

## Public Finance Advisory: U.S. Supreme Court Upholds Municipal Bond Market's State Tax System

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On May 19, 2008, the U.S. Supreme Court released its long-awaited decision in *Davis v. Kentucky Department of Revenue of the Finance and Administration Cabinet*, upholding the constitutionality of state laws that tax interest on out-of-state municipal bonds while exempting municipal bonds of in-state issuers. The 7-2 decision, which reversed an intermediate Kentucky appellate court's holding that such laws discriminate against interstate commerce in violation of the U.S. Constitution's "dormant" Commerce Clause, preserves the existing structure of the municipal bond market and, in particular, the state tax preferences that induce state residents to favor their own state's municipal bonds and that have promoted the growth of single-state municipal bond funds.

### The Decision's Scope and Effect

The *Davis* decision ends the current litigation regarding Kentucky's tax statute, and effectively ends copycat lawsuits brought in various other states to the extent that they challenge state tax preferences for in-state "governmental" municipal bonds such as general obligation bonds and revenue bonds. As foreshadowed by Justice Ginsburg's comments at the oral argument, the U.S. Supreme Court limited its holding to such governmental municipal bonds, indicating in a footnote that the decision does not address what the Court characterized as "so-called 'private activity,' 'industrial-revenue' or 'conduit' bonds." In the majority opinion authored by Justice Souter, the Court noted the argument that private activity bonds are different for dormant Commerce Clause purposes from governmental bonds, but said that the argument "was not considered below, was never pressed by the [taxpayer plaintiffs] themselves, and is barely developed by *amici*," and that accordingly "it is best to set this argument aside and leave for another day any claim that differential treatment of interest on private-activity bonds should be evaluated differently from the treatment of municipal bond interest generally."

Defendants in similar lawsuits in other states likely will move promptly for dismissal of such cases on the basis of the Court's *Davis* decision. Plaintiffs may resist dismissal by narrowing or amending their challenges so that they are limited to private activity bonds. Private activity bonds constitute approximately one quarter of the municipal bond market. Although the Court did not slam the door on the continuation of such narrower challenges, it went out of its way to hint that any such further litigation was unlikely to succeed. The Court's footnote regarding private activity bonds states that although "we cannot tell with certainty what the consequences would be of holding that Kentucky violates the Commerce Clause by exempting [private activity] bonds ... we must assume that it could disrupt important projects that the States have deemed to have public purposes." This language is likely to discourage most, if not all, litigants from devoting the resources necessary to continue the multiyear process of pursuing actions on behalf of a reduced universe of claimants in the face of a precedent that shows no predisposition by the U.S. Supreme Court to interpret the U.S. Constitution in a manner that would disrupt long-standing state tax practices and market expectations in the municipal marketplace. Also cast into doubt is the viability of pending litigation challenging state tax benefits for a state's own "section 529" college savings program on dormant Commerce Clause grounds. It is possible that, due to the majority opinion's carveout, some official statements for future offerings of private activity bonds will continue to disclose the theoretical possibility of future invalidation of favorable state tax treatment on dormant Commerce Clause grounds, but as a practical matter that risk now appears minimal.

### The Decision's Practical and Legal Underpinnings

The Court's majority opinion suggests that the outcome was determined as much by practical considerations as by legal analysis, a point emphasized by Justice Kennedy in a dissent joined by Justice Alito, which notes that the majority's opinion is based on the twin premises that "the interstate discrimination has been entrenched in many States and for a considerable time" and that "were this law to be invalidated, the national market for bonds would be disrupted." As to the existing structure of the municipal bond market and the market consequences of declaring Kentucky-like statutes unconstitutional, the majority opinion relied principally on an *amicus* brief submitted by Mintz Levin on behalf of the National Federation of Municipal Analysts (NFMA). In particular, the Court focused on the assertion in the NFMA brief that absent state tax preferences for in-state issuers, single-state mutual funds would cease to exist, and adopted the brief's conclusion that "[t]he main adverse impact of the disappearance of single state funds ... would be felt by small municipal issuers" because they "would stand to lose much of the intrastate market for the bonds that has developed under the currently prevailing state tax system without gaining much of an interstate market from its elimination." Based on the NFMA brief's description of the effects of invalidating tax preferences for in-state issuers, the Court concluded that "[f]inancing for long-term municipal improvements would ... change radically if the differential tax feature disappeared."

In addition to its consideration of the disruptive effect of upholding the lower court's invalidation of Kentucky's tax preference for its municipal bonds, the Court clearly was influenced by the fact that the other 49 states all joined an *amicus* brief in support of Kentucky and the status quo. As noted by the majority, "[i]t is striking, after all, that most of the harms allegedly flowing directly or indirectly to Kentucky's sister States and their citizens have failed to dissuade even a single State from supporting the current system; every one of them, including States with no income tax, have lined up with Kentucky in this case." In light of the unanimity of support of the existing system by the states, the Court rejected an outcome "which to a certainty would upset the market in bonds and the settled expectations of their issuers based on the experience of nearly a century."

In terms of legal argument, the Court's majority opinion distinguished a long line of cases under which state tax statutes that discriminate against out-of-state entities have been struck down time and again, and emphasized that, in contrast to those cases, the beneficiaries of Kentucky's tax statute are public sector entities. According to the Court, "[t]he Kentucky tax scheme falls outside the forbidden paradigm because [it] favors, not local private entrepreneurs, but the Commonwealth [of Kentucky] and local governments." The majority opinion relied on last term's *United Haulers Association, Inc. v. Oneida-Herkimer Solid Waste Management Authority* case for the proposition that a statute is discriminatory under the dormant Commerce Clause only if it discriminates against "substantially similar" out-of-state entities. The majority opinion accepted Kentucky's argument that for Commerce Clause purposes, a state, as a sovereign within its borders, is unique, and therefore not "substantially similar" to other states. Justice Souter, joined by Justices Stevens and Breyer, articulated a second legal rationale for upholding the Kentucky statute, arguing that the "market participant" exception to the dormant Commerce Clause's ban on in-state favoritism should extend to situations in which a state uses its regulatory powers, such as the taxing power, to bolster its status as a market participant; the other members of the majority declined to join that aspect of the opinion on the basis that it was unnecessary to the result.

All seven Justices in the majority declined to send the case back to the Kentucky courts for the conduct of a balancing test generally required in dormant Commerce Clause litigation involving statutes that are determined to be nondiscriminatory but that nonetheless may adversely impact interstate commerce. Under this so-called *Pike* balancing, a nondiscriminatory statute may be invalidated if the court determines that the burdens the statute imposes on interstate commerce clearly outweigh the benefits of a state or local practice. Showing no appetite for further judicial scrutiny in this case, the majority asserted that the judicial branch is unsuited to making determinations regarding the burdens and benefits of tax statutes such as Kentucky's, and that any such determination should be made by Congress, which "has some hope of acquiring more complete information than adversary trials may produce, and ... is the preferable institution for incurring the economic risks of any alteration in the way things have traditionally been done."

The Court thus validated the decades-old municipal bond taxation system, notwithstanding a substantial legal challenge, because it was persuaded that the existing system is generally accepted and that upending the status quo in an approximately \$3 trillion market could severely undermine the public sector and investor expectations. As aptly noted by the majority, "practical consequences have always been relevant in deciding the constitutionality of local tax laws."

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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 any of the members of Mintz Levin's Public Finance section listed below.

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