeking the turnover of property held by the Navy consisting of the earned but unpaid sums of money from the completed contracts.

In answer to the turnover motion,[6] the Navy filed a motion to dismiss the complaint on the ground of lack of summary jurisdic-

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2. Department of the Navy, Final Dec. No. 77-97 (Aug. 4, 1977):

Contract No.	Earned by Bankrupt (but unpaid)	
N62474-74-C-1923	$17,333.39	
N62474-74-C-1922	2,803.87	
N62474-74-C-2051	10,845.82	
N62474-73-C-3195	15,233.92	
N62474-75-C-3345	11,583.31	
N62474-73-C-3484	8,190.60)	retained by
N62474-74-C-3235	288.00)	Navy
N62474-74-C-3236	1,646.00)	
	$64,924.91	

3. The Navy withheld funds in contract nos. N62474-73-C-3484, N62474-74-C-3235 and N62474-74-C-3236 pursuant to the Department of Labor request and in order to satisfy partially a prior lien filed by the IRS.

4. *In re* Soledad Enterprises, No. 75-1354 (S.D. Cal. March 20, 1978).

5. On May 27, 1977, the trustee filed a complaint for turnover and restitution with the bankruptcy court, Judge Herbert Katz presiding. *See In re* Soledad Enterprises, No. 75-1354 (S.D. Cal. March 20, 1978).

6. A turnover motion consists of a written complaint which affirmatively alleges that the party to whom the motion is directed has the requisite possession and control of the property and that such property is under the summary jurisdiction of the bankruptcy court. The turnover order, if issued by the bankruptcy court, directs the adverse holder to "turn over" such property to the receiver or trustee. The turnover proceeding is "essentially . . . for restitution rather than indemnification, with some characteristics of a proceeding *in rem*; the primary condition of relief is possession of existing chattels or their proceeds capable of being surrendered by the person ordered to do so." Maggio v. Zeitz, 333 U.S. 56, 62-63 (1948).

tion,[7] submitting the contracting officer's final decision as evidence of the Navy's adverse claim[8] to the funds in question. The issues facing the bankruptcy court were based on three diverse factors:

(1) The jurisdiction of the bankruptcy court as determined by the possession of the res (actual or constructive) and the nature of the Navy's claim (adverse or merely colorable);

(2) The propriety of the Navy's actions including (a) set-off, (b) retention of funds for the benefit of the IRS and the Department of Labor, and (c) independent assessments of administrative costs;

(3) The concept of sovereign immunity and the right of the trustee to sue the Navy.

Judge Herbert Katz conceptualized the dismissal motion as follows:

> If the Navy is entitled to hold those funds for those two other agencies of the government [IRS and Labor Department] under some claim that it, the Navy, as an agency, is holding for other agencies, thereby making the whole matter one claim, then perhaps the Navy's claim would be more than merely colorable[9] and jurisdiction would not lie.
>
> The Navy argues for this proposition on the theory that an agency or administrative body of the executive branch are not juridical persons, but are strictly representatives of the United States who may not be sued to evade sovereign immunity. That therefore any suit against any agency is a suit against the United States. Hence since a suit against the Navy, the IRS or the Department of Labor is really a suit against the United States, the Navy as one instrumentality of the United States may withhold funds for the benefit of any other instrumentality of the United States and that constitutes a substantial adverse claim to the funds so as to oust the Bankruptcy Court of jurisdiction.[10]

Because of actions by the IRS before Soledad filed its bankruptcy petition, the above issues were not decided within the context of *In re Soledad*. The IRS had filed tax liens totalling $174,958.80 and had served a notice of levy[11] on Soledad before

7. For a discussion of the basis of summary jurisdiction, *see* text accompanying notes 18-27 *infra*.

8. For a discussion of the distinction between adverse and merely colorable claims, *see* notes 29-30 and accompanying text *infra*.

9. *Id.*

10. *In re* Soledad Enterprises, No. 75-1354, at 4-5 (S.D. Cal. March 20, 1978) (order granting dismissal motion). The Navy's position is hereinafter referred to as the "monolith" theory.

11. Notice of levy is notice and opportunity for a taxpayer to question the extent and validity of a tax claim against his property before such taxes become irrevocably fixed as a charge against his property. 84 C.J.S. *Taxation* § 359 (1954).

Soledad filed its bankruptcy proceeding. The holding of *Phelps v. United States*[12] governed the outcome of *In re Soledad*. In *Phelps*, the Supreme Court held that when the United States has served a bankrupt taxpayer's assignee with a valid notice of levy, it takes constructive custody of cash proceeds in the assignee's possession. The Supreme Court concluded that neither the bankrupt nor the receiver can assert a claim to those proceeds.

Judge Katz concluded that the bankruptcy court lacked summary jurisdiction over the Navy, the holder of the funds, and granted the Navy's motion to dismiss. The case was dismissed in toto because the funds in question had been reduced to the constructive possession of the IRS and exceeded the amount of Soledad's claim.

The holding in *In re Soledad* did not adversely affect the status or effectiveness of the bankruptcy court. However, repercussions of the future acceptance of the Government's position in *Soledad* could greatly curtail both the power and jurisdiction of the bankruptcy court. If, in relation to a bankruptcy proceeding, a suit against any governmental agency were to be construed as a suit against the United States, then the United States could determine the claims of various governmental agencies, including their priority and amount, outside the proceeding.

This Comment will examine the three issues raised in *Soledad* beyond the factual limitations imposed by the notice of levy and by the holding of *Phelps*. The analysis will center upon the Government's claim of sovereign immunity and will discuss its effect on the jurisdiction of the bankruptcy court and the right to set-off. In conclusion, this Comment will call for an expansion of the bankruptcy court's powers as exemplified by the recent Bankruptcy Act reform.[13]

BACKGROUND

Jurisdiction

The Constitution grants Congress the power to create bankruptcy courts and to establish a uniform system of bankruptcy throughout the United States.[14] Although Congress could grant complete and exclusive jurisdiction over all bankruptcy matters to the bankruptcy courts, it has not done so.[15] Instead, Congress

12. 421 U.S. 330 (1975).

13. *See* text accompanying notes 145-70 *supra*.

14. U.S. CONST. art. I, § 8, cl. 4: "The Congress shall have Power . . . To establish . . . uniform Laws on the subject of Bankruptcies throughout the United States . . . ."

15. Forrester, *The Nature of a "Federal Question,"* 16 TUL. L. REV. 362, 370-71

has granted the bankruptcy courts exclusive jurisdiction over administrative bankruptcy matters, but only limited jurisdiction over controversies between the bankruptcy trustee or receiver and an adverse claimant to property.[16] This concept of "limited jurisdiction" has presented definitional problems and has been a recurring source of litigation in the bankruptcy courts. It is within this context that the Navy based its dismissal motion in *In re Soledad.*

Congress, within the mandate of the Constitution, has struck a balance between establishing uniform bankruptcy laws and leaving matters of the state law to state courts. Although principles of federal supremacy preclude separate state laws of bankruptcy, the Bankruptcy Act in numerous instances expressly incorporates state law.[17] Therefore, depending upon the extent of federal jurisdiction over the subject matter, specific controversies may be heard either only in a bankruptcy court, only in a state court, or in either a federal bankruptcy or non-bankruptcy court or a state court. In *Soledad*, federal jurisdiction existed because of both the bankruptcy filing and the nature of the res and litigants involved. The question facing the bankruptcy court was whether the facts warranted summary or plenary treatment.

The differences between summary and plenary jurisdiction are procedural rather than substantive, and the purpose is to expedite matters that are considered routine in nature.[18] Subject to limited exceptions,[19] the bankruptcy court exercises only summary jurisdiction.

Summary jurisdiction exists with respect to two main categories of matters: proceedings in bankruptcy and controversies arising in proceedings in bankruptcy. The bankruptcy court always

(1942): "[I]f Congress can pass a law creating legal rights under its legislative power, the federal courts can be given jurisdiction by Congress to handle all litigation existing by reason thereof . . . ."

