No. 12-27

IN THE
UNITED STATES BANKRUPTCY APPELLATE PANEL
FOR THE TENTH CIRCUIT COURT OF APPEALS

In re DUSTIN JAY WESTBY AND BRANDI MICHELLE WESTBY
Debtors.

DARCY D. WILLIAMSON
Trustee-Appellant
— v. —

DUSTIN JAY WESTBY and BRANDI MICELLE WESTBY
Debtors-Appellees

And

DEREK SCHMIDT,
Kansas Attorney General, Intervenor-Appellee

ON APPEAL FROM THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF KANSAS

DEBTORS-APPELLEES' BRIEF

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STATEMENT OF RELATED CASES

Debtor is not aware of any related cases pending in this Court.

JURISDICTIONAL STATEMENT

Debtors-Appellees concur with Trustee-Appellant's Jurisdictional Statement.

STATEMENT OF THE ISSUE

Whether the State of Kansas' earned income tax credit exemption, K.S.A. 60-2315[1], which is applicable only to debtors in bankruptcy, violates the Bankruptcy Clause or the Supremacy Clause of the United States Constitution?

STATEMENT OF THE CASE

Debtors-Appellees concur with Trustee-Appellant's Statement of the Case.

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[1] K.S.A. **60-2315. Bankruptcy proceedings; earned income tax credits.** An individual debtor under the federal bankruptcy reform act of 1978 (11 U.S.C. § 101 et seq.), may exempt the debtor's right to receive tax credits allowed pursuant to section 32 of the federal internal revenue code of 1986, as amended, and K.S.A. 2011 Supp. 79-32,205, and amendments thereto. An exemption pursuant to this section shall not exceed the maximum credit allowed to the debtor under section 32 of the federal internal revenue code of 1986, as amended, for one tax year. Nothing in this section shall be construed to limit the right of offset, attachment or other process with respect to the earned income tax credit for the payment of child support or spousal maintenance.
History: L. 2011, ch. 25, § 1; Apr. 14.

STATEMENT OF THE FACTS

Under legislation effective April 14, 2011, the Kansas legislature authorized Kansas bankruptcy debtors to exempt from the bankruptcy estate the right to receive the federal and state earned income tax credit. ("EIC")[2].

On June 22, 2011, Debtors, Dustin and Brandi Westby, filed a petition for relief under chapter 7 of the Bankruptcy Code. [Appx.2, 139] At the time, the Westbys and their four children were struggling financially. [Appx.2, 171] Mr. Westby was working as a handyman as jobs became available to contribute to the household income. [Appx.2, 142, 147] Mrs. Westby worked as a certified nurses aide and took additional housekeeping jobs to supplement the family's income. [Appx.2, 142, 147, 170].

Together, the Westby's Annualized Current Monthly Income was only $11,408. [Appx.2, 188] This figure is a fraction of the Applicable Median Family Income of $84,272 for a Kansas household of six. [Appx.2, 188] The Westbys' annual income was also below (38%) the 2011 Federal Poverty Guidelines[3] of $29,990 for family of six persons.

The Westby are of limited means and limited assets. [Appx.2, 170, 155]. They live modestly, if not frugally. [Appx.2, 171] The live in rental housing in Abilene,

[2] The Kansas legislature acted at the behest of the 10th Circuit in *In Re Montgomery*, 224 F.3d 1193 (10th Cir. 2000) which said debtors needed a specific EIC exemption.

[3] The 2011 Poverty Guidelines for the 48 Contiguous States and the District of Columbia, http://aspe.hhs.gov/poverty/11fedreg.shtml.

Kansas, and own one 11-year old car with nearly 195,000 miles on it. [Appx.2, 139, 168, 157]. Uncollected child support ($12,626) owed to Mrs. Westby is two-thirds of their assets. [Appx.2, 155, 156].

Even with monthly Food Stamp assistance of $700, the family's expenses often exceeded their income because of debt payments. [Appx.2, 143, 171, 174] The money owed to creditors with unsecured, non-priority claims was not the result of frivolous expenditures, but rather nearly one third of this debt is attributable to medical expenses. [Appx.2, 162-167].

At the time of the filing of the petition, the Westbys listed their right to receive the EITC as an asset on Schedule B, and exempted the EITC with an "unknown" value on Schedule C. [Appx.2, 156, 158].

The Westbys received their federal and state tax returns on or about March 5, 2012. [Appx.2, 235] For 2011, the Westbys were entitled to receive a federal tax refund of $6,702, of which $5,751 was attributable to the EITC, and a state tax refund of $1490, of which $1035 was attributable to the state EITC. [Appx.2, 235].

The Trustee seeks to take the Westbys Earned Income Credit refunds to pay her own 25% commission[4] and her administrative expenses then distribute what is left to the Westbys unsecured creditors, a process often resulting in pennies on the dollar

[4] 11 U.S.C. 326(a) Limitation on compensation of trustee - 25% on first $5,000, 10% next $5,000 to $50,000.

disbursed. [Appx.1, 117].

SUMMARY OF THE ARGUMENT

State laws related to bankruptcies are presumed valid as long as they meet two constitutional standards. First, under the Supremacy Clause the state law must not conflict with federal law. Second, any bankruptcy law must apply uniformly to defined groups of debtors and creditors. The latter is a requirement of the Bankruptcy Clause. The Kansas Earned Income Credit (EIC) exemption passes both tests.

