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Related Case May Resolve Kentucky Case Regarding Constitutionality of State Municipal Bond Taxation by June 2007

The U.S. Supreme Court has linked the outcome of the closely watched case of *Davis v. Kentucky Dep't of Revenue of the Finance and Admin. Cabinet*, 97 S.W.3d 557 (2006) to the outcome of a solid waste disposal case to be decided by the Court in the next few months. Although the exact impact of the Court's treatment of the *Davis* case as a "related case" to *United Haulers v. Oneida-Herkimer Solid Waste Management Authority* will not be known until the Court hands down its *Oneida* decision, it now appears likely that the Court will not grant full review of the *Davis* case, but will either affirm or reverse it simultaneously with the issuance of its *Oneida* decision or remand it to the Kentucky state court system for reconsideration in light of the principles to be articulated in *Oneida*. The outcome of the *Davis* case remains uncertain, but, as discussed below, supporters of the status quo in the municipal bond market may have reason to be optimistic in light of this development.

Description of the *Davis* Case and Issue Presented

The Davises, residents of Kentucky who paid Kentucky income tax on the interest they received on their out-of-state bonds, challenged the state's tax policy, which they claim constitutes illegal favoring of in-state versus out-of-state commerce. The Davises base their claim on the so-called "dormant Commerce Clause," a judicial interpretation of the Commerce Clause of the U.S. Constitution that prohibits states from competing against each other in a way that burdens interstate commerce. A Kentucky appellate court ruled in early 2006 that Kentucky's tax policy violates the dormant Commerce

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Clause. That court reasoned that by granting an exemption only to its own bonds, the state was dissuading its residents from investing in bonds issued in other states and thereby was impeding interstate commerce. The Kentucky Supreme Court subsequently declined to hear an appeal of the matter, and the State of Kentucky sought review by the U.S. Supreme Court. The National Association of State Treasurers filed a friend-of-the-court brief urging the Court to review the *Davis* case, emphasizing the need for certainty and nationwide consistency regarding this widely used technique for making municipal bonds more attractive to residents of the state in which they are issued.

The U.S. Supreme Court has never considered the specific question of the permissibility of state tax preferences for bonds issued in the taxing state, and only two state courts have squarely addressed the question—the *Davis* court and an appellate court in Ohio which upheld Ohio's similar state tax exemption, limited to bonds issued in Ohio, on the basis that there was no precedent for holding tax preferences unconstitutional in the context of municipal bonds.[1] Close to 40 states have tax statutes similar to the statute invalidated by the Kentucky appellate court in the *Davis* case, and similar challenges have started to work their way through the court systems in other states.[2] Accordingly, states with such statutes, sponsors of single-state mutual funds that cater to residents of such states and other participants in the bond market have been eagerly awaiting the Court's decision on whether it will review the *Davis* case and cut short a potentially lengthy period of uncertainty and conflicting decisions about the constitutionality of such statutes. The numerous states that offer preferential tax treatment, in the form of state tax deductions or tax credits, to residents who participate in the state's own Section 529 college savings plan versus some other state's plan, and the private sector distributors of Section 529 plans, also are attuned to the Court's disposition of the *Davis* case. The Court's linking of *Davis* to *Oneida*, recently confirmed by a Court clerk's statement to Donald Lipkin, a managing director of Banc of America Securities, LLC, that *Davis* is referenced on the Court's internal docket as "related to" *Oneida*, suggests that a decision with nationwide impact that resolves or substantially influences the *Davis* dispute will be forthcoming by the end of June 2007, if not sooner, and that the Court's thinking on the dormant Commerce Clause issue will be outlined in the context of its *Oneida* decision, rather than in the direct context of *Davis*.

The *Oneida* Case and Its Implications for *Davis*

Oneida involves a dormant Commerce Clause challenge to two New York counties' solid waste flow control regulations, which require delivery of all trash generated within such counties to processing

facilities owned and operated by a municipal corporation. Private trash collecting firms challenged the regulations on the grounds that they impaired interstate commerce by precluding the trash haulers from disposing of the collected solid waste at facilities outside the two counties. The federal court of appeals for the Second Circuit upheld the regulations on the grounds that they did not involve "patent discrimination" against interstate commerce (*i.e.* the intent of the regulations was not to discriminate against interstate commerce even if the effect arguably was), and that the regulations survived a more relaxed standard of review applicable to burdens on interstate commerce that are not caused by laws or regulations that are clearly protectionist.[3] Under this lower-level standard of review, the so-called "*Pike* test," a regulation challenged under the dormant Commerce Clause will be upheld unless the burden it places on interstate commerce is clearly excessive in relation to the local benefits.