16. Katchen v. Landy, 382 U.S. 323 (1966); Thompson v. Magnolia Petroleum Co., 309 U.S. 478 (1940); Pepper v. Litton, 308 U.S. 295 (1939); *In re* Pennsylvania Cent. Transp. Co., 520 F.2d 1388 (3d Cir. 1975); *In re* Continental Vending Mach. Corp., 517 F.2d 997 (2d Cir. 1975); 11 U.S.C. §§ 11, 46 (1976); 28 U.S.C. § 1334 (1976); 13 C. WRIGHT, A. MILLER, & E. COOPER, FEDERAL PRACTICE AND PROCEDURE § 3570 (1975); Mussman & Riesenfeld, *Jurisdiction in Bankruptcy*, 13 L. & CONTEMP. PROB. 88 (1948).

17. For examples of the Bankruptcy Code incorporating state law, *see* Bankruptcy Act §§ 6, 70a(5), 70e, 11 U.S.C. §§ 24, 110a(5), 110e (1976).

18. 2 COLLIER ON BANKRUPTCY ¶ 23.02 (J. Moore ed. 14th ed. 1976).

19. Bankruptcy Act §§ 60b, 67, 70e(3), 11 U.S.C. §§ 96b, 107, 110e(3)(1976).

has summary jurisdiction over proceedings in bankruptcy,[20] while it has only limited summary jurisdiction over controversies arising in proceedings in bankruptcy.[21]

The adjective "summary" is appropriate to describe the procedures in a bankruptcy hearing involving administrative or nonadversary matters.[22] The procedure is summary only in the sense that there are generally fewer delays in a bankruptcy court's determination of a contested matter than in a comparable plenary proceeding.[23]

Summary jurisdiction over controversies arising in proceedings in bankruptcy generally turns on either possession of the res or consent[24] to summary jurisdiction by the adverse claimant. In *Soledad*, the issue of possession surrounded both the earned but unpaid funds owed to Soledad and held by the Navy and the nature of the claims asserted to these funds by the IRS, the Department of Labor, and the Navy.

Possession, for the purpose of summary jurisdiction, may be actual or constructive.[25] Property in the debtor's possession at the time of the filing of the bankruptcy petition is deemed to be in the possession of the bankruptcy court.[26] The trustee takes possession of all property within the actual control of the debtor. The bankruptcy court may also assume jurisdiction even though the bankrupt is out of possession if the third party in possession does not have a bona fide claim to the res.

The central jurisdictional inquiry in cases of constructive possession focuses on the nature of the claim asserted by the third party. In *Soledad*, the trustee claimed that the bankruptcy court had constructive possession over the earned but unpaid funds be-

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20. *Id.* § 2a, 11 U.S.C. § 11a.

21. *Id.* § 23a, 11 U.S.C. § 46a.

22. *E.g.,* taking the bankrupt estate into possession, liquidating the estate, and deciding the relative rights of claimants.

23. Plenary jurisdiction is the type of jurisdiction exercised by the state and the federal district courts. A plenary proceeding is an ordinary civil action which may be heard in any court of competent jurisdiction. Except for the right of jury trial, the procedural differences between summary and plenary jurisdiction are minimal.

24. The bankruptcy court may acquire jurisdiction through the actual or constructive consent of the adverse party. Although one could argue that the Government in *Soledad* did consent to the bankruptcy court's jurisdiction when the IRS and the Department of Labor filed proofs of claim, this possibility was not discussed in any of the memoranda or opinions in *Soledad.* Therefore, this § will not discuss consent as a basis for acquiring summary jurisdiction. For an analysis of this area, *see* Cline v. Kaplan, 323 U.S. 97 (1944); 2 COLLIER ON BANKRUPTCY ¶ 23.08 (J. Moore ed. 14th ed. 1976).

25. *See* Note, 44 CORNELL L.Q. 107, 112 (1958).

26. Harris v. Avery Brundage Co., 305 U.S. 160 (1938); *In re* Goldstein, Samuelson, Inc., 517 F.2d 324 (10th Cir. 1975).

cause the nature of the Navy's claim was neither bona fide nor sufficiently adverse to divest the court of jurisdiction. The mere assertion of an adverse claim to the property in issue does not ipso facto divest the bankruptcy court of summary jurisdiction.[27]

The bankruptcy court has the inherent power to determine whether it has jurisdiction.[28] If the adverse party holds the property under a bona fide claim, the bankruptcy court does not have summary jurisdiction over an action by the trustee to recover the property.[29] However, if the claim is merely colorable,[30] the bankruptcy court is deemed to have jurisdiction on the theory that the court holds constructive possession. Aside from the sovereign immunity issue, the critical issue in *Soledad* was the question of whether the court had constructive possession sufficient for the exercise of summary jurisdiction.

Set-Off

There are two distinct motives behind a court granting a debtor the right to set-off. One motive is based on the belief that it is unfair to refuse the defendant this privilege, the other on the belief that unnecessary lawsuits are a nuisance.[31] However, within the statutory limits defined by the set-off provision of the Bankruptcy Code (section 68),[32] the prerequisites of mutuality, provability,

27. Cline v. Kaplan, 323 U.S. 97, 98-99 (1944); Harrison v. Chamberlain, 271 U.S. 191, 194 (1926); Taubel-Scott-Kitzmiller Co. v. Fox, 264 U.S. 426, 433 (1924); Note, 68 HARV. L. REV. 1028 (1955).

28. In Taubel-Scott-Kitzmiller Co. v. Fox, 264 U.S. 426, 433 (1924), the Court stated: "As every court must have power to determine, in the first instance, whether it has jurisdiction to proceed, the bankruptcy court has, in every case, jurisdiction to determine whether it has possession actual or constructive." *Accord,* Harrison v. Chamberlain, 271 U.S. 191, 195 (1926); *In re* Todd Bldg. Corp., 172 F.2d 254, 257 (7th Cir. 1949); *In re* American Fidelity Corp., 28 F. Supp. 462, 467 (S.D. Cal. 1939). *See also* 2 COLLIER ON BANKRUPTCY ¶ 23.07 (J. Moore ed. 14th ed. 1976).

29. *See* authorities cited note 27 *supra.*

30. In *In re* Western Rope & Mfg., 298 F. 926, 927 (8th Cir. 1924), *aff'd*, 271 U.S. 191 (1925), the court said as to the meaning of the word "colorable": "In our judgment, the meaning of that word as used in this connection is that a claim alleged to be adverse is only colorably so when, admitting the facts to be as alleged by the claimant, there is, as a matter of law, no adverseness in the claim."

31. Loyd, *The Development of Set-Off*, 64 U. PA. L. REV. 541, 562 (1916).

32. (a) In all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor the amount shall be stated and one debt shall be set-off against the other, and the balance only shall be allowed or paid.

(b) A set-off or counterclaim shall not be allowed in favor of any debtor of the bankrupt which (1) is not provable against the estate and allowable under subdivision g of section 93 of this title; or (2) was purchased by or transferred to him after the filing of the petition or within

and allowability must be met before the court will allow a party to exercise a set-off.[33]

Several purposes have been ascribed to Congress in enacting section 68. The Supreme Court has held that the basic rationale was to prevent debtors of the bankrupt from acquiring claims against the bankrupt and then to set them off.[34] The Court later stated that the import of section 68 was to prescribe a rule of set-off upon distribution of the assets of the bankrupt's estate.[35] A final purpose, from the perspective of the claimant against the bankrupt, is to avoid payment of a debt in full with a receipt in return of only a percentage dividend.[36]

The thrust of the Navy's claim in *Soledad* centered on the right to set-off funds earned by the bankrupt against alleged administrative costs and debts owed the IRS and the Department of Labor. It is important to note that only a few times within a bankruptcy proceeding has one agency of the Government attempted such an action for the benefit of another governmental agency.[37] However, before examining *Soledad*, an analysis of the legislative history concerning mutual debts and credits will clarify both the congressional intent surrounding this section of the Bankruptcy Act and the propriety of the Navy's actions.