Kansas's law does not conflict with federal law in violation of the Supremacy Clause. Congress expressly authorized states to supply the exemptions to be allowed in bankruptcy cases. Because of the clear Congressional directive for state involvement in the area of bankruptcy exemptions, there is no express or implied federal preemption.

Assuming for the sake of argument that the Bankruptcy Clause applies to state legislation, Kansas's law passes muster under the appropriate contemporary standard for determining what the Clause requires. Kansas's EIC exemption law applies uniformly to defined classes of debtors. The classifications are not directed to only one debtor (the law is not private legislation) and the classifications are not arbitrary. This is all the uniformity that the Bankruptcy Clause requires.

Lastly, the Bankruptcy Court correctly held that the trustee's remaining arguments were without merit. All the trustee's arguments rest on her assumption that she has a duty or the ability to administer exempt assets, which she does not. Nothing in the Bankruptcy Code permits the trustee to liquidate exempt assets for the benefit of the trustee and unsecured creditors.

ARGUMENT

I. THE BANKRUPTCY COURT PROPERLY CONCLUDED THAT KANSAS' BANKRUPTCY-SPECIFIC EXEMPTION FUNCTIONS CONSISTENTLY WITH CONGRESS'S POWER TO ESTABLISH UNIFORM BANKRUPTCY LAWS.

A. THE UNIFORMITY REQUIREMENT OF THE BANKRUPTCY CLAUSE DOES NOT APPLY TO STATE LAWS

The Bankruptcy Clause grants to Congress the power "[t]o establish . . . uniform Laws on the subject of Bankruptcies throughout the United States." U.S. Const. Art. I, § 8, cl. 4[5]. By its express language, the Bankruptcy Clause refers only to Congress's authority to enact uniform bankruptcy laws. The Bankruptcy Clause is inapplicable to state legislation. *In re Jones*, 428 B.R. 720, 729 n.9 (Bankr. W.D. Mich. 2010). Nonetheless, the Trustee argues that Congress could not authorize

[5] U.S. Const. Art. I, § 8, cl. 4: To establish an uniform Rule of Naturalization, and uniform Laws on the subject of Bankruptcies throughout the United States;

enforcement of Kansas EIC exemption under 11 U.S.C. 522(b)(3)(A)[6] because to do so would give effect to a bankruptcy law that was not "uniform."

Under current Supreme Court precedent Congress may defer to state property laws without compromising its obligation to enact uniform bankruptcy laws. *Comm'r of Internal Rev. v. Stern,* 357 U.S. 39, 45 (1958) (fraudulent transfer in bankruptcy context determined according to state law even though "[w]hat is good transfer in one jurisdiction might not be so in another"). State property laws are frequently incorporated into federal bankruptcy law despite the fact that their inclusion may cause operation of the federal law to lead to disparate results from state to state and within states and courts have routinely rejected arguments asserting that Congress violates the uniformity requirement by incorporation of state law. *See, e.g., Jafari v. Wynn Las Vegas*, 569 F.3d 644, 648 (7th Cir. 2009) (property rights in bankruptcy determined by reference to state law despite resulting lack of uniformity); *Herrin v. GreenTree-AL, L.L.C.*, 376 B.R. 316, 321 (S.D. Ala. 2007) (applying state law to

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[6] 11 U.S.C. 522(b)(3)(A) (b)(1) Notwithstanding section 541 of this title, an individual debtor may exempt from property of the estate the property listed in either paragraph (2) or, in the alternative, paragraph (3) of this subsection.

. . .

(3) Property listed in this paragraph is - A) subject to subsections (o) and (p), any property that is exempt under Federal law, other than subsection (d) of this section, or State or local law that is applicable on the date of the filing of the petition to the place in which the debtor's domicile has been located for the 730 days immediately preceding the date of the filing of the petition or if the debtor's domicile has not been located in a single State for such 730-day period, the place in which the debtor's domicile was located for 180 days immediately preceding the 730-day period or for a longer portion of such 180-day period than in any other place;

determine real property interests subject to modification under 11 U.S.C. § 1322(b)(2) does not violate the Bankruptcy Clause); *In re Simon*, 311 B.R. 641 (Bankr. S. D. Fla. 2004) (construing fine and penalty discharge exception under state laws not contrary to Bankruptcy Clause).

Federal bankruptcy laws are "uniform" when they operate the same way throughout the country even though application of state laws may cause variations in results from state to state. *Vanston Bondholders Protective Committee v. Green*, 329 U.S. 156 (1946) (Frankfurter, J, concurrence); *In re Urban*, 375 B.R. 882 (B.A.P. 9th Cir. 2007). Therefore, the Bankruptcy Clause is not violated by Congress's adoption of state exemptions, whether specific to bankruptcy debtors or applicable to the general population of the state, because the federal bankruptcy law operates the same way throughout the country.

In its comprehensive opinion, the Bankruptcy Court examined the evolution of Supreme Court decisions addressing the scope and coverage of the Bankruptcy Clause, and correctly concluded that "the Uniformity Clause require[s] only that the *federal* system of bankruptcy be uniform in its particulars." Op. p. 17.[7] Reference to disparate state exemption laws, even those aimed only at bankruptcy debtors, does not

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[7] Discussing *Vanston Bondholders Protective Committee v. Green*, 329 U.S. 156 (1946) (Frankfurter, J, concurrence); *International Shoe Co.v. Pinkus*, 278 U.S. 261 (1929); *Stellwagen v. Clum*, *245 U.S. 605 (1918); Hanover National Bank v. Moyses*, 186 U.S. 181 (1902*); Sturges v. Crowninshield,* 17 U.S. 122 (1819).

violate that requirement because states have no obligation to create uniformity in their exemption laws under the Bankruptcy Clause.

