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Taxpayers and One *Amicus* File Briefs in Supreme Court Municipal Bond Taxation Case

On September 21, 2007, respondents George W. Davis and Catherine V. Davis filed their brief in *Davis v. Kentucky Department of Revenue of the Finance and Administration Cabinet*, urging that the U.S. Supreme Court affirm a Kentucky appellate court's early 2006 ruling holding unconstitutional a statute that exempts from Kentucky's income tax interest on municipal bonds issued by Kentucky issuers while taxing interest on municipal bonds issued in other states. The brief on behalf of the Kentucky taxpayers, who paid Kentucky income tax on their out-of-state municipal mutual fund holdings, lists nine different law firms as co-counsel, including Bingham McCutchen as counsel of record and various plaintiffs' class action firms. Whereas eight *amicus* briefs were filed in support of the State of Kentucky's position, one *amicus* brief was filed in support of the Davises' brief, by the Tax Foundation, a nonprofit research organization that advocates on tax policy issues.

The brief filed on behalf of the Davises effectively presents the anticipated counter-arguments to the well-crafted briefs filed on behalf of the State of Kentucky, making the outcome of this case anything but a foregone conclusion. The State of Kentucky now has the opportunity to file a reply brief by October 26, 2007, and oral arguments will be held before the Supreme Court on November 5, 2007. The Supreme Court's decision in the case, which involves the application of the "dormant" Commerce Clause of the U.S. Constitution, is expected no later than the end of term in June 2008, and more likely in early 2008.

The yin and yang to which the Supreme Court will be responding when it decides the *Davis* case include, among numerous arguments and counter-arguments, the following:

- The State of Kentucky's brief argues that because Kentucky is a sovereign state that has sole responsibility for the public welfare of Kentucky residents, it is not "substantially similar" to other states within the meaning of Supreme Court precedents

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precluding discrimination against “substantially similar” out-of-state participants in commerce. The Davises’ brief contains the following rebuttal:

Kentucky contends that its scheme is not discriminatory on the theory that it is not similar to other States, and its municipal bonds are not similar to other municipal bonds. It claims this special status because only Kentucky can raise revenue for Kentucky. But every State raises revenue only for itself, and this contention demonstrates not that Kentucky is different from all other States, but that it is like all other States. So too, Kentucky’s municipal bonds are exactly like those issued by other States: all are rated by the same agencies, regulated by the same federal law, compete for the same capital, and are traded by the same participants in the same national market. That Kentucky introduces bonds into the national market for a public purpose does not authorize Kentucky to use its tax power to discourage the private trade of out-of-state municipal bonds in the same market. *Everything* a State does is for a public purpose. If Kentucky can justify its tax on the grounds that it serves a public purpose, any State could justify any discriminatory tax for the same reason.

Although the Davises’ characterization overstates the argument made by Kentucky—which is more narrowly based on the use by the state’s own public entities of moneys raised through the issuance of municipal bonds, not just on the existence of a public purpose for the tax legislation—the suggestion that the line-drawing issues presented by the case are (as they almost always are in constitutional cases) quite difficult is accurate.

- Kentucky’s brief argues that the dormant Commerce Clause has only been applied to protect private commerce, and that municipal bonds benefit the public sector rather than private enterprises. The Davises’ brief points out that as of June 30, 2006, \$7.9 billion of the approximately \$33.8 billion in outstanding Kentucky bonds are industrial revenue bonds, and that accordingly roughly 23% of Kentucky’s outstanding bonds finance private businesses in Kentucky. The Davises’ brief also asserts: “Kentucky’s law has a greater impact on the market than its effect on issuers. For example, it affects other private sellers of out-of-state municipal bonds who also encounter a

barrier to access to Kentucky investors.” The Davises’ brief thus disputes both the factual premise that this case is only about competition involving public sector entities and products and the legal premise that Commerce Clause prohibitions do not apply because the state is seeking to lower the cost of discharging its public duties. Whereas Kentucky’s brief asks the Supreme Court to evaluate the challenged tax policy in the context of the purposes for which the municipal bonds are issued, the Davises’ brief repeatedly seeks to differentiate between the state’s bonding power and the state’s taxing power: “The issue is not the benefits Kentucky secures with its bond scheme, but rather the burdens it imposes with its tax scheme.”