The concept of mutuality has appeared in the set-off section of every bankruptcy act Congress has enacted.[38] Congress first introduced the provability requirement[39] in section 20 of the 1867 Act.[40] That Act denied set-off claims when the debtor acquired them after the filing of a voluntary petition.[41]

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four months before such filing with a view to such use and with knowledge or notice that such bankrupt was insolvent or had committed an act of bankruptcy.

Bankruptcy Act § 68, 11 U.S.C. § 108 (1976).

33. For an in-depth analysis of these three factors, *see* Rochelle v. United States, 521 F.2d 844, 850-53 (5th Cir. 1975).

34. Continental & Commercial Trust & Sav. Bank v. Chicago Title & Trust Co., 229 U.S. 435 (1913).

35. Lowden v. Northwestern Nat'l Bank & Trust Co., 298 U.S. 160 (1936).

36. United States v. Brunner, 282 F.2d 535 (10th Cir. 1960).

37. *See, e.g., In re* Brewster-Raymond Co., 344 F.2d 903 (6th Cir. 1965); text accompanying notes 129-35 *infra*.

38. Morton, *Creditor Setoffs in Business Reorganization and Relief Cases Under the Bankruptcy Act*, 50 AM. BANKR. L.J. 373, 375 (1976).

39. *See* Bankruptcy Act § 68b(1), 11 U.S.C. § 108(b)(1) (1976).

40. Act of Mar. 22, 1867, ch. 176, § 20, 14 Stat. 517 (repealed 1878).

41.

[I]n all cases of mutual debts or mutual credits between the parties, the account between them shall be stated, and one debt set off against the other, and the balance only shall be allowed or paid, but no set-off shall be allowed of a claim in its nature not provable against the estate: *Provided*, That no set-off shall be allowed in favor of any debtor to the bankrupt of a claim purchased by or transferred to him after the filing of the petition.

The comprehensive Act of 1898 retained the basic provisions of section 20 of the 1867 Act as section 68.[42] The statute remains the same today except for the addition of the allowability provisions in the Chandler Act amendments of 1938,[43] which were necessary for clarification and coordination of section 57[44] with the set-off provision.[45]

The Federal Rules of Civil Procedure follow the concept of judicial economy espoused by set-offs through Rule 13(a),[46] which mandates a single form of action for responsive assertion of any claim as a compulsory counterclaim. The compulsory counterclaim must be distinguished from the permissive counterclaim, which gives the opposing party the option of asserting a counterclaim not arising out of the same transaction or occurrence.[47] The Government in *Soledad* sought to erase this distinction by permitting one agency to withhold funds for the benefit of another agency.

It should be emphasized that section 68 does not create a new right or enlarge jurisdiction.[48] Section 68 merely codifies the existence of the doctrine of set-off and provides for the enforcement of the legal and equitable principles therein.[49]

The Government has maintained its right to apply due and unpaid funds to the extinguishment of its obligations on other accounts.[50] The Government has the same right as any other creditor at common law; this right is not dependent upon statu-

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Id.

42. Act of July 1, 1898, ch. 541, § 68, 30 Stat. 544 (current version at 11 U.S.C. § 108 (1976)).

43. Act of June 22, 1938, ch. 575, § 57, 52 Stat. 840.

44. Bankruptcy Act § 57, 11 U.S.C. § 93 (1976).

45. S. REP. NO. 1916, 75th Cong., 3d Sess. 10 (1938).

46.

> A pleading shall state as a counterclaim any claim which at the time of serving the pleading the pleader has against any opposing party, if it arises out of the transaction or occurrence that is the subject matter of the opposing party's claim and does not require for its adjudication the presence of third parties of whom the court cannot acquire jurisdiction.

FED. R. CIV. P. 13(A).

47. *Id.* 13(b).

48. Studley v. Boylston Nat'l Bank, 229 U.S. 523 (1913); Inter-State Nat'l Bank v. Luther, 221 F.2d 383 (10th Cir. 1955). *See generally* 4 COLLIER ON BANKRUPTCY ¶ 68.02 (J. Moore ed. 14th ed. 1976).

49. Inter-State Nat'l Bank v. Luther, 221 F.2d 383 (10th Cir. 1955).

50. The first case in which the Government asserted a right to set-off was Gratiot v. United States, 40 U.S. (1 Pet.) 336 (1841).

tory authorization.[51] However, the bankruptcy set-off provision is permissive rather than mandatory and cannot be invoked in cases in which the general principles of set-off would not justify its use.[52] The entire matter is placed within the control of the bankruptcy court, which exercises discretion upon the general principles of equity.

The set-off problem in *Soledad* involved the propriety of the Navy's set-off. By holding money concededly owed to Soledad, and thus effectively paying itself back for alleged set-offs due from Soledad, the Navy created a preferential situation that violated section 68b(2).[53] The proper procedure for the Navy would have been to file a proof of claim as an unsecured creditor for the trustee and the bankruptcy court to administer. In response to this suggestion, the Navy claimed sovereign immunity.

Sovereign Immunity[54]

The most formidable obstacle the Navy placed before Soledad's turnover motion[55] was the time-honored concept of sovereign immunity. The principle that the Government cannot be sued by its citizens without its consent[56] is well established.[57] The concept of sovereign immunity allows Government defendants to set up an almost impregnable defense that either effectively blocks any possible award by a court or diminishes any award granted to an insignificant sum.

However, despite the doctrine's longstanding acceptance,[58] it has come under increasingly heavy attack in recent years. Growing discontent with the concept has led to its legislative and judicial abandonment in different areas and degrees in a number of

51. 1A J. McBRIDE, GOVERNMENT CONTRACTS § 7.70 (1979).
52. *In re* Jonker Corp., 385 F. Supp. 327, 330 (D. Md. 1974).
53. 11 U.S.C. § 108(b)(2) (1976).
54. This discussion will be limited to the Government's purported immunity from contract liability. No reference will be made concerning tort liability.
55. *See* note 6 *supra.*
56. Affiliated Ute Citizens v. United States, 406 U.S. 128, 141-42 (1972); United States v. Sherwood, 312 U.S. 584, 586 (1941).
57. *See generally* 28 U.S.C. § 1346 (1976).
58. The rationale for the sovereign's immunity from suit has ancient origins. In the seventeenth century, Thomas Hobbes in *Leviathan* alluded to this rationale where he stated in part that: "[t]he Soveraign of a Common-wealth, be it an Assembly, or one Man, is not Subject to the Civill Lawes." T. HOBBES, LEVIATHAN 313 (London 1651) (Macpherson ed. 1968). Justice Holmes explained the rationale when he stated: "A sovereign is exempt from suit, not because of any formal conception or obsolete theory, but on the logical and practical ground that there can be no legal right as against the authority that makes the law on which the right depends." Kawananakoa v. Polybank, 205 U.S. 349, 353 (1907).

states.[59] In *Kersten Co. v. Department of Social Services*,[60] the Supreme Court of Iowa examined the various rationales that other courts had utilized in abrogating the doctrine of sovereign immunity within a contractual context. These rationales are summarized as follows:

(1) Constitutional—by invoking sovereign immunity the Government is violating the contracting party's right of due process or is taking property without just compensation.

(2) Legislative—a specific statute authorizes the Government to participate in the contract in question.

(3) Actual Consent—the Government's action in voluntarily entering into a contractual relationship bars a claim of sovereign immunity.

The *Kersten* court adopted the actual consent rationale but articulated it in an implied waiver via contract format. The court found that the Government had waived its right to assert sovereign immunity as a defense to the plaintiff's claim or, more simply, that the Government had impliedly consented to this suit.[61]

Judge Hilliard, commenting on a tax claim filed by the Government in *In re Ward*,[62] apparently adopted the same rationale as the court in *Kersten* when he stated that: "Congress by the terms of the Bankruptcy Act has conferred jurisdiction on the Bankruptcy Court to entertain suits against the United States as it may against any other creditor."[63] The alternative would allow the Government simultaneously to gather the benefits of the Act and to recede under the veil of sovereign immunity. The inequity of such a result may indicate that Congress intended to waive sovereign immunity when the United States acts as a claimant in bankruptcy proceedings.[64]

In *Soledad*, the Government attempted precisely what Judge Hilliard had warned against. Through the IRS and the Department of Labor, the Government was taking an active role in the bankruptcy proceedings as an unsecured creditor. However, through the Navy, the Government was invoking sovereign immunity and an absolute right to the funds as an adverse claimant.