The U.S. Supreme Court granted the trash haulers' petition for review of the lower court decision. At oral argument before the Court on January 8, 2007, the justices who asked questions expressed substantial concern that if the challenged regulation were struck down, all publicly owned monopolies, such as municipal gas and electric providers, that require local residents or businesses to deal with them rather than other providers might be vulnerable to constitutional challenge. Justice Breyer in his questioning stated, "I don't think it was an object of the Commerce Clause to prevent a State from protecting its own government," a view that, were it to command a majority of the Court, would likely result in a reversal of *Davis* and the preservation of the status quo in the municipal bond market. The oral arguments focused on various intermediate lines that might be drawn by the Court between the poles of

- exempting all state regulations that favor state government actors at the expense of interstate commerce, or
- applying the dormant Commerce Clause equally to all state regulations, whether they favor the public sector or local businesses.

Intermediate positions that were discussed included exempting or applying a lower standard of Commerce Clause scrutiny to regulations involving traditional state functions, but some of the justices expressed skepticism about the clarity of the line between "traditional" and "nontraditional" state functions. Justice Scalia also expressed distaste for the prospect of having to apply the *Pike* balancing test on a case-by-case basis to determine the constitutionality of regulations requiring private sector participants to deal with publicly owned entities.

The justices' statements or questions at oral arguments do not

necessarily correlate to the outcome of the cases argued before them, and several of the justices did not even provide material for speculation in their questioning of the *Oneida* litigants. However, it is fair to say that the more active justices at oral argument seemed troubled by the notion of applying dormant Commerce Clause analysis with equal vigor to regulations that favor the public sector or facilitate governmental operations. If the Court resolves *Oneida* by deciding that the dormant Commerce Clause is inapplicable to certain categories of regulation that favor or assist public entities, or that dormant Commerce Clause review should be lighter in such cases than it is when local private businesses are favored, the *Oneida* decision would have favorable implications for the state's position in the *Davis* litigation. Such a development could result in the Court, on the date it issues its *Oneida* opinion, simultaneously granting review in *Davis* and issuing a one-sentence or one-paragraph opinion reversing, by reference to *Oneida*, the Kentucky court's holding of unconstitutionality of Kentucky's municipal bond taxation system. Somewhat less likely in light of the concerns expressed at oral argument, but still possible, is a decision in *Oneida* that the dormant Commerce Clause applies to regulations that favor public entities to the same degree as it does to regulations that favor local businesses; if that were the Court's holding, on the date it issues its *Oneida* opinion, the Court could simultaneously grant review in *Davis* and issue a one-sentence or one-paragraph opinion affirming, by reference to *Oneida*, the Kentucky court's holding of unconstitutionality. If the Court adopts a middle ground and articulates a new test that must be applied in analyzing the constitutionality of regulations that favor public entities at the expense of interstate commerce (such as whether the regulated activity is a traditional state function), or if the Court does not resolve how state regulations that assist the public sector but explicitly disfavor transactions involving other states should be evaluated, the *Oneida* decision would not necessarily be dispositive of *Davis*, and the Court might remand the *Davis* case back to the Kentucky courts for reconsideration under its *Oneida* principles.

Although the opera is not over, we anticipate guidance from the Court, and the potential resolution of uncertainty over the constitutionality of state tax exemptions limited to in-state municipal bonds, in the next few months.

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[1] *Shaper v. Tracy*, 97 Ohio App.3d 760, 647 N.E.2d 550 (1994).

[2] A case challenging North Carolina's tax exemption for bonds issued in North Carolina has been found eligible for class action status, *see Dunn v. Cook*, 635 S.E.2d 604 (N.C. App. 2006), and similar statutes are being challenged in Arizona and Louisiana.

[3] *United Haulers Association, Inc. v. Oneida-Herkimer Solid Waste*

Management Authority, 438 F.3d 150 (2d Cir. 2006).

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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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