- Kentucky’s brief argues that last term’s *United Haulers v. Oneida-Herkimer Solid Waste Management Authority* decision, in which the Supreme Court upheld county ordinances requiring that all local solid waste be delivered by private contractors to a county-owned disposal facility, stands for the proposition that public actors have greater latitude under the dormant Commerce Clause when they act for the public benefit. The Davises’ brief argues that *United Haulers* has no relevance to taxation of municipal bonds: “[T]he question presented here—whether a State may use its *tax* power to restrict interstate commerce by discriminating against the issuance, purchase and sale of out-of-state municipal bonds in the national market—was not at issue in *United Haulers*.” The brief also argues that the taxation of out-of-state bonds by a state that exempts in-state bonds amounts to a state tariff against another state’s products, the prohibition of which is at the heart of the dormant Commerce Clause jurisprudence. “Here, Kentucky’s tax discriminates in favor of one public issuer against other public issuers and in favor of private ownership of in-state bonds against private ownership of out-of-state bonds. It thus bears *all* the hallmarks of a proscribed tariff designed to keep out commodities issued by other States and sold by out-of-state sellers in private interstate commerce.”
- The Davises’ brief dismisses the arguments raised by Kentucky and its *amici* that invalidating Kentucky-type statutes would disrupt the existing municipal bond market. According to the Davises’ brief:

Affirmance will not cause any State to default on its bonds, will not cause the municipal bond market to collapse, and will not cause any State to forego repairing its roads or rebuilding its schools. It will simply put an end to Kentucky’s

discriminatory, inefficient and counter-productive tax scheme. Absent discrimination, investment diversification will be easier. Likewise, smaller States that lack the same access to capital as New York or California will have an *easier* time finding purchasers for their bonds.

- The Davises’ brief also seeks to refute arguments based on the prevalence of the municipal bond taxation system used by Kentucky (43 states have similar tax statutes, and all 50 states signed an *amicus* brief supporting Kentucky). The Davises’ brief characterizes the prevalence of tax statutes that exempt municipal bonds of a state’s own issuers while taxing other states’ municipal bonds as a “race to the bottom” started by New York when it enacted the first such statute. The Davises’ brief also asserts that state legislatures and legal commentators have been aware for some time that such tax statutes are constitutionally suspect, and that arguments that states and investors have a reliance interest in the existing system are therefore flawed. “The States have long known that their discriminatory tax schemes are problematic under the dormant Commerce Clause. Moreover, should the Court affirm, the market will adjust quickly without the dire consequences Kentucky predicts. More importantly, it will function as the national free market the Framers envisioned.”
- The Davises’ brief (as well as the supporting *amicus* brief from the Tax Foundation) also raises a new argument that Kentucky-type statutes violate a separate clause of the United States Constitution, known as the “Import-Export Clause.” However, the “Import-Export Clause” has previously been interpreted by the U.S. Supreme Court as applicable only to transactions involving foreign nations, not to transactions involving other states within the United States. Accordingly, this argument does not appear to have much force.

The case is now teed up for oral arguments, with Kentucky having one more opportunity to supplement the written arguments with the reply brief to the Davises’ arguments due on October 26th. The case has been well-briefed on both sides, and the Supreme Court will have plenty to think about as it evaluates whether and how the judicially developed dormant Commerce Clause should be applied in the context of a state’s desire to lower borrowing costs on its own issuers’ municipal bonds through state tax exemption without foregoing the revenues obtained from taxing other states’ municipal bonds.

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If you wish to discuss the contents of this advisory, or for assistance with issues raised by the legal developments that are the subject of this advisory, please contact the Mintz Levin lawyers listed below or any other member of Mintz Levin's Public Finance section.

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