59. *See generally* K. DAVIS, ADMINISTRATIVE LAW OF THE SEVENTIES § 25.00 (1976 & Supp. 1977); 2 K. DAVIS, ADMINISTRATIVE LAW TREATISE § 25.00 (Supp. 1970); 3 K. DAVIS, ADMINISTRATIVE LAW TREATISE § 25.01 (1958 & Supp. 1965).
60. 207 N.W.2d 117, 119 (Iowa 1973).
61. *Id.*
62. 131 F. Supp. 387 (D. Colo. 1955).
63. *Id.* at 396.
64. *Id.*

Despite the inequity of this situation, the prevailing law today does not prohibit it. Because the Government's claim of sovereign immunity effectively bars any consideration of jurisdiction or set-off, *In re Soledad* will be analyzed in this sovereign immunity-oriented context.

ANALYSIS

Judge Jenkins, in a paper presented to the Southwest Seminar for Bankruptcy Referees in 1969,[65] posed a hypothetical question strikingly similar to the *Soledad* facts.[66] In reviewing the relevant case law at that time, Judge Jenkins concluded that although the bankruptcy court may find facts and points of law stating that the sovereign should disgorge funds to which it had a merely colorable claim, the court "has no *express* power to tell the sovereign it *must* disgorge."[67]

Judge Jenkins' conclusion should be contrasted with two Supreme Court statements. In *Pepper v. Litton*,[68] the Court declared that in the exercise of jurisdiction the bankruptcy court should apply the principles and values of equity jurisprudence. In *Katchen v. Landy*,[69] the Court declared that by securing the administration and settlement of the bankrupt's estate without a time-consuming and expensive plenary hearing, the judiciary was effectively carrying out the congressional intent behind the Bankruptcy Act.

In the following analysis, this Comment will focus upon the detrimental effect of sovereign immunity upon the equitable purpose and relief-oriented philosophy behind the Bankruptcy Act. This Comment will discuss how the benefits of judicial economy, lower costs, expeditious relief, equity, and equality before the law are as relevant in dealing with the Government in bankruptcy cases as

65. Jenkins, *Jurisdiction of the Bankruptcy Court to Deal with Claims of the Sovereign, Objections to such Claims and Counterclaims Against the Sovereign*, 43 REF. J. 104 (1969).

66. *Id.* at 107:

> If now, instead of Mr. Katchen, we have the United States of America. And instead of Landy as trustee, we have one of our own. And the claim is for taxes, or S.B.A. money or something comparable. And the Trustee asserts 57(g) objections characterizing the claims of the sovereign as "improper" and asks that the sovereign United States be ordered to disgorge. And the sovereign United States files a motion to dismiss asserting—
>
> (1) The counterclaim of the Trustee is beyond the summary jurisdiction of the court and requires a separate plenary action.
>
> (2) The counterclaim violates the sovereign immunity of the United States.
>
> What then—what then?

67. *Id.* at 108 (emphasis original).

68. 308 U.S. 295, 307 (1939).

69. 382 U.S. 323, 328-29 (1965).

they are in dealing with any other creditor. Because the recently enacted Bankruptcy Act reform[70] has mooted some of the jurisdictional and set-off issues raised in *In re Soledad*, the following deliberation will focus upon the Government's claim of sovereign immunity which, for the first time, is given statutory consideration in the new bankruptcy legislation.[71]

The general policy of the Bankruptcy Act outlined above is supplemented by the provisions of section 68a,[72] which in effect declares a statutory policy to settle all permissible claims or accounts "between the estate of a bankrupt and a creditor."[73] Although the law is clear in granting the bankruptcy court jurisdiction to decide the validity of any defenses or set-offs of non-sovereign claims,[74] the courts are divided as to sovereign claims.[75]

Sovereign Claims

The Government's Case—Issues Raised and Answered

It is important to note that *In re Soledad* is factually distinguishable from all the cases discussed below. In *Soledad*, the Government, *not* the bankrupt, asserted the right to set-off. Also, most of the other cases dealt with only one agency of the Government while *Soledad* involved multiple Government claimants. Finally, the Government's "monolith" theory[76] and claim of sovereign immunity in *Soledad* were clouded because the IRS and wage and labor claimants filed proofs of claim while the Navy contended that it was an adverse claimant.

In re Monongahela Rye Liquors[77] is a landmark case which is often cited for the Government's position that there is no authority for set-offs against the claims of a sovereign. The Commonwealth of Pennsylvania filed proofs of claim for taxes due from a liquor dealer who had petitioned for reorganization under chapter

70. Act of Nov. 6, 1978, Pub. L. No. 95-598, 92 Stat. 2549. *See* text accompanying notes 145-70 *infra*.

71. *See* text accompanying notes 145-70 *infra*.

72. 11 U.S.C. 108(a) (1976).

73. *See generally* Cumberland Glass Mfg. v. DeWitt & Co., 237 U.S. 447, 454-56 (1915).

74. Alexander v. Hillman, 296 U.S. 222, 238-39 (1935); *In re* Barnett, 12 F.2d 73, 81 (2d Cir. 1926); *In re* Germain, 144 F. Supp. 678 (S.D. Cal. 1956); *In re* Ward, 131 F. Supp. 387 (D. Colo. 1955); *In re* Nathan, 98 F. Supp. 686, 690-91 (S.D. Cal. 1951); 2 COLLIER ON BANKRUPTCY ¶ 23.08[6] (J. Moore ed. 14th ed. 1976).

75. *See* text accompanying notes 76-144 *infra*.

76. *See* note 10 and accompanying text *supra*.

77. 141 F.2d 864 (3d Cir. 1944).

X of the Bankruptcy Act. The trustee in bankruptcy counterclaimed for money due the bankrupt for liquor sold to the Pennsylvania Liquor Control Board, a state agency.

The Court of Appeals for the Third Circuit held that the set-off provision of section 68a did not give rise to an independent claim against a sovereign.[78] The court noted that a set-off is based upon an independent cause of action because it arises from a transaction apart from the transactions giving rise to the primary claim. Although a compulsory counterclaim must be asserted in the same action as a primary claim,[79] set-offs may be asserted as permissive counterclaims[80] in a secondary hearing. The court explained that because a set-off is based upon different subject matter than the primary claim, it is the same as an independent suit against the sovereign, and the sovereign may be sued only with its consent.[81] However, the court acknowledged that when the sovereign submits itself to the jurisdiction of the court, it remains vulnerable to any adverse claims that may have arisen from the same transaction giving rise to its suit.[82] The court concluded by differentiating between recoupment[83] (the defendant's right in the above situation) and set-off.