B. A Bankruptcy Law Is Uniform When it Applies to Defined Classes of Debtors.

An early Supreme Court decision addressing the application of state exemption laws in bankruptcy is *Hanover National Bank v. Moyses*, 186 U.S. 181 (1902). In *Hanover,* the Supreme Court approved an existing practice under federal law in which bankruptcy debtors could claim the exemptions applicable under the law of the state where they had lived for the greater portion of the preceding six months. *Id.* at 189-90. The debtor claimed exemptions under Tennessee law where he was domiciled, presumably leaving the creditor with a lesser recovery than the creditor, holding a Mississippi judgment against the debtor, would have received under Mississippi law. In validating the reference to state exemptions in federal bankruptcy cases, the Court found that the differences between state exemption laws and the resulting differing outcomes under the federal laws between citizens of different states, did not result in violation of the uniformity requirement because that requirement was "geographical, not personal" and the federal bankruptcy law operated identically throughout the United States. *Id.* This came to be known as geographic uniformity.

Although *Hanover* involved the broad question of whether federal bankruptcy laws could constitutionally incorporate state exemption laws, the trustee, relying on *In re Pontius,* 421 B.R. 814 (Bankr. W.D. Mich. 2009) and *In re Schafer*, 455 B.R. 590 (B.A.P. 6th Cir. 2011), has excised language from that case to support the narrow proposition that to satisfy the uniformity requirement an exemption must provide for a creditor to take in bankruptcy what would have been available outside bankruptcy. Specifically, the trustee points to the following statement by the *Hanover* Court: "We concur in this view and hold that the system is, in a constitutional sense, uniform throughout the United States, when the trustee takes in each state whatever would have been available to the creditor if the bankrupt[cy] law had not been passed." *Hanover*, 186 U.S. at 190. Because, in Kansas, the trustee would not take under K.S.A. 60-2315 (Senate Bill 12) what a creditor outside bankruptcy would take, the trustee argues that the Kansas statute is not geographically uniform.

Since *Hanover*, the Supreme Court has clarified the uniformity requirement under the Bankruptcy Clause and expanded it beyond geographic uniformity. In approving the exemption scheme then in effect, the *Hanover* Court was not declaring all other exemption systems unconstitutional under the Bankruptcy Clause. The question of uniformity based on a class definition rather than geography was not

before the *Hanover* Court and the characterization of uniformity as a geographic limitation does not reflect current law.

Two later decisions reflect the evolution of the Supreme Court's standard for determining uniformity under the Bankruptcy Clause. *Railway Labor Executive Ass'n v. Gibbons*, 455 U.S. 457 (1982); *Blanchette v. Connecticut Gen. Ins. Corp.*, 419 U.S. 102 (1974). In these cases, the Court recognized an alternative basis for assessing whether a law complies with the Bankruptcy Clause's uniformity requirement. If the bankruptcy law in question applies to debtors differently over a common geographic area, it can nevertheless withstand constitutional challenge if it treats the debtors differently based upon a reasonable classification. *See also St. Angelo v. Victoria Farms*, 38 F.3d 1525, 1531 (9th Cir. 1994) (interpreting Supreme Court jurisprudence to determine rationality of classification).

The Supreme Court moved away from the geographic uniformity rule in *Blanchette v. Connecticut General Insurance Corp.*, 419 U.S. 102 (1974), which involved a challenge to legislation creating a special insolvency reorganization system for regional railroads. Certain railroads challenged the statute as violating the Bankruptcy Clause's uniformity requirement because it treated debtors differently based on geographic location. The Supreme Court rejected this contention. The Court concluded that the bankruptcy laws, like laws pertaining to duties and excise taxes, may designate an "evil

to be remedied" and adopt classifications for addressing the problem. *Id.* at 160-61 (*quoting The Head Money Cases*, 112 U.S. 580, 594-95 (1884)). Despite disparate geographical impact, legislation may be uniform if the classifications apply to defined parties as necessary to address a particular government objective.

The concept of class uniformity was again discussed in *Railway Labor Executives Ass'n v. Gibbons*, 455 U.S. 457 (1982), which is the only case in which the Supreme Court has struck down a bankruptcy statute for failure to comply with the Bankruptcy Clause. In that case, Congress enacted the statute in question to regulate labor relations of a single insolvent railroad. Because the statute applied to only one entity it was deemed "nothing more than a private bill." *Id.* at 471. A private bill could not possibly apply uniformly to a class of similarly situated entities. In striking down the law, the Court summarized the limited situations in which it was appropriate to invalidate a statute under the Bankruptcy Clause:

> Prior to today, the Court has never invalidated a bankruptcy law for lack of uniformity. The uniformity requirement is not a straightjacket that forbids Congress to distinguish among classes of debtors, nor does it prohibit Congress from recognizing that state laws do not treat commercial transactions in a uniform manner.

Id. at 469. Recognizing that lack of geographic uniformity is not fatal to a bankruptcy law the *Gibbons* Court said, "[t]o survive scrutiny under the Bankruptcy Clause, a law must at least apply uniformly to a defined class of debtors." *Id.* at 473.