In re Monongahela Rye Liquors[84] spawned a series of cases which support the Government's position in *Soledad.* These will now be examined chronologically. In *Danning v. United States*,[85] the Court of Appeals for the Ninth Circuit gave the Government its strongest support for denying a creditor affirmative relief via sovereign immunity.[86] The issue in *Danning* was whether a bankruptcy court has jurisdiction to hear a trustee's counterclaim for affirmative relief arising out of the same transaction as the claim filed by the Government in the bankruptcy proceedings. The plaintiff properly indicated that if a private individual were a party claimant, the court would have jurisdiction to render a judgment against the claimant on a counterclaim.[87] However, the

78. *Id.* at 869.
79. FED. R. CIV. P. 13(a).
80. FED. R. CIV. P. 13(b).
81. 141 F.2d at 869.
82. *Id.*
83. "[R]ecoupment is in the nature of a defense arising out of some feature of the transaction upon which the action is grounded." Bull v. United States, 295 U.S. 247, 262 (1935). A set-off generally deals with mutual debts or credits arising from different transactions. *See generally* 4 COLLIER ON BANKRUPTCY ¶ 68.03 (J. Moore ed. 14th ed. 1976).
84. 141 F.2d 864 (3d Cir. 1944).
85. 259 F.2d 305 (9th Cir. 1958), *cert. denied*, 359 U.S. 911 (1959).
86. It is interesting to note that the Government did not cite *Danning* in *Soledad.*
87. *See* Katchen v. Landy, 382 U.S. 323, 326 (1965); Danning v. United States,

Government claimed that the doctrine of sovereign immunity barred the assumption of jurisdiction and thus mandated a dismissal. The *Danning* court agreed with the Government and found that the bankruptcy court lacked jurisdiction.[88] The court held that the judiciary does not have the power to create a "consent to be sued" when Congress has not expressly enunciated such consent.[89]

Despite the absolute nature of its holding in *Danning*, the court discussed two other points. First, the court held that in certain situations[90] section 68a includes the United States as a creditor.[91] Second, the court stated that the doctrine of sovereign immunity may not have been favored by the test of time and may be waning.[92]

United States v. Owens,[93] the next case in the *Monongahela* line of cases, presented another *Soledad*-type fact situation. Bruce Construction Corp. was owed monies from contracts performed for the United States. Before the corporation received payment, it went into chapter X reorganization proceedings. Accordingly, the Government ascertained that there was a need for a set-off because of a substantial amount of unpaid taxes owed by the bankrupt. The chapter X proceedings amounted to a turnover order directing the United States to make a final disposition of the funds in question.

The Government made two claims against the trustee's request for the unpaid funds. First, the Government contended that the action could be brought only in the Court of Claims.[94] Second, as in *Soledad*, the Government claimed that it had an adverse claim and that the court did not possess summary jurisdiction over the funds.[95] In reversing the trial court, the Fifth Circuit held that the Government's claim was bona fide and deserved plenary treat-

259 F.2d 305, 308-11 (9th Cir. 1958), *cert. denied*, 359 U.S. 911 (1959); Gendel, *Jurisdiction of a Referee in Bankruptcy to Render Affirmative Judgment on a Counterclaim in Favor of a Trustee*, 26 S. CAL. L. REV. 167 (1953); text accompanying notes 47-48 *supra*.

88. 259 F.2d at 309-10.

89. "Only Congress has the power to grant jurisdiction over the sovereign." *Id.* at 309.

90. *E.g.*, tax claims.

91. *See* United States v. Roth, 164 F.2d 575, 578 (2d Cir. 1948).

92. 259 F.2d at 309.

93. 329 F.2d 678 (5th Cir. 1964).

94. *Id.* at 678.

95. *Id.* at 679.

ment. The appellate court appeared hesitant to subject the Government's funds to a summary turnover order unless the trustee could prove either that the bankrupt had actual or constructive possession or that the Government's claim was merely colorable.

The appellate ruling in *Owens* is suspect for two reasons. First, because the Government did not file its tax claim until *after* the debtor had filed its reorganization petition, the funds had already passed into the constructive possession of the bankruptcy court when the petition was filed. This constructive possession allowed the court to invoke summary jurisdiction to determine the rights of the claimants.[96] Second, *Phelps v. United States*,[97] the case that ultimately determined *In re Soledad*,[98] expressly required the notice of levy and tax lien of the IRS to be issued *before* the bankruptcy court assumed jurisdiction. Because the Government's actions were post-filing, *Owens* cannot serve as precedent for *Soledad*.

Twenty-eight U.S.C. § 1346 contains the basic congressional exceptions to the sovereign immunity doctrine.[99] The interpretive case law holds that a suit will be treated as against the sovereign and thus as requiring express consent when the judgment sought would expend itself on the public treasury or would interfere with public administration[100] whether it is in the form of an original action, a set-off, or a counterclaim.[101]

The courts have criticized[102] and circumvented the doctrine of sovereign immunity notwithstanding the congressional authority

96. *See generally In re* Goldman, 5 F. Supp. 973, 974 (S.D.N.Y. 1933).

97. 421 U.S. 330 (1975).

98. *See* text accompanying notes 11-13 *supra*.

99. The two basic congressional exceptions to the sovereign immunity doctrine are the Tucker Act, 28 U.S.C. § 1346(a)(2) (1976), and the Federal Tort Claims Act, *id.* § 1346(b). Other statutory exceptions include *id.* §§ 1347, 1353, 2410; 43 U.S.C. § 666a (1976).

100. St. Louis Univ. v. Blue Cross Hosp. Serv., Inc., 393 F. Supp. 367 (E.D. Mo. 1975); United States v. Pennsylvania Envt'l Hearing Bd., 377 F. Supp. 545 (M.D. Pa. 1974); Kentucky *ex rel.* Hancock v. Ruckelshaus, 362 F. Supp. 360 (W.D. Ky. 1973), *aff'd*, 497 F.2d 1172 (6th Cir. 1974), *cert. granted*, 420 U.S. 971 (1975); Central La. Elec. Co. v. Rural Electrification Adm'r, 236 F. Supp. 271 (W.D. La. 1964), *rev'd on other grounds*, 354 F.2d 859 (5th Cir.), *cert. denied*, 385 U.S. 815 (1966).

101. Chrome Plate, Inc. v. Distict Dir. of Internal Revenue, 442 F. Supp. 1023 (W.D. Tex. 1977); United States v. 597.75 Acres of Land, More or Less, 241 F. Supp. 796 (W.D. La. 1965).

102. *E.g.*, Kelley v. Metropolitan County Bd. of Educ., 372 F. Supp. 528, 535 (M.D. Tenn. 1973) (sovereign immunity still exists even though it "should be abolished because it lacks a rational basis"); Hartke v. Federal Aviation Adm'r, 369 F. Supp. 741, 745 (E.D.N.Y. 1973) ("sovereign immunity [as] contrary to modern concept that individuals should have remedy for every legal wrong"); Glenn v. United States, 129 F. Supp. 914, 918 (S.D. Cal. 1955), *rev'd on other grounds*, 231 F.2d 884 (9th Cir.), *cert. denied*, 352 U.S. 926 (1956) ("the moribund doctrine of sovereign immunity").

implicit within section 1346. For example, a court has used the Bankruptcy Act to retain jurisdiction after the trustee paid a dividend to the United States.[103] Furthermore, the Court of Appeals for the Eighth Circuit denied the Government's claim for withholding income tax in *United States v. Kalishman*.[104] The *Kalishman* court held that in regard to bankruptcy matters, the Bankruptcy Act takes precedence over all other statutes and governs whenever a conflict may exist.[105] The court concluded, as did Judge Katz in *Soledad*, that the scheme of distribution to creditors in section 64[106] must be upheld regardless of the other statutory preferences.

The Bankrupt's Case—A Plea for Rationality

Despite the longstanding acceptance of the *Monongahela* line of cases,[107] several circuits seem to agree that legislative authority exists for set-offs against the claims of the sovereign.[108] In *United States v. Roth*,[109] the Second Circuit applied the set-off provision of section 68a to a tax claim filed by the Government. The court, in granting one of plaintiff's two asserted set-offs, predicated its decision on the Chandler Act amendments,[110] which granted congressional authorization for set-offs against certain claims of the United States.[111]

The *Roth* decision is generally discussed without any reference to the decision of the district court,[112] which was modified on appeal. The district court opinion presents many arguments subsequently accepted by the appellate court and applicable in

103. *In re* Madden, 388 F. Supp. 47 (D. Idaho 1975).
104. 346 F.2d 514 (8th Cir. 1965), *cert. denied*, 384 U.S. 1004 (1966).
105. *Id.* at 517. *Accord,* Guarantee Title & Trust Co. v. Title Guar. & Sur. Co., 224 U.S. 152 (1912); Gwilliam v. United States, 519 F.2d 407 (9th Cir. 1975); *In re* Dolard, 519 F.2d 282 (9th Cir. 1975). *Contra,* Chrome Plate, Inc. v. District Dir. of Internal Revenue, 442 F. Supp. 1023, 1025 (W.D. Tex. 1977) (court stated that "if there is a clash between the purposes of the Bankruptcy Act and the principle of sovereign immunity, it is the Bankruptcy Act that must yield"). *See also* United States v. Testan, 424 U.S. 392, 399 (1976); Safeway Portland E.F.C.U. v. FDIC, 506 F.2d 1213, 1216 (9th Cir. 1974).
106. Bankruptcy Act § 64, 11 U.S.C. § 104 (1976).
107. *See* text accompanying notes 84-98 *supra.*
108. *See* text accompanying notes 109-36 *infra.*
109. 164 F.2d 575 (2d Cir. 1948).
110. Act of June 22, 1938, ch. 575, 52 Stat. 840.
111. United States v. Roth, 164 F.2d 575, 578 (2d Cir. 1948).
112. *In re* Flato, 68 F. Supp. 632 (S.D.N.Y. 1946), *modified sub nom.* United States v. Roth, 164 F.2d 575 (2d Cir. 1948).

Soledad. The district court declared that it was "a manifest absurdity"[113] for the Government to contend that section 68 did not apply to the Government because it was not specifically mentioned in that Code section.[114] Furthermore, to the extent that the Bankruptcy Act requires the United States to file proofs of claim, Congress "must be held to have authorized suit [and set-offs] against the United States in the bankruptcy court."[115] The alternative would result in undue delay and a waste of judicial time by forcing a set-off to be adjudicated in a subsequent hearing.

The *Roth* decision also created a precedent that has been followed by several circuits.[116] The Court of Appeals for the Seventh Circuit upheld the doctrine of sovereign immunity in *In re Greenstreet, Inc.*,[117] by stating that the filing of a claim in bankruptcy proceedings does not constitute a consent to an affirmative judgment on the counterclaim. However, by declaring that the bankruptcy court does have jurisdiction to determine the bankruptcy trustee's counterclaim to the extent that it serves to set-off, decrease, or extinguish the Government's unsecured claim,[118] the court gave implicit recognition to the *Roth* rationale. As in *Soledad*, the bankruptcy court should have jurisdiction to determine a bankrupt's claim for earned but unpaid funds against the Government's asserted set-off of assets within the constructive possession of the bankruptcy court.

A district court case in Colorado, *In re Ward*,[119] expressly granted the bankruptcy trustee an affirmative judgment against the United States on an amount due from the Government that was over and above the Government's duly filed tax claim. On reconsideration, the Government raised the issue of sovereign immunity. Judge Hilliard, in a well-reasoned and articulated opinion,[120] stated that the Bankruptcy Act places the United States in the same position as any other claimant or creditor.[121] Therefore, Congress intended to waive sovereign immunity when the United States is participating as a claimant in bankruptcy pro-

113. *Id.* at 638.
114. *Id.*
115. *Id.*
116. *See* text accompanying notes 117-36 *infra*.
117. 209 F.2d 660 (7th Cir. 1954).
118. *Id.* at 667.
119. 131 F. Supp. 387 (D. Colo. 1955).
120. *See* text accompanying notes 62-64 *supra*.
121. *Cf.* Bankruptcy Act § 64, 11 U.S.C. § 104 (1976) (this statute, although not quite treating the United States as any other creditor, places the Government in distinct categories in subsections (4) and (5). This placement serves to negate the Government's claim of sovereign immunity).

ceedings.[122]

Citing *Roth*, Judge Hilliard continued his analysis by stating that section 68a was applicable and that by filing an unsecured claim the Government subjected itself to an adverse judgment if the trustee could establish that the Government was indeed indebted to the bankrupt. *Ward* exemplifies the *Roth* line of cases in holding that the Bankruptcy Code per se and section 68a in particular are evidence of congressional intent to hold the Government responsible for its actions in dealing with creditors and debtors alike.[123] If this were not the case, the Government would be able simultaneously to gain the financial benefits of a creditor in a bankruptcy proceeding and to withdraw under the cloak of sovereign immunity.[124]

The *Roth* rationale found further expression in *In re Techcraft, Inc.*[125] Anticipating *Phelps*,[126] the district court concluded that by failing to make demand on a tax claim prior to bankruptcy, the Government could not properly issue a lien by assessing its claim after the debtor's bankruptcy petition was filed. Furthermore, the *Techcraft* court, citing *Roth* and *Danning*, disregarded *Monongahela* to hold expressly that "an order disallowing the tax claims unless the amount due on the contract is paid over *would not constitute an affirmative judgment against the United States*."[127] Therefore, the Government's payment of the above claim would not constitute an affirmative judgment,[128] and the defense of sovereign immunity would not be available to the Government.

The jurisdictional and set-off issues in *Soledad*, with respect to sovereign immunity, were foreshadowed by *In re Brewster-Raymond Co.*[129] In *Brewster-Raymond*, the Sixth Circuit heard an appeal from a judgment of the district court denying the United States the right to recover certain tax penalties and interest thereon from the bankrupt. Prior to the filing of the bankruptcy

122. *See* text accompanying notes 62-64 *supra*.
123. 131 F. Supp. at 395-96.
124. *Id.*
125. 177 F. Supp. 790 (S.D.N.Y. 1959). The fact situation in *Techcraft* is closely analogous to *Soledad*.
126. Phelps v. United States, 421 U.S. 330 (1975).
127. 177 F. Supp. at 792 (emphasis added).
128. For an explanation of how "affirmative judgment" is defined in this Comment, *see* text accompanying notes 100-01 *supra*.
129. 344 F.2d 903 (6th Cir. 1965).

petition, the bankrupt had been engaged in the performance of a contract for the Navy. As in *Techcraft*,[130] a substantial sum of money became due to the bankrupt before the bankruptcy petition was filed. Although the court ordered the Navy to pay the amount of its indebtedness to the bankruptcy trustee, the Government asserted a right to set-off these funds against the alleged tax penalties. The issue facing the Sixth Circuit was whether the Government's claim could be legally collected or set-off against the bankrupt estate. Instead of following the rationale of the *Techcraft* court,[131] the Sixth Circuit held that the funds were an asset of the bankruptcy estate and that the bankruptcy court had jurisdiction to decide any alleged adverse claims.[132]

Thus, *Techcraft* and *Brewster-Raymond* provide the bankruptcy court with alternative yet viable means to reach the same jurisdictional objective against the Government's claim of sovereign immunity—that the bankruptcy court has jurisdiction over earned but unpaid funds of the bankrupt when he files his bankruptcy petition before the Government issues a tax lien or notice of levy.[133]

In re United General Wood Products Corp.[134] continued the *Roth* series of cases and extended *Brewster-Raymond* in holding that the bankruptcy court had summary jurisdiction over a fund derived from the debtor's accounts receivable. The court declared that in acquiring jurisdiction, a debtor is deemed to have constructive possession of any asset in which he has a merely colorable interest when the actual possessor does not assert any claim to it. Third-party claims to the same asset do not affect the jurisdictional issue.[135]

The fact situation in *General Wood* may be analogized with that in *Soledad*. The Navy in *Soledad* was holding funds both for itself and for the benefit of the IRS and the Department of Labor. According to *General Wood*, the Navy was not asserting any self-interest in these third-party funds. Therefore, Soledad was in constructive possession of at least that portion of the money earmarked for the IRS and the Department of Labor.

The rationale of the *Roth* line of cases with respect to the sovereign's claim of set-off is sound doctrine and is applicable in *Soledad*. If a sovereign seeks the court's assistance, the princi-

130. 177 F. Supp. 790 (S.D.N.Y. 1959).
131. *See* text accompanying notes 125-28 *supra*.
132. *See In re* Brewster-Raymond Co., 344 F.2d 903, 909 (6th Cir. 1965) (citing Bankruptcy Act § 2a(2), (7), 11 U.S.C. § 11a(2), (7) (1976)).
133. *See* notes 11-13 and accompanying text *supra*.
134. 483 F.2d 975 (9th Cir. 1973).
135. *Id.* at 976.

ples of law and equity imply that it should also subject itself to the court's jurisdiction with respect to a counterclaim or set-off properly asserted as a defense in a similar suit between non-sovereign litigants.[136] The Government should recognize the congressional intent behind the Bankruptcy Act and its recent reform and the trend toward finding jurisdiction evidenced by the rationale of the *Roth* line of cases.

In re Soledad—The Case in Perspective

Soledad presented two sharply defined and antagonistic propositions for judicial review. First, the trustee argued that, for bankruptcy purposes, the Navy's refusal to turn over money because of claims by the Department of Labor and the IRS was unwarranted irrespective of the Government's general right to set-off claims against it outside of bankruptcy.[137] Second, the Government's argument presented a "monolith" theory by which any claim made against the bankrupt by any governmental agency would divest the bankruptcy court of jurisdiction to hear the matter.[138]

If the Government's theory had been accepted, the Bankruptcy Code could possibly be deemed irrelevant in determining priority claims and in other administrative procedures regarding the estates of bankrupts. A further discussion of Bankruptcy Act section 64 will demonstrate the potential danger of the Government's advocated theory.

Section 64 sets out a definitive scheme of distribution by breaking down categories of debts for priority of payment.[139] The sec-

136. United States v. National City Bank, 83 F.2d 236, 238 (2d Cir. 1936); Seligson & King, *Jurisdiction and Venue in Bankruptcy* (pt. 2), 36 REF. J. 73, 76 (1962).

137. In Supplemental Brief for Defendants, *In re* Soledad Enterprises, No. 75-1354 (S.D. Cal. March 20, 1978), the Government cited a series of non-bankruptcy cases for the proposition that the Government, within a bankruptcy context, could set-off funds to satisfy claims of different agencies under its purview. These cases included: United States v. Munsey Trust Co., 332 U.S. 234 (1947); Pacific Nat'l Ins. Co. v. United States, 422 F.2d 76 (9th Cir.), *cert. denied*, 398 U.S. 937 (1970); DiSilvestro v. United States, 405 F.2d 150 (2d Cir. 1968); United States v. Cohen, 389 F.2d 689 (5th Cir. 1967); Project Map, Inc. v. United States, 486 F.2d 1375 (Ct. Cl. 1973); Algonac Mfg. v. United States, 428 F.2d 1241 (Ct. Cl. 1970); T.F. Scholes, Inc. v. United States, 357 F.2d 963 (Ct. Cl. 1966).

138. *See* note 10 and accompanying text *supra*.

139. The priority of payment in Bankruptcy Act § 64, 11 U.S.C. § 104 (1976), proceeds as follows:

(1) Costs and expenses of administration,
(2) Wages due to workmen, servants, employees, *etc.*,

tion states in effect that debts having priority in advance of the payment of dividends to creditors must be paid in full out of the bankrupt estate. Section 64 does not state that all debts owed the United States are to be paid in a uniform manner. Rather, it explicitly delineates and differentiates between tax debts owed agencies such as the IRS and the Department of Labor and debts other than for taxes owed the United States. Thus, if the Government's monolith position were accepted and the United States were construed as a single entity encompassing all its subparts and agencies, then section 64 would be irrelevant when the bankruptcy court made administrative decisions regarding priority debts.

The proofs of claim[140] filed by the laborers, the materialmen, and the IRS further evidence the necessity of the bankruptcy court administering the bankrupt's estate. Only by ignoring sections 68 and 64 and the fact that proofs of claim had been filed could the bankruptcy court have upheld the Government's position. Furthermore, the Government's claim of lack of jurisdiction is inconsistent with the primary power of the bankruptcy court to determine claims against the estate, including claims of the Government and its agencies.

One further case illustrates the bankruptcy court's right to administer the *Soledad* estate. In *In re Jonker Corp.*[141] the district court decided an issue concerning the Government's ability to set-off certain funds in its possession against a claim. After the adjudication of bankruptcy, the court determined that the Army held a substantial sum of money owed the bankrupt under its government contract. Despite the bankruptcy court's scheduled order of distribution, the Comptroller General ordered that the Army-held money be distributed to the federal agencies that filed claims against the bankrupt. These federal agencies, including the IRS, received the money in accordance with the Comptroller General's instructions.

The bankruptcy court determined that it was not bound by the

(3) Reasonable costs and expenses of creditors in pursuing claims,
(4) Taxes which are due to the United States or any state or subdivision thereof,
(5) Debts other than for taxes owing to any person, including the United States.

140. A proof of claim is the mere statement of the creditor to the effect that the alleged bankrupt owes the creditor a debt. An unsecured creditor must file such a claim to enable him to participate in creditors' meetings and in the division of the bankrupt estate. Thus, by filing their proofs of claim, the laborers, materialmen, and the IRS (and thereby the Government) indicated their interest in having the bankruptcy court administer the *Soledad* estate.

141. 385 F. Supp. 327 (D. Md. 1974).

Comptroller General's distribution order and ordered that the money be set-off against a tax claim. The United States appealed. The *Jonker* court, citing *Kalishman*[142] and *Brewster-Raymond*,[143] stated that none of the cases advanced by the United States involved bankruptcy matters.[144] The court concluded that the Bankruptcy Act supersedes conflicting statutes and case law, including the determination of priorities.

Without the *Phelps* issue, the trustee in bankruptcy for Soledad would have successfully contended that the bankruptcy court had constructive possession of the funds held by the Navy. *Soledad* was a bankruptcy case; it required administration of claims and analysis under sections 68 and 64. The contracting officer of the Navy had no valid or legal authority to administer the claims assessed against Soledad after the bankruptcy petition was filed. Without the IRS's tax lien and notice of levy, the bankruptcy court had the jurisdiction to mandate the turnover of the earned but unpaid funds owed to Soledad.

THE BANKRUPTCY CODE RESTRUCTURED—THE 1978 BANKRUPTCY REFORM AND ITS EFFECT UPON *IN RE SOLEDAD*

From 1973 to 1978 Congress studied a comprehensive revision of the bankruptcy system and its substantive law.[145] On October 6, 1978, this congressional research culminated in the passage of the first major substantive Bankruptcy Code reform in forty years. When President Carter signed the legislation on November 6, 1978, the Bankruptcy Act of 1898 was finally put to rest. The following discussion will analyze the probable effect of the new Act on the facts in *In re Soledad*.

The new Act accomplishes significant reform in the bankruptcy courts.[146] It improves the administration of bankruptcy cases[147]

142. 346 F.2d 514 (8th Cir. 1965), *cert. denied*, 384 U.S. 1003 (1966). *See* text accompanying notes 104-06 *supra*.

143. 344 F.2d 903 (6th Cir. 1965). *See* text accompanying notes 129-35 *supra*.

144. 385 F. Supp. 327, 332 (D. Md. 1974). *See also* note 137 *supra*.

145. *See* Anderson, *A Digest of Broader Perspectives for Bankruptcy Court Reforms*, 81 COM. L.J. 240 (1976); Anderson, *Bankruptcy Court Reforms Through the Looking Glass*, 82 COM. L.J. 257 (1977); Drake, *Proposed Bankruptcy Legislation of 1977*, 13 GA. ST. B.J. 113 (1977); Klee, *Congress and the Bankruptcy Act of 1976*, 61 A.B.A. J. 1268 (1975); Trost & King, *Congress and Bankruptcy Reform Circa 1977*, 33 BUS. LAW. 489 (1978).

146. Act of Nov. 6, 1978, Pub. L. No. 95-598, § 201(a), 92 Stat. 2549 (to be codified as 28 U.S.C. §§ 151-160).

147. *Id.* § 101 (to be codified as 11 U.S.C. §§ 15303-15345).

by elevating the status of bankruptcy judges,[148] by initiating the pilot United States Trustee program,[149] and by consolidating former chapters X, XI, and XII into a single reorganization chapter for all cases.[150] The new Act's effect upon the *Soledad* issues of jurisdiction, set-off, and sovereign immunity is significant. However, the new Act also injects an element of confusion that will wear off only through judicial review and clarification.

The section of the new Act dealing with jurisdiction[151] vests the bankruptcy court with subject matter jurisdiction over all controversies affecting the debtor or his estate. The Act erases the distinction between summary and plenary jurisdiction and renders possession of the res irrelevant whether possession is actual or constructive. Furthermore, if a bankruptcy should arise in an action pending in another court, a removal procedure similar to the federal removal procedure[152] is available to remove the action to the bankruptcy court.[153] Generally, the jurisdictional changes substantially shorten the time and costs involved in litigation.

The set-off section of the new Act[154] was constructed primarily to clarify past confusion concerning bank set-offs and reorganizations rather than straight bankruptcies.[155] Section 553[156] reduces the pre-bankruptcy time period in which the debtor may safely transfer or purchase assets and still utilize a set-off from four months to ninety days. It also omits the knowledge or notice requirement in the old Code's section 68b(2). The new Act preserves the basic theory and concept of set-off previously discussed.[157]

The new Code, with some minor adjustments and redefinitions, retains basically intact the priority of claims under section 64 of the 1898 Act.[158] It is important to note that the new Code significantly changes the tax priority,[159] breaking it down into five cate-

148. *Id.* § 201(a) (to be codified as 28 U.S.C. §§ 151-160).
149. *Id.* § 224(a) (to be codified as 28 U.S.C. §§ 581-589).
150. *Id.* § 101 (to be codified as 11 U.S.C. §§ 151102-151163).
151. *Id.* § 241(a) (to be codified as 28 U.S.C. § 1471).
152. 28 U.S.C. § 1441 (1976).
153. Act of Nov. 6, 1978, Pub. L. No. 95-598, § 241(a), 92 Stat. 2549 (to be codified as 28 U.S.C. § 1478).
154. *Id.* § 101 (to be codified as 11 U.S.C. § 553).
155. Trost & King, *Congress and Bankruptcy Reform Circa 1977*, 33 BUS. LAW. 489, 519-20 (1978).
156. Act of Nov. 6, 1978, Pub. L. No. 95-598, § 101, 92 Stat. 2549 (to be codified as 11 U.S.C. § 553).
157. *See* text accompanying notes 31-53 *supra*.
158. Act of Nov. 6, 1978, Pub. L. No. 95-598, § 101, 92 Stat. 2549 (to be codified as 11 U.S.C. § 507).
159. 11 U.S.C. § 104(a)(4) (1976).

gories concerning the type of tax, the relative time at which the tax was assessed, and the age of the tax claim.[160]

The expansive grant of jurisdiction in the new Code would have been of great import to *In re Soledad*. Because the 1978 Act extinguishes possession as a basis of jurisdiction,[161] the Navy's adverse claim over the res would have been of no consequence. The only question for the bankruptcy court to decide, because it would have had jurisdiction over the subject matter of the litigation, would have been whether its jurisdiction extended over and beyond the Government's claim of sovereign immunity. The 1978 Act marks the first time that the Bankruptcy Code has dealt expressly with the issue of sovereign immunity.[162]

The grounds for the waiver of sovereign immunity announced in the new Code appear to apply directly to the *Soledad* fact situation. Subsections (a) and (b) of section 106[163] would seem to have given the trustee in *Soledad* sufficient authority to assert and gain a favorable ruling on a motion for summary judgment or directed verdict. However, section 106(c)[164] and the accompanying congressional comments[165] make this statute confusing and unpredictable.[166]

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160. Act of Nov. 6, 1978, Pub. L. No. 95-598, § 101, 92 Stat. 2549 (to be codified as 11 U.S.C. § 507(a), (b)).

161. *Id.* § 241(a) (to be codified as 28 U.S.C. § 1471).

162. *Id.* § 101 (to be codified as 11 U.S.C. § 106).

163.

> (a) A governmental unit is deemed to have waived sovereign immunity with respect to any claim against such governmental unit that is property of the estate and that arose out of the same transaction or occurrence out of which such governmental unit's claim arose.
>
> (b) There shall be offset against an allowed claim or interest of a governmental unit any claim against such governmental unit that is property of the estate.

Id. (to be codified as 11 U.S.C. § 106(a), (b)).

164.

> (c) Except as provided in subsections (a) and (b) of this section and notwithstanding any assertion of sovereign immunity—
>
> (1) a provision of this title that contains "creditor", "entity", or "governmental unit" applies to governmental units; and
>
> (2) a determination by the court of an issue arising under such a provision binds governmental units.

Id. (to be codified as 11 U.S.C. § 106(c)).

165. 124 CONG. REC. S17407 (daily ed. Oct. 6, 1978) (remarks of Sen. DeConcini); *id.* at H11091 (daily ed. Sept. 28, 1978) (remarks of Rep. Edwards).

166. Telephone Interview with Thomas P. Breen, Counsel for the Subcommittee on Civil and Constitutional Rights of the House Committee on the Judiciary (Oct. 19, 1978).

In reference to section 106(c), the congressional comment states that "[t]he provision is included to comply with the requirement in case law that an express waiver of sovereign immunity is required in order to be effective."[167] Therefore, despite the apparent grant of the necessary jurisdiction and power to overcome the Government's assertion of sovereign immunity in section 106(a) and (b), Congress also has stated that the sovereign must expressly waive its immunity for section 106 to be effective. The sovereign has no motivating reason to waive its immunity in a *Soledad*-type fact situation: The Government could only lose money by waiving immunity.[168]

The inconsistency between the statute and the congressional comment cannot be resolved. By enacting section 106 with the above explanatory comment, Congress in one breath destroyed and resurrected the doctrine of sovereign immunity. There are three possible interpretations the bankruptcy courts could formulate to resolve this conflict:

(1) The courts could read the statute without reference to the congressional comment and prohibit the Government from asserting sovereign immunity in a bankruptcy forum.

(2) The courts could read the statute with reference to the congressional comment and universally allow the Government to assert sovereign immunity whenever it is not expressly waived.

(3) A split of authority between (1) and (2) could arise with each bankruptcy judge reading the statute according to his own interpretation.

The last possibility would prove disastrous. Forum shopping, according to the bankruptcy judges' prior decisions, would cause the courts to lose both judicial integrity and public respect. The second possibility would leave the law in approximately its present state, allowing the Government to continue to assert its monolith theory.[169] Only the first possibility would permit the debtor adequate relief and a fresh start and continue to hold the Government accountable for its actions.

Although the possibility exists that the bankruptcy court will abrogate the doctrine of sovereign immunity before the October 1, 1979, implementation of the new Code, such action is doubtful. However, the opportunity will soon be at hand for the bankruptcy

167. 124 CONG. REC. S17407 (daily ed. Oct. 6, 1978) (remarks of Sen. DeConcini); *id.* at H11091 (daily ed. Sept. 28, 1978) (remarks of Rep. Edwards).

168. Although this congressional comment relates expressly only to § 106(c), its import would most probably limit the overall effectiveness of § 106 (a), (b).

169. *See* note 10 and accompanying text *supra*.

courts to utilize the statutory waiver of sovereign immunity[170] and to remove forever this doctrine's presence from bankruptcy proceedings. By recognizing the purpose and philosophy of the Bankruptcy Act and the judicial concern evidenced by the rationale of the *Roth* line of cases, the bankruptcy courts will hopefully put the Government in the same position as all other unsecured creditors in bankruptcy proceedings.

CONCLUSION

In re Soledad will be remembered more for what it might have held than for its actual holding. The Government's advocacy of a monolith theory, by which any claim by any governmental agency against the bankrupt would divest the bankruptcy court of jurisdiction, threatened the administrative structure upon which the bankruptcy court rests. However, because of the filing of a tax lien and a notice of levy by the IRS, the propriety of the government's monolith theory was never adjudicated.

The 1978 Bankruptcy Act addresses the issue of sovereign immunity and negates the possibility of a monolith theory of government. However, the congressional comments surrounding this statute provide a source of confusion and uncertainty, which leave the issue of sovereign immunity in doubt. To resolve this state of confusion, the decisions of the bankruptcy courts interpreting this statute should ignore the congressional comments and uphold the statutory waiver of sovereign immunity.

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170. Act of Nov. 6, 1978, Pub. L. No. 95-598, § 101, 92 Stat. 2549 (to be codified as 11 U.S.C. § 106).