Although the Constitutional provision applicable to laws establishing duties and excise taxes[8] sets a higher standard for uniformity than the Bankruptcy Clause, *see Schultz v. U.S.*, 529 F.3d 343, 355 (6th Cir. 2008), even under this stricter standard, the Supreme Court has recognized alternatives to the geographic uniformity standard. *See United States v. Ptasynski*, 462 U.S. 74, 82 (1983) (federal oil production excise tax exemption that preferred one geographic area over all others upheld as reasonably based classification). Thus, the uniformity rule encompasses both geographic uniformity and uniformity in classes of debtors and many cases have recognized this expansive view. *See also* Dan J. Schulman, *The Constitution, Interest Groups, and the Requirements of Uniformity: The United States Trustee and the Bankruptcy Administrator Programs.* 74 Neb. L. Rev. 91, 105 (1995) ("[T]he Supreme Court has held that debtors may be classified and dealt with differently provided that the bankruptcy statute applies uniformly to a defined class, which class must have more than one member.").

In *Matter of Reese*, 91 F.3d 37 (7th Cir. 1996), Judge Posner of the Seventh Circuit succinctly stated the current rule with respect to the uniformity requirement: "the [Bankruptcy] Clause forbids only two things: The first is arbitrary regional differences in the provisions of the Bankruptcy Code. The second is private bankruptcy bills – that is, bankruptcy laws limited to a single debtor – or the

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[8] Congress is empowered to lay and collect "all Duties and Excises (which) shall be uniform throughout the United States." U.S. Const. Art. 1, sec. 8 cl. 1)."

equivalent." *Id.* at 39. *See also Wood v. U.S.*, 866 F.2d 1367, 1372 (11th Cir. 1989) (the Uniformity Clause "requires that bankruptcy laws apply uniformly among classes of debtors.").

Where *Gibbons* was a clear example of private legislation, *St. Angelo v. Victoria Farms, Inc.,* 38 F.3d 1525 (9th Cir. 1994), is a case involving the other scenario, a fundamentally arbitrary regional classification under the bankruptcy laws. The *Victoria Farms* court struck down a provision of federal bankruptcy legislation that delayed implementation of various aspects of the U.S. Trustee program in only two states. No rationale was proffered as to why these two states had been singled out for different treatment, leading the court to conclude that the classifications were arbitrary and therefore not uniform.

Notwithstanding the rare instances in which a classification under a federal bankruptcy law is deemed irrational or is limited to a class of one, challenges to state statutes under the uniformity requirement generally fail. In *Schultz v. U.S.*, 529 F.3d 343 (6th Cir. 2008), the Sixth Circuit reviewed the development of the "geographic uniformity" standard under the Bankruptcy Clause. *Schultz* involved a Bankruptcy Clause challenge to the means-testing standards enacted in 2005. These amendments apply a federally mandated set of standards, which vary from state to state based on federal data, to determine chapter 13 debtors' disposable income. The debtors claimed

that the system failed the "geographic uniformity" test. Construing the uniformity standard as modified by *Blanchette*, the court concluded that the BAPCPA means testing provisions functioned as a uniform law, even though it treats debtors differently depending not just on what state the debtor lives in, but on the county the debtor lives in. The court concluded, "Congress is allowed to distinguish among classes of debtors, and to treat categories of debtors differently, whether it be through the incorporation of varying state laws 'affecting dower, exemptions, the validity of mortgages, priorities of payment and the like.' " *Id.* at 352 (*quoting Stellwagen v. Clum*, 245 U.S. 605, 613 (1918)).

Other courts have analyzed the post-*Hanover* Supreme Court decisions in the same way. In construing the Bankruptcy Clause, the Bankruptcy Appellate Panel for the Ninth Circuit rejected an argument for geographic uniformity that relied heavily on *Hanover*. *See In re Applebaum*, 422 B.R. 684, 692 (B.A.P. 9th Cir. 2009) ("The concept of uniformity requires that federal bankruptcy laws apply equally in form (but not necessarily in effect) to all creditors and debtors, or to 'defined classes' of debtors and creditors," (*quoting Gibbons*, 455 U.S. at 473)); *In re Urban*, 375 B.R. 882, 890 (B.A.P. 9th Cir. 2007) (finding that the *Hanover* Court's "bright line" rule requiring identical distribution to creditors inside and outside of bankruptcy within the same geographic area had been modified by the addition of more flexible standards based

on classification of debtors along non- geographic terms). *Accord In re Chandler,* 362 B.R. 723, 728-29 (Bankr. N.D. W.Va. 2007) ("Geographical uniformity and class uniformity are separate concepts, and when a law is applied to a specified class of debtors, the uniformity requirement is met, so long as the law applies uniformly to that defined class of debtors.").

Classes may be defined within states even though such classifications result in debtors or creditors in bankruptcy receiving different treatment than those outside bankruptcy. In *In re Varanasi*, 394 B.R. 430 (Bankr. S.D. Ohio 2008), the court approved application of the New Hampshire homestead exemption to an Ohio resident who, had he fulfilled the post-BAPCPA residency requirement of section 522(b)(3)(A), would otherwise have been limited to the same Ohio homestead exemption applicable to other Ohio residents. As the bankruptcy trustee in *Varanasi* did not recover what a creditor would have received in a non-bankruptcy action, this disparate treatment of neighbors would clearly not conform to the *Hanover* holding as characterized by the Trustee and yet, the Ohio bankruptcy court rejected a challenge based upon this disparity. *Id.* at 439. The court noted that in amending section 522(b)(3)(A), Congress created "a specific class of debtors based on whether they have relocated from one state to another within a defined period of time." *Id. See also In re Jones*, 428 B.R. 720, 729 n. 8 (Bankr. W.D. Mich. 2010) (discussing the "mansion

loophole" establishing an extended domiciliary requirement that must be satisfied before a debtor can claim the state homestead exemption); *In re Applebaum*, 422 B.R. 684, 690 (B.A.P. 9th Cir. 2009).

The trustee equates the law at issue here, in which debtors are treated according to class-wide distinctions, with the one struck down in *Gibbons*, in which the law applied to a single debtor. Nothing in Supreme Court jurisprudence supports this contention. *Gibbons* involved Congress's power under the Bankruptcy Clause to pass a law directed at an isolated problem involving a single debtor. Where the law applies to only one entity, it could hardly be said to be "uniform." In the case of state exemptions applicable to the class of debtors in bankruptcy the classification is neither a "private bill," nor is it irrational. Where federal bankruptcy law may apply differently to different classes of debtors, certainly, state laws, incorporated into the bankruptcy scheme, can do the same.[9]

Although the issue of constitutionality of state bankruptcy-only exemptions is in the early stages of review by appellate courts, the Tenth Circuit spoke on the issue over two decades ago. In *In re Kulp*, 949 F.2d 1106 (10th Cir. 1991), the court rejected the argument that bankruptcy-only exemptions violate the uniformity clause. In so holding, the court specifically rejected two of the cases upon which the trustee relies,

[9] In fact, as explained earlier, because the uniformity clause applies only to Congress and does not govern state action, it would not invalidate even a state exemption law that applied to a single debtor.

stating, "[t]he *In re Mata*, [115 B.R. 288 (Bankr. D. Colo. 1990)] and *In re Lennen,* [71 B.R. 80 (Bankr. N.D. Cal. 1987)] cases confuse the geographical uniformity doctrine with the well-established principle that states may pass laws which do not conflict with the federal scheme. . . . In this case, we have no conflict because 11 U.S.C. § 522 expressly delegates to states the power to create bankruptcy exemptions." *Kulp*, 949 F.2d at 1109 n.3. The following year, the Tenth Circuit again addressed arguments similar to those raised by the trustee here, and again found them to be without merit. In *In re Walker*, 959 F.2d 894 (10th Cir. 1992), the trustee challenged an Oklahoma exemption statute that permitted the exemption of certain retirement accounts on the basis that the statute exceeded the power Congress had bestowed upon the states in section 522. The Tenth Circuit rejected this argument stating:

> Pursuant to Congress' authority to establish uniform bankruptcy laws, it may delegate to the States the authority to legislate bankruptcy exemptions. Trustee argues that the Oklahoma exemption statute exceeds the scope of this authority, but he cites no persuasive authority from case law or from the structure of legislative history of the current Bankruptcy Act. . . . Congress certainly was aware of the "wide disparity in the type and amount of exemptions allowed by the various states," and by delegating to the states the option to legislate bankruptcy exemptions Congress implicitly acknowledged the disparity.

Id. at 900-01 (citations omitted). *See also In re Shumaker*, 124 B.R. 820, 826 (Bankr. D. Mont. 1991)("Therefore, the underlying premise of Mata and Lennen that it is not permissible for states to seek to enact two different levels of exemptions, one

applicable in bankruptcy and one without, simply misstates the applicable constitutional power of a state to enact bankruptcy laws where Congress has not sought to act.").

As these cases clearly demonstrate, the contemporary uniformity standard for state exemption schemes, unlike the geographical uniformity scheme approved in *Hanover* , *does* allow for disparate treatment of debtors residing in the same geographical area. Under this rule a trustee will not always take the same property in bankruptcy that a creditor in the same state would take absent the bankruptcy. The trustee's assertion that in order to comply with the uniformity requirement of the Bankruptcy Clause a creditor must obtain from a debtor in bankruptcy that which he could have obtained from that debtor outside bankruptcy has no validity.

While Debtor does not concede that the Bankruptcy Clause applies to state legislation, even if it did, the Kansas statute at issue here, which applies uniformly to all Kansas debtors in bankruptcy, passes that test.

I. THE BANKRUPTCY COURT PROPERLY CONCLUDED THAT THE KANSAS EIC EXEMPTION IS NOT PREEMPTED BY SECTION 522(B)(3)(A) AND DOES NOT VIOLATE THE SUPREMACY CLAUSE.

A. WHERE CONGRESS HAS EXPLICITLY PERMITTED REFERENCE TO STATE EXEMPTION LAWS THOSE LAWS ARE NOT PREEMPTED.

State law is preempted to the extent that it falls within a field that Congress has evidenced an intent to occupy. *Pacific Gas & Electric Co. v. State Energy Resources*

Conservation & Development Comm'n, 461 U.S. 190, 203-04 (1983). Or, if Congress has not completely displaced state regulation in a given area, a state law may be preempted if it actually conflicts with federal law in such a way that it is impossible to comply with both state and federal law. *Florida Lime & Avocado Growers, Inc. v. Paul,* 373 U.S. 132, 142-43 (1963). A state law that stands as an obstacle to the accomplishment of the purposes and objectives of Congress is also preempted. *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941). *See also Perez v. Campbell,* 402 U.S. 637, 652 (1971) (state law preempted if it "frustrates the full effectiveness of the federal law."); *In re Vasko*, 6 B.R. 317, 323 (Bankr D. Ohio 1980) ("The state law must in its effect, obstruct the basic objectives of the federal law."). "States may not pass or enforce laws to interfere with or complement the Bankruptcy Act or to provide additional or auxiliary regulations." *International Shoe, Inc. v. Pinkus,* 278 U.S. 261, 265 (1929) (state insolvency systems that operated tangentially to the federal system preempted).

Applying these principles to the case before this Court, it is significant that Congress placed no limits on the content of state law exemptions to be recognized in bankruptcy cases. Section 522(b)(3)(A) provides that a debtor may exempt from the bankruptcy estate "any property that is exempt under federal law . . . or State or local law that is applicable on the date of the filing of the petition." This provision "allows the States to define what property a debtor may exempt from the bankruptcy estate

that will be distributed among his creditors." *Owen v. Owen*, 500 U.S. 305, 306 (1991). The opt-out provision operates consistently with the Bankruptcy Code's general approach of allowing state law to determine property rights in bankruptcy cases. *Butner v. United States*, 440 U.S. 48, 54 (1979) ("Congress has generally left the determination of property rights in the assets of a bankruptcy estate to state law."). *See also Rhodes*, 705 F.2d at 163 (states and the federal government have concurrent jurisdiction in the area of defining exemptions that are to be applied in bankruptcy cases).

Given the range of exemptions that are routinely enforced in bankruptcy cases nationally, it cannot be seriously argued that Kansas' exemption law actually conflicts with or interferes with the operation of federal bankruptcy laws. *In re Applebaum*, 422 B.R. 684, 691(B.A.P. 9th Cir. 2009) ("There is no conflict between the purposes and goals of the Bankruptcy Code and the California bankruptcy-only exemption statute. Simply because the exemptions differ from the federal exemptions (or from its non-bankruptcy counterpart), does not mean that such differences create a conflict that impedes the accomplishment and execution of the Bankruptcy Code."). Since its genesis, the federal bankruptcy construct has always tolerated the inclusion of varied state exemption laws. *See Smalley v. Laugenour,* 196 U.S. 93 (1904)(discussing state exemptions in the context of section 6 of the 1878 Bankruptcy Act); *In re Reese*, 91 F.3d 37, 39 (7th Cir. 1996); *In re Schafer*, 455 B.R. 590 (B.A.P. 6th Cir. 2011).

With section 522(b)(3)(A), Congress did not limit its grant of authority to the states to fashion the exemption laws to be recognized in bankruptcy cases and there is no textual or historical support for the insertion of qualifiers into this plain language.[10] Rather, Congress expressly authorized states to create exemptions to be used in the context of federal bankruptcy law. Case law has consistently acknowledged that Congress chose not to preempt state law in the area of defining the exemptions to be allowed in bankruptcy cases. *Sheehan v. Peveich*, 574 F.3d 248 (4th Cir. 2009) *cert. denied sub nom, Sheehan v. Jackson*, 130 S. Ct. 1066 (2010) ("There can be no preemption, however, where Congress 'expressly and concurrently authorizes' state legislation on the subject.");*Storer v. French*, 58 F.3d 1125, 1128 (6th Cir. 1995); *In re Kulp*, 949 F.2d 1106, 1109 n.3 (10th Cir. 1991) (no conflict because Congress expressly delegated the power to create bankruptcy exemptions to states); *Rhodes v. Stewart*, 705 F.2d 159, 163 (6th Cir. 1983) (Congress "vested in the states the ultimate authority to determine their own bankruptcy exemptions")*; In re Sullivan*, 680 F.2d 1131, 1136 (7th Cir. 1982) ("To apply a preemption analysis in this context is to ignore totally the explicit language of the section 522(b)(1) opt-out provision."); *In re Stephens*, 402 B.R. 1 (B.A.P. 10th Cir. 2009) ("Rather than preempting the [exemption] area, Congress

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[10] Although many courts refer to Congress's "delegation" of power to the courts[do you mean to the states?], the Supreme Court, in *Hanover,* rejected the idea that references to state exemption laws were unconstitutional delegations of legislative power. *Hanover*, 186 U.S. at 190 ("Nor can we perceive in the recognition of the local law in the matter of exemptions, dower, priority of payments, and the like, any attempt by Congress to unlawfully delegate its legislative power.)(citation omitted). *See also In re Sullivan*, 680 F.2d 1131, 1137 (7th Cir. 1982) (state exemptions that differ from federal exemptions do not constitute unconstitutional delegation of legislative power). The trustee does not raise the issue of delegation of legislative power in this appeal.

expressly authorizes the states to 'preempt' the *federal* legislation.") (internal quotation omitted).

Where Congress has specifically authorized the states to act, the prohibition set forth in *International Shoe, Inc. v. Pinkus,* 278 U.S. 261, 265 (1929) and cited by the trustee in this case is inapplicable. The trustee makes much of the fact that the *Pinkus* Court stated that "complementary" state laws are preempted. In *Pinkus* the state statute in question purported to operate as a full-service bankruptcy law, setting out a scheme for liquidation of assets, distribution to creditors, and discharge of debts. The debtor was barred from obtaining a discharge of debts under the federal Bankruptcy Act because he had obtained a federal bankruptcy discharge within the past six years. So the debtor sought relief through the state law. The complementary state law in that case, was not a law that functioned in accordance with federal bankruptcy law, but one that usurped it altogether.

Unlike the situation in *Pinkus*, section 522(b)(3)(A) invites states to "complement" federal bankruptcy law by permitting them to formulate their own bankruptcy exemptions. States that accept this invitation are not obstructing the basic objectives of the federal law; they are furthering those objectives. The sentence from *Pinkus* referring to the prohibition against "complementing" federal bankruptcy law is an outdated characterization of the relevant constitutional test, applied in a vastly

different context, and predating Bankruptcy Code section 522(b)(3)(A) by several decades. A state law does not conflict with a federal law when that federal law has expressly authorized the state law.

In accordance with Congress's clear edict to the contrary, it cannot reasonably be concluded that Congress has preempted state bankruptcy-specific exemption laws.

B. The Opt-Out Provision Is Not Ambiguous and Does Not Include an Implicit Limitation Precluding State Bankruptcy-Specific Exemption Laws

Apparently recognizing that federal legislation cannot be said to preempt state laws that Congress has specifically permitted the states to use, the trustee argues that the opt-out provision giving the states that right is somehow ambiguous "because the scope of State or Local exemption laws is unclear." The trustee goes on to argue that K.S.A. 60-2315 is preempted by section 522(b)(3)(A) because it exceeds the power Congress gave the states in the opt-out provision. Although Congress placed no express limits on the scope of state or local laws, the trustee maintains that Congress, in fact, intended to place the arbitrary limitation that state exemption laws may not be bankruptcy-specific. Further, the argument runs, Congress neglected to include this limitation in the text of the provision even though Congress limited the very next paragraph of section 522, relating to treatment of joint tenancy, in exactly that way. 11 U.S.C. § 522(b)(3)(B) ("any interest in property in which debtor had . . . an interest as

a tenant by the entirely or joint tenant . . . is exempt from process under applicable *non-bankruptcy* law.") (emphasis added). *See Russello v. United States*, 464 U.S. 16, 23, 104 S. Ct. 296, 78 L. Ed. 2d 17 (1983) (where Congress includes particular language in one section of a statute but omits it from another, it is presumed that Congress acted intentionally and purposely). In short, the trustee argues that even though Congress explicitly said that states may use their own state or local laws instead of the federal exemption scheme, Congress, in fact, meant something different.

The trustee then supplies the supposedly missing limitation, arguing that when Congress enacted the opt-out provision, it conferred on the states the power to *preclude* their citizens from availing themselves of the federal exemptions but did not confer to the states the power to affirmatively *create* their own bankruptcy exemptions. Several courts finding bankruptcy-specific exemptions to be unconstitutional have relied on this distinction. *See In re Schafer*, 455 B.R. 590, 603-04 (BAP 6th Cir. 2011) ("The states' 'concurrent jurisdiction' is limited to 'opting-out' or passing laws which apply to all state residents"); *In re Wallace*, 347 B.R. 626, 627 (Bankr. W.D. Mich. 2006) (drawing this distinction in an opinion more notable for its reference to the laws of Kazakhstan than the logic of its legal analysis); *In re Cross*, 255 B.R. 25 (Bankr. N.D. Ind. 2000); *In re Pontius,* 421B.R. 814 (Bankr. W.D. Mich. 2009), and *Applebaum*, 422 B.R. at 697 (dissenting opinion).

This judicially-created limitation has no basis in the language of the Code, however, and does not bear scrutiny as it begs the very question at issue: How can Congress "reference" a scheme of state exemptions unless a state has first decided what the scheme of state exemptions to be referenced will be? Obviously, states have the power to enact and amend their own exemptions, and under section 522(b)(3)(A), Congress unquestionably authorized states to supply the exemption scheme that will be recognized in bankruptcy cases. The Fourth Circuit specifically found that section 522(b)(3)(A) grants states the power to create state bankruptcy-specific exemptions. *Sheehan v. Peveich*, 574 F.3d 248, 252 (4th Cir. 2009) ("This statutory provision is an express delegation to the states of the power to create state exemptions in lieu of the federal bankruptcy exemption scheme.").

If the states were prohibited from enacting bankruptcy-specific exemptions prior to 1978, it might be reasonable to assume that congressional silence on the issue would carry forth that prohibition. But there was no such prohibition. And Congress's silence on the issue does not create one. It is not for this or any other court to correct phantom legislative errors by rewriting federal legislation to better conform to speculative, unexpressed, congressional intent. *Sheehan,* 574 F.3d at 252. ("Congress has not seen fit to restrict the authority delegated to the states by requiring that state exemptions apply equally to bankruptcy and non-bankruptcy cases, and we are

without authority to impose such a requirement."). The lack of limitation on the scope of the opt-out provision does not render it ambiguous, it renders it unlimited.

Seeking historical support for her contention, the trustee cites *Smalley v. Laugenour,* 196 U.S. 93 (1904), for the proposition that only state exemptions that apply in non-bankruptcy cases have been permitted by Congress. *Smalley* dealt with section 6 of the 1898 Bankruptcy Act which provided "This act shall not affect the allowance to bankrupts of the exemptions which are prescribed by the state laws in force at the time of the filing of the petition in the state wherein they have had their domicil [sic] for the six months or the greater portion thereof immediately preceding the filing of the petition." The *Smalley* Court stated that in order to be exempt under federal bankruptcy law, the property must not be "subject to levy and sale" under the state statutes. *Smalley* did not deal with whether the challenged state exemption law could be specific to bankruptcy and nothing in the opinion suggests that it could not. To the contrary, the lesson to taken from *Smalley* is the historical deference the federal bankruptcy structure gives to state exemption laws.

The trustee's reliance on *In re Duffin,* 457 B.R. 820 (10th Cir. 2011) is similarly misplaced. That case involved the trustee's power under section 544 to step into the shoes of a hypothetical creditor to preclude the debtor from exempting proceeds paid into a life insurance plan within a year prior to a creditor's execution or levy upon

those funds. The issue revolved around whether the creation of a bankruptcy estate was comparable to a creditor's unrealized execution upon the property that would trigger the state law exception to exemption. After finding that the plain language of the state statute rendered the two actions equivalent, the court went on, in *dictum*, to address the policy ramifications of its decision saying, "To hold otherwise would permit a Utah debtor to keep more of his life insurance assets if he filed bankruptcy, than if he tries to work through his financial problems and stay out of bankruptcy." *Id.* at 829.

The trustee misconstrues the *Duffin* court's holding and ignores other aspects of that court's discussion. The fact that the decision in *Duffin* resulted in the debtor paying in bankruptcy what he would have had to pay outside of bankruptcy was not dispositive and the court did not state that states could not enact legislation that would have a different result. The court merely observed that, pursuant to the plain language of the statute, there was no reason to believe that the legislature had done so in that case. The case simply has no bearing on the issue of state bankruptcy-only exemptions. To say that a debtor can never obtain an advantage in bankruptcy that he could not obtain outside of bankruptcy would render the entire bankruptcy system irrelevant.

I. THE BANKRUPTCY COURT CORRECTLY HELD THAT THE TRUSTEES REMAINING ARGUMENTS WERE WITHOUT MERIT.

In addition to the Constitutional argument, the trustee raised a host of other issues. The Bankruptcy Court properly rejected all of these arguments. The trustee has abandoned arguments that the Kansas EIC exemption law violates to the Due Process and Equal Protection Clause of the 14th Amendment, that Kansas EIC exemption law which refers to debtors under the bankruptcy reform act of 1978 does not apply to debtors filing bankruptcy under the Bankruptcy Code as amended in 2005 by the Bankruptcy Abuse and Consumer Protection Act, that the Kansas EIC exemption law conflicts with the Internal Revenue Code, and that the Kansas EIC exemption law creates an unauthorized transfer under section 549. The trustee raises none of these issues on appeal.

The trustee argues that the Kansas EIC exemption law somehow "impermissibly prioritizes and preempts bankruptcy law with regard to the payment of bankruptcy claims." Tr. Brief at 32. The Bankruptcy Court quickly dispatched this meritless argument and found that there is no conflict between the Kansas EIC exemption law and section 507, which spells out the duties of the trustee. As the Bankruptcy Court correctly held under the Kansas statute, refunds attributable to the EIC are exempt, removed from the estate, and not subject to administration by

the trustee. *See* 11 U.S.C. § 704(a)(1) (precluding the trustee from selling exempt property). Section 507 contains no grant of authority for a trustee to liquidate exempt assets to pay domestic support obligations when section 507 itself simply provides the priorities for distribution of property of the estate. *See* In re *Quezeda*, 368 B.R. 44 (Bankr. S.D. Fla. 2007).

Additionally, the trustee argues that she is entitled to the Westby EIC refund because section 544(a) permits her to stand in the shoes of a judgment lien creditor. First, this argument should be rejected because it was not timely raised in the bankruptcy court. Indeed, the trustee acknowledges that she raised this issue for the first time in a supplemental brief that was rejected by the bankruptcy court. Tr. Brief at 31-32. It was within the bankruptcy court's discretion to reject the trustee's untimely argument. *See* In re *Brown*, 391 B.R. 210 (B.A.P. 6th Cir. 2008) ("case management decisions, such as the bankruptcy court not considering the Trustee's supplemental brief…are reviewed for abuse of discretion.") *citing* Int'l Union v. General Motors Corp., 497 F.3d 615 (6th Cir. 2007). The bankruptcy court did not abuse its discretion. Because the issue was not raised below, this court should not consider the issue for the first time on appeal.

However, even if this Court were to consider the trustee's 544 argument, which it should not, the argument has no more merit than the host of other

ancillary issues raised by the trustee. Contrary to the trustee's argument section 544 does not authorize her to reach the Westby's exempt assets. The only case cited by the trustee, *Rupp v. Duffin*, 457 B.R. 820 (B.A.P. 10th Cir. 2011), is inapposite because it addresses the trustee's ability to gain access to non-exempt funds. Further, the trustee ignores section 522(g), under which the Debtors may exempt property that the trustee recovers under section 550 if it was not voluntarily transferred. In this case, the Westby's EIC refund is exempt under Kansas law; the trustee may not administer that asset under any of the arguments she has offered.

CONCLUSION

For the foregoing reasons, the Westbys urge this Court to affirm the decision of the bankruptcy court.

Respectfully submitted,

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CERTIFICATE OF COMPLIANCE

This brief, exclusive of the certifications, tables of contents and authorities and the identity of counsel at the end of the brief, is 8649 words in text and footnotes as counted by Word Perfect X3, the word processing system used to prepare this brief. This brief has been prepared in a proportionally spaced typeface using Microsoft Word in Garamond 14-point font.

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I certify under penalty of perjury that the foregoing is true and correct.

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CERTIFICATE OF SERVICE

I hereby certify that on June 17, 2012, I electronically filed the foregoing document with the Clerk of the Court for the Bankruptcy Appellate Panel for the Tenth Circuit by using the CM/ECF system.

I further certify that parties of record to this appeal who either are registered CM/ECF users, or who have registered for electronic notice, or who have consented in writing to electronic service, will be served through the CM/ECF system.

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I further certify that some of the parties of record to this appeal have not consented to electronic service. I have mailed the foregoing document by First-Class Mail, postage prepaid, or have dispatched it to a third party commercial carrier for delivery within 3 calendar days, to the following parties: none, not applicable